# A STUDY OF CORPORATE GOVERNANCE.

# THE CASE OF QUOTED COMPANIES IN KENYA

BY:

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# DECLARATION

This management research project is my original work and has not been presented for a degree in any other university.

Jebet. 1/11/2001

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This management research project has been submitted for examination with my approval as the university supervisor.

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Often in life there are those goals that we really aspire to. For me this was one of them. It has been a long road to achieving this goal. Along the way there were many who encouraged, inspired and challenged me to give my very best. To all these, I say thank you.

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# DEDICATION

To my children Maya and Kiplimo,

May this inspire you

To reach high, for you may touch a star.

To dream deep for every dream precedes the goal.

To my husband and best friend, Kigen,

To have dreamt was the first step towards the goal

To have shared the dream with you

Who believed in me

Was to take giant leaps to achieve the goal.

## ABBREVIATIONS

| | |
|---|---|
| ACCA | Association of Chartered Certified Accountants |
| AGM | Annual General Meeting |
| CACG: | Commonwealth Association for Corporate Governance. |
| CBK | Central Bank of Kenya |
| CMA | Capital Markets Authority |
| IAS: | International Accounting Standards |
| ICPAK | Institute of Certified Public Accountants of Kenya |
| NSE | Nairobi Stock Exchange |
| OECD: | Organization for Economic Cooperation and Development |
| PSCGT | Private Sector Corporate Governance Trust |

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## ABSTRACT

Corporate governance, the system by which companies are controlled, directed and evaluated, has gained prominence throughout the world in the 1990s. According to the Commonwealth Association for Corporate Governance (CACG), this interest in corporate governance has been triggered by the globalization of economies and the financial and investment markets in the 1990s. Increasingly, investors are insisting on high standards of corporate governance in the companies in which they invest. Good corporate governance practices are now becoming a necessity in every country. In Kenya, the main concerns particularly in the late 1980s and the early 1990s were on governance of the public sector. However these concerns have shifted to corporate governance and in particular on how to ensure that the private sector corporations use resources effectively and efficiently.

This study, using primary data from the quoted companies in the Nairobi Stock Exchange (NSE), established that mechanisms of corporate governance are complex and different companies differ in their corporate governance arrangements. There are certain factors that influence the corporate governance arrangements in different companies. These include the ability of the shareholders to elect and control directors, the extent of their shareholding and the identity of these shareholders. The board of directors also plays a key role in corporate governance. This role is enhanced by the independence of the board and its ability to effectively monitor the management. The use of various board committees has also been cited as one way of improving their role in corporate governance.

# CHAPTER ONE

## INTRODUCTION

This study was concerned with identifying the current corporate governance structure prevalent in quoted companies in Kenya. Specifically the study sought to determine the nature of shareholders in Kenya, the extent of their shareholding, their statutory voting rights, as well as the composition and leadership structure of the board of directors. In addition, the Capital Markets Authority (CMA) had issued guidelines on the establishment of audit committees in 1998 as one measure of improving corporate governance in Kenya. This study sought to find out how many of the quoted companies have established audit committees and the extent to which they have complied with the guidelines issued by the CMA.

The study focused on those companies listed on the Nairobi Stock Exchange (NSE), since they have a wide range of shareholders who are not involved in the running of the companies and must therefore address issues of corporate governance. Forty three (43) companies quoted on the stock exchange were reviewed to determine their corporate governance structure.

This study established that the share ownership of the companies is not widely dispersed. In 84 percent of the sample companies, the largest shareholder was found to control well over 15 percent of the shares. Except in one company, these shareholders were able to elect their representatives to the board of directors by virtue of their voting rights. These majority shareholders were therefore able to monitor management and ensure that they act in their best interests through their representation on the board. The study however found that it would be difficult for the minority shareholders to elect their own representatives to the board. They therefore lack an appropriate mechanism of monitoring the management and ensuring that they act in their best interests always. The main corporate governance concern, therefore would be the minority shareholders.

The study also found that there were differences in the size of the board although majority of the companies had between 5 and 10 directors. With respect to the board leadership structure, all the companies had a separate leadership structure in that the position of chairman of the board and that of the chief executive or managing director were held by different individuals. In many companies it was not possible to determine the independence of the board since there was no indication as to which of the directors were executive and which were non-executive. Generally, in the companies where this information was disclosed, the non-executive directors were more than the executive directors.

Only 28 percent of the sample companies had formed the audit committees during 1999. Only two companies made use of other committees. Clearly, the CMA needs to encourage more companies to form audit committees and ensure that they follow the guidelines laid down by them.

The analysis of financial performance and corporate governance was not conclusive since there were differences in performance despite similarities in governance structure. This may have been due to the fact that the governance of companies is a complex process and cannot be fully determined from the annual financial statements of the company. Further there can never be one best structure and in any event, having the right structure is not enough. The shareholders and directors must play their part to ensure that the structure works to improve the governance of their companies and ultimately the financial performance. This also implies that any guidelines or policies on corporate governance should not be prescriptive but rather should be descriptive such that companies should be left to identify what structure or mechanisms best suit their corporate governance needs.

### 1.1. Background To The Study.

Corporate governance, the system by which companies are directed and controlled, has gained prominence throughout the world in the 1990s. Peter Drucker, when examining the challenges that managers will face in the 1990s, pointed out that

> "The governance of business is likely to become an issue throughout the developed world." (The Economist, 21st October 1989: pg. 26).

In fact corporate governance has become an issue in both developed and developing countries. James Wolfenson, President of the World Bank said in 1999

> "The proper governance of companies will become as crucial to the world economy as the proper governing of countries."(Bowes G, 2000: pg. 1).

According to the Commonwealth Association for Corporate Governance (CACG), this interest in corporate governance has been triggered by the globalization of economies and the financial and investment markets in the 1990s. In particular, globalization has presented an opportunity for institutional investors to deploy their massive funds internationally. Increasingly, as they seek to do so, these investors are insisting on high standards of corporate governance in the companies in which they invest. In some cases, the institutions have set their own corporate governance standards as a measure for determining their investment decisions. In addition, public attention through high profile corporate scandals and collapses has forced governments and boards of corporations to carefully reconsider fundamental issues of corporate governance as essential for public economic interest. The volatility and instability experienced in emerging markets in recent times has drawn attention to the implications of corrupt practices and mal-administration in national and international financial systems and on public expenditure.

Good corporate governance practices are now becoming a necessity for every country and business enterprise. If countries are to reap the full benefits of the global capital market and if they are to attract long-term capital, their corporate governance arrangements must be credible and well understood across borders. The CACG has indicated that adherence to good corporate governance practices will help restore investor confidence, reduce the cost of capital and ultimately induce more stable capital flows. However issues of corporate governance are complex and different countries differ in their corporate governance arrangements depending on their particular circumstances, their legal and regulatory framework, and structures of business enterprises, inherent cultural characteristics and heritage. Different countries have therefore been reexamining their respective corporate governance arrangements with a view to addressing the weaknesses therein.

Foremost among these is Britain, where, concerns over corporate governance led to the establishment in May 1991 of the Committee on the Financial Aspects of Corporate Governance. This Committee which later came to be referred to as the Cadbury Committee was set up by the Financial Reporting Council, the London Stock Exchange and the accountancy profession to address the financial aspects of corporate governance. Specifically, the committee was to address factors such as the looseness of accounting standards, the absence of a clear framework for ensuring that directors kept under review the controls in their business and competitive pressures both on companies and on auditors which made it difficult for auditors to stand up to demanding boards. The committee released its report in December 1992 in which they made recommendations focussing on the control and reporting functions of the boards and on the role of the auditors. In particular, the Cadbury report recommended the separation of power between the CEO and chairman, the use of more independent directors on boards and the use of audit committees comprising independent directors. These recommendations are reviewed in greater detail in chapter 2 of this study. The report also detailed a Code of Best Practice directed at all listed companies registered in the UK.

Other countries have since then established national Codes of Best Practice to address their own special requirements with regard to corporate governance. Bowes has estimated that "there are in excess of 60 codes on corporate governance currently in use throughout the world" (Bowes G., 2000: pg. 2). This unfortunately leads to confusion for directors and those countries endeavoring to develop their own code. To address these concerns, the CACG was founded in 1998 to prepare a set of guidelines that could appropriately represent the commonwealth approach to corporate governance. According to the CACG, the Commonwealth countries have certain common characteristics. These include a similar structure and system of government, public administration and law, a similar structure and system of commerce and a common working language. They also have an organizational structure that enables governments and professional associations to regularly meet, debate and develop common policies and ideas to promote a positive policy environment. Nevertheless, the countries of the Commonwealth are diverse. Consequently, the guidelines developed by the CACG are neither mandatory nor prescriptive. They are intended to facilitate best business practice and behavior whether of a private sector or state owned enterprise.

Additionally, the World Bank and the Organization for Economic Cooperation and Development (OECD) have established the Global Corporate Governance Forum in 1999 to try and co-ordinate corporate governance activities throughout the world.

In Kenya, the main concerns particularly in the late 1980s and the early 1990s were on the governance of the public sector. The underlying reasons for these concerns have been the realization that poor public governance has led to wastage and misuse of public resources. There was also increasing demands by the donor agencies and the World Bank that there should be good governance as a condition for aid. The World Bank indicated that governance is a critical ingredient in the development process. During this period, the government sought to reduce its traditional role of playing a pervasive role in economic and social development. As per the Sessional Paper No 1 of 1986 on Economic Management for Renewed Growth, the government was expected to play a facilitating role whereas the private sector was to become the engine of growth. Consequently, concern shifted to corporate governance and in particular, how to ensure that private sector corporations used resources effectively and efficiently. As was noted by the Minister for Finance at a Corporate Governance workshop organized by the Capital Markets Authority (CMA) and reported in the 1996/97 annual report,

> "Every economy depended on the drive, productivity and efficiency of its corporate sector. The effectiveness of the board of directors and management of companies in

discharging their responsibilities determined the level of corporate efficiency, productivity and competitiveness."(CMA Annual Report, 1996/97: pg. 41).

According to the Private Sector Corporate Governance Trust (PSCGT) in Kenya, there were concerns that the private sector motivated by greed, self-interest and self-advancement would pursue wealth maximization at the expense of the bulk of the population. The PSCGT point out a report on who controls industry in Kenya that stated

> "But, even more important, directors have the power to shape the future.... They can respond to the incentives provided. .... The essential decisions about development in the private sector await the judgement of the Boards of Directors. Whether to expand, how much to invest, how soon, in what direction - these decisions are in the hands of the directors as long as there is a private sector of the economy." (Who Controls Industry in Kenya; Report of a Working Party, 1968: pg. 137 as quoted in Corporate Governance Vol. 2., 1999: pg. 11)

Since the private sector was now gaining prominence as the engine of growth, it became important that the private sector was responsible, responsive, accountable and transparent. Only in this way would the country ensure that the private sector achieved maximum utilization of resources to create sustainable wealth and production.

In addition, during the early 1990s, the government, in line with the new policy, embarked on a programme of parastatal reform which involved the privatization of state owned enterprises. Since 1988 nine public firms have been privatized through the Nairobi Stock Exchange (NSE). Most of these parastatals had previously performed poorly with "an average return of only 0.2 percent compared with 15 percent for private firms" (Market intelligence, 14th December 1998: pg.16). After privatization, a substantial portion of their shareholding shifted to the public who started demanding accountability and transparency.

To address these concerns, , the CMA in 1996 formed a Disclosure Standards Committee. One of its responsibilities was to develop guidelines to ensure and enhance good corporate governance particularly of the publicly quoted companies. The Disclosure Standards Committee of the CMA, in April 1998, released Guidelines on Audit Committees as the first part of the Committees task to develop guidelines on corporate governance. At the time the guidelines were released, "all quoted companies were expected to establish audit committees by December 1998" (Weekly Review, 24th April 1998, pg. 15). However the Guidelines are yet to be gazzetted. These guidelines have been evaluated in detail in chapter 2 of this study

In addition, several seminars and workshops have been organized by various organizations among them the (CMA), the Central Bank of Kenya (CBK) and such professional bodies as the Institute of Certified Public Accountants of Kenya (ICPAK). One of these was a workshop on the Role of Non-Executive Directors held at the Kenya College of Communications Technology, Mbagathi, Nairobi in November 1998. The workshop was sponsored and supported by the NSE, CMA, ICPAK and the Kenya chapter of the Association of Chartered Certified Accountants (ACCA). During the workshop it was agreed that another forum be convened to deliberate on the many issues that emerged. A second follow up seminar was organized in March 1999, during which an interim committee to be known as the Private Sector Initiative on Corporate Governance was created. This committee has established a trust; the PSCGT with the main responsibility being to formulate a Code of Best Practice for Corporate Governance in Kenya and to co-ordinate with other efforts in the region and beyond for purposes of improving corporate governance in the country. The code of best practice released by the PSCGT has been evaluated in detail in chapter 2 of this study.

## 1.2. The Research Problem

That there is a need for good governance and that good governance is pivotal to economic development goes without saying. Given the globalization of markets and the need to attract strong capital flows, all countries must address the mechanisms and ways of promoting good corporate governance in their country. In Kenya, it has also been recognized that there is a need to revisit, examine and redefine the manner in which companies are managed in order to be better and viable instruments of business dealing, productivity, employment and income. It is important to establish the current manner in which companies are governed before this can be improved. The manner in which companies are governed are influenced by the structures within the company and in particular the nature of their shareholders and extent of their shareholding and the composition and leadership structure of the board of directors.

This study will seek to find out what are the corporate governance structure prevalent in quoted companies in Kenya and what are the weaknesses of this structure? In addition, given that the CMA issued guidelines on the establishment of audit committees in 1998, this study will seek to find out how many companies have established audit committees and to what extent have they complied with the guidelines issued by the CMA?

## 1.3. Objectives Of The Study.

To determine the existing corporate governance structure in publicly quoted companies in Kenya and

To identify the weaknesses in this structure and suggest improvements.

To determine the extent to which companies have established audit committees as per the CMA guidelines.

### 1.4. <u>Importance Of The Study</u>

This study will be of importance to

1) Shareholders: This study will enable shareholders understand the key indicators of good and bad corporate governance. They will therefore be able to demand good corporate governance from directors and managers of their companies.
2) Policy Makers: The Capital Markets Authority and the Nairobi Stock Exchange: Improved corporate governance is at the heart of corporate efficiency and significantly influences national efficiency and growth. This study will therefore aid policy makers in designing guidelines to promote good corporate governance practices by quoted companies by providing an insight into the current corporate governance structure and the weaknesses therein.
3) Academicians: This study will provide a basis for further research into the area of corporate governance.

# CHAPTER TWO

# GENERAL DISCUSSION ON CORPORATE GOVERNANCE

## 2.1. Corporate Governance: Definition

Corporate governance is concerned with the way corporations are governed. Despite extensive use there is no one universally accepted definition of the term corporate governance. Some of the more common definitions include:

> "Corporate governance is the system by which companies are directed and controlled." (Cadbury, 1992 as quoted in Corporate Governance: Workshop Seminar and Report. Vol. 2, pg. 32).

> "Whilst management processes have been widely explored, relatively little attention has been paid to the processes by which companies are governed. If management is about running business, governance is about seeing that it is run properly. All companies need governing as well as managing."(Tricker, 1984 as quoted in the CACG Guidelines, 1999: pg. i).

> "Corporate governance can be thought of as "the way in which managers are made responsible to boards of directors and they in turn to the shareholders." (Dimsdale: 1994, pg. 13).

> "Corporate governance is the set of institutional arrangements governing the relationships among several groups of stakeholders (investors, both shareholders and creditors; managers and workers) in order to realize economic gains from such a coalition. These institutional arrangements serve to bridge the divergent interests that arise between investors and mangers and therefore ensure that directors and management act in the interest of all stakeholders and in particular the shareholders to whom they owe duty." (Aoki and Kim, 1995: pg. 235).

To fully understand the term, however, it is important to first define the term "governance". The Oxford Advanced Learners Dictionary defines the term governance as the "manner of governing." Governing on the other hand is defined as "having the power or the right to direct and control…." The term governance can therefore be defined as the manner in which the power or right to direct and control is exercised. It implies two parties: one with power to control the other. With respect to the corporation, these two parties are the directors and managers on the one hand and shareholders on the other.

Thus for purposes of this study, the term corporate governance will be defined as the manner by which companies are directed and controlled. In a company, the Boards of directors are appointed to represent the interest of shareholders. Managers on the other hand are appointed by the directors and report to the board. Collectively, therefore, the directors and managers are the decision takers involved in the day to day running of the company, whereas shareholders are the owners of the company. The management (directors and managers) must ultimately be accountable to the shareholders as owners of the company. The manner in which companies are managed and directed will depend on certain factors. These have been identified by Gedajlovic and Shapiro (1998: pg.537) as "ownership dispersion, ownership identity, the independence of the board of directors, shareholder powers, the prevalence of takeovers, and the nature of financing." The first four are internal while the latter two are external determinants of corporate governance. Collectively, these determine the structure of corporate governance in companies and ultimately in a country. This study focused on the internal determinants of corporate governance, specifically, the extent of ownership dispersion, shareholder powers and the independence of the board of directors among the companies quoted on the NSE.

## 2.2. Basic Tenets Of Good Corporate Governance

If corporate governance is about how companies are directed and controlled, to ensure those companies are well run, then those who direct and control these companies must promote good leadership. According to the CACG Guidelines (1999; pg. 3) good corporate governance is essentially about leadership:

(a) Leadership for efficiency and effectiveness

(b) Leadership for probity.

(c) Leadership with responsibility.

(d) Leadership which is transparent and which is accountable.

In addition, the Economist has suggested that an ideal system of corporate governance would do several things;

> "It would give managers enough freedom to manage well. It would ensure that they used that freedom to manage the firm in the interests of shareholders. The directors and managers would know what shareholders expected and shareholders would have enough information to judge whether their expectations were being met; and the power to act decisively if they were not. It would keep shareholders sufficiently distinct from managers to let them buy and sell freely without breaching rules against insider trading in stock markets." (The Economist, 29th January 1994: pg. 2).

The above has certain implications with regard to the indicators of good governance at the level of the board of directors and with regard to the role of shareholders.

To provide leadership for effectiveness, the board must;

(a) be aware of its responsibilities, which must be distinguished from that of the management. In particular, the board ought to be responsible for strategy development -ensuring that a strategic planning process is in place, is used and produces sound choices. They must monitor implementation of strategies to ensure that these are producing effective results that meet the shareholders requirements.

(b) ensure that the company has the highest caliber CEO and executive team and that certain senior managers are being groomed for CEO positions in future.

(c) ensure that it has the combined knowledge and experience to match the company's strategic demands. This will be reflected in the capabilities of board members.

(d) ensure that it keeps informed on trends and events that may affect the company. As such it obtain information from a broad range of sources both from within and without on the company (for instance its competitors and industry conditions).

(e) have the power to monitor and ensure that senior management is accepting and implementing its decisions. The board should therefore be sufficiently independent from management. It must also demand and expect to receive adequate information on a regular basis to be able to judge the managers and be sure the company is faring well and if not to take remedial measures. The board should not involve itself in the day to day running of the company.

(f) ensure that they have sufficient time to work together as a group. Thus the frequency of meetings should be adequate to deliberate on important decisions and there is adequate preparation for the meetings.

To provide leadership for probity the board must;

(g) ensure that there are established mechanisms and internal controls to ensure those managers conduct themselves with integrity. An example of such a mechanism is the use of a code of ethics for the employees.

(h) comply with legal and ethical standards imposed by law

To provide leadership with responsibility, the board must;

(i) be aware of the its obligations to shareholders and discharge their delegated authority in a capable manner. For instance by ensuring full participation in board meetings and directing the affairs of the company in a responsible and responsive manner. In Kenya, since the corporate sector is expected to play a key role in economic development, the board must be expected to be socially responsible as well. Thus they should create wealth not just for shareholders but for the society too.

To provide leadership that is accountable and transparent, the board must

(j) derive its mandate from the shareholders. Further, they have an obligation to account to the shareholders. Good corporate governance is evidenced by accountability. Accountability has been defined as "the obligation of an employee, agent, or other person to supply a satisfactory report, often periodic, of action, or of failure to act following delegated authority" (Kohler: pg. 6 as quoted in Owiti and Kibwana, 1994.). To be accountable and transparent, directors must provide accurate and timely disclosure of information to the shareholders. The board must ensure that there is an effective system of internal financial control and audit. During the AGM, directors must allow shareholders the opportunity to ask any question which they must answer truthfully.

(k) truly represent the interests of all shareholders regardless of the amount of their shareholding. Shareholders must actively participate in their election and must do so with sufficient information on the capabilities and experience of the potential directors.

Additionally, there must be mechanisms to align the directors' and shareholders' interests, for instance use of a reward system that compensates directors at least in part with shares rather than cash. Their rewards and remuneration must directly reflect their performance in discharging the responsibility that shareholders have placed on them.

Shareholders must also play a role in enhancing their companies' corporate governance. To ensure that they are fully aware of whether their expectations are being met, they must be active and committed to the company. They must participate fully in the annual general Meeting (AGM) and vote on issues affecting the company. For instance to enhance transparency and accountability of directors, they must play an active role in selecting the external auditor and not merely endorse the directors' choice. They must actively seek information regarding the company and remain vigilant. As Dimsdale has pointed out, there can be no effective system of corporate governance without long term committed and knowledgeable shareholders.

If good corporate governance is practiced in organizations, it is expected that it will translate to good performance of the company. As such one other indicator of good governance should be the financial performance of the company. In a study of performance changes following top management dismissal, Denis and Denis (1995), concluded that management changes that were due to forced resignation and poor performance were preceded by active monitoring by large shareholders, creditors, and potential acquirers. In addition, there was a significant improvement in the firms' performance following the management turnover. This study has been reviewed in detail in chapter 3. Thus in addition to financial ratios, changes in top management and subsequent financial data can be used as an indicator of good or poor corporate governance.

### 2.3. An Overview Of The Different Models Of Corporate Governance:

According to Gedajlovic and Shapiro, 1998, there are two general systems of corporate governance. These have been variously referred to as "shareholder and stakeholder capitalism" (The Economist, 10th February 1996: pg. 21) or outsider and insider systems.

#### 2.3.1. Shareholder/ Outsider Model of Corporate Governance:

The shareholder/outsider system is mainly associated with the US and Britain and is also referred to as a market based system. According to Dimsdale, 1994, in Britain, the stock market is characterized by a large number of widely dispersed shareholders often holding small percentages of the companies' shares. The US is also characterized by a wide dispersion of shareholders with "50 percent of the shares being held by individuals"(Gedajlovic & Shapiro, 1998: pg. 536).

Dimsdale reports that "in both countries, the shareholders are however largely passive and lack the long-term commitment to be active shareholders. The investment institutions want the freedom to buy and sell shares freely. They do not want to cooperate with the other investors because they are in competition with each other to attract and retain investment funds. In addition, the institutional investors are guided by the extent of the shareholding in a company relative to their other holdings. Where this is small, then such institutions may be reluctant to interfere with problems of company particularly where they may not have special expertise in the area. Frequently, therefore, although institutional investors can be instrumental in bringing about change and enforcing corporate governance, they have resorted to disposing their shareholding rather than interfere in the management" (Dimsdale, 1994; pg.20).

As regards the board of directors, "in Britain and the US, there is minimal shareholder involvement in electing members of the board of directors due to the substantial shareholding required to nominate and elect board members" (Gedajlovic & Shapiro, 1998: pg. 538). In addition, in Britain "there has been a tendency to increase the proportion of executive directors. These are directors who combine their role as directors with responsibility for management within the company" (Dimsdale, 1994; pg.18). With respect to the leadership structure of the board, Britain is characterized by a "joint structure where the chief executive also serves as the chairman of the board" (Dimsdale, 1994; pg.19). Conger et al, 1998 report that the US is also the same.

In this model of corporate governance, the capital market "has become a market for companies in which control of a company can be acquired by a bidder willing to pay a sufficient premium over prevailing market prices through takeovers" (Dimsdale; 1994; 23). Further, the threat of takeover "serves as a constraint on managers since they can lose their jobs subsequent to the takeover" (Gedajlovic & Shapiro, 1998: pg. 538). It therefore serves as an inducement to corporate efficiency and as an important protection for investors.

To enhance corporate governance in these countries, Charkham (as quoted in Dimsdale, 1994) has suggested that shareholders must actively participate in the affairs of the companies in which they hold shares. In particular institutional investors must be willing to be collectively involved in company affairs in an effort to improve company performance to the benefit of all shareholders. They should encourage regular contact at senior executive level to exchange views on strategy performance, board membership and quality of management. They should also take a positive interest in the composition of boards of directors. Individual investors should also form groups or form associations with institutional investors. They may deposit their shares with the institutions and allow them to exercise their voting rights by proxy. In this way they are able to strengthen their influence thereby serving as an important check on directors. Both individual as well as institutional investors should ensure that they actively participate in the nomination of directors who will represent their interests. They should not merely endorse directors presented by management. Increased participation of shareholders will directly benefit them in the form of increased wealth.

In UK, the Committee on the Financial Aspects of Corporate Governance, (as quoted in Dimsdale, 1994) in its report recommended the separation of the two roles of the chief executive and chairman of the board. The committee also suggested the formation of a remuneration committee comprised of non-executive directors or alternatively elected from the general shareholding group. These should determine and assess both the level and structure of management remuneration as well as executive directors. In addition, remuneration should be designed in such a way that encourages managers to promote the interest of shareholders.

The Committee also recommended that directors' total emoluments should be fully disclosed and split into their salary and performance related elements. The basis on which performance is measured should be fully explained in the financial report.

The committee also suggested that companies set up audit committees composed mainly or wholly of non-executive directors. The committee will be responsible for considering the scope of the audit, choice of auditors and the audit fee. The audit committees will serve to oversee the financial reporting progress and the company's internal controls and thereby improve the quality of financial reporting and strengthen the respective position of both the internal and external auditors. They will be expected to ensure that an objective and professional relationship is maintained with the auditors.

In particular the audit committee is expected to meet regularly to review the internal auditing function, examine the effectiveness of internal controls as well as the general operations of the company. They should liase with the external auditors as to the findings of their annual audit. In addition they should ensure that the recommendations of the external auditor as regards weaknesses in the systems are implemented. The audit committee therefore assists corporate directors in fulfilling their responsibility to shareholders and other stakeholders.

The Committee has also recommended that there be a regular rotation of the partner in charge of the audit so that managers and auditors do not build up too close a relationship during the course of time. Companies should also disclose all their relationships with auditors including consultancy. The Committee has also recommended disclosure of payments by companies to auditors for non-audit work. In addition Marsh, (as quoted in Dimsdale, 1994) has suggested that in addition to the audit report, the auditors should also make the management letter available to the shareholders. This is because in the management letter, the auditors give details of any accounting and control deficiencies and the company's response to them. This would allow shareholders to judge the quality of the accounting, control and fraud-preventing systems.

In the UK the Cadbury Committee, formed to address the concerns over corporate governance developed a code of best practice. The aim of the code was to secure sufficient disclosure so that the investors can assess the companies' performance and governance practice and respond in an informed way, and therefore improve public accountability. The code is applicable to the companies listed on the London Stock Exchange. These companies are required to disclose how they apply the principles in the code and where they do not comply with the provisions of the code, provide an explanation in the annual report. Some of the provisions of the code include;

(a) The position of Chairman of the Board and the Chief Executive should be separated. Where they are combined, the decision must be publicly justified.
(b) There should be formal and transparent procedures that the nominating committee should follow in making recommendations for members of the board. Once elected directors should submit themselves for re-election at regular intervals of no more than three years. To ensure shareholders make an informed decision, sufficient biographical data should be submitted with the directors' names.
(c) Upon appointment to the board, new directors should receive training.

(d) Non executive directors should comprise no less than one-third of the board. In addition, the majority of the non-executive directors should be independent of management and free from any business or other relationship that would interfere with their independent judgement. These directors should be identified in the annual report.

(e) Companies should make use of audit, remuneration and nominating committees comprising mostly of non-executive directors and with written terms of reference. They must report their activities in the annual report and the chairmen must be available to answer shareholder questions during the AGM.

(f) There should be regular board meetings and directors should receive timely information to enable them make decisions. They are free to seek professional advice at the company expense.

(g) Other aspects of the code deal with the role of the shareholder and financial reporting, transparency and audit.

### 2.3.2. The Stakeholder/Insider Model of Corporate Governance

The stakeholder/insider system is associated with continental Europe, notably, Germany, Canada and France as well as Japan. It is sometimes referred to as a bank based system. In France, Canada and Germany, the ownership of firms is less widely dispersed than in the US or UK. Germany is characterized by shareholders, often families, companies and banks, who hold "large shareholdings usually in excess of 25 percent" (Franks, Mayer & Sonia: 1991,as quoted in Dimsdale, 1994: pg. 188). In fact in many German firms the "largest five shareholders own about 40 percent of equity which they tend to be maintained for years" (The Economist, 10th February 1996: pg. 21). In Canada majority of the large firms have a dominant shareholder. In most cases, this "dominant shareholder in most corporations is often families whereas in France, the main shareholders are non-financial institutions and the State" (Gedajlovic & Shapiro, 1998,pg. 537). In all these countries, the shareholder is an active one, constantly interacting with management. These shareholders are able to closely monitor their managers and when dissatisfied with them resort to discussions with them rather than dispose of their shares as in the Outsider system.

In Germany, France and Canada, the composition of the board reflects the institutions that are the major shareholders. In Germany, for example, Gates & Saghir, 1995 report that large public corporations are required to adopt a two-tier board structure with a supervisory board as well as a management board. The supervisory board comprises both shareholders' as well as employees' representatives. For companies with more than 2000 employees, the law requires that half the members of the supervisory board represent the firm's employees. For those companies with between 500 and 2000 employees, a third of the supervisory board members must represent the employees. No managers are permitted on this board. The company's main or primary lender is also represented on the board and often acts as the supervisory board's chairman. Their main function is the control of management including the right to appoint and dismiss members of the management board. The supervisory board is also responsible for fixing the salaries of the management board. The management board on the other hand is responsible for the running of the company. It is obliged to inform the supervisory board about future business policies, the company performance and any other necessary information.

Corbett (as quoted in Dimsdale, 1994) indicates that in Japan the structure of the board is hierarchically ranked in that there is usually a president, senior executive directors and other executive directors. Most of the executive directors will have been former middle managers who have been promoted from inside the company. Other directors are drawn from institutional investors of the company as well as the company's bankers.

According to Dimsdale, 1994, in evaluating the system of corporate governance in Germany and Japan, consideration must be given to the role of the banks in influencing management. This stems from the part the banks have historically played in the two countries in financing industrial investment. German banks also hold equity in various companies. In addition they hold bearer shares which are deposited with them by shareholders. Because German shares are unregistered bearer ones, the banks' securities deposit service is widely used for shares. The banks which hold shares for depositors can "exercise the voting rights attached to these shares under the direction of the depositors" (Gedajlovic & Shapiro, 1998, pg. 537). Banks are often represented on the supervisory board and frequently hold either the chairmanship or the deputy chairmanship of the supervisory board.

### 2.4. <u>Corporate Governance In Kenya</u>

In Kenya, governance in general and corporate governance in particular has received attention due to the realization that the success of the Kenyan economy depended on the drive, productivity and efficiency of the corporate sector. The effectiveness of the board of directors and the management of companies in discharging their responsibilities determine the level of corporate efficiency, productivity and competitiveness. There is a need to develop good corporate governance practices or mechanisms. As mentioned earlier, there have been certain seminars held to discuss corporate governance in Kenya. During these seminars some of the aspects of corporate governance that were discussed. These have been summarized below.

#### 2.4.1. <u>Laws and Regulations:</u>

In Kenya there are many laws that affect the corporation. Foremost is the Companies Act CAP 486 which is the statute of general application. To incorporate the principles of good governance, the Companies Act must contain provisions that

i." Define the modern management team
ii. Prescribe the minimum qualifications for directors and managers
iii. Spell out the directors' performance criteria
iv. Regulate the directors' exercise of discretionary powers
v. Provide for checks and balances
vi. Enhance sanctions for default in duty and performance" (Eshiwani, 2000: pg. 9).

A review of the Act to determine the extent to which it incorporates the above principles of good governance indicates the following;

i. "Part V of the Act shows that the company's management team consists of the Director, the managers, the Company Secretary, the auditors and the shareholders. The Act further elaborates on the role of the director in the management of the company. Unfortunately the Act does not give the legal role of the manager, although the courts have previously ruled that managers are to be subject to the same levels of accountability in their duties as directors are" (Eshiwani, 2000: pg. 10). There is also need for the Act to be more elaborate on the role of the Company Secretary. The courts have held that an auditor, once appointed, "becomes an officer of the company subjected to penal sanctions suffered by other officers for default on company accounts" (Eshiwani, 2000: pg. 10). This raises a key corporate governance concern in that the auditor is an appointee of the shareholder. He cannot be an officer of the company.

ii. The Act makes the following provisions as regards the appointment of a director;

He must be between 21 and 70

He must not be under bankruptcy declaration

He must not be guilty of a past fraudulent act in the management of any company

He must not advertise or otherwise campaign to win appointment

He must not be both secretary and director of the company

The Act does not therefore consider academic or professional qualifications as necessary. The corporate governance concern is whether companies should not require their directors to have the right academic and professional qualifications as well as the relevant experience. Granted, there are many successful managers and directors who did not go to school. But given that directors govern companies on behalf of shareholders, who expect maximum returns, shouldn't the directors meet minimum statutory requirements as to academic and professional qualifications?

iii. The Act provides that the directors who may exercise all the powers of the company shall manage the business of the company. The courts of law have interpreted the Act and defined the powers and duties of the directors as fiduciary duties and duties of care and skill. With regard with fiduciary duties the courts have stated:

> "The directors are a body to whom is delegated the duty of managing the general affairs of the company. A corporate body can only act by agents and it is of course the duty of those agents to act as best to promote the interests of the Corporation whose affairs they are conducting. Such agents have duties to discharge of a fiduciary nature towards their principal. And it is a rule of general application that no one, having such duties to discharge, shall be allowed to enter into engagements in which he has or can have a personal interest conflicting or which possibly may conflict with the interests of those whom he is bound to protect." (Aberdeen Railway Co. Vs Blaikie Bros., 1854 as quoted in Corporate Governance; Workshop and Seminar Report, Vol. 2: pg. 9)

Thus directors are agents of shareholders and must always act in the best interests of the company. They must perform their duties in accordance with applicable statutes and cannot use their positions to further their private business at the expense of the company. The corporate governance issue is how the rules developed by the courts can be communicated to the directors in order to enforce them.

With respect to the duties of care and skill, the courts have indicated that a director must act with the care and skill that may be reasonably expected from a person of his knowledge and experience. Thus to hold the directors responsible for failure to exercise care and skill one must determine whether he had the necessary knowledge and experience. Yet the law does not place any minimum statutory requirement as to academic and professional qualifications and experience that the directors should have.

The courts further indicated that a director is not bound to give continuos attention to the affairs of the company. His duties are of an intermittent nature to be performed at periodical meetings, and at meetings of any committee of the Board upon which he happens to be placed. He is not however bound to attend all such meetings, though he ought to attend whenever, in the circumstances he is reasonably able to do so. This rule has led to a lot of corporate governance abuses. For example, "a director who did not attend board meetings for 20 consecutive years, during which time statutory rules were breached, was not held responsible for the breach" (Eshiwani, 2000: pg. 15).

iv. With regard to directors' remuneration, the Act requires that any salaries and pensions be reflected in the accounts. However, the corporate governance concern is that the Act does not regulate how these should be fixed. Other payments such as loans to directors or using the company as guarantors for loans elsewhere are prohibited. Tax-free payments to directors are also prohibited. This ensures transparency and that directors do not abuse their positions for their own benefit.

### 2.4.2. The Capital Markets Authority

The CMA was established under the Capital Markets Authority Act, CAP 485A in1990 with the mandate to promote and facilitate the development of an orderly, fair and efficient capital markets in Kenya. One of its principal objectives is the protection of investor interests; a key corporate governance concern.

To achieve this objective, the CMA has focused on ensuring that public investors get the information they need in order to assess their investment. Thus the CMA has published minimum disclosure requirements both for the primary and secondary markets. For the primary market, the CMA requires that a company that intends to offer shares to the public for purposes of listing at the stock exchange must publish a prospectus that provides full disclosure to all potential investors.

For companies already listed on the stock exchange the CMA requires that investors should be continuously informed of their investments. As such the CMA requires such companies to immediately disclose any material information which may affect the value of their shares. Further, the companies are required to publish half yearly and annual financial statements, copies of which must be submitted to both the CMA and the NSE. Two levels of disclosure frameworks; mandatory disclosure and good practice disclosure usually dictate the format and content of such reports.

### 2.4.3. The Nairobi Stock Exchange

The NSE has played an important role in mobilizing resources and providing a means by which companies raise capital. It has also offered a mode of privatizing public enterprises and ensured that the ownership of such companies is widely distributed among members of the public. From 1995, when the Government permitted foreign investors to participate in the ownership of locally controlled quoted companies, the NSE has also promoted the inflow of foreign capital into the country.

With respect to corporate governance, the NSE plays an important role in ensuring adequate disclosure of information by the market participants. The NSE listing rules detail the requirements of companies quoted on the exchange with respect to financial information. These requirements are similar to those of the CMA and ensure that investors are adequately informed.

### 2.4.4. The Board of Directors

As has been mentioned earlier, the board of directors gets its mandate from the Companies Act which provides that the business of the company shall be managed by the directors who may exercise all powers of the company subject to the limitations contained in the Companies Act, the memorandum and articles and to any directions given by special resolution. It is important to note that the powers of the directors are vested in the board (the directors acting as a collective agency) and not on the individuals.

Legally, the board is considered the representative of the shareholders. The board is responsible for appointing the chief executive and top managers and monitoring their performance. Every year, the board must call an annual general meeting, to inform the shareholders about the companies' performance during the year. Among other things, the directors present the audited financial accounts to the shareholders for approval. During this meeting the directors whose terms have expired and are still eligible for re-election, seek re-election from the shareholders. Other directors are also elected during the annual general meeting.

There have however been concerns that the board does not always represent the interests of shareholders. One reason for this concern has been the fact that it is often the management who recommend to shareholders individuals to be elected as directors. It is unlikely that the managers would recommend individuals who are hostile to them. Further if elected on the basis of the managers' recommendations, how can such a director be expected to monitor the same managers? In addition, shareholders are not informed of the basis for such recommendation; the qualifications of the directors and how they are expected to contribute to the company.

As regard composition of the board, good corporate governance practices requires that the board comprise an appropriate mix of both executive and non-executive members. Executive directors are those who are also involved in the day to day operations of the company whereas non-executive directors are not involved in the operations of the company either directly or indirectly. The rationale for this is that a board made up exclusively of executive directors would be unable to monitor management since thy are a part of management. Non executive board members would bring in an element of independence and external checks. In Kenya, no study has been undertaken to determine the proportion of executive and non-executive members in boards of directors and whether this affects their representation of shareholder interests

In Kenya, some of the quoted companies, particularly those that were previously state owned, also had a board leadership structure where the chairman of the board was also the company's chief executive. This raised certain corporate governance concerns, in that the chairman may become too powerful and exert undue influence on the board. Yet the board is supposed to monitor the chief executive on behalf of shareholders. Such concerns have since been addressed with shareholders of such companies demanding that the two positions be separated.

### 2.4.5. <u>The Shareholders</u>

Shareholders are the owners of the company and may be of two types; those who hold preferred shares and those who hold ordinary shares. Ordinary shareholders, in law, participate in the residual benefit of the corporation after all parties with a legitimate claim have been satisfied. They are therefore the ones who bear the brunt of poor corporate governance. In Kenya, shareholders have the right to elect directors during the annual general meeting. They can also remove those directors who have not performed satisfactorily. In addition, the Companies' Act provides that shareholders can pass special resolutions in extraordinary general meetings to remove some or all directors. Theoretically therefore, shareholders can ensure that they are adequately and properly represented on the board of directors. They also have the power to control the affairs of the company and ensure that the companies are properly managed. However in practice the power of the shareholders to control the board of directors is limited by various factors as follows;

**The extent of ownership:** It is expected that those shareholders with significant shareholding will be able to influence the membership of the board. Unfortunately, minority shareholders will be unable to elect their own representative on the board. The main corporate governance concern would be how to ensure that the interests of the minority shareholders are protected.

**The type and nature of shareholders:** Shareholders are generally of two types; individuals and institutions. Individual shareholders often have minimal holdings in companies. Individual shareholders that are dissatisfied with results of the company and the performance of the directors are unlikely to have much impact on the board and/ or its constitution during the Annual General Meeting. Institutional investors include major financial institutions, insurance companies, pension funds as well as other large companies. They typically hold large investments in companies although this may not always be the case. Such shareholders are expected to play a key role in their companies to ensure good corporate governance. This is because they are in a better position to make use of experts to conduct a financial analysis and evaluation of the companies they own. It follows therefore that a company with a predominance of institutional investors would have good corporate governance practices. We would expect such a company to perform better due to the demands of institutional shareholders.

### 2.4.6. External Auditors

Shareholders appoint external auditors during the AGM. The external auditors are supposed to review the financial statements prepared by the directors with a view to expressing an opinion on them. The only information that shareholders get concerning the performance of the company is through the annual reports. The reports provide the only mechanism through which the shareholders can judge the directors' and managers' performance; how well they discharged their responsibility. The only assurance that shareholders get that the reports reflect a true and fair position of the company is the opinion of the external auditor. The auditor therefore plays a key role in corporate governance. There have been certain concerns about the role of the external auditor in the organization. Firstly, although the shareholder is supposed to appoint the auditors, often it is the directors who recommend them. Further during the AGM, shareholders also give directors the authority to fix the auditors' fees. The question therefore arises; how are auditors expected to represent shareholders yet it is the management, which fixes its fees and recommends their appointment? The auditors are unlikely to antagonize the management. In addition, the auditors' independence is compromised where they offer other services such as consultancy to the company. In addition shareholders have no access to the auditors letter to the management which details weaknesses that the auditors have found and the response of management.

### 2.4.7. Disclosure of Information: Financial Transparency

One of the key elements of good governance is accountability and transparency. In the quoted company, directors and managers present the annual report to shareholders during the AGM, indicating how they have utilized the resources of the company. The annual report is the only information that shareholders have with which to judge the directors and managers and evaluate their company's performance. The statements must therefore "disclose fully the economic and financial reality in a comprehensive and clear manner"(Nzomo, 1993; pg.6). To achieve financial transparency and ensure full disclosure, the data on financial transactions must be systematically collected in accordance with the generally accepted accounting principles and reported in a comprehensive and clearly understandable manner. The accounting information must therefore be relevant and reliable. The substance of reliability encompasses verifiability, neutrality and representational faithfulness while that of relevance encompasses timeliness, feedback and predictive value.

In Kenya the reporting of accounting information is covered by the companies' Act, which specifies that the annual accounts must be presented to shareholders at the AGM. The Act also specifies what must be shown. The CMA and NSE also have disclosure requirements for the quoted companies. These requirements include publishing annual and half-yearly accounts.

With effect from 1st January 2000, the ICPAK, adopted the International Accounting Standards (IAS) issued by the International Accounting Standards Committee (IASC). As such all companies are required to apply this standards in the production of financial statements. The standards indicate that the objective of financial statements is to provide information to the users about the financial position, performance and changes in the financial position of the enterprise over time. They also aim at providing a basis for gauging the effectiveness of management especially its accountability for the resources entrusted to them. IAS 1 deals with the presentation of financial statements and disclosure of accounting policies whereas detailed requirements are dealt with in the other standards. It requires that significant policies must be disclosed to ensure the financial statements are understood. Any departure from the standards must be fully explained.

It is expected that following these International accounting Standards will result in accurate and transparent information to shareholders. However it is important that bodies such as the CMA, NSE and ICPAK ensure that all companies adhere to the standards.

## 2.5. Proposed Reforms To Corporate Governance In Kenya

It has been recognized that improved corporate governance will lead to improved productivity, efficiency and effectiveness. This will directly impact on the country's economic development. As such there have been various suggestions and developments designed to address the weaknesses identified above in Kenya's corporate governance structure. These reforms include;

### 2.5.1. The Role of the Government

Companies operate within a wider framework of regulations. Where this wider framework is perceived as weak or no transparent, corporations will struggle to implement their own governance systems. Consequently, the government's role must be ensure good national governance, create an enabling environment and introduce orderly and well publicized business procedures and practices leading to the elimination of corrupt and anti-competitive practices. The Government must also review various laws and regulations particularly those that impact on governance. In fact in 1994, the Kenya Government appointed a Task Force to review laws relating to companies, partnerships, investments and insolvency. One of the issues that the task force was to address was Corporate Governance. The report of the task force is yet to be released.

A technical workshop and forum on corporate governance for East Africa, held in Arusha on the 12th to 15th April 2000 requested the governments of the three East African countries to urgently review the business and company laws to facilitate effective implementation of good corporate governance. The workshop also suggested the provision of tax incentives aimed at enhancing corporate social responsibility (Summary Report and Recommendations of the Technical Workshop and Forum on Corporate Governance, April 2000).

### 2.5.2. The Capital Markets Authority

To address corporate governance among quoted companies, the CMA board approved the establishment of a committee known as Disclosure Standards Committee in 1996. Initially, the committee comprised eleven (11) members who were to operate for three years. With effect from September 1999 fourteen (14) persons were appointed as members of the committee for a further three years. The members of the committee are highly respected professionals and include senior executives from the private sector and representatives of listed companies, the accounting and legal professions.

The committee is expected to serve as an important interface between the Authority and issuers of securities as well as other private sector operators in the capital markets. It will also serve as a useful forum for building consensus on matters mandating on good practice disclosure requirements as well as good corporate governance requirements. Specifically the committee is expected to review the existing disclosure requirements and make recommendations on formulation of minimum disclosure standards. They will also review and make recommendations on minimum capacity requirements and reporting obligations for auditors of public listed companies as well as review and make recommendations on good corporate governance practices by public listed companies.

Since it inception, the committee has held six meetings and with respect to good corporate governance practices, has developed Guidelines on Audit Committees, which were released by the Authority in April 1998

#### 2.5.2.1. Guidelines on Audit Committees:

The CMA has indicated that the boards of directors of all public companies will be required to establish audit committees using the following guidelines;

Composition of the committee:

The committee shall be composed of directors who are independent of the management of the corporation and free of any relationship that in the opinion of the board of directors would interfere with their exercise of independent judgement as committee members. In addition, committee members should have broad business knowledge, keen awareness of the interests of the investing public and be familiar with basic accounting principles. Ideally, members of the committee should have diverse, broad based but complimentary backgrounds.

Size of the Committee:

The committee should be small enough so that each member is an active participant. The size of the committee should not be fewer than three members whereas more than five may be unnecessary for all but very large companies.

Term of office:

The term of audit committee members should be tied to their board term. It is recommended that the audit members be rotated so as to keep interest high. For example, a rotation policy for a three-member committee may be to have three-year terms with one member's term expiring each year.

Functions of the committee:

The committee should ensure that the corporate accounting and reporting practices of the company are in accordance with all the requirements and that the financial reports are of the highest quality and integrity. Consequently, some of its functions would include the following;

a) Meet with independent auditors and the corporate financial management to review the scope of the proposed audit for the current year and the audit procedures to be utilized. At the conclusion of the audit, the committee should review the results of the audit as well as the comments and recommendations of the independent auditors. To perform this function well, the committee should maintain open lines of communication with the independent auditor.
b) Review and make recommendations on the internal audit function of the corporation. This review will include the independence and authority of the internal audit function, the proposed audit plans for the coming year and the co-ordination of such plans with external auditors. The internal audit function should help the audit committee by evaluating compliance with corporate policy and performing audits for operating efficiencies. The audit function may also assist the committee with special investigations. Thus the Head of Internal Audit should attend all audit committee meetings or may meet privately with the committee.
c) Ensure that the independent auditors are satisfied with the disclosure and content of financial statements to be presented to the shareholders.
d) Review and make recommendations on utilization of financial and human resources of the company and ensure efficiency and effectiveness are achieved.
e) Oversee the financial reporting process and the company's internal control system.

f) Review and make recommendations on the annual management programmes established to monitor compliance with the company's code of conduct.

g) Review the half-year and annual financial statements before submission to the board focusing particularly on any changes in accounting policies and practices, major judgmental areas, significant adjustments resulting from the audit, the going concern assumption, compliance with accounting standards and compliance with stock exchange and legal requirements and any other statutory requirements.

h) Review and recommend to the directors the independent auditors to be selected to audit the financial statements of the corporation.

To adequately fulfill it functions and responsibilities, the board must ensure that the committee has adequate resources and authority. In addition, the committee should have the power to retain outside counsel or seek any appropriate advice that they consider necessary in discharging their duties. The committee should also develop a written charter setting forth its duties and responsibilities. The board of directors who should review it periodically and modify it as necessary should approve this charter.

<u>Committee meetings and reports:</u>

Although, the number of meetings should be dictated by the committee's objectives, the scope of its activities and the needs of the company, the CMA recommends that the committee have at least three meetings in a year. The minutes of the meetings should be taken and included as part of the report to the full board. It should report to the full board on a regular basis so that the board is kept aware of its activities. In the annual report to the shareholders, the committee should include letter signed by the chairman detailing the committee's responsibilities and activities during the year.

The CMA expects that the audit committees can bring significant benefits if they operate effectively. They can improve the quality of financial reporting, strengthen the respective positions of the external and internal auditors and increase public confidence in the credibility and objectivity of financial statements.

Initially it was expected that all listed companies would establish audit committees by the end of 1998. However, the guidelines are yet to be gazetted by the CMA, and are therefore not yet law.

#### 2.5.2.2. Other reforms

The CMA is currently developing a code of best practice for corporate governance for public listed companies. In addition, the CMA is developing a new comprehensive disclosure framework and guidelines

### 2.5.3. The Central Bank Of Kenya (CBK)

The CBK has also reviewed corporate governance practices in the banking sector. To this end they have issued guidelines that govern the conduct and responsibilities of for bank directors. The CBK hopes that the guidelines will assist in the development of effective boards that will positively support and monitor management of banks. Some of the guidelines include

**The board of directors:** the guidelines point out that directors should be people with impeccable, professional technical and moral records. They will need to understand finance and banking more than the average man so as to be able to contribute knowledgeably and positively to the bank. The CBK also requires banks to submit names of any new director for approval.

Leadership structure of the board: the CBK requires that the position of chairman of the board is kept separate from that of the chief executive.

Directors training: once appointed the directors should receive sufficient information to enable them perform their duties they should also keep abreast of any developments in the banking industry.

Directors' independence; directors should maintain independence from the bank by ensuring that any business and personal relationships with the banks are at arm's length. They should not interfere in any way with the day to day running of the bank.

Good boardroom practice: the board should establish and comply with written procedures for the conduct of its business and ensure each director has a copy of these procedures. The directors should demand and receive information prior to the meetings. In addition, they should demand quarterly reports from management with sufficient information on the bank's activities. The directors should be diligent in attending board meetings and reviewing pertinent information.

The use of committees; the board should form committees to help in discharging some of the important functions. The CBK suggests that banks form the following committees;

1) Audit committees: whose membership should be ideally confined to non-executive directors. The minimum number of members should be three. The committee will review the financial statements on behalf of the other directors and ensure financial transparency.
2) Asset liability committee: whose task would be to review the bank's deposit structures and ensure sound fund management. The membership need not be confined to the board and

should ideally include personnel from investments, lending and finance divisions of the bank.

3) Lending committee: to formulate lending procedures and policies and ensure that lending is carried out properly. This committee should comprise at least one director and the advances and fund managers.
4) Investments committee: to deliberate on major investment decisions and formulate polices to guide the day to day management of this area. It should include at least one director and other relevant personnel.
5) Marketing committee: to be headed by a marketing professional, this committee is charged with formulation of an appropriate marketing strategy.
6) Manpower training and developments committee;

Bank performance evaluation indices: the guidelines also indicate certain indices with which to evaluate the operations sand performance of the banks.

The above guidelines are specific for the banking sector although they could also be adapted to other areas or industries.

### 2.5.4. Private Sector Corporate Governance Trust

As was earlier mentioned the PSCGT was established following a workshop on the Role of Non-Executive Directors and a subsequent seminar. The Trust was created to formulate a code of Best Practice for Corporate Governance in Kenya and to co-ordinate with other efforts in the region and beyond for purposes of improving corporate governance.

The trust has since produced a code of best practice. The Trust also organized a two-day workshop of experts followed by a seminar in October 1999 at the Safari Park Hotel, during which the code of best practice was adopted to guide corporate governance in Kenya.

#### 2.5.4.1. Code of Best Practice

Although the code is neither prescriptive nor mandatory, it is intended to assist companies develop their own governance code. Some of the areas that the code provides for include;

(a) : The Shareholders

Shareholders have a responsibility to ensure that only competent and reliable persons who can add value to the company are elected or appointed. They must also ensure that the board is held accountable and responsible for efficient and effective governance of the company. They must be given an opportunity to participate fully in the AGM. As such they must receive sufficient and timely information about date, location and agenda of general meetings. They must be given an opportunity to ask questions and place items on the agenda. All shareholders of the same class shall be treated equitably, irrespective of whether they are majority or minority shareholders.

(b) The board of directors

The board shall include a balance of executive and non-executive directors such that no one individual or group dominates decision-making. The code suggests that a third of the board members be independent non-executive directors. These are directors who are "independent of management and are free from any business or other relationship which would interfere with the exercise of their ability to bring an independent judgement to bear on issues of strategy, performance, resources, key appointments and standards of conduct." (Principles for Corporate Governance in Kenya, 1999: 13). To enhance the board's independence, the code suggests that all directors at regular intervals should disclose to the external auditors any business or other interest that is likely to create a potential conflict of interest. If removed or in the case of resignation, the director must disclose to the external auditors and if necessary to the shareholders the reason for removal or resignation. An independent director who is not managing the company shall chair the board. Where the two roles are combined the company should explain the reasons.

The board shall set up a search and nominations committee whose responsibility will be to recommend qualified and competent persons to be nominated to the board. The code suggests that the board formally review its composition at least once every year to ensure that the mix of membership is appropriate with the needs of the company. The board shall also set up an independent remuneration committee to determine the remuneration of the individual executive directors. The committee should include in the company's annual report a statement of the remuneration policy and details of the remuneration and benefits of each director. The board shall also establish an audit committee composed of independent non-executive directors who will be responsible for a thorough and detailed review of audit matters. The code is however not as detailed as the guidelines issued by the CMA on the Audit committees. For example, the code suggests the committee meet at least twice a year whereas the CMA Guidelines require that they meet at least three times a year.

To ensure that directors are equipped to fulfill their responsibilities, the code suggests that all directors receive formal training on their role, duties and responsibilities as well as on board practices and procedures. The code has also given details on the role and functions of the board and given guidelines on board meeting management and procedures. In addition, the code suggests that directors regularly assess its performance and effectiveness as a whole and that of the individual directors including the chief executive officer. To aid in this, the code has provided a framework to be used in the performance evaluation.

#### 2.5.4.2. Training and Research

The Trust also intends to undertake institutional capacity building and undertake research in the area of corporate governance. The trust also intends to train directors on good corporate governance practices. It also intends to sensitive shareholders and other professionals on corporate governance. To promote good governance practices, the trust will create an award to be given to well run companies.

### 2.5.5. Other Reforms.

In a report on corporate governance published in the Daily Nation (4th July 2000) PriceWaterhouseCoopers, an audit and consulting firm, pointed out that although a code of best practice is good, it cannot by itself deliver good governance. Good corporate governance must emerge from deep within the corporation. The firm suggests that good corporate governance can be incorporated into an organization in the following ways;

i. Corporate success is founded on having a winning strategy. Governance therefore must support and enhance the setting and implementation of corporate strategy. The company's corporate governance structure must therefore provide for clearly defined and well understood roles for the board of directors and the management team in defining strategic direction and delivering success.

ii. Directors must provide a strong and vibrant leadership that sets the example. The imperatives of efficiency, probity, responsibility and transparency must flow from the top downwards.

iii. Establishment of a clear widely accepted ethical basis to business. Companies need to focus on developing long term success based on sound ethical principles.

iv. The organization should be suitably structured to effect good corporate governance. Reporting systems should also be structured to provide transparency and accountability.

v. Although the focus of any company should be on shareholder value, nevertheless the company cannot ignore the interests of other stakeholders such as the employees, the government and the wider community

# CHAPTER THREE

## LITERATURE REVIEW

According to Gedajlovic and Shapiro (1998), there are certain elements that have been widely identified in literature as having an impact on the ability of the owners to effectively monitor managers and thereby improve corporate performance. These factors collectively define the corporate governance system or structure of any given country. These elements include the extent of ownership dispersion; ownership identity; shareholder powers and especially their ability to elect and dismiss members of the board of directors. Other elements include the composition of the board of directors as well as the leadership structure; the prevalence of takeovers and the role of the capital markets; and the nature of financing as well as the role of the banks.

In the previous chapter some of these factors were mentioned in general. This chapter examines empirical studies that have been conducted in the area of corporate governance. Most of these studies have focused on one of the factors identified above as having an impact on corporate governance.

### 3.1. Separation Of Ownership And Control and the Extent of Ownership Dispersion

Berle and Means (1932) were the first to observe that the separation of ownership and control had become a common feature of large non-financial corporations in the United States during the 1930s. They studied the 200 largest US non-financial corporations and sought to classify them as to whether they were controlled by owners or by the management. By control, they meant the individual or group within the company, who had the power to select the board of directors or to dictate the policy of a corporation to management. Control did not necessarily mean that the individual or group was making normal day to day decisions involved in operating the company.

In their study, Berle and Means (1932) classified companies as owner controlled and management controlled according to the extent to which their voting shares were concentrated in a single party. They regarded a 20 percent voting concentration as the minimum concentration necessary for owner control. The corporations therefore were classified as owner controlled if a single party held 20 percent or more of their voting stock. Those companies that did not meet this criterion were classified as manager controlled. Using this classification, Berle and Means concluded that 44 percent of the firms they studied were manager controlled.

In a follow up study in the early 1960s, Larner (1966) concluded that 85 percent of the 200 largest non-financial firms in the US were under the control of the management. In his study, Larner put the minimum shareholding necessary for the owners to have control at 10 percent. This was lower than the cutoff used by Berle and Means but was based on the greater size of the companies and the wider dispersion of their stock in the 1960s compared to the 1930s when Berle and Means conducted their study. Whereas these two studies recognized that shareholding in the US companies was getting increasingly dispersed, they did not establish the effect of this separation of owners from managers on the companies' performance which is what corporate governance is concerned about.

Vernon (1975) also studied the separation of ownership and control among large banks in the US. He classified the banks as owner controlled if a single party held 10 percent or more of their voting stock. Using data on ownership from 1962 and 1966, he found that the owners controlled only 22 percent of the 200 largest banks in the US while 75 percent of the banks were classified as manager controlled. 3 percent of the banks were not classified. Thus he concluded that management control has been the dominant form of control among large banks in the US.

In Britain, there has also been considerable separation of ownership and control. The stock market is characterized by a large number of widely dispersed shareholders. In a sample of 56 quoted companies studied by Mayer and Alexander (1991) (as quoted in Dimsdale & Prevezer, 1994), on average less than two holdings per company in excess of five percent were recorded. Even in these cases the average size of the large holdings was less than ten percent. This indicates a dominance of management control at least among quoted companies in Britain.

The separation of ownership and control has attracted much attention in the literature, primarily because it may influence the performance goals to which firms address themselves. According to Vernon (1975) profit maximization may be pursued less vigorously where firms are management controlled rather than owner controlled because it may be less consistent with the interests of managers than the interests of owners. Similarly there may be a difference in attitudes of firms with the two control types towards growth rate, risk acceptance, efficiency, management remuneration, research expenditure and other performance goals. The studies reviewed above only indicated the extent to which shareholding were dispersed. However they did not indicate the effect this had on the companies' performance. Other studies have since been undertaken on the effect of the separation on the performance of the companies. A few of this are evaluated below.

## 3.2. <u>The Relationship Between Ownership Dispersion And Performance</u>

In their study on corporate control and the decline of banking in the U.S. Gorton and Rosen (1995) noted that during the 1980s, bank profitability declined steadily whether measured by accounting return on equity, return on assets or market value. Banking also became riskier with bank failures, which averaged six per year from 1946 to 1980 rising to an average of 104 banks per year during the 1980s. Their study sought to explain the cause of this decline in the banking industry.

They examined the lending decisions of managers and specifically categorize the types of loans that bank managers make according to their risk return characteristics. If managers have different objectives than outside shareholders and monitoring and disciplining managers is costly to the shareholders, then managerial decisions may be at odds with the decisions outside shareholders would like them to take. Gorton and Rosen (1995) explore the effect of this conflict on the risk-taking behavior of banks. To do this they develop a model of corporate control that analyses the conflict between managers and shareholders. In their model they assume that shareholders have taken steps to align the interests of managers with the objectives of the shareholders through managerial ownership of the companies' shares.

Examining banks in the U.S. with over 300 million dollars in assets and the types of loans in their portfolios and their non performing rate during 1984 to 1990, they identified Commercial and Industrial loans as the riskiest followed by real estate loans and consumer loans are the safest. They also obtained data on the ownership of outsiders that own at least five percent of the outstanding shares and the holdings of the managers. Their model sought to analyze the relationship between the share of particular loan type and the share of the firm held by insiders.

Their study found that those banks in which although managers held shares, the fraction they held was not sufficient to align their interests with those of the shareholders, had more risky loans (Commercial and Industrial and Real estate loans) and fewer relatively safe (consumer) loans. These banks were consequently less profitable. In those banks in which the managers' interests were aligned with the other shareholders such that managers held a substantial ratio of the companies' shares, there were fewer risky loans and more safer loans which resulted in greater profitability in the long term. Thus the separation of ownership and control and the resultant conflicts between management and owners make it imperative that shareholders must find appropriate incentives with which to induce managers to maximize shareholder value. This study implies that one of the ways to improve the governance of companies is by ensuring that the top management team holds a proportion of shares of their companies.

Li and Simerly (1998) also sought to explore the ownership and performance relationship and the moderating effect of environmental dynamism on this relationship. They studied 90 companies in two different industries, Food and Beverage and Computing and Electronics in the U.S. and examined their performance over a four-year period 1990 to 1993. In particular they assumed that shareholders relied on managers to manage the company on their behalf, then to align the managers' interest with theirs, these managers were given shares in the company. They therefore tested the relationship between the ownership by top management and four performance measures namely return on assets, return on equity, return on investment and operating return assets.

This was done using a moderated regression analysis with ownership by top management (measured as the shares held as a percentage of total shares for the year 1992) as the independent variable. The four performance measures (measured as an average for the four years 1990 to 1993) were the dependent variables. Various control variables such as industry effects, the firm's capital structure, and size were also introduced. The results of the study indicated that there exists a positive relationship between ownership and performance. Increased insider ownership reduces the potential conflicts between top management and shareholders and therefore leads to increased profitability. This study also confirms the implication from the Gorton and Rosen study that participation in share holding by managers serves to improve corporate governance.

Gedajlovic & Shapiro, (1998) noted that there were many studies which examined the relationship between ownership and performance. They also noted that various researchers, including Short (1994) Hunt (1986) and Vining and Boardman, (1992) (as quoted in Gedajlovic & Shapiro, 1998) who reviewed these studies, concluded that the majority of the studies find support for the hypothesis that owner-controlled firms should report higher profitability measures than manager controlled firms. However most of the studies cited used U.S. data. Among those that examined non-U.S. firms, the results were mixed. Gedajlovic and Shapiro therefore set out to determine whether the relationship between ownership and profitability varies across five countries; the U.S., Britain, Germany, France and Canada.

They noted that in the U.S. and Britain, the shares in most large firm are relatively widely held. In both countries the largest shareholders were mainly institutional investors particularly, pension funds which invest on behalf of individuals. The boards of directors in these two countries were mainly composed of managers of the companies themselves. Shareholder involvement in their companies is minimal. The level of takeover in these two countries was very high due to the inability of the owners to effectively monitor managers. Given these facts, they therefore hypothesized that in these countries higher ownership of shares by a single party will be positively related to profitability. This is because a party with greater share ownership will be able to monitor managers effectively.

On the other hand France, Germany and Canada were characterized by shareholders that are less widely dispersed. In Germany the main shareholders are companies and the banks. In Canada the dominant shareholder in most corporations are often families whereas in France, the main shareholders are non-financial institutions and the State. Such shareholders are willing and actively interact with management. Indeed the shareholders in all three countries had strong board representation. The level of takeovers in these countries was therefore very low. The hypothesis for these countries was that there is no relationship between ownership and profitability. The shareholders are already actively involved with and monitoring managers such that the level of ownership will not have an impact on the firms' profitability.

To test their hypotheses, they collected data on 1,030 publicly traded companies from the five countries. Ownership data on the percentage of total shares held by the largest shareholder was obtained. This they referred to as ownership concentration and took to be the independent variable. Performance as measured by the return on assets for the companies was taken to be the dependent variable. Various control variables were also taken into account, such as industry effects, firm size among others. Regression analysis was performed on the data obtained.

They found that there was a positive and significant relationship between ownership concentration and profitability in the U.S. In Britain, however, this relationship was positive only at very high levels of ownership concentration. In France and Canada their findings were that there was no relationship between ownership concentration and profitability. However this relationship was found to be positive for companies in Germany. They concluded that the profitability-ownership relationship differed across countries.

In Kenya, some of the studies done have however focused on the identity of the shareholder or owner and its effect on performance. Ogeto (1994) for example compared the financial performance of public enterprises and privately owned companies to find out whether there were significant differences in their performance. Public enterprises are those whose main or only shareholder is the government. He studied the financial results of 28 companies quoted on the NSE and 28 companies from the public sector. Using these results he computed and compared average ratios for the two groups for the years 1985 to 1992. Some of the ratios computed were Return On Equity, Return on Capital Employed, Basic Earnings Power and Debt to Equity Ratio. He found that public enterprises performed poorly compared to private companies. This difference in performance was attributed to the fact that the government did not pursue profitability as aggressively as private owners. Generally, the managers of these public enterprises were not free from political interference. They were appointed for various political reasons and they tended to protect their political interests at the expense of their companies.

Although this study was not specifically focused on corporate governance, it did make an important contribution. The earlier studies reviewed suggested that to ensure good governance, companies need to have a large shareholder who has the power to appoint representatives to the board of directors and can generally ensure good corporate governance. Ogeto's study however points out that the identity of this shareholder is just as important as the extent of ownership. In Kenya there are cases where the government has substantial shareholding in companies and is able to considerably influence such companies and appoint the board of directors and even the top management team. The government should be able to enforce good governance but has not done so.

### 3.3. <u>The Board Of Directors</u>

Dalton et al (1998) on the other hand focussed on the role of the board of directors in organizations. They undertook a narrative review of various studies addressing the relationship between board composition, board leadership structure and firm financial performance. In general they found that neither board composition or board leadership structure has been consistently linked to firm financial performance. This is because some studies found that there was a positive relationship between outside directors and profitability.

Other studies found a positive relationship between inside directors and profitability. As regards the board's leadership structure, some studies found that firms with separate positions of CEO and chairman of the board outperformed those that had a joint leadership structure where the CEO was also the chairman of the board. On the other hand they noted that various companies in the U. S. had adopted a joint leadership structure. They therefore sought to provide meta-analyses of empirical studies on board composition and on board leadership structure and their relationships to firm financial performance.

"Meta-analysis is a statistical technique which, while correcting for various statistical anti facts, allows for the aggregation of results across studies to obtain an estimate of the true relationship between two variables the population. Each observed co-relation is weighted by the sample size in order to calculate the mean weighted co-relation across all of the studies involved in the analysis". (Dalton et al, 1998: pg. 277).

Board composition refers to the extent to which the composition actually captures the distinction between a board comprising directors who independent of management and specifically the Chief Executive Officer (CEO) and a board largely comprised on members of the management. Board composition was operationalized in four ways; the proportion of inside to total directors; the ratio of outside to total directors; independent and interdependent directors whereby independent directors are those who were on the board prior to the current CEO's appointment and interdependent are those appointed by the current CEO; affiliated directors and non affiliated directors where affiliated directors are those who maintain personal or professional relationships with management. Board leadership structure refers to whether or not the CEO serves simultaneously as the chairperson of the board.

Moderating variables for board composition included size of the firm, in that a small company's board is likely to have greater influence on the company whereas the opposite is true of large firms. Thus they expect the link between performance and board composition to be stronger in small firms. Another moderating variable was the nature of indicator and whether this was accounting based or market based. Whereas management has greater control over accounting based measures; they may not have as much control over market based measures.

To obtain their sample, they undertook computer aided key word searches and manual searches of relevant journals to identify empirical studies related to board composition, leadership structure and financial performance. They identified 54 empirical studies dealing with board composition and 31 studies addressing board leadership /financial performance relationship.

Using Meta analysis, they found that board composition has no effect on board performance. In addition the site of the firm and the nature of performance indicator does not affect this relationship. They also found no support for s systematic relationship between board leadership structure and firm performance. The size of the firm and the nature of performance indices have no effect on this relationship.

Denis and Denis (1995) were concerned with the effectiveness of internal control devices in generating improvements in corporate performance. Generally they hypothesized that if there internal control mechanisms are effective, there should be a great incidence of top management changes in poorly performing firms and improvements in firm performance following management changes. By internal control mechanisms, they were referring to the role of boards of directors in monitoring and disciplining poorly performing managers.

They reviewed 1,689 firms in the US to identify any changes in the composition of the top management team occurring the period 1984 to 1988. The top management team comprised either the CEO and/or chairperson of the board. Out of the 1,689 firms, 909 firms had experienced a total of 1,480 changes in top management over the period. To identify those changes that were due to poor performance or were forced resignations, they reviewed the Wall Street Journal to identify any articles describing the change. From this review they identified 110 normal retirement and 107 forced resignations and those attributed to poor performance. If not specifically stated, a resignation was classified as forced if it involved an external appointment, the departing manager leaves the firm and the departing manager is not between the ages of 64 and 66.

Using standard event- study methodology, they computed the stock price over 250 days before and after the announcement of change. They also examined changes in performance indicators such as operating income, total assets, and number of employees and capital expenditures for the 3 years before and after announcement of the change. These were compared for the two groups of companies; those with normal retirements and those with forced resignations.

Generally they found that forced top management changes are preceded by large and significant operating performance declines and followed by significant improvements in operating performance. These firms also significantly down size their operations following the management change exhibiting large and significant declines in employment, capital expenditures and total assets. They also found that the majority of forced resignations were preceded by factors such as campaigns by large block shareholders, takeover attempt, and shareholders lawsuits rather than to normal board monitoring. This study seems to suggest that although shareholders can rely on directors to monitor and remove poorly performing managers, they must also play an active role in the company.

### 3.4. Summary And Conclusion

The above studies have established that increasingly companies face a separation of ownership and control. Companies have shareholders that are widely dispersed. Consequently, the nature of the shareholders is such that they cannot be realistically expected to participate in the day-to-day running of the companies. Thus, the shareholders elect a board of directors who in turn delegate the firm's day to day operations to a management team. However the ability of the shareholders to elect and control directors is influenced by the extent of their shareholding as well as whether such shareholders are institutions or individuals. Generally, the studies have shown that where a shareholder holds a large percentage of shares of a company, such shareholder is able to closely monitor the company and ensure good governance. However the studies also show that in Kenya, if that large shareholder is the government, it does not necessarily result in good governance.

The role of the board of directors in corporate governance has also been established and in particular, the fact that the board's composition and its leadership structure would influence the effectiveness of the board. In addition, the role of the board and managers in corporate governance can be enhanced if they participated in the ownership of their companies. It is also noted that the structure of corporate governance varies from country to country and that this affects the way managers and directors are held accountable by shareholders in those countries. Countries with high ownership dispersion and low shareholder powers had boards of directors that were not independent of management. These shareholders relied on the capital markets and particularly the threat of takeovers as the main mechanism of enforcing accountability. Countries with low shareholder dispersion had high shareholder powers and boards that were representative of shareholders. Such shareholders relied on internal mechanisms and particularly the board to enforce accountability.

The studies were however not conclusive on how the leadership structure and board composition influences performance. This inconsistency may be due to the fact that the studies tried to use statistical analyses to establish a relationship. Statistical analyses can only capture quantitative factors whereas there are qualitative factors that influence the companies' performance. For example two companies may have a similar board structure as well as similarities in the board composition. However the companies may differ in that the members of the board have different skills, experiences and knowledge that ultimately influences the quality of their decisions. These two companies may well have differences in performance despite the similarities in corporate governance structures.

In Kenya, there have been various discussions on corporate governance. However, to my knowledge, no empirical study has been undertaken to establish the different factors that affect corporate governance. This study will attempt to do so by identifying such aspects of corporate governance as the extent of dispersion of shareholders, the composition of the board of directors, the leadership structure as well as the use of committees by the board of directors. These factors will be related to the performance of the companies to establish strengths or weaknesses of these corporate governance structures.

# CHAPTER FOUR

# RESEARCH METHODOLOGY

This study was concerned with the corporate governance structure prevalent in Kenya. It also sought to determine the weaknesses of these structures and to establish the extent of compliance with the CMA guidelines regarding the establishment of audit committees. The study mainly focused on the companies listed on the NSE. These are the companies where there is a separation of owners from the managers in that they have a wide range of shareholders with varying amounts of shares that are not involved in the running of the companies. Consequently, these are the companies that must address issues of corporate governance.

In terms of corporate governance structures, the main areas that the study focused on included the shareholders and the extent of their shareholding, the powers that shareholders have to vote in directors, the composition of the board of directors, the leadership structure and the use of committees by the board, particularly the audit committee. This information was sought from the financial statements of the companies and the NSE. The reason for this was that corporate governance is ultimately supposed to ensure that the board and management are taking care of the shareholder's interests. The only information that the shareholder has about the company is obtained from the annual financial report released by the company. It is from this report that the shareholder can judge whether the company is well managed or not. In fact, in Britain as was earlier pointed out, the companies listed on the London Stock Exchange are supposed to include a statement in their annual report regarding corporate governance.

Specifically, these companies are supposed to state whether they are applying the code of best practice and if not give the reasons. This study therefore used the financial statements of the companies to discern the companies' corporate governance structures.

To determine if the corporate governance structure is good or not, the study reviewed the financial performances of the quoted companies for the period 1995 to 1999. The companies' performances were compared to identify those that performed well and those that did not. Likewise the corporate governance structures of the companies were then compared. It was expected that the companies that performed well would have a different structure from those that performed poorly. However unlike the studies reviewed earlier in chapter 3, statistical analyses were not done since it would have been impossible to capture all the factors affecting performance and especially the qualitative ones. In addition, two companies may have identical structures but have totally different performances due to differences such as the qualities of their directors. Instead a narrative review of performance and corporate governance structure was done.

The following describes in detail how the study was conducted.

### 4.1. Population and Sample Selection

A list of all companies listed on the Stock Exchange as at 31st December 1999 was obtained from the Nairobi Stock Exchange as per appendix 2. This list had 56 companies whose equity was quoted on the stock exchange. One company, KPCU Ltd. had only loan stock quoted on the exchange whereas four companies Kenya Hotels Ltd., KenStock Ltd., Kenya Orchards and Chancery Investments had only preference shares floated on the exchange. These five companies were therefore excluded from the list of companies to be studied. The remaining 51 companies therefore formed the population of this study.

Since the study was concerned with performance from the years 1995 to 1999, a review of the companies, which were listed during this period, was done. From the list of 51 companies, two of the companies, Kenya Airways and Rea Vipingo were listed in 1996. Their financial statements for 1995 were available from the NSE and the companies were therefore included in the sample. Two other companies, TPS Serena and Athi River Mining were listed in 1997. Their financial statements of TPS Serena, and Athi River Mining for the year 1995 were not available. Consequently, these companies were excluded from the population of study.

One company, Theta Group, has not been actively trading. The only audited financial reports for this company was for 1995 and 1996. The other reports were not available and therefore this company was not included in the analysis. One company, Ol Pejeta Ranching was wound up in 1999. Two other companies had not submitted their audited annual reports for the year 1999. These were Hutchings Biemer, and Dunlop Kenya. For Pearl DryCleaners, their latest annual report was for 1998 and this report was not audited. These five companies were therefore excluded from the analysis. The remaining 43 companies formed the sample for this study.

### 4.2. Data Collection.

Data collection was done in stages depending on the information being gathered as follows;

Data on the shareholders and the extent of shareholding was obtained from the NSE which has classified companies as either foreign controlled or locally controlled. Companies that are foreign controlled have over fifty percent of their shareholding owned by a foreign shareholder. These companies obviously have shareholding that is not widely dispersed. For the locally controlled companies, data was obtained from the NSE regarding the top shareholders and their shareholding in the companies. To determine the powers of the shareholders to elect directors, data was obtained from the NSE on the voting rights of the shareholders.

Data on the composition of the board of directors and the leadership structure was obtained from the annual reports of the companies. The report was also reviewed to determine how the board of directors is appointed. Data on the use of audit committees was also obtained from the annual report. This is because the CMA guidelines require that companies include in the annual report a statement on the audit committee, the members of the committee and a report from the committee's chairman on the it's activities during the year. The annual report was also reviewed to determine if the companies used any other committees.

The data on the companies' financial performance was obtained from the companies' financial statements for the years 1990 to 1995. The annual accounts were obtained from the Nairobi Stock Exchange library since all quoted companies are required to avail a copy of the same to the stock exchange.

The above data was collected and summarized as per the collection instrument on appendix 1.

## 4.3. Method Of Data Analysis

The data obtained on the shareholders was analyzed using percentages to determine the extent to which the shareholding is widely dispersed. The companies were grouped depending on whether the majority shareholder had more than fifty percent of the ordinary shares of the company or less than that.

The data obtained on the composition of board of directors was analyzed using percentages to determine the proportion of directors who were executive and those who were non-executive. Likewise percentages were used to determine the number of companies with a joint leadership structure of the board and those with a separate structure. Content analysis was performed to determine the way the companies appointed new members to the board. With respect to the use of audit committees, the analysis done was to identify how many of the companies had established committees as per the CMA requirements. Comparisons were done to determine the extent to which the companies had adhered to the CMA guidelines in the areas of size of the committee, membership, and any reports issued by the committee.

With respect to company performances, financial analysis was undertaken. In particular, financial ratios were computed so as to facilitate comparison by adjusting for size. As was mentioned earlier in chapter 2 of this study, good corporate governance is about leadership for efficiency and effectiveness. Consequently two types of ratios were computed to judge the companies' efficiency and effectiveness. These were Activity ratios, which are used to evaluate the firm's efficiency in managing and utilizing its assets and Profitability ratios, which measure the operating efficiency of a company. In particular the following ratios were computed;

1) Activity Ratios:

a) Total Assets Turnover (TAT): this ratio measures how well the management has been using their assets to generate sales and was computed as follows;

$$TAT = \frac{\text{Turnover}}{\text{Total Assets}}$$

b) Fixed Assets Turnover (FAT) $= \frac{\text{Turnover}}{\text{Fixed Assets}}$

2) Profitability Ratios:

a) Net Profit Margin (NPM): This ratio is an indication of how well a company is able to turn sales into profit. It also indicates the firm's capacity to withstand adverse economic conditions. Firms with a high net profit margin will be able to survive in the face of such adverse conditions such as falling prices or declining demand of their products. The ratio was computed as follows;

$$NPM = \frac{\text{Net Profit}}{\text{Turnover}}$$

b) Return on Shareholder's Equity (ROE). This ratios measures how well how management has utilized the owner's equity and was computed as follows;

$$ROE = \frac{\text{Net Profit}}{\text{Shareholder's Equity}}$$

c) Return on Capital Employed (ROCE).

$$ROCE = \frac{\text{Net Profit}}{\text{Total Capital Employed}}$$

The ratios were computed for the five years from 1995 to 1999 for each company. Five-year averages were then computed. To facilitate comparison, the companies were grouped into four sectors depending on their primary activity. These sectors are the same ones used by the NSE to classify the companies and they are Agricultural, Financial, Commercial and Industrial Sectors. This was done because each sector and industry operates under different circumstances that affect its performances. Comparisons of companies across sectors would therefore be misleading. Inter firm analysis was thereafter done by comparing the performances of firms within the same sector. In addition, industry analysis was done by comparing each company's performance with the average ratios of the industry/ sector to which the firm belongs. This comparison indicated the relative financial position and performance of the firm and allowed the identification of the good performers and the poor performers. The corporate governance structures of the companies were then compared to determine whether there were differences in the governance structures of the good and poor performers. This comparison was used to determine whether there is one best corporate governance structure that leads to better performance.

# CHAPTER FIVE

# DATA ANALYSIS

## 5.1. The extent of dispersion of shareholders.

As was earlier mentioned, information was obtained from the NSE as to which of the companies were foreign controlled and which were locally controlled. This information indicated that out of the sample 43 companies, 13 of them were foreign controlled. Of the remaining 30 locally controlled companies, data was obtained on the largest shareholder and the percentage held as at the end of 1999 from the NSE. However not all the local companies had provided this information to the NSE. Only 23 of the sample companies had done so. An analysis of these 23 companies indicated that 7 of them had the largest shareholder holding over 50 percent of the companies' shares. Of these Kenya National Mills, Marshalls and Firestone had the shareholder with the largest percentage of shares at 77 percent, 66 percent and 63 percent respectively. 14 of them had the largest shareholder holding between 20 and 50 percent of the total shares. Two of the companies had the largest shareholder holding less than 20 percent of the shares. These two companies were Uchumi Supermarkets and Pan Africa where the largest shareholder held 19 percent and 14 percent of the shares respectively.

Table 1 presents a summary of the extent of shareholding among the quoted companies. From the table, it can be seen that the share ownership of the companies is not widely dispersed. This is because in 46 percent of the sample companies the largest shareholder controls over 50 percent of the shares whereas in 38 percent of the companies the largest shareholder controls between 15 and 50 percent of the shares.

| TABLE 1: Percentage Shareholding Held By The Largest Shareholder | | |
|---|---|---|
| **Percentage of shares held by the largest shareholder** | **No. of Companies** | **Percentage of Total Companies %** |
| **Foreign Control:** Over 50% | **13** | **30%** |
| **Local Control** Over 50% | 7 | 16% |
| 20% to 50% | 14 | 33% |
| Less than 20% | 2 | 5% |
| **Total** | **23** | **54%** |
| **Companies for which data was unavailable** | **7** | **16%** |
| **TOTAL** | **43** | **100%** |

During the review of the annual reports an observation was made that 7 of the companies had indicated who their principal shareholders were and their shareholding. These were Brookebond, Kakuzi, Limuru Tea, Sasini, Kenya Airways, Firestone and Crown Berger. Of these, Brookebond, Limuru Tea and Crown Berger are foreign controlled and the largest shareholder controls 88 percent, 52 percent and 64 percent of the ordinary shares respectively. One of these companies, Kakuzi, had also indicated the shareholding held by the directors although in total the directors held less than one percent of the total shares of the company. Kenya Airways had also given a breakdown of the shareholding and indicated the total number of local and foreign institutions and individuals and the total percentage of shares held by them.

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It was also observed that some of the companies held controlling shares in others. These included Brookebond, which had 52 percent of the shares of Limuru Tea and Unga, which held 78 percent of the shares of Kenya National Mills. Consequently, Brookebond had common directors with Limuru Tea as did Unga and Kenya National Mills. This seems to confirm that the largest shareholder can easily control the board of directors.

## 5.2. Shareholder Powers (Voting Rights)

A review of these companies' voting rights indicated that except for two companies Kenya Power &Lighting Co.(KPLC) and Kenya Oil (Kenol), only ordinary shareholders were entitled to vote during the AGM with one share having one vote. In KPLC, ordinary shareholders had one vote per share held whereas the preference shareholders were entitled to one vote per share on a show of hands and one vote per ten shares held on a poll. In Kenol, the ordinary shareholders had one vote per share. However the company had issued two management shares whose holders were entitled to 2.9 times as many votes as all the ordinary shareholders. Except in the case of Kenol, therefore, the largest shareholder in all the other companies has control over who gets elected to the board of directors especially since they control such a large percentage of the companies' shares. In the case of Kenol, the company had disclosed the voting rights in the annual report and indicated that the management shares are held by a council of trustees.

Given the above, it can be concluded that the largest shareholder has sufficient powers to easily elect their representative to the board of directors and ultimately enforce good governance in their companies.

### 5.3. The Board of Directors

In general, the members of the board seemed to reflect the shareholding. For example, in six of the local companies, the government or a parastatal held a substantial percentage of the shares. These companies included Kenya Airways in which the government held 23 %, Uchumi in which Kenya Wine Agencies Ltd. held 19 %, and Housing Finance Co. of Kenya where the National Social Security Fund (NSSF) holds 11%. The NSSF also holds 48% of the shares in National Bank and 27% in E. A. Portland Cement. Others were I.C.D.C. and Kenya Commercial Bank (KCB) in which the government holds 23% and 35% respectively. In all of these companies, one or more of the directors were government representatives such as permanent secretaries of various ministries. In fact these companies experienced changes in the board members whenever there were changes in government. For instance, whenever a permanent secretary was replaced, his position on the board would be taken by the new holder of office.

A review of the size of the board indicated differences in the companies. The CMA in its guidelines on audit committees has suggested that the committee should have between 3 and 5 members. A board with only three members would not be able to form an effective committee. Likewise a small board may not be able to effectively make use of different committees. Among the 43 sample companies, there were differences with some of the companies, such as Eaagads having as few as three directors and others such as Bamburi having as many as 16 directors. However 70 percent of the sample companies had between five and 10 directors whereas 16 percent had between 11 and 15 directors as indicated by Table 2.

| Table 2: Summary Of The Size Of The Board Of Directors As At The End Of 1999 | | |
|---|---|---|
| **Size of the board** | **Number of companies** | **Percentage %** |
| Less than 4 directors | 5 | 12% |
| 5 to 10 directors | 30 | 70% |
| 11 to 15 directors | 7 | 16% |
| More than 16 directors | 1 | 2% |
| **TOTAL** | **43** | **100%** |

With respect to the board leadership structure, as per the annual report for 1999, in 42 of the sample companies, the position of chairman of the board was held by a different person from the managing director. Only one company, Kenya Commercial Bank, had combined the role of chairman of the board with the chief executive as at the end of 1999. However this company had indicated its intention to separate the two positions in the year 2000. Thus as regards leadership structure of the board, the companies had a separate leadership structure. This structure is assumed to enhance the independence of the board and makes it more effective in discharging its monitoring role.

There was a difficulty in evaluating which of the directors were executive and which were not since not all companies specifically identify them in the annual report. All the companies had identified which of the directors was the chairman of the board and which one was the managing director or chief executive.

Only six companies had provided this information in the annual report. These were Diamond Trust Jubilee Insurance, BAT., Firestone and East Africa Breweries. Table 3 below indicates the proportion of directors in these companies who were executive and those who were non-executive.

| Table 3: Summary Of Executive And Non Executive Directors | | | | | | |
|---|---|---|---|---|---|---|
| **Name Of Company** | **Executive Directors** | | **Non Executive Directors** | | **Total Number Of Directors** | |
| | **Number** | **Percentage** | **Number** | **Percentage** | **Number** | **Percentag e** |
| Diamond Trust | 2 | 17% | 10 | 83% | 12 | 100% |
| Jubilee Insurance | 4 | 36% | 7 | 64% | 11 | 100% |
| B.A.T. | 4 | 57% | 3 | 43% | 7 | 100% |
| Firestone | 3 | 60% | 2 | 40% | 5 | 100% |
| East Africa Breweries | 4 | 44% | 5 | 56% | 9 | 100% |

As can be seen from Table 3, in three of the companies, the non-executive directors were more than the executive directors. This would indicate that the board is independent from management and would therefore be able to monitor the activities of management on behalf of shareholders. East Africa Breweries, was the only company that had a specific statement regarding corporate governance. Their annual report stated that the non-executive directors were satisfied that they had received all the information pertinent to their work from the executive directors during the year.

Of the 43 companies, only one company, Rea Vipingo had given details about their directors' qualification and other directorships they hold in the annual Report..

### 5.4. The Use Of Audit Committees

Only 12 companies had established audit committees representing 28 percent of the sample companies. These companies had formed the audit committees during 1999, as there was no mention of the same in the earlier annual reports. These have been indicated in Table 4.

Rea Vipingo had indicated that the audit committee comprised three members and stated who the members were. BAT had the largest size of audit committee comprising nine members. Of these, 5 were members of the board of directors whereas 4 were members of staff in the organization. Of the five directors, 2 were non-executive and 3 were executive directors. However Kakuzi and Sasini made no mention of who the members of the committee were neither did they indicate the size of the committee. Pan Africa Insurance also had an audit committee but the annual report did not indicate the size or the members of the committee. National Bank and Firestone also did not give an indication of who the members of the audit committee were. East Africa Breweries also did not state the members of the committee. Instead, the company stated that the committee comprised non-executive members of the board and other professionals who are independent of the day to day management.

None of the companies had included a comprehensive report of the work of the committee. Instead all the companies had a general statement indicating that the committee was responsible for the internal control systems of the company and was to deal with all matters relating to the financial statements in conjunction with the independent auditors. There was no report from the chairman of the audit committee detailing the work of the committee during the year as per the CMA guidelines.

| **Table 4: The Use of Audit Committees Used By The Companies** | |
|---|---|
| **Company** | **Size Of The Committees** |
| Rea Vipingo | 3 Members |
| Kakuzi | Not Indicated |
| Sasini | Not Indicated |
| NIC Bank | 3 Members |
| Kenya Commercial Bank | 5 Members |
| Jubilee Insurance | 4 members |
| HFCK | 3 Members |
| Pan Africa Insurance | Not Indicated |
| National Bank | Not Indicated |
| Firestone | Not Indicated |
| Kenya Breweries Ltd. | Not Indicated |
| BAT K. Ltd. | 9 Members |

### 5.5. The Use of Other Committees

Two companies, National Bank and Jubilee Insurance made use of other committees as shown by Table 5. National Bank made use of three other committees and in its report indicated the role of the different committees. The credit committee was charged with monitoring of loans and approval of loans exceeding the management's' limit. The finance committee was responsible for review and evaluation of the bank's financial management and its financing policies. However the bank did not give an indication of who the members of the various committees were and there was no statement regarding the results of their work. Jubilee

Insurance did not indicate the role of the committees and did not issue any report on their work.

| Table 5: Other Committees Used by The Companies | |
|---|---|
| **COMPANY** | **NAME & SIZE COMMITTEE** |
| Jubilee Insurance | ξ EXECUTIVE(5 Members)<br>ξ FINANCE(5 Members)<br>ξ STRATEGY REVIEW (3 Members)<br>ξ SENIOR MANAGEMENT REMUNERATION(3 Members) |
| National Bank | ξ FINANCE<br>ξ CREDIT<br>ξ STAFF |

### 5.6. Other Observations: Disclosure of Information

All the companies whose year ends were 31st December 1999, had adopted the International Accounting Standards in the preparation of their annual accounts. A review of the reports for these companies indicated certain changes arising from the use of the IAS. One of these was the requirement for companies to include in the statement to the accounts details of staff costs, including how much is paid for salary and other statutory deductions. The companies are also required to disclose the number of staff working for the companies. The companies were also required to disclose any retirement benefit scheme set up for employees and indicate who was running the scheme. There was also disclosure of related party transactions, although this was a general statement that the transactions arose in the normal course of business.

## 5.7. Review Of Financial Performance

### 5.7.1. Agricultural Sector

FIGURE 1: 5 YEAR AVERAGE TOTAL ASSETS AND FIXED ASSETS TURNOVERS FOR AGRICULTURAL SECTOR

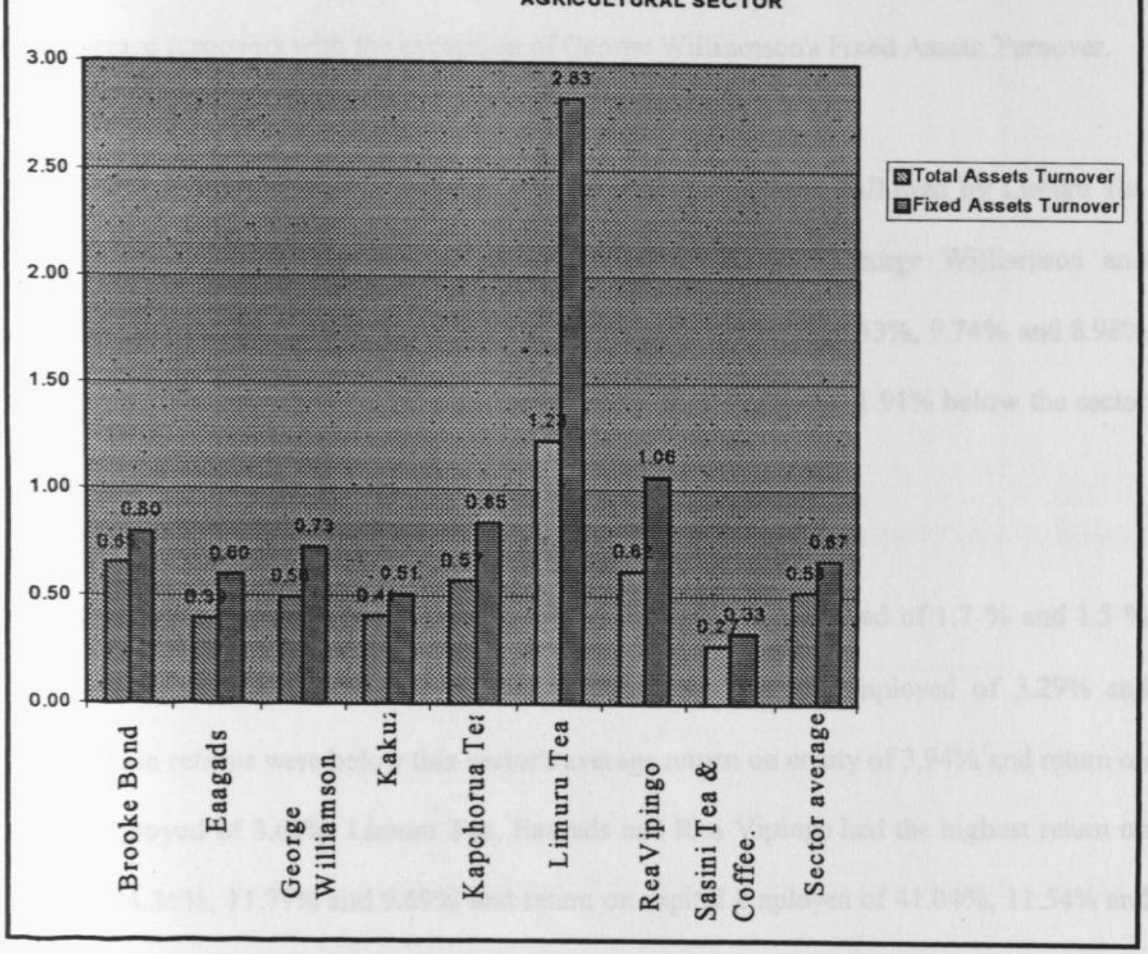



Figure 1. above shows the asset turnovers of the companies in this sector. In this sector, Limuru Tea Co. had the highest Total Assets and Fixed Assets Turnover at 2.83 and 1.23 well above the sector's average of 0.53 and 0.67 respectively. Brookebond, Rea Vipingo and Kapchorua also had above average Total Assets Turnovers of 0.65, 0.62 and 0.57 respectively. These companies posted Fixed Assets Turnovers of 0.80, 1.06, and 0.85

respectively. The companies with the worst turnovers were Sasini, Eaagads, Kakuzi and George Williamson, which had Total Assets Turnovers of 0.27, 0.39, 0.41, and 0.50, and Fixed Assets Turnovers of 0.33, 0.0.60, 0.51, and 0.73 respectively. These companies had below average turnovers with the exception of George Williamson's Fixed Assets Turnover.

In terms of Net Profit Margins, Eaagads was the leading company, followed by Limuru Tea with margins of 26% and 24% respectively. Sasini, Kakuzi, George Williamson and Kapchorua also had above average Net Profit Margins of 11.20%, 10.43%, 9.74% and 8.98% respectively. The worst performer was Brookebond, with margin of 1.91% below the sector average of 5.70 %.

Brookebond also had the worst returns on equity and capital employed of 1.7 % and 1.5 % respectively. Sasini also had poor returns on equity and capital employed of 3.29% and 3.22%. These returns were below this sector's average return on equity of 3.94% and return on capital employed of 3.62%. Limuru Tea, Eaagads and Rea Vipingo had the highest return on equity of 44.36%, 11.79% and 9.69% and return on capital employed of 41.04%, 11.54% and 8.85% respectively.

The Net Profit Margins. Return on Equity and Return on Capital Employed for this sector have been summarized in Figure 2 below.

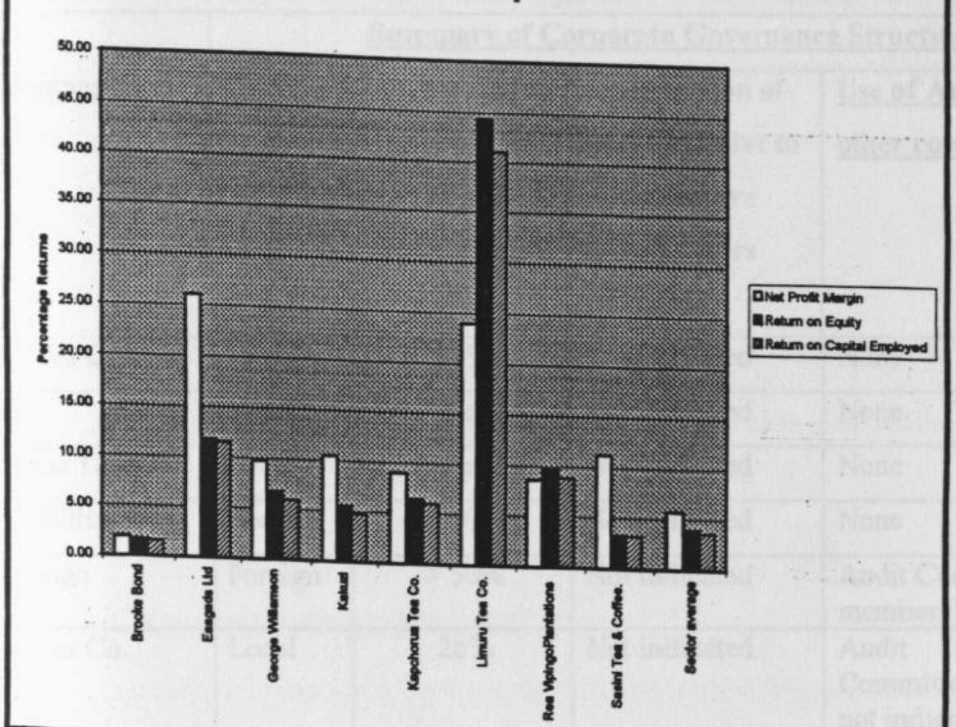



**FIGURE 2:5 Yr. Profitability Ratios For the Agricultural Sector Companies**

From the above analysis, it is clear that the best performing companies were Limuru Tea, Eaagads and Kapchorua. These companies had relatively high turnovers and returns indicating efficiency in utilization of their assets, equity and capital employed. The worst performers were Brookebond, Sasini and Kakuzi. Table 6 gives the companies listed in order of their performance and a summary of their corporate governance structures.

| **Table 6: List of Companies in the Agricultural Sector in Order Of Performance and a Summary of their Corporate Governance Structure** | | | | |
|---|---|---|---|---|
| **Company** | **Summary of Corporate Governance Structure** | | | |
| | **Control** | **Percentage held by the Largest Shareholder %** | **Proportion of non executive to executive directors %** | **Use of Audit and other committees** |
| Limuru Tea Co. | Foreign | 52% | Not indicated | None |
| Eaagads | Local | Not available | Not indicated | None |
| Kapchorua Tea Co. | Local | Not available | Not indicated | None |
| George Williamson | Local | 50% | Not indicated | None |
| Rea Vipingo | Foreign | > 50% | Not indicated | Audit Committee(3 members) |
| Kakuzi Tea Co. | Local | 26% | Not indicated | Audit Committee(members not indicated) |
| Sasini | Local | 42% | Not indicated | Audit Committee(members not indicated) |
| Brookebond | Foreign | 88% | Not indicated | None |

Except for Eaagads and Kapchorua, all the other companies have the largest shareholder holding a substantial percentage of the companies' shares. It was therefore not possible to evaluate the effect of dispersion of shareholders on performance. In fact the worst performer had the largest shareholder holding 88 % of the total shareholding. Presumably this shareholder should have been able to enforce good governance which should have resulted in good performance. In addition, Brookebond was the majority shareholder of Limuru Tea the best performer, holding 52 % of the total shares.

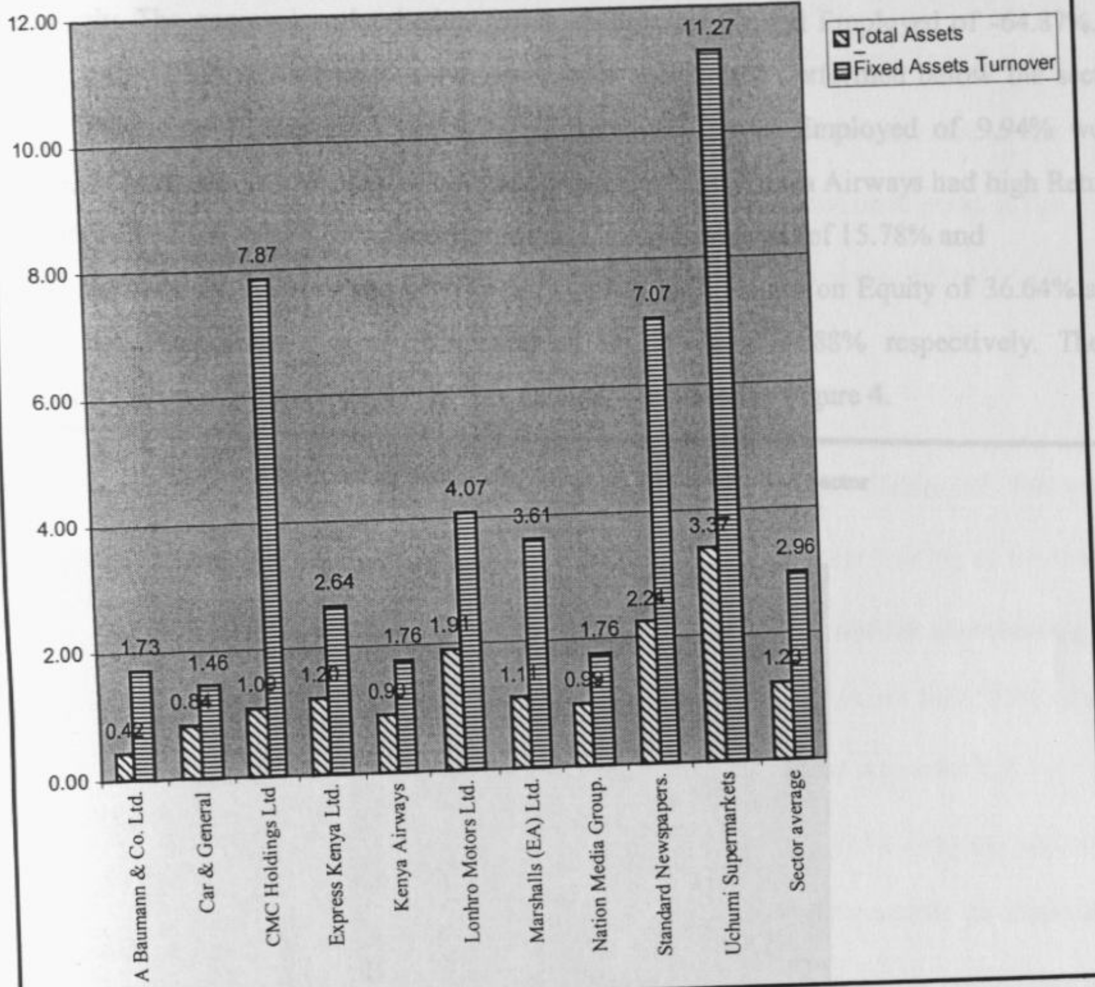
These companies had not indicated the composition of the board and the proportion of directors who were executive and those who were not. It was therefore not possible to evaluate whether increased board independence leads to good performance. All the companies had separated the position of chairman from that of the chief executive.

With respect to the use of committees, the best performers did not use any. In fact Brookebond, the worst performer is the one that made use of an audit committee. However since the company established the committee during the year 1999, it is unlikely that the impact would have been felt.

### 5.7.2. Commercial and Services Sector.

In this sector, Uchumi and Standard Newspapers had the highest Total Assets Turnover at 3.37 and 2.24 well above the sector average of 1.23. These companies also had high Fixed Assets Turnovers at 11.27 and 7.07 respectively compared to the sector average of 2.96. CMC Holdings had a high Fixed Assets Turnover of 7.87 but the Total Assets Turnover for this company was 1.09 which was below this sector's average. A. Baumann, and Car & General posted poor Total Assets and Fixed Assets turnovers of 0.42 and 0.84 in the case of Total Assets Turnover and 1.73 and 1.46 in the case of Fixed Assets Turnover respectively. The Fixed Assets and Total Assets Turnover for the companies in the Commercial Sector are summarized in figure 3.

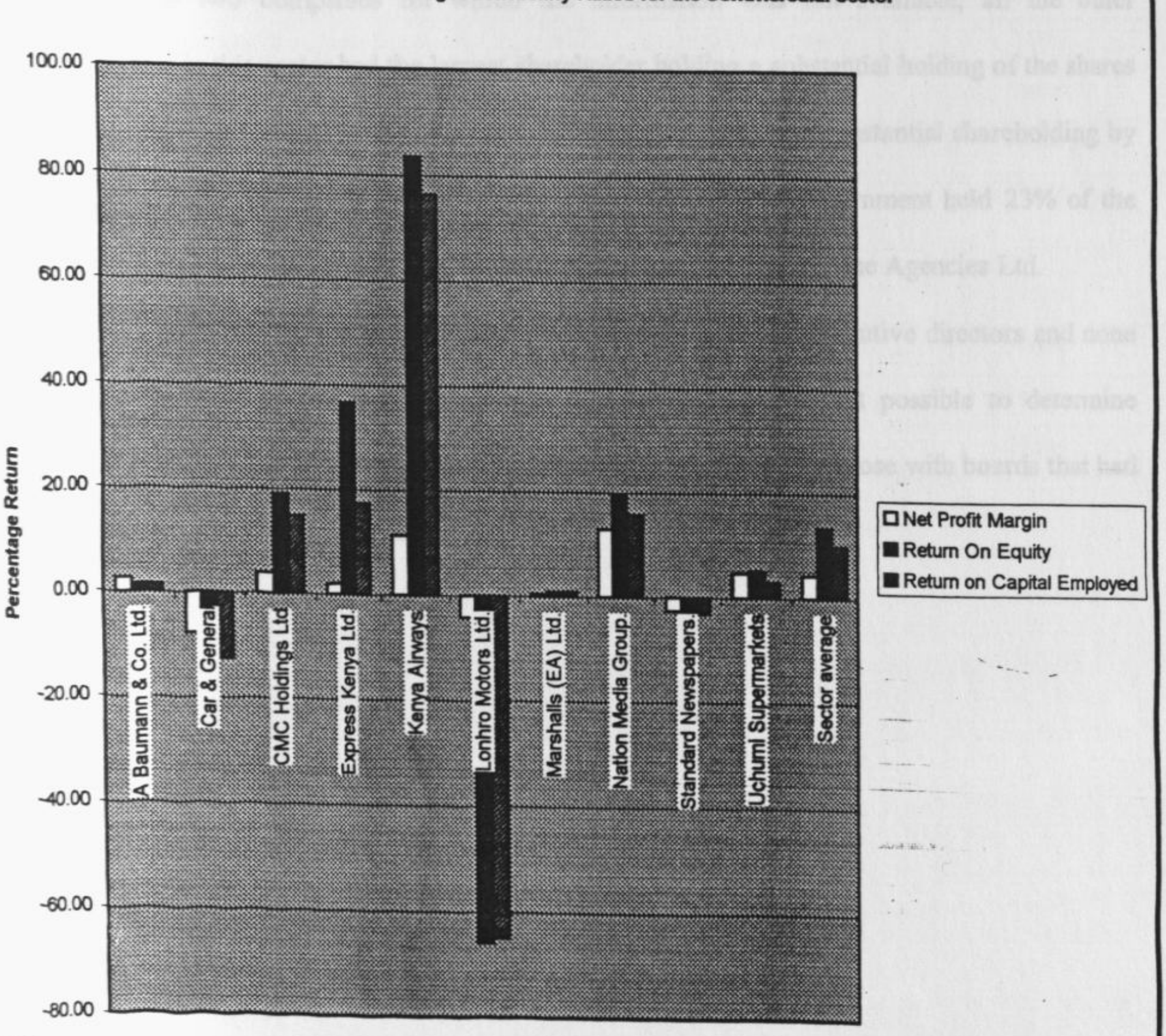
FIGURE 3: 5 YEAR AVERAGE TOTAL ASSETS TND FIXED ASSETS TURNOVER FOR COMMERCIAL




In terms of Net Profit Margins, three companies in this sector had negative margins. These were Lonrho Motors, Car & General and Standard Newspapers which had Net Profit Margins of -4.14%, -7.78% and -2.55% respectively. The leading performers were Nation Media Group and Kenya Airways with Net Profit Margins of 12.91% and 11.41% respectively. All the other five companies in this sector had Net Profit Margins that were below the sector's average of 4.76%. These were Uchumi (4.70%), CMC Holdings (3.87%), A. Baumann (2.59%), Express (1.98%) and Marshalls (0.43%).

With respect to the Return on Equity, three companies, Lonrho Motors, Car & General and Standard Newspapers had negative Returns on Equity of -65.84%, -12.36% and -3.18% respectively. The companies also had negative Returns on Capital Employed of -64.87%., -12.64% and -3.08% respectively. Other companies which had performed below the sector average Return on Equity of 13.52% and Return on Capital Employed of 9.94% were Uchumi, A Baumann and Marshalls. Nation Newspapers and Kenya Airways had high Return on Equity of 19.56% and 83.55%, and Return on Capital Employed of 15.78% and 76.48% respectively. Express and CMC Holdings had high Return on Equity of 36.64% and 19.11% and Return on Capital Employed of 17.37% and 14.88% respectively. These profitability ratios for the companies in this sector are included in Figure 4.

Figure 4: 5 Year Average Profitability Ratios for the Commercuial Sector



From the above analysis it can be seen that the companies have mixed performances in that whereas some high activity ratios they at the same time have low profitability ratios. For example, Uchumi has the highest activity ratios in this sector but at the same time has an average performance in terms of profitability ratios relative to the other companies in this sector. In determining the best performance therefore, consideration has been given to the overall performance. Table 7 shows the companies in this sector ranked according to overall performance and summarizes their corporate governance structure.

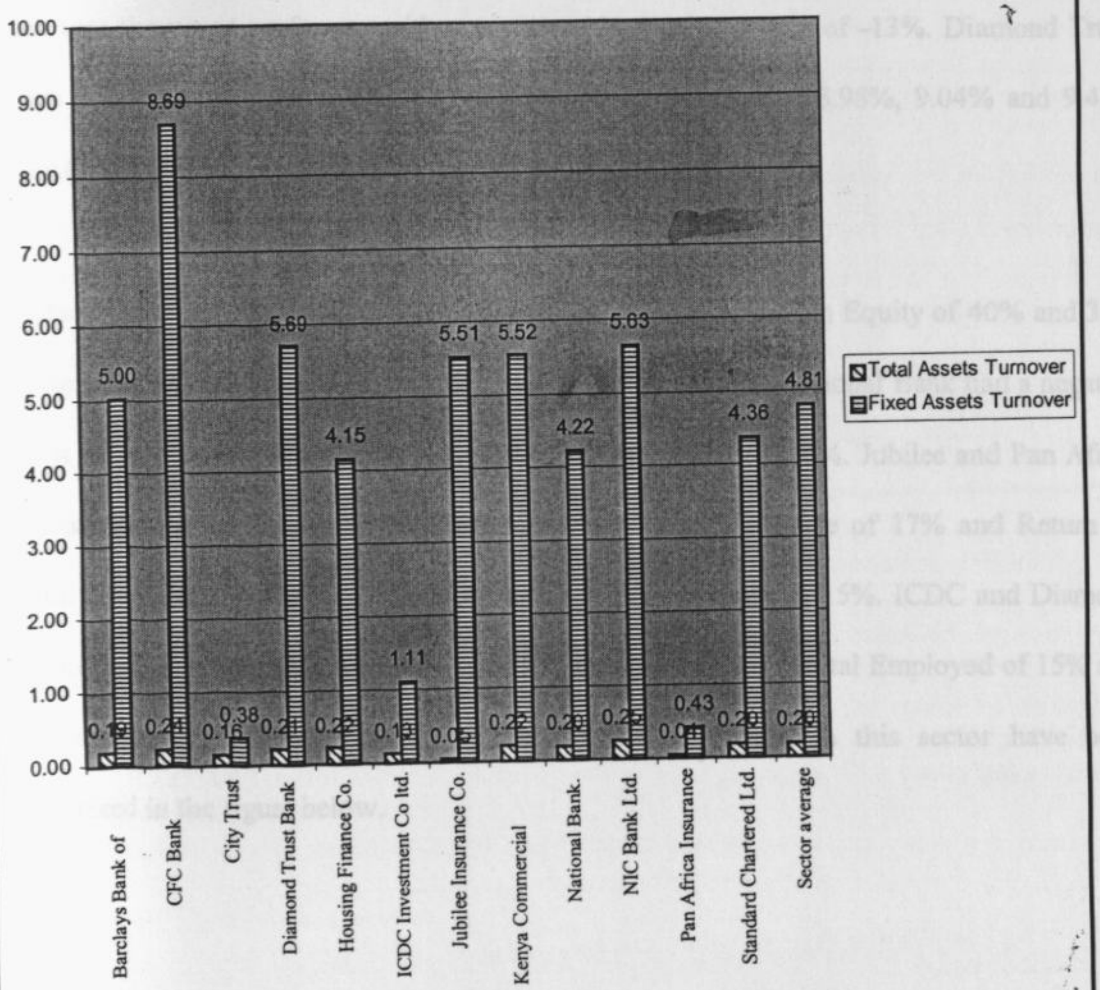
Except for two companies for which the information was not available, all the other companies in this sector had the largest shareholder holding a substantial holding of the shares of the company. In fact in the two leading companies, there was substantial shareholding by the government or a public enterprise. In Kenya Airways the government held 23% of the shares whereas in Uchumi, 19% of the shares were held by Kenya Wine Agencies Ltd.
None of these companies had indicated their executive and non-executive directors and none made use of audit or other committees. Consequently, it was not possible to determine whether companies with independent boards performed better than those with boards that had a majority of their members being executive.

| Table 7: List of Companies in the Commercial Sector in Order Of Performance and a Summary of their Corporate Governance Structure | | | | |
|---|---|---|---|---|
| | Summary of Corporate Governance Structure | | | |
| Company | Control | Percentage held by the Largest Shareholder % | Proportion of non executive to executive directors % | Use of Audit and other committees |
| Uchumi | Local | 19% | Not indicated | None |
| Kenya Airways | Local | 26% | Not indicated | None |
| Nation Newspapers | Local | 45% | Not indicated | None |
| Express K. Ltd. | Local | 50% | Not indicated | None |
| CMC Holdings | Local | Not available | Not indicated | None |
| Standard Newspapers | Foreign | > 50% | Not indicated | None |
| Marshalls | Local | 66% | Not indicated | None |
| A. Baumann | Foreign | > 50% | Not indicated | None |
| Lonrho Motors | Foreign | > 50% | Not indicated | None |
| Car & General | Local | Not available | Not indicated | None |

### 5.7.3. The Financial Sector

The companies with the highest Total Assets and Fixed Assets turnovers in this sector included CFC Bank, Diamond Trust and NIC bank. These companies had Fixed assets Turnovers of 8.69, 5.69, and 5.63 and Total Assets Turnovers of 0.24, 0.21 and 0.25 respectively.

FIGURE 5: 5 YEAR AVERAGE TOTAL ASSETS AND FIXED ASSETS TURNOVER FOR THE FINANCIAL SECTOR

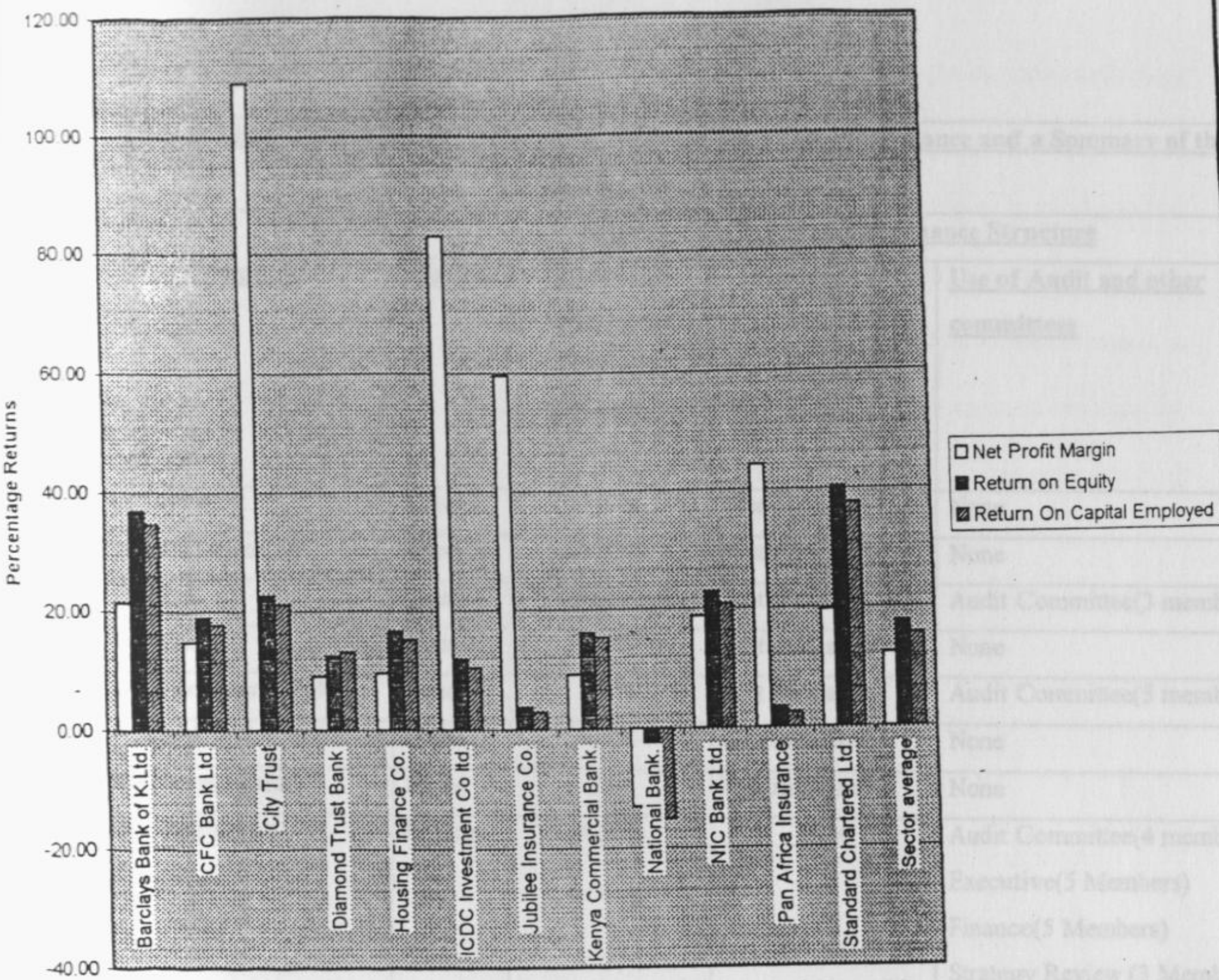


Companies that performed poorly included Pan Africa, City Trust, and ICDC Investments which had Total Assets Turnovers of 0.04, 0.16 and 0.13 compared to the sector average of 0.20 and Fixed Assets Turnovers of 0.43, 0.38, and 1.11 respectively compared to the sector average of 4.81. The Figure above shows the Total Assets and Fixed Assets Turnovers of the companies in this sector

In terms of profitability ratios, City Trust had the highest Net profit margin in this sector of 109%. ICDC and Pan Africa also had high Net Profit Margins of 82% and 44% respectively. It is also noted that these were the same companies which had poor activity ratios. National Bank was the worst performer with a negative Net Profit Margin of -13%. Diamond Trust, Kenya Commercial Bank and HFCK had Net Profit Margins of 8.98%, 9.04% and 9.48% respectively which was below this sector's average of 12.35%.

Standard Chartered and Barclays Bank posted the highest Return on Equity of 40% and 36% and Return on Capital Employed of 37% and 34% respectively. National Bank had a negative Return on Equity of -20% and Return on Capital Employed of -15%. Jubilee and Pan Africa also had Return on Equity of 3% each below the sector's average of 17% and Return on Capital Employed of 2% each compared to the sector's average of 15%. ICDC and Diamond Trust had a Return on Equity of 11% and 12% and a Return on Capital Employed of 15% and 13% respectively. The profitability ratios for the companies in this sector have been summarized in the figure below.

Figure 6: 5 year Average Profitability Ratios for the Financial Sector




An overall review of the companies in this sector shows that companies such as Barclays and Standard had consistent activity ratios and profitability ratios compared to the other companies in the sector. National Bank had poor overall performance because they had below average activity ratios while their profitability ratios were negative. The Table below shows the companies in this sector in order of their overall performance and gives a summary of their corporate governance structure.

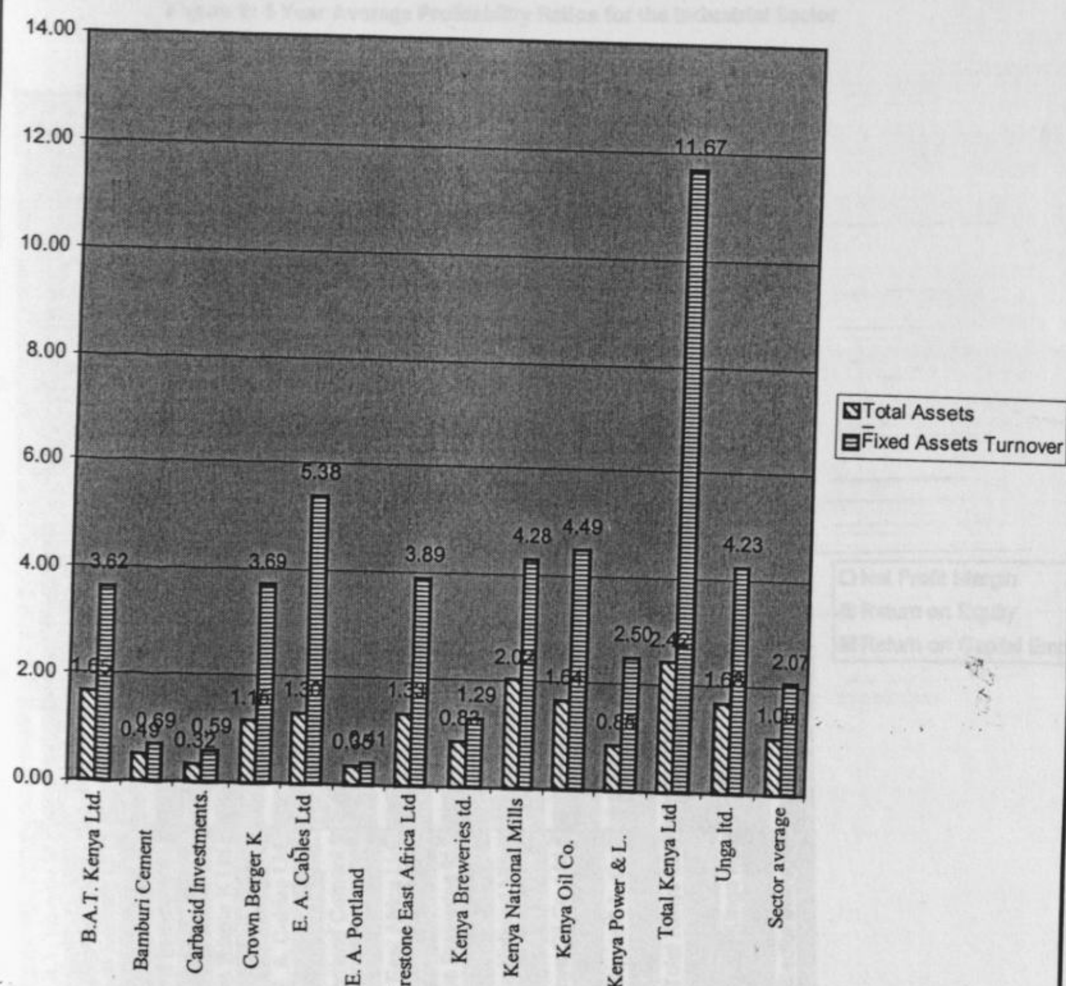
| **Table 8: List of Companies in the Financial Sector in Order Of Performance and a Summary of their Corporate Governance Structure** | | | | |
|---|---|---|---|---|
| | **Summary of Corporate Governance Structure** | | | |
| **Company** | **Control** | **Percentage held by the Largest Shareholder %** | **Proportion of non executive to executive directors %** | **Use of Audit and other committees** |
| Barclays Bank | Foreign | > 50% | Not indicated | None |
| Standard Chartered | Foreign | > 50% | Not indicated | None |
| NIC Bank | Local | Not available | Not indicated | Audit Committee(3 members) |
| City Trust | Local | 50% | Not indicated | None |
| Kenya Commercial Bank | Local | 35% | Not indicated | Audit Committee(5 members) |
| CFC Bank | Local | 46% | Not indicated | None |
| ICDC Investments | Local | 23% | Not indicated | None |
| Jubilee Insurance | Foreign | > 50% | 64% | Audit Committee(4 members)<br>Executive(5 Members)<br>Finance(5 Members)<br>Strategy Review (3 Members)<br>Senior Management Remuneration(3 Members) |
| HFCK | Local | 30% | Not indicated | Audit Committee(3 members) |
| Diamond Trust | Local | 23% | 83% | None |
| Pan Africa Insurance | Local | 14% | Not indicated | Audit Committee(members not indicated) |
| National Bank | Local | 88% | Not indicated | Audit Committee(members not indicated)<br>Finance<br>Credit<br>Staff |

A review of the corporate governance structures as summarized in Table 8 shows that the all the companies have a large shareholder. Only two companies in this sector had indicated their directors and whether they were executive or non executive. These companies' boards were independent given that the non-executive directors were the majority. However these companies did not necessarily perform well compared to the other companies in the sector. The good performers do not make use of audit committees. In fact it seems it is poor performers that have audit committees. These committees seem to have been formed in response to the poor performance of the companies. However it is too soon to evaluate the effectiveness of the committees in improving performance given that the committees were established in 1999.

### 5.7.4. <u>The Industrial Sector</u>

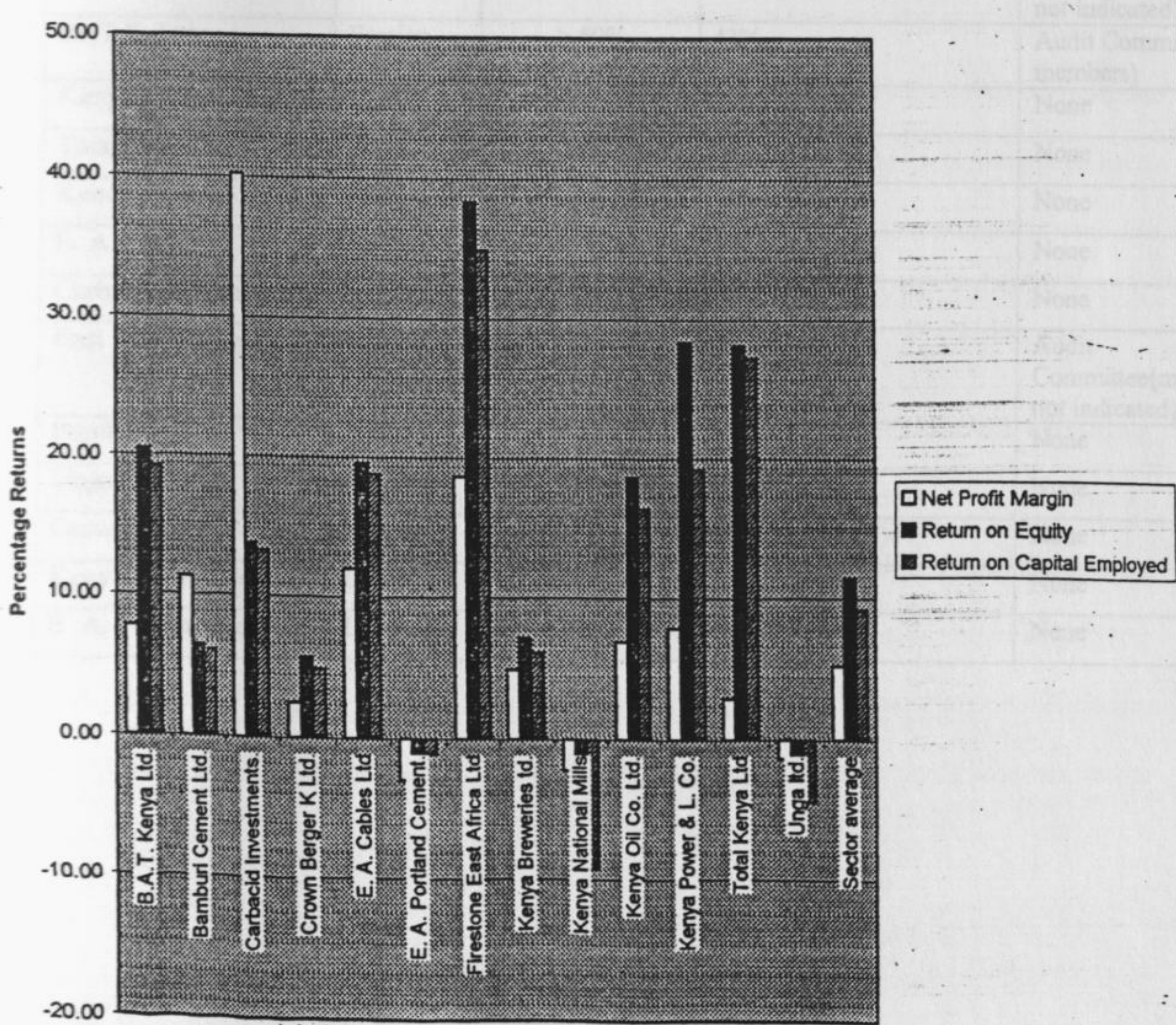
In this sector, the companies with the highest Total Assets Turnovers were Total and BAT which had turnovers of 2.42 and 1.65 respectively. These companies also had high Fixed Assets Turnovers of 11.67 and 3.62 respectively. East Africa Cables and Kenya Oil Co. also had high Fixed Assets Turnovers of 5.38 and 4.49 respectively. The worst performers were E.A. Portland Carbacid and Bamburi which had below average Fixed assets and Total Assets Turnovers. The activity ratios for the companies in this sector are shown in the figure below.

FIGURE 7: 5 YEAR AVERAGE TOTAL ASSETS AND FIXED ASSETS TURNOVER FOR INDUSTRIAL SECTOR



With respect to the Net Profit Margins, three companies in this sector, E. A. Portland Cement, Kenya National Mills and Unga Ltd had negative margins of -2.95%, -2.22% and -1.32% respectively. These companies also had negative Returns on Equity of -5.11%, -9.43% and -4.51% and negative Returns on Capital Employed of -1.11%, -9.26% and -4.4% respectively. Carbacid had the highest Net Profit Margin of 40% whereas Firestone had a Net Profit Margin of 18%. Firestone had the highest Return on Equity of 38 % and Return on Capital Employed of 34%. Kenya Power, Total and B.A.T also had high Returns on Equity of 28.37%, 28.12% and 20.5% and Returns on Capital Employed of 19.21%, 24.24% and 19.19% respectively. The figure below indicates the profitability ratios for the companies in this sector.

Figure 8: 5 Year Average Profitability Ratios for the Industrial Sector



An overall review of performance shows that the best performers in this sector are Firestone and BAT whereas the poor performers include Kenya National Mills and E. A. Portland. The Table below shows the companies in this sector and gives a summary of their structure.

**Table 9: List of Companies in the Financial Sector in Order Of Performance and a Summary of their Corporate Governance Structure**

| Company | Summary of Corporate Governance Structure | | | |
|---|---|---|---|---|
| | Control | Percentage held by the Largest Shareholder % | Proportion of non executive to executive directors % | Use of Audit and other committees |
| Firestone | Local | 64% | 40% | Audit Committee(members not indicated) |
| BAT K. Ltd. | Foreign | > 50% | 43% | Audit Committee(9 members) |
| Kenya Power Lighting | Local | Not available | Not indicated | None |
| Total K. Ltd. | Local | Not available | Not indicated | None |
| Kenol | Local | Not available | Not indicated | None |
| E. A. Cables | Foreign | > 50% | Not indicated | None |
| Carbacid Investments | Local | 42% | Not indicated | None |
| East Africa Breweries | Local | 40% | 56% | Audit Committee(members not indicated) |
| Bamburi | Foreign | > 50% | Not indicated | None |
| Unga | Local | 60% | Not indicated | None |
| Crown Berger | Foreign | > 50% | Not indicated | None |
| Kenya National Mills | Local | 77% | Not indicated | None |
| E. A. Portland Cement | Local | 88% | Not indicated | None |

Except for three companies whose ownership details are not available, all the other companies had a large majority shareholder. Unfortunately only three companies in this sector had indicated their directors' status as either executive or non-executive. Of the three, two of the companies, Firestone and BAT had boards with a majority of the directors being executive. Such a board is assumed not to be independent and would not be able to effectively monitor the managers' actions. Such companies are expected to perform worse than those with independent boards. In this case however, these two companies are the best performers in their sector contrary to expectations. East Africa Breweries which had a an independent board and had a specific statement on corporate governance in their annual report had an average performance.

The leading companies in this sector, Firestone and BAT made use of audit committees as did E.A. Breweries. This was unlike in the financial sector where it is the poor performers that used audit committees.

### 5.8. <u>Conclusions And Recommendations</u>

This study has established that the share ownership of the companies is not widely dispersed. This is because in 84 percent of the sample companies the largest shareholder controls over 15 percent of the shares. Except in one company, these shareholders were able to control the board of directors by virtue of their voting rights. Only 7 of the companies had indicated who their principal shareholders were and their shareholding in their annual report. The main concern would be the minority shareholders. It would be difficult for such shareholders to elect their own directors to the board.

In general, the members of the board seemed to reflect the shareholding. There were differences in the size of the board although majority of the companies had between 5 and 10 directors. With respect to the board leadership structure, all the companies had a separate leadership structure.

There was a difficulty in evaluating which of the directors were executive and which were not since not all companies specifically identify them in the annual report. Generally, in the companies where this information was disclosed, the executive directors were more than the executive directors. This would indicate that the board is independent from management and would therefore be able to monitor the activities of management on behalf of shareholders. However there was minimal disclosure of the directors' qualification and other directorships they hold to allow shareholders judge the capabilities of the directors. Companies should be encouraged to disclose the directors who are executive and those who are not. In addition, the qualifications of directors, especially the new ones should also be disclosed to aid shareholders evaluate their contribution to the company.

Only 28 percent of the sample companies had formed the audit committees during 1999. However these companies had not adhered to the CMA guidelines with regard to the reporting from the chairman of the committee. Only two companies made use of other committees. Clearly, the CMA needs to encourage more companies to form audit committees and ensure that they follow the guidelines laid down by them.

The use of the IAS will improve disclosure particularly of staff costs. However companies should be more explicit in the disclosure of related party transactions. For example, in disclosing directors' loans a breakdown should be given as to the amount of each director's loan.

The analysis of financial performance and corporate governance was not conclusive. This may have been due to the fact that the governance of companies is a complex issue and cannot be fully determined from the annual financial statements of the company. Only the results of that governance can be determined from the financial results. The fact that there were differences in performance despite similarities in governance structure, shows that there is no one best structure. Further having the right structure in place is not enough. The structure must be seen to work. Thus although a company may have large shareholders and a board that is independent of management, this will not automatically lead to improved corporate governance. The shareholders and directors must play their part to improve the governance of their companies and ultimately the financial performance. This also implies that any guidelines on corporate governance should not be prescriptive. For example, a requirement that all companies have boards with two thirds of the directors should be non-executive is not necessary. Instead companies should be left to identify what structure suits their needs and explain to shareholders why they have chosen the said structure.

## CHAPTER SIX

## SUMMARY AND CONCLUSIONS

This study was concerned with the corporate governance practices prevalent in Kenya and particularly whether these practices are good or not. The study was also concerned with establishing the extent of compliance with the CMA guidelines regarding the establishment of audit committees. The focus was on the companies listed on the NSE since they have a wide range of shareholders with varying amounts of shares that are not involved in the running of the companies and must therefore address issues of corporate governance.

Chapter 1 of the study gave a background to corporate governance explaining why it has become an important issue for both countries and companies. Corporate governance in Kenya was also discussed. The second chapter involved a general discussion on corporate governance. Generally there are two systems of corporate governance that have been identified. These are the shareholder and Stakeholder systems. The shareholder system is associated with the US and Britain and is characterized by wide dispersion of shareholders. Consequently these shareholders rely on the capital markets to discipline the managers and ensure good governance. The stakeholder system associated with Germany and Japan has large shareholders that interact with managers to ensure good governance. This chapter also examined corporate governance in Kenya and the factors that influence it.

Chapter 3 provided a review of studies that have been done in the area of corporate governance. The above studies have established there are certain factors that influence corporate governance. These include the extent to which shareholders are widely dispersed. The ability of the shareholders to elect and control directors is influenced by the extent of their shareholding as well as whether such shareholders are institutions or individuals. The role of the board of directors in corporate governance has also been established.

Chapter 4 and 5 presented the research methodology as well as the findings of the study.

### 6.1. Conclusions

The study established that the share ownership of the companies is not widely dispersed. As such the largest shareholder is able to easily control the board of directors by virtue of their voting rights. In general, the members of the board seemed to reflect the shareholding. With respect to the board leadership structure, all the companies had a separate leadership structure. There was a difficulty in evaluating which of the directors were executive and which were not since not all companies specifically identify them in the annual report. Generally, in the companies where this information was disclosed, the non-executive directors were more than the executive directors.

The key concerns from the above structure would be the rights of the minority shareholders especially where these are many but individually control very small percentages of their companies' shares. Whereas the majority shareholders are easily able to elect their own directors, the small shareholders would not be able to do so. The directors elected by the majority shareholder may not necessarily represent the interests of the small shareholders. To give the minority shareholders a chance to vote in a director of their choice, I would suggest that the voting rights be amended to allow for cumulative voting. Thus if there are 5 directors to be voted in, a shareholder with 100 shares can decide to cast 100 votes for each director, or can abstain from voting for 4 of the directors and accumulate his or her votes such that the shareholder can vote for the fifth director with 500 votes.

In most cases, directors proposed individuals for directorship. However there was minimal disclosure of the directors' qualification and other directorships they hold. To allow shareholders judge the capabilities of the directors, when voting, companies should be encouraged to disclose the directors' capabilities and what benefits they are expected to bring to the company. they should also disclose those directors who are executive and those who are not since this will enable shareholders to evaluate the board's independence. It was also noted that the companies disclosed the directors' fees but did not give the basis of such fees. Prior to shareholders approving such fees, the companies should explain the basis of such payments. There should also be disclosure of the shareholding of directors.

As regards the use of audit committees, very few had established them. These were mainly in the financial sector probably due to the fact that these companies are closely monitored by the CBK, which issued guidelines on the use of committees earlier than the CMA. In addition, these companies had not adhered to the CMA guidelines. Only two companies made use of other committees. Clearly, the CMA needs to encourage more companies to form audit committees and ensure that they follow the guidelines laid down by them.

The analysis of financial performance and corporate governance structure was not conclusive mainly due to the complexities involved in governance.. This indicates that different companies operate differently. As such there is no one best governance structure. For instance among the sample companies, the separation of board leadership may be viewed as best whereas other companies may prefer a joint leadership of the board. In addition the fact that there were differences in performance despite similarities in governance structure, shows that having the right structure in place is not enough. The structure must be seen to work.

### 6.2. Limitations Of The Study

The study focused on the companies quoted on the stock exchange to identify the corporate governance structure of companies in Kenya. However in Kenya there are less than 60 companies that are listed. There are many other private companies operating in Kenya. The findings of the study can therefore not be generalized.

Further the study used the financial reports of the company to obtain information on their corporate governance structures. This was limiting in that in most cases the companies would only disclose the minimum information provided for by the Act, the IAS/KAS, the CMA and the NSE. The information was therefore not comprehensive. For example information ion which directors are executive and which ones are not is not a mandatory disclosure and many companies did not therefore disclose it.

The study did not also control for the other variables that have been identified as having an impact on performance and profitability. These include elements such as the firm's size and capital structure among others.

### 6.3. Suggestions For Further Research.

This study concentrated on obtaining an overview of corporate governance structures in Kenya focusing on the dispersion of shareholders, their powers and the board of directors. The fact that the financial performances of the companies differed despite similarities in structure indicates that further research is needed in how these structures work.

With respect to shareholders, research could be done to identify whether they are actively involved in their companies by reviewing their attendance at the Annual General Meeting as well as whether they vote on key issues. The identity of the shareholders could also be reviewed as to whether they are largely individuals, financial institutions and pension funds and how this impacts on performance.

The board of directors normally carries out the monitoring activities of the shareholders. Research could be done on how the board carries out its functions. For example the frequency of meetings, whether there are guidelines as to how to conduct these meetings and the use of expert advice among others.

With respect to the use of audit committees, research could be done to find out how effective these are in enhancing corporate governance particularly as more companies adopt them. The performance of the companies could be compared before and after the use of the committees to see whether there is any difference.

## APPENDIX 1

## DATA COLLECTION FORM

### 1). GENERAL INFORMATION

a) Name Of Company:............................................................................................................

b) Industry:............................................................................................................................

c) Nature Of Business: ..........................................................................................................

### 2). FINANCIAL PERFORMANCE

**A) PROFIT AND LOSS STATEMENT FOR THE PERIOD ENDED----------------------------------------**

| | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|
| Turnover | | | | | |
| Profit Before Tax | | | | | |
| Taxation | | | | | |
| Profit After Tax | | | | | |
| Preference Dividends | | | | | |
| Profit Attributable To Ordinary Shareholders | | | | | |
| Ordinary Dividends | | | | | |
| Retained Earnings | | | | | |
| No. Of Ordinary Shares | | | | | |

**B) BALANCE SHEET AS AT ------------------------------------------------------------------------------------**

| | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|
| Fixed Assets | | | | | |
| Other Non Current Assets | | | | | |
| | | | | | |
| Current Assets | | | | | |
| Current Liabilities | | | | | |
| Net Current Assets | | | | | |
| | | | | | |
| Long Term Liabilities | | | | | |
| Total Net Assets | | | | | |
| | | | | | |
| Financed By | | | | | |
| Share Capital | | | | | |
| Reserves | | | | | |
| Total Shareholders Funds | | | | | |

**3) CORPORATE GOVERNANCE STRUCTURES**

a) SHAREHOLDERS:

- Control: Foreign Or Local:................................................................................................
- If Local Name Of Largest Shareholder.................................................................................
- Percentage Of Total Shares Held By Largest Shareholder....................................................
- Voting Rights.......................................................................................................................

b) BOARD OF DIRECTORS

- Chairman Of The Board.......................................................................................................
- Leadership Structure Of The Board; Joint Or Separate.........................................................
- Names Of Board Of Directors:..............................................................................................

..................................................................................................................................................

..................................................................................................................................................

- Identify Directors Who Are Executive And Those Who Are Not............................................

..................................................................................................................................................

..................................................................................................................................................

- How Are New Directors Appointed:......................................................................................

..................................................................................................................................................

- Other Observations:..............................................................................................................

c) USE OF COMMITTEES:

- Names Of Committee:...........................................................................................................
- Members Of The Committee:................................................................................................
- Responsibilities Of The Committee:.....................................................................................
- Report Of The Committee:...................................................................................................

d) OTHER OBSERVATIONS:.......................................................................................................

## APPENDIX 2

## LIST OF COMPANIES QUOTED ON THE NAIROBI STOCK EXCHANGE IN 1999

**AGRICULTURAL**

Brooke Bond Kenya Ltd.

*Eaagads Ltd.*

*Kapchorua Tea Co Ltd.*

*K.P.C.U. Ltd.*

Limuru Tea Co. Ltd.

Rea Vipingo Plantations

Ol Pejeta Ranching Ltd..

*Sasini Tea & Coffee Ltd.*

*Theta Group Ltd.*

*Kakuzi Ltd..*

*George Williamson K. Ltd..*

**COMMERCIAL AND SERVICES**

A Baumann & Co. Ltd.

Lonhro Motors Ltd.

The Standard Newspapers.

*Car & General (K) Ltd.*

*CMC Holdings Ltd.*

*Express Kenya Ltd.*

*Hutchings Biemer Ltd.*

*Kenya Airways*

*Marshalls (EA) Ltd.*

*Pearl Drycleaners Ltd.*

*Nation Media Group.*

*Uchumi Supermarkets*

*TPS (Serena) Ltd.*

**FINANCE &INVESTMENT**

Barclays Bank of K. Ltd.

Chancery Investments Ltd.

Standard Chartered Ltd.

*CFC Bank Ltd.*

*City Trust Ltd.*

*Diamond Trust Bank (K)Ltd.*

*Housing Finance Co. K. Ltd..*

*ICDC Investment Co ltd.*

Jubilee Insurance Co.

*Kenstock Ltd.*

*Kenya Commercial Bank.*

*NIC Bank Ltd.*

*National Bank of Kenya Ltd.*

*Pan Africa Insurance Co Ltd.*

**INDUSTRIAL & ALLIED**

Athi River Mining Co Ltd.

*E. A. Portland Cement Ltd.*

B.A.T. Kenya Ltd.

Bamburi Cement Ltd.

BOC Kenya Ltd

Crown Berger K Ltd.

*Kenya Breweries Ltd.*

*Kenya National Mills*

*Kenya Oil Co. Ltd.*

*Kenya Orchards Ltd.*

*Unga ltd.*

Dunlop K Ltd.

E. A. Cables Ltd.

E. A. Packaging Ind. Ltd.

Firestone East Africa Ltd.

*Kenya Power & L. Co.*

*Carbacid Investments Ltd.*

Total Kenya Ltd

*NB: Locally controlled companies are marked out in Italics above.*

Source: Nairobi Stock Exchange

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