International Journal of Business and Public Management (ISSN: 2223-6244) Vol. 1(1): 36-41
Available online at: http//:www.journals.mku.ac.ke

Full Length Research Paper

An analysis of the effect of Corporate Governance on Performance of Commercial State Corporations in Kenya

Miring'u Alice N.[1], Muoria Esther T.[2]
[1]P. O. Box 407, Kalimoni.
[2]Jomo Kenyatta University of Agriculture and Technology, P. O. Box 62000 00200, Nairobi.

Corresponding Author: Muoria Esther T.

Recieved: January 15, 2011 Accepted: February 2, 2011

Abstract
This study sought to examine how Corporate Governance affects performance in commercial state corporations in Kenya. Well-governed firms have higher firm performance. Mismanagement, bureaucracy, wastage, incompetence and irresponsibility by directors and employees are the main problems that have made State corporations (SCs) fail to achieve their performance. The poor performance of SCs in Kenya by 1990 led to outflow from central government to parastatals equivalent to 1 percent of the GDP in 1991. The objective of the study is to identify the relationship between financial performance, board composition and size. The study used descriptive survey design. The target population for this study was 41 commercial SCs in Kenya as presented by Inspectorate of SCs. Sample of 30 respondents out of 41 was found ideal. Respondents were 30 human resource officers. Data were analyzed through descriptive statistics and multilinear regression technique. The findings were that the board size mean for the sample was found to be ten while a minimum of three outside directors is required on the board. The study thus discloses that there is a positive relationship between RoE and board size and board compositions of all SCs.

Keywords: Corporate Governance, Performance, State Corporations,
JEL Classification: M14

1.0 Introduction

An argument has been advanced time and again that the governance structure of any corporate entity affects the firm's ability to respond to external factors that have some bearing on its performance. In this regard, it has been noted that well - governed firms largely perform better and that good corporate governance is of essence to firms. The concept is gradually warming itself to the top of policy agenda in the African continent like in Ghana and South Africa. Indeed, it is believed that the Asian crisis and the seemingly poor performance of the corporate sector in Africa have made the concept of corporate governance a catch phrase in the development debate (Berglof and Von Thadden, 1999). Empirical studies have provided the nexus between corporate governance and firm performance. Bebchuk, L., Cohen, A. and Ferrell, A. (2004) indicate that well-governed firms have higher firm performance.

Developing countries are now increasingly embracing the concept of corporate governance knowing it leads to sustainable economic growth. Indeed, corporate governance in Kenya is now gaining some level of recognition with very little work in the area even in the well-regulated institutions and sectors. The state corporations have tremendous governance problems. Some of the state corporations have folded up partly as a result of governance problems as observed in South Africa by (Kyereboah and Biekpe, 2006). In Kenya, a parastatal is a State Corporation (SC) under State Corporation Act Cap 446 (1987). SC has various meanings. First, it may be a corporate body established by or under an Act of parliament. Second, the president may by order establish a SC as a body corporate to perform the functions specified in the order. Third, it also represents a bank or a financial institution licensed under banking Act or other company incorporated under the company Act (Wamalwa, 2003).

Sessional Paper No.4 (GoK, 1991) on development and employment in Kenya decried the continued deterioration of the performance of SCs. The paper observes that while the creation of SCs through which government participation in economic activities was promoted was perhaps appropriate soon after independence, the objectives for and the circumstances under which most of the state enterprises were created have since changed. The paper underlines the need to implement privatization and divestiture of SCs urgently in view of the managerial problems afflicting the parastatals leading to poor return on government investments, the existence of a larger pool of qualified manpower, availability of more indigenous entrepreneurship to permit private sector - led economy and the need for non-tax revenue for the government. The government has made progress in parastatals' reform.

Steps to restructure key public enterprises like the Kenya Ports Authority (KPA), Kenya Railways (KR), Kenya Power and Lighting Company (KPLC) have really progressed. However, further steps will need to be taken in order to accelerate the progress in this area and thereby improve on the low investment efficiency that limits economic growth (Wamalwa, 2003).

As early as 1970s, many governments in Africa had recognized the fact that SCs were performing poorly. Poor SCs performance was associated with labour rigidities in the market increased fiscal and foreign debt and inflation problems. State corporations provided poor and unreliable services, failed to meet demand and were lagging behind in technology areas like telecommunications (Shirley, 1993). Mismanagement, bureaucracy, wastage, pilferage incompetence and irresponsibility by directors and employees are the main problems that have made SCs to fail to achieve their objectives. The poor performance of SCs in Kenya by 1990 led to outflow from central government to parastatals equivalent to 1 percent of the GDP in 1991. Further, in 1990 – 1992, the direct subsidies to parastatals amounted to Ksh 7.2 billion and as additional indirect subsidies amounted to Ksh. 14.2 billion. By 1994, the subsidies paid to parastatals or organizations were taking 5.5 % of the GDP. The levels of inflation in the country then reflected deficits financed by the Central Bank. Some ways were devised to solve these problems, such as negotiations between SC and government in a bid to clarify the former's objectives and set targets, introduction of competition and better accountability to customers, provision of incentives in form of higher salaries and benefits to employees based on performance and increased training of employees. All these measures were not 100% successful. Failure of the above measures made many governments embark on privatization (Kamung'a, 2000).

2.0 Literature review

2.1 East and West Perspective

The Asian financial crisis, which caused so much damage to the global economy, was triggered by poor corporate governance practices just as the recent Enron scandal in the US has shown poor practice undermines investor confidence and affects overall market stability (Reuters, July 2002). This scandal led to the reduction of Enron's market value from US$ 80 billion in August 2000 to less than US$ 1 billion in 2001, when the financial scandal was revealed. Institutional investors rely on the quality of corporate governance regimes in making decisions, and place a financial premium (a cost) where systems are weak. An effective regime that promotes corporate governance contributes positively to the development of both national capital markets and to the promotion of foreign direct investment. Thus, the significance of corporate governance is now widely recognized both for national development, and as part of the international financial architecture. In the words of the President of the World Bank: "The proper governance of companies will become as crucial to the world economy as the proper governance of countries" (Godfrey, 2002).

2.2 An African Perspective

Godfrey (2002) posits that in addition to the South African King Report, there has been a rapid growth in the development of African thinking on corporate governance. New thinking is to attack on the supply side of corruption (company bribes) by complementary anti-corruption measures by the state. The recent initiative of the African Union (AU) to develop an AU Convention on Combating Corruption addresses the importance of declaring public officials' assets, and also breaks ground by targeting unfair and unethical practices in the private sector. Corporate governance is now established as an important component of the international financial architecture, but barely half a decade ago it was little known beyond specialists in a few countries such as the US, the UK, Australia, Canada and South Africa.

2.3 Commonwealth Association for Corporate Governance (CACG)

The critical areas to be addressed by corporate governance can be easily described as, efficient, responsible, transparent and honest governance of economic entities, whether they are private or state owned, large, medium or small. The principles set out by the Commonwealth Association for Corporate Governance (CACG) are a well-recognized benchmark within the Commonwealth; but similar codes and principles, for example the Cadbury and King Reports, are available in other jurisdictions. Corporate governance is a concept that is still at its evolution stage.

The CACG guidelines were agreed by the Commonwealth Business Council (CBC) in 1999 and presented to Commonwealth Heads of Government at their 1999 Summit, which endorsed them. The guidelines have been designed with particular focus on the emerging and transitional economies, making up a large part of the Commonwealth, but also meet the needs of international investors and multilateral international agencies. The CACG guidelines also explore some of the complex issues relating to public and state enterprises, business ethics and corruption, and the role of international professions operating in emerging and transitional economies. Further definitions by other scholars go on to state that corporate governance is ''both the promise to repay a fair return on capital invested and the commitment to operate a firm efficiently given investment'' from the perspective of the investor (Metrick and Ishii, 2002).

2.4 Private Sector Perspective

From a private sector perspective two general comments are important at the outset. First, corporate governance should not be seen in isolation from the wider concept of corporate citizenship. Any successful modern company has to take responsibility, in co-operation with government, in developing sustainable business and commercial activities that serve communities. Shareholder value and profits are not sustainable in isolation from this broader business strategy, which demands quality services, the good will of communities, and a belief in the ethical standards of companies. Exceptions to these standards of behavior serve to underline the penalties which companies pay when they forfeit public trust.

2.5 Motive for Establishing Public Enterprises

It is observed that various motives are behind the establishment of public enterprises in the Sub – Saharan African countries (SSA). For instance, in Uganda, the Ugandan Development Corporation created in 1963 a subsidiary known as African Business Promotion Ltd., the objective of which was to "establish and promote our own people in the trade and commerce field generally so that Ugandans may play a reasonable part and hold a reasonable share of the country's commerce" (Kamung'a, 2000). Similarly in Kenya, for desire of sufficient indigenous private entrepreneurship after independence, the government had to use parastatals to fill the existing entrepreneurship gap. Thus, public enterprises served as a means to promote the establishment of private African enterprises (Wamalwa, 2003).

3.0 Data Analysis and Findings

3.1 The Board of Directors

The board of directors is the link between the people who provide capital (shareholders) and the people who use that capital to create value. Their primary role is to monitor and influence the performance of management on behalf of shareholders in an informed way. Efficient corporations can only be established and developed by responsible, creative, innovative boards and more appropriately elected and governed boards. Board attributes in this study are board size and board composition. (Table 1)

The board should neither be too large like 14 members and above nor too small like below 5 so as not to compromise the inter-active discussion during board meeting or to limit inclusion of a wider expertise and skills that are necessary for the board to be effective. As can be seen, some boards have even numbers but worthy to note, among the members, there could be cases of non - voting members as is the case of Central Bank of Kenya in that when they had 12 members, the Permanent Secretary of finance was a non – voting member. The data from Table 1 reflect the highest percentage of 23.3% to comprise 9 board members, followed by that of 20% having 11 members and 16.7% having 13 members. Those that have chosen to have either large (14 members) or relatively small (either 6, 7, 8 members) have a relatively low percentage of 6.7%. Conclusion can therefore be drawn that most commercial state corporations have opted to have relatively large board numbers. This is consistent with other empirical studies such as Sanda et al, (2003). (See Table 2 at the end).

The results of Table 2 display that the highest percentage of non – executive or outside directors is 26.7% which is represented by 6 non – executive directors followed by 20% which represents 5 and 13.3% for 3 non – executive directors. Those having 1, 10 and 11 non – executive directors have a percentage of 3.3% while 6.7% is held by 2, 4 and 9 non – executive directors respectively. This implies that most commercial SCs have their boards with more than a third of non – executive directors. Despite that the study is in agreement with other studies like that of John and Senbet (1998) who argue that boards of directors are more independent as the proportion of their outside directors increases. This enables them to run their issues without any undue optimistic influence from the inside directors. (fig 2).

Most of the commercial SCs have the board appointed by the government as represented by 43.3%, with 30% by vote of majority shareholders while 26.7% being appointed by vote of all shareholders as shown by fig. 5. Therefore, the government is observed to have an upper hand in the control of most commercial SCs. (Table 3). Most of the board appointees are qualified graduates and professionally skilled as accountants, lawyers, engineers, and house architects like in National Housing Corporation.

4.0 Conclusions

The relevance of corporate governance cannot be over-emphasized since it constitutes the organizational climate for the internal activities of a company. Corporate governance brings new outlook and enhances a firm's corporate entrepreneurship and competitiveness. The study examined the role of corporate governance and its effect on the performance of commercial SCs in Kenya. From table 8, it was evident that there is a positive relationship between return on equity (ROE) and board size and board compositions of all SCs since their coefficient estimates are positive and the P-values less than 0.05.since the critical value is 42.56. These research findings are consistent with earlier research by Kihara (2006) who observes that unlike inside directors, outside directors are better and able to challenge the CEO hence a minimum of three outside directors is required on the board. It also concurs with Jensen (1993) who voices his concern that, lack of independent leadership makes it difficult for boards to respond to failure in top management team.

From the summary results (Table 4), out of the minimum of six and the maximum of fourteen, the mean of board size of the firms is 10.44. The mean suggests that on the average, the sampled commercial SCs have board membership of about ten directors. However, a standard deviation of 2.434 suggests that while some commercial SCs have relative large board sizes, others have relatively small board sizes. With board composition, an average of about 53 percent of directors is chosen from outside the commercial SCs (non-executive board members). The study reveals that most of the boards are deemed independent and it concurs with John and Senbet (1998) who argues, that boards of directors are more independent as the proportion of their outside directors increases.

The government should therefore enforce the measures it has laid down to ensure SCs are following them so that the recommended governance structures are followed. The concerned ministries should also be very keen in the supervisory role through the relevant committees to ensure that all regulations are enforced as required e.g. books of accounts are well - kept and audited as they should be. A related study also could be carried out to find out corporate governance practices in other state corporations like the non - commercial state corporations comprising those that are of regulatory, educational, research institutes, and others.

References

Bebchuk, L., Cohen, A. and Ferrell, A., 2004. What Matters in Corporate Governance? Working paper, Harvard Law School, Cambridge, MA.

Berglof, E. and Von Thadden, E.-L., 1999.The Changing Corporate Governance Paradigm:
Implications for Transition and Developing Countries, Conference paper, Annual World Bank Conference on Development Economics, Washington, DC.

Godfrey, S., 2002. A Private Sector Perspective, Benchmarks and Indicators for Corporate Governance, African Security

Review Vol 11 No 4, http://www 2002.iss.co.za/pubs /ASR/11 No 4/Contenthtm.html [accessed in June 2007]

Jensen, M., 1993. The Modern Industrial Revolution, Exit and The Failure of Internal Control Systems, Journal of Finance, Vol. 4 No. 3, pp. 831-80.

John, K. and Senbet, L.W., 1998. Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, Journal of Banking and Finance, Vol. 26, pp. 271-95.

Kamung'a J. I., 2000. The Impact of the Method of Privatization used on Firm's Financial Performance: A Study of Privatized Firms, Unpublished Thesis, Kenyatta University, Kenya.

Kihara, M.N., 2006. Relationship Between, Ownership Structure, Governance Structure And Performance of Firms Listed with NSE, Unpublished Thesis, Nairobi University, Kenya.

Kyereboah-Coleman, Anthony and Biekpe, Nicholas, 2006. Corporate Governance, Vol 6, No.5 Emerald Group Publishing limited, South Africa.

Metrick, A. and Ishii, J., 2002. Firm Level Corporate Governance, paper presented at the Global Corporate Governance Forum, Research Network Meeting, Washington, DC April.

Reuters, 2002. Pension Fund Manager Suit, www.houstonchronicles.com [accessed in June 2007]

Sanda, A.U., Mukaila, A.S. and Garba, T., 2003. Corporate Governance Mechanisms and Firm Financial Performance in Nigeria: Final Report, Paper presented to the Biannual Research Workshop of the AERC, Nairobi, Kenya.

Wamalwa, E., 2003. Factors Influencing Investment Decisions in Parastatals in Kenya, Unpublished Thesis, Kenyatta University, Kenya.

Yermack, D., 1996. Higher Market Valuation of Companies with a Small Board of Directors, *Journal of Financial Economics*. Vol. 40 No. 2, pp.185-221.

Appendices

Table 1: Board Size

No. of Directors	Frequency	Percent
6	2	6.7
7	2	6.7
8	2	6.7
9	7	23.3
10	1	3.3
11	6	20.0
12	3	10.0
13	5	16.7
14	2	6.7
Total	30	100.0

Table 2: Board composition (Non-Executive Directors)

No. of Non – Executive directors	Frequency	Percent
1	1	3.3
2	2	6.7
3	4	13.3
4	2	6.7
5	6	20.0
6	8	26.7
7	3	10.0
9	2	6.7
10	1	3.3
11	1	3.3
Total	30	100.0

Fig. 2: Appointment of Board

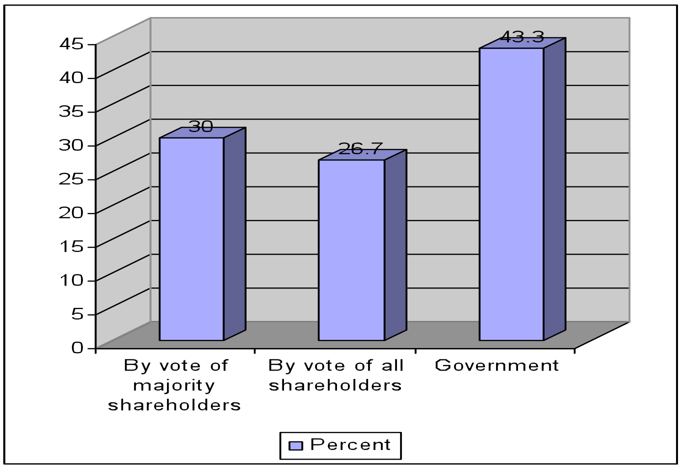

Table 3: Qualification of Board

Qualification	Frequency	Percent
University trained	30	100.0

Table 4: Summary results of the relationship return on equity (ROE) and the governance variables.

	Non – Exec Directors	Exec. Directors	Board composition	Total board size	Return on Equity
N	30	30	30	30	30
Mean	5.36	5.08	.525488179	10.44	
Std. Error of Mean	.510	.611	.0504539259	.487	
Median	5.00	6.00	.461538462	11.00	
Mode	6	6	.3636364	11	.3180716
Std. Deviation	2.548	3.054	.2522696296	2.434	
Minimum	1	1	.1428571	6	-.2602967
maximum	11	11	.9090909	14	.31989695

Table 5: Board Composition, Board Size and ROE of 25 State Corporations (83% Response Rate)

COMPANY	Board composition	Board size	ROE
KPOSB	0.8333333	6	0.499999980
COB	0.8571429	7	0.600000030
KNTC	0.3333333	9	0.299999970
NHC	0.3000000	10	0.300000000
DBK	0.1428571	7	0.099999970
KERE	0.8333333	6	0.499999980
ADC	0.2142857	14	0.299999980
NBK	0.5384615	13	0.699999950
ICDC	0.8750000	8	0.700000000
SAFCOM	0.8461538	13	1.099999940
CBK	0.5000000	12	0.600000000
KENGEN	0.9090909	11	0.999999990
KBC	0.8181818	11	0.899999980
NOCK	0.3636364	11	0.400000040
AFC	0.1666667	12	0.200000040

KPLC	0.3636364	11	0.400000040
BOK	0.2500000	8	0.200000000
KLB	0.4285714	14	0.599999960
KIE	0.2307692	12	0.276923040
KPRL	0.4545455	11	0.500000050
IDB	0.5454545	11	0.599999950
JKF	0.4615385	13	0.600000050
KMC	0.4545455	11	0.500000050
TELCOM	0.7500000	12	0.900000000
EAPC	0.6666667	9	0.600000030

Source: Research Data.

Table 6: Regression Model Summary
Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.970[a]	.941	.935	.065070447513

a. Predictors: (Constant), Board Size, Board Composition

Table 7: Analysis of Variance Table
ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1.476	2	.738	174.279	.000[a]
	Residual	.093	22	.004		
	Total	1.569	24			

a. Predictors: (Constant), Board Size, Board Composition

b. Dependent Variable: Performance

Table 8: Regression Model Parameter Estimates
Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-.572	.075		-7.627	.000
	boardcompo	.983	.055	.970	17.975	.000
	boardsize	.056	.006	.525	9.728	.000

a. Dependent Variable: Performance