

**“CORPORATE GOVERNANCE OF PARASTATALS: A  
CRITIQUE IN THE CONTEXT OF THE NEW  
CONSTITUTION”**

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## DECLARATION

I, **AUSTIN ANDREW OMONDI OUKO**, do hereby declare that this is my original work and has not been submitted and is not currently being submitted for a degree in any other University.

SIGNED:.....



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This thesis has been submitted with my approval as the University of Nairobi Supervisor,

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## DEDICATION

This project is dedicated to my beloved late mother Mrs. Patricia Akeyo Ouko who passed away on June 21, 2010 while I was undertaking this LL.M course, "*Nind gi kue Nyar Rae*" (May the good Lord rest your great soul in eternal peace) and to my sisters Phyllis, Atieno, Caro and Betty, and brothers Nasser and Steve without whose encouragement, moral support and believing in me even at the trying moment I could not have made it through this journey. May God bless you all!

## LIST OF ABBREVIATIONS

AGM	Annual General Meeting
AG-C	Auditor General Corporations
C & AG	Controller and Auditor-General
CCK	Communications Commission of Kenya
CEO	Chief Executive Officer
CGD	Centre for Governance and Development
DGIPE	Department of Government Investments and Public Enterprises
EGP	Economic Governance Programme
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IPSASs	International Public Sector Accounting Standards
NHC	National Housing Corporation
OECD	Organisation for Economic Co-operation and Development
PIC	Parliamentary Public Investments Committee
PPPs	Public-Private Partnerships
SCA	State Corporations Act
SCAC	State Corporations Advisory Committee
SOEs	State Owned Enterprises

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# CHAPTER 1: INTRODUCTION

## 1.1. CONCEPTUAL BACKGROUND

There is no generally agreed upon definition of corporate governance; however, there have been attempts at defining the term. The term “corporate governance” has a clear origin from a Greek word, “kybernan” meaning to steer, guide or govern. From a Greek word, it moved over to Latin, where it was known as “gubernare” and this further gave way to the French version “gouverner”.<sup>1</sup> The OECD defines corporate governance as a set of relationships between a company’s management, its board of directors, its shareholders and other stakeholders.<sup>2</sup> Corporate governance is also defined as embodying processes and systems by which corporate enterprises are directed, controlled and held to account.<sup>3</sup> Corporate Governance, therefore, refers to the manner in which the power of a company is exercised in the stewardship of the company’s total portfolio of assets and resources with the objective of satisfying stakeholders’ expectations in the context of parastatals.<sup>4</sup>

The term “parastatal” is used rather loosely in Kenya, being often applied to a wide range of bodies, such as boards, corporations, and companies, that operate in the state-dominated sector of the economy.<sup>5</sup> It is unfortunate that there has not been greater consistency in its official usage, as parastatals are also sometimes referred to as SOEs, state corporations, public enterprises, public sector enterprises, public companies and public corporations. The vagaries in terminology also reflect a degree of uncertainty in

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<sup>1</sup> Haslinda Abdullah and Benedict Valentine, “Fundamental and Ethics Theories of Corporate Governance” (EuroJournals Publishing, Inc. 2009) available at <<http://www.eurojournals.com/MEFE.htm>> accessed on May 19, 2010 at p 88.

<sup>2</sup> Organisation for Economic Co-operation and Development, “Principles of Corporate Governance”, (OECD 2004), available at <[www.oecd.org/dataoecd/32/18/31557724.pdf](http://www.oecd.org/dataoecd/32/18/31557724.pdf)> accessed on April 25, 2010.

<sup>3</sup> Protocol on Corporate Governance in the Public Sector, Republic of South Africa (Department of Public Enterprises, 2002), available at <[www.info.gov.za/view/DownloadFileAction?id=70233](http://www.info.gov.za/view/DownloadFileAction?id=70233)> accessed on June 8, 2010.

<sup>4</sup> Private Sector Initiative for Corporate Governance, “Principles for Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance” at available at <[www.ecgi.org/codes/documents/principles\\_2.pdf](http://www.ecgi.org/codes/documents/principles_2.pdf)> accessed on April 26, 2010.

<sup>5</sup> David Robinett, “The Challenge of SOE Corporate Governance for Emerging Markets”, (World Bank Corporate Governance Department, May 2006) available at <<http://rru.worldbank.org/Documents/Other/CorpGovSOEs.pdf>> accessed on May 19, 2010 at p 4.

government policy on how the public sector should be ordered, as well as a piecemeal approach in its interventions in the economy since independence.<sup>6</sup>

Discussing parastatals in the 21<sup>st</sup> Century brings back memories of the various ambiguities that surrounded this field when the parastatal was dominating the involvement of the State in economic activities. Some of the ambiguity in fact stemmed from the nomenclature itself. The intense debate that surrounded the subject of the parastatals especially during the 1960s and 70s subsided before the ambiguities were ironed out and I do not believe that they will ever be.<sup>7</sup> However, in recent years the nomenclature has received greater attention out of recognition that parastatals loom rather large in the economy, often being more prominent than government departments and more visible than the private sector.<sup>8</sup>

A parastatal is an enterprise over which the state has significant control, whether wholly with a full, a majority, or a significant minority ownership.<sup>9</sup> This definition comports with that given by Section 2 of the SCA,<sup>10</sup> which defines a state corporation as a body that is:<sup>11</sup>

- defined that way by statute;
- a body corporate established by an Act of Parliament;

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<sup>6</sup> *Ibid.*

<sup>7</sup> John-Mary Kauzya, "The Question of the Public Enterprise and Africa's Development Challenge: a Governance and Leadership Perspective in Public Enterprises: Unresolved Challenges and New Opportunities" a publication based on the Expert Group Meeting on Re-inventing Public Enterprise and their Management 27-28 October 2005, (Department of Economic and Social Affairs Division for Public Administration and Development Management United Nations New York, 2008), available at <[unpan1.un.org/intradoc/groups/public/.../un/unpan022073.pdf](http://unpan1.un.org/intradoc/groups/public/.../un/unpan022073.pdf)> accessed on June 8, 2010 at p 74.

<sup>8</sup> Ben Turok, "Control in the Parastatal Sector of Zambia", *The Journal of Modern African Studies*, Vol. 19, No. 3 (Sep., 1981), Cambridge University Press, available at <<http://www.jstor.org/stable/160753>> accessed on June 5, 2010 p 421-445.

<sup>9</sup> Agata Waclawik-Wejman, "Corporate Governance of State-Owned Enterprises in Poland 2005" available at <[www.msp.gov.pl/download.php?s=2&id=670](http://www.msp.gov.pl/download.php?s=2&id=670)>, accessed on May 12, 2010.

<sup>10</sup> Chapter 446 of the Laws of Kenya. The Act's Preamble states that it is an Act of Parliament to make provision for the establishment of state corporation: for control and regulation of state corporation; and for connected purposes. Its commencement date was November 1, 1986.

<sup>11</sup> Centre for Corporate Governance Development, "*A Decade of Parastatal Waste*" *A Study of the Audited Accounts of State Corporations over the Period from 1993 to 2002*" (Centre For Governance And Development, 2005), available at <<http://www.cgd.or.ke/publications.asp?title=&formpost=1&documentypeid=&Year=2005&languageid=&>> accessed on April 23, 2010 at p 25.

- a bank or other financial institution or other company whose shares or a majority of whose shares are owned by government or by another State Corporation, and;
- a subsidiary of a state corporation.

This study will consistently use the term parastatal as it is the widest term that embodies statutory bodies, public enterprises, government limited companies and state corporations. The distinction between the enterprises, bodies and corporations is not purely legal.<sup>12</sup> The study will take the term parastatal to refer to an organisation established by the government under public or private law as a legal personality which is autonomous or semi-autonomous and produces goods or services on a full or partial self-financing basis and in which the government or a public body participates by way of having shares or representation in its decision making structure.<sup>13</sup>

Parastatals were first established in Kenya by the colonial government on the understanding that they would be the most appropriate mechanism for providing services that were not provided by the private sector.<sup>14</sup> They were also to meet explicit social and political objectives such as to provide education, health or even redistribute income or develop marginal areas. In addition, it was felt that they were better placed to curb the exploitation of consumers.<sup>15</sup> Following independence in 1963, the independent Kenya government devised strategies to achieve three goals that were considered imperative for development: A fast overall economic growth rate, equitable distribution of development benefits and Kenyanisation of the economy. The means of achieving these goals were clearly defined in Sessional Paper No. 10 of 1965 on African Socialism and its

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<sup>12</sup> Ben Turok, *supra* note 8 at p 422. David Robinett, *supra* note 5 at p 8 defines public enterprises as state level public enterprises, state controlled co-operatives, organizations created by special statutes, joint ventures of state and central governments, departmental undertakings, and companies promoted by developmental financial institutions of the government.” and departmental enterprises.

<sup>13</sup> John-Mary Kauzya, *supra* note 7 at p 75.

<sup>14</sup> Kiarie Mwaura, “The Failure of Corporate Governance in State Owned Enterprises and The Need For Restructured Governance In Fully and Partially Privatized Enterprises: The Case of Kenya”, at 31 *Fordham Int'l L.J.* 34 (December 2007) at p 1.

<sup>15</sup> See John Nellis, “Public Enterprises in Sub-Saharan Africa”, in Barbara Grosh, “Public Enterprise in Kenya: What Works, What Doesn't, and Why ?” (1991) cited in Kiarie Mwaura, *Ibid* at p 4.

Application to Planning in Kenya. It stated that “under African Socialism, the power to control resource use resides with the state”.<sup>16</sup>

From 1965 onwards, the government actively expanded and strengthened parastatals as the vehicles of development and Kenyanisation. Indeed, as parastatals proliferated in the first decade of independence, Kenya’s economy grew apace at an impressive rate of 6.8%. Economic growth, however, dropped marginally to 5% in the 1980s, and further declined to a mere 0.3% in 1990s. A combination of factors explains this, key among them being increased government expenditure and investment in commercial enterprises that were under-performing while relying on its subventions for survival. This hurt the economy as most of the money allocated to parastatals went into waste, paying wages to a bloated workforce and rewarding political cronies.<sup>17</sup>

It is against this background that this paper will examine the legal and regulatory framework under which parastatals operate, the likely causes of their poor performance, possible solutions to this problems and the impact the new Constitution will have on their governance framework.

## 1.2. PROBLEM STATEMENT

As with other Sub-Saharan African countries characterised by excessive government ownership and control, parastatals in Kenya have had a depressing record.<sup>18</sup> Even the now profitable and growing Kenya Airways made loses for many of its pre-privatisation years.<sup>19</sup> More than 40 parastatals and companies in which the Government had shares have been placed under receivership since 1980.<sup>20</sup> The reports of the Auditor General-Corporations’ between the years 1993 to 2002 on the accounts of various parastatals make depressing reading. Out of every 100 reports from the parastatals examined by the

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<sup>16</sup> *Ibid.*

<sup>17</sup> *Ibid.*

<sup>18</sup> Centre for Corporate Governance Development, *supra* note 11 at p 7.

<sup>19</sup> *Ibid.*

<sup>20</sup> See "45 Parastatals, Govt Firms in Receivership" *East African Standard*, (Kenya July 12, 2001)" cited in Kiarie Mwaura, "Regulation of Directors in Kenya: An Empirical Study", *I.C.C.L.R.* 2002, 13(12), p 465-479.

AG-C, only eight managed a clean bill of health. Of the nearly 130 parastatals reviewed only 23 managed a clean report. The general story is one of loss, fraud, theft and gross mismanagement.<sup>21</sup>

This study will examine the likely reasons why the parastatals have performed poorly over the years in light of the legal and regulatory framework under which they operate. This is expected to shed light on the possible remedial measures that can be introduced to make them efficient and effective in line with international best practices and standards.

### **1.3. ISSUES**

Firstly, parastatals are faced with agency problems. Lack of clear and identifiable owners or principals has led to competing objectives or sometimes conflicting ones which hinder their efficiency in goods and service delivery.

Secondly, the statutory powers given to the President and Ministers to appoint directors of parastatals have politicised parastatal boards. There is no statutory provision requiring the directors to have expertise or experience in the management of parastatals. Moreover, the remuneration currently paid to the directors has made it difficult to attract, incentivise and retain high quality skill, experience and expertise in the boards.

Thirdly, a mismatch between the ostensible objectives and operational regulations under which parastatals operate is also a likely factor that may have contributed to their depressing performance. Most of the operational regulations introduce a lot of bureaucracies and bottlenecks that deprive parastatals the incentive to increase gains, cut costs and operate efficiently. Furthermore, unlike private companies, the ultimate internal control of parastatals lies with the government as per the provisions of the SCA. Therefore, financial and investment decisions by parastatals are restricted, with any capital intensive project or one time expenditure or the raising of outside funds or the distribution of profits requiring government approval. Accordingly, the government has a greater say in the strategy and purpose of the parastatals than their boards. Moreover,

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<sup>21</sup> Centre for Corporate Governance Development, supra note 11 at p 11.

parastatals control key sectors of the economy thus given their centrality to the economy a lot of public funds are allocated to them. It therefore follows that since tax payers are the main shareholders of parastatals, it is only fair that they should accurately and transparently account to the tax payers. However, this seems not to be happening as books of accounts of many parastatals have been noted to be inaccurate and incomplete while others were none existent having been lost completely under doubtful circumstances. Additionally, parastatals accounting and disclosure procedures as currently contained in the statutes are only oriented towards public expenditure control. This may be burdensome and cannot fulfill the requirements of timeliness and materiality.<sup>22</sup>

Fourthly, unlike a widely held company in the private sector, a parastatal generally cannot have its board changed via a takeover or proxy contest. They do not face the threat of bankruptcy.<sup>23</sup> The absence of potential takeovers and proxy contests reduces the incentive of board members and managers to maximise the value of parastatals. In turn, lack of bankruptcy threats has led to reliance on the government for funding leading to *soft budget constraints*.<sup>24</sup> The state is unlikely to allow a large parastatal to face bankruptcy. Thus the discipline enforced on private firms by capital markets and the threat of financial distress is less important to parastatals.<sup>25</sup> Hence, two of the most important checks on underperformance are absent.<sup>26</sup>

#### 1.4. HYPOTHESIS

It is the study's hypothesis that parastatals accountability and performance can be enhanced if they had a well defined ownership policy. If only the government established a single state ownership entity such as a Ministry or holding company, responsible for its

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<sup>22</sup> Organisation for Economic Co-operation and Development (OECD), "The Guidelines of Corporate Governance of State-Owned Enterprise" (OECD 2004) available at <[www.oecd.org/.../0,3343,en\\_2649\\_34847\\_34046561\\_1\\_1\\_1\\_37439,00.html](http://www.oecd.org/.../0,3343,en_2649_34847_34046561_1_1_1_37439,00.html)> accessed on April 26, 2010.

<sup>23</sup> David Robinett, *supra* note 5 at p 3.

<sup>24</sup> *Ibid.*

<sup>25</sup> William L. Megginson and Jeffrey M. Netter, "From State to Market: A Survey of Empirical Studies on Privatization", (June 2001) *Journal of Economic Literature* Vol. XXXIX at p 321–389.

<sup>26</sup> David Robinett, *supra* note 5 at p 3.

stake in them.<sup>27</sup> The entity should be held accountable to Parliament. It should create a coordination mechanism that harmonises the exercise of ownership supervision of parastatals.<sup>28</sup> Reason being that parastatals do not have a centralised system of corporate supervision as a result they are supervised by several sectoral ministries and government departments which may somewhat have different objectives. Each could attempt to influence the parastatals accordingly. However, with the promulgation of the new Constitution Cabinet Secretaries will now become chief executive officers and will be accountable individually, and collectively for exercise of their powers and the performance of their functions hopefully this will insulate parastatals from influence of politicians and meddling bureaucrats. Further, they will be required to give Parliament full and regular reports concerning matters under their control.<sup>29</sup>

Secondly, it is the study's hypothesis that many of the problems facing parastatals can be solved by having more effective boards and quality management.<sup>30</sup> To ensure an effective board, parastatals need to have structured and transparent board nomination processes.<sup>31</sup> The board members would then be obliged to act solely in the interest of the parastatals thereby fulfilling their fiduciary duties. The chief executive officers and board directors should be required to have relevant qualifications and experience for their positions.<sup>32</sup> The new Constitution provides that the guiding principles for selection of public officers should be premised on personal integrity, competence and suitability.<sup>33</sup> Article 260 of the Constitution defines a public officer as any person whose remuneration and benefits are payable directly from the consolidated fund or directly out of money provided by Parliament. Parastatals directors fall within this realm as plans and budgets of parastatals are presented to parliament as line Ministry votes for approval and appropriation of the money by Parliament from the Consolidated Fund. Further, Article 232(2)(b) expressly

<sup>27</sup> David Robinett, *supra* note 5 at p 11.

<sup>28</sup> Agata Waclawik-Wejman, *supra* note 9 at p 6.

<sup>29</sup> Article 153(2) and 153(4)(b) of the Constitution.

<sup>30</sup> Centre for Corporate Governance Development, *supra* note 11 at p 32.

<sup>31</sup> David Robinett, *supra* note 5 at 28.

<sup>32</sup> Centre for Corporate Governance Development, *supra* note 11 at p 35.

<sup>33</sup> Article 73(2)(a) of the Constitution states that "The guiding principle of leadership and integrity include - Selection on the basis of personal integrity, competence and suitability, or election in free and fair elections". Also see Section 24 of the Government Financial Management Act, Chapter 412B of the Laws of Kenya, that requires that revenue generated by parastatals in the form of dividends shall be revenue of the Ministry of Finance.



provides for values and principles of public service which are binding to parastatals in a similar way they apply to all other state organs thereby putting them in the same province in the way they conduct their affairs.

Additionally, the Constitution requires public officers to be guided by objectivity and impartiality in their decision making. They should ensure their decisions are not influenced by nepotism, favouritism, other improper motives or corrupt practices.<sup>34</sup> Moreover, they will be accountable to the public for any decisions and actions they take.<sup>35</sup>

Thirdly, it is the study's hypothesis that if parastatals had explicitly defined ostensible objectives and operational regulations they would have greater political autonomy. Their boards would be clear on what they are supposed to achieve, allowing for improved monitoring and increased performance in the process.<sup>36</sup> Ideally the government should not be involved in the day-to-day management of parastatals. Its role should be limited to setting general directions in strategic issues and policies.<sup>37</sup> The objectives can be set out in performance agreements between the government and parastatals or their boards, defining the goals and requirements for each parastatal and giving their boards certain authority to achieve them.<sup>38</sup>

Fourthly, the study hypothesises that as a corrective measure to over reliance on government funding, the government should only support those parastatals that it can pay for or those that can fund themselves. It should impose hard budget constraints on them.<sup>39</sup>

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<sup>34</sup> Article 73(2)(b) states that as a guiding principle of leadership and integrity, public officers should ensure- objectivity and impartiality in decision making, and ensure that decisions are not influenced by nepotism, favouritism, other improper motives or corrupt practices.

<sup>35</sup> Article 73(2)(d) while Article 232(1) sets out the values and principles of public service which parastatals are required to adhere to, this include but are not limited to observing high standards of professional ethics, efficient, effective and economic use of resources, accountability for administrative acts, and transparency and provision to the public of timely, accurate information.

<sup>36</sup> David Robinett, *supra* note 5 at p 9.

<sup>37</sup> Agata Waclawik-Wejman, *supra* note 9 at p 33.

<sup>38</sup> *Ibid.*

<sup>39</sup> Dennis A. Rondinelli, "Can Public Enterprise Contribute to Development? A Critical Assessment and Alternatives for Management Improvement" in *"Public Enterprises: Unresolved Challenges and New Opportunities"* a publication based on the Expert Group Meeting on Re-inventing Public Enterprise and

In addition, parastatals boards' should be held accountable for their financial management. Each parastatal should be required to keep proper and up to date books of accounts in line with internationally accepted accounting standards.

Lastly, it is the study's hypothesis that the new Constitution heralds a new dawn that will reshape, for the better, the legal and regulatory framework under which parastatals will be governed. For example, the Constitution requires that all appointments to parastatals must be based on fair competition and merit.<sup>40</sup> The values and principles of public service which parastatals are required to adhere to, require them to observe high standards of professional ethics, to be responsive, prompt, effective, impartial and equitable in provision of services, to be accountable for all their administrative acts, and to be transparent and provide to the public timely and accurate information.<sup>41</sup> Moreover, parastatals are required to use the resources allocated to them in an efficient, effective and economic manner. The above stated provisions and many more which will be highlighted in this study are a radical departure from the current existing framework.<sup>42</sup>

## 1.5. LITERATURE REVIEW

The general underlying problems of corporate governance facing parastatals in the developed world are well documented. However, neither the current literature nor empirical studies on corporate governance have paid much attention to corporate governance of parastatals in Kenya. In particular there has been no attempt to critically examine reasons for their poor and depressing performance in light of the corporate governance framework under which they operate while benchmarking them against

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their Management 27-28 October 2005, (Department of Economic and Social Affairs Division for Public Administration and Development Management United Nations New York, 2008), available at <[unpan1.un.org/intradoc/groups/public/.../un/unpan022073.pdf](http://unpan1.un.org/intradoc/groups/public/.../un/unpan022073.pdf)> accessed on June 8, 2010 p 21 at 30.

<sup>40</sup> Article 73(2)(a) of the Constitution provides that the guiding principles of leadership and integrity which shall apply to state and public officers shall include - "Selection on the basis of personal integrity, competence and suitability, or election in free and fair elections".

<sup>41</sup> Article 232(1) lists the values and principles of public service which parastatals are required to observe as being: high standards of professional ethics; efficient, effective and economic use of resources; responsive, prompt, effective, impartial and equitable provision of services; involvement of the people in the process of policy making; accountability for administrative act; transparency and provision to the public of timely, accurate information; fair competition and merit as the basis of appointments and promotions; representation of Kenya's diverse communities; and affording adequate and equal opportunities for appointment, training and advancement.

<sup>42</sup> *Ibid.*

international corporate governance standards of best practices. Furthermore, currently there is no literature critically analysing the impact the new Constitution will have on governance of parastatals. It is this gap that this study intends to fill.

In 2005, the **Centre for Governance and Development (CGD)**, through its Economic Governance Programme (EGP), commissioned a study to examine the legal, legislative, and administrative factors that impede effective and efficient performance of parastatals. The study examined the political economy of state involvement in business in Kenya, the legislative framework for the management of public finance within parastatals, the management and administrative framework of parastatals, and documented and quantified waste in parastatals over the past two decades. It published the findings of its study in a publication titled *“A Decade of Parastatal Waste: A Study of the Audited Accounts of State corporations over the Period from 1993 to 2002”*.<sup>43</sup>

The publication noted that the Kenyan government had promised in its Policy Paper on Public Enterprise Reform and Privatization as well as the Policy Framework Paper of 1993-96, that private sector corporate governance principles would be applied in the management of the parastatals in which it had majority shares or was the sole owner. To secure these ambitions, the 1992 policy paper redefined the parastatals board's functions and character. Among the key measures it recommended were 1) separating ownership from management and 2) enhancing the autonomy, professionalism and accountability of management. Henceforth, the Government promised that it would appoint only competent and qualified managers to public enterprise boards. These appointments would be based on a widely publicized and transparent process; managers would be given clear, non-conflicting objectives and the government would leave management free to set and achieve efficiency goals. Unfortunately, in the decade between 1992 and 2002, the promises of the policy paper were honoured more in breach than in fulfillment.

It argued that if there is to be proper control of the operations and finances of parastatals, the President's excessive powers over parastatals under the SCA should be removed. Moreover,

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<sup>43</sup> available at

<<http://www.cgd.or.ke/publications.asp?title=&formpost=1&documenttypeid=&Year=2005&languageid>  
=> accessed on April 23, 2010.

to avoid many of the shortcomings in the management of parastatals, a system of board appointments, clear performance benchmarks, memoranda of understanding on board and CEO accountability should also be instituted.

**Kiarie Mwaura** in his article, *“The Failure of Corporate Governance in State Owned Enterprises and The Need For Restructured Governance in Fully and Partially Privatized Enterprises: The Case of Kenya”*, observed that parastatals are deeply implicated in most fiscal problems of African governments because of their inefficiency, losses, budgetary burdens, and provision of poor products and services. Occasionally, they achieve some non-commercial objectives, which are used to justify their poor economic performance.<sup>44</sup> Although the government agreed to reduce its participation in the economy, some government intervention was deemed necessary for the purposes of guiding appropriate development of the country. The intervention was preferred in order to ensure a stable, conducive economic environment for private sector activities and to provide administrative and social services, such as health and water, which the private sector could not readily offer. Rather than divesting its entire stake in parastatals, the government sought to privatise some selected services and give priority to local investors rather than foreign ones. To do so the Privatisation Act was enacted which, among other targets, seeks to involve the private sector in order to improve the infrastructure and the delivery of public services.<sup>45</sup>

Mwaura posits that, one of the reasons for the poor performance of parastatals is the fact that the objective of some parastatals, as set out by the Kenyan government, is to foster private sector activity rather than their own growth. This often results in conflicts of objectives and can be regarded as a source of inefficiency. The need to assist the private sector partly undermines the efficiency and solvency of parastatals, as the need to have high profits is rarely on the agenda of some parastatals.

Further, due to the political nature of appointments, parastatal boards are composed of many directors who are ex-civil servants with little or no private business experience. The

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<sup>44</sup> Fordham International Law Journal, (December 2007).

<sup>45</sup> Chapter 485C of the Laws of Kenya.

appointment of directors by the President and the Ministers politicizes directorships. The directors, who sometimes serve concurrently as nominated Members of Parliament and Assistant Ministers, act in the interests of their appointers rather than the corporation. From an economic perspective, it is true to say that the performance of directors of parastatals is constrained by the many agency problems that arise from their political appointments. Although the directors are appointed by the State, the State is not the principal because it derives its mandate from the voters. The poor and ineffective management of parastatals can be attributed, partly, to the appointment criteria, which is based on political influence rather than relevant technical expertise. This has had detrimental effects on the managerial capacity of the boards and on the morale of competent staff.

Further, he states that since the board of directors is made responsible for the proper management of the affairs of parastatals, it is accountable for funds and responsible for the financial business and the management of the parastatal. However, unlike private companies, the ultimate internal control of parastatals lies in the government. The government performs the role of the general meeting by appointing directors and issuing directives. The State Corporations Act does not impose any limit on the ability of Ministers to direct the board, the board of directors is not able to question or review undesirable directions. Ministers are also not under any obligation to adopt sound corporate governance practices. As such, the position of parastatal directors differs from that of their counterparts in the private sector.

Lastly, Mwaura is of the view that lack of autonomy in a board of directors impacts negatively on its effectiveness, as an independent board is key to appropriate corporate governance. To assess how effective the parastatal boards are in discharging their responsibilities, it is important to consider what the functions of an effective board ought to be. Directors of parastatals are not able to perform efficiently because the government does not practice effective corporate governance. As a result, it is true to say that "directors are appointed to a position that carries with it all of the liabilities but are not given the power to carry out the roles that the law imposes."

The **2004, Guidelines of Corporate Governance of State-Owned Enterprises**, as developed by the Organisation for Economic Cooperation and Development (OECD Guidelines) is the first attempt to work out international best practices and standards that parastatals should abide by. It also seeks to create an international benchmark that would be helpful assessing and projecting future reforms for parastatals.

The Guidelines propose that the exercise of the state's ownership rights over parastatals should be clearly identified within the state administration. This may be facilitated by setting up a coordinating entity or, more appropriately, by the centralisation of the ownership function. The coordinating or ownership entity should be held accountable to representative bodies such as the Parliament and have clearly defined relationships with relevant public bodies, including the state supreme audit institutions. This will help to ensure that each parastatal has a clear mandate and receives a coherent message in terms of strategic guidance or reporting requirements. The coordinating entity would harmonise and coordinate the actions and policies undertaken by different ownership departments in various ministries. The coordinating entity should also be in charge of establishing an overall ownership policy, developing specific guidelines and unifying practices among the various ministries.

Further, the Guidelines propose that parastatals should be subject to the same high quality accounting and auditing standards as listed companies. Large or listed parastatals should disclose financial and non-financial information according to high quality internationally recognised standards. In the interest of the general public, parastatals should be as transparent as publicly traded companies. Regardless of their legal status and even if they are not listed, all parastatals should report according to best practice accounting and auditing standards.

Moreover, the Guidelines propose that the boards of parastatals should be assigned a clear mandate and ultimate responsibility for the parastatal's performance. A central prerequisite in empowering parastatal boards is to structure them so that they can

effectively exercise objective and independent judgement, be in position to monitor senior management and take strategic decisions. All board members should be nominated through a transparent process and it should be clear that it is their duty to act in the best interests of the parastatal as a whole. They should not act as individual representatives of the constituencies that appointed them. Parastatals boards should also be protected from undue and direct political interference that could detract them from focusing on achieving the objectives agreed on with the government and the ownership entity.

**David Robinett of the World Bank Corporate Governance Department** argues that state ownership and government control of parastatals present inherent governance challenges that contribute to their poor performance.<sup>46</sup> The emergence of large, shareholder owned corporations in the first half of the 20th century seemed to provide evidence that “publicly owned” enterprises could be successful, including state-owned ones. However, it has become clear that companies with dispersed shareholders presents significant challenges in terms of governance and require a developed institutional framework. Parastatals have the same core problem in terms of separation of control and ownership. The owners in this case being the citizens of a country but they also face additional challenges that can severely undermine their efficiency.

Robinett states that, unlike a widely held corporation in the private sector, a parastatal generally cannot have its board changed via a takeover or proxy contest, and most cannot go bankrupt. The absence of potential takeovers and proxy contests reduces the incentives of board members and managers to maximize the value of the company, and the lack of bankruptcy can introduce a soft budget constraint, which reduces pressure to contain costs. Hence, two of the most important checks on underperformance are absent.

He further posits that although the state and its citizens own parastatals, in between them are the part, or perhaps many parts, of the government that performs the ownership function for the state. This can be one or more ministries, an ownership entity specifically created to oversee parastatals, the Parliament, or frequently some sort of combination. At

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<sup>46</sup> The Challenge of SOE Corporate Governance for Emerging Markets”, (World Bank Corporate Governance Department, May 2006).

the worst, these various authorities may use parastatals to achieve short-term political goals at the cost of both efficiency and longer-term policy objectives. Even without flagrant abuse, this complex agency chain through and across various levels of the government may present difficulties not present in the more straightforward relationship between a company's board and managers on the one hand and its shareholders on the other. Even if the various objectives are perfectly legitimate, the overall impact of this competition for influence reduces accountability and weakens the incentives for managers and board members. Managing multiple and potentially conflicting objectives is one of the central challenges in the governance of parastatals. The government should therefore strive to ensure that the ownership function is exercised in an efficient and accountable manner.

Penultimately, lack of transparency is one of the most common, and unfortunate, shortcomings of parastatals. Opacity undermines performance monitoring, limits accountability at all levels, and can conceal liabilities that can have an impact on national budgets and even financial stability.

Lastly, he notes that, boards play a central role in the governance of the enterprise. A strong board participates effectively in company strategy and provides proper incentives for management, maximizing value, while taking into consideration the policy objectives of the enterprise. However, boards in parastatals often do not play this role. At best, they may act as a kind of parliament that represents the interests of employees, various ministries, and in some cases, non-state shareholders, leaving control of the parastatals to management and various parts of the government. To ensure an effective board, a structured and transparent nomination process should be developed that includes appraisals of board members, avoids complex negotiations between various parts of the government, and has a role for non-state owners when appropriate.

## **1.6. THEORETICAL FRAMEWORK**

According to Sessional Paper No. 10 of 1965, the Kenyan Government recognised the fact that efforts need to be made to ensure that where large amounts of productive assets



must be assembled to achieve economies of scale, ownership of such assets should be widely distributed.<sup>47</sup> One of the methods it identified for achieving a diffusion of ownership of large scale enterprises included state ownership, joint ventures by the state with private investors, companies and partnerships. State ownership vests ownership in the people generally providing for the utmost in diffusion of ownership and permitting operation on a large scale basis. State or joint ownership and operation is desirable where general services of major importance must be provided at low or subsidised cost to citizens, firms or farms or extending such services into unprofitable areas.<sup>48</sup> Therefore, state ownership or involvement in business in Kenya has a complex mixture of social, political and commercial objectives with the primary aim not being profit maximisation as the case would be in a private firm. This makes parastatals fundamentally different from private companies. Dandelot makes the important distinction that the social benefit of having the state provide a particular service is that the state theoretically reinvests profits for the benefit of the citizenry while the private sector distributes the profits for the benefit of its shareholders.<sup>49</sup>

If the overriding objective of parastatals is not profit, then what is it? In official documents the answer is often described vaguely as pursuing the "public interest" or the "national interest" since parastatals belong to society at large but almost nowhere are these terms operationally defined. The closest theoretical concept is what welfare economists call the "social welfare function", which economists have used to prescribe principles for pricing and investment by parastatals.<sup>50</sup> However, the failure to measure parastatals performance by profitability is regarded by neo-classical law and economic

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<sup>47</sup> the African Socialism and its Application to Planning in Kenya, Sessional Paper Number 10 of 1965 (Republic of Kenya, Government Printer, 1965) at p 15.

<sup>48</sup> *Ibid* at p 14.

<sup>49</sup> Marc Dandelot, Discussions from EGM on "Re-inventing Public Enterprise and Their Management" cited in M. Adil Khan, "Introduction: Reinventing Public Enterprises", in *Public Enterprises: Unresolved Challenges and New Opportunities* a publication based on the Expert Group Meeting on Re-inventing Public Enterprise and their Management 27-28 October 2005, (Department of Economic and Social Affairs Division for Public Administration and Development Management United Nations New York, 2008), available at <[unpan1.un.org/intradoc/groups/public/.../un/unpan022073.pdf](http://unpan1.un.org/intradoc/groups/public/.../un/unpan022073.pdf)> accessed on June 8, 2010, p 3-8.

<sup>50</sup> Ravi Ramamurti, "Performance Evaluation of State-Owned Enterprises in Theory and Practice", (July 1987), *Management Science*, Vol. 33, No. 7, p 876-893.

theorists as the main cause of their inefficiency as it deprives them the incentives to increase gains, cut costs and operate efficiently.<sup>51</sup>

I therefore argue that it is not feasible to subject parastatals to the widely developed corporate governance principles applicable to private companies as attempts have been made in some instances. For example, some parastatals are established to achieve the dual purpose of earning profits and achieving other societal objectives as highlighted above. Thus, different standards of best practice need to be developed to govern and to measure and appraise their performance. Unlike private companies where achievement of the profit objective can be measured using accounting tools to ascertain performance the same cannot realistically be applied to parastatals to measure achievement of their societal objectives which are non financial and intangible.<sup>52</sup> Jaindi Kisero is of the opinion, which I agree with, that there is need to demolish and overhaul the current regime governing parastatals and put them on a completely new corporate governance architecture.<sup>53</sup>

As was stated earlier, the OECD Guidelines of Corporate Governance of State-Owned Enterprises, are the first attempt to work out international best practices and standards.<sup>54</sup> The guidelines recommend that the legal and regulatory framework for parastatals should ensure a level-playing field in markets where parastatals and private sector companies compete in order to avoid market distortions.<sup>55</sup>

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<sup>51</sup> Kiarie Mwaura, supra note 14 at p 2.

<sup>52</sup> Jacob Haile-Mariam and Berhanu Mengistu, "Public Enterprises and the Privatisation Thesis in the Third World" (Oct., 1988) *Third World Quarterly*, Vol. 10, No. 4, at p. 1565-1587.

<sup>53</sup> Jaindi Kisero, supra note 29.

<sup>54</sup> The Organisation for Economic Co-operation and Development ('The OECD') groups 30 member countries sharing a commitment to democratic government and the market economy. Its works covers economic and social issues from macroeconomics, to trade, education, development, science and innovation. The OECD plays a prominent role in fostering good governance in the public service and in corporate activity. The OECD Guidelines on Corporate Governance of State Owned Enterprises (the Guidelines) are the first international benchmark to help governments in improving the corporate governance of SOEs. The Principles were adopted by the OECD in April 2005. Addressing the State as an owner, the Guidelines establish the core elements of a good corporate governance regime. They provide standards and good practices, as well as guidance on implementation, and should be adapted to the specific circumstances of individual countries and regions. The guidelines are available at <[www.oecd.org/.../0,3343,en\\_2649\\_34847\\_34046561\\_1\\_1\\_1\\_37439,00.html](http://www.oecd.org/.../0,3343,en_2649_34847_34046561_1_1_1_37439,00.html)> accessed on April 26, 2010.

<sup>55</sup> OECD, Guideline 1 at p 12.

The guidelines also propose that the state should act as an informed and active owner and establish a clear and consistent ownership policy while ensuring that the governance of parastatals is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness.<sup>56</sup> The state should let parastatal boards exercise their responsibilities and respect their independence. The state as an active owner should exercise its ownership rights in corporatised parastatals according to their legal structures. Its prime responsibilities include: establishing well structured and transparent board nomination processes in fully or majority owned parastatals, and actively participate in the nomination of all parastatals' boards; ensuring that remuneration schemes for the board members foster their long term interests and can attract and motivate qualified professionals.

Parastatals are required to observe high standards of transparency in accordance with the OECD Principles of Corporate Governance.<sup>57</sup> They should develop efficient internal audit procedures and establish an internal audit function that is monitored by and reports directly to the board's audit committee. They should also be subject to the same high quality accounting and auditing standards as public listed companies.

From reading the OECD guidelines, they seem to me like they are not intended to be of a one-size-fits-all variety bearing in mind that legal transplants of corporate governance rules have not always been successful. Although best practices are identified, each country needs to identify those components and mechanisms which provide a "good fit" to its circumstances and capabilities. For instance, the guideline proposal that the legal and regulatory framework for parastatals should ensure a level-playing field in markets where parastatals and private sector companies compete in order to avoid market distortions cannot work in Kenya. This is due to the fact that parastatals are fundamentally different from private companies and have additional social objectives and goals even in areas that they compete with the private sector. However, the guideline

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<sup>56</sup> OECD, Guideline 2 at p 13.

<sup>57</sup> OECD, Guideline 5 at p 16.

proposal that the state should act as an informed and active owner of parastatals by ensuring that the governance of parastatals is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness is now workable in Kenya with the promulgation of the new Constitution.

Furthermore, the guidelines depend on the political goodwill of the government for their adoption. This goodwill seemed to have been lacking. The initial successful resistance of parastatals to privatisation programs is an example that has been encountered in Kenya.<sup>58</sup> Lastly, the guidelines are primarily intended to cover parastatals that are profit and commercially oriented and not non-commercial or those solely engaged in public policy related activities.<sup>59</sup>

## 1.7. OBJECTIVES OF THE STUDY

This study has three objectives:

- (1) to conduct an analysis of Kenyan parastatals, their performance, and legal and regulatory framework governing them *vis a vis* the provisions contained in the new Constitution;
- (2) to identify possible corporate governance weaknesses in the framework; and
- (3) to make recommendations on the possible measures that can be undertaken to improve their corporate governance.

## 1.8. RESEARCH METHODOLOGY

The study will primarily undertake a desk review. Primary sources will include the new Constitution, national legislations, OECD Guidelines on state owned enterprises, OECD principles of corporate governance, the CMA Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya, Private Sector Initiative for Corporate Governance -Principles for Corporate Governance in Kenya and Sample Code of Best

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<sup>58</sup> Charles C. Okeahalam and Oludele A. Akinboade, "A Review of Corporate Governance in Africa: Literature, Issues and Challenges", Paper prepared for the Global Corporate Governance Forum 15 June 2003, available at <[www.ifc.org/...Africa.../Charles%20Okeahalam%20-%20Corporate-Governance%20ver%204%20Jul%202003.pdf](http://www.ifc.org/...Africa.../Charles%20Okeahalam%20-%20Corporate-Governance%20ver%204%20Jul%202003.pdf)> accessed on June 8, 2010 p 18.

<sup>59</sup> Agata Waclawik-Wejman, *supra* note 9 at p 11.

Practice for Corporate Governance while secondary sources will include textbooks, articles and Internet sources.

## **1.9. CHAPTER BREAKDOWN**

**Chapter One** contains the introduction part which basically states what this study intends to achieve and consists of the conceptual background, the issues, problem statement, theoretical framework, hypothesis, literature review as well as the methodology of study and chapter breakdown.

**Chapter Two** will analyse the problems that arise from separation of ownership from control of parastatals. It will examine the agency cost theory in detail. It will also highlight the multiple shareholder ownership problems that parastatals face which are further compounded by the legal and regulatory framework under which they operate. Lastly, it will propose possible corporate governance solutions to these problems.

**Chapter Three** will examine the roles and composition of parastatals boards, how these roles differ with those of private companies, the standards of care and skill required of the directors, the legal and regulatory framework under which parastatals directors are appointed and remunerated, the challenges encountered in the appointments and remuneration, and propose possible solutions to these challenges.

**Chapter Four** will examine the legal and regulatory framework governing parastatals financial management, accounting and audit. Secondly, it will examine performance of parastatals over the last two decades based on the reports of the Parliamentary Public Investment Committee (PIC). It will also examine how parastatals procure their goods and services. How far privatisation of parastatals has gone and other policy approaches which may be adopted as alternatives to privatisation. Lastly, it will look at how the provisions of Chapter 12 (on public finance) of the new Constitution are bound to change how parastatals manage their finances and account for the same.

**Chapter Five** will make a conclusion by way of summary and set out possible recommendations or solutions that may help in solving or mitigating the problems encountered by parastatals as were discussed in the study.

## CHAPTER 2: AGENCY PRINCIPAL DICHOTOMY

### 2.1 INTRODUCTION

..the directors of such companies [parastatals] however being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance [as if it was their own].<sup>60</sup>

Managers are supposed to be the “agents” of an enterprise’s “owners”, but managers must be monitored and institutional arrangements must provide some checks and balances to make sure they do not abuse their power. The costs resulting from managers misusing their position, as well as the costs of monitoring and disciplining them to try to prevent abuse, have been called “agency costs”.

This chapter analyses the problems that arise from separation between ownership and control of parastatals. In so doing, the chapter focuses on two key issues. Firstly, it examines the agency cost theory. The concern here is that if actions of directors of parastatals are not monitored and going by human nature, as the argument goes, the directors (agents) interests may deviate from those of their “principals”. Secondly, unlike private companies, parastatals directors find themselves accountable to multiple principals with multiple interests all trying to bring to bear their influence on the management and running of parastatals accordingly. The chapter will examine this multiple principal problem faced by parastatals and propose possible solutions to it.

### 2.2 AGENCY COST THEORY

#### 2.2.1 The Agency Theory

Agency theory explains how best to organise relationships in which one party (principal) determines the work which another party (agent) undertakes.<sup>61</sup> The agent performs some

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<sup>60</sup> Adam Smith, *The Wealth of the Nations*, (Ward Lock, 1838), London, as cited by Christine A. Mallin, *Corporate Governance*, (Oxford University Press, 2<sup>nd</sup> Edition 2006) at p 13.

task that is in the principal's interest, but not necessarily the agent's.<sup>62</sup> The principal can achieve this effect either through moral suasion (in effect, changing the agent's intentional states in order to make him more disposed towards performance of the task), or through the provision of incentives.<sup>63</sup>

The theory argues that under conditions of incomplete information and uncertainty, a situation characterising most business settings, two agency problems arise: Adverse selection and moral hazard.<sup>64</sup> Adverse selection is the condition under which the principal cannot ascertain whether the agent has accurately represented his ability to do the work for which he is being paid. Moral hazard is the condition under which the principal cannot be sure whether the agent has put forth maximal effort. It arises when the agent's action, or the outcome of that action, is only imperfectly observable to the principal. A manager, for example, may exercise a low level of effort, waste corporate resources, or take inappropriate risks.<sup>65</sup> In its narrow sense, corporate governance is, in fact, centered on the agency problems that arise from the separation of management from ownership.

Berle and Means first articulated the agency cost problem in their book on the Modern Corporation and Property.<sup>66</sup> They posit that as firms grew, it became increasingly difficult for the original owners to maintain their majority share holdings, and shares became dispersed among a large number of small shareholders.<sup>67</sup> The consequence of this dispersal, Berle and Means suggested, was the usurpation, by default, of power by the firm's managers, those who ran the day-to-day affairs of the firm. These managers

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<sup>61</sup> Agung Wicaksono, "Corporate Governance of State-Owned Enterprises: Investment Holding Structure of Government-Linked Companies in Singapore and Malaysia and Applicability For Indonesian State-Owned Enterprises", (Unpublished dissertation, The University of St. Gallen, Graduate School of Business Administration, Economics, Law and Social Sciences (HSG), 2008) available at <[www1.unisg.ch/www/edis.nsf/wwwDisplayIdentifier/3488/.../dis3488.pdf](http://www1.unisg.ch/www/edis.nsf/wwwDisplayIdentifier/3488/.../dis3488.pdf)> accessed on May 19, 2010 at p 19.

<sup>62</sup> Joseph Heath and Wayne Norman, "Stakeholder Theory, Corporate Governance and Public Management: What Can the History of State-Run Enterprises Teach Us in the Post-Enron Era?", (Sep., 2004) *Journal of Business Ethics*, Vol. 53, No. 3, p 247-265.

<sup>63</sup> *Ibid.*

<sup>64</sup> Agung Wicaksono, supra note 60 at p 19.

<sup>65</sup> *Ibid.*

<sup>66</sup> Adolf A. Berle Jr., Gardiner C. Means, "*The Modern Corporation and Property*" (The Macmillan Company, New York, 1982 Reprint).

<sup>67</sup> Mark S. Mizruchi, "Berle and Means revisited: the governance and power of large U.S. corporation", available at <[www-personal.umich.edu/~mizruchi/tsweb.pdf](http://www-personal.umich.edu/~mizruchi/tsweb.pdf)> accessed on July 23, 2010 at p 4



were seen as having interests not necessarily in line with those of the shareholders. Whereas owners preferred that profits be returned to them in the form of dividends, for example, managers preferred to either reinvest the profits or in more sinister interpretations, to further their own privileges in the form of higher salaries or “perks”. Removed from the pressures of shareholders, managers, for Berle and Means, were now viewed as a self-perpetuating oligarchy, unaccountable to the owners whom they were expected to represent.<sup>68</sup>

Jensen and Meckling subsequently shed further light on the agency cost problem in their seminal article on the Theory of the Firm.<sup>69</sup> They defined the agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.<sup>70</sup> If both parties to the relationship are utility maximisers, there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent.<sup>71</sup> In addition, in some situations the principal pays the agent bonding costs to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions. They define the agency costs as the sum of monitoring costs, bonding costs, and residual loss, which are incurred by the principal to control and provide incentives to an agent.<sup>72</sup>

Before moving on, it is worthwhile to point out the generality of the agency problem. The problem of inducing an “agent” to behave as if he were maximising the “principal’s” welfare is quite general. It exists in all organisations and in all cooperative efforts at

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<sup>68</sup> *Ibid.*

<sup>69</sup> Michael C. Jensen and William H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, (1976) 3 *J. Fin. Econ.* 305 cited in Winifred Mary Tarinyeba, *Corporate Governance in Uganda: The Role of Bank Finance*, (Unpublished Masters Thesis, Stanford Law School, May 2006) at p 6.

<sup>70</sup> Michael C. Jensen and William H. Meckling, *supra* note 68 at p 5.

<sup>71</sup> *Ibid.*

<sup>72</sup> *Ibid.*

every level of management in firms, in universities, in governmental authorities and parastatals, in unions, and in relationships normally classified as agency relationships.<sup>73</sup> Infact, it has been argued that the agency problems in parastatals are more acute than in the private sector due to the peculiar character of the state as an owner. For example, a parastatal cannot give its managers an ownership stake in the operation that they run. The top end of the pay scale is also significantly lower than in the private sector, for a variety of reasons, and this may make it difficult for parastatals to attract or retain top managers.<sup>74</sup>

### **2.2.2 Corporate Governance Solutions to The Agency Cost Problem**

Some factors may come into play to prevent managers of private companies from acting contrary to the interests of investors. Legal rules impose obligations on managers especially with regard to accounting and disclosure requirements, which then deter managers from improper conduct due to the strong enforcement mechanisms. Increased and improved disclosure reduces agency costs as better information flows from the company to its shareholders reduces information asymmetry.

In addition, capital markets, labour markets, product markets and the market for corporate control also deter managers from acting contrary to the interests of investors. Companies with bad managers may not be able to raise sufficient capital from capital markets if outside investors are concerned about their internal governance. Labour markets will replace managers who reduce firm value by failing to maximise utility while product markets deter bad managerial behaviour through competition. The market for corporate control, on the other hand, deters bad managerial behaviour through take over threats.<sup>75</sup> Firms where managers fail to maximise value will have their share prices drop hence making them targets for take overs.<sup>76</sup>

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<sup>73</sup> *Ibid.*

<sup>74</sup> Joseph Heath and Wayne Norman, *supra* note 61 at p 257.

<sup>75</sup> Henry Manne first identified the market for corporate control in his article "Mergers and the Market for Corporate Control", (1965) 73 J. Pol. Econ. 110. He stated that if management decision is poor, this will be reflected in a depressed share price for the company. If management is ineffective, the share price if the company should fall. A lower share price due to poor management is an invitation for a potential take over. A take over is more likely because the company can be bought on the cheap.

<sup>76</sup> Winifred Mary Tarinyeba, *supra* note 68 at p 16.

Corporate governance is designed to minimise these divergent interests between the various participants in an enterprise and involves mechanisms for reducing agency costs.<sup>77</sup> Through widely accepted corporate governance best practices there are various ways in which shareholders of a private company can “monitor” a company’s management and help to resolve the agency conflicts.<sup>78</sup> For example, corporate governance best practice outline basic shareholder rights which a company should observe as being the right to participate and vote in general shareholder meetings, and to elect and remove members of the board.<sup>79</sup> As owners of the company, shareholders have a right to influence the way in which their company is run through voting at Annual General Meetings (AGM).<sup>80</sup> Shareholders can influence the composition of the board of directors in their investee companies through voting at AGMs.<sup>81</sup> Further, as a matter of best practice all public listed companies in Kenya are required to ensure that all their shareholders receive relevant information on their company’s performance through distribution of regular annual reports and accounts.<sup>82</sup>

However, in parastatals the situation is different. As stated in Chapter 1 of this study, a parastatal generally cannot have its board changed via a takeover or proxy contest, and most cannot go bankrupt. The state is unlikely to allow a large parastatal to face bankruptcy. As a consequence, financial losses can be subsidised from other sources of government finance. At the same time, parastatals may have access to state loans that significantly reduce the possibility of bankruptcy. Providers of capital are often state-

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<sup>77</sup> *Ibid* at p 17.

<sup>78</sup> Christine A. Mallin, *supra* note 59 at p 18.

<sup>79</sup> Principle II (A) of the Organisation for Economic Co-operation and Development (OECD), “*Principles of Corporate Governance*” (OECD 2004). See also the following guidelines; Private Sector Corporate Governance Trust, “Principles for Corporate Governance in Kenya and a Sample Code of Best Practice for Corporate Governance”, (Private Sector Corporate Governance Trust, 1999) available at <[www.ecgi.org/codes/documents/principles\\_2.pdf](http://www.ecgi.org/codes/documents/principles_2.pdf)> accessed on April 26, 2010 at p 11, The Kings Committee Report on Corporate Governance (2002), Malaysian Code on Corporate Governance (2000), and the American Law Institute, *Principles of Corporate Governance* (1994).

<sup>80</sup> Christine A. Mallin, *supra* note 59 at p 18.

<sup>81</sup> *Ibid*.

<sup>82</sup> The Capital Markets Act, Guidelines on Corporate Governance Practices by Public listed Companies in Kenya, Gazette Notice No. 3362 of 2002, at p 488.

owned banks, which limits the possibility of bankruptcies.<sup>83</sup> Thus the discipline enforced on private firms by capital markets and the threat of financial distress is less important to parastatals.<sup>84</sup> Hence, two of the most important checks on underperformance are absent.<sup>85</sup>

Although truly “publicly owned,” many parastatals report little to the public. Normally, a parastatal reports to its “Parent Ministry” that is charged with the responsibility of overseeing it and which in practice is also normally deeply involved in its management. For instance, a Permanent Secretary is the accounting officer in the Parent Ministry while at the same time he also sits on the board of the parastatal that he is to supervise and therefore becomes a party to the board’s decisions.<sup>86</sup> Parastatals that are fully owned by the government or that are regulatory in their nature do not hold AGM’s to elect their board of directors or to take a vote on their key decisions as the case would be in private firms. The only way that parastatals shareholder equivalents can vote with their feet is indirectly through national elections, where a new party might impose a different set of priorities for parastatals.<sup>87</sup>

However, under certain circumstances, it may be easier to monitor parastatals than to monitor private sector companies with dispersed ownership. On the one hand, the public, comprising taxpayers whose contributions will be squandered if parastatals are inefficiently managed, has at least as great an incentive to discipline errant parastatal managers as do shareholders in the private sector. On the other hand, the centralised governance structure within which parastatals operate makes it easier to monitor them. In the public sector, there is often one, or, at most a few, clearly identifiable agencies responsible for monitoring parastatal performance for example, sector ministries or the government’s audit body, whereas dispersed shareholders of private enterprises cannot take concerted actions unless there are some shareholders that are large enough to

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<sup>83</sup> Daniel Shapiro, “The International Activities and Impacts of State-Owned Enterprises”, (2007) CIBC Centre for Corporate Governance and Risk Management Simon Fraser University, available at <[business.sfu.ca/files/PDF/cibc-centre/Shapiro\\_and\\_Globerman\\_2007.pdf](http://business.sfu.ca/files/PDF/cibc-centre/Shapiro_and_Globerman_2007.pdf)> accessed on May 19, 2010 at p 13.

<sup>84</sup> William L. Megginson and Jeffrey M. Netter, *supra* note 25.

<sup>85</sup> David Robinett, *supra* note 5 at p 4.

<sup>86</sup> *Ibid* at p 19.

<sup>87</sup> Daniel Sokol, “Competition Policy and Comparative Corporate Governance of State-Owned Enterprises”, (2009) Brigham Young University Law Review, at p 1715-1811.

unilaterally provide the “public good” of monitoring. Indeed, we may say that governments are set up to solve “public good problems”, of which monitoring of hired managers (of parastatals) is an example.<sup>88</sup>

### 2.2.3 Manifestation of the Agency Problem in Parastatals

Like a private company, a parastatal is, by definition, run by directors and managers who do not own the firm. Given the self seeking nature of humans, the argument goes, no parastatal manager will run the firm as efficiently as an owner-manager would run his own firm. This problem would not exist if the Kenyan citizens, who are the owners (principals) of parastatals, can perfectly monitor parastatal managers (their agents). However, because it is inherently difficult to verify (although managers know) whether poor performance of parastatals is due to shirking by the managers or circumstances beyond their control, monitoring by principals will always remain imperfect, resulting in inefficient management.<sup>89</sup>

Moreover, individual citizens do not have the incentive, and means, to monitor parastatal managers. Instead, the costs that an individual owner (citizen) incurs in monitoring parastatal managers are solely his or hers, while the benefits of improved management accrue to all owners. In other words, the monitoring of hired managers is a “public good”, whose provision is a problem for both parastatals and private sector firms.<sup>90</sup>

The reports of the AG-C on the accounts of various parastatals reveal the agency problems facing parastatals. Again as was stated in Chapter One, out of every 100 reports from the parastatals examined by the AG-C, only eight managed a clean bill of health. Of the nearly 130 parastatals reviewed only 23 managed a clean report.<sup>91</sup> And even among these, ten parastatals managed only one clean report in the decade that was under review.

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<sup>88</sup> Ha-Joon Chang, “State-Owned Enterprise reform”, United Nations Department for economic and Social Affairs 2007, available at <esa.un.org/techcoop/documents/PN\_PARASTATALReformNote.pdf> accessed on May 19, 2010 at p 14.

<sup>89</sup> *Ibid.*

<sup>90</sup> *Ibid.*

<sup>91</sup> Centre for Corporate Governance Development, *supra* note 11 at p 11.

The general story is one of fraud, theft and gross mismanagement.<sup>92</sup> Daniel Okwembah observed that:

Boards of Directors and their chairmen are fleecing state corporations of millions of shillings through sitting allowances, honoraria and foreign trips... some directors earn in excess of Sh400,000 a month and enjoy office, telephone and secretarial services, in breach of an Office of the President circular issued in 2004. The circular disbanded the position of executive chairmen in all state corporations, thus scrapping the huge allowances extended to such appointees. But to circumvent the Office of the President's directive board members now hold numerous meetings with the aim of increasing their monthly earnings. In one parastatal, board members gobbled up Sh29.7 million but only Sh5.2 million could be supported by the register book during the 2006/7 financial year.

In August 2001, the Parliamentary Public Investment Committee revealed how directors of the National Social Security Fund abdicated their duties when they awarded themselves executive treats. As a result, the parastatal lost three billion Kenyan shillings between 1996 and 1998.<sup>93</sup> In addition, the Inspector-General (Corporations) declared the National Housing Corporation (NHC) insolvent because of mismanagement. The directors had commissioned real estate projects worth 319 million Kenyan shillings without either competitive bidding or approval of the NHC board of directors. The NHC also lost 69 million Kenyan shillings when the managing director deposited the money into the now collapsed Prudential Bank, despite opposition by its Finance Director and a Treasury directive requiring parastatal surplus funds to be invested in Treasury Bills and Bonds.<sup>94</sup>

However, as per the new Constitution any parastatal director(s), who directs or approves the use of the parastatals funds contrary to law or instructions, will be liable for any loss

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<sup>92</sup> *Ibid.*

<sup>93</sup> Kiarie Mwaura, *supra* note 14 at p 11.

<sup>94</sup> *Ibid.*

arising from that use and will be required to make good the loss, whether (s)he remains a director or not.<sup>95</sup>

The Public Officers Ethics Act also prohibits parastatals directors and employees from improperly using their offices to enrich themselves or others. Moreover, it requires the selection of the directors and employees to be based on their integrity.<sup>96</sup> On the other hand, the Anti-Corruption and Economic Crimes Act makes it an offence for parastatals directors and employees to fraudulently acquire a parastatal's property or to misuse the public funds allotted to them.<sup>97</sup> It is an offence punishable by a fine not exceeding one million shillings, or to imprisonment for a term not exceeding ten years, or to both for a parastatal director or employee to improperly enrich themselves by virtue of using their office.<sup>98</sup>

#### **2.2.4 Criticism of the Agency Cost Theory**

The fact that many firms, both private and state-owned, are well managed despite dispersed ownership and control suggests there is more to good management of an enterprise than giving individuals the right material incentives as the agency cost theory suggests. Individual self-interest is not the only thing that drives humans.<sup>99</sup> People working in an enterprise are not simply motivated by "selfish" things like their own salaries and power but also by loyalty to the enterprise, a sense of obligation to their colleagues, commitment to workmanship, honesty, dignity, a work ethic, and many other moral values. When it comes to parastatals, there may be additional motives that need to be taken into account, such as nationalism, dedication to public service, concern for

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<sup>95</sup> Article 226(5) states that "if the holder of a public office, including a political office, directs or approves the use of public funds contrary to law or instructions, the person is liable for any loss arising from that use and shall make good the loss, whether the person remains the holder of the office or not".

<sup>96</sup> Chapter 183 of the Laws of Kenya. See Section 11. The Act commenced operation on May 2, 2003. It advances the ethics of public officers by providing for a Code of Conduct and Ethics for public officers and requiring financial declarations from certain public officers and to provide for connected purposes.

<sup>97</sup> Chapter 65 of the Laws of Kenya. Its commencement date was May 22, 2003. It provides for prevention, investigation and punishment of corruption, economic crime and related offences. See Section 45.

<sup>98</sup> Sections 46 and 47.

<sup>99</sup> Ha-Joon Chang, *supra* note 87 at p 14.

social justice, pride in working for a “leading” company, and so on. These motives matter and cannot be ignored.<sup>100</sup>

As the 1978 Economics Nobel Laureate, Herbert Simon once remarked, “if human beings were as selfish as depicted in orthodox economics textbooks, it would be impossible to run any enterprise”. In such a world, companies would collapse under the burden of monitoring and bargaining costs (transaction costs). Moreover, if non-selfish motives did not matter, there would be no difference between good and bad managers. All a manager has to do is to contractually specify the employees’ duties and to design an effective, but obvious, incentive system, using individual rewards and punishments. However, non-selfish motives matter and good managers are those who can induce his workers to do extra through mechanisms that cannot be contractually specified – it is impossible to contractually specify that an employee should be, say, “loyal to the company” or “take pride in his work”.<sup>101</sup>

## **2.3 PARASTATALS MULTIPLE SHAREHOLDER OR PRINCIPAL DILEMMA**

If owners of an enterprise —public or private— are not clear about the goals of the enterprise, they can hardly expect to achieve them. The problem facing parastatals managers is even worse. They have multiple principals who have multiple and often conflicting goals.<sup>102</sup> Parastatals management finds itself accountable to and monitored by a shifting coalition of interest groups, consisting of politicians, bureaucrats, labor unions, and a plethora of other stakeholders.<sup>103</sup> As Stiglitz suggests, this sort of vagueness creates serious agency problems for parastatals:

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<sup>100</sup> *Ibid* at p 15.

<sup>101</sup> *Ibid*.

<sup>102</sup> Prajapati Trivedi, “Designing and Implementing Mechanisms to Enhance Accountability for State Owned Enterprises, Perspective in Public Enterprises: Unresolved Challenges and New Opportunities” Publication based on the Expert Group Meeting on Re-inventing Public Enterprise and their Management 27-28 October 2005, Department of Economic and Social Affairs Division for Public Administration and Development Management United Nations New York, 2008 at p 43, available at <[unpan1.un.org/intradoc/groups/public/.../un/unpan022073.pdf](http://unpan1.un.org/intradoc/groups/public/.../un/unpan022073.pdf)> accessed on June 8, 2010.

<sup>103</sup> Maria Vagliasindi, “Governance Arrangements for State Owned Enterprises”, (March 2008) *Policy Research Working Paper 4542*, Sustainable Development Network, The World Bank, at p 4. Maria Vagliasindi, in her other article “The Effectiveness of Boards of Directors of State Owned Enterprises in



[T]he ambiguity of objectives provides the managers further discretion to pursue their own interests. In the private sector, there is one over-riding concern: profits. In the public sector, there may be a multiplicity of objectives; economic (such as employment) as well as non-economic (national security). Managers can always claim that the reason they are losing money is not that they are inefficient or incompetent, but that they have been pursuing other goals. And it is virtually impossible for an outsider to judge the validity of those claims.<sup>104</sup>

A number of institutions and organisations in the usual governmental structure feel that they have a right to supervise the functioning of parastatals.<sup>105</sup> Parliament feels it needs to hold parastatals accountable on behalf of the people; Parent Ministry feels it is charged with the responsibility to manage the sector and hence needs to supervise parastatals in the sector; Ministry of Finance believes that it has the oversight responsibility over parastatals as public funds are invested in them; and of course the Ministry of Planning needs to supervise parastatals to ensure that they fit the plans. The risk of interest and conflicting objectives are definitely inherent.<sup>106</sup> The Ndegwa committee in its report noted that there was no inter-ministerial co-ordination on major policy issues relating to parastatals. More often than not representatives from the various ministries represented in parastatals boards did not speak the same language during board meetings. This gives way to confusion and delayed decision making.<sup>107</sup> As Frank Easterbrook and Daniel Fischel articulated:

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Developing Countries”, (March 2008) *Policy Research Working Paper 4579* The World Bank Sustainable Development Network, at p 12 states that Multiple objectives arise either because they are mandated by legislation or because a number of government ministries are in a position to exert influence on parastatals. The latter situation becomes especially problematic if the ministries have different aims for parastatals and do not reconcile their divergent views. For instance she gives the example, when shares are held jointly by the treasury and line ministry, the treasury may be concerned principally with the impact of the parastatals on the government’s budget, while the line ministry may focus on increasing the quality of the service with less regard to costs.

<sup>104</sup> Stiglitz, J. , “*The Economic Role of the State*” (Basil Blackwell, Oxford, (1898) cited in Joseph Heath and Wayne Norman, supra note 61 at p 258.

<sup>105</sup> Prajapati Trivedi, supra note 101 at p 44.

<sup>106</sup> OECD, “OECD Comparative Report on Corporate Governance of State-Owned Enterprises”, (OECD, 2005) available at <[www.oecd.org/dataoecd/59/41/35313181.pdf](http://www.oecd.org/dataoecd/59/41/35313181.pdf)> accessed on May 19, 2010 at p 7.

<sup>107</sup> The Commission of Inquiry on Public Service Structure and Remuneration, popularly known as the Ndegwa Committee at page 207. The Commission was constituted on January 15, 1970 by the former president H.E. Jomo Kenyatta to investigate the organisation and structure of the Public Services and to recommend reforms wherever desirable. It published its report in May 1971 (Report of the Commission of Inquiry - Service Structure and Remuneration Commission) and presented the same to the President.

A manager told to serve two masters (a little for the equity holders, a little for the community) has been freed of both and is answerable to neither. Faced with a demand from either group, the manager can appeal to the interests of the other.<sup>108</sup>

Public choice theorists argue that politicians and bureaucrats are typically poor overseers of parastatals. Like ordinary people, they are self interested individuals who seek to attain, exploit and maintain power.<sup>109</sup> While they are supposed to work in the public interest when exercising their control over parastatals, putting into practice policies of government to ensure that parastatals are efficiently, competitively and sustainably managed, public choice theorists see politicians as self interested utility-maximisers who are only motivated by factors such as: “salary, prerequisites of the office, public reputation, power and patronage”.<sup>110</sup> For example, a politician may take steps to forestall the closure of an unprofitable parastatal located in his electoral constituency in order to boost his re-election prospects.<sup>111</sup> As the *Daily Nation* noted:

.. the bane of politicians interfering in the running of State Corporations won't go away soon. A CEO, who sought anonymity, told FJ some politicians were back to their wayward habits of demanding money from parastatals for their own use... between 1980 and 2000, some parastatals had become cash cows for politicians.<sup>112</sup>

It has also been argued that politicians and bureaucrats are also poor overseers because they do not benefit financially or otherwise if a parastatal is highly profitable but may be

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<sup>108</sup>Easterbrook, F. and D. Fischel, “*The Economic Structure of Corporate Law*”, Harvard University Press, Cambridge, Mass (1991) cited in Joseph Heath and Wayne Norman, supra note 61 at p 259.

<sup>109</sup>“Public Choice Theory” was originally articulated by Nobel laureate James Buchanan, “*The Economics of Politics*”, (London: Institute of Economic Affairs, 1978). He argued that in the conventional “public interest” view, public officials are portrayed as benevolent “public servants” who faithfully carry out the “will of the people.” In tending to the public’s business, voters, politicians, and policymakers are supposed somehow to rise above their own parochial concerns. But public choice, like the economic model of rational behavior on which it rests, assumes that people are guided chiefly by their own self-interests and, more important, that the motivations of people in the political process are no different from those of people in the housing or car market. They are the same human beings, after all. Bureaucrats strive to advance their own careers; and politicians seek election or re-election to office.

<sup>110</sup>William A. Niskanen, “W.A. Bureaucracy: Servant or Master?” available at <<http://perspicuity.net/sd/pub-choice.html>> accessed on May 11, 2010.

<sup>111</sup>Maria Vagliasindi, “The Effectiveness of Boards of Directors of State Owned Enterprises in Developing Countries” supra note 102.

<sup>112</sup>Luke Anami and Benson Kathuri, “Politicians call the shots in parastatal chiefs sacking”, *Daily Nation* (Kenya September 9, 2008) at p 19.

blamed when a parastatal acts “too commercially” (for example, undertaking layoffs) or other things go wrong. Typically, they are called to account when things go wrong but not commended when things go right.<sup>113</sup>

However, the public choice theory is limited because there is little room for public officials or politicians who adhere to particular ideologies or who may adopt goals that transcend the interests of any particular group or coalition groups. Though it indicates the importance of the power-seeking motivations of decision makers, it tells us little about how their motivations are developed or altered over time.<sup>114</sup>

## **2.4 POSSIBLE SOLUTIONS TO THE PARASTATALS MULTIPLE DILEMMA**

As a solution to this problem the OECD Guidelines propose that the government should establish a single state ownership entity such as a Ministry or holding company, responsible for the government’s stake in all parastatals.<sup>115</sup> For example, in Kenya we can have a system whereby the running of parastatals is placed under the Ministry of Finance. A legal and regulatory framework is then enacted to give the Ministry powers to intervene in parastatals management and control analogous to the relationship between the shareholder, and board and management of a private company.<sup>116</sup> The Ministry is then held accountable to Parliament. However, it cannot be stated that the Ministry will actively be able to monitor parastatals with the same zeal that shareholders of a private company who derive benefits in the form profits and dividends arising from such monitoring and supervision will. Further, the Ministry will have to incur more monitoring costs in terms of bringing in expertise to monitor the very many parastatals that will be

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<sup>113</sup> Maria Vagliasindi, *supra* note 102.

<sup>114</sup> Joseph R. A. Ayee, “Public Sector Management in Africa”, African Development Bank, Economic Research Working Paper, No 82, November 2005 available at <[www.afdb.org/./afdb/./Publications/00457499-EN-ERWP-82.PDF](http://www.afdb.org/./afdb/./Publications/00457499-EN-ERWP-82.PDF)> accessed on July 27, 2010 at p 7.

<sup>115</sup> David Robinett, *supra* note 5 at p 11.

<sup>116</sup> Jaindi Kiseru, ‘Need for a Radical Change in State Corporations’, *Daily Nation*, (Kenya September 3, 2008).

placed under it if compared to the costs that will be incurred when a Sector Ministry does the monitoring.

The guidelines explain that centralisation of the ownership function brings together relevant competencies by organising “pools” of experts on key matters, such as financial reporting or board nomination. It is also an effective way to clearly separate the exercise of ownership functions from other activities performed by the government.<sup>117</sup>

As an alternative to the above recommendation, the guidelines propose that if the ownership function is not centralised, a minimum requirement should be to establish a strong coordinating entity among the different ministries involved. This will help to ensure that each parastatal has a clear mandate and receives a coherent message in terms of strategic guidance or reporting requirements. The entity should harmonise and coordinate the actions and policies undertaken by the various Ministries. It should also be in charge of establishing an overall ownership policy, developing specific guidelines and unifying practices among the various Ministries. Centralisation of the ownership function in a single entity is probably most relevant for parastatals that are in profit and commercially oriented sectors.<sup>118</sup>

To me the establishment of a centralised or single state ownership entity such as a Ministry or holding company, responsible for the government’s stake in all parastatals may not be a solution to their multiple principal problem. The numerous principals and stakeholder groups have to be given representation in the entity which is charged with the task of reconciling the divergent interests, and issuing a coherent set of imperatives to parastatals management. This in itself is not an easy task.<sup>119</sup> The main disadvantage of giving a specific Ministry such a responsibility is that there is the likelihood that the depth of sectoral expertise available lets say in the Ministry of Finance as has been

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<sup>117</sup> Guideline II (E) at p 13.

<sup>118</sup> *Ibid* at p 196.

<sup>119</sup> Joseph Heath and Wayne Norman, *supra* note 61 at p 260.

proposed, may be shallower than in a sectoral Ministry such as agriculture in relation to agriculture matters.<sup>120</sup>

In Spain, for example, the state holding company for its parastatals initially had representatives of the Ministries of finance, commerce, industry, public works, agriculture, as well as the Ministries of the army, navy and air force, on its board of directors. The result was almost completely unworkable. Furthermore, the creation of a unified governance structure "on paper" did not mean that multi-principal agency problems went away in practice. Even though parastatal managers were technically accountable to only a single agency, they usually exercised considerable influence over the processes of deliberation that informed the agency's decisions. Thus managers would routinely "play politics" with the stakeholder groups, in order to change the balance of political power. Managers of public utilities, for example, would often appeal to large industrial clients, who had an interest in maintaining low rates, in order to help them lobby for expanded capacity, or to resist demands for profitability. The ability of management to selectively disseminate or leak information gives them a particularly powerful card to play in these affairs.<sup>121</sup>

It is worthwhile to note that the proposal to establish a coordinating entity for parastatals is not new to the Kenyan government. In June 1998, the Government published a policy paper on Public Enterprises Reform and Privatization.<sup>122</sup> Amongst the proposals contained in the paper was the establishment of an autonomous Department of Government Investments and Public Enterprises ("DGIPE") within the Ministry of Finance. One of the roles of DGIPE was to represent the Government's ownership function in regard to parastatals in all sectors. It was to exercise oversight and leadership functions in setting strategic objectives for parastatals and ensuring that those objectives were met. Sector Ministry functions in relation to parastatals were to be limited to developing sector-wide policies and programmes. Parastatals boards were to be

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<sup>120</sup> Maria Vagliasindi, *supra* note 102 at p 11.

<sup>121</sup> Joseph Heath and Wayne Norman, *supra* note 61 at p 260.

<sup>122</sup> Ministry of Finance, "*Policy Paper on Public Enterprises Reform and Privatization*", Department of Government Investments and Public Enterprises together with the Executive Secretariat and Technical Unit June 1998.

responsible for setting corporate operational policies and to ensure that their executive managements carried them out. Not much has been heard of these proposals since then.

#### 2.4.1 OVER LAPPING REGULATIONS

The laws compound the agency problems faced by parastatals. Under the SCA, the President has plenary powers to:<sup>123</sup>

..give directions of a general or specific nature to a Board with regard to the better exercise and performance of the functions of the state corporation and the Board shall give effect to these directions.

Parastatals are subject to overlapping regulations. For instance, although all directors and chief executives of the Communications Commission of Kenya (CCK) are appointees of the Minister under the Kenya Information and Communications Act, CCK is still governed by the SCA because it is a state corporation.<sup>124</sup> As such, the President is empowered by the State Corporation Act to appoint its chief executive.<sup>125</sup> The reality therefore is that parastatals corporate governance has been severely eroded both by the laws and by the political environment. As Jaindi Kiseru observed:<sup>126</sup>

Right now, the telecommunications market regulator, the Communications Commission of Kenya, does not have a chairman, reportedly because of a power struggle between Office of the President and its parent Ministry. We must blame this confusion on a corporate governance regime that allows the Office of the President and the so-called parent ministries to wield too much influence over parastatals. As opposed to shareholders in private companies, our government -mainly through parent ministries and Harambee House- insists on steering and at the same time rowing the boat. In the private sector, the shareholder allows the board of directors to steer the company. The management does the rowing...

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<sup>123</sup> Section 7 of the State Corporations Act.

<sup>124</sup> Kenya Information and Communications Act, Chapter 411A of the Laws of Kenya.

<sup>125</sup> Kiarie Mwaura, supra note 14 at p 10.

<sup>126</sup> Jaindi Kiseru, 'There's need for radical change in State Corporations', *Daily Nation*, (Kenya September 10, 2008).

Another example would be the Kenya Reinsurance Corporation which is governed under multiple Acts of Parliament – the SCA, the Reinsurance Act,<sup>127</sup> The Companies Act<sup>128</sup> and the Capital Markets Authority Act.<sup>129</sup>

Furthermore, parastatals are subject to direct regulation by Parliament. Parliament scrutinizes them under the legislation that establishes them. In most cases, the government exercises control of parastatals through Ministers. Since all state corporations fall under a Ministry, a Minister has powers to give directions of a general character to the parastatals. Unlike private companies, where a board of directors sets the objectives of the company, the Ministers are responsible for identifying such objectives in parastatals.<sup>130</sup> They are bestowed with the responsibility of setting both commercial and non-commercial objectives. The parastatal board must answer to the Ministers who are in turn accountable to Parliament. In any case, the plans and budgets of parastatals are presented to Parliament as line Ministry votes, which give the Minister powers in resources allocations.<sup>131</sup>

Additionally, excessive regulations, coupled with extensive Ministerial intervention in the functioning of the boards, tend to impair their ability to make sound decisions.<sup>132</sup> Parastatals, including the ones with specific enabling legislation, are required to: 1) report directly to the parent Ministry because the Ministry, in conjunction with the Treasury, must approve parastatal establishment and the remuneration system; 2) obtain budget and investment approval from the Treasury; and 3) justify their accounts before the Public Accounts Committee of Parliament. Also, parastatals are subject to review by the State

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<sup>127</sup> Chapter 487A of the Laws of Kenya. For example in the recently highlighted court case involving *Eunice Mbogo (Managing Director of Kenya Reinsurance Corporation) –Vs- Kenya Reinsurance Corporation Limited and Three Others*, High Court Miscellaneous Civil Case No. 135 of 2010, it emerged that the Kenya Re Corporation is governed under multiple Acts of Parliament namely – the State Corporations Act, the Kenya Re-insurance Corporation Act, the Companies Act and the Capital Markets Act. Under the State Corporations Act, the managing director is an appointee of the Minister of the parent ministry while the directors are appointees of the President this could led to an agency problem in the corporation that led to the above stated case.

<sup>128</sup> Chapter 486 of the Laws of Kenya.

<sup>129</sup> Chapter 485A of the Laws of Kenya.

<sup>130</sup> Kiarie Mwaura, *supra* note 14 at p 10.

<sup>131</sup> Centre for Corporate Governance Development, *supra* note 11 at p 27.

<sup>132</sup> Kiarie Mwaura, *supra* note 14 at p 10.

Corporations Advisory Committee (SCAC), the Controller and Auditor-General, and the Inspector-General (Corporations).<sup>133</sup>

The numerous approval requirements have the overall effect of constraining the ability of directors to make decisions. Moreover, the expediency of the decision making process is also rendered ineffective by requirements of Ministerial approval.<sup>134</sup> For example, a Minister, in consultation with the SCAC has to give approval for the employment of a chief executive. The delay in obtaining such approvals is one of the main reasons parastatals are unable to make strategic decisions. As such, the process impacts negatively on the general operational performance of parastatals.<sup>135</sup>

This brings me to the question of why government continues to be in business yet the operational regulations it puts in place for its business enterprises are not business oriented. If for example, the parastatal in question is a profit oriented one competing with private companies, yet it requires all the above stated approvals before it invests or expends any monies, such a parastatal will be driven out of the market due such bureaucracies and bottlenecks. Therefore, I propose that we need to amend the legal and regulatory framework governing parastatals to allow profit-oriented parastatals to operate on the same footing with their private sector competitors in the market if they are to remain viable. They should be exempted from the stipulated statutory requirements where there is need to respond promptly to a business opportunity that can be demonstrated. More or less I am suggesting that there is a need to classify parastatals according to their

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<sup>133</sup> *Ibid* and as per Sections 18, 26 and 27 of the SCA. See also Centre for Corporate Governance Development, *supra* note 11 at p 26. The office of the Controller and Auditor -General was established by Section 104 of the old Constitution and its functions specified by Section 105 and supplemented by the provisions of the Exchequer and Audit Act. Under the old Constitution, the Controller and Auditor-General was required to ascertain that expenditures and withdrawals of public funds from the Consolidated Fund are authorized by law or by a vote of the National Assembly. If not, section 105 (2) requires the C & A-G to notify Treasury of any illegal withdrawals.

As regards audit, section 105 (2) (b) the C & A- G duty of ensuring that all funds appropriated by Parliament and disbursed are applied for the purpose they were intended. In discharge of that duty, section 105 (2) (c) required him to, at least once a year, audit and report on the public accounts of the government. If he noted any discrepancies, he was to report these to Parliament. Upon investigation, Parliament was responsible for taking action for misuse.

<sup>134</sup> *Ibid.*

<sup>135</sup> *Ibid.*



objectives and to develop suitable and viable frameworks to govern them depending on their categorisation.

## **2.5 CONCLUSION**

This chapter has explicitly shown that the poor performance of parastatals can be attributed to separation of their ownership from control, and the multiple principal dilemma that they are faced with. Therefore, there is need to streamline the ownership and control function of parastatals as has been proposed in this chapter. Having majorly discussed the ownership dilemma that parastatals are faced with the next chapter will discuss issues relating to control and management of parastatals by their board of directors and the boards themselves. Boards constitute a fundamental base of corporate governance in the parastatals.<sup>136</sup>

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<sup>136</sup> Protocol on Corporate Governance in the Public Sector, supra note 3.

# CHAPTER 3: APPOINTMENT AND REMUNERATION OF DIRECTORS

## 3.1 INTRODUCTION

A well functioning and effective board of directors is the holy grail sought by every ambitious company. A company's board is its heart and as a heart it needs to be healthy, fit and carefully nurtured for the company to run effectively. Signs of fatigue, lack of energy, lack of interest and general ill health within the board's functioning require urgent action.<sup>137</sup>

A firm has a board of directors rather than an executive who rules by fiat because deliberations of a group with complimentary skills and oversight duties "should" lead to better business outcomes. Most corporate governance guidelines recognise the fact that the board is the focal point of corporate governance.<sup>138</sup> It is ultimately accountable and responsible for the performance and affairs of the firm.<sup>139</sup> Thus composition and structure of the board, methods of appointment and policies on remuneration have a direct bearing on corporate governance.<sup>140</sup>

By making reference to relevant literature this chapter will examine; the role and composition of parastatals boards, how these roles differ with those of private companies, the legal and regulatory framework under which parastatals directors are appointed and remunerated, the challenges encountered in the appointments and remuneration, possible solutions to the challenges, and how the new Constitution is bound to reshape the existing framework on the directors appointments and remuneration.

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<sup>137</sup>Christine A. Mallin, *supra* note 59 at p 77.

<sup>138</sup>Winifred Mary Tarinyeba, *supra* note 68 at p 8. Examples of Corporate Governance guidelines recognising the fact include; The OECD Principles on Corporate Governance (2004), Principles of Corporate Governance in Kenya prepared by the Private Sector Initiative for Corporate Governance (1999), The Capital Markets Act, Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya (2002), The South African, King Committee Report on Corporate Governance (1994).

<sup>139</sup>Guideline 2.1.1., King Committee Report on Corporate Governance (1994).

<sup>140</sup>Winifred Mary Tarinyeba, *supra* note 68 at p 8.

## 3.2 ROLE AND APPOINTMENT OF PARASTATALS BOARDS OF DIRECTORS

### 3.2.1 Roles and Responsibilities of the Boards

A board of directors is an enterprise's supreme executive body.<sup>141</sup> Its primary task is to ensure that management is acting in the interests of the shareholder and stakeholders, through an advisory and monitoring role.<sup>142</sup> It has been argued that this statutory monitoring role of directors bears little resemblance to reality, or at least practice.

Axworthy argues that directors, especially of large companies or parastatals, not only do not do what the law envisages of them but, indeed, cannot fulfill the law's requirements. It is the senior managers who fulfill these functions. This is because the policy making and monitoring roles, for example, are beyond the competence of most of the boards' directors. They will not, and cannot be expected to spend much of their time considering the company's affairs. Between managing their own businesses and serving on multiple boards, directors cannot be able to understand the business well enough to be truly effective. Additionally, they only meet a few times in a year to discuss the company's affairs while relying on information provided by the senior managers.<sup>143</sup> Thus, Axworthy is of the opinion that there is no clear necessary role for directors in companies or parastatals as the shareholders, the stock market, creditors and the senior managers who, taken together, can effectively perform the required monitoring functions. Consequently, corporate law should dispense with the need for directors.<sup>144</sup>

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<sup>41</sup>Mahmoud Ezzamel and Robert Watson, "Wearing Two Hats: The Conflicting Control and Management Roles of Non Executive Directors" cited in Kevin Keasey, and others, "Corporate Governance: Economic", Management and Financial Issues at p 54-79.

<sup>42</sup>Maria Vagliasindi, supra note 110 at p 2.

<sup>43</sup>Eisenberg M.A., "The Modernisation of Corporate Law: An Essay for Bill Cary" (1983), 37 *U. Miami L.Rev.* 187, at p 204 cited in Christopher S. Axworthy, "Corporate Directors. Who Needs Them?", (May, 1988), *The Modern Law Review*, Vol. 51, No. 3, at p 275.

<sup>44</sup>*Ibid* p 295.

Further, Bebchuck has articulated concern that a board of directors may not use its powers to maximize the well-being of shareholders.<sup>145</sup> A good example I can give to support the above arguments is the collapse of Uchumi Supermarkets Limited which was attributed to having a dysfunctional board. Dysfunctional boards have also been associated with corporate governance failures in developed corporate governance regimes, such as those present in developed countries like the United States. In the collapse of Enron in the United States, directors failed in monitoring the activities of the management of Enron and its financial affairs, by mainly relying on the explanations of management because they trusted them and did not question the information that was given to them. May be this is what happened in the case of Uchumi.<sup>146</sup> Eshiwani characterises typical non-performing boards in Kenya as having directors who are always present at company meetings, as executive remuneration takes the form of an allowance awarded for each meeting attended. Age-wise, the members of the board are typically elderly people and the discussion that takes place for the better part of the meeting has little to do with the objectives of the company or parastatal.<sup>147</sup>

However, according corporate governance best practices, each parastatal should be headed and controlled by an effective and efficient board, in order to ensure independence and objectivity in decision making.<sup>148</sup> The board should ideally be responsible for formulating and implementing policies, procedures and business strategy on behalf of shareholders or stakeholders and ensure that all activities are conducted in a manner which complies with the law.<sup>149</sup>

According to the **State Corporations (Performance Contracting) Regulations** (Regulations), parastatals boards are required to: Implement budgets approved by the treasury and their parent Ministry, recruit staff including the chief executives, develop

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<sup>145</sup>Lucian A. Bebchuk, "The Case for Increasing Shareholder Power" (2005) 118 Harv. L. Rev. 835 cited in Daniel Sokol, *supra* note 86.

<sup>146</sup>Lois M. Musikali, "The Law Affecting Corporate Governance In Kenya: A Need For Review", (2008), *I.C.C.L.R* 19(7), p 213-227.

<sup>147</sup>Eshiwani, "Director Liability in the Wake of Uchumi (Collapse)", Institute of Directors (Kenya), July 14, 2006 cited in *Ibid*.

<sup>148</sup>Protocol on Corporate Governance in the Public Sector, *supra* note 3 at p 9.

<sup>149</sup> Mahmoud Ezzamel and Robert Watson, *supra* note 140 at p 54.

and negotiate with the parent Ministry performance targets for a specified financial year, develop, maintain and review on a regular basis the strategic plan for the parastatals, manage the assets of the parastatals, enter into and implement performance contracts with the chief executive, submit quarterly reports of the performance of the parastatal to the parent Ministry, the Treasury and the Inspector-General (Corporations), and perform any other duties that may be deemed necessary or expedient for the implementation of the performance contracts.<sup>150</sup>

### 3.2.2 Directors Standard of Skill and Care

The Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya, recommend that all listed companies when making appointments to their boards should only consider persons of caliber, credibility and who have the necessary skills and expertise to exercise independent judgment on issues that are necessary to promote a company's objectives and performance in its area of business.<sup>151</sup>

The roots of directors' duties of skill and care lay in the treatment of directors by the 19<sup>th</sup> century Courts of Chancery as "trustees" or "quasi-trustees". Directors were long treated as well meaning amateurs "free from liability for anything short of culpable and gross negligence". The legacy of this background is to be seen in the case that forms the *locus classicus* of the modern law: **Re City Fire Equitable Insurance Co. Ltd.** In his judgment, **Romer J** reduced the law to three propositions. Firstly, he emphasised the relative nature of the duty of skill and care, stating that a director need not exhibit in the performance of his duties "a greater degree of skill than may reasonably be expected from a person of (his) knowledge and experience".<sup>152</sup> As Mackenzie notes:

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<sup>150</sup>Regulation 4 of Legal Notice No. 93 of 2004, issued pursuant to Section 30 of the State Corporations Act, that empowers the President to make regulations generally for the better carrying into effect of the provisions of the Act.

<sup>151</sup>The Capital Markets Act, Guidelines on Corporate Governance Practices by Public listed Companies in Kenya, Gazette Notice No. 3362 of 2002, guideline 3.1.3 at p 484.

<sup>152</sup>*Re City Equitable Fire Insurance Co Ltd* [1925] Ch 407.

The director is obliged only to do as much as could be expected from someone as incompetent and foolish as he happens to be...<sup>153</sup>

Secondly, a director is not bound to give continuous attention to the affairs of his company but is bound to attend all meetings he reasonably could. Thirdly, a director, in the absence of grounds for suspicion, is justified in trusting officials to perform duties honestly where he allocates those duties properly, having regard to the exigencies of business and to the company's Articles.<sup>154</sup> The court was reluctant to interfere with the internal management of companies and sought to have shareholders who appointed amateur directors to bear the consequent risks.<sup>155</sup>

In Kenya, the rules to determine whether a director is in breach of his duty of skill and care were adopted from the subjective common law position as were set by **Romer J.** Commissioner of Assize **Mr P.J.S. Hewett** in his ruling in the precedent setting case of ***Flagship Carriers Limited v Imperial Bank Limited*** adopted the subjective position to determine liability of directors for breach of duty of skill and care based on business judgments.<sup>156</sup>

Given that a director is only required to exhibit a degree of skill and care that may be reasonably expected from a person of his knowledge and experience, a director cannot be held liable for honest mistakes of judgment. It is worthwhile to note that there are no statutory provisions in Kenya requiring directors of a company or parastatal to have expertise and experience in the management of its business or operations.<sup>157</sup>

Due to public expectations and exigencies of today's business, the courts in some jurisdictions have continuously changed their attitude towards the low subjective

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<sup>153</sup> Mackenzie, "A Company Director's Obligations of Care and Skill" [1982] *JBL* 460, 475-76 cited in Vanessa Finch, "Company Directors: Who Cares about Skill and Care?", (Mar., 1992), *The Modern Law Review*, Vol. 55, No. 2, at p 179-214.

<sup>154</sup> *Ibid.*

<sup>155</sup> Kiarie Mwaura in his article "Company Directors' Duty of Skill and Care: A Need for Reform", *Comp. Law*. 2003, 24(9), 283-288.

<sup>156</sup> High Court Civil Case No. 1643 of 1999 (unreported) cited in *Ibid.*

<sup>157</sup> *Ibid.*

standards set in earlier cases. As a result, they have sought to raise the standards by suggesting that the relevant test of the duties of a director involves not only a subjective element but also an objective one which requires a director to possess skills that "may reasonably be expected from a person undertaking those duties".<sup>158</sup> A number of attempts to lay down statutory tests have also been made or are current. For instance, in the 1975 Business Corporations Act of Canada (the degree of care, diligence and skill a reasonably prudent person would show in comparable circumstances); in Section 309 of the California Corporation Code 1977 (such care, including reasonable inquiry, as an ordinary prudent person in a like position would use under similar circumstances); and in section 229 of the Australian Companies Code (the objective test of which was reaffirmed by the Cooney Committee in 1989).<sup>159</sup> The Nigerian Law Reform Commission also sought to raise the low standards by requiring directors to conform to a professional standard of care, just as doctors or lawyers must.<sup>160</sup> This approach followed the objective standard adopted by the Lawrence Committee (Ontario) in 1967, which provides that:

Every director of a company shall exercise the powers and discharge the duties of his office honestly, in good faith and in the best interests of the company, and in connection therewith, shall exercise that degree of care, diligence and skill which a reasonably prudent director would exercise in comparable circumstances.<sup>161</sup>

From the illustrations, the consideration of objective elements requires directors to have some degree of common intelligence. It is notable that the application of an objective standard of care in Kenya would make many directors liable in negligence because directors are not required to have any special qualifications to assume office. There is a need to review Kenya's law on director liability to reflect a dual standard of liability with both objective and subjective elements of liability.<sup>162</sup> It would therefore be appropriate to

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<sup>158</sup> *Ibid.*

<sup>159</sup> Vanessa Finch, *supra* note 152 at p 203.

<sup>160</sup> *Ibid.*

<sup>161</sup> Nigeria Law Reform Commission, "Working Papers on the Reform of Nigerian Company Law" (1987), *Vol. 1-Review and Recommendations*, cited in Kiarie Mwaura, *supra* note 154.

<sup>162</sup> Lois M. Musikali, *supra* note 145.

prescribe minimum standards for directors in order to maintain high standards of skill and care. This would introduce professionalism to the board.<sup>163</sup>

### 3.2.3 Private Sector Boards Mirrored Against Parastatals Boards

The Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya, further, recommend that the boards of all listed companies should appoint a nominating committee consisting mainly of independent and non-executive directors with the responsibility of proposing new nominees to the board and for assessing the performance and effectiveness of directors in the Company.<sup>164</sup> Thereafter the company's shareholders are required to approve and confirm the appointment of such director(s) at the company's general meeting.<sup>165</sup>

A key difference between the private sector and parastatals boards is the relationship between the board and its controlling shareholder and the relative authority of the two.<sup>166</sup>

The **OECD Principles of Corporate Governance** lists a number of key functions that a board of directors should be responsible for, these include; reviewing and guiding corporate strategy; setting performance objectives; monitoring implementation and corporate performance; overseeing major capital expenditures; selecting, compensating, monitoring and when necessary replacing key executives; ensuring a formal and transparent board nomination and election process; ensuring the integrity of the corporation's accounting and financial reporting systems and overseeing the process of disclosure and communication.<sup>167</sup>

The shifting of authority from the board to the state as represented by the government tends to go further in parastatals than in many private sector companies.<sup>168</sup> The SCA gives the President and Ministers special powers. For example, as was stated the

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<sup>163</sup> *Ibid.*

<sup>164</sup> Guideline 3.1.3, The Capital Markets Act, *supra* note 150.

<sup>165</sup> Section 184 of the Companies Act, Chapter 486 of the Laws of Kenya.

<sup>166</sup> David Robinett, *supra* note 5 at p 24.

<sup>167</sup> OECD Principles of Corporate Governance (2004) Guideline vi (d).

<sup>168</sup> David Robinett, *supra* note 5 at p 24.



President has plenary powers to give directions of a general or specific nature to a board with regard to the better exercise and performance of the functions of the parastatal and the board has no option but to give effect to such directions.<sup>169</sup> The Regulations list a number of areas of responsibility for the board and by implication it is the board that has “absolute responsibility for the performance of the parastatals”. However, it is the Minister charged with the oversight of the parastatal who chooses the chief executive, albeit in consultation with the board.<sup>170</sup> Normally, choosing top management is one of the principal responsibilities of a company’s board.<sup>171</sup> Additionally, in some instances, Permanent Secretaries have been known to appoint or transfer parastatals departmental heads without board approval.<sup>172</sup> Therefore, unlike private companies, parastatal boards do not have overall responsibility for the performance of the organisation given their minimal authority over matters regarding the parastatals.<sup>173</sup>

In practice, almost all of the “key functions” for a board are performed or at least heavily influenced, by the government and or Ministers. “The power of parastatal boards to take basic policy decisions is more theoretical than real”.<sup>174</sup> As per the Regulations, the power of running parastatals is shared between Permanent Secretaries, Ministers, boards of directors, the Treasury, and the Office of the President.<sup>175</sup> These restrictions and requirements reflect an inherent reluctance of the government to delegate authority to the boards.<sup>176</sup>

### **3.2.4 Appointments of Parastatals Board of Directors and Board Composition**

Appointment of directors to a board of any enterprise be it a private company or parastatal should ideally be done through a managed and effective process to ensure that a balanced mix of proficient individuals is made. That each of those appointed is able to

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<sup>169</sup> Section 7.

<sup>170</sup> David Robinett, *supra* note 5 at p 24.

<sup>171</sup> *Ibid.*

<sup>172</sup> Centre for Corporate Governance Development, *supra* note 11 at p 31.

<sup>173</sup> *Ibid.*

<sup>174</sup> David Robinett, *supra* note 5 at p 24.

<sup>175</sup> Regulation 4, State Corporations (Performance Contracting) Regulations (2004).

<sup>176</sup> David Robinett, *supra* note 5 at p 24.

add value and bring independent judgment to bear on decision making processes.<sup>177</sup> The Ndegwa committee recommended that in so far as possible appointments, whether of chairmen or directors of parastatals should be made on the basis of ability, judgment, experience and integrity.<sup>178</sup> The size of a board of directors should be such as to permit sound policy formulation and evaluation of management performance.<sup>179</sup>

The SCA empowers the President or the Minister in charge of a parastatal to appoint its board of directors.<sup>180</sup> It also allows the President to provide for the management of every parastatal established under the SCA. The President is also empowered to determine the composition of the board of directors.<sup>181</sup> The Ndegwa committee recommended that the number of directors on a parastatal board should not exceed ten as emphasis should be placed on efficiency of representation rather than having a large board pacifying vested interests demands of a cross section of representation.<sup>182</sup> Therefore, parastatals boards of directors generally consist of:<sup>183</sup>

- Chairman appointed by the President
- Chief Executive
- The Permanent Secretary of the parent Ministry
- The Permanent Secretary of the Treasury
- Less than seven other members who are not employees of parastatals three of whom are required to be public officers, appointed by the Minister.

Further, SCAC may advise the President or Minister on the appointment, removal or transfer of officers and staff of parastatals, the secondment of public officers to

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<sup>177</sup> Private Sector Initiative for Corporate Governance, supra note 4 at p 8.

<sup>178</sup> Ndegwa Committee supra note 106 at p 206.

<sup>179</sup> *Ibid.*

<sup>180</sup> Section 6 of the SCA.

<sup>181</sup> Kiarie Mwaura, supra note 14 at p 6.

<sup>182</sup> Ndegwa Committee Report, supra note 106 at p 206.

<sup>183</sup> *Ibid.*

parastatals and the terms and conditions of the same.<sup>184</sup> The SCAC as the name suggests is only an advisory committee with no real oversight legal authority.<sup>185</sup>

With the introduction of the Regulations, boards of parastatals are empowered to recruit chief executives of parastatals competitively.<sup>186</sup> While the sector Minister's role is limited to choosing the chief executive from a list of three recruits presented to them by the board.<sup>187</sup> Despite the provisions of the regulations, some Ministers have been hand-picking their cronies and tribesmen, and appointing them to such positions even where they do not possess the required experience or qualifications.<sup>188</sup> In that scenario, it is difficult for such political lackey directors and ethnic protégés to effectively exercise objectivity and independence of judgment when making critical decisions pertaining to the parastatals. They are more likely act as individual representatives of the constituencies that appointed them, a task which is often at odds with bringing efficiency improvements. Jaindi Kiseru articulates:<sup>189</sup>

We really need to streamline the laws and procedures governing the appointments of parastatal chiefs. If there is a lesson we have learnt from the controversy over the renewal of Mr. George Muhoho's contract as the Kenya Airports Authority's CEO, it is that this new fad about performance contracting will remain worthless until we introduce a completely new corporate governance system for parastatals.

The laws and regulations governing the appointment of parastatal CEOs are both confusing and contradictory, leaving huge loopholes that Ministers exploit to appoint their cronies. The hypocrisy which the political elite displays when it comes to competition for public office is simply astonishing... Consider the predicament which KAA [Kenya Airport Authority] deputy Managing Director, Mr. Mathew Wamalwa, found himself in. On Tuesday morning,

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<sup>184</sup> Section 27 of the SCA.

<sup>185</sup> Established by Section 26 of the SCA. George Wachira, "Shield Parastatals From Bad Politics", *Business Daily* (Kenya 15 December 2009) available at <<http://allafrica.com/stories/200912141737.html>> accessed on August 13, 2010.

<sup>186</sup> State Corporations (Performance Contracting) Regulations (2004), Regulation 4.

<sup>187</sup> Jaindi Kiseru, 'Appoint parastatal chiefs in a more transparent manner', *Daily Nation*, (Kenya April 15, 2009).

<sup>188</sup> Samuel Siringi, 'Ministers flout the rules over state jobs', *Daily Nation* (Kenya May 19, 2009) at p 1.

<sup>189</sup> Jaindi Kiseru, *supra* note 186.

he receives a letter from Transport Permanent Secretary Abudrazik Ali appointing him acting managing director of the Authority. The following day, the chairman of the board, Mr. Erastus Mwongera, moves in quickly and assembles all directors who proceed to install him to the high office. On the fourth day, Transport Minister Ali Mwakwere, citing powers under the Kenya Airports Authority Act, extends Mr. Muhoho's term by a year. Why did the Minister choose to undermine the powers of the board in such a blatant manner? Was due process followed? The jury is out on that one.

Furthermore, as has been stated above, there is no statutory provision requiring directors to have expertise and experience in the management of parastatals<sup>190</sup>. Parastatal boards are composed of many directors who are ex-civil servants with little or no private business experience.<sup>191</sup> The PIC in its report on the accounts of State Corporation noted that most appointments to parastatals boards have not measured to the requirements of the performance of the respective parastatals.<sup>192</sup> In certain cases chief executives appointed to manage respective parastatals were so appointed without due regard to their technical qualifications, past performance, age and relevant experience.<sup>193</sup>

Additionally, the powers given to the President and the line Minister to appoint parastatals directors have heavily politicised the boards.<sup>194</sup> This is despite the fact that the Public Officers Ethics Act 2003 requires parastatals directors and employees to be politically neutral.<sup>195</sup> As the Daily Nation reported:<sup>196</sup>

President Kibaki has named a former MP to lead a State Corporation in what is becoming the trend in government. The appointment of former assistant Minister Anania Mwaboza to chair the board of the Catering and Tourism Development Levy Trustees for three

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<sup>190</sup> Kiarie Mwaura, supra note 20.

<sup>191</sup> *Ibid.*

<sup>192</sup> Eleventh Report of the Public Investments Committee on the Accounts of State Corporations at p XV. The Public Investments Committee, is a select committee of Parliament established under Standing Order No. 188. The functions of the Committee as stated in the standing Order 188 (5) are: 1) to examine the reports and accounts of the public investments; 2) to examine the reports, if any, of the Auditor-General (Corporations) and 3) to examine, in the context of the autonomy and efficiency of the public investments, whether the affairs of the public investments are being managed in accordance with sound business principles and prudent commercial practice.

<sup>193</sup> Kiarie Mwaura, supra note 20 at p 7.

<sup>194</sup> *Ibid.*

<sup>195</sup> Chapter 183 of the Laws of Kenya, Section 16.

<sup>196</sup> By Saturday Nation Reporter, 'Former Kibaki loyalists land plum parastatal jobs', *Saturday Nation* (Kenya April 24, 2010).

years is contained in the latest issue of the *Kenya Gazette*, dated April 23, 2010... Another politician, Mr. Hosea Kiplagat has been appointed to the board of Ewaso Ng'iro South Development Authority... Just a month ago, Regional Development Minister Fred Gumo had also appointed former Cabinet Minister Ochillo Ayacko to the Lake Basin Development Authority board. Also appointed to the same board were political activists Carey Francis Onyango, Dickson Katibi and Alex Mukabwa. In the same gazette notice, dated March 26, Finance Minister Uhuru Kenyatta appointed Mombasa politician Taib Ali Taib to the board of the Kenya Investment Authority.

Sadly, some of the directors who were responsible for the collapse of parastatals were not only appointed to other directorships, they were also appointed to the Cabinet. For instance, despite the public outcry and prosecution that followed the investigation of the former managing director of the Kenya Posts and Telecommunications (KPTC), Mr Kipng'eno Arap Ng'eny, for masterminding the loss incurred by the corporation, he was retired in 1993 and appointed to head the Kerio Valley Development Authority. According to the 1990/91 Auditor General's Report on the Kenya Posts and Telecommunication, the managing director was responsible for a number of fraudulent dealings. First, in 1985, the corporation lost nine million Kenya Shillings after making payments to a firm of advocates to wind up the former Kenya External Telecommunications Corporations (KETC). The payment was made despite the fact that KETC was in the process of being merged with KPTC. The winding-up process was rendered a sham when the two companies merged. Secondly, by 30<sup>th</sup> June 1990, the corporation had failed to remit to various public authorities statutory deductions from staff salaries amounting to about 170 million Kenya Shillings.<sup>197</sup>

Despite several recommendations made by the PIC that, the people it adversely named should be charged in court, surcharged and barred from holding public offices, such individuals continued to serve in high positions both in the government and the private sector.<sup>198</sup> Such parastatal heads included Alfred Kiptanui Keter (Cereals and Produce Board), Harun Lempaka (Mwea Rice Mills Limited), Cyrus Maina (Teachers Service

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<sup>7</sup> Kiarie Mwaura, "Disqualification of Directors in Kenya", (2003) *54 Northern Ireland Legal Quarterly*, at p 118-135.

<sup>8</sup> *Ibid.*

Commission), Oluoch Kanindo (South Nyanza Sugar Company Limited) and Lawi Kiplagat (Milling Corporation of Kenya Limited).<sup>199</sup> When asked why no action had been taken against these heads, the Attorney General's answer was that some of these cases were civil and that the affected parastatals should act against their former chief executives.<sup>200</sup> This was despite the fact that the Public Officers Ethics Act 2003 requires that parastatals directors and employees should be selected on the basis of their integrity.<sup>201</sup> The Daily Nation aptly noted that:

The tragedy in Kenya is that those who have mismanaged the Government, the Development, Finance Institutions, and even multinational corporations are those who continue to circulate in and out of Government as Ministers, Assistant Ministers, advisers and so on.<sup>202</sup>

Key reforms are therefore needed at the board level that relate to appointment structures and conduct so as to eliminate cronyism and to provide tools to evaluate board performance.<sup>203</sup> The PIC in its eleventh report on the accounts of parastatals recommended that all stakeholders must be involved in the appointment of board members. Where the enabling Acts do not make the above provision, it directed the Attorney General to ensure that affected Acts are amended to enable stakeholders appoint their representatives to the boards in order to limit the discretions of the Ministers in parastatals.<sup>204</sup>

However, the involvement of stakeholders in board appointments also seems not to be adding much value. For example, it is normally the Central Organisation for Trade Unions (COTU) Secretary General who takes up the directorship in all parastatals boards where the organisation has been allotted a slot to appoint a representative. As of now it is reported that the Secretary General sits in half a dozen of parastatal boards in addition to

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<sup>199</sup> Centre for Corporate Governance Development, *supra* note 11 at p 36.

<sup>200</sup> *Ibid.*

<sup>201</sup> Section 22.

<sup>202</sup> *Ibid.*

<sup>203</sup> Centre for Corporate Governance Development, *supra* note 11 at p 29.

<sup>204</sup> PIC's Eleventh Report, *supra* note 191 at p xvi.

his trade unions obligations.<sup>205</sup> It is not actually physically possible to attend that many board meetings or immerse oneself in the details of that many enterprises. And so we have the spectacle of the director who cruises into a couple of meetings a year, having not even glanced at the papers, drops a few generic pearls of pseudo-wisdom, and cruises out.<sup>206</sup> Thus raising the question of whether stakeholders effectively participate or add any value to parastatals boards as they were intended to.

The main way of restricting political interference in the nomination of parastatals boards and increasing their independence and professionalism is to put in place a structured nomination process. Making sure that the ultimate selection criterion is competency. Until very recently, not even developed countries had established procedures or criteria for appointment of their parastatals' board members, except for the recommendations of the responsible Minister presented to the government as a whole. Very few countries, such as Australia, New Zealand and Sweden, have set up such structured and clearly skill based nomination systems. A few countries have also introduced nomination committees, but only for their public listed parastatals. The countries have clearly spelt out the requirements that the process has to be efficient, transparent and based on merit, excluding political activity and affiliation from selection criteria.<sup>207</sup>

However, legal transplants of corporate governance rules have not always been successful. Probably what might work in Kenya is to empower the SCAC so that it is able to set mandatory criteria for appointments to boards instead of just being an advisory body. It should be required to generate a database for board candidates, from which Ministers can pick appointees from. It can also be empowered in such a way that it can be able to name, shame and blacklist individuals who may have defrauded parastatals in the

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<sup>205</sup> David Ochami, 'Atwoli Warns MPs From Meddling in Cotu Affairs', *The Daily Standard* (Kenya August 18, 2010).

<sup>206</sup> Sunny Bindra, 'Before joining any board of directors, ask yourself 'why?'' *Business daily* (Kenya, April 12, 2010 <<http://www.businessdailyafrica.com/>> accessed on September 20, 2010.

<sup>207</sup> Maria Vagliasindi, supra note 102 at p 8.

past.<sup>208</sup> There is a suggestion that SCAC should be modeled along the same line as the Public Service Commission.<sup>209</sup>

On the other hand, if the Government is adamant it does not want to relinquish its control over the appointments then the Indian model can be adopted. In India, parastatal board members are recommended and recruited by a Public Enterprise Selection Board, an autonomous government body.<sup>210</sup> However, the final decision lies with the Ministers in the Appointment Committee of the Cabinet. All appointments are subject to due diligence and clearance by the Central Vigilance Commissioner.<sup>211</sup>

With or without a structured nomination process, a growing number of countries such as Finland or Sweden are also increasingly relying on the professional services of recruitment agencies to fulfill this key task of board nomination.<sup>212</sup> The development of such practices would help in enlarging the pool of potential experts for parastatal boards, especially to bring in more private sector experience, thereby improving parastatals boards' professionalism.<sup>213</sup> In Poland, the Ministry of State Treasury requires potential candidates to its parastatals supervisory boards to pass an exam before receiving a special certificate and being registered in a database. The database for parastatals directors contained 35,000 names for 5,000 positions as of 2005. The training and certification for board members, possibly developed with an independent Institute of Directors, may also be useful in increasing the competence and effective pool of parastatals board members.<sup>214</sup>

Again, it is worthwhile to note that all these reform proposals are not new to the Kenyan government. In the 1998 Policy Paper on Public Enterprise Reform and Privatisation that was to implement the Public Enterprise Reform Programme it was proposed that one of the roles of the Department of Government Investments and Public Enterprises (DGIPE)

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<sup>208</sup> Centre for Corporate Governance Development, *supra* note 11 at p 29.

<sup>209</sup> George Wachira, *supra* note 185.

<sup>210</sup> David Robinett, *supra* note 5 at p 25.

<sup>211</sup> *Ibid.*

<sup>212</sup> Maria Vagliasindi, *supra* note 102 at p 10.

<sup>213</sup> *Ibid.*

<sup>214</sup> David Robinett, *supra* note 5 at p 26.



within the Ministry of Finance, was to design and implement a transparent system for selection and appointment of competent and qualified persons to parastatal boards.<sup>215</sup> Moreover, as a permanent function, the DGIPE was to set up and maintain a database of qualified candidates for parastatal boards and senior management posts and recommend all parastatal board member appointments from the database in accordance with the principle of transparency.<sup>216</sup> These noble proposals never saw the light of day.

The new Constitution heralds a new dawn that will reshape the legal and regulatory framework governing appointment of parastatal directors and chief executives. The President's excessive powers over parastatals under the law will be removed. His power to issue directives to boards of parastatals and to appoint chief executives will be curtailed. The Constitution requires that all appointments to parastatal boards must be based on fair competition and merit.<sup>217</sup> Ministers (Cabinet Secretaries) will now have to be accountable to the public in all appointments they make. Further, Parliament now has the power to vet all Presidential appointments.<sup>218</sup> These two provisions are a radical departure from the current appointments system discussed in this chapter.

However, although the constitution marks a good reform starting point, I am not certain that they will resolve the appointments challenges discussed in this chapter. This is because there is no guarantee that the appointments and vetting will not be based on political expediency with horse trading among politicians and political parties taking the centre stage. It may just be a revolution that was never to be as we may end up in the same position with the same people being re-appointed to directorships on the basis of their "experience". Article 118 of the Constitution may provide a safeguard to horse trading as it requires parliament to conduct its business in an open manner and facilitate public participation and involvement in its legislative and other business. It is given that the general public will not be a party to such schemes and most probably than will not support political appointees especially if they do not merit the position as required by the

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<sup>215</sup> Ministry of Finance, *supra* note 121 at p 7.

<sup>216</sup> *Ibid.*

<sup>217</sup> Article 232 (g).

<sup>218</sup> Article 132 (2).

constitution. I am therefore of the opinion that lack of fair competition and merit in an appointment can form sufficient grounds for the public to challenge the appointment in the constitutional court, however, bearing in mind the doctrine of separation of powers. Further, under Article 165 of the Constitution the High Court is given jurisdiction to hear and determine any matter relating to contravention of the provisions of the Constitution.

Jaindi Kisero aptly sums up these new provisions when he notes:<sup>219</sup>

I support the provision of the proposed [new] Constitution that stipulates that all future political appointments will be vetted by parliament. This is a good starting point.

We must rid boards of state owned enterprises of individuals with nothing to offer in skills and experience. We must replace these people, who are usually cronies of Ministers with well-functioning professionals in these boards.

In the case of Kenya Re, the Government needs to appreciate that reinsurance is a very technical field. A good number of the directors on that board do not have much to offer. Why should the Financial Secretary at the Treasury sit on a board of state owned enterprise? Nomination of boards should be transparent, clearly structured and based on appraisal of skills and competences.

In order to curb politicisation of parastatals boards, the new Constitution provides that parastatals directors cannot hold offices in political parties. Additionally, retired civil servants can now not hold more than two concurrent remunerative positions as chairperson or directorships of parastatals as has been case.<sup>220</sup>

The impunity that was witnessed in the past whereby some of the directors who were responsible for the collapse of parastatals were not only appointed to other directorships

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<sup>219</sup> Jaindi Kisero, 'Government Should Learn lesson from Kenya Re fiasco', *Daily Nation* (Kenya April 21, 2010) at p 12.

<sup>220</sup> Article 77 (3) provides that, "A retired State Officer who is receiving a pension from public funds shall not hold more than two concurrent remunerative positions as chairperson, director or employee of – (a) a company owned or controlled by the State; or (b) a State organ".

but to cabinet will be a thing of the past. As per Article 75 of the Constitution such people will be barred from holding any other public or state office.

### 3.3 REMUNERATION OF PARASTATALS DIRECTORS

Remuneration is an important incentive instrument for the board members.<sup>221</sup> Any scheme employed in remunerating directors should take into account the need to attract, incentivise and retain high quality skill, experience and expertise as well as loyalty and commitment to the parastatal.<sup>222</sup> Therefore, board remuneration should first be based on an individual director's level of skill, experience and expertise, and secondly on his contribution to the performance and success of the parastatal over the director's term of office.<sup>223</sup>

Currently, the remuneration of parastatals directors is determined in accordance with the SCAC scales.<sup>224</sup> According to a November 2004 circular from the Office of the President, the maximum honoraria to parastatal chairmen should be Kshs. 80,000 while sitting allowance should not exceed Kshs. 20,000.<sup>225</sup> Other benefits board members can enjoy include provision of an office for the chairman when he turns up to chair meetings, and secretarial services should, however, not be exclusive to the chairman.<sup>226</sup>

Recruiting qualified board members requires more than the nominal fee as set by the SCAC.<sup>227</sup> Corporate governance codes recommend that performance related elements of remuneration should constitute a substantial portion of the total remuneration package of board members in order to align their interests with those of the shareholders and stakeholders.<sup>228</sup> Therefore, the Government should consider setting aside the 2004 circular. However, it is good to bear in mind that in some instances parastatals are charged with social welfare and developmental goals which cannot be clearly quantified.

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<sup>221</sup> Agata Waclawik-Wejman, supra note 9 at p 54.

<sup>222</sup> Protocol on Corporate Governance in the Public Sector, supra note 3 at p 21.

<sup>223</sup> *Ibid.*

<sup>224</sup> Kiarie Mwaura, supra note 14 at p 8.

<sup>225</sup> David Okwembah, 'How Parastatal chiefs line their pockets', *Sunday Nation*, (Kenya November 1, 2009), at p 9.

<sup>226</sup> *Ibid.*

<sup>227</sup> Agata Waclawik-Wejman, supra note 9 at p 54.

<sup>228</sup> Guideline 2.5.5. King Committee Report on Corporate Governance (1994).

Thus, it can be difficult to distinguish a good performance from a bad one.<sup>229</sup> The conventional performance measurement tool of using profits cannot be used in such cases as it fails to capture the additional objectives that parastatals are asked to fulfill which in turn makes it difficult to provide performance based incentives to parastatal board members.<sup>230</sup>

Additionally, many potential directors and managers will choose careers in the private sector rather than parastatals because of greater pay.<sup>231</sup> According to the results of the 2009 remuneration and salaries survey conducted by PriceWaterhouseCoopers, the monthly salaries of chief executive officers of parastatals fell way below the average cost of hiring that caliber of employees in the private sector. The salary of one CEO in the financial services sector can pay three of his peers heading a parastatal and still have about Kshs. 800,000 left over.<sup>232</sup> However, this is not to suggest that other excellent people do not choose government service within a parastatal out of sense of civic duty or altruistic motivations.

Even the introduction of performance contracts whereby directors of parastatals were required to achieve set targets within a particular period, and the government promised to increase their remuneration and to award a bonus when the targets are met or to replace them when they are not has not been of much help.<sup>233</sup> As the targets set are either too low or not achievable at all due to the above highlighted factors.<sup>234</sup>

Another issue as regards the remuneration of parastatal boards and which the PIC in its Thirteenth Report reported, was the conflict between the specific parastatal enabling statutes and the SCA. The PIC observed that some parastatals had been paying allowances to their board members in accordance with their specific enabling statutes, which empowered them to do so an act which was in contravention of Section 10 of the

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<sup>229</sup> Maria Vagliasindi, supra note 102 at p 5.

<sup>230</sup> *Ibid.*

<sup>231</sup> Daniel Sokol, supra note 86 at p 1713.

<sup>232</sup> Cosmas Butunyi, 'Financial services sector offers the best pay' *The East African* (Kenya September 27-October 3, 2010 at p 24.

<sup>233</sup> Kiarie Mwaura, supra note 14 at p 8.

<sup>234</sup> *Ibid.*

SCA.<sup>235</sup> For instance, the National Hospital Insurance Fund as at June 30, 2006 had been paying to its board members allowances at rates higher than those set by the Office of the President circular but in accordance with its enabling Act (the National Hospital Insurance Fund Act) which empowered it to do so.<sup>236</sup> As a result, the PIC directed that in the event of any conflict between the SCA and any other written law establishing a parastatal except where the SCA specifically provides or where the parastatal is exempt as per the provisions of the SCA, the SCA's provisions and the SCAC's salary scales shall prevail.<sup>237</sup>

The new Constitution establishes a Salaries and Remuneration Commission.<sup>238</sup> One of the commission's duties will be to advise the Government on the remuneration and benefits of all public officers including parastatal directors.<sup>239</sup> As it discharges its duties, the commission is required to bear in mind the need to ensure that parastatals are able to attract and retain the skills required to execute their functions, the need to recognise productivity and performance, and transparency and fairness.<sup>240</sup> This is another good starting point in reforming the governance framework that parastatals are currently operating under. This provision is likely to provide appropriate compensation standards and incentives needed to attract experienced, qualified, and professionally trained directors, managers and staff to work in parastatals.<sup>241</sup>

### 3.4 CONCLUSION

As demonstrated, board composition and independence are certainly very important ingredients of corporate governance reforms.<sup>242</sup> As discussed in this chapter, the poor and

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<sup>235</sup> The Thirteenth Report of the Public Investments Committee on the Accounts of State Corporations, (2006) Volume I at p x.

<sup>236</sup> National Hospital Insurance Fund Act, Act No. 9 of 1998.

<sup>237</sup> The Thirteenth Report of the Public Investments Committee, *supra* note 234.

<sup>238</sup> Article 230 (1) provides that, "There is established the Salaries and Remuneration Commission".

<sup>239</sup> As per Article 230 (4)(b) one of the functions of the Commission will be to "advise the national and county governments on the remuneration and benefits of all other public officers".

<sup>240</sup> Article 230 (5)(b) provides that in performing its advisory functions the Commission shall take into account "the need to ensure that the public services are able to attract and retain the skills required to execute their functions".

<sup>241</sup> Dennis A. Rondinelli, *supra* note 39 at p 21- 42.

<sup>242</sup> Maria Vagliasindi, *supra* note 102 at p 6.

ineffective management of parastatals can be attributed, partly, to the appointment criteria, which has been based on political influence rather than relevant technical expertise. This has had detrimental effects on the managerial capacity of the boards and on the morale of competent staff.<sup>243</sup> Further, finding the right board members, providing the proper incentives, and ensuring that the board maintains high ethical standards for themselves and the parastatals as a whole are all critical challenges which have had a direct impact on the performance of parastatals.<sup>244</sup> Empowering and improving the quality of parastatals boards is a fundamental step in improving their corporate governance.

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<sup>243</sup> Kiarie Mwaura, *supra* note 14 at p 8.

<sup>244</sup> David Robinett, *supra* note 5 at p 26.

# CHAPTER 4: PARASTATALS FINANCIAL MANAGEMENT AND PERFORMANCE

## 4.1 INTRODUCTION

Parastatals control key sectors of the economy such as health, education, transport and communication, and manufacturing. Given their centrality to the economy they are allotted a lot of public funds. It therefore, follows that since tax payers are their main shareholders it is only fair that they should accurately and transparently account to the tax payers for the funds.<sup>245</sup> Establishment of efficient and effective disclosure and reporting systems should be a key feature of parastatals corporate governance.<sup>246</sup> The most direct method of ensuring that parastatals are accountable for their actions is through open disclosure by their boards and through audits carried out against strict accounting standards.<sup>247</sup>

This chapter will examine the legal and regulatory framework governing parastatals financial management, accounting and audit. Secondly, it will examine the performance of parastatals over the last two decades based on PIC reports. It will also examine how far privatisation of parastatals has gone, and other policy approaches which may be adopted as alternatives to privatisation. Lastly, it will look at how the provisions of Chapter 12 of the new Constitution are bound to change how parastatals the manage allocated finances and account for the same.

## 4.2 LEGAL AND REGULATORY FRAMEWORK

Part IV of the SCA lays down the legal controls relating to parastatal finances.<sup>248</sup> Every year, all parastatals boards are required to prepare and submit their budgets to their line

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<sup>245</sup>Florence Gatome, "Why Kenya's public sector needs global accounting standards", *Business Daily*, (Kenya December 24, 2009) available at <<http://www.businessdailyafrica.com/Company%20Industry/-/539550/830436/-/item/0/-/w03w6wz/-/index.html>>, accessed on September 6, 2010.

<sup>246</sup>Agata Waclawik-Wejman, *supra* note 9 at p 54.

<sup>247</sup>Cadbury Code, "*The (December 1992) Report of the Committee on the Financial Aspects of Corporate Governance: The Code of Best Practice*", Gee Professional Publishing, London, Recommendation 5.2.

<sup>248</sup>Chapter 446 of the Laws of Kenya.

Minister and the treasury for approval.<sup>249</sup> They are required to keep proper books of accounts in the form prescribed by the Minister of Finance.<sup>250</sup> The Act establishes an Inspector-General's (Corporations) office. The office is charged with the responsibility of reporting to the Controller and Auditor-General (C & AG) any cases where moneys appropriated by Parliament were not being applied by a parastatal for the purposes for which they were appropriated.<sup>251</sup> The office has powers to call for, and inspect all books accounts and documents of any parastatal. It can also conduct special investigations on any parastatal on behalf of the SCAC or the C & AG and report its findings.

Furthermore, it has powers to surcharge any person who authorises or misappropriates a parastatal's funds.<sup>252</sup> The PIC in its fifteenth report on the accounts of parastatals recognised the fact that Inspector General's office had been helpful in advising and guiding it in execution of its mandate. The office was also instrumental in implementing the PIC's recommendations. For instance, arising from the PIC's reports, the office had recovered a total of Kshs. 55 million and had compiled more than fifty cases for surcharge with a face value of over Kshs. 2 billion arising from Seventh to Thirteenth Reports of the PIC.<sup>253</sup>

The annual audit is one of the cornerstones of corporate governance. Given the separation of ownership from management, parastatals directors are required to report on their stewardship by preparing books of accounts. The audit provides an external and objective check on the way in which the books of accounts have been prepared and presented, and it is an essential part of required the checks and balances.<sup>254</sup> The Public Audit Act substantially amended the provisions of the Exchequer and Audit Act and the SCA. It prescribes the manner in which parastatals books of accounts are to be audited and

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<sup>249</sup> Sections 11 and 15 of the SCA.

<sup>250</sup> Section 14.

<sup>251</sup> The office of the Controller and Auditor -General was established by section 104 of the old Constitution and its functions were specified by section 105 and supplemented by the provisions of the Exchequer and Audit Act.

<sup>252</sup> Sections 18 and 19.

<sup>253</sup> The Fifteenth Report of the Public Investments Committee on the Accounts of State Corporations, (2007) Volume I at p xiv.

<sup>254</sup> Cadbury Code, supra note 246, Recommendation 5.1.



reported by the C & AG.<sup>255</sup> The C & AG is required to prepare an audit report and submit the same to the Minister of Finance.<sup>256</sup> The Minister of finance is then required to present the report to Parliament. If the Minister fails to do so then the C & AG is required to submit it to the Speaker who will be required to present it before Parliament.<sup>257</sup> As per the provisions of the SCA, a chief executive of a parastatal may be summoned by the PIC to answer on behalf of the board any question arising from the audit report.<sup>258</sup>

The audit is often criticized for acting too late, and of being undertaken only when omissions and errors have already been committed and damage done.<sup>259</sup> Further, the C & AG is an auditor of Parliament for constitutional purposes, hence audit reports should ideally go directly to the speaker with copies to treasury for information purposes only instead of convoluting the matter by requiring that it be submitted to the Minister of Finance first who has political responsibility for financial irregularity in government.<sup>260</sup>

The Public Officer Ethics Act prohibits parastatals directors and employees from giving to the public false or misleading information knowingly.<sup>261</sup> On the other hand the Anti-Corruption and Economic Crimes Act makes it an offence for parastatals directors and employees to fraudulently acquire a parastatal's property or to misuse the public funds allotted to them. Further, it makes it an offence for the parastatals chief executives or officers in charge of their finances to pay for sub-standard goods or goods not supplied or

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<sup>255</sup> Act Number 12 of 2003. Its objective is to; provide for the audit of government, parastatals and local authorities; to provide for economical, efficient and effective examinations; and for certain matters relating to the Controller and Auditor-General's office. Section 12 and 13 of the Act provide that for each financial year and within three months from the end of the year, each parastatal shall prepare its accounts and submit the same to the Controller and Auditor-General for audit. The accounts shall include the following - (a) a balance sheet showing the assets and liabilities as of the end of the financial year; (b) a statement of the income and expenditures for the financial year; (c) a cash flow statement for the financial year; and (d) any other statements and accounts that may be necessary to fully disclose the financial position of the parastatal. The Act repeals Parts III, V, VI and VII of the Exchequer and Audit Act.

<sup>256</sup> Section 15.

<sup>257</sup> Section 16.

<sup>258</sup> Section 15(2).

<sup>259</sup> Mut uwafhethu John Mafunisa, "Enhancing Accountability in the Public service: The Case of the Republic of South Africa", Panel Paper Discussion presented at the South African Universities Social Science Conference (1999).

<sup>260</sup> Centre for Corporate Governance Development, supra note 11 at p 42.

<sup>261</sup> Chapter 183 of the Laws of Kenya. It came into operation on May 2, 2003. Sections 19 and 22.

to willfully or carelessly fail to comply with procurement law or guidelines or to engage in projects without proper planning.<sup>262</sup>

### 4.3 PARASTATALS PERFORMANCE OVER THE LAST TWO DECADES

As stated in Chapter 2 of this study, unlike a widely held corporation in the private sector, most parastatals cannot go bankrupt. If the managers of a privately-owned firm cannot keep it in the black, shareholders will eventually withdraw their investment, regardless of the social consequences. Because of this, private owners are able to issue much more credible threats to their managers.<sup>263</sup> On the other hand, the state is unlikely to allow a large parastatal to face bankruptcy due to the social and political repercussions that would occur and the managers know this. Thus, the discipline enforced on private firms by capital markets and the threat of financial distress is less important to parastatals.<sup>264</sup> It has been argued that the absence of potential takeovers and proxy contests reduces the incentives for parastatals boards and managers to maximise the value of the parastatals. Lack of bankruptcy threats has led to over reliance on government funding leading to what economic theorists refer to as “*soft budget constraint*”. This reliance reduces parastatals pressure to contain costs, allowing for wasteful investments thereby harming their performance over time.<sup>265</sup>

The Minister for Finance in his 1994 annual budget speech reported that the parastatal sector was surviving on direct and indirect government subsidies equivalent to as much

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<sup>262</sup>Chapter 65 of the Laws of Kenya. Its commencement date was May 22, 2003. It provides for prevention, investigation and punishment of corruption, economic crime and related offences. See Section 45.

<sup>263</sup> Joseph Heath and Wayne Norman, *supra* note 61 p 247-265.

<sup>264</sup> William L. Megginson and Jeffrey M. Netter, *supra* note 25 at p 330.

<sup>265</sup> David Robinett *supra* note 5 at p 3. The term “soft budget constraint” was coined by János Kornai, (“The Soft Budget Constraint”, (1986) 39 *Kyklos* 3; Kornai, János; Maskin, Eric; Roland, Gérard (2003) “Understanding the Soft Budget Constraint”, *Journal of Economic Literature*, 41 (4), p 1095-1136). He stated that an organization (e.g., a parastatal) has a budget constraint. That is, it must cover its expenditures out of its initial endowment and revenue. If it fails to do so and a deficit arises, it cannot survive without intervention. Some sort of constraint—on liquidity, solvency, or debt— sets the upper limit on the sustainability of the financial deficit. The Soft Budget Constraint phenomenon occurs if one or more supporting organizations are ready to cover all or part of the deficit. In the case of parastatals, the supporting role is played by one or more organs of the state to keep social peace, maintain artificial high levels of employment, or to respond to political needs to subsidize firms.

as 5.5 percent of the country's Gross Domestic Product. On the other hand, the PIC in its Sixteenth report, noted with concern that majority of parastatals were relying on the exchequer to finance losses they had incurred.<sup>266</sup>

The Centre for Governance and Development (CGD) conducted a study of the audited accounts of state corporations over a period nine years – from 1993 to 2002. The study gleaned over several reports of the PIC dating back from the fourth report (1993) to the eleventh report (2002).<sup>267</sup> I carried the study further by gleaning over the PIC's reports from the year 2003 to 2009.

The CGD in its study report noted that the most recurrent symptom of mismanagement and waste in parastatals was the level of financial distress afflicting them. Of the 140 odd parastatals that the CGD examined, a worryingly large number were described as being technically insolvent. They survived on the generosity of creditors, bankers and the Kenya government, that is, the taxpayers.<sup>268</sup>

Table 1 below shows the losses suffered and deficits in the books of a sample of parastatals that the CGD reviewed in its study.

Table 1: LOSSES MADE BY VARIOUS STATE CORPORATION

CORPORATION	DETAILS OF THE LOSS	AMOUNT (KSHS)
Kenya Posts and Telecommunications Corporation	Negative Working capital	13,527,893,820
Kenya Railways Corporation	Accumulated deficit	5,308,253,037
Agricultural Finance Corporation	Accumulated loss	336,167,000
Cotton Board of Kenya	Operating Loss	35,078,692
Kenya Cashew Nuts Ltd	Operating Loss	47,681,102
National Housing Corporation	Accumulated Loss	439,067,440
National Social Security Fund	Accumulated Deficit	9,388,631,000
Egerton University	University hotel operated at a loss due to	3,254,500

<sup>266</sup> The Sixteenth Report of the Public Investments Committee on the Accounts of State Corporations, (2009) Volume 1, at p viii.

<sup>267</sup> Centre for Corporate Governance Development, supra note 11 at p 11.

<sup>268</sup> *Ibid* at p 13.

	mismanagement	
National Oil Corporation	Trading loss for the year – mainly from dealing with agent	24,402,926
Kenya National Library Services	Accumulated deficit	13,294,061
South Nyanza Sugar Company	Accumulated losses	428,490,287
Catering Levy Trustees	Net loss	39,845,374
Kenya Pipeline Co. Ltd	Negative working capital	1,516,697,000
University of Nairobi	Accumulated deficit	509,053,240
Mepal Plastics (K) Limited	Cumulative loss	41,996,808
Mount Kenya Textiles Ltd	Cumulative losses	610,834,742
Coffee Board of Kenya	Accumulated deficit	305,076,300
Kerio Valley Development Authority	Loss for the year	98,671,318
Moi University	Unexplained Farm losses	14,776,000
Homa Bay Hotel Ltd	Accumulated Losses	9,018,437
Kenatco Taxis Ltd	Operating loss	1,572,077
Kenya Broadcasting Corporation	Cumulative Deficit	5,166,658,017
Nzoia Sugar Company	Accumulated losses	4,950,997,887
National Water Conservation and Pipeline Company	Cumulative deficit	1,988,017,926
Muhoroni Sugar Company	Accumulated losses	939,633,894
Kenya Meat Commission	Accumulated losses	572,490,960
Industrial Development Bank	Accumulated losses	160,845,745
Kenya Ferry Services	Accumulated losses	65,211,161
Lake Basin Development Authority	Accumulated deficit	103,332,448
Golf Hotel Ltd	Accumulated losses	40,374,099
Eldoret Sirikwa Hotel	Accumulated losses	33,694,540
Tea Hotel	Accumulated losses	3,315,333
Kabarnet Hotels Ltd	Accumulated losses	10,806,420

From the outset, I would like to point out that the studies and examinations conducted by the PIC, CGD and myself, examined the parastatals return on investment in financial terms but I argue that this falls short of telling the whole story of the performance of parastatals. It is difficult, if not impossible to measure all the non-financial, societal contributions or external benefits such as a road built by a parastatal may generate. For example, the new Constitution requires parastatals when implementing their strategies and decisions to address the needs of vulnerable groups within society, including women,

persons with disabilities, members of minority or marginalised communities, and members of particular ethnic, religious or cultural communities.<sup>269</sup>

Therefore some of the profits of a parastatal may even be carried in the profit and loss statements of private companies which use the benefits generated by the parastatals. A parastatal which may have been making financial losses may have been effective in the use of its resources, and yet show financial losses due to the cost of non-profit goals imposed on it which it may have attained successfully.<sup>270</sup>

Achievement of the multiple societal objectives imposed on parastatals may, in fact, be a much more important indicator of successful performance than quantitative measures of profitability. Therefore, parastatals should be appraised by reference to the objectives they were set up to achieve, not only by the financial criteria used to measure the performance of private profit-making companies. However, policymakers should be alerted, nevertheless, to the fact that these societal objectives could be used as permanent excuses for parastatals managerial incompetence resulting in poor financial performance.<sup>271</sup>

Corporate governance guidelines recommend that, where a parastatal is required to pursue non-commercial objectives for social and public policy purposes such as employment stability, cultural preservation and so forth, the government should clearly identify the related cost of the pursuits and disclose them publicly. Better yet, separate funding should be provided by the government to pay for the non-commercial objectives.<sup>272</sup> Additionally, some of these objectives can be addressed using other mechanisms. The 1967 *Rapport sur les entreprises publiques* (or "Nora report") concluded that:

Unless we can clearly distinguish the potential for profit specific to a particular economic activity from the costs imposed by the public interest constraints, there are no standards

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<sup>269</sup> Article 21(3) of the Constitution provides that – “All State organs and all public officers have the duty to address the needs of vulnerable groups within society, including women, older members of society, persons with disabilities, children, youth, members of minority or marginalised communities, and members of particular ethnic, religious or cultural communities”.

<sup>270</sup> Yacob Haile-Mariam and Berhanu Mengistu, *supra* note 51 at 1572.

<sup>271</sup> *Ibid* at p 1573.

<sup>272</sup> Maria Vagliasindi, *supra* note 110 at p 15.

for these enterprises: no criteria of good management, no incentive to improve management, and no penalty for bad management. How then can we expect balanced finances from these enterprises, along with the innovative, autonomous and responsible action that constitutes its guarantee?<sup>273</sup>

Over the years, many of these parastatals losses not only occurred more frequently, but actually worsened. The Kenya Airports Authority, for example, realised a deficit of Kshs. 626 million in 2002 but by June 30, 2002 its cumulative deficit was an astonishing Kshs. 1.949 billion.<sup>274</sup> The PIC attributed such losses to inefficiency, ineptitude and corruption. At the National Social Security Fund, the income and expenditure statement for the year ended 30<sup>th</sup> June 1999 reflected a deficit of Kshs. 1.5 billion, bringing the parastatal's accumulated deficit as at 30<sup>th</sup> June 1999 to Kshs 6.4 billion.<sup>275</sup>

The C & AG also queried questionable investment decisions taken by a number of parastatals. Many of these were investments of surplus funds in commercial banks in contravention of Treasury circular No. 10 of 15<sup>th</sup> July 1992, which required that parastatals invest such funds in either treasury bills or bonds. Investment elsewhere could only be made with the Treasury's approval. Some of the financial institutions in which investments were made had serious liquidity problems. Kenyatta National Hospital, for example, deposited Kshs 246 million in Eurobank, in February 1999. The bank had serious problems and eventually collapsed.

The PIC in its Sixteenth report observed that the books of accounts in various parastatals were inaccurate and incomplete, while others were none existent having been lost completely under doubtful circumstances. It also observed that the accounts for some parastatals were in arrears over long periods of time owing to the absence of critical accounting records. The timeliness and quality of accounts is, of course, crucial to their effective use. This definitely undermined the parastatals performance monitoring, limited

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<sup>273</sup>Nora, S, "Rapport sur les entreprises publiques" (Paris, La documentation francaise, 1967).

<sup>274</sup>The Fifteenth Report of the Public Investments Committee on the Accounts of State Corporations, (2007) Volume I at p 14. and the Sixteenth Report, supra note 265 at p 275.

<sup>275</sup>The Twelfth Report of the Public Investments Committee on the Accounts of State Corporations, (2004) Volume I at p 89.

their accountability at all levels, and created conditions under which corruption flourished. As a remedy the PIC recommended that the chief executives of parastatals were to ensure that parastatals kept proper books of accounts.<sup>276</sup>

The PIC further observed that some parastatals had failed in their duty to safeguard their assets thereby leading to huge financial losses and at times loss of human lives. For example, it noted with concern failure by Kenya Ferry Services Limited to adhere to its insurance policy specifications in terms of payments of premiums and loading capacity of Mtongwe I Ferry. This led to deaths of 257 passengers in 1994 and loss of compensation claims. In another case, between the years 2001 and 2004, the board of the Communications Commission of Kenya bought furniture and other household appliances for its directors at a cost of Kshs. 5.8 million. The PIC noted with concern that the furniture in question could not have been fully depreciated by the time the directors left the board and recommended that their depreciated value should have been recovered from the directors.<sup>277</sup>

## 4.4 THE WAY OUT OF THE WOODS

### 4.4.1. Parastatals Public Procurement Processes

Public procurement means procurement by a procuring entity using public funds.<sup>278</sup> Thus, anything a parastatal procures is categorised as being public procurement and thus governed by the provisions and regulations set out in the Public Procurement and Disposal Act<sup>279</sup>, Public Procurement and Disposal Regulations (2006 and 2009) and Supplies Practitioners Management Act (2007)<sup>280</sup>.

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<sup>276</sup> The Sixteenth Report, *supra* note 265 at p v and vi.

<sup>277</sup> *Ibid.*

<sup>278</sup> Public Procurement Oversight Authority, “The Long Term Policy Framework for Public Procurement in Kenya”, University of Nairobi Enterprises and Services, (September, 2009) available <[www.uneskenya.com/.../Draft\\_Zero\\_Long\\_Term\\_Public\\_Procurement\\_Policy%20-%20Revision3.pdf](http://www.uneskenya.com/.../Draft_Zero_Long_Term_Public_Procurement_Policy%20-%20Revision3.pdf)> accessed on September 14, 2010 at p 1.

<sup>279</sup> Act No. 3 of 2005.

<sup>280</sup> Act No. 17 of 2007.

As has been discussed before in this study, some parastatals are commercial and profit oriented in nature. Thus, they generate their own funds through the economic activities they are engaged in while competing with private sector firms at times. They actually even provide funds to the state in the form of dividends.<sup>281</sup> In the literal sense, anything they purchase or sell ideally should not be classified as public procurement as they generate their own funds. However, in practice their procurements are classified as public procurement and are therefore governed by the slower and not always efficient public procurement legal and regulatory framework cited above.

I therefore argue that there is an urgent need to amend the public procurement framework to allow profit-oriented parastatals to operate on the same footing with their private sector competitors in the market if they are to remain viable. I am certain that this will lead to more efficiency in service delivery and translate to higher returns for the benefit of the shareholders — citizens of Kenya. For instance, it has been proposed that commercially oriented parastatals should be allowed, in a transparent manner, to foster long-term partnerships with suppliers, to enhance negotiations and promote value for money. Financial evaluations of bids for their tenders should be allowed to include cost-benefit analysis, value for money, opportunity cost, return on investment and all other hidden costs and benefits, not just the lowest financial bid as is currently provided in the framework. Moreover, they should be exempted from the stipulated mandatory requirements such as advertising times for tenders, where there is need to respond promptly to a business opportunity that can be demonstrated.<sup>282</sup> Procurement in the private sector, seeks merely to achieve efficiency and a good economic result for the buyer. Securing the best price for goods and services is paramount to the sector. When the best supplier is identified, the negotiations that follow are straight forward. Consequently, procurement in the private sector is a simple operation that does not follow

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<sup>281</sup> See Section 24 of the Government Financial Management Act, Chapter 412B of the Laws of Kenya, that requires that revenue generated by parastatals in the form of dividends shall be revenue of the Ministry of Finance.

<sup>282</sup> Public Procurement Oversight Authority, *supra* note 277 at p 9.



any firm procedure when compared to parastatals that they may be competing with for a market share.<sup>283</sup>

Further, the procurement Act has been faulted as being an impediment to procurement. It contradicts the law of contract and works against performance contracts by limiting procurement decisions that can be taken by parastatals heads. Under the regulations, they cannot commission a project worth more than Kshs. 500,000 without the Public Procurement Oversight Authority approval. In a private company a middle-level manager can spend up to Kshs. 5 Million without requiring so many approvals. There are a number of examples of how the stringent procurement laws have done harm. The Kenya Power and Lighting Company (KPLC) blames the drawn out procurement procedures for its failure to meet its targets of connecting 150,000 new users annually. Nexant, a transaction adviser appointed to help work out KPLC's turn around strategy recommended that the power utility be freed from public procurement rules. The award of a poles supply tender to a South African company was successfully challenged by a losing bidder, introducing an inventory gap of nine months in sourcing new suppliers.<sup>284</sup>

As a result of these bureaucracies, the parastatals procurement processes are much more complicated and slower, and not always as efficient as private sector purchasing. Again as proposed above, there is need for a new procurement framework to especially govern profit oriented parastatals if they are to remain viable in the competitive market and to turn around what seems to be their depressing financial records and soft budget constraints problem as illustrated in this chapter.

#### **4.4.2. Improper Books of Accounts**

Again as noted in this chapter, most parastatals do not keep proper books of accounts and if they do the accounts are inaccurate and not timely. Furthermore, not all parastatals have strong transparency systems that allow for internal and external controls for independent audits. A World Bank report noted that the internal and external financial

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<sup>283</sup> *Ibid* at p 21.

<sup>284</sup> Michael Ouma, 'State firms tied by rigid spending law', *Daily Nation* (Kenya May 16, 2006).

and non-financial reporting of parastatals was usually incomplete and inaccurate, and did not provide an adequate basis for decision-making by boards and executive managers, and misled the government, legislature and the public.<sup>285</sup>

In the interest of the public, parastatals should be as “transparent” as publicly traded companies. Regardless of their legal status and even if they are not listed, all parastatals should account and report in line accepted accounting and auditing standards.<sup>286</sup> The OECD Guidelines recommend the development of consistent and aggregated reporting systems for parastatals and the publication of annual reports meant to ensure high standards of transparency. Further, the guidelines recommend subjecting parastatals to an annual independent external audit based on international accounting standards.<sup>287</sup>

I agree with the PIC recommendation that parastatals should comply with the International Financial Reporting Standards (IFRS).<sup>288</sup> IFRS are accounting standards of best practice issued by the International Accounting Standards Board (IASB) and can be applied to commercially oriented parastatals. For non-commercial parastatals, the International Public Sector Accounting Standards (IPSASs) of best practice prepared by International Public Sector Accounting Standards Board (IPSASB) are applicable.<sup>289</sup> In a similar way to the OECD Guidelines, IFRS and IPSASs elaborate principles for responsibility, communication with stakeholders, reporting, risk management, duties of the management and a “code of conduct” for parastatals. The standards are geared towards enhancing the quality and transparency of parastatals financial reporting and strengthen public confidence in public sector financial management.<sup>290</sup> They set out

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<sup>285</sup> David H. Scott, “Strengthening the Governance and Performance of State Owned Financial Institutions” 7-8, (2007) World bank Policy Research, Working Paper No. 4321.

<sup>286</sup> OECD Guidelines on Corporate Governance of State-owned Enterprises, Part II, Guideline 5 (OECD, 2005) at p 214.

<sup>287</sup> *Ibid.*

<sup>288</sup> Sixteenth Report, supra note 265 at p v and vi.

<sup>289</sup> International Public Sector Accounting Standards Board (IPSASB) is a body established by International Federation of Accountants (IFAC). IFAC is a global organization for the accountancy profession which develops international standards on ethics, auditing and assurance, education, and public sector accounting standards available at <<http://www.ifac.org/About/>> accessed on August 30, 2010.

<sup>290</sup> International Public Sector Accounting Standards Board, 2007, Preface to International Public Sector Accounting Standards, international Federation of Accountants, New York.

recognition, measurement, presentation and disclosure requirements dealing with transactions and events in general purpose financial statements.<sup>291</sup>

It has been argued that a financial reporting system supported by strong governance, high quality standards, and sound regulatory frameworks are key to efficient and effective management of parastatals. Thus, adoption of accounting standards such as IPSAS would lead to high quality financial reporting which would enable better decision making. In particular, the government would be able to make better informed decisions on resource allocation thereby increasing transparency and accountability.<sup>292</sup>

#### 4.4.3. Is Privatisation the Answer?

The term privatisation refers to procedures through which a government transfers ownership of its assets and control of commercial activities to the private sector.<sup>293</sup>

Underlying the privatisation thesis is the objective to improve profitability of parastatals based on the belief that private firms tend to be more efficient than state owned ones. Those who advance this thesis argue that private ownership and profitability of a corporation are inseparably linked. Alan Waters maintains that:

...economic theory is now quite explicit and clear that due to the nature of ownership, and hence incentive, a state entity cannot be as efficient as private entity in the production of the same output.<sup>294</sup>

He further argues that vigorous economic growth in developing countries can only be achieved through one solution: Privatisation of parastatals. He reaches this conclusion by reasoning that the managers of private enterprises have the incentive to work harder and manage better than parastatal managers. In the public sector, it is argued, only the manager's salary is at stake while in the private sector it is also loss of profit, hence total

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<sup>1</sup>Matei Ani I. and Popa Florin Marius, "Instruments for Promotion and Assurance of Public Integrity (September 28, 2009) at p 241-294 cited in Patrycja Suwaj and Hans Rieger, "Public Integrity: Theories And Practical Instruments", (NISPACEE Press, 2009). Available at SSRN: <<http://ssrn.com/abstract=1479732>> accessed on 28<sup>th</sup> July 2010.

<sup>2</sup>Florence Gatome, supra note 244.

<sup>3</sup>Kathryn L. Dewenter and Paul H. Malatesta, "Public Offerings of State-Owned and Privately-Owned Enterprises: An International Comparison", (Sep., 1997) *The Journal of Finance*, Vol. 52, No. 4, at p 1659-1679.

<sup>4</sup>Alan Rufus Waters, "Privatization: a viable policy option?", Manila: Asian Development Bank", 1985, p 2-54 cited in Yacob Haile-Mariam and Berhanu Mengistu, supra note 51 at p 1579.

assets. It follows that, if privatised, loss-making parastatals will be turned around to show profit. Taxpayers would benefit, and consumers would be able to purchase better quality goods at lower prices because of competition.<sup>295</sup> Whether profitability of parastatals depends on the system of ownership, however, is still a contentious issue. Robert Millward reviewed the empirical evidence for the contrasted views and concluded that there is no evidence to suggest that ownership systems have any bearing on profitability of firms.<sup>296</sup>

The Kenyan Parliament with the aim of improving the depressing performance of parastatals, coupled with the success of privatisation in other countries such as the United Kingdom enacted the Privatisation Act in 2005.<sup>297</sup> The desired benefits of the privatisation programme are: a) the improvement of infrastructure and the delivery of public services by parastatals by involving of private capital and expertise; (b) to reduce demand for government resources by parastatals; (c) the generation of additional government revenues by receiving compensation for privatisations; (d) the improvement of the regulation of the economy by reducing conflicts between the parastatal's regulatory and commercial functions; (e) the improvement of the efficiency of the Kenyan economy by making it more responsive to market forces; (f) the broadening of the base of ownership in the Kenyan economy; and (g) the enhancement and development of the capital markets.<sup>298</sup>

However, it might take a long time to achieve the above stated desired benefits and to finalise the process of privatisation due to the government's reluctance to sell or give up profitable enterprises by placing a high priority on unprofitable parastatals which do not attract buyers. There is no reason why private investors would want take over the kind of money-losing operations which some of those parastatals are engaged in.<sup>299</sup> Secondly,

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<sup>295</sup> *Ibid* at p 1579.

<sup>296</sup> Robert Millward, "The comparative performance of public and private ownership", in Lord Rall of Ipsden (ed), "*The Mixed Economy*", (New York: Holmes and Meier, 1982), p 83-4 cited in Yacob Haile-Mariam and Berhanu Mengistu, *Ibid* at p 1580.

<sup>297</sup> Chapter 485C of the Laws of Kenya.

<sup>298</sup> Section 18 of the Privatization Act.

<sup>299</sup> Ministry of Finance, *supra* note 121 at p 1. The government in its Policy Paper on Public Enterprise Reform and Privatisation classified two hundred and seven parastatals as "non-strategic enterprises" and

finding qualified buyers from the narrow field has been a hindering factor.<sup>300</sup> Thirdly, lack of necessary expertise to support the privatisation process, and an uncertain investment climate prevailing in the country are other obstructing factors. Besides, the Privatisation Act seems to favour commercialisation of public services rather than entire privatisation of parastatals. In addition, the utilities - which are likely to be retained in the long run because they are profitable will still have a sizeable amount of shares owned by the government.<sup>301</sup>

Lastly, it has been argued that privatisation raises a host of other problems that many developing countries like Kenya are not at present equipped to solve. If privatisation is undertaken, to whom would these parastatals be sold? They would probably have to be sold to foreign interests, because the private indigenous sector does not have the capital and is not sufficiently organised to secure funds from local banks that demand unreasonable collateral and charge exorbitantly high interest rates. Would not the sale of these enterprises to private foreign buyers conjure up the fear of neo-colonial domination? Hence, the government must not look at privatisation as a means to an end but as one of the avenues of reforming parastatals.<sup>302</sup>

#### 4.4.4. Other Policy Alternatives

As stated above, privatisation alone cannot be taken to be the panacea to the problems facing parastatals. The argument that once money-losing public enterprises are privatised, all problems will go away is an over-simplification of the problem.<sup>303</sup> Among other potential policy alternatives open to the government may include commercialization or

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only sought privatize those ones. It defined a parastatal as “strategic” if they provide essential services or are considered to play a key role from the view points of national security, health and protection of environment.

<sup>300</sup>As The Economist (as cited by Yacob Haile-Mariam and Berhanu Mengistu, supra note 51 at p 1581) puts it, “the theoretical arguments for privatization are not as clear-cut or convincing as the propagandists would wish”. There are a number of problems. How does one, for example, define privatisation in the context of Third World countries? Privatisation in the Western context, including Japan, may mean denationalisation, and that in turn means the transfer of ownership from the public to private citizens. In the Third World, however, since there is a lack of private investors, privatisation may mean the internationalisation of important sectors of the national economy. For example Togo's experience in selling its public enterprises to foreign buyers.

<sup>301</sup>Kiarie Mwaura, supra note 14 at p 13.

<sup>302</sup>Yacob Haile-Mariam and Berhanu Mengistu, supra note 51 at p 1583.

<sup>303</sup>*Ibid.*

marketisation of parastatals. Under commercialization, the government deregulates relevant sectors of the economy to allow for greater market competition in providing what had previously been considered purely “public goods.” Deregulation to allow market competition is often followed by “corporatization,” that is, legally making parastatals independent corporate entities and requiring them to cover their costs and to generate revenues under hard budget constraints. This insulates the parastatal from government interference because the Companies Act limits the right of shareholders to directly manage the enterprise. Management rights are delegated to the chief executive and are monitored by company’s Board of Directors, unless otherwise stipulated.<sup>304</sup>

The last stage of commercialisation involves “marketisation” - that is, opening goods, services, and infrastructure provision to the private sector and requiring parastatals to compete in the market with private or civil society providers. The government can marketise services through franchising, the use of vouchers, or leaving service provision to voluntary organisations or to individuals.<sup>305</sup>

However, effective commercialisation depends on legal institutions to establish and enforce product and pricing standards, securities and exchange regulations, rights of access to credit and capital, regulation of bank operations, and guidelines for viable contracts and adjudication of disputes are all essential market institutions.<sup>306</sup>

In some circumstances the government can choose to maintain parastatals but outsource or contract-out the provision of some services, for example the construction or operation of infrastructure, or the management of some or all of a parastatal’s functions. Contracting for infrastructure and services allows parastatals to arrange with private companies to provide services or facilities that meet government specifications. Generally, parastatals can outsource to private organisations through three mechanisms: Service, management and leasing contracts. Service contracts allow a parastatal to purchase services on a long-term basis from the private sector. Parastatals can use out

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<sup>304</sup> Maria Vagliasindi, *supra* note 102 at p 3.

<sup>305</sup> Dennis A. Rondinelli, *supra* note 39.

<sup>306</sup> *Ibid* at p 33.

sourcing to modernise government housing projects, obtain defense equipment, and expand schools, prisons and hospitals. Management contracts allow a private firm to take over responsibility for operation and maintenance of parastatal facilities for a specified period of time with the freedom to make routine management decisions. Lease contracts are also used extensively for both public services and commercial operations. For example, in Latin America, state-owned industries have been leased to private companies for long-term operation. In Cote d'Ivoire the government has leased electricity and water supply enterprises; steel mills and refineries in Togo.<sup>307</sup>

Another potential means of improving the management of parastatals is through Public-Private Partnerships (PPPs) – collaborations with corporations, small businesses and non-government organisations to provide socially-beneficial goods and services. Parastatals and the private sector cooperate in providing services and infrastructure through a variety of mechanisms including concessions, build-operate-and transfer arrangements, joint ventures, and informal and voluntary cooperation. Public-private partnerships allow or encourage domestic- and foreign-owned businesses, community groups, cooperatives and other non-governmental organisations to offer social services. In some countries PPPs are an intermediate phase in privatising parastatals or an alternative to privatisation.<sup>308</sup>

#### **4.5 THE NEW CONSTITUTION**

A Constitution is more than just a set of rules or laws regulating society and government.

It is an expression of the general will of a nation [the sum total of] its history, fears, concerns, aspirations, vision, and indeed, the soul of that nation.<sup>309</sup>

As per the new Constitution, transparency, accountability and participation of Kenyan citizens in governance are the guiding national principles and values that have to bind

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<sup>307</sup> *Ibid* at p 34.

<sup>308</sup> *Ibid* at p 35.

<sup>309</sup> Commonwealth Human Rights Initiative, “Promoting a Culture of Constitutionalism and Democracy in Commonwealth Africa”, Recommendations to Commonwealth Heads of Government 1999, 19 October 1999 available at < [www.humanrightsinitiative.org/.../constitutionalism\\_booklet\\_1999.pdf](http://www.humanrightsinitiative.org/.../constitutionalism_booklet_1999.pdf) > accessed on September 7, 2010.

public officers, state organs, parastatals and their directors when making and implementing decisions.<sup>310</sup>

Chapter 12 (Public Finance) of the Constitution appositely provides for principles and frameworks for management public finances. As guiding principles it provides that there has to be openness and accountability, including public participation in matters relating to public bodies and public funds. It requires that public funds should always be used in a prudent and responsible way.<sup>311</sup> Transparency only makes sense when the word is followed by deed. Therefore, Parliament is required to enact legislation that will provide for maintenance and auditing of financial records and accounts of all parastatals. The legislation will also prescribe other measures for securing efficient and transparent fiscal management.

Parastatals mainly rely on allocations from the state budget to finance their operations. As a guiding principle parastatals will now be required to use the funds allotted to them efficiently, effectively and economically. They will also have to be accountable to the public in the ways that they spend the allocations. As could be deduced from the PIC reports, most parastatals books of accounts were inaccurate and incomplete, while others were none existent. With the promulgation of the new Constitution and the subsequent enactment of the Act of Parliament to operationalise Chapter 12 such opacity will be a thing of the past. This is a very good starting point in restructuring parastatals. I am convinced that a legislative framework with a set of generic accountability measures, with emphasis, among other things, on performance, propriety and accountability of parastatals will be put in place.<sup>312</sup> The public will also have a right to access such records and information so that it can easily make a meaningful analysis of parastatals actions, their economic fundamentals and the non-financial aspects pertinent to them.<sup>313</sup>

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<sup>310</sup> Article 10 of the Constitution. Also generally see Article 232 Supra note 41.

<sup>311</sup> Article 201.

<sup>312</sup> Article 232-(1)(b) and (1)(f) require parastatals to use resources allocated to them efficiently, effectively and economically, and to be transparent and provide to the public timely and accurate information.

<sup>313</sup> Article 35 provides that “(1) Every citizen has the right of access to - (a) information held by the State”



The Constitution further provides that if the holder of a public office directs or approves the use of public funds contrary to law or instructions as has been the case in many parastatals, such an officer will be liable for any loss arising from that use and will be called upon to make good the loss.<sup>314</sup>

Article 229 of the Constitution establishes the office of the Auditor-General. The office amongst other duties is charged with the responsibility of auditing and reporting on the accounts of parastatals. It is required to confirm whether or not the public funds invested in them have been applied in a lawful and effective way. Parliament is required within three months after receiving an audit report to debate and consider the report and thereafter take appropriate action. It can now be posited that the office of the Auditor-General should be able to promote ethics and accountability in parastatals. Parastatals directors and management on the other hand will have to endeavour to perform their duties effectively and efficiently now that it is clear that their actions will be investigated.

The above stated Constitutional principles and provisions are bound to re-shape how parastatals utilise the public funds appropriated to them and how they account to the public on the use unlike never before. Consequently, the performance of parastatals will definitely improve when the new framework comes into place as transparency and accountability are the corner stones of good and efficient governance.

## **4.6 CONCLUSION**

In order to improve performance of parastatals and implement the new Constitution's provisions, the government will first have to begin with a comprehensive performance review of parastatals and formulate a government strategy for reform. The government is unlikely to be successful in any attempt at restructuring parastatals unless it develops a strategy that sets out a clear vision of how parastatals are expected to contribute to development and defines clear missions and performance criteria for each parastatal.<sup>315</sup>

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<sup>314</sup> Generally see Article 226 of the Constitution.

<sup>315</sup> Sivi Gounden, "Restructuring of State Owned Enterprises – A Critical Element of Economic Restructuring in South Africa," speech delivered at Leadership Center, University of Kwazulu-Natal, South Africa, March 7, 2001 cited in Dennis A. Rondinelli, *supra* note 39 at p 29.

In South Africa, for example, the government declared the goal of its parastatals would be to “contribute to sustainable economic and social development,” an objective that was “more likely to occur where there is a mixed economy, that is an economy that is responsive to market incentives within a framework of socially integrative institutional mechanisms.”

## CHAPTER 5: CONCLUSION

The study was based on the hypothesis that parastatals accountability and performance can be enhanced if they had a well defined ownership policy. Many of the problems facing parastatals could be solved through having more effective boards and quality management. If parastatals had explicitly defined objectives they would have greater political autonomy and their boards would be clear on what they are supposed to achieve. This would in turn allow for improved monitoring and increased performance in the process. However, despite all the legal and regulatory challenges that have plagued parastatals performance and efficiency, the new constitution marks a good starting for reforming corporate governance of parastatals. A series of studies suggest that a relatively modest improvement in the efficiency of parastatals of five percent in a given country could free up financial resources of approximately one to five percent of a country's Gross Domestic Product.<sup>316</sup>

The objective of this dissertation has been to conduct an analysis of parastatals performance, the legal and regulatory framework governing them vis a vis the provisions of the new constitution. It also sought to identify possible corporate governance weaknesses in the framework and propose corrective remedial measures to the same.

The general underlying problems of corporate governance facing parastatals in the developed world are well documented, and to some extent emerging economies such as China, India and Eastern Europe. However, neither the current literature nor empirical studies on corporate governance have paid much attention to corporate governance of parastatals in Kenya. In particular there has been no attempt to critically examine reasons for their poor and depressing performance in light of the corporate governance framework under which they operate while benchmarking them against international corporate governance standards of best practices. Furthermore, there is currently no literature critically analysing the impact the new Constitution will have on the governance of parastatals. Therefore, this is the gap that this study intended to fill.

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<sup>316</sup> Maria Vagliasindi, *supra* note 102.

As indicated in Chapters One and Two, the state's involvement in business has a complex mixture of social, political and commercial objectives with the primary aim not being profit maximisation as is the case with a private firm. This distinction makes parastatals fundamentally different from private companies. Thus, it is not feasible to subject parastatals to the widely developed corporate governance standards of best practices applicable to private companies. Hence, different standards of best practice need to be developed to govern and to their performance.

The origin and the mission of some parastatals indicate that they are expected to be profitable. At the same time, they are expected to assist in the solution of societal problems such as providing employment without due regard to their short-term economic efficiency. As highlighted in this study, such societal contributions cannot be measured by financial standards such as return on investment. Therefore, measuring performance of such parastatals solely in terms of their returns on investments is inappropriate. The best way of assessing parastatals performance would be to consider their profitability together with their societal contributions.<sup>317</sup>

The canonical agency problem that exists between a firm's owners and shareholders does not only affect private companies but also parastatals. The relationship between shareholders and directors of a firm is a principal-agent relationship and the problems that arise out of the separation of ownership from control are intimately associated with the general problems of such relationships. Such problems as were pointed out in this study include divergent interests between the principal and agent, the costs of monitoring the agent, and the costs of inducing the agent to maximise the principal's welfare.<sup>318</sup> Corporate governance standards of best practices are designed to minimise these divergent interests and involve mechanisms for reducing agency costs.

As discussed in Chapter 2 and 4, a parastatal generally cannot have its board changed via a takeover or proxy contest, and most cannot go bankrupt. The state is unlikely to allow a large parastatal to face bankruptcy. As a consequence, their financial losses are

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<sup>317</sup> Yacob Haile-Mariam and Berhanu Mengistu, *supra* note 51 at p 1582.

<sup>318</sup> Winifred Mary Tarinyeba, *supra* note 68 at p 6.

subsidised from other sources of government finance. The discipline enforced on private firms by capital markets and the threat of financial distress is less important to parastatals.<sup>319</sup> Hence, two of the most important checks on underperformance are absent.<sup>320</sup> This reduces the incentives for parastatals boards and managers to maximise their value. Thereby leading to over reliance on government funding which reduces the pressure they have to contain costs, allowing for wasteful investments and harming performance over time. As a corrective measure to over reliance on government for funding, the government should support only those parastatals that it can pay for or those that can fund themselves. It should impose hard budget constraints on them.<sup>321</sup>

The people, in theory, are the real owners, on whose behalf the government manages the parastatals through its representatives. These representatives should be accountable through various control mechanisms in much the same way as managers of private companies are accountable to their shareholders. The purpose of the control mechanisms is to ensure the efficiency of the parastatals. These control mechanisms include the national legislature, the sectoral Ministry responsible for the parastatal, the Ministry of Finance, and control agencies which are all charged by law to see to it that parastatals do not run consistent losses and fail to accomplish their objectives. However, the control and accountability mechanism can become a 'bureaucratic bottleneck' as observed unless there is a political commitment on the part of the government to ensure efficiency.<sup>322</sup>

Furthermore, whereas the government is the “shareholder” of parastatals and thus has a legitimate right to influence parastatals, the scope and extent of the influence has been excessive and calls for some limitations. Namely, appropriate roles for the government should only include; setting objectives and performance targets, appointing directors, monitoring the performance of the enterprise and its board. Aside from these intervention rights – which need to be clearly spelled out and publicly disclosed – the remaining authority should sit with a professional board and management.

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<sup>319</sup> William L. Megginson and Jeffrey M. Netter, *supra* note 25 at p 330.

<sup>320</sup> David Robinett, *supra* note 5 at p 4.

<sup>321</sup> Dennis A. Rondinelli, *supra* note 39 at p 30.

<sup>322</sup> Yacob Haile-Mariam and Berhanu Mengistu, *supra* note 51 at p 1582.

As a solution to the multiple principals and often conflicting goals problems, the government should establish a single state ownership entity such as a ministry or holding company responsible for the government's stake in parastatals.<sup>323</sup> The entity should be charged with the responsibility of harmonising and coordinating the actions and policies undertaken by the various principals.

As discussed in Chapter 4, there is need to amend the legal and regulatory framework governing parastatals to allow profit-oriented parastatals to operate on the same footing with their private sector competitors in the market if they are to remain viable. Procurement for a private firm is mostly a simple operation. Since the focus is on profit, the company will seek the goods and services that will bring about the best relation of cost versus benefit. Government procurement on the other hand is painstakingly a complicated task. Parastatals that have to go through tenuous public procurement procedures find themselves at odds with the fast changing markets.<sup>324</sup> They should be exempted from the stipulated statutory requirements where there is need to respond promptly to a business opportunity that can be demonstrated. Moreover, there is need to classify parastatals according to their objectives and to develop suitable and viable frameworks to govern them depending on their categorisation.

Parastatals directors' appointments can no longer be based on cronyism, political allegiance or nepotism. Each of those appointed to the parastatal boards should be able to add value and bring independent judgment to bear in decision making processes. This can only be achieved when structured nomination processes are put in place so as to ensure that the ultimate selection criterion is competency. The new Constitution provides a good starting point in streamlining the appointments as discussed in the study. Further, if parastatals are to be viable and successful, the directors have to be able to steer them to

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<sup>323</sup> David Robinett, *supra* note 5 at p 11.

<sup>324</sup> Michael Ouma, *supra* note 283.

sustained prosperity with subjective and objective elements of degree of skill and care. Nothing less will do.<sup>325</sup>

From the study I can finally conclude that the three pillars of parastatals corporate governance reform will be; avoiding conflicting objectives, minimising political intervention, and improving their transparency. Parastatals will be with us for awhile. And while many of the fundamental problems they face can be dealt with by legal change, the underlying difficulties are attitudinal, mismanagement and waste.<sup>326</sup> It will be necessary for further studies to be conducted to establish the impact the new constitution is going to have on the corporate governance framework of parastatals once it is fully implemented and the requisite laws and regulations are enacted, amended or repealed.

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<sup>325</sup> Sunny Bindra, “Who are you appointing on your board, and why?”, *Business Daily*, (Kenya August 23, 2010).

<sup>326</sup> Centre for Corporate Governance Development, *supra* note 11 at p 44.

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