

CORPORATE GOVERNANCE PRACTICES AND PERFORMANCE OF COFFEE FARMER'S CO-OPERATIVE SOCIETIES IN KENYA

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ABSTRACT

The central thesis in this paper is that the performance of coffee farmer's co-operative societies is a function of corporate governance mechanisms; Board Size, Board Composition and status of the Chief Executive Officer (CEO). The research settled on Cash Coverage Ratio and Return On Assets, as performance variables and was guided by the null hypothesis that there exists no linear relationship between the performance variables and the corporate governance mechanisms..The regression analysis result showed that there exist a linear relationship between performance and corporate governance practice in farmer's co-operative societies, thus rejecting the null hypothesis. In genera the findings were; societies with smaller size of boards posted better performance as compared with those with bigger sizes more than 9 members. The same results were for those societies whose board comprised of individuals with a mix of skills and the role of the CEO was separate from that of the Chairman. Indeed as suggested by the results the failure by coffee farmer's co-operative societies in Kenya to embrace corporate governance have made them not to underperform.

Key Words: *Corporate governance, corporate governance mechanisms, performance*

Introduction

A Co-operative is a business entity that is member-owned, meaning the business is controlled and owned by the same people who utilize its services. The owners of the cooperative finance and operate the business, striving for a mutual benefit by working together. They combine resources, decrease overall production costs, and through which capabilities and marketing successes are increased. Cooperatives are run similar to other business entities and usually incorporated under state laws. The cooperative movement in Kenya was one of the nationally organized institutions available for all cadres of persons.

In Kenya the Center for Co-operative Governance stipulates seven core principles in the code of best practice in mainstreaming corporate governance in cooperatives; voluntary and open membership, democratic member control, economic participation by members, autonomy and

independence, education, training and information, cooperation among co-operatives and concern for community in general. The corporate governance principles in Kenya borrow heavily from the OCED principles which focus on publicly traded companies, both financial and non-financial. However they are applicable to improve corporate governance in non-traded. Companies including cooperative societies (OECD, 2004). For public listed firms in Kenya the Capital Markets Authority has a code of conduct for observance in order to enhance corporate governance amongst them.

In Kenya, little attention has been paid to the governance of co-operative societies needs, despite their considerable contribution to the economy. The co-operative sector as a whole remains poorly understood and its specific governance challenges remain as yet largely unexplored (Shaw, 2007). Empirical studies widely claim that good corporate governance enhances a firm's performance (Brickley and James, 1987; Byrd and Hickman, 1992; Rosenstein and Wyatt, 1990; Weisbach, 1988). However other studies have reported negative relationship between corporate governance and firm performance (Bathala and Rao, 1995; Hutchinson, 2002) and others have not found any relationship (Singh and Davidson, 2003; Young, 2003). Arguments in favor of the conflicting results are that they come about because of the use of either publicly available data or survey data all which are restricted in scope. Besides measures such as return on assets (ROA), return on equity (ROE), return on capital employed (ROCE) or restrictive use of market based measures (such as market value of equities) could also have contributed to the inconsistency (Gani and Jermias, 2006) which are restricted in scope. Besides measures such as return on assets (ROA), return on equity (ROE), return on capital employed (ROCE) or restrictive use of market based measures (such as market value of equities) could also have contributed to the inconsistency (Gani and Jermias, 2006).

Coleman (2007) concluded that the direction and the extent of impact of governance is dependent on the performance measure being examined. Specifically, the findings showed that large and independent boards enhance firm value and that combining the positions of Chief Executive Officer (CEO) and board chair had a negative impact on corporate performance. He also found out that CEO's tenure in office enhances a firm's profitability while board activity intensity affects profitability negatively. The size of audit committees and the frequency of their meetings had positive influence on market based performance measures and that institutional shareholding enhances market valuation of firms. Finally, the results pointed out that both country and sector characteristics influence the impact of governance on corporate performance. For enhanced performance of corporate entities, he recommended a clear separation of the positions of CEO and board chair and also the maintenance of relatively independent audit committees.

Large boards are less effective, difficult to coordinate and not able to process and tackle strategic problems of an organization (Theodore, Wells and Sundgren, 1998). The study results found a significant negative correlation between board size and profitability in a sample of small and

midsize Finnish firms, and this is much applicable to the coffee cooperative societies. More precisely an optimum board size composed of 5 directors was found by Mak and Yuanto (2003) using sample firms from Malaysia and Singapore, where firm performance was highest.

Concept of Corporate Governance

Corporate governance is defined as the system by which a corporation is directed, controlled and held to account for the manner in which power is exercised in the stewardship of its assets and resources, to increase and sustain shareholder value and satisfy the needs and interests of all stakeholders (Cadbury, 2000). The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on firm's affairs. The principles of corporate governance cover the rights of owners, the equitable treatment of shareholders, the role of stakeholders, disclosure and transparency and the responsibilities of the board (OECD, 2004).

Mwangi (2003) investigated the determinants of corporate governance practices; and Kegode (2005) investigated the application of corporate governance on the performance of the Kenya sugar board. Langat (2006) did study on the effect of corporate governance on performance for listed firms; and lastly Gathura (2007) studied corporate governance structure and performance of manufacturing listed firms on the Nairobi Stock Exchange. The latest study findings were in agreement to previous empirical studies conducted in Kenya (Lang'at, 2006; Mululu, 2005; Kegode 2005 and Mwangi; 2003). Mudibo (2005) argued that indeed the lack of implementation of corporate governance principles by most cooperative societies led to their failure to such an effect that board members succumbed to political pressure from external forces. There was lack of accountability from the management to members in running the society's affairs. The research investigated the relationship of the application of Kenya as a possible explanation for performance.

Governance Mechanisms

The size and composition of the board of director's act as a corporate governance mechanism this was echoed by Jensen (1993) ,that the preference for smaller board size stems from technological and organizational change which ultimately leads to cost cutting and downsizing. Hermalin and Weisbach (2003) argued the possibility that larger boards can be less effective than small boards. When boards consist of too many members agency problems may increase, as some directors may tag along as free-riders. Lipton and Lorch (1992) recommended limiting the number of directors on a board to seven (7) or eight (8), as numbers beyond that it would be difficult for the CEO to control. A large board could also result in less meaningful discussion, since expressing opinions within a large group is generally time consuming and difficult and frequently results in a lack of cohesiveness on the board (Lipton and Lorch, 1992). In addition,

the problem of coordination outweighs the advantages of having more directors (Jensen, 1993) and when a board becomes too big, it often moves into a more symbolic role, rather than fulfilling its intended function as part of the management (Hermalin and Weisback, 2003). Jensen (1986) suggested that when boards get beyond seven or eight people, they are less likely to function effectively and are easier for the Chief Executive Officer (CEO) to control. A similar view was suggested by Swanstrom (2006) who stated that the norms of behavior in most boardrooms are dysfunctional because directors rarely criticize the policies of the top managers or hold candid discussions about corporate performance. Believing that these problems increase with the number of directors, they recommended limiting the membership of boards to 10, with a preferred size of 8 or 9.

Enhanced director independence, according to Jaskwicz & Uhlenbunck (2003) is preferred because a director with ties to a firm or its CEO would find it more difficult to turn down an excessive pay packet, challenge the rationale behind a proposed merger or bring to bear the skepticism necessary for effective monitoring. The paper further suggests that independent outsider dominated boards will effectively monitor managers and improve firm performance. In contrast, dependent, insider dominated boards are detrimental to firm performance because personal relationships reduce the incentives of insiders for effective monitoring of managers.

Most corporate governance principles including the East African code of best practice highlight the importance of separating the roles of the Managing Director and Board Chair. Other studies have examined the separation of CEO and chairman of the board, saying that agency problems are higher when the same person occupies the two positions. Using a sample of firms in USA between 1984 and 1991, Yermack (1996) shows that firms are more valuable when the CEO and the chairman of the board positions are occupied by different persons. Companies whose CEOs also serve as board Chair are more likely to have certain troubling corporate governance characteristics than companies where the roles are separated Lacroix (2009).The report concluded that as a corporate governance best practice, companies should ensure that there is a Chairman-CEO split after an incumbent who holds the dual roles leaves.

A study done on Kenyan listed firms by Barako,Hancock & Izan (2006) revealed that the major issue often discussed is whether the chair of the board of directors and CEO positions should be held by different persons (dual leadership structure) or by one person (unitary leadership structure). Agency theory suggests that the combined functions (unitary leadership structure) can significantly impair the boards' most important function of monitoring, disciplining and compensating senior managers. It also enables the CEO to engage in opportunistic behaviour because of his/her dominance over the board.

Performance

Performance measures can be grouped into two basic types: those that relate to results (outputs or outcomes such as competitiveness or financial performance) and those that focus on the determinants of the results (inputs such as quality, flexibility, resource utilization, and innovation). They serve to align an organization's efforts to the achievement of its mission. As part of a company's evaluation and control program, they quantifiably monitor important characteristics of the company's products and services and the performance of the individuals and processes creating them. Performance measures best serve an organization when they are understandable, broadly applicable, uniformly interpreted, and economic to apply. They should cascade through an organization's hierarchy such that achievement of lower tiered performance goals support higher tiered goals that in turn ultimately support achievement of the company's mission. This suggests that performance measurement frameworks can be built around the concepts of results and determinants (Mululu, 2008).

Most studies of organizational performance define performance as a dependent variable and seek to identify variables that produce variations in performance (March & Sutton, 1997). While financial measures of performance are often used to gauge organizational performance, some firms have experienced negative consequences from relying solely on these measures. Traditional financial measures are better at measuring the consequences of yesterday's actions than at projecting tomorrow's performance. Therefore, it is better that managers not rely on one set of measures to provide a clear performance target. Many firms still rely on measures of cost and efficiency, when at times such indicators as time, quality, and service would be more appropriate measures. To be effective, performance yardsticks should continuously evolve in order to properly assess performance and focus resources on continuous improvement and motivating personnel. In order to incorporate various types of performance measures, some firms develop performance measurement frameworks. The most widely used measure in the academic literature, the Jensen Measure, is the intercept from a regression of the excess return (return minus the risk-free rate) of the managed portfolio on the excess return of a benchmark portfolio. Despite its wide use, this measure has been subject to considerable criticism (Grinblatt, 1993).

Research Problem

The accountability and transparency component of corporate governance would help companies gain shareholders' and investors' trust. These stakeholders need assurance that the company will be run both honestly and cleverly (Morck and Steier, 2005). Many companies are run mostly for the benefit of the shareholders, the rightful owners. There exists another model, where companies are run for the benefit of other significant groupings as well - such as customers, the general public or employees. The stakeholder model involves a board for each of these models - or something in between - requires people with different backgrounds and outlooks (ICO, 2008).

Empirical recent studies on co-operative forms of business have remained relatively limited however studies on the governance modes of firms, including labour managed firms and co-operative business models have addressed the question of why cooperative and other worker owned business models are relatively rare (Hansmann, 1996). Typically the failure of the co-operative model is explained by its democratic governance structures which prevent effective control over managers and profit distribution systems that lead to shorter time horizons (Shaw, 2006). However specific studies into corporate governance issues as they impact on cooperatives performance in the Kenya and other developing nations are very few and this presents considerable difficulty in reaching any definitive conclusions.

Research Methodology

Research Design

Documentary evidence was a source of data especially when it came to financial data. The research relied on annual returns and annexures submitted by co-operatives societies that are filled with the Commissioner of Co-operatives. The administration of questionnaires to the management of the co-operative societies was indeed important in obtaining information relating to the research objectives. The study population was all farmer's co-operative societies in Kenya, while the target population constituted farmer's societies within Bungoma County of Kenya. For the study period all the coffee farmer's co-operative societies that were still active numbered 20, and were all included in the study.

Validity and Reliability of the instruments

In order for the study to control quality, the researcher endeavored to attain validity co-efficient of at least 0.70 or 70%, Validity was determined by giving to two experts to evaluate the relevance of each item in the instrument to the objectives and rate each item on the scale of very relevant (4) quite relevant (3) some what relevant (2) and not relevant (1). Validity was determined using content validity index (C.V.I) $CVI = \frac{\text{items rated 3 or 4 by both judges}}{\text{total number of items in the questionnaire}}$. This is symbolized as n^3_4/N .

Performance Measurement

Co-operative Societies are business entities, thus their core purpose of existence & sustainability is profitability in addition to achieving the principles of the co-operative movement. Therefore research settled on the Cash Coverage ratio and Return on Assets (ROA) as measures of performance. This measure of performance is more reliable as it eliminates the non-cash expense, depreciation, that is used in profit measurement (Ross, Westerfield & Jordan, 1988).

$$\text{Cash coverage ratio} = (\text{Earnings Before Interest \& Taxes} + \text{Depreciation}) / \text{Interest}$$

Research Model Formulation

This economic model adopted in the study is in line with what has been mostly and successfully used in other literature such as (Kajola, 2008). Performance of the co-operatives was proxied by the Cash Coverage Ratio and Return On Assets ratio, the dependant variables of the research, against the independent variables, the corporate governance mechanisms. The research will regress the variables using the following economic model:

$$Y = \beta_0 + \beta X + E \text{-----} (1)$$

Where Y is the dependent variable. β_0 is constant; β is the coefficient of the independent variable X and E is the error term. The following conceptual and analytical model represented by equation (2) & (3) respectively develops atomically from the economic model (eq 1)

$$\text{Performance} = f(\text{Board Size, CEO status, Board Composition}) \text{-----} (2)$$

$$\text{SOCIETYPERF}_{ij} = \beta_0 + \beta_1 \text{BSIZE} + \beta_2 \text{BCOMP} + \beta_3 \text{CEO} + \epsilon_{it} \text{---}(3)$$

Whereby: (SOCIETYPERF_{ij}) represent performance of the ith cooperative in jth year; and ϵ_{it} is the error term. Equation (3) specifies three independent variables; the number of directors serving on the board (Board Size); Board composition signified by the ratio of outside to internal directors (Composition); Chief Executive Officer role (CEO status). In order to examine the hypothesis of the research, two economic models were formulated as follows;

$$\text{ROA}_{ij} = \beta_0 + \beta_1 \text{BSIZE} + \beta_2 \text{BCOMP} + \beta_3 \text{CEO} + \epsilon_{it}$$

$$\text{CASH RATIO}_{ij} = \beta_0 + \beta_1 \text{BSIZE} + \beta_2 \text{BCOMP} + \beta_3 \text{CEO} + \epsilon_{it}$$

The ratios were computed at the end of calendar years; 1999-2008 measured as follows:

Table 1a: Dependent variable definition and measurement

CR= Cash coverage ratio = [Earnings Before Interest & Taxes + Depreciation] /Interest

ROA= Return on assets = Net profit / total assets

Table 1b: Independent variable definition and measurement

BSIZE= Board size= Total no. of directors or members of management committees

BCOMP = Board composition = Non-executive/total directors * 100

CEO status Chief Executive role Role separate = 0 . Role separated = 1

The statistical software, XLSTAT 2010, was used for the analysis of the descriptive results obtained from the regression analysis.

Research Results

The findings indicate the average scores of the coffee cooperative societies performance measures and the governance mechanisms for the period 1999-2008. The ROA measure indicated the societies had a 16.18 mean(std Dev. 27.46) return and the cash coverage ratio was about 3.25 times (4.650). As much as some cooperatives performed better in terms of ROA, a number of them over the period performed poorly. The mean number of board size was 10 (std Dev. 2.78). The average number of non-executive directors serving on the various boards was about 18% (std Dev.11.04) and finally CEO status score was 0.5 (std Dev .548).

The relationship between the society's governance structures and performance was measured by multiple linear regression model specified by equation (3) with the Cash Coverage ratio as the dependant variables. F-test was performed at 95% to establish the significance of the model which implies a linear significance between the dependent and independent variables. The test was based on the null hypothesis that there exists no linear relationship between Cash Coverage Ratio and the Corporate governance mechanisms. The decision rule was to reject Ho if the P-value was less than 0.05.

$$(\text{Cash Coverage Ratio})_{ij} = \alpha_0 + \alpha_1 (\text{Board Size}) + \alpha_2 (\text{Board Composition}) + \alpha_3 (\text{CEO status}) + \epsilon_{ij}$$

Table 2a: the effect of Cash coverage on board size, board composition and CEO status

Source	Sum Sq.	D.F.	Mean Sq.	F	Prob.
Regression	56.086	3	18.695	0.719	0.626
Residual	52.014	2	26.007		
Total	108.101	5			

Table 2b: Regression Coefficients for the for board size (α_1) and CEO status (α_3)

Source	Coefficient	Std Error	Std Beta	CI(-95%)	CI(+95%)	t	Prob
α_0	0.078	11.728	-50.383	50.539	0.007	0.995	
α_1	0.240	0.920	0.144	-3.717	4.196	0.261	0.819
α_2	-0.163	0.271	-0.386	-1.331	1.005	-0.599	0.610
α_3	7.532	5.178	0.887	-14.745	29.809	1.455	0.283

Findings in table 3b indicated that regression coefficients for the for board size (α_1) and CEO status (α_3) were positive indicating a direct relationship while the one for board composition indicated a negative relationship. The relationship between the society's governance structures and performance was measured by multiple linear regression model specified by equation (3) with the ROA as the dependant variable. F-test was performed at 95% to establish the significance of the model which implies a linear significance between the dependent and independent variables. The test was based on the null hypothesis that there exists no linear

relationship between ROA and the governance mechanisms. The decision rule was to reject H_0 if the P-value was less than 0.05. The findings in Table 3a indicate that there is a significant relationship between ROA and Board size; CEO status; and Board composition.

$$(ROA)_{ij} = \alpha_0 + \alpha_1 (\text{Board Size}) + \alpha_2 (\text{Board Composition}) + \alpha_3 (\text{CEO status}) + \epsilon_{ij} n$$

Table 3a: regression coefficients for the for board size (α_1) and board composition

Source	Sum Sq.	D.F.	Mean Sq.	F	P-value
Regression	2723.598	3	907.866	1.760	0.001
Residual	1031.877	2	515.939		
Total	3755.476	5			

Table 3b: Regression coefficients for CEO status

Source	Coefficient	Std Error	Std Beta	(CI)-95%	(C.I.) +95%	t	Prob
α_0	7.818	52.236		-216.935	232.571	0.150	0.895
α_1	-0.463	4.096	-0.047	-18.085	17.158	-0.113	0.920
α_2	-0.613	1.209	-0.247	-5.816	4.590	-0.507	0.662
α_3	48.075	23.061	0.961	-51.148	147.298	2.085	0.172

Findings in table 3b indicates that regression coefficients for the for board size (α_1) and board composition (α_2) were negative indicating an inverse relationship while the one for CEO status (α_3) indicated a positive relationship.

Table 4: Pearson Correlations

	ROA	Bsize	BCOMP	CEO Status
ROA	1.000	-0.251	0.341	0.830
Bsize	-0.251	1.000	-0.449	-0.328
BCOMP	0.341	-0.449	1.000	0.590
CEO status	0.830	0.328	0.590	1.000
	Cash R	BCOMP	CEO Status	BSIZE
Cash R	1.000		0.073	0.612
0.027				
BCOMP		1.000		0.590
-0.449				
CEO			1.000	
status		0.612	0.590	1.000
-0.328				
BSIZE		0.027	-0.449	-0.328
1.000				

The analysis in Table 4 shows that there was a positive correlation between board composition; CEO status and Board Size. ROA had a positive correlation with board composition and CEO status; however the correlation was negative with board size.

Discussion of Results

Results from the all the societies investigated showed a correlation between performance and the governance mechanisms. On Board composition there were only two ex-officials that can be said to be non-executive directors that sat on board meetings to deliberate decisions. One was the co-operative officer representing the ministry at the county and the other was an official from the ministry of Agriculture. Notably the ex-officials were not full time employees and are constrained to serve on all the boards. Most societies had a board size of 7 and 8 comprising of farmers representing the geographical coffee production regions. The survey showed that most of the directors somehow did not understand their duty towards creating value for the farmers they used to represent. The results revealed that the role separation of the office of the CEO and chairman significantly had the most impact on performance. The findings indicate that the average cash coverage ratio was 12 times while the lowest was below zero. The average score was 3.14 and the results revealed that there was a deviation of 10.6. By this was the most important measure of performance for the study determining the ability of the cooperatives to generate cash to meet their obligations.

Conclusions

The research findings indicated that co-operative societies that had clearly separation of the roles of the board chair and CEO, showed improved performance. However board composition did not significantly show improved performance. The non-executive directors were not independent since they both came from the government side being ex-officials from the ministry of cooperative development and ministry of agriculture. But generally the research has found that corporate governance compliance enhances performance. The study findings are in agreement to previous empirical studies for other firms in the mainstream industry (Langat, 2006; Mululu, 2005; and Mwangi, 2003).

The data results showed the cooperatives had that did attempt to separate the role of the chairman from that of the manager- secretary standing in as the CEO, performed better during the period. The secretary-manager was responsible to the board in implementing resolutions and incharge of the day to day business activities. The agency costs were significant in cooperatives that did not attempt to structure the offices of the chairman and the secretary-manager. The survey also indicated that separation of roles of Board chair & CEO, appointment of non-executive directors and board size limit mitigate the agency conflict. Therefore corporate governance practice mitigates the agency conflict.

The survey findings indicated that a majority of the respondents regardless of their education levels and period of experience strongly agreed the challenges in corporate governance practice were political interference, wrangles and litigations; lack of adequate controls; lack of a mixed of skills of individuals on the board and lack of access to financial resources. The research also did indicate that a number of board members were not aware of their duty towards creating value for the cooperative as a whole and this was a challenge too.

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