AN ANALYSIS OF THE CHALLENGES AFFECTING CORPORATE GOVERNANCE IN STATE OWNED ENTERPRISES (SOEs) IN KENYA

(A case study of National Social Security Fund (NSSF))

RORI, Andrew Moirore

A THESIS

Submitted to
KDI School of Public Policy and Management
In partial fulfillment of requirements for the degree of

MASTERS OF PUBLIC POLICY

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Committee in charge:

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ABSTRACT

AN ANALYSIS OF THE CHALLENGES AFFECTING EFFECTIVE CORPORATE GOVERNANCE IN THE STATE OWNED ENTERPRISES (SOEs) IN KENYA:

"CASE STUDY OF NATIONAL SOCIAL SECURITY FUND (NSSF)"

BY

RORI, Andrew Moirore

Efforts to improve corporate governance in the public and private sectors are gaining growing support from both outside and inside Kenya. The rationale of the study was to identify the corporate governance challenges facing state owned enterprises and how they are meeting them through various policy options, existing or new. The study was carried out at the National Social Security Fund of Kenya.

The study's specific objectives were to establish if state owned enterprises in Kenya are subject to a binding legal system, identify the main corporate governance challenges facing state owned enterprises in Kenya and also to find out structural reforms being made by state owned enterprises in Kenya to effectively abide by the principles of corporate governance.

The study was through a descriptive survey. This approach was preferred because it was considered to be most convenient and one that could ensure that the data obtained gave response to the research study questions. The research targeted 1800 employees of the National Social Security Fund. Stratified random sampling was adopted for this study. The study grouped the target population into relatively homogeneous subgroups then random sampling was applied within each stratum. A convenient and manageable sample size of 120 was identified for the study. The sample size took into consideration the study's sampling design.

The study found out that although corporate governance is important in the management of state owned enterprises it faces several challenges among them being inadequate management and audit and assessment committee oversight of business lines, quite a number of members of the board of directors do not understand the legal, reputational, and compliance risks facing their organization.

The study concluded that effective corporate governance in state owned enterprises is affected and depends on whether the state owned enterprise has clearly defined roles for directors and management, board members who are appointed based on considerations of merit and the necessary skills, qualifications and experience for the position.

The study recommends that there should be separation of management functions from ownership interests, clear guidelines when procuring goods and services, proper succession plans, promotion of transparency, internal controls and the management of state owned enterprises should strive to always act responsibly.

DEDICATION

The research is dedicated humbly, to my parents James Rori and Florence Bosibori, my wife Lucy and children, who inspired and encouraged me to go the extra miles in pursuit of excellence.

ACKNOWLEDGEMENT

I am deeply indebted to all those people who in their own individual ways contributed either directly or indirectly to the production of this project.

I am especially grateful to my supervisor Professor Lee, Kun – Ho who was not only interested in the subject of problems of corporate governance in state owned enterprises but also provided the necessary criticisms, suggestions and encouragements.

I am convinced that without his immense concern, this project would not be a success. I am also grateful to the members of my family for their encouragement throughout my college life and for the faith they had in me even when the going was really tough.

Table of contents

Acronyms

CCG - Center for Corporate Governance

COTU - Central Organization of Trade Unions

COYA - Company of the Year Award

FKE - Federation of Kenya Employers

ICPAK - Institute of Certified Public Accountants (Kenya)

NSSF - National Social Security Fund

OECD - Organization for Economic Cooperation and Development

CHAPTER ONE

1.0 INTRODUCTION

We live in a global economy whose growth is driven by conformance to good corporate governance, Morris and Heck (2001). The higher the conformance to good corporate governance practices the stronger the organization's competitiveness, Ho (2005).

According to Lipman and Lipman (2006), Good corporate governance helps to prevent corporate scandals, fraud, and potential civil and criminal liability of the organization. A good corporate governance image enhances the reputation of the organization and makes it more attractive to customers, investors, suppliers, and in the case of non-profit organizations, contributors. Organizations with good governance tend to have higher values in the market, better access to finance and higher credit ratings and institutional investors, consistently express preferences for organizations with good corporate governance, Saidi (2004).

This research proposal presents the background of the study, the statement of the problem, the research objectives and questions. The proposal also discusses the significance of the study, the scope and limitations of the study, literature review, and an insight into the strategies and methodologies of the study. The study is an analysis of the challenges affecting effective corporate governance in state owned enterprises in Kenya, a cases study of the National Social Security Fund (NSSF). Two more chapters will be added later after the collection of data: chapter four on data analysis and presentation and chapter five on summary of findings, conclusions and recommendations.

1.1 BACKGROUND TO THE STUDY

The term corporate governance is often defined as the formal system of accountability by top management to the stakeholders. A more expansive explanation includes the entire set of legal rules, relations and behaviors that represent the scheme by which a company is controlled and directed. Scholars and practitioners in the field of corporate governance tend to give the term a wide array of definitions, Jeswald (2004). It is the institutions that influence how business firms allocate wealth and returns, and the corporations' systems and rules affect expectations thereof about the exercise of control of resources in firms. The definition should not only focus on the formal rules, systems and institutions of corporate governance, but also on the informal practices that evolve in the absence or weakness of formal rules. According to the United Kingdom's 1992 Cadbury Report's frequently cited definition corporate governance is the system by which businesses are directed and controlled. (www.ecgn.org.).As applied in practice, this definition focuses almost absolutely on the internal constitution and operation of the corporation's decision-making process. It has been this narrower definition that has been critical to public policy considerations about corporate governance in most countries, Jeswald (2004).

Corporate governance has become very important for the survival of organizations and indeed of national economies in the increasingly global economy, Tumuheki (2007). In the case of Kenya, where the infusion of international investor capital and foreign aid is essential to economic stability and growth, good corporate governance in the public service especially by state owned enterprises has become a critical factor. State owned enterprises in Kenya stand at the threshold of a new era: The new era demands a transformed state owned enterprise. One that is truly transparent and accountable to the public.

With the dawn of the twenty-first century, corporate governance has got heightened importance and attention in government policy arenas, academic world, and the press throughout much of the world, Jeswald (2004). A variety of reasons explain the current prominence of corporate governance. The latest century's financial scandals affecting major American firms, such as Enron, WorldCom, Freddie Mac and Arthur Andersen, and the resulting loss of confidence of investing in the capital market led to dramatic declines in share prices and substantial financial losses to millions of investing public. The public and the experts have often identified failed corporate governance as a prime cause of most of the financial scandals being experienced in the world today.

This research study on the analysis of the corporate governance challenges faced by the state owned enterprises in Kenya is a case study of the National Social Security of Fund of Kenya.

1.1.1 Profile of the National Social Security Fund of Kenya (NSSF)

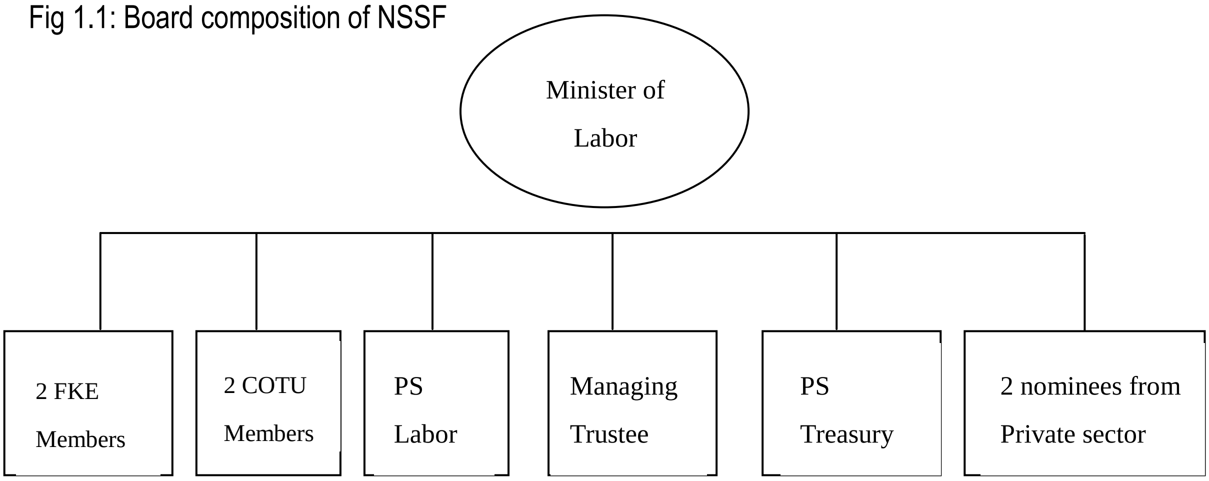
The National Social Security Fund was established in 1965 through an Act of Parliament Cap 258 of the Laws of Kenya. The Fund initially operated as a Department of the Ministry of Labor until 1987 when the NSSF Act was amended transforming the Fund into a State Corporation under the Management of a Board of Trustees.

Plans are underway to further amend the NSSF Act in order to convert the Fund into a mandatory National Social Insurance Pension Scheme to which every Kenyan with an income shall contribute a percentage of his/her gross earnings so as to be guaranteed basic compensation in case of permanent disability, basic assistance to needy dependants in case of death and a monthly life pension upon retirement.

1.1.2 Board composition and Management structure

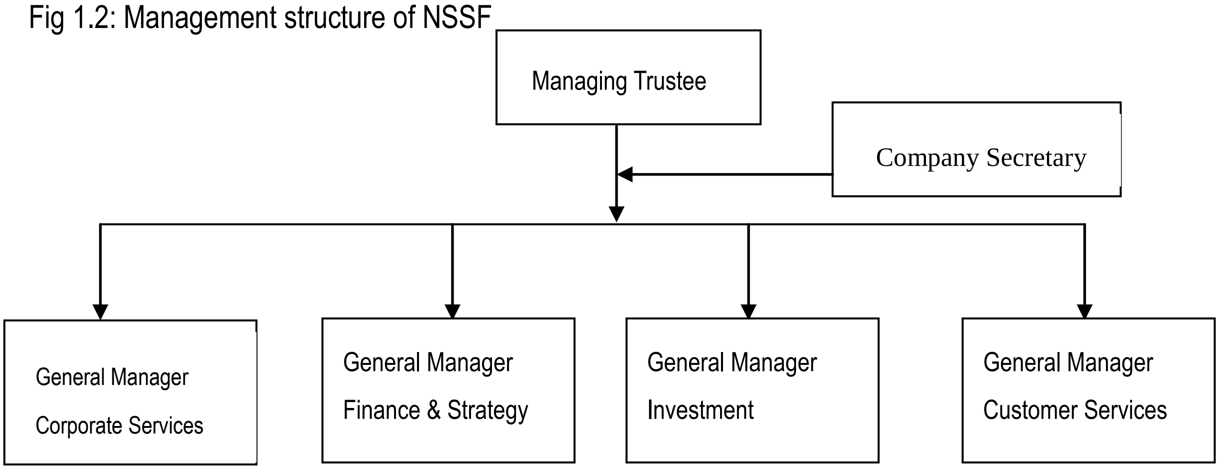
Policy formulation and implementation of NSSF is entrusted on a tripartite Board of Trustees representing employers, workers and the government (www.nssfkenya.com)

Fig 1.1: Board composition of NSSF



In running the affairs of the fund, the NSSF Managing trustee is supported by a number of managers as shown below

Fig 1.2: Management structure of NSSF



1.1.3 JUSTIFICATION FOR NSSF

NSSF has been operating since 1965 one year after Kenya became a Republic. All the large employers in Kenya (other than the army, and the pensionable civil servants - those with 5 employees are above) are all members of NSSF. To date NSSF 129, 571 employers are members. Kenya's formal sector has 2.5 million workers. 1,146,817 are members of NSSF. The capital base of NSSF is Ksh. 110 billion (USD 9.46 billion), making it the largest state owned financial enterprise. NSSF is the only mandatory provident fund that is also guaranteed by the government of the Republic of Kenya.

NSSF being a state owned enterprise, its budget is subject to the treasure and changes in its high level management personnel (Managing Trustee) is subject to the approval of the responsible ministry – Ministry of Labour.

NSSF is required to the Treasury (Ministry of Finance) its annual finance plan its approval. All procurement done by NSSF are subject to Kenya's Public Procurement and Disposals Act 2005.

NSSF as a state owned enterprise is subject to auditing by the Inspector General – State Corporation. It is also supervised by Government under the performance contracting framework.

1.2 STATEMENT OF THE PROBLEM

The ability of countries, large state-owned, foreign-owned, and private family-owned companies to attract external capital is affected by their systems sets of corporate governance and the degree to which corporate administration is constrained to respect the binding rights of creditors, bondholders, and non-controlling shareholders. Institutional and individual investors will refrain from giving capital or will demand a high risk premium for their investment from enterprises in countries and institutions without effective systems of corporate governance compared to similar enterprises in countries with stringent corporate governance standards, Jeswald (2004).

External funding not only provides organizations with investment and expanding sources of capital, but also encourages the unrelenting incorporation of sound corporate governance practices, that may help the corporations to achieve the confidence of investors, reduce their cost of capital and induce more stable financial sources, Melinda and Lori (2006).

This research study seeks to find out the corporate governance challenges that state owned enterprises in Kenya face.

1.3 OBJECTIVES OF THE STUDY

The main objective of the study is to analyze corporate governance challenges faced by the state owned enterprises in Kenya.

1.3.1 Specific Objectives of the study

The study will specifically seek to:

a) establish if state owned enterprises in Kenya are subject to a binding legal system

b) identify the main corporate governance challenges facing state owned enterprises in Kenya

c) find out structural reforms being made by state owned enterprises in Kenya to effectively abide by the principles of corporate governance.

1.4 RESEARCH QUESTIONS

The study seeks to answer the following research questions:

a) Are state owned enterprises in Kenya subject to binding rules or legal system

b) What are the main corporate governance challenges facing state owned enterprises in Kenya?

c) What structural reforms are being made by state owned enterprises in Kenya, to make them effectively abide to corporate governance principles?

1.5 SIGNIFICANCE OF THE STUDY

A state owned enterprise gains credibility in several ways: by developing a record of standing by its promises, by being subject to a compulsory legal system, and by a well structured system of incentives so that managers gain if they accomplish their promises and get reprimand if they do not. If a state owned enterprise acts contrary to its promises, it undermines its steadfast record and becomes less able to obtain new equity financing.

The findings of this study will help state owned enterprises to appreciate the challenges of effective corporate governance and to identify strategies that can apply in order not to break their promises and to win the confidence investors.

1.6 THE STUDY SCOPE AND STUDY LIMITATIONS

This study on the corporate governance challenges facing state owned enterprises in Kenya was carried at the National Social Security Fund in Nairobi, Kenya. The population targeted in this study was 1800. The population will cover the Board of Trustees of the National Social Security Fund, the Members of Fund, Civil society members, the Ministry of Labour officials, and the employees of the Fund.

The following are some of the limitations the study is likely to meet:

a) Management may be too busy to give all the necessary information

b) Inadequate funds for the research

c) Lack of enough time for the study

d) Lack of cooperation from some of the respondents

CHAPTER TWO

2.0 LITERATURE REVIEW

The purpose of the literature review in this study is to provide some literature corporate governance from textbooks, newspapers, the internet, magazines, other researchers work. It is hoped that the review will add impetus to the study. The literature will also address the gap to be filled by the study.

2. 1 THEORETICAL MODEL OF CORPORATE GOVERNANCE

Corporate governance field describes all the influences that affect the institutional processes, as well as those that appoint the controllers and/or regulators, involved in organizing the production, manufacturing and sale of products and services. Portrayed in this way, corporate governance includes all types of organizations whether or not they are incorporated under civil law. Firms can exist as either, civil or common law companies, partnership, limited liability partnerships, mutual associations, joint ventures, building societies, co-operatives, friendly societies, trading trusts, etc. Fama & Jensen (1983b) even considered churches. However, organizations like churches, that are not active in the production and sale of products and services, generally do not meet operational description of a firm.

Corporate governance refers to the structures and processes for the direction and control of companies. Corporate governance concerns the relationships among the controlling shareholders, management, Board of Directors, minority shareholders and other stakeholders. Good corporate governance promotes sustainable economic development by enhancing the performance of companies and fosters their access to outside capital.

Corporate governance could be defined as the relationship between management, directors and the equity providers, populace and institutions that save and invest their capital expecting to earn a return. It compels companies to improve their performance in order to attract investment.

Corporate governance inadvertently enables corporations to realize their objectives, protect shareholder rights, and meet legal requirements. It enables the firm to demonstrate to the general public how they are conducting their business. The combination of good corporate governance practices and functioning legal infrastructures are key to the development, growth and sustainability of markets.

2.1.1 THEORIES AND PRACTICES RELEVANT TO CORPORATE GOVERNANCE

As a background paper for the Organization for Economic Cooperation and Development (OECD), Hawley & Williams (1996) undertook in-depth analysis and a literature review of corporate governance practices in the United States. Four corporate control models were identified: the Simple Finance Model; the Stakeholder Model; the Political Model and the Stewardship Model. While Shleifer & Vishny (1996) *Survey of Corporate Governance* for the National Bureau of Economic Research was not limited to the US, its extent was restricted to the finance model consistent with the specialized definition of corporate governance adopted by the authors quoted earlier.

Three additional ways of analyzing corporate governance is discussed in the next section.

2.1.1.1 The simple finance model

In the finance view, the critical problem in corporate governance is implicit or explicit contracts that is to construct rules and incentive to effectively align the behaviour of managers (agents) with the wishes of principals (owners), (Hawley & Williams 1996). However, the 'rules' and 'incentives' reflected on, are by and large only those within the existing US system of publicly traded corporations having unitary boards.

The rules and incentives in the finance model refer to those instituted by the firm as opposed to the legal/political/regulatory system and culture of the host nation's economy or the characteristics of the owners. The finance view represents the political model sub-section of corporate governance.

2.1.1.2 The stewardship model

In the stewardship model, managers are the best stewards of the organizations and diligently work to attain high levels of corporate profit and shareholders wealth maximization (Donaldson & Davis 1994). Donaldson & Davis noted that Managers are chiefly motivated by accomplishment and responsibility needs and given the needs of managers for responsible, self-directed work; corporations may be better served to free managers from subservience to boards dominated by non-executive director.

However, supporting stewardship theory are the individuals who contribute their own funds and other resources to non-profit organizations to become a director. In analyzing the welfare distributed to stakeholders by introducing a separation of powers, Persson, Roland & Tabellini (1996) made a provision in their equations to take account of the welfare contributed by controllers.

In commenting on stewardship theory, Hawley & Williams (1996) stated that the logical extension either tends to an executive-dominated board or in the direction of no board at all. Donaldson & Davis pointed out that by its design, the non-executive board of directors is an ineffective control mechanism and cites evidence to support the view that the whole justification for having a board becomes self defeating.

When there is a dominant active shareholder, especially when the majority shareholder is a family or government boards tend to be redundant. One could speculate that a number of boards are established from cultural habit, blind conviction in their efficiency, or to make the government or the family firms take “more business outlook”.

However, research by Pfeffer (1972) has revealed that the value of external directors is not to a great extent how they influence managers but how they influence constituencies of the organization. He established that for more regulated industry there are more outsiders in the board to restore confidence of the regulators, bankers, and other interest groups.

Tricker (1996) points out that key to the company law are the requirements that directors should exercise a fiduciary duty towards the stockholders of the company. Inherent in the idea of fiduciary duty is the fact that the directors can be trusted and will act as stewards over the resources of the corporation. Thus in the Anglo law, duties of the directors are based on stewardship theory. These duties are superior to that of an agent since the person is required to act as if he or she was the principal rather than a representative.

2.1.1.3 The stakeholder model

In describing 'Stakeholder Theory' Clarkson (1994) states that the firm is a system of stake holders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the organization's activities. The rationale of the firm is to create wealth or value for its stake holders by translating their stakes into goods and services. This view is also held by Blair (1995) who suggests that the goal of directors and management should be that of maximizing wealth creation by the organization. The key to achieving this is to boost the voice of and offer ownership-like incentives to those participants in the firm who contribute or control significant, specialized inputs (firm specific human capital) and to align the interests of these significant stakeholders with the interests of outside, passive shareholders.

Porter (1992:17) also advocated that corporations should seek long-term owners and give them a direct voice in governance (that is, relationship investors) and to nominate significant shareholders, customers, suppliers, employees, and community representatives to the board of directors.

2.1.1.4 The political model

The political model recognizes that the allocation of privileges, corporate power and net gains between owners, managers and other stakeholders is established by how governments favor their different constituencies. The capability of corporate stakeholders to influence allocations among themselves at the micro level is affected by the macro framework, which is interactively subjected to the muscle of the corporate sector.

According to Hawley & Williams (1996), the political model of corporate governance has remarkably had immense influence on corporate governance developments in the recent years. However, Hawley & Williams focus their discussion only on the micro segments of how shareholders can affect firms.

Hawley & Williams (1996) focused on the political model at the micro level as articulated by Gundfest (1990) and Pound (1993b). Pound (1993b) looked at the political model of governance as an approach, "... in which active investors attempt to change corporate policy by developing voting support from dispersed shareholders, rather than by merely procuring voting power or control...". Pound (1992) states this new form of governance based on politics as opposed to finance will provide a means of oversight that is both far more effective and less expensive than the takeovers of the 1980's.

Gundfest (1993) points out that a deep insight into the political marketplace is essential to understand the role capital-market frameworks can play in corporate governance. For example, Gordon & Pound (1991) demonstrated that corporations with little anti-takeover provisions in their constitutions out performed those having anti takeover measures in place.

Bhide (1994) develops details of this position. Hawley & Williams (1996) states that the political model of corporate governance whether Gundfest's or Pound's version places stringent limits on the traditional economic study of the corporate governance problem, and locates the performance-governance concern squarely in a wider political context. Political does not necessarily imply a government role, but merely that it is non market.

In other words, the analysis of economists needs to be truncated and incorporated into the insights of Ben-Porath (1978) and Hollingsworth & Lindberg (1985) to appreciate how both economic transactions and their co-coordinating institutions are governed. Distribution of national income is also an aspect neglected by economists; it can be distributed without work or welfare by distributing corporate ownership directly to individuals not necessarily through institutional intermediaries (Turnbull 1991b; Kelso & Adler 1958; 1994b; Kelso & Hetter 1986).

2.2 CORPORATE GOVERNANCE IN STATE OWNED ENTERPRISES

Good corporate governance of state owned enterprises is becoming a reform priority in many countries. Improved efficiency and better transparency in the state owned sector will result in considerable economic gains especially in countries where state ownership is important, www.oecd.org . State ownership still remains significant in middle and lower-income countries despite extensive privatization over the last two decades. State owned enterprises—sometimes also referred to as government corporations, government-linked companies, public enterprises, public sector enterprises or parastatals are a diverse mix ranging from internationally competitive listed companies, large-scale public service providers, wholly owned manufacturing and financial firms, to small and medium enterprises, World Bank (2006).

Traditionally, state ownership has been advocated as an alternative to regulation, especially for natural monopolies or oligopolies, including network industries such as telephony. It was believed that in these industries direct government ownership would allow for greater economies of scale, more efficient pricing, and higher levels of investment and innovation. Reinforced by the perceived failures of industrial regulation in western economies in the 1930s, state ownership became a popular policy prescription for a wide number of market failures in the decades following World War II (Lange 1937; Shleifer 1998). Modern theories of ownership generally take a restrictive view of both regulatory malfunction and the role of the state as owner.

2.3 GUIDELINES ON CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES

In 2005, the OECD published "Guidelines on Corporate Governance of State-Owned Enterprises", aimed at promoting efficiency and enhancing transparency in the public sector. The guidelines stress the need to establish a clear legal and regulatory framework for state-owned enterprises, one that is as close as possible to the guidelines for private sector companies, so as to avoid market distortions and establish a level playing field.

This requires a clear separation between the different roles the state plays in the market, as business owner and as market regulator. With respect to financing, the OECD recommends that governments should avoid situations in which the state implicitly guarantees or automatically assumes responsibility for a state-owned enterprise's debts. As majority shareholder, the state should actively exercise its ownership function. According to the OECD guidelines, hands-on and politically motivated ownership interference should be avoided as much as totally passive or distant ownership by the state. The best method for the exercise of state control is through a centralized entity that clarifies the state's ownership policy and orientation and ensures its consistent implementation. This entity should be accountable to Parliament.

In state-owned enterprises that have private shareholders, all shareholders should be treated equitably and have access to corporate information. This includes measures to foster the participation of minority shareholders and ensure that their rights and interests are respected. State-owned enterprises must also explicitly recognize their commitments to all stakeholders and acknowledge stakeholders' influence on corporate decision making.

For such transparency to become a reality, the OECD recommends that the reports on different aspects of state-owned enterprises' activities, in particular those that may entail a conflict of interest, be made public, and also that state-owned enterprises be subject to internal and external audits. The agency that oversees state-owned enterprises should provide aggregate information in an annual report.

To improve the quality of oversight of state-owned enterprises, the OECD recommends that boards have the necessary authority to monitor management independently of government policy. To do this, the guidelines suggest that government should develop a structured nomination process that preserves boards' objectivity, professionalism and independence. Remuneration schemes for board members must also be designed to favor the long-term interests of the company and attract suitably qualified professionals.

To promote real strategic discussion and objective advice, boards should be made up of a small number of members, who should not also be managers of the company. And to preserve the board's independence with respect to management, the OECD recommends that the Chair of the board be separate from the CEO.

In developing strategies to improve the corporate governance of state-owned enterprises, governments should use the principles that guide private companies, though adapted to the specific circumstances of the public sector. However, corporate governance in the public sector faces three unique challenges: how to clearly define the state's ownership function; how to make the company's goals and performance more transparent; and how to empower managers and boards to make the right decisions.

2.4 THE CHALLENGES OF CORPORATE GOVERNANCE IN STATE OWNED ENTERPRISES

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. SOEs have the same core problem in terms of separation of control and ownership the owners in this scenario being the populace of a country but they also face additional challenges that can severely undermine their efficiency, World Bank (2006).

Unlike a widely held firm in the private sector, a state owned enterprise generally cannot have its board changed via a proxy contest or a takeover, and majority cannot go bankrupt. The absence of potential takeovers and proxy contests decreases the incentives of board members and managers to maximize the value of the firm, and the lack of bankruptcy can introduce a soft budget restraint, which may reduce pressure to contain costs. Hence, two of the most important checks on underperformance are absent (Baygan Robinett 2004; Estrin 1998).

Although a state owned enterprise has very diffused owners, it generally has a higher body or bodies that oversee its operations. This can be one or a number of ministries, an ownership entity specifically created to oversee state owned enterprises, the Parliament, or frequently some sort of combination. At the worst, these various authorities may use state owned enterprises to achieve short-term political ambitions at the cost of both efficacy and longer term policy objectives. Even without flagrant abuse, this composite agency chain through and across various levels of the government more often may present difficulties not present in the more straightforward relationship between a company's board of directors and management on the one hand and its shareholders on the other hand (Estrin 1998; OECD 2005a).

State owned enterprises also have the related problem of common agency. Given that each pertinent part of the government has somewhat different objectives, each could attempt to influence the state owned enterprise accordingly. 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 (Dixit 1997). Managing multiple and potentially conflicting objectives is one of the critical tests in the governance of state owned enterprises.

In recent years, enhancing the corporate governance of the state owned enterprises has become a major policy objective in countries around the world. This study will analyze the corporate governance challenges facing state owned enterprises in Kenya.

2.5 CRITICAL GAP

Improving the governance of state owned enterprises can bring substantial benefits. By increasing profitability, corporate governance reform can contribute to the government's financial position and allow greater reinvestment. Better corporate governance can increase productivity and contribute to overall economic performance both directly and by reallocating resources within the state sector and across the economy as a whole. Further, improved governance in the state sector is more likely to create a model for and amplify pressure on the private sector to improve its own governance.

Even when privatization is planned for state owned state owned enterprises, corporate governance remains crucial. An inattention to governance in the privatization process has caused sometimes spectacular failures and widespread abuse, Chong and Lopez-de-Silanes (2003). It may take time to develop the institutional infrastructure needed to ensure adequate governance for privatized firms, and the privatization process itself may take substantial time, especially when difficult restructuring and liquidation are necessary. By enhancing the governance of the state owned enterprises, the state can better protect its assets, enhance performance, and ensure higher valuations and revenue from privatization. Finally, state ownership remains an element of many countries' economic strategies. Major companies around the world will retain state ownership for many decades to come.

This study therefore attempts to identify some of the corporate governance challenges facing state owned enterprises in Kenya.

CHAPTER THREE

3.0 RESEARCH DESIGN AND METHODOLOGY

This chapter focuses on how the research was conducted. It identifies the methods, the study's research design, techniques and strategies. It identifies the target population, sample design, sampling procedure and data collection procedures, validity, reliability as well as data analysis techniques.

3.1 RESEARCH DESIGN

The design of this study will be descriptive survey. This design has been identified as the most convenient and one that can ensure that the data obtained to give answers to the research questions. Descriptive design will also offer the opportunity for a logical structure of the inquiry into the problem of the study. According to Marsh (1982) and Yin (1993), descriptive surveys are good at providing information and explanations to research questions.

3.2 TARGET POPULATION

The research targeted the 1800 employees of the National Social Security Fund.

3.2.1 Sampling Design

Stratified random sampling will be used for this study. The study will group the target population into relatively homogeneous subgroups then random sampling will be applied within each stratum. Simple random sampling will ensure that there no bias among the respondents as all the respondents have equal chances of being selected to participate in the study hence simple random sampling technique has been deemed suitable for the research study.

3.2.2 Sampling size

Due to limited resources, time and money, it was not possible to collect data from the 1800 population that was targeted for the study. A convenient and manageable sample size of 120 was identified for the study. The sample size took into consideration the study's sampling design.

3.3 DATA COLLECTION

According to Polit (1999) data collection is the gathering of pieces of information that are necessary for research process. A structured approach to collecting data will be utilized to ensure that all respondents from the sampling size are covered.

3.4.1 Data Collection Instruments

Questionnaires will be issued to respondents in the four categories of the target population. The respondents will be given enough time to complete the questionnaires.

There were two parts of the questionnaire – Part A and part B. The questions in the questionnaire will be both structured and unstructured. Structured questionnaires list have close-end questions. These include multiple choice questions which offered respondents the ability to answer "yes" or "no" or select from a list of several answer choices. Close-end questions also included scales in questions that asked respondents to rank their answers at a particular point on a scale. Some of the questions were open-ended. Respondents were expected to answer in their own words. Therefore the study will use structured and unstructured questionnaires so as to ease the analysis of the research findings.

3.5 VALIDITY

According to Best and Kahn (2000) validity of an instrument is asking relevant questions framed in the simplest way. Validity per ser is the degree to which research instruments evaluate what they are supposed to measure. This was determined and established through expert judgment. In this study, content validity was established in two stages. The researcher critically considered each item in the questionnaire to ensure that it evaluates what it is supposed to evaluate. The developed instruments were given to the fellow students in the KDI School of Public Policy and Management to evaluate their applicability, appropriateness, clarity and the adequacy of the construction of the instrument from the research perspective. Using their suggestions the instruments were modified accordingly.

3.6 RELIABILITY

Reliability is that which has the ability to consistently yield the same results when repeated measurements are taken on the same individuals under the same conditions as stated by Mugenda (1999). It tells how well a test measures what it is supposed to measure prior to the actual collection, the instruments were given to 7 members of the fund within an interval of two weeks. The responses were compared in both cases. The test-retest method was then used to approximate the reliability of the test instruments.

3.7 DATA ANALYSIS

Data analysis will first be analyzed according to descriptive information following the research questions. Calculating the percentages and means scored. Descriptive statistical analysis will be employed, this will enable the researcher to reduce summarize organize, evaluate and interpret the numeric information. Descriptive statistics will be used because they are easy to analyze and convenient for the researcher and the study. The findings will be presented by use of tables, bar graphs, mean, frequencies and percentages because they are also easy to use and analyze.

CHAPTER FOUR

4.0 DATA ANALYSIS AND PRESENTATION

This chapter discusses data analysis and presentation of the study's research findings, the chapter elaborates on the processes, procedures and techniques that applied to analyze and present the data obtained from the questionnaires. This was undertaken to contribute towards the identification of the relationship that existed between the research variables. The participating respondents answered questionnaires in various ways by giving different views on the challenges affecting effective corporate governance in state owned enterprises.

4.1 ANALYSIS OF THE RESPONSE RATE

Out of the 120 questionnaires that were issued to the identified respondents, 78 of them were returned. The response rate was considerably high since the difference between the sample size and response rate was only 42, giving a response rate of 65%. The data obtained was further analyzed under each research variable through the use of quantitative and qualitative analysis.

4.1.1 Period the respondents have been associated with the state enterprise

Table 4.1 the length of time respondents have been associated with the state enterprise

Association Period	FREQ	%
0 – 3 years	20	26
4 – 5 years	24	31
5 years and above	34	43
TOTAL	78	100

Source: author (2008)

From table 4.1 above, 74% of the respondents have been associated with the state enterprise for a period of over three years. This is quite a high number and they may be aware of the challenges affecting effective corporate governance challenges facing state owned enterprises.

4.2 THE MEANING OF CORPORATE GOVERNANCE AND THE CHARACTERISTICS OF EFFECTIVE CORPORATE GOVERNANCE

4.2.1 The meaning of corporate governance

The respondents described corporate governance as shown by table 4.2 below:

Table 4.2: The meaning of corporate governance

	Meaning of corporate governance	FREQ	%
1	It is the process of decision-making and the procedure by which decisions are implemented by organizations.	39	50
2	The roles, responsibilities, and interactions of top management and the corporations' board of directors.	21	27
3	Is the framework of rules, relationships, systems, and processes within and by which authority is exercised and controlled in the corporations	10	13
4	It is a system of rules, processes, procedures and relationships to manage the organization and fulfill its financial, legal and ethical obligations.	08	10
	TOTAL	78	100

Source: author (2008)

From the table 4.2 above analyses it is clear that the respondents understood what is meant by the term corporate governance and are likely to describe the challenges affecting effective corporate governance in the state owned enterprises in Kenya.

4.2.2 Characteristics of effective corporate governance

The study's respondents were asked what in their opinion they considered as characteristics of effective corporate governance. Table 4.3 below presents the characteristics given by the respondents.

Table 4.3: Characteristics of effective corporate governance

	Meaning of corporate governance	FREQ
1	It follows the rule of law	50
2	It is participatory,	47
3	It is consensus oriented,	40
4	It is accountable,	40
5	It is transparent,	38
6	It is responsive,	36
7	It is effective and efficient,	35
8	It is equitable and inclusive	33

Source: author (2008)

4.2.2.1 Participation

Participation by all stakeholders is a key cornerstone of good governance. Participation can either be direct or through legal intermediate institutions or representatives. Participation needs to be informed and organized.

4.2.2.2 Rule of law

Good governance requires fair legal frameworks that are enforceable impartially by the state owned enterprises.

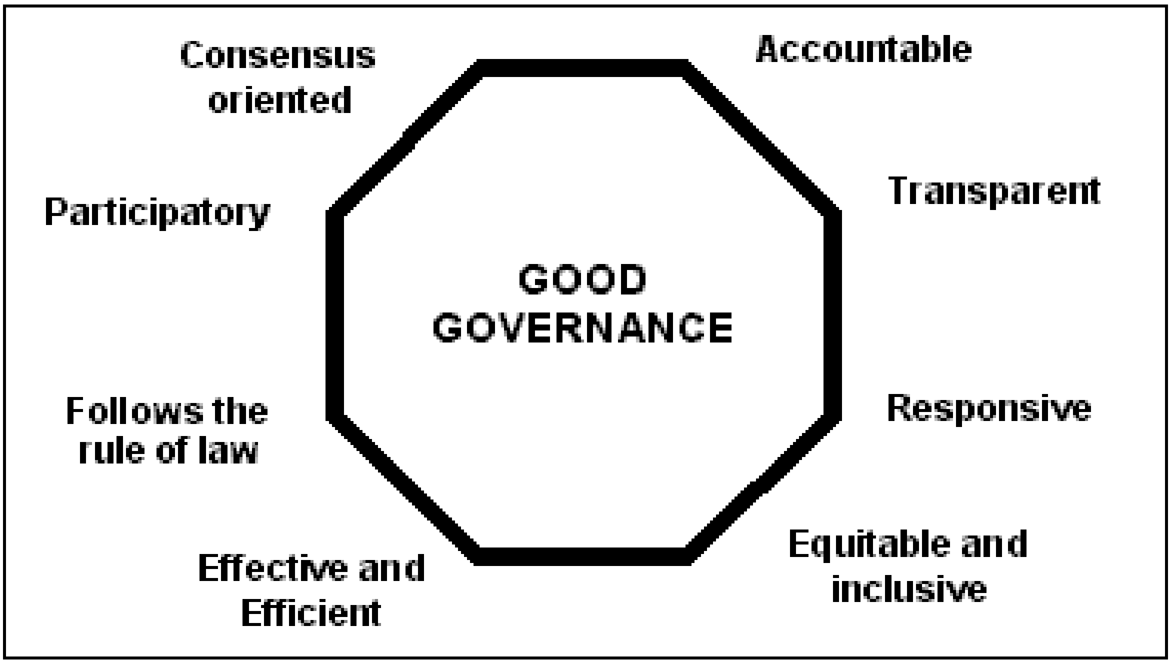


Fig 4.1: Characteristics of effective corporate governance

4.2.2.3 Transparency

Transparency means that decisions taken over time and their enforcement are done in a scheme that follows laid down rules and regulations. It also implies that information is unreservedly available and easily accessible to any person who will be affected by such decisions made and their enforcement. It also means that sufficient information is provided and that it is disseminated in easily understandable forms and media.

4.2.2.4 Responsiveness

Good governance requires that systems, institutions and processes try to serve all stakeholders in a reasonable timeframe.

4.2.2.5 Consensus oriented

There are several actors and a diverse view points in a given state owned enterprise. Good governance requires intercession of the different interests in the state owned enterprise to reach a broad consensus on what is in the best interest of the state owned enterprise how this can be achieved.

4.2.2.6 Equity and inclusiveness

A society's well being depends on guaranteeing that all its constituents feel that they have a stake and do not feel excluded from the majority of society. This entails all groups, particularly the most vulnerable, are afforded opportunities to advance or sustain their well being.

4.2.2.7 Effectiveness and efficiency

Good corporate governance seeks that processes and institutions produce results that meet the desires of the organization while making the best utilization of resources at their disposal.

4.2.2.8 Accountability

Accountability is a key requirement of effective corporate governance. State owned enterprises should be accountable to those who will be influenced by its decisions or actions.

4.2.3 Relevance of corporate governance in state owned enterprises

The study's respondents were asked what in their opinion whether corporate governance was relevant and important to state owned enterprises. Table 4.4 below presents the characteristics given by the respondents.

Table 4.4: Relevance of effective corporate governance state owned enterprises

	Relevance of corporate governance	FREQ
1	Corporate governance promotes greater transparency	50
2	Corporate governance promotes accountability, and conformity to laid down laws and regulations.	47
3	Corporate governance promotes and preserves the state enterprises' integrity and reputation, by minimizing abuse of power, employment discrimination, mistreatment of stakeholders, and poor accounting practices.	40
4	Corporate governance acts as a shield against widespread financial crises.	40
5	Corporate governance emphasizes the significance of ethics in business, thus lessening the likelihood of fraudulent business dealings.	38
6	Corporate governance ensures the maximization of wealth and long-term prosperity for the state owned enterprise, its owners, and stakeholders.	34

From table 4.4 above it can be seen that corporate governance is important and necessary for state owned enterprises.

4.3 MANAGEMENT OF STATE OWNED ENTERPRISES

4.3.1 Legal entity of state owned enterprises

Accountability cannot be enforced without transparency and the rule of law. Respondents were asked whether their state owned enterprise was operating under an Act of Parliament and 100% respondent positively that their organization was operating under an Act of Parliament.

4.3.2 Who should promote corporate governance in state owned enterprises?

The corporate governance environment predominantly determines the quality of corporate governance and the path that it will take. Its principal players are board of directors, top management, shareholders, employees, regulators and auditors, investors, clients/customers, and suppliers. 80% of the respondents reported the responsibility of ensuring good corporate governance rests in state owned enterprises rests heavily on the shoulders of the board of directors. This therefore means that all the other players are secondary and the board of directors acts as a major pivot around which most state owned enterprises activities revolve.

4.4 CORPORATE GOVERNANCE CHALLENGES

The study's respondents were asked what they consider as the key challenges to affecting corpor ate governance in state owned enterprises and the following were their responses..

4.4.1 Discipline

55 (92%) of the respondents felt that the greatest challenge to corporate governance in state owned enterprises was corporate discipline.

Corporate discipline is a commitment by the state owned enterprises' senior management to adhere to a behavior which is universally recognized and accepted to be correct and proper, written or unwritten. This includes state owned enterprises' awareness of, and commitment to, the underlying tenets of good governance, especially at the senior management level.

4.4.2 Transparency

47 (78%) of the respondents described transparently as another challenge corporate governance in state owned enterprises was corporate discipline. In the National Social Security Fund, the respondents reported that the board is dominated by political appointees acting under firm directives of the state agency to which they are subordinate getting rid of the independence, deliberative function required of directors for effective management of their organizations.

Transparency is the ease with which an external party is able to make meaningful analysis of a state owned enterprises' actions, its economic fundamentals and the non-financial aspects which are pertinent to that business. It is a measure of how good management is at availing necessary information in a candid, accurate and timely manner not only the audit information but also the general reports and press releases. It reflects whether or not the public is obtaining a true and precise picture of what is happening inside the enterprise.

4.4.3 Independence

48 (75%) described independence of the state owned enterprises as a big challenge.

Independence is the degree to which measures have been put in place to reduce or eradicate potential conflicts of interest that may exist, for instance, dominance by a strong chief executive or the government. These measures range widely from the composition and structure of the board, to nominations and eventual appointments to board committees, and third parties such as the auditors and accountants.

4.4.4 Accountability

44 (73%) of the respondents described lack of accountability as one of the key challenges affecting effective corporate governance in state owned enterprises. Some individuals or groups in state owned enterprises, which make decisions and mandated to take actions on specific issues, are rarely held accountable.

4.4.5 Responsibility

40 (67%) of the respondents felt that the board of directors was not responsible enough with regard to management.

4.4.6 Fairness

40 (67%) of the respondents felt that fairness was a big challenge to corporate governance. The systems that exist within state owned enterprises are not balanced in taking into account all parties which have an interest in the state owned enterprise and its future especially in employment.

4.4.7 Social responsibility

39 (65%) of the respondents described issues related to corporate social responsibility as a big challenge to corporate governance issues in state owned enterprises.

4.4.8 Succession planning

39 (65%) of the respondents reported that the National Social Security Fund did not have a proper succession plan for its senior managers and the Managing Trustee.

4.5 BUILDING EFFECTIVE CORPORATE GOVERNANCE

Considering the greater urgency among them being to build lucid, strong, and feasible corporate governance systems and structures in state owned enterprises, the respondents were asked to suggest mechanisms through which effective corporate governance can be build in state owned enterprises.

	How to build effective corporate governance	FREQ
1	All involved parties should have a commitment to adhere to procedures, processes, arrangements and authority structures established by the firm	53

2	All actions implemented by a state owned enterprise together with their decision support should be made available for inspection regularly by authorized organization and provider parties.	50
3	State owned enterprises should work towards the promotion of a healthy corporate culture that is committed to social and environmental responsibility;	47
4	There should be a clear criteria of who should be appointed to board membership and its committees	43
5	The decisions made, and internal processes developed, should be objective and give limited room for undue influences. All processes, decision-making, and interventions should be well established so as to minimize or eradicate potential conflicts of interest.	41
6	Boards have to ensure that a trustworthy financial reporting is adhered to, as well as ensure compliance with regulatory bodies and the Corporate Codes of Conduct.	39
8	Individuals or groups in state owned enterprises, who make decisions and take actions on specific issues, are not accountable. There is need to be accountable for their decisions and actions. Mechanisms must exist and be effective to permit accountability	36

Source: Author (2008)

CHAPTER FIVE

5.0 SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.1 INTRODUCTION

Effective corporate governance especially in the state owned enterprises is meant to encourage and ensure efficient use of resources and to equally require accountability for the stewardship of those resources. It aims at aligning as nearly as possible the interests of individuals, the enterprises and society. Corporate governance in state owned enterprises attempts to ensure that the enterprises are made responsive to the rights and wishes of the stakeholders.

Corporate governance lies at the heart of the most important issues of affecting the performance of state owned enterprises and shapes corporate efficiency and effectiveness. Corporate governance exists to serve state owned enterprises by providing a structure within which shareholders, directors and management can pursue most effectively the objectives of the enterprise. This study sought to find out how state owned enterprises are governed. Who has the power to make decisions for a state owned enterprise and within what guidelines? The purpose of this study was to analyze the challenges affecting effective corporate governance in state owned enterprises. This chapter presents a summary of the study's findings; it also gives the conclusions and the recommendations that were made as a result of the research.

5.2 SUMMARY OF FINDINGS

The study found out that good corporate governance is essential in state owned enterprises. According to the study's findings, corporate governance in state owned enterprises refers to laws, regulations, and generally acceptable business practices that determine relationships between the state owned enterprise, the government (owner), and its managers, on one hand, and its investors, on the other hand. The research found out that corporate governance in state enterprises is meant to build a system of rules that will guide the board of directors, ensure disclosures of all relevant information to stakeholders and creditors. It monitors and controls management and helps in the strengthening and improving of the legal and regulatory systems of the organization. This not only reduces reputational risk but also helps to ensure better enforcement of the enterprises' commitments.

Effective corporate governance as the research found out is important as it promotes greater transparency, accountability, and compliance to laws and regulations. This preserves an organization's integrity and reputation, as it reduces abuse of power, incidences of employment discrimination, mistreatment of shareholders, and poor accounting practices. Above all, it functions as a shield against prevalent financial crises.

According to the study, although corporate governance is important in the management of state owned enterprises it faces several challenges among them being: inadequate management and audit committee oversight of business lines, some board members do not understand the legal, reputational, and compliance risks facing their organizations. The study also found that supporting functions such as legal, accounting, internal audit, and risk management do not independently monitor the control processes to ensure that they are effective and that threats are measured appropriately.

5.3 ANSWERS TO THE RESEARCH QUESTIONS

5.3.1 Are state owned enterprises in Kenya subject to a binding legal system?

It is generally agreed that a good corporate governance mechanism is supported by a strong and enforceable legal system. State owned enterprises operate under an Act of Parliament.

5.3.2 What are the main corporate governance challenges facing state owned enterprises in Kenya?

The last few years have seen some major scams and corporate collapses across the globe, be it Enron, Arthur Anderson, Freddie Mac or WorldCom. All these events have made stake holders realize the importance and urgency of good corporate governance. The public is con cerned how state owned enterprises are being administered; after all it's the public funds or investment which is at stake in most of these enterprises. Although efforts are being made to have a common set of disclosure policies and norms transparency, participation accountab ility, effectiveness, responsiveness and following of the rules were found to be the main chall enges facing state owned enterprises in Kenya.

5.3.3 What structural reforms are being made by state owned enterprises in Kenya, to make them effectively abide to corporate governance principles?

State owned enterprises are towards amending their Acts of Parliament so that they can involve all parties and also ensure a commitment to adhere to procedures, processes, arrangements and authority structures established by the organizations.

5.4 CONCLUSION

Effective corporate governance in the state owned enterprises is affected and depends on whether the state owned enterprise has clearly defined tasks for directors and management, board members who are appointed based on considerations of merit and the necessary skills, qualifications and experience for the position. Effective corporate governance in the state owned enterprises is also affected and challenged by the ability, and obligation of the board members, to exercise independent judgment in accordance with the best interests of the corporations.

Transparency among state owned enterprises is also critical for good corporate governance. Without transparency, regulations, governance codes and new laws can do little to boost public confidence and particularly for organizations like the National Social Security Fund that depend on contributions from registered members and employers.

5.5 RECOMMENDATIONS

Good corporate governance in state owned enterprises makes for good business judgment. It enhances the confidence of the public in enterprise.

The study has therefore made the following recommendations.

5.5.1 Separation of management functions from ownership interests

A fundamental principle of good corporate governance is the formal separation of management functions from ownership interests. State owned enterprises are liable to state or ministerial influence, this takes away the independence of the directors/trustees.

There is need to consider amending the Acts of Parliament governing state owned enterprises so as to guarantee independence of the directors.

This conclusion is supported by OECD* 2010, publication, in which transparency and accountability are regarded as key to investment, growth and competitiveness. State-owned enterprises which are transparent and accountable are more likely to conform to the rule of law, including respecting shareholder and stakeholder rights. They enjoy higher levels of public trust and have better access to capital at lower cost.

5.5.2 Follow the set out guidelines in goods and services procurement

State owned enterprises such as the National Social Security Fund are often responsible for large-scale spending and procurement of goods and services. The methods used for procurement are the best indication of the value of governance. State owned enterprises should set clear guidelines and checks to minimize bias. For instance, an independent review of tenders above a certain value could be a typical requirement. Contracts for the same or similar goods or materials made within, for example, a 12-month period, must be assessed if the total of all such contracts exceeds a specified value.

5.5.3 Act responsibly/ discipline

The rationale of corporate governance is to ensure that a firm achieves its strategic goals over the long term by meeting the needs of its stakeholders. While the board is accountable to the corporation, it must conduct itself responsively to and with due reason towards all stakeholders of the organization. Board members should not act responsibly to the state owned enterprise but also to all the stakeholders of the corporation.

Takahashi (2000), supports this assertion when he notes that an arrangement under which governance of SOEs is essentially in the hands of a particular ministry would work well if the government were benevolent to taxpayers. However, the interests and decisions of government bureaucrats do not necessarily reflect the interests of taxpayers. In some cases, taxpayers might not consent to the activities of the SOE. Takahshi's assertion is reflected in this study because the members of NSSF (contributors) have no forum other than through institutional representation where they can voice their opinion.

5.5.4 Succession planning

There is need for proper succession planning, particularly for positions like that of the Managing Trustee/ Chief Executive Officer. Candidate requirements should be spelt out clearly by the governing board and an assessment of internal potential candidates should be made. If none is found apt, an external candidate should be sought after. It's also critical that the people recruited believe in the state owned enterprise's values and imbibe those values.

Cannela and Shen (2001), assert that for any organization to be successful, an effective and orderly succession is important. In the literature there is ample evidence to demonstrate that the lack of leadership planning can be a costly experience as there are obvious flow-on effects on the board.

5.5.5 Promotion of internal controls

Supporting functions such as accounting, internal audit, legal and risk management should independently keep an eye on the control processes to ensure that they are effective and that risks are evaluated appropriately. The outcome of these independent time to time reviews should be routinely reported to executive administration and boards of directors. The board of directors should be effectively engaged in the process to establish whether such reviews are in reality independent of the operating areas and whether the officers performing the reviews can speak and act freely. Where it appears that supporting functions have not been adequately involved, directors must insist that management adjust the processes as necessary. If the legal, accounting, or internal audit staff judges that a supporting function has not been given sufficient information or opportunity for consultation, such deficiency must be brought to the attention of the board

5.5.6 Management of reputational risks

There is need for state owned enterprises to take steps to ensure that reputational and legal risks are adequately addressed. State owned enterprises should for instance have a formal policy that addresses tolerance levels for reputational and legal risks, including continuous reassessments of risk acceptance levels by appropriate senior management; every effort should be made to ensure there is appropriate due diligence on control processes on behalf of the organization's corporate clients, and measures for addressing any shortcomings in those processes that could result in greater risk exposure for the institution.

5.5.7 Commitment

All involved parties should have a commitment to stick to procedures, processes, arrangements a nd authority structures established by the organization

5.5.8 Appointment of board members

There should be transparency with clearly identified criteria of who should be appointed to board membership and its committees

5.5.9 Objectivity

The decisions made, and internal procedures established, must be objective and should not allow for undue influences. All processes, decision-making, and interventions used should be established so as to reduce or avoid potential conflicts of interest.

5.5.10 Accountability

Individuals or groups in state owned enterprises, who make decisions and take measures on specific issues, are not accountable. There is a need for such individuals to be held accountable for their behaviors, actions and decisions. Mechanisms must exist and be effective to allow for accountability.

This fact concurs with Luke (2010) accountability in the public sector has been presented as elusive (Sinclair, 1995) and evolving (Parker and Gould, 1999; Sands, 2004). Operating as government-owned but commercially focused, state-owned enterprises [SOEs] face a pointed challenge in balancing multiple interests and, at times, opposing objectives. With express profit-making requirements, as well as responsibility for social and environmental objectives

5.5.11 SUGGESTION FOR FURTHER READING

The study was basically to find out the challenges affecting effective corporate governance in state owned enterprises. A further research can be carried out to specifically investigate the factors that can enhance effective corporate governance in state owned enterprises.

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APPENDEX 1 QUESTIONNAIRE

Dear Respondent,

CHALLENGES AFFECTING EFFECTIVE CORPORATE GOVERNANCE IN THE STATE OWNED ENTERPRISES

I am a student at Korean Development Institute, School of Public Policy and Management pursuing a Masters in Public Policy. I am conducting a research on "**THE CHALLENGES**

AFFECTING EFFECTIVE CORPORATE GOVERNANCE IN STATE OWNED ENTERPRISES IN KENYA" to enable me to carry out this research kindly fill in the attached questionnaire to the best of your knowledge.

All your views will be treated with all confidentiality it deserves and only be utilized for the purpose of this study.

Thank you for your cooperation.

Rori, Andrew Moirore

PART A

Personal Information

1) What is your current designation at the state owned enterprise?

Trustee ☐

Managing Trustee ☐

Manager ☐

2) How long have you been associated with the state enterprise?

☐ 0 – 3 years

☐ 4 – 5 Years

☐ 5 years and above

PART B

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3. State what you understand by the phrase corporate governance?

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4. a) Do you think corporate governance is important for state owned enterprises?

Yes ☐ **No** ☐

4. b) What are some of the reasons why you think governance is important.

----

5) In your view what do you think are the characteristics of an institution that practices good corporate governance?

a) --

b) --

c) --

d) --

e) --

f) --

g) --

6). Does your institution operate under an Act of Parliament?

Yes ☐ **No** ☐

7.) Who should drive corporate governance issues in state owned enterprises?

- ☐ Board of directors
- ☐ Managing Director
- ☐ Senior managers
- ☐ Suppliers
- ☐ Customers
- ☐ Employees
- ☐ Auditors

8). Highlight are some of the challenges facing your organization in terms of effective corporate governance?

a) --

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b) --

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c) --

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d) --

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e) --

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9) Suggest what ways on the challenges you highlighted on (8) above can be addressed?

a) --

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b) --

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c) --

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d) --