EMBRACING CORPORATE GOVERNANCE PRACTICES AMONG LISTED ENTITIES

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Introduction

In the history of the Firm, the concept of corporate governance has never been so topical that it has attracted the attention of a various stakeholders.

This has come because of the awareness that bad governance can indeed lead to economic destruction when institutions fail.

Introduction Cont'd

The efforts to reform corporate governance have been driven, in part, by the needs and desires of shareholders to exercise the rights of corporate ownership and to increase the value of their shares and ultimately, wealth

The Sarbanes Act of 2002 in the U.S. was triggered by a series of frauds in companies like Enron, WorldCom and Tyco.

Definition of Corporate Governance

Corporate governance refers to the system by which organizations are directed and controlled in a manner that promote corporate fairness, transparency and accountability

The famous Cadbury Committee (1992) defines corporate governance system as "the systems by which companies are directed and controlled".

Definition of Corporate Governance Cont'd

The essence of corporate governance is to make sure that the key shareholder objective of wealth maximization is implemented. Shareholders want companies to hire managers who are able and willing to take whatever legal and ethical actions they can to maximize stock prices.

Definition of Corporate Governance Cont'd

This objective is achieved through:

- Ensuring that corporate power is exercised in the best interest of the organisation and other stakeholders.
- Finding the appropriate mechanism for governing the leadership of several groups within the company to generate long term value.
- Creating structures to ensure protection of the rights of all shareholders and optimize shareholder value, reduction conflicts of interest among various stakeholders,

Definition of Corporate Governance Cont'd

- Making sure that the right people make the right decisions;
- Creating and implement effective sysyems of internal controls in an organization; and
- Ensuring that corporate power is exercised in the best interest of the organisation and other stakeholders.

Corporate Governance Challenges in Kenya

- The Boards want freedom, trust, free hand and no interference in running corporations;
- Directors sitting in too many Boards, some in even in competing firms which could end up compromising companies competitiveness;
- Influence from external sources such as the Government .

Corporate Governance Challenges in Kenya Cont'd

- Financial illiteracy on the part of the shareholders. Most Kenyan shareholders believe that they buy shares to get dividends and if they do not receive dividends they question the performance of the Board;

- Companies failure to educate their shareholders on business issues and particularly on their activities.

Theories of Corporate Governance

Agency Theory

In the context of corporations and issues of corporate control, Agency Theory views corporate governance mechanisms as being an essential monitoring device in ensuring that any problems that may be brought about by principal – agent relationships are minimized.

Theories of Corporate Governance Cont'd

Agency Theory is based on the idea that in a modern corporation, <u>there is a separation of ownership and management, resulting in agency costs associated with resolving the conflict between the owners and the agents</u> (Berle & Means, 1932; Jensen and Meckling, 1976).This implies that management cannot be trusted, thereby calling for strict monitoring by the Board in order to protect shareholders' interest.

Theories of Corporate Governance Cont'd

The main concern of Agency Theory therefore, is effective monitoring which is achieved when Board have majority of outside and ideally independent directors. The position of Chairman and CEO should be held by different persons.

Theories of Corporate Governance Cont'd

Stewardship Theory

In contrast, Stewardship Theory takes a diametrically different view. It looks at directors and managers as stewards of the Firm. As stewards, they are essentially presumed to be trustworthy individuals and therefore good stewards of the resources entrusted to them, which makes monitoring redundant (Donaldson and Davis, 1991).

Theories of Corporate Governance Cont'd

Proponents of this theory contend that superior corporate performance will be linked to a majority of inside directors as they work to maximize profit for shareholders. The reason so far advanced for this, is that inside directors understand the business they govern better than outside directors and therefore make superior decisions (Donaldson and Davis, 1991; Donaldson, 1990).

Theories of Corporate Governance Cont'd

With regard to the Board, proponents of Stewardship Theory contend that superior corporate performance will be linked to a majority of inside directors and that the position of Chairman and CEO should be held by same person since this provides clear leadership (Donaldson and Davis, 1991).

Theories of Corporate Governance Cont’d

Conclusion

The Cadbury report which is the report of the committee on the financial aspects of corporate governance, 1992 chaired by Sir Adrian Cadbury, had far reaching ramifications.

It can then be said that since the publication of the Code of Best Practice in the UK, it has touched off an explosion of similar codes around the globe. Some of the key recommendations of the Code are that Board of publicly traded companies have at least three outside Directors

Theories of Corporate Governance Cont'd

The position of the CEO and the Chairman of the Board are held by two different individuals. Most of these Codes specify a minimum standard for the representation of outside directors on Board of publicly traded companies.

In some countries, Kenya included, they are framed as a minimum fraction of outside directors. This shows the influence of the Agency Theory in the formulations of these Codes of Best Practice.

Theories of Corporate Governance Cont'd

It can thus be said, that the presumption that appears to underlie this movement towards more outside directors, is that Board with more outside directors will lead to better Board decisions and, as consequence, better corporate performance.

Legal Framework on Corporate Governance Disclosures by Listed Companies

a) **Code of Corporate Governance Practices for Issuers of Securities to the Public**

- This Code applies to listed companies in Kenya
- Enforceable with effect from March 2017.
- This Code succeeds the Guidelines on Corporate Governance Practices by Public Listed Companies in Kenya, 2002 it advocates for the adoption of standards that go beyond the minimum prescribed by legislation.

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

- The Code moves away from the "comply or explain" principle that was in the former corporate governance guidelines and introduces a "apply or explain" principle.

- The "apply or explain" model recognizes that no set of regulations can be applicable to all types of listed companies.

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

- This approach is principle-based rather than rule-based, and recognizes that a satisfactory explanation for any non-compliance will be acceptable in certain circumstances.

- The approach therefore requires boards to fully disclose any non-compliance with the Code to relevant stakeholders including the Capital Markets Authority with a firm commitment to move towards full compliance.

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

- However, the Code contains mandatory provisions which are the minimum standards that issuers must implement, and these are replicated in the Capital Markets (Securities) (Public Offers, Listing and Disclosures) Regulations, 2002.

- Where Mandatory provisions are imposed by this Code, it is stated that companies shall comply with the particular requirement.

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

- This Code is intended to provide the minimum standards required from shareholders, directors, chief executive officers and management of a listed company or an unlisted company that issues securities to the public, so as to promote high standards of conduct as well as ensure that they exercise their duties and responsibilities with clarity, assurance and effectiveness.
- The <u>Code should not restrict or replace the proper judgement of the management and employees</u>.

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

The Board of directors of each company shall be responsible for formulating policies, procedures and guidelines, which ensure that:

a) All directors, chief executive officers and management are made fully aware of the requirements of this Code;

b) All management decisions are made in accordance with prudent corporate governance practices; and the shareholders of each institution are responsible for the appointment of a competent and dedicated Board of directors.

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

<u>Implementation and Oversight</u>

- Issuers are encouraged to implement this Code immediately but not later than one year after its publication in the Gazette.

- ***At the end of every year, the Board shall disclose in its annual report a statement of policy on good governance and the status of application of this Code.***

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

- ***Where an issuer does not implement this Code one year after it has been published, the issuer shall disclose to the Capital Markets Authority the reasons for non-application, and clearly indicate the time frame required and the strategies to be put in place towards full application.***
- The Authority shall work with other complementary institutions in ensuring compliance with this Code. The complementary institutions are; the Licensed Securities Exchanges; the Registrar of Companies; and the Courts.

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

Summary of Selected Provisions in the Code

<u>Board Operations and Control</u>

- Shareholders are ultimately responsible for appointments to the Board.
- a balance of executive and non-executive directors, with a majority of non-executive directors.
- Independent directors shall be at least one third of the total number of Board Members.
- Diversity in Board composition

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

- A director of a listed company, except a corporate director shall not hold such position in more than three public listed companies at any one time.
- A chairperson of a listed company shall not hold such position in more than two public listed companies.
- Establishment of an audit committee of at least three independent and non-executive directors.
- The functions of the Chairperson and the Chief Executive Officer shall not be exercised by the same individual.

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

- Company Secretary to be a member of Institute of Certified Public Secretaries of Kenya (ICPSK) in good standing.

- The Code recommends an age limit of 70 years for Members of the Board.

- The Board shall establish, periodically review and make public (through the Company's website) its Board Charter.

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

Right of Shareholders

- Shareholders shall receive relevant information on the company's performance through distribution of half-year and annual reports through websites, postal mail or newspapers.

- The annual report and accounts to shareholders must include highlights of the operations of the company, financial performance and status of application of the Code.

Shareholder Relations

- have a stakeholder-inclusive approach in its practice of corporate governance and shall take into account the interests of all key stakeholder groups before making its decisions.

- The Board shall establish whistle-blowing mechanisms that encourage stakeholders to bring out information helpful in enforcing good corporate governance practices.

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

Ethics & Social Responsibility

- The Board shall set standards of ethical behavior required of its members, senior executives and employees and ensure observance of those standards.
- The Board shall ensure that ethical risks and opportunities are incorporated in the risk management process.
- The Board shall ensure that a Code of Ethics and Conduct is developed and implemented.

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

- The Board shall protect, enhance and invest in the well-being of the economy, society and the environment.

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

Accountability, Risk Management & Internal Control

- *Truthful and factual presentation of the company's financial position including the review and consideration of the financial statements by the Audit Committee.*
- *The Board shall take full responsibility for the accuracy of the financial statements.*
- *The Board shall rotate independent auditors every six and nine years.*

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

- *The Board shall continually work towards the introduction of integrated reporting.*

- *The Board shall set out its responsibility for internal control in the Board Charter.*

- *At least once a year, the Audit Committee shall meet with the external auditors without members of Management being present.*

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

Transparency & Disclosure

- *The Board shall disclose in its annual report whether it has an Audit Committee, the members, their qualifications, independence and the mandate of such Committee.*

- *The Board shall disclose the company's Board Charter on its website.*

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

- *Disclose whether evaluation of the Board, the Chairperson, the Chief Executive Officer and Company Secretary has been undertaken in the annual report and financial statements of the company.*

- *Disclose in the annual report whether independent and other non-executive directors constitute at least-two' thirds of the Board and if it satisfies the representation of the minority shareholders.*

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

- *The Board shall disclose the company's Code of Ethics and Conduct on its website.*
- *The Board shall ensure that the company discloses its environmental, social and governance policies and implementation thereof in its annual report and website.*
- *The Board shall disclose that a Governance audit was carried out.*

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

- *Disclosure on compliance with the International Financial Reporting Standards (IFRS) in preparing their financial statements. Any deviation from these financial standards should be disclosed.*

- *The Board shall include in its annual report the governance structure including the composition and size of the Board, the Committees of the Board, management and their mandate.*

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

- *The Board shall include in its annual report a statement on compliance with corporate governance principles. The statement shall indicate aspects of this Code which have not been applied, the reasons thereof, indicative timelines and proposed strategies towards application.*
- *The Board shall disclose the company's policy on procurement.*

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

- *The Board shall disclose the company's Whistle Blowing Policy on its annual report and website.*

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

ICPAK
Uphold Public Interest

b) The Companies Act

The Kenyan Companies Act is places the following responsibilities on the Board of Directors of any company.

- Preparing financial statements which give a true and fair view of the state of financial affairs of the company;
- Maintaining proper books of account that disclose with accuracy the financial position of the company;
- Safeguarding the assets of the company;

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

- Designing and implementing suitable internal controls to prevent and detect fraud and other financial misreporting; and

- Providing the auditors and regulators all the necessary information and explanations with unrestricted access to the underlying financial records and documentation to allow them perform their work.

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

The new Companies Act (2015) introduces a much heavier regime requiring substantial compliance to ensure the proper running of the affairs of companies in Kenya.

- *Section 681 : Appointment of Directors for public companies - Shareholders approval required.*
- ***Section 189*** *: Disqualification of directors: Act provides for automatic disqualification and disqualification by court order.*

Legal Framework on Corporate Governance Disclosures by Listed Companies Cont'd

- *Section 215: Director's liabilities: The Act has introduced a dual test for director liability under the duty of care and skill.*
- *leaves no room for a defense based on ignorance.*
- *Directors expected to expend a high standard of care and skill in carrying out the activities of the Company.*

NSE Commitment Towards Promoting Corporate Governance Disclosures

- The NSE is a key sponsor of the annual Financial Reporting (FiRe) Awards that promote excellence in financial reporting, foster sound corporate governance practices and enhance corporate social responsibility and environmental reporting in East Africa.
- As a new Partner Exchange on the Sustainable Stock Exchanges Initiative, we are keen to learn from our colleagues worldwide. We are keen on establishing partnerships that will help us develop a substantive strategy around sustainability.

NSE Commitment Towards Promoting Corporate Governance Disclosures Cont'd

- Monitor listed companies compliance with the Corporate Governance Code for Issuers of Securities to the Public, 2015 which sets out the principles and specific recommendations on corporate governance disclosures.

- Requiring the Directors of companies listing under the Growth Enterprise Market Segment to undergo a Directors Induction Program as a condition for listing.

NSE Commitment Towards Promoting Corporate Governance Disclosures Cont'd

- Promoting the adoption of integrated reporting by listed companies which is a requirement of the Corporate Governance Code for Issuers of Securities to the Public, 2015 and the new companies Act.

- Compliance audits of market participants to ensure compliance with the capital markets corporate governance regulations for market intermediaries.

Corporate Governance and Ethics

- Corporate governance cannot be achieved if the corporate team does not pay critical attention to ethical and integrity matters in the exercise of their powers. Ethical conduct is vital in ensuring the integrity and stability of any organization.

- Ethics refers to an individual personal belief regarding what is right and wrong or what is good and bad. They are morally decent standards that a corporation attempts to stand for.

Corporate Governance and Ethics Cont'd

- Organizations are required to ensure that all the Directors and staff are familiar with the standards provided in the Code of Ethics and the implementation of these ethics is on daily basis.

Conclusion

- *Corporate Governance is one of the key elements that has been called into question in the recent issues arising from placement of well capitalized companies into statutory management.*

- *A proper corporate governance framework on paper is not effective in ensuring compliance by Directors in the Board or senior management in the day to day running of the companies.*

Conclusion

- *Strong enforcement action must be taken to ensure that consequences of undesired conduct are felt by wayward directors.*

- *The enhanced regime on disqualification of Directors under the new Act allows for this enforcement action to be taken against rogue Directors.*