EXECUTIVE COMPENSATION AND CORPORATE PERFORMANCE IN KENYA: A SURVEY OF LISTED COMPANIES AT THE NAIROBI STOCK EXCHANGE.

BY

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DECLARATION

This management research project is my original work and has not been submitted for award of a degree in any other University.

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This research project has been submitted for examination with my approval as the University supervisor.

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ABSTRACT

Corporations play an important role in the production of goods and services in a market economy such as Kenya's. The productivity of a corporation depends on the efforts of its managers. The management on the other hand is an agent and is under obligation to act in the best interest of the share holders in return for remuneration. Economic theory suggests that in the absence of constraints, the managers would act in their own best interest.

There are three basic ways of ensuring corporate goal congruence: monitoring the activities of managers, tying their wealth closely to that of the shareholders through stock compensation, and incentive contracting. The first method is sometimes impeded by corporate information asymmetry and differences in specialization between shareholders and managers.

The objective of this research was to establish the extent to which incentive contracting is applied amongst listed companies at the Nairobi Stock exchange. The findings indicate that most listed companies use this method to a limited extent and predominantly with the chief executive.

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Corporations play an important role in the production of goods and services in a market economy such as Kenya's. The productivity of a corporation depends on the efforts of its managers. The management on the other hand is an agent and is under obligation to act in the best interest of the share holders in return for remuneration. Economic theory suggests that in the absence of constraints, the managers would act in their own best interest.

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CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND

In market economies corporate entities are the backbone of production of goods and services. The growth in size and numbers of corporate entities mirrors the economic growth and development in those economies ranging from United States of America, Europe, to Asia. The trend is also discernable in southern Africa and Eastern Africa. Whether private sector or public sector, corporations provide a driving force for development today that transcends economics and extends to the broad scope of the societies a round the world. These entities provide the most convenient economic vehicle for marshalling societal savings into productive investment. The recent overwhelming public response to IPO's at the Nairobi stock exchange e.g. KenGen offer (Omondi, 2006) is a clear indication that Kenya will take that road in its quest for economic development.

The role of corporate executives is important in determining the performance of any entity. They select the corporate strategies that are suited to the entity's mission, vision, and operating environment; design those strategies and direct and control corporate activities intended to deliver those strategic objectives. They are not only responsible for delivering value in a sustainable way to corporate customers and share holders but also to the society at large, while ensuring survival growth and prosperity of the entity. On the other hand the executives are agents of the stock holders and are under obligation to satisfy their interest foremost in return for their remuneration and continued employment.

The main object of share holder investment on corporate stocks is to obtain a return: dividend cash flows and capital gain. Both objects are maximized when an

enterprise obtains high returns from its investments. However higher returns entails investing on increasingly risky assets (Pandey, 2001), which may threaten the survival of the firm e.g Enron, Tyco, Global Crossing, and WorldCom in the USA (Todd, 2003). While share holders can reduce risk by investing on a well diversified portfolio of assets and are therefore risk neutral, corporate executives' investment is concentrated on human capital invested in the entity and are not able to diversify a way the consequences of bad outcomes. They are therefore risk averse and may turn down risky projects that have positive expected returns. Thus corporate executives, when selecting investment assets, are unlikely to select high-return high-risk assets in the best interest of the stock holders (Kaplan and Atkinson, 1998).How then do shareholders encourage managers to enhance return on investment?

Sustainable corporate growth and prosperity require continual strategic fitting of the entity into its macro-environment to ensure the corporation stays a head of competition. This requires long-term managerial involvement. On the other hand managers are essentially on contract and can leave the organization at any time subject to terms of the contract. How then do corporate stock holders reconcile the short term managerial interest with the need for long-term managerial perspective?

Stock holders also buy executives time, skills, attitudes, and experience in exchange for remuneration, and provide capital in anticipation that they will be fully utilized to create, grow and sustain value of the firm. On the other hand corporate executives' discretionally split their time between effort and leisure and split expenditure of capital between personal perquisites and investment assets (Kaplan and Atkinson, 1998). The stock holders can neither measure the managers on job performance directly from results because of the intervening environmental circumstances nor accurately infer their contribution to corporate performance due to information asymmetry occasioned by differences in skills

and specialization. How then do they ensure the management act in their best interest?

According to Jensen and Meckling (1976), the "negligence and profusion" of directors in joint-stock companies are documented as early as in 1776 by Adam Smith and later by Berle and Means (1932). Devices to prevent managers from reaching sub-optimal decisions include monitoring by a board of directors (Fama and Jensen, 1983) and outside large shareholders (Shleifer and Vishny, 1986), as well as the forces from corporate control markets (Manne, 1965; Jensen and Ruback, 1983) and managerial labor markets (Fama, 1980). A more direct way to motivate firm managers to work on behalf of their shareholders is to bond their wealth to that of the shareholders through management equity ownership (Jensen and Meckling, 1976) or performance-based compensation (Jensen and Murphy, 1990).

Agency literature suggests that top managers; like other employees, need to be motivated to achieve specific organizational objectives (Fama 1980). By identifying those measures of corporate performance that are instrumental in achieving the desired share holder goals and tying an appropriate mix of executive compensation to their progressive achievement , the share holder goals are made to coincide with the executives' personal goals. Performance based compensation provides incentive for the executives to achieve share holder goals (Kaplan and Atkinson, 1998). However an incentive system can only work under sound corporate governance; environment in which corporate decisions are transparently and professionally made; where the executives not only involve share holders meaningfully in making important decisions but are also accountable to them for their actions. In this regard, effective oversight is imperative.

Ehrenberg and Milkovich (1986) among others, point out that a large body of literature exists indicating that directors of major corporations typically develop

compensation packages for their top executives so that the interest of the managers will be aligned with those of the stockholders to some degree.

This is generally done by basing various types of compensation (e.g. bonuses, deferred compensation etc) on measures of performance (e g profit). They also note that Executive compensation tends to be unrelated to performance the lower the stockholder control. Studies such as Santerre and Neun (1986) and Dyl (1988) have found an inverse relation between stock holder control and Executive compensation after controlling for the profitability of the firm. Santerre and Neun (1989) established from an empirical study, after controlling for profitability and competitiveness, that the degree of stockholder control does influence executive compensation ceteris paribus. Santerre and Neun (1989) observe that when stocks are concentrated in the hands of one or relatively few, the owners have both the incentive to monitor and the ability to discipline management. The stock holders, when willing and able, seek to minimize the compensation rate. A greater concentration of the firm's outstanding stock gives one or a few stock holders more willingness, with regards to incentive, to monitor executive behavior, and ability in terms of corporate power, to either threaten or actually control management. Conversely a thinly spread shareholding, in the absence of a well structured managerial environment and reporting requirements which empower stock holders, would permit managers to pursue self-interest. Palmer (1973) observes that Economic theory suggests that managers are only free to pursue their own interest when slack exist in both the stockholder and product market constraint. It is therefore apparent that a combination of strategies is necessary to achieve corporate goal congruence. This prompts us to enquire: To what extent, do boards of quoted companies at the Nairobi stock exchange, use compensation contracts to align the interest of stockholders with those of the management?

Globally, weak corporate governance has permitted numerous corporate financial scandals and managerial errors resulting in business failures that have cost investors, who had invested their savings in those companies, their wealth and

devastated the lives of millions of employees. These corporate failures are epitomized by Enron, WorldCom, Global Crossing and Tyco in the USA, Parmalat in Europe (Bingham, 2004) and Uchumi supermarket Ltd in Kenya. These failures have shaken investors' confidence to the core and called into question the honesty and integrity among corporate boards and executives.

Several approaches have been proposed world wide to structure managerial environment not only to compel executives to disclose material information to the stock holders and provide incentives for them to act in the best interest of the stock holders but also to disclose personal information and to allow meaningful participation of the stock holders in decision making. Broadly three approaches are discernable: compensation, governance, and reporting practices: corporate governance reforms; aimed at restructuring corporate management practices with a view to enhancing transparency, professionalism, and empowerment of share holders to enable them take responsibility of monitoring management even in environments where share holding is diffused. In all cases performance based compensation has been seen as a critical ingredient to providing incentive to management to act in the best interest of the share holders. This is in line with positive agency literature which highlights the value of placing greater amounts of managerial compensation and managerial wealth at risk by tying it closer to firm performance (Jensen and Murphy, 1990). However the normative agency literature stresses the need to consider the potential disadvantages of forcing managers to bear excessive compensation risk (Holmstrom, 1979, 1987; Shavell, 1979; Stiglitz, 1987; Fama, 1992).

In Kenya Corporate Governance reforms were introduced by Capital Market Authority: the capital market regulator, with effect from the financial year ending in 2002. They are mandatory to all listed companies at the Nairobi Stock Exchange and fixed return security issuers (C.M.A, 2002). However experience from the U.S.A indicates that such externally induced reforms do not in any way affect executive compensation. According to Bingham (2004), US corporate governance was overhauled the two years proceeding 2004, but executive pay

escaped virtually unscathed. That experience prompts the question: have these reforms made any impact on executive compensation among quoted companies in Kenya?

Kiarie (2005) examined the preponderance of any form of performance based compensation schemes for all employees amongst quoted companies at the Nairobi stock exchange and concluded that only 37% of the listed companies had any scheme that included a risky component. Moreover share based compensation was notably unused.

1.2 STATEMENT OF THE PROBLEM

Corporate executives play a significant role in shaping the strategies, objectives and operating activities of the corporation under their control. The behavior of corporate executives is significantly influenced by the goals set by the board of directors: goal setting theory. In deed "What Gets Measured Gets Done" (Gregory and Myers, 2002). The significant relationship between corporate sector growth and prosperity and National economic growth and development cannot be over stated. Sound corporate governance environment is instrumental to capital formation as it encourages savers to put their savings in corporations. It's also instrumental to economic development as it encourages the transfer of savings from non productive to productive enterprises. Sound corporate governance may be achieved in three ways: closer monitoring of the executives by stock holders, tying the wealth of the executives closely to those of stockholders through share based compensation, and use of a suitable mix of incentives to elicit voluntary effort maximization. Performance based compensation for corporate executive is an important instrument by which investors objectives are made to coincide with those of corporate management through voluntary actions of the executives. However the experience in the US (Bingham, 2004) raises concern on the ability of corporate boards to implement externally induced reforms touching on

executive compensation. Kiarie (2005) also casts doubt as to whether incentive is used as one of the principal ways of resolving agent-principal conflict in Kenya.

Moreover performance based pay in other jurisdictions receive income tax concessions through lower tax rate but in Kenya there are no such tax concession; rather being subject to the higher marginal income tax rate. This brings us to two questions: Given the implementation of C.M.A guidelines on corporate governance from the financial year ending 2002, which require that executive director's remuneration be competitively structured and linked to performance.

(a) To what extent are executive directors' compensation linked to expected performance amongst quoted companies at the Nairobi stock exchange?

(b) Upon what performance measures are executive compensation predominantly linked, if at all, amongst quoted companies at the Nairobi stock exchange?

1.3 OBJECTIVES OF THE STUDY

This study has the following two objectives:

(i) To measure the extent to which compensation for corporate executives of companies listed at the Nairobi Stock Exchange is contingent on corporate performance.

(ii) To identify the most common corporate executive performance indicators among companies listed at the Nairobi Stock Exchange.

1.4 IMPORTANCE OF THE STUDY

This study will be of use to:

a) Investors at the Nairobi stock exchange, who will be able, assess the extent to which corporate executives, on average, earn merit compensation and the performance measures upon which merit compensation is based.
b) CPAs as compensation consultants, who will be able to determine on average the scope for merit pay for executives of companies listed at the Nairobi stock exchange and evaluate the relevance and efficiency of performance measures currently in use as corporate performance indicators.
c) CMA will use the study to gauge the extent to which listed companies have complied with its recommendation to link executive compensation to corporate performance.
d) Members of corporate boards, who will know the extent to which they have aligned executive compensation to shareholder goals.
e) Corporate employees whose relative earnings will decline with increasingly performance based compensation for executives (McDonough, 2002; Beer and Katz, 2003; Phillips, 2002).
f) Academicians would use the information gained from this study to inform further studies on corporate governance in Kenya.

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

Goal-setting theory requires that a manager delegating duties to a subordinate indicate clearly the goals to be achieved (goal specificity). This practice enables the principal to communicate concisely the performance expectations to the subordinate, motivates the subordinate, and provides clear and Unambiguous parameters for the subordinate's performance evaluation (Steers and Porter, 1974; Locke and Latham, 1990). Agency theory literature is replete with reasons why principals need to communicate concise objectives to the agent and compensate the agent based on the job performance (Ross, 1973; Jensen and Meckling, 1976). Corporate executives are agents of and their interest is subordinate to stockholders. In part these theories explain why there is a general agreement that sound corporate governance require the corporate executives' compensation to be performance based (CMA,2002.). Upon what performance measures should corporate executives' compensation be based? To what extent should executive compensation be based on the corporate performance?

The key objectives of executive compensation programs are to attract, motivate and retain executives who drive the corporate's marketplace success and industry leadership (IBM, 2004).

What then are the indicators of market place success and industry leadership?

2.2.0 TRADITIONAL MEASURES OF CORPORATE PERFORMANCE

2.2.1 Stock price

The fundamental objective of a firm is to maximize shareholder wealth (Pandey, 2001).

This objective is primarily achieved through maximization of the market value of the firm; the market price of its outstanding shares. Share price therefore serves as an important measure of corporate performance. An increase in the market value of shares represents an increase in shareholder wealth. They can then adjust their cash flow to optimize consumption over time. However changes in share price may not be determined exclusively by managerial actions. If efficient market hypothesis holds true then the share price reflects all available information about firm performance; the long run firm profitability. However share price like other prices in market economy reflect the equilibrium of demand and supply which can be manipulated by restricting supply or inflating demand. Sometimes the demand can be based on market anticipation of the future with no underlying economic substance such as witnessed by Enron, and Amazon in the USA (Jenkins, 2003)

2.2.2 Earnings targets.

A second method of evaluating firm performance is with annual earnings targets. Although stock prices and earnings are related, there is no evidence that suggests that stock prices are fixed multiples of earnings. This can be interpreted to mean that security prices and earnings provide different indications of performance. The additional information provided by earnings helps differentiate the effect of the CEO's actions from uncontrollable exogenous factors. Earnings targets also help balance the effects of risk that CEOs would incur if their performance was measured solely by share price (Lambert and Larcker, 1985). Earning may be measured by net cash flow, sales, accounting profit, residual profit or economic value added. However it must be noted that there are two primary dangers with these measures: they are based on annual financial statements which measure only short-term effects of managerial actions, and the source of the information is the management therefore the integrity of the information is dependent on the integrity of both the management and the audit process (Cochran and Wood, 1984).

2.2.3 Accounting ratios.

Accounting ratios are measures of profitability and efficiency that are tracked by internal and external evaluators of the firm to assess the firm's health (Weiner and Mahoney, 1981). Measures used in empirical studies include return on assets (Virany, Tushman, and Romanelli, 1985; Harrison, Torres, and Kukalis, 1988), return on equity (James and Soref, 1981; Allen and Panian, 1982; Lubatkin and Chung, 1985; Robinson and Brief, 1985; Harrison, Torres, and Kukalis, 1988), and profit margin on sales (Salancik and Pfeffer, 1980; Harrison, Torres, and Kukalis, 1988).

2.3 ECONOMIC VALUE ADDED (EVA)

EVA is thought to be a single corporate performance measure that enables investors to identify investment opportunities and motivate managers to make value-added business decisions? Obviously, this measure is of utmost importance to investors, managers, and business researchers (Tully, 1993). As defined by Stern Stewart Management Services of New York, EVA is the difference between a company's net operating income after taxes and its cost of capital of both equity and debt (Stern Stewart, 1993). Although the term EVA had appeared in the literature as early as 1989 (Finegan, 1989; Walter, 1992), it did not receive much attention until a September 20, 1993, article in Fortune magazine (Tully, 1993). Following the article's strong praise of EVA as the most recent and exciting innovation in measuring corporate success, a number of papers were published telling successful EVA stories and promoting EVA adoption (Rutledge, 1993; Walbert, 1993 and 1994; Birchard, 1994; Brossy and Balkcom, 1994; Byrne, 1994, McConville, 1994; White, 1994; Stewart, 1995).

One major reason for EVA's sudden popularity was that it appeared to have an impressive list of corporate sponsors including such American Corporate giants as AT&T and Coca-Cola. Executives from these companies stated how very satisfied they were with EVA as their new measurement tool. They purportedly

found the ideal corporate performance measure and publicly shared their high expectations for EVA to move their stocks up to a new high. As one of the most enthusiastic EVA proponents, Coca-Cola's experience is anecdotal.

Adopting EVA encouraged the company to concentrate capital in its highly profitable soft drink business and to raise return faster than the cost of capital by increasing the use of leverage. As a result, Coke increased its EVA by an average of 27% annually and its stock returned about 200% from the inception of EVA in 1987 to the middle of 1993. Coke's CFO commented that "EVA forces you to find ingenious ways to do more with less capital" (Tully, 1993: 48).
The sentiment was echoed by CSX's CEO, "EVA is anything but theoretical . . . How we use capital determines market value" (Tully, 1993: 39).
Like Coca-Cola, the adoption of EVA in 1988 led CSX to a significant reduction in its investment in locomotives, containers, and railcars with a 25% increase in freight volume. By mid-1993, CSX's stock price had soared from $28/share when EVA was introduced to an impressive price of $75. Similar stories of EVA successes have been repeated by other well known American companies such as AT&T, Briggs & Stratton, Chrysler, Compaq Computer, GE, Quaker Oats, and Scott Paper (Tully, 1993; Walbert, 1994). Although the anecdotal evidence may differ in detail between companies and economic regions, a common theme emerges. Advocates find that EVA motivates companies to find ways to increase the efficiency of capital utilization and consequently brings about a superior stock performance

EVA is a useful performance measurement metric but cannot be applied entirely without asking provoking, critical questions such as: Is increasing EVA all that matters in the marketplace? Is EVA a real innovation that provides corporations with the golden key to creating wealth? Are the traditional measures of accounting earnings still useful? Are there pitfalls that management needs to be aware of before embracing EVA? While accounting profits such as earnings per share and return on equity are among the most commonly used performance

measures. they are criticized for not taking into consideration the total cost of capital and for being unduly influenced by accrual-based accounting conventions. In contrast, EVA, the difference between after-tax operating profits and the total cost of capital, is promoted as a measure of a company's real profitability.
Stern Stewart Management Service of USA, uses the following equation to calculate EVA in its 1,000 company database: EVA = (Return on Capital - Cost of Capital) * Total Capital where (1) total capital is defined as the sum of total equity and interest-bearing debt, and (2) cost of capital is the weighted average cost of these two capital components.

The equation illustrates the importance of the spread between return on capital and cost of capital in determining EVA.
To eliminate potential distortions introduced by accounting rules, Stern Stewart suggests adding equity equivalent reserves to capital and periodic changes in the reserves to after-tax operating profits (Stewart, 1991). The equivalent reserves contain items such as deferred income tax reserves, the cumulative amortization of goodwill, capitalized intangibles such as R&D, allowance for doubtful accounts, and reserves for warranty claims. By explicitly considering the total cost of capital and adjusting the equity equivalent reserves, EVA measures economic profits. In other words, EVA allows investors to evaluate whether the return being earned on invested capital exceeds its cost as measured by the returns from alternative capital uses. Management may do different things to create value for the business. Whatever it does, the value created will ultimately be reflected in the EVA measure. The EVA or value of a company increases if it: (1) raises operating profits without requiring more capital, (2) uses less capital for the same level of operation, or (3) invests in projects that earn more than the cost of capital.

Since value is a primary concern to investors, proponents claim that EVA is the only performance measure that ties directly to a stock's intrinsic value (Stewart, 1991). All the anecdotal EVA stories allude to this as the major advantage of adopting EVA. It has been asserted that stock prices and EVA show a remarkable

tendency to move up and down together. As commented by the CFO of AT&T's long-distance unit, "We calculated our EVA back to 1984 and found an almost perfect correlation with stock price" (Tully, 1993: 40-41).

The superiority of EVA as an internal performance measure over accounting earnings does not necessarily lead to the conclusion that it is the single best internal performance measure that drives stock price. Many years of stock market research seem to suggest no single determinant on which one can rely to profitably predict the market (Foster, 1986). Furthermore, relating an operation's profit to its capital is not an advance in performance measurement metric but rather a refinement of the old metrics. It has been a long standing practice of performance measurement in management accounting. As early as in the 1920s, multi-product diversified companies such as DuPont and General Motors began measuring divisional profitability by linking profits to the capital employed to create them. Return on investment (ROI), defined as operating income divided by net operating assets or capital, was frequently used to allocate limited resources among different divisions. While the cost of capital is not explicit in ROI, it is often the basis on which a division's ROI is evaluated. Practically, using ROI as a performance measure will most likely lead to the same result as an EVA measure in terms of motivating managers to increase the efficiency of capital utilization. ROI's draw back however lies in its indirect reference to the absolute earnings. Unless carefully interpreted, it can lead to suboptimal decisions: maximizing ROI doesn't necessarily lead to maximizing value of the firm.

To promote goal congruence between divisions and the company as a whole, residual income (defined as operating income minus imputed interest charge for investment) was invented and recommended as a comparable and better measure to ROI (Horngren et al , 1996). In practice, the imputed interest charge is often the minimum acceptable return based on the cost of capital. The difference between the measurement paradigm of residual income that has existed for decades and EVA lie in the treatment of specific items such as R&D expenditure, amortization

of goodwill etc. EVA is not constrained to accounting concepts and conventions: it measures the true value creation by the enterprise.

Since what gets measured gets done, the inclusion of discretional expenditure items such as R&D ensures that management does not ignore them. In any case learning and innovation cannot be taken for granted in an increasingly competitive business environment. Certainly EVA is a well recognized and recommended practice.

Although EVA may be a conceptually better measure of profitability than accounting earnings, its relative strength has not been empirically verified.
EVA and accounting earnings are not mutually exclusive. They are fundamentally related in that EVA is built upon operating profits from an income statement.
Even with all the adjustments proposed by Stern Stewart, it is still not difficult to discern the relationship between them.

An empirical research taken by Chen & Dodd (1997) found out that companies may not need to make these adjustments in order to adopt an EVA paradigm. Instead, they may implement performance measures based on residual income which will likely provide them with most of the practical benefits promised by an EVA system. Adjusting the equity equivalent reserves to both capital and operating profits, however, may differentiate EVA from residual income. EVA measures what investors truly care about, the net cash return from operations. In comparison, various accounting rules may distort residual income. A good example is the accounting for research and development (R&D). From the asset valuation perspective, R&D expenditures are expected to bring about future benefits to a company and thus should be capitalized. However, Generally Accepted Accounting Principles (GAAP) require that R&D be expensed in the same period incurred, potentially distorting profit and capital. While it is conceptually sound to adjust for various distortions as proposed by Stern Stewart,

the adjustments are not free. Companies need not commit resources to make these adjustments unless they pass a cost-benefit test.

A fundamental drawback to traditional performance measures and EVA is that they depend on historical data whether taken over the short-term or in the long term. They cannot therefore be efficient in predicting future performance: they are lag indicators of performance. It is the responsibility of the executives to safe guard the interest of the stock holders both in the short and long term. It is a fact that present performance has an impact on future performance. Therefore an optimal performance measure must adequately incorporate the impact of present actions on future performance. Consequently there is a need to include lead performance indicators in the evaluation of executive performance.

2.4 BALANCED SCORE CARD

The Balanced Scorecard (BSC) is a performance management tool that has been used to foster a more integrated perspective of the organization and the valuation process. Developed by Kaplan and Norton (1992), it is based on the concept that managers must manage and evaluate their business from at least four major perspectives: customers, internal business process, innovation and learning, and financial. These four perspectives encourage management to develop an integrated strategy around the following four questions:

1 How do customers view the firm? (The customer perspective is measured in part by indicators of customer satisfaction, on-time delivery, share of key accounts' purchases, ranking by key accounts.)

2 What business processes must the firm improve and exceed at? (The internal business perspective is measured in part by indicators such as cycle time, unit cost, yield, and quality.)

3. Can the firm continue to learn and innovate? (The innovation and learning perspective is measured in part by indicators such as percent of sales from new

products, development time for the next generation of products, quantity and quality of employee suggestions, and employee skill development.)

4. How does the firm appear to its shareholders? (The financial perspective is measured in part by such indicators as cash flow, return on equity, market share.)

The scorecard takes a balanced look at the organization because it focuses on (1) leading and lagging drivers of performance, (2) financial and non-financial measurements, and (3) quantitative as well as qualitative measures of performance. If properly implemented, it is an excellent management framework to help managers track the many factors that influence performance The ability of the BSC to provide this view depends upon the construction of a set of performance measures that track how successfully a firm is carrying out its strategies, objectives, and overall mission.

Financial performance, whether measured by EVA or some other metric, should always be the end goal, but the balance scorecard reminds us that financial measures are lagging indicators. They tell us how the company performed after the fact (Young & O'Byrne 2001, Fisher 1992). Delivering ever increasing amounts of EVA requires that we understand the leading indicators of value: the measures that signal value-creation or value-destroying behavior before the results ever show up in EVA. A limitation of the BSC, however, is that it lacks a single focus for accountability and that it focuses on evaluation of strategy implementation. To use the methodology, the board of directors must come up with agreed performance parameters and targets on a rolling yearly basis. At least it does show what to look for in performance measurement. However what the BSC does not do but a Board needs it to do is to give one comprehensive index to summarize the interaction between these leading and lagging measures of performance. While the BSC may tell us what measures to look at, it does not tell us how to look at them or their relative importance

2.5 INTERGRATING ECONOMIC VALUE ADDED AND BALANCED SCORE CARD

Although the balanced scorecard was not explicitly created with EVA in mind, the framework has proven to be highly complementary to it (Young & O'Byrne 2001). In practice, EVA and BSC must be viewed as an integrated system representing a continuum going from leading indicators such as employee satisfaction and morale, quality, and customer satisfaction to lagging indicators such as EVA. The strength of EVA is that it focuses the firm on its fundamental mission of value creation. The strength of BSC is that it focuses management attention on the key causal pathways to value creation.

The key to integrating these two systems is quantifying the relative importance of the firm's leading and lagging indicators and meshing them into one comprehensive performance index.

This can be done by employing the multi-criteria decision-making technique: the analytical hierarchy process (AHP) as the tool to facilitate this Linkage, to develop an integrated performance index, and to monitor its implementation. AHP has been increasingly used to link qualitative and quantitative measures in an integrating framework (Liberatore et al 1997, Pineno 2000). It has been applied to business problems and is particularly useful for allocating resources, planning, analyzing the impact of policy and resolving conflicts (Saaty 1996).

2.5.1 The AHP-Based Valuation Framework

The AHP developed by Saaty is a proven method for structuring and analyzing complex, multilevel decision-making problems (Saaty 1996). Basically, the AHP is a method of breaking down a complex situation into its component parts; arranging these parts (or variables) into a hierarchic order; assigning numeric values to subjective judgments on the relative importance of each variable; and synthesizing the judgments to determine which variables have the highest priority and should be acted up to influence the outcome of the situation. AHP incorporates judgments and personal values in a logical way.

It depends on imagination, intuition and knowledge to structure the hierarchy of a problem and on logic, intuition and experience to provide judgments about the relative rankings.

When AHP is applied to BSC, for the purposes of corporate performance evaluation, the financial perspective measurement can be based on EVA, while the customer, internal business process and learning and innovation perspectives measurement can encompass factors such as product innovation, customer satisfaction and loyalty, employee productivity, product quality, brand equity The evaluation variable would then be a number that reflects both lead and lag indicators of performance (Harold and Brannigan, 2004). However the integration may be qualitative as a cursory examination of proxy statement of a number of USA companies' reveal.

2.6 RELATIVE PERFORMANCE EVALUATION

The relative performance evaluation hypothesis states that firms benefit from comparing their own performance to that of a peer group when evaluating its performance (Holmstrom 1979, 1982). In theory, relative performance evaluation filters out aspects of firm performance that the management cannot control. For this reason, theory advocates the superiority of relative performance over absolute performance in determining CEO compensation. However, empirical research generally does not support the use of Relative Performance Evaluation in practice (e.g., Janakiraman et al. 1992; Aggarwal and Samwick 1999a, 1999b). Where it is in use the most common performance metrics used include stock return or return on investment, return on assets, return on equity, sales, net income and cash flow relative to a comparable group (Antle and Smith 1986; Gibbons and Murphy 1990; Janakiraman et al 1992). Compensation committees often consider unfavorable external factors, such as recession, to filter out noise in the CEO

evaluation process while remaining silent where favorable external events drove favorable corporate performance.

Firms may emphasize adverse economic conditions to mitigate their impact on CEO compensation, thereby minimizing the CEO's downside compensation risk, but discount favorable economic conditions to give the CEO credit for the firm's performance. This asymmetry is equivalent to using one-sided Relative Performance Evaluation, where a firm compensates the CEO after filtering out factors that adversely affect industry performance, but credits the CEO for factors that aid industry performance. Perhaps the fact that some firms discount only negative impacting external factors when determining CEO compensation signals weak governance. For example, when firm performance is unfavorable, firms with weak corporate governance may be more likely to discuss negative external factors to mitigate their impact on CEO compensation.

For example, Newman and Mozes (1999) find evidence that when firm performance is unfavorable, the presence of insider directors on the compensation committee, suggesting weaker corporate governance, results in a relation between firm performance and CEO compensation that is more favorable toward the CEO.

2.7 TYPICAL EXECUTIVE COMPENSATION SCHEMES

Performance based CEO compensation contracts typically include multiple bonus schemes that can take three forms: stock option plans based on future stock prices, performance plans based on the attainment of corporate earnings targets, and to a lesser extent, target accounting ratios selectively determined by the board of directors to quantify their specific performance objectives. Compensation contracts often contain bonus schemes based on more than one indicator of corporate performance. There are at least two reasons this practice occurs that can be derived from an agency theory framework. The first is grounded in a theoretical contract model that demonstrates that as the number of performance criteria increases, the evaluation of CEO effectiveness becomes more optimal

(Holmstrom, 1979). Since each criterion included in the compensation contract can measure performance differently, combining them helps remove some of the noise contained in each individual measure, thereby providing a clearer assessment of the CEO's contribution to organizational performance. A second reason for multiple indicators is that performance measures must encourage the CEO to act in the shareholders' interests as well as safeguard some of the CEO's interests. Otherwise, the CEO may feel threatened or exploited and may not act in the organization's best interests (Lambert and Larcker, 1985). The three types of bonus plans and there relationship to the evaluation of CEOs is discussed below.

2.7.1 Stock Plans

Stock plans frequently appear as incentives in CEO compensation contracts in the form of stock options, stock appreciation rights, phantom stock, dividend units, and restricted stock (Larcker, 1983). Stock plans are typically viewed as a form of long-term compensation and are structured accordingly. For example, stock options are fixed at a level above the current selling price. If the stock price rises above the option price, the CEO is able to buy shares at the fixed price, which is below their prevailing market price. Stock plans have potentially mixed success in aligning the shareholders' and the CEO's interests. On the one hand, by having a stake in the firm's performance in the stock market, the CEO has an incentive to undertake projects that improve the price of the company's shares. Any increase in share price makes the CEO better off. Stock options have been blamed for pushing management to select increasingly high-risk high return investments to satisfy investor appetite for high returns which drive share price to greater heights while putting the investment at great risk e.g. Enron (Jenkins, 2003). On the other hand, strictly relying on compensation via a stock plan may impose too much risk on the CEO, because the stock price includes the effects of factors beyond management's control. As a result, the CEO may adopt a more conservative investment strategy to protect his or her personal interests and forego risky ventures with potentially high returns to shareholders (Lambert and Larcker, 1985). However, there have been numerous studies that have attempted to relate

corporate performance to the proportion of stock owned or controlled by managers and/or board of director members. Vance (1964), Monsen, Chiu, and Cooley (1968), Larner (1970), Pfeffer (1972), Kim, Lee, and Francis (1988), Schellenger, Wood, and Tashakori (1989) and Oswald and Jahera (1991) find a positive relationship between insider stock ownership and various measures of financial performance

2.7.2 Earning Plans

Bonus plans based on annual earnings targets are a common feature of many compensation plans. In 1980 they were used by 90 percent of the 1000 largest U.S. manufacturing corporations (Healy, 1985).

Earnings-based bonus plans constitute a substantial portion of short-term executive compensation in other jurisdictions.

For instance, in 1978 the median ratio of accounting bonus to base salary for senior executives in the USA was 52 percent (Fox, 1980).

Although earnings-based bonus schemes vary widely, they typically define a measure of reported earnings and an earnings target or lower bound. If reported earnings exceed the target, the contract defines the maximum percentage of the difference that can be allocated to a bonus pool. Typically, no funds are allocated to the pool if earnings are less than the target. In Kenya information on corporate compensation practice is scanty because there are limited disclosure requirements by CMA.

2.7.3 Accounting Ratios.

Accounting ratios are used much less frequently than share price and earnings targets. They generally take the form of current accounting performance measured against past performance. This tends to be done in an idiosyncratic way by each firm.

For example, some firms in the USA use a measure of the firm's average return on capital compared to the firm's average or for selected competitors over some years.

The use of multiple performance measurement criteria is considered better than single indicators. The management and the directors may not be unanimous about single criteria if selected by the board and may cause the management to feel that the measures and procedures used invite unfair evaluations. However it is difficult to determine the relative significance of each performance measure in the mix. In most cases this measure is based on subjective judgment.

2.8 BALANCE BETWEEN RISKY AND NON-RISKY COMPONENTS OF EXECUTIVE COMPENSATION

Performance (output) is used only as a variable in constructing an incentive contract when contract input (managerial effort and ability) cannot be measured (Kaplan and Atkinson, 1998).Where the outcome is directly a consequence of the managerial input then a simple wage/penalty scheme may be used; the greater the wage/penalty, the greater, the incentive to achieve the principal's goals. On the other hand, where the outcome is a consequence of the interplay between the managerial input and non controllable exogenous variables, then the use of contingent compensation increases managerial risk. The stockholders, being able to hold a well diversified portfolio, are risk neutral and should therefore bear more risk than the management who has already invested most of his or her nondiversifiable and nontradable human capital in the firm and is relatively risk averse . Linking a manager's compensation too closely to firm performance might lead to risk-avoiding behavior on the part of the manager. This argument, as summarized in Fama (1992) and Holmstrom (1987), stresses the fact that while contingent compensation may seem to have desirable incentive and motivational properties relative to noncontingent forms of compensation, it also has undesirable risk-bearing properties

It follows that agents would be reluctant to bear this risk of firm performance and that it is therefore difficult and costly for the principal to have the agent bear this risk (Myron Scholes, 1992).

Managers are more likely to attach significantly more value to a given level of cash than to the same expected level in stock or options because they can use that cash to buy a diversified portfolio of common stocks, bonds, or whatever. But, as managers are forced to reduce their cash compensation while making a larger investment in their own firm, they are being asked to bear more risk; risk that cannot be diversified away by holding other stocks and bonds. And because that risk cannot be diversified, companies will be forced to pay their executives disproportionately more in total compensation to compensate them for bearing this nondiversifiable risk. Therefore the composition of the bonus would affect its size.

The principal's problem is to find the lowest-cost pay-for-performance scheme that motivates the agent to provide the level of effort that the principal thinks best benefits the firm. The compensation offered must meet two criteria: individual rationality and incentive compatibility (Kaplan and Atkinson, 1998). Where no performance standards are set, individual rationality is sufficient and a fixed remuneration is contracted. To provide incentive to the management to achieve specified results, incentive compatibility in addition to individual rationality is imperative: affixed remuneration at the market rate plus a contingent incentive is contracted. What then determines the relative significance of the incentive component of executive compensation?

Traditionally, incentive pay is justified by drawing, either implicitly or explicitly, on the rationale of expectancy theory or agency theory (Gomez-Mejia & Wiseman, 1997). Both approaches treat compensation as a tool that can help maximize motivation and performance and presuppose a direct relation with performance. But some skeptics have questioned whether the movement to link Executive pay to corporate performance is really about motivating executives. Rather, these skeptics suggest that the primary reason for linking Executive pay to

performance may be to justify or provide "cover" for huge payouts to senior management (Hambrick & Finkelstein, 1995; Crystal, 1991; Zajac & Westphal, 1995) or to make compensation a variable cost to reduce operating leverage Beer and Katz (2003).

Most of the empirical research into Executive bonuses has been devoted to establishing a link between Executive incentives and company performance (Gomez-Mejia & Wiseman, 1997). Not only have empirical researchers been unable to establish that incentive compensation is causally related to firm performance, but in their focus on establishing a link between Executive incentives and corporate performance they have generally neglected the question of how bonuses influence performance .That is, how do bonuses shape Executive behavior and decision-making (Beer and Katz, 2003)?.

In the study by Beer and Katz (2003), it was found that the most important reason cited for instituting bonuses is top management's belief that monetary incentives are essential to motivating executives But the survey results suggested that bonuses have little to no positive effect on performance, and that their real function could be to attract and keep executives. The finding is consistent with skeptics view that ulterior motives other than the stated reason inform the practice and Famai 1992) and Holmstrom(1987) view that management could adopt a risk avoiding behavior when faced with performance based pay. However recent corporate failures blamed on increasingly high risk investment such as Enron confirm compensation experts view that performance based bonuses influence executive directors objectivity(Todd, 2003) and in particular stock options are seen as a powerful form of behavior modification tool, making the stock price a central consideration in every decision executive directors make. Consequently it pushes companies to be more risk-taking to meet the risk appetite of public investors (Jenkins, 2003). Beer and Katz (2003) also found evidence that the belief in executive incentives is more prevalent among U.S. managers than among managers from Europe and Asia, supporting the inference that beliefs

about monetary incentives can become socially constructed myths unless rigorously researched and tested.

From the fore mentioned studies it is apparent that performance based compensation at best improves reported performance but at the risk of higher business risk profile while providing incentive to management to adopt deceptive accounting methods. It must be used with caution. The controversies aside; what are the components of contingent executive compensation in Kenya? To what extent do corporate executives receive contingent pay in Kenya?

2.9 CONCLUSION

There is no doubt that maintaining market and industry leadership in a sustainable way requires competent management to take a long term view of corporate performance and no doubt long term managerial commitment to the vision and mission of the entity. The long term performance perspective can be achieved by either retaining the same competitive management over along period through incentive system tied to the desired period of employment or encouraging the management to take a long term perspective of corporate performance by using suitable performance based compensation scheme for executive directors. Because of the difficulties in monitoring managerial effort, performance based compensation has often been preferred to elicit managerial effort towards the desired corporate objects. However its limitations as a tool are apparent and moderation in its use is evidently necessary. To what extent then do companies listed at the Nairobi Stock Exchange use compensation to align shareholders interest with those of the executive directors? What performance measures do they use to asses the performance of corporate executives?

CHAPTER THREE

RESEARCH DESIGN

3.1 POPULATION

The population consisted of all the forty-nine companies listed at the Nairobi stock exchange on 1/7/2006. As the population was small, there was no need for sampling. All the companies were surveyed.

3.2 DATA COLLECTION

As at the present, the information required on executive compensation practices of listed companies for this study, was not available in the periodic reports filed by these companies at the Nairobi stock exchange. The information was therefore obtained directly from the companies. We obtained the information through a questionnaire. The questionnaire was delivered to the company respondent: (Personnel Manager), by and collected two weeks later A follow up was made by phone.

3.3 DATA DESCRIPTION

The data collected include a list of five highest paid executive officers of the corporation, the value of cash bonus paid in the last financial year expressed as a percentage of basic salary, the value of stock bonus paid in the last financial year expressed as a percentage of basic salary, the performance measures upon which the cash bonus was contingent, and the performance measures upon which the stock bonus/option was contingent for each of the five executives in descending order of remuneration.. The performance measures were selected from a given set of classes as indicated below:

A) Earnings target, inclusive of; net profit, revenue growth, or cash flow (IBM,2004)

B) Target Residual profit or economic value added (Tully,1993; Chen & Dodd,1997)

C) Target Accounting Ratios, inclusive of Return on Assets, Return on Equity, Return on Investment, and profit margin on sales.(Harrison, Torres, and Kukalis, 1988)

D) Target growth in Share Price(IBM,2004; Larcker,1983)

E) Relative performance Measured by a comparison of earnings or accounting ratio performance relative to a comparative firm or group of firms (Jensen and Murphy,1990;Antle and Smith,1986; Gibbons and Murphy, 1990; Janakiraman et al,1992)

F) An Integrated measure of financial performance, customer satisfaction, market share growth, workforce development, acquisition of strategic competencies, and product or process innovation. (IBM,2004)

3.4 DATA ANALYSIS

3.4.1 Hypothesis

3.4.2 Hypothesis one:

H_0: contingent compensation is not a significant component of executive compensation for listed companies at the Nairobi Stock Exchange.

H_1: contingent compensation is a significant component of executive compensation for companies listed at the Nairobi stock exchange.

3.4.3 Data Analysis Model one.

The distribution of the contingent proportion X_i: the sum of the contingent proportion of cash bonus and the contingent proportion of stock bonus paid to

executive officer i in company j for all executive officers n and all companies m that participated in the survey was analyzed using:

$$\text{Arithmetic mean } (\mu) = \sum_{j=1}^{J=m} \sum_{i=1}^{i=n} x_{ij}/nm$$

Median

Quartiles

$$\text{Standard deviation } \sigma = \sqrt{\left(\sum_{J=1}^{J=m} \sum_{i=1}^{i=n} (x_{ij}^2/nm - (1/nm \sum_{j=1}^{j=m} \sum_{i=1}^{i=n} x_{ij})^2\right)}$$

$$\text{Skew ness } \gamma_1 = \mu_3 / (\mu_2)^{3/2} \qquad \mu_k = \sum_{J=1}^{J=m} \sum_{i=1}^{i=n} (x_{ij} - M)^k /nm \ ;$$

$$M = \sum_{J=1}^{J=m} \sum_{i=1}^{i=n} (x_{ij}/nm),$$

K=1, 2, 3, 4, ...

$$\text{Kurtosis } \gamma_2 = \mu_4/(\mu_2)^2 - 3$$

1.4 .4 Hypothesis two

Ho: contingent compensation for corporate executives of companies listed at the Nairobi stock exchange is not predominantly based on one of the corporate performance measures listed below:

A) Earnings target, inclusive of; net profit, revenue growth, or cash flow (IBM,2004)

B) Target Residual profit or economic value added.(Tully,1993; Chen & Dodd,1997)

C) Target Accounting Ratios, inclusive of Return on Assets, Return on Equity, Return on Investment, and profit margin on sales (Harrison, Torres, and Kukalis, 1988)

D) Target growth in Share Price(IBM,2004, Larcker,1983)

E) Relative performance Measured by a comparison of earnings or accounting ratio performance relative to a comparative firm or group of firms (Jensen and Murphy,1990,Antle and Smith,1986; Gibbons and Murphy, 1990; Janakiraman et al,1992)

F) An Integrated measure of financial performance, customer satisfaction, market share growth, workforce development, acquisition of strategic competencies, and product or process innovation (IBM,2004)

H_1: contingent compensation for corporate executives of companies listed at the Nairobi stock exchange is predominantly based on one of the corporate performance measures listed above.

3.4.5 Data Analysis Model two

The frequency distribution of the performance criteria used based on the performance measures listed in 3.4.4 above was analyzed using:

(i) Mode

(ii) Frequency distribution chart

3.5 ASSUMPTIONS

In order to under take this study, the following assumption was necessary;

A) The chief executive of any corporation shares the managerial responsibility with at least a team of managers. A figure of five was assumed being the number of executives for which mandatory compensation reports are equally required in proxy statements in the USA.

CHAPTER FOUR

DATA ANALYSIS

4.1 Introduction

This chapter presents the results of the data analysis. Forty-nine companies listed at the Nairobi Stock Exchange were surveyed. However, only Thirty-three agreed to participate.

4.2 Analysis

The response rate was 33 out of 49 companies surveyed. This translates to 67.3%. The sample is therefore large and fairly representative of the companies listed at the Nairobi Stock Exchange. A number of respondents did not fill in the date of their company's first listing and therefore the datum was eliminated from the analysis.

Most companies predominantly compensate only the chief executive with performance cash bonus in addition to fixed cash emoluments .TABLE 4.1 shows the frequency at which performance measures are used to determine the amount of performance bonuses. The totals for each officer show the frequency at which an officer of the same rank in the participating companies are remunerated by a risky pay component. Table 4.2 shows a graphical illustration of the totals in Table 4.1 The average cash bonus expressed as a percentage of the basic salary was obtained as a mean of 11.02% with standard deviation of 8.12%, mode of 10%, and median of 10% (TABLE 4.0). Some companies compensate all their executive directors with a fixed non-performance based cash emoluments. TABLE 4.0 shows cases where the cash bonus expressed as a percentage of basic pay is zero, while TABLE 4.1 shows instances where no performance measure is used to determine any payment implying non-risky compensation. Table 4.3 shows where officer1 receives non-contingent pay represented by letter G. Other

executives; Officer2, Officer3, Officer4, and Officer5 receive a risky compensation with a mean of 11.18%, 0.95%, 0.636% and 0.6360% and standard deviation of 10.21%, 3.02%, 2.51% and 2.51% of the basic salary. The mode and the median risky compensation as a percentage of basic pay however is 0% (TABLE 4.0). This implies that most companies predominantly pay other executive directors other than the chief executive with a non-risky remuneration Tables 4.4, 4.5, 4.6 and 4.7 show the frequency at which no performance measure(G) is used to determine compensation awarded to these executives. Stock based compensation was notably unused by companies. When all executive directors are considered the mean proportion of performance based compensation to fixed compensation falls to a mean of 3.59%, with a standard deviation of 6.855%, mode of 0%, and median of 0%(TABLE 4.0).

The most commonly used measures in evaluating directors' performance include such measures as revenue growth targets, net profit target, earnings target, and cash flow measures(A) (TABLE 4.8). The second most commonly used measure is an integrated measure of financial performance, customer satisfaction, workforce development, acquisition of strategic competencies and process or product innovation (F). This latter criterion is predominantly used in assessing the performance of the chief executive (TABLE 4.3).

Economic value added and residual profit (B), target accounting ratios (C), share price (D) and relative performance measures (E), were not used by any participating company (TABLE 4.8). The modal performance measure was therefore the set of measures that include revenue growth targets, net profit target, earnings target, and cash flow measures (A). Some companies did not use any performance measure (G) in evaluating the performance of some of their

executive directors and remunerated them with a non-risky pay Tables 4.3, 4.4, 4.5, 4.6, and 4.7

comp	CASH OFF1	BONUS PAID AS %OF BASIC SALARY OFF2	OFF3	OFF4	OFF5
1	30 5	30 5	10	10	0
2	10	0	0	0	0
3	10	0	0	0	0
4	10	0	0	0	0
5	0	0	0	0	0
6	10	10	0	0	0
7	10	10	0	0	0
8	0	0	0	0	0
9	10	10	10	0	0
10	10	0	0	0	0
11	10	10	0	0	0
12	10	10	0	0	0
13	10	10	0	0	0
14	10	0	0	0	0
15	10	10	0	0	0
16	30 5	10	0	0	0
17	0	0	0	0	0
18	10	0	0	0	0
19	10	0	0	0	0
20	10	0	0	0	0
21	10	0	0	0	0
22	0	0	0	0	0
23	30 5	30 5	10	10	10
24	10	0	0	0	0
25	0	0	0	0	0
26	10	0	0	0	0
27	30 5	10	0	0	0
28	10	0	0	0	0
29	10	0	0	0	0
30	10	0	0	0	0
31	10	0	0	0	0
32	10	0	0	0	0
33	0	0	0	0	0
TOTAL	**310**	**130**	**30**	**20**	**10**
MEAN	11 02%	11 18%	0 95%	0 64%	0 64%
MODE	10%	0%	0%	0%	0%
MEDIAN	10%	0%	0%	0%	0%
Standard deviation	8 12%	10 29%	3 02%	2 51%	2 51%

OVERALL	
MEAN	3 59%
MEDIAN	0%
MODE	0%
STANDARD DEVIATION	6 86%

TABLE 4.0

FREQUENCY OF USAGE OF PERFORMANCE MEASURES

COMP I	OFF1	OFF2	OFF3	OFF4	OFF5	TOTAL
1	F	F	A	A	_	4
2	F	_	_	_	_	1
3	A	_	_	_	_	1
4	A	_	_	_	_	1
5	_	_	_	_	_	0
6	F	A	_	_	_	2
7	F	A	_	_	_	2
8	_	_	_	_	_	0
9	F	F	A	A	_	4
10	A	_	_	_	_	1
11	A	A	_	_	_	2
12	A	A	A	_	_	3
13	F	A	_	_	_	2
14	A	_	_	_	_	1
15	A	A	_	_	_	2
16	F	A	_	_	_	2
17	_	_	_	_	_	0
18	A	_	_	_	_	1
19	A	_	_	_	_	1
20	A	_	_	_	_	1
21	F	_	_	_	_	1
22	_	_	_	_	_	0
23	F	A	A	A	A	5
24	A	_	_	_	_	1
25	_	_	_	_	_	0
26	A	_	_	_	_	1
27	F	A	_	_	_	2
28	F	A	A	_	_	3
29	A	_	_	_	_	1
30	A	_	_	_	_	1
31	A	A	A	_	_	3
32	A	_	_	_	_	1
33	_	_	_	_	_	0
TOTAL		27	13	6	3	1	50

TABLE 4 1

COMP I	OFF1	OFF2	OFF3	OFF4	OFF5
TOTAL	27	13	6	3	1

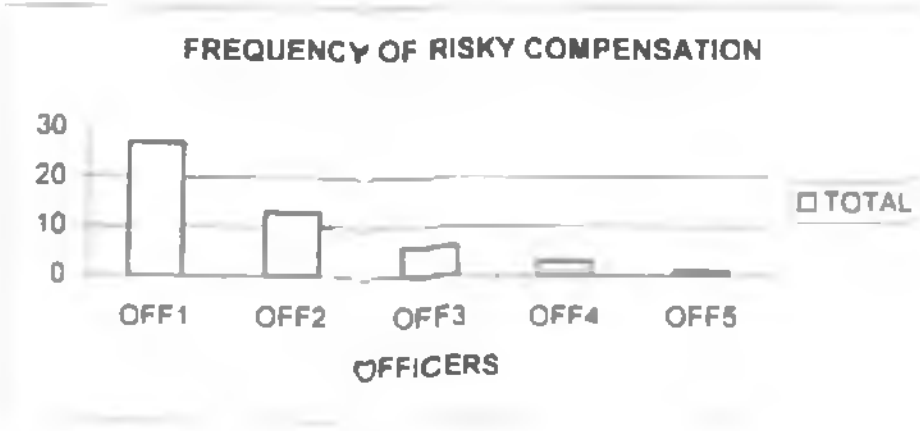

TABLE 12

FREQUENCY DISTRIBUTION TABLE USAGE OF PERFORMANCE MEASURES

Number of times used

MEASURE	OFF1	OFF2	OFF3	OFF4	OFF5	TOTAL
A	16	11	6	3	1	37
B	0	0	0	0	0	0
C	0	0	0	0	0	0
D	0	0	0	0	0	0
E	0	0	0	0	0	0
F	11	2	0	0	0	13
G	6	20	27	30	32	115

FREQUENCY OF USAGE OF PERFORMANCE MEASURE

TABLE 4 3

FREQUENCY OF USAGE OF PERFORMANCE MEASURE

TABLE 4 4

FREQUENCY OF USAGE OF PERFORMANCE MEASURE

TABLE 4 5

FREQUENCY OF USAGE OF PERFORMANCE MEASURE

TABLE 4 6

FREQUENCY OF USAGE OF PERFORMANCE MEASURE

TABLE 4 7

FREQUENCY OF USAGE OF PERFORMANCE MEASURE

TABLE 4 8

KEY

ABREVIATIONS

OFF1	Officer 1
OFF2	Officer 2
OFF3	Officer 3
OFF4	Officer 4
OFF5	Officer 5
COMPi	i^{th} Company

PERFORMANCE MEASURES

A	Earnings Target, inclusive of revenue growth, or cashflow or cash flow
B	Target residual profit or Economic value added
C	Target Accounting Ratios, inclusive of Return on assets on assets Return on Equity Return on Investment and Profit margin on sales
D	Target growth in shareprice
E	Relative performance measured by a comparison of earnings or or accounting ratio performance relative to a comparative firm or group of firms
F	An intergrated measure of financial performance, customer satisfaction market share growth workforce development acquisition of strategic competencies, and product or process innovation
G	No performance measure used Non-risky pay

CHAPTER FIVE

DISCUSSION AND CONCLUSION

5.1 Introduction

This chapter discus the results of the data analysis in chapter four and draws conclusions there from.

5.2 Discussion

5.2.1 Preamble

This study had two objectives; the first was to determine the extent to which executive directors of companies listed at the Nairobi Stock Exchange receive compensation that is contingent on the corporate performance in general; and the second was to determine the performance measures predominantly used to evaluate corporate performance amongst listed companies at the Nairobi Stock Exchange. This was in recognition that corporation is an important vehicle for national economic production and that incentive contracting is of great significance in influencing the behavioral orientation of executive directors as postulated in agency literature (Fama 1980).

5.2.2 Cash based performance contingent compensation.

The study established that in most companies only the chief executive receives a risky compensation of about 10% of the basic pay. When all other executive directors are considered an average executive director of a company listed at the Nairobi Stock Exchange receives only 3.03% of the basic pay as a risky component of his total compensation. Some companies remunerate all their

executive directors with a non-risky pay. Compared to the practice in the USA where 52 % is the norm (Fox, 1980), this proportion is small.

These findings tend to suggest that Board of Directors of listed companies at the NSE do not see compensation as the best way to resolve principal-agent conflict as in positive agency theory This finding is consistent with the normative agency theory (Fama, 1992; Holmstrom, 1979, 1987). The normative agency theory postulates that remunerating agents with performance contingent pay exposes the agent to more firm performance risk than the stock holder. This is because the agent has already invested non-diversifiable human capital in the firm and further exposure through performance contingent pay would increase the risk in excess of that borne by stockholders. The agent, it's supposed, may resort to risk avoidance leading to sub-optimal firm performance. Recent evidence show that in some instances, exposing agents to risk pushes companies to be more risk-taking to meet the risk appetite of public investors (Jenkins, 2003). Such risk-taking often results in business failure. This study establishes that companies' at the Nairobi Stock Exchange take a more conservative approach to incentive contracting. Perhaps this approach could explain the relative absence of accounting fraud in Kenya; accounting fraud is the product of business failure (Jenkins, 2003). It also confirms Beer and Katz (2003) finding that the belief in incentives could be more prevalent among USA managers than in other social economic environments.

However the use of performance based compensation is not only to provide motivation to management to pursue shareholder goals but also to provide direction to the management to ensure goal specificity (Steers and Porter, 1974). This ensures efficiency and effectiveness of managers. How then do companies at the Nairobi Stock Exchange ensure that management focuses their attention on effective and efficient value creation?

5.2.3 Stock based performance contingent compensation

Stock based compensation is one other method that is commonly used to align shareholder goals with those of management. This study however finds that neither share options nor share price based compensation is used by any of the companies in remunerating its corporate executive directors. This finding concurs with Kiarie (2003). Where share ownership by employees is encouraged at the Nairobi Stock Exchange, share price is unused as a performance measure; Kenya Electricity Generating Company Ltd, made provisions for its employees to acquire its shares during the competitive IPO (Omondi, 2003) and Kenya Oil Company Ltd has an Employee Share ownership Plan in place which do not use share price as a vesting criteria. Where as stock compensation could be resisted on the ground that it erodes control particularly where there exists a single major share holder even though it improves the balance sheet (settling an expense without cash outflow (Hake, 2005)), phantom stocks and stock units as compensation components however cannot be resisted on this ground. According to Hake (2005) stock options would be used only if stock values represent the true underlying value of the corporation. This study as is Kiarie (2003) may lend credence to Ngumi (1995) fears that Nairobi Stock Exchange is not a reliable indicator of company values. These fears are blamed on inadequate disclosure requirements, opacity of company accounts, non communication of companies' strategies, little independent research on companies, insider trading, front running, undeclared market making and before the recent introduction of electronic trading, non-timely market information for traders outside Nairobi. Though Capital Markets Authority and Nairobi Stock Exchange have made positive reforms to ensure capital market efficiency, a lot still needs to be done. Its unlikely that companies traded in inefficient capital markets could be compelled by market forces to be efficient and effective in value creation. What methods then do shareholders use to ensure goal congruence between managers and stockholders?

When Board of directors opt to remunerate the executive directors with performance based compensation they prefer to use simple measures of corporate performance such as revenue growth, net profit, earnings, and cash flow measure. This practice is consistent with (Kaplan and Atkinson, 1998). A number of companies assess the performance of the chief executive using an integrated measure of financial performance, customer satisfaction, workforce development, acquisition of strategic competencies and process or product innovation consistent with Harold and Brannigan (2004).

However the conspicuous absence of such measures as residual profit and economic value added raises the issue as to whether management are able to focus on value creation to shareholders; accounting ratios, efficiency of business processes; and relative performance measures, competitive performance.

5.3 Conclusion

There are three main ways of ensuring corporate goal congruence. The basic way is through monitoring of the management by shareholders. This method is not only costly but is sometimes rendered impractical due to information asymmetry and differences in specialization (Kaplan and Atkinson, 1998). The second best method is then incentive contracting; tying the managers' remuneration to an appropriate mix of corporate performance measures. The third method is tying the manager's wealth to that of the shareholder closely through share-based remuneration. This study establishes that the last method is hardly used amongst companies listed at the Nairobi Stock Exchange and that the second method is used to a limited extent.

5.4 Recommendations

Incentive contracting is the second best method for ensuring the congruence of goals between corporate management and shareholders (Kaplan and Atkinson, 1998). This study has established that there is still scope for the usage of this method.

5.5 Limitations of the study

The study had the intention of covering all listed companies at the Nairobi Stock Exchange and envisaged receiving information from the Human resource managers who would be privy to all the information required. This was not possible in all cases: some companies did not respond while others assigned the task to officers not quite versed with some parts of the questionnaire.

In an attempt to make response on the questionnaire easy, large class interval was used for the contingent compensation as percentage of the basic pay. Though that objective was achieved, the resulting data has resulted in less discriminative classes as a number of executives are lamped together in the same class.

5.6 Suggestion for further Research

Since incentive contracting and share-based compensation are not significantly used at the Nairobi stock Exchange to promote corporate goal congruence, one would expect the level of corporate monitoring to be relatively high or else there would be corporate governance problem leading to sub optimal returns to shareholders. This study recommends another study to establish the level of corporate monitoring at the Nairobi Stock Exchange.

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APPENDIX A

QUESTIONNAIRE

INSTRUCTIONS

A) Please read instructions A, B and C and answer the questions 1 to 11 as accurately as possible, in the spaces provided. For clarification on the questions see notes at the bottom of each question.

B) Do not write the name of the company on this form for confidentiality purposes

C) Mail the questionnaire directly to the e-mail address 'address on the enclosed envelope.

QUESTIONS.

1) When was the company incorporated? (Date/month/year)...../...../.....

2) When was the company first listed? (Date/month/year)...../...../.....

3) What are the titles of five most senior managers, in descending order of seniority?

(The titles of five most senior corporate managers)

Officer [1].....

Officer [2].....

Officer [3].....

Officer [4].....

Officer [5].....

4) How are the managers listed above remunerated?

[Please tick to field the selected compensation components from the ones listed that are in use by the company to remunerate the managers listed in (3) above]

[*Salary, *Cash Bonuses, *Stock Bonuses, *Stock Options, *Stock Units, * any other way (briefly describe below)]

5) If cash-bonus was used in respect of any officer above what was the cash bonuses paid to that executive officer listed in (3) above expressed as a percentage of Basic annual salary, in the last financial year?

[Mark(X) in the box corresponding to the percentage class below that best represents the bonus paid in the previous financial year as a Percentage of basic pay for each of the five officers listed in (3) above]

	Officer 1	Officer 2	Officer 3	Officer 4	Officer 5
0%	[ ]	[ ]	[ ]	[ ]	[ ]
1-20%	[ ]	[ ]	[ ]	[ ]	[ ]
21-40%	[ ]	[ ]	[ ]	[ ]	[ ]
41-60%	[ ]	[ ]	[ ]	[ ]	[ ]
61-80%	[ ]	[ ]	[ ]	[ ]	[ ]
80+ %	[ ]	[ ]	[ ]	[ ]	[ ]

6) Did any of the officers listed in (3) above receive stock bonus or stock option as part of the annual bonus in the last financial year?

[Mark[X] for the correct answer]

YES [ ] NO [ ]

7) If your answer in (6) above is Yes, what was the value of the stock bonus/ option paid to each of the five executives listed in (3) above expressed as a percentage of Basic annual salary, in the last financial year?

[Mark[X] in the box corresponding to the percentage class that best represents the bonus paid in the previous financial year expressed as a Percentage of basic pay for each of the five officers listed in (3) above.]

	Officer 1	Officer 2	Officer 3	Officer 4	Officer 5
0%	[ ]	[ ]	[ ]	[ ]	[ ]
1-20%	[ ]	[ ]	[ ]	[ ]	[ ]
21-40%	[ ]	[ ]	[ ]	[ ]	[ ]
41-60%	[ ]	[ ]	[ ]	[ ]	[ ]
61-80%	[ ]	[ ]	[ ]	[ ]	[ ]
80+ %	[ ]	[ ]	[ ]	[ ]	[ ]

8) Are the cash bonuses and or stock bonuses paid upon a contingency/condition?

[Mark[X] for the correct answer]

YES [ ] NO [ ]

9) If your answer in (8) above is yes then under a column for each officer below Mark[X] in the bracket corresponding to the contingency/condition applicable as indicated below:

[The condition to be satisfied before the bonus is paid. You may select two or more conditions for one officer if relevant]

Achievement of:

A) Earnings target, inclusive of; net profit, revenue growth or cash flow.

B) Target Residual profit or economic value added

C) Target Accounting Ratios inclusive of Return on Assets, Return on Equity, Return on Investment, and profit margin on sales

D) Target Growth in Share Price

E) Relative performance Measured by a comparison of earnings or accounting ratio performance relative to a comparative firm or group of firms

F) An integrated measure of financial performance, customer satisfaction, workforce development acquisition of strategic competencies, and process or product innovation

	Officer 1	Officer 2	Officer 3	Officer 4	Officer 5
A	[ ]	[ ]	[ ]	[ ]	[ ]
B	[ ]	[ ]	[ ]	[ ]	[ ]
C	[ ]	[ ]	[ ]	[ ]	[ ]
D	[ ]	[ ]	[ ]	[ ]	[ ]
E	[ ]	[ ]	[ ]	[ ]	[ ]
F	[ ]	[ ]	[ ]	[ ]	[ ]

10) If in (4) above you indicated that some officers received remuneration that vests two or more years in the future(deferred compensation), such as stock options, stock appreciation rights, stock units, terminal benefits, and change of corporate control compensation, upon what contingency was the highest of such compensation/benefit pegged?

	Officer 1	Officer 2	Officer 3	Officer 4	Officer 5
A	[ ]	[ ]	[ ]	[ ]	[ ]
B	[ ]	[ ]	[ ]	[ ]	[ ]
C	[ ]	[ ]	[ ]	[ ]	[ ]
D	[ ]	[ ]	[ ]	[ ]	[ ]
E	[ ]	[ ]	[ ]	[ ]	[ ]
F	[ ]	[ ]	[ ]	[ ]	[ ]

[Mark[X] in the bracket above corresponding to the condition to be satisfied before each of the officers listed become entitled to receive the compensation component based on the scale below]

[illegible]

A	B	C	D	E
None	completed Period of Employment contract	increase in Share price	(Appropriate) competen	achievement of specific Internal Performance Indicators

11) Designation and signature of the respondent. .....

.....

[The designation of the person with access to the information used in filling the questionnaire]

Thank you for your cooperation. Now Please Mail this questionnaire back to the sender

APPENDIX B

LIST OF COMPANIES QUOTED AT THE NAIROBI STOCK EXCHANGE

Unilever Tea Ltd
Kakuzi
Rea Vipingo Plantations Ltd
Sasini Tea & Coffee Ltd
Car & General(k)
CMC Holdings Ltd
Hutchings Biemer Ltd
Kenya Airways Ltd
Nation Media Group
Uchumi Supermarket Ltd
C.F.C Bank Ltd
Housing Finance Company Ltd
Jubilee Insurance Co Ltd
National Bank of Kenya Ltd
Pan Africa Insurance Holdings Ltd
Athi River Mining Co Ltd
Bamburi Cement Ltd
Carbacid Investments Ltd
Olympia Capital Holdings Ltd
E.A Portland Cement Ltd
Sameer Africa Ltd
Mumias Sugar Co Ltd
Total Kenya Ltd
KenGen Ltd
City Trust Ltd
Williamson Tea Kenya Ltd
Kapchorua Tea Co Ltd
Kenya Orchards Ltd
Limuru Tea Co Ltd
Standard Group Ltd
Express Ltd
Eaagads Ltd
Marshalls (E.A) Ltd
TPS Eastern Africa (Serena) Ltd
Barclays Bank Ltd
Diamond Trust Bank Kenya Ltd
I.C.D.C Investments Co Ltd
Kenya Commercial Bank Ltd
NIC Bank Ltd
Standard Chartered Bank Ltd
B.O.C Kenya Ltd
British American Tobacco Kenya Ltd
Crown Berger Ltd
E.A Cables Ltd
East African Breweries Ltd
Kenya Oil Co Ltd
Kenya Power & Lighting Ltd
Unga Group Ltd
A.Baumann & Co Ltd

APPENDIX C

	CASH	BONUS PAID AS %OF BASIC SALARY			
comp r	OFF1	OFF2	OFF3	OFF4	OFF5
1	30 5	30 5	10	10	0
2	10	0	0	0	0
3	10	0	0	0	0
4	10	0	0	0	0
5	0	0	0	0	0
6	10	10	0	0	0
7	10	10	0	0	0
8	0	0	0	0	0
9	10	10	10	0	0
10	10	0	0	0	0
11	10	10	0	0	0
12	10	10	0	0	0
13	10	10	0	0	0
14	10	0	0	0	0
15	10	10	0	0	0
16	30 5	10	0	0	0
17	0	0	0	0	0
18	10	0	0	0	0
19	10	0	0	0	0
20	10	0	0	0	0
21	10	0	0	0	0
22	0	0	0	0	0
23	30 5	30 5	10	10	10
24	10	0	0	0	0
25	0	0	0	0	0
26	10	0	0	0	0
27	30 5	10	0	0	0
28	10	0	0	0	0
29	10	0	0	0	0
30	10	0	0	0	0
31	10	0	0	0	0
32	10	0	0	0	0
33	0	0	0	0	0
TOTAL	**310**	**130**	**30**	**20**	**10**
MEAN	11 02%	11 18%	0 95%	0 64%	0 64%
MODE	10%	0%	0%	0%	0%
MEDIAN	10%	0%	0%	0%	0%
Standard deviation	8 12%	10 29%	3 02%	2 51%	2 51%

OVERALL

MEAN	3 59%
MEDIAN	0%
MODE	0%
STANDARD DEVIATION	6 86%

CASH BONUS PAID AS A PERCENTAGE OF BASIC SALARY

	OFFIC1	OFFIC 2	OFFIC 3	OFFIC4	OFFIC 5	TOTAL
0	6	22	30	31	31	120
1- 20%	23	9	3	2	2	39
21 - 40%	4	2	0	0	0	6
41 - 60%	0	0	0	0	0	0
61 - 80%	0	0	0	0	0	0
81 - 100%	0	0	0	0	0	0
	33	33	33	33	33	165
MEAN	11 02	11.18	0 95	0 636	0 636	3 59
MODE	0	0	0	0	0	0
MEDIAN	0	0	0	0	0	0
SD	8 118	10.29	3.02	2.51	2.51	6.855

	OVERAL
MEAN	3 59
MODE	0
MEDIAN	0
SD	6.855
SKEWNESS	0.198
KURTOSIS	-2 94

odhiambooa@yahoo.com

P. O. 190

Kakamega

07/ 08/ 06

The Corporate Human Resource Manager,

.....

.....

.....

Dear Sir/Madam,

Re: Academic Research Facilitation.

Sir/ Madam. I am an MBA student at the University of Nairobi as indicated in the letter of introduction attached. I am currently undertaking an academic research on Corporate Executive compensation amongst companies listed at the Nairobi Stock Exchange.

The purpose of this letter is to kindly request you to assist me with some information as indicated in the attached questionnaire to facilitate this project. I wish to assure you that the data supplied will be kept confidential and used purely for the purpose disclosed, and that upon request you will be supplied with the research findings.

I would be grateful if the information could reach me at the E-mail address earlier than 27/08/06 or available for collection by 1st September 2006.

Yours faithfully

Albert Odhiambo.

D61/7683/03

CASH BONUS PAID AS A PERCENTAGE OF BASIC SALARY

	OFFIC1	OFFIC 2	OFFIC 3	OFFIC4	OFFIC 5	TOTAL
0	6	22	30	31	31	120
1- 20%	23	9	3	2	2	39
21 - 40%	4	2	0	0	0	6
41 - 60%	0	0	0	0	0	0
61 - 80%	0	0	0	0	0	0
81 - 100%	0	0	0	0	0	0
	33	33	33	33	33	165
MEAN	11.02	11.18	0.95	0 636	0 636	3 59
MODE	0	0	0	0	0	0
MEDIAN	0	0	0	0	0	0
SD	8.118	10 29	3 02	2 51	2.51	6 855

	OVERAL
MEAN	3 59
MODE	0
MEDIAN	0
SD	6 855
SKEWNESS	0 198
KURTOSIS	-2 94

TABLE 4 9

UNIVERSITY OF NAIROBI

SCHOOL OF BUSINESS

MBA PROGRAM – LOWER KABETE CAMPUS

Telephone: 4184160/4 Ext. 208
Telegrams: Varsity, Nairobi
Telex: 22095 Varsity

P.O. Box 30197
Nairobi, Kenya

DATE 7/8/06

TO WHOM IT MAY CONCERN

The bearer of this letter ALBERT ODHIAMBO ONYANGO

Registration No D61/7683/03

is a Master of Business Administration (MBA) student of the University of Nairobi

He/~~she~~ is required to submit as part of his/~~her~~ coursework assessment a research project report on a management problem. We would like the students to do their projects on real problems affecting firms in Kenya. We would therefore, appreciate if you assist him/~~her~~ by allowing him/~~her~~ to collect data in your organization for the research.

The results of the report will be used solely for academic purposes and a copy of the same will be availed to the interviewed organizations on request.

Thank you

UNIVERSITY OF NAIROBI
SCHOOL OF BUSINESS
MBA OFFICE
P. O. Box 30197
NAIROBI

J.T. KARIUKI
CO-ORDINATOR, MBA PROGRAM