

**THE RELATIONSHIP BETWEEN EXECUTIVE
COMPENSATION AND FINANCIAL PERFORMANCE
OF COMPANIES LISTED IN NAIROBI SECURITIES
EXCHANGE IN KENYA**

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DECLARATION

This research project is my original work and has not been presented in this or any other University for examination or any other purposes.

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

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DEDICATION

This research project is devoted to my parents for their sacrifices and support to see me through university education.

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ABBREVIATIONS AND ACRONYMS

AIMS	Alternative Investment Segment
CEO	Chief Executive Officer
CMA	Capital Markets Authority
FIMS	Fixed Income Securities Segment
FOMS	Futures and Options Market Segment
MIMS	Main Investment Segment
NSE	Nairobi Securities Exchange
ROA	Return on Assets (ROA),
ROCE	Return on Capital Employed
ROE	Return on Equity
SPSS	Statistical Package for Social Sciences

ABSTRACT

Compensation schemes are instrumental in motivating the top management executives in making the right investment choices which contribute towards creation of the shareholders' wealth. This research study was set out to establish how executive fees contribute towards improving financial performance of listed firms. A descriptive research design was applied to establish the link between executive compensation and financial performance of listed firms. The research study population involved 66 listed firms. Documents sources of data were obtained from capital markets authority covering a period of 5 years from 2010 to 2014. Data was analysed with the help of inferential and descriptive statistics. The research found non-significant nexus between directors' compensation and financial performance of listed firms. Executive fees had a positive link to financial performance; capitalization of the market was insignificantly but negatively link to performance. Listed firms should attach their reward schemes to performance to motivate the management team to work harder in the realization of their set targets. Top management should be exposed to a rigorous training and development programmes to polish up their knowledge and skills in implementing their investment decisions to boost profitability. A key limitation for this study is that document sources are historic in nature and might not be accurate; this might impact negatively on the results. The study was limited to 4 study variables; it is worth to note that there are factors that affect performance of firms such as efficiency and competence by the top management. Future researchers might want to find out the linkage between executive fees and other economic factors such as earnings and dividend per share. This might offer more insights to the investors and stakeholders when making investment decisions. Researchers should reinvestigate this study using an exploratory research design that takes a longtime duration; this will allow the researchers to discover the 'cause and effect relation that might be present between variables.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Companies hire managers to run their businesses. Limited companies are considered legal persons and as such, can carry out businesses and binding relationships under their names. However, for this to happen there must be a natural person involved in the decision making of the company (Hengartner, 2006). It is for this reason that the companies hire executives to make the business carry the organization's vision, craft, and implement a success strategy. In return, the executives are well compensated by the organization to ensure that the set objectives are achieved.

The success of the organization therefore, entirely depends on the plans which have been laid down to ensure that that the long term strategy has been achieved. There are various metrics which are used to ascertain whether the company is successful or not. This vary from organization to another based on various factors such as the type of industry, the past performance, the industry peers, the internal key performance Indicators among other (Jensen & Murphy, 2010).

There arises a conflict of interest therefore, when a person working for a company sees an opportunity to promote his own interests which are not congruent to the interests of the company that hires him. The agency theory in management suggests that different business relationships present different situations of conflict of interest between the principles and the agents (Kothari, 2008). There has been over the recent past debates on how to ensure that the firms' managers align their personal interests to those of the company or even better, to shelf their own interests and faithfully pursue the interests of the company.

To do this, the managers would be compelled to make decisions that always maximize the shareholders wealth. This, in finance is the primary goal of any company. Whereas an organization exists to satisfy the needs and expectation of different stakeholders, shareholder wealth maximization always tops the list of the goals of any company (Kothari, 2008). This is because the shareholders are usually treated with preference to other stakeholder since without them the company would never exist.

The other stakeholders to a company include employees, the government, Suppliers and customers, among others. All the above named stakeholders have their own expectations from the company and more often than not, the expectations are not always similar to the shareholders expectations. For instance, a government would expect the company to report as much profit as it can so that it can pay higher taxes. The government also expects the company to conduct its business while taking care of the environment and not engaging in activity that degrade the natural resources enjoyed by everyone (Gabriel, 2009)

The employees expect the company to compensate them adequately for them to continue working in the firms. They also expect the firm to offer benefits which may not be related to their performance at work. A firm that focused fully on employee satisfaction may therefore, end up incurring huge employees costs without necessarily translating that to shareholder wealth maximization. There arises a conflict.

The suppliers expect the company to pay up its short terms obligations to the suppliers possibly before they are due. This may not be the best decision for the company since working capital management is an important aspect of maximizing shareholders wealth. The society at large expects the company to engage in corporate social responsibility and give back to the society that offers a conducive environment to the

firm. Most firms have over the recent past spent huge amounts of money to social courses which may never translate into shareholders' wealth (Doucouliagos, Haman, & Askary, 2007).

Top managers of a firm may want to build a business empire so that they can manage bigger businesses, which have different branches and operations in different regions. This may not necessarily be the best decision that would maximize the shareholders wealth. This is mostly the highest form of agency conflict when a firm's top executive do not make decisions which maximize the company's shareholders' wealth (Geetha, Mohidin, & Chandran , 2011). As such, there has been a need to manage the agency relationship in order to mediate between the two conflicting interests. Many firms have adopted a performance and a skill based compensation approach.

To normal employees, firms now reward accomplishment of preset objectives and not just what happens. Firms develop performance standards and skill level standards that, when attained, will be rewarded with employee growth and advancement and incentives for results achieved. However, to the top executives, the firms pay them in order to come up with the objectives which would ensure that the firm's mission and vision are being achieved. Top executives are paid to craft the business strategy which leads to achievement of goals while other employees are paid to achieve these goals (Herdan & Szczepanska, 2012). This, therefore, raises the question as to whether executive compensation translates to shareholders wealth maximization.

1.1.1 Executive Compensation

Executive compensation refers to the monetary, non-monetary and psychological payments that an organization makes to its top executives. The key objective of such a broad spectrum of compensation is to encourage the executives to make decisions that ensure maximization of firm's performance. There are two types of compensation; a direct and indirect pay. Direct pay includes basic pay, overtime, leave pay, bonuses etc. Indirect pay includes retirement benefits, health insurance schemes, club memberships etc (Herdan & Szczepanska, 2012).

Executives who are improperly compensated may not have any incentive to perform in the best interest of the company they are leading. As such, they may engage in other activities which divert their attentions from maximizing the shareholders' wealth. Traditionally it is thought that for executive to have the motivation to ensure a firm performs, their compensation must be appealing and should take the form of incentive and be equally appealing. Remuneration to top executives should therefore, appear as an indicator of value to the executives (Doucouliagos, Haman, & Askary, 2007). It should encourage executives to make sound decisions which would translate to a firm's good performance.

1.1.2 Financial Performance

Financial performance is a measure of a firm's ability to use its assets in its ordinary course of business to generate a flow of economic benefits to the shareholders. It is therefore, a measure of a firm's financial health and is often used alongside other tools to evaluate a firm's success status. It can be used to measure a company's performance over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation to enable a

business make decision on how it can improve on the prevailing situation or sustain a desirable position (Hengartner, 2006).

There are different ways to measure financial performance. This is because there is no single known measure that can conclusively indicate the financial health of a company it is therefore, important to use all measures in aggregation. Different components of the financial performance measures carry different weights and as such, that consideration should be borne in mind.

1.1.3 Executive Compensation and Financial Performance

A good knowledge of this relationship would offer shareholder invaluable insight into effective ways and means ensuring that the executives have the right incentives in order to make decisions which ensure that the shareholders' wealth is maximized. Compensation issues though, have not been too topical in Kenya unlike other advanced economies such as in the United States of America. Past studies on the relationship between the executive compensation and financial performance have often offered mixed results with various observations being made in different environments and cultures. The relative role of various performance indicators of the top executives should be related to how well each indicator communicates to the shareholders about the executive's performance and the sensitivity to each of the incentives to perform. A good knowledge of this would therefore, inform the shareholders on how best to design a compensation package that generates both short term and long term financial performance by the firm.

1.1.4 Nairobi Securities Exchange

The Nairobi Securities exchange was approved as an overseas stock exchange in July 1953 by the London Stock Exchange. In 1954 it was registered under the societies Act as a voluntary of organization of stockbrokers and charged with the responsibility of developing the securities market and regulating trading activities. It is currently divided into four segment; the main investment segment (MIMS), the Alternative investment segment (AIMS), the fixed income securities segment (FIMS), and the futures and options market segment (FOMS). There are 64 companies listed with the NSE with a market capitalization of Kshs.2, 013.79 billion as at 2nd October 2015 (Source NSE).

1.2 Statement of the Problem

Different studies have been carried out but there still is controversy on whether executive compensation and a firm's financial performance. Good compensation schemes are thought to provide stimulus to top executives to make decisions which increase the shareholders' wealth. An executive whose compensation is solely a fixed salary would not have any drive to increase the shareholders wealth because he does not share in the success of the company achieved by his decisions. This motivation problem can be solved by pegging part of the executive's compensation to the firm's financial performance.

According to Lambert and Larker, (1985) compensations schemes really matter to the executives because they actually respond predictably to the incentives built in their compensation contracts. They also noted that changes in compensation plans affect executive decision making in ways consistent to agency theory. Kurawa, (2014) established a relationship between executive compensation and financial performance

of listed banks in Nigeria. However, Aduda (2011) found out that there is statistically negative non-significant relationship between executive compensation and performance of commercial banks in Kenya.

Aduda (2011) further suggested that there is a need to sensitize executives among the Kenyan banking fraternity on the need to align their payment to accounting performance measures as these measures are directly linked to shareholders wealth maximization. Tarus, Aboko, and Nyaoga (2014) found out that there is negative non-significant relationship between the executive compensation and financial performance of Insurance companies in Kenya.

In regard to the above mentioned non-conclusive findings, this research was set out to study the relationship between executive compensation and firm's performance for the companies listed in the Nairobi Securities Exchange.

1.3 Objectives of the Study

The objective of the study was to establish the compensation schemes for the top executives on the companies listed the Nairobi securities exchange and how they relate to the financial performance of the companies.

1.4 Significance of the Study

It is anticipated that the findings of this study will be important to:

The academicians since it will contribute to the existing knowledge of literature, and create better understanding of the compensation packages that firms design for their top management teams. The will also inspire the academicians to carry out further studies on the same topic as well as related areas. The research will also be useful in

critiquing the various compensation versus performance theories by either supporting or showing whether they actually hold.

This research will also be useful to the shareholders of various companies both listed and unlisted. This is because the findings will shed more light on the weather more pay to top executives translates to better performance by the firms listed in the securities exchange. The findings will therefore, help the shareholders widen their knowledge of executive compensation and financial performance and the relationship between the two.

The study will also be useful to the top management of the various companies. This is because they will learn on the current status within the industry and also understand the different compensation schemes being implemented among the firms in the firms listed in the Nairobi Securities exchange.

The research findings will also be useful to the various executive recruitment and Human resource consultancy firms who will gain further understanding on the relationship between executive compensation and the financial performance of the companies which they could be hired to recruit or contracted to design the compensation schemes for.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter discusses the theoretical review, empirical review, conceptualization and the research gaps. The theoretical review discusses the theories related to the study while the empirical review looks at literature derived from various research works by various researchers. Lastly, this chapter will offer summary in regard to these sections as discussed.

2.2 Theoretical Review

The basic purpose of any pay is to act as a compensation for the efforts that an employee has put in the process of producing goods and services to the employer. For the goods or services to be considered valuable to the employer, the net effect of the services offered by the employee ought to add value to the firm (Crespi-Cladera & Gispert,, 2003). This is often the measure of a firm's financial performance.

To an average junior employee, the pay-performance relationship often ends as soon as the service is offered and pay is received. However, for the senior level executive employees the value of the work rendered to the company is measured using more defined financial metrics such as the company's projects' Net present Value, Internal Rate of Return, Profitability index, among other financial performance tools.

According to dale-Olsen (2006), actual nature of employee compensation varies across companies. It includes not only monetary pay but also such fringe benefits such as medical health insurance, pensions, holiday pay etc. which are often regarded by many employees as more important than the monetary rewards which comes on short

term basis usually during or immediately after a certain piece of work has been completed. Aduda (2006) also states that a worker's wellbeing is highly correlated with the perceptions of their [ay relative to their contemporaries or peers.

2.3 Pay for performance theories

Pay for performance is usually a motivation concept used in human resources. This is where employees are compensated based on the attainment of certain preset targets. This may happen either individually or as a team. What this concept suggests is that for a given level of work, employees receive a predetermined variable pay and as such, if their sole motivation is to earn more, then they will work even harder in order to earn more (Vanek, 1970).

The design of incentives contracts and use of performance measures in these contracts, introduces the agency problem concept. This is where the designers of these contracts who are also primarily the owners of the business acting as the principals incentivize the employees who in this case act as agents to provide effort at work. The anticipation of the principal is that the agents will abandon their own personal and seemingly self interest in order to pursue the interest of the business owners which in turn translate to value of the firm (Sigler, 2011).

The assumption of these agency models is that the performance measures used in the contracts affect the behavior of the agent. The result is that the agent directs his attention to the job aspects which are being measured by the principal. As such, the weight of incentives offered determine the amount of effort that the agent puts towards the aspects of his job which are being measured. Ensuing is a discussion of three pay for performance theories.

2.3.1 Risk Aversion, Performance Measurement and Management Discretion Theory

Agency theory provides useful insight on the role of incentive pay. The first insight concerns the role of risk aversion. Generally, it is assumed that a firm is risk neutral and the executives are risk averse. In such a case, the choice of the type of compensation perk to the executives revolves around the tradeoff between the efficiency and insurance (Schivardi, Pistaferri, & Pencavel, 2006). In a situation where the employee is under a standard fixed wage contract, he is fully insured from all the performance based risks and he is usually under no compulsion to exert more pressure or assume more risks. In such a case, the employee exerts minimal efforts and this eventually reduces the efficiency of the employee. As such, an organization which has employees who serve under a fixed pay contract usually experiences low efficiency levels by the employees since they are under no incentive to take any risk which could bolster earnings (Niap, 2012).

Where an employee's pay is based piece rate pay system, the employee assumes all the risks and as such, has a risk appetite which eventually results in increased efficiency and more productive work. Under this scheme, the expected result is communicated to the employee and this becomes the performance target. The employee therefore, assumes all the risks associated with that particular piece of work. According to Locke and Latham (1990), goal setting theory suggests that higher goals lead to higher level of performance by employees.

Activities for which no goals have been assigned are interpreted as less relevant and the attention of the individual is therefore focused on goal-relevant activities. Furthermore, more specific goals make it easier for individuals to direct their attention than more general goals. Second, assuming sufficient ability, the more

demanded from an individual, i.e., the more difficult a goal, the greater the expended effort. Third, given goal commitment, individuals continue to expend effort until the assigned goal is achieved. That is, goals lead to a persistence of effort over a certain period of time, where more difficult goals lead to greater persistence and thus higher performance.

It is commonly observed that most firms however, tend to blend the two types of pays while designing the compensation schemes for the executives. This is done by having base pay which is a fixed rate and an additional pay which is pegged on the achievement of certain set targets which are directly related to a firm's value creation (Gabriel, 2009).

Management discretion is defined as the complexity of the strategic choices and decisions in an organization that is left to the top management to make. Essentially the managerial discretion is the extent to which a firm's form and fate sit within the control of the top managers (Jensen & Murphy, 2010). The weight of this concept lies in the believe that the more the managerial discretion, the more the potential of the managers to impact on the organization's success. Therefore, the executive compensation is expected to be high in higher managerial discretion contexts.

The other insight on the agency theory is concerned with measurement of the performance. This is usually based on the precept that output is measurable and as such, an employees expected performance can be out on to a scale which determines whether the set target are being achieved or not. This theory is assumed to work because typically, the role of any human resources is to ensure that employee's efforts at work are aligned to the firm's strategy (Herdan & Szczepanska, 2012). It is commonly thought that there is no better way to do this than to offer the employees an

extra carrot but only upon them achieving some targets which they would not have otherwise earned had their performance not hit the target. The concept of management discretion is explained in Finkelstein and Boyd (1998) where they refer it as the extent to which a company's key decisions rest in the hands of the top level management. It is therefore, imperative to provide the top management with the right incentive to enable them to make decision that steer the company towards the right direction in line with its strategy. This, then means that the top managers have the ability to directly influence a company's performance.

2.3.2 Heterogeneity and Selection Model Theory

This theory suggests that market offers both fixed term and variable (Piece rate) contracts. If worker have different abilities, the more abled workers produce higher output for the same level of effort. On the other hand, workers who are equally abled will experience lower disutility of their efforts and produce more.

If the same employment contract is then offered to everyone, it will be more beneficial to some than to others and as such, producing a more sorting of workers by contract. A piece rate system will therefore, elicit more efforts from the equally abled employees and as such, result in increased output. This reason for this differs in the case of the two different workers in that the more abled will deliver with their minimal efforts while the less abled will exert more effort to deliver the set target but eventually, irrespective of the workers' differing abilities, same level of output will be realized (Hengartner, 2006).

2.3.3 Group Incentives and Monitoring

Group-based incentive schemes and financial participation are an alternative or a complement to individual performance pay when it is difficult to measure individual performance. This includes situations when individual output is not observable and only group performance can be used to write a formal contingent contract (Gabriel, 2009). The one challenge with the group performance measurement is that as the measurement is taken to a higher level of aggregation in terms of profits or other elements of financial performance, the employer may have an incentive to manipulate the earnings such that the presented results do not necessarily present a true and fair position of the firm's performance and hence, low compensation pay to the employees.

Apart from the issues brought about by the measurement inaccuracies, this model is admired since it largely reduces monitoring costs (Herdan & Szczepanska, 2012). When individual pay is computed on the basis of the aggregate performance of a group, everyone has an incentive to monitor co-workers to avoid drops in output which would be reflected in lower pay.

2.4 Financial Performance

Financial performance means achieving a set goal at certain time and cost. Various measures are employed to assess the performance of a firm. These measures are intended to ascertain whether the firm is making profits or not so that appropriate action can be taken and ensure that the firm is headed in the right direction (Geetha, Mohidin, & Chandran, 2011).

There are financial and non-financial measures however, financial measures are popular because it is easier to access documented sources of information. Raw data might take long while it's tedious and time consuming to achieve. Firms aspire to be the best in the market place and so they have to remain competitive and sustain their profitability, this cannot be achievable without determining the status of their performance (Jensen & Murphy, 2010).

A few approaches are applied to ascertain a firm's performance. When looking at an organization's financial structure measures such as leverage, cash flows, and liquidity are useful indicators. These measurers can be said to be useful in ascertaining the ability of an organization to meet or pay its liabilities as they fall due. They all look at different sub-components of financial structure. Leverage looks at a firm's structure of its sources of finance whether debt or equity.

On the other hand, a firm's ease of converting its assets to cash is measured by liquidity. Current ratio as well as quick ratio is useful measures under this category. One final financial structure measure is cash flow which can be simply defined as the amount of cash that an organization generates through its ordinary course of business (Gabriel, 2009). This can be through its core operations or even from the events which aren't in its core mandate such as assets disposal etc.

2.4.1 Profitability

Colasse (2009) reckons that profitability shows the ability of an organization to add monetary value to the activities it is involved in. This is seen in the ability of an organization to offer goods and services at a price above the costs it incurs to produce such goods and services. The surplus finds from the difference between revenue and

cost is referred to as profit and the ability of an organization to sustainably engage in profitable activities is considered critical in the success of the organization.

Profit however, cannot be used in isolation as an absolute measure to determine an organizations' efficiency. A firm with high profit is not necessarily an indication of a highly efficient organization; neither is a firm with low profitability an indication of low efficiency levels in the organization (Hengartner, 2006). As such, other performance metrics are used which are interconnected with profit include ROA and ROE which are utilized in measuring the status of performance of the firm.

2.4.2 Leverage

This is a measure that is used to show how much of a company's assets or operations are financed by either debt or equity. A firm is considered highly leveraged if its total debts exceed two thirds of its total capital. Debt usually brings about an unconditional commitment of an organization's cash through the payment of interests and principal redemption (Doucouliagos, Haman, & Askary, 2007). On the other hand, a firm that has financed its assets through equity does not have to go through the pain of periodic payments since it is not mandatory for the firm to reward its shareholder by way of cash on an ongoing basis. Besides the returns to shareholder are always from profit appropriation and as such do not affect the profit that an organization makes through inflating costs.

Therefore, a firm that is highly leveraged will be exposed to a higher risk of bankruptcy than one which is equity financed in situations of financial distress (Jensen & Murphy, 2010). However, in good times a highly leveraged firm will always bring better returns than one which is all equity financed. The concept of risk-reward tradeoff is born out of this relationship.

2.4.3 Liquidity

Liquidity is a performance measure that helps determine whether a firm is able to meet its financial obligations in a timely manner as they fall due. A firm which meets its obligations on a timely manner can be referred to as liquid. Assets which are easily converted to cash are referred to as liquid whereas those which are not are called illiquid (Gabriel, 2009). A firm therefore, is required to arrange its affairs in such a way that it is able to pay off its debt obligation as they fall due. An organization in a financial distress is not able to honor its debt covenants and may end to being insolvent in the long run.

Liquidity as a measure can be presented in both absolute and relative terms. An example of absolute liquidity measure is the current ratio which is calculated by subtracting the current liabilities from the current assets (Crespi-Cladera & Gispert,, 2003). To convert this measure from absolute to percentage, a quotient of current assets on current liabilities is obtained. The only disadvantage of liquidity as a measure of financial performance is that it doesn't cover any other source of short term financing such as lines of credit etc. A firm that has negotiated and has access to other sources of short term borrowing always underreports on its liquidity

2.4.4 Cash flow

Cash flow is one of the most important measures of a firm's performance. It is from cash that a firm is able to pay off its providers of resources. A firm which is reporting profit but has not cash flow is more often under more solvency risk than a firm which is reporting losses but has cash flow to meet its obligations. Whether cash is generated from Operation, sell of a assets, or from financing from providers of capital, it is critical to ensure that a firm remains on a positive cash flow position (Niap, 2012).

In line with the goal of shareholder's wealth maximization, the ultimate measure of a firm's value is the stock price. However, it is not prudent to judge the managerial performance using only the stock price since there are more often than not many other factors which contribute to the stock price of the firm and which are not in the control of the executives.

2.4.5 Growth as a performance measure

The use of growth as a measure of performance has attracted wide literature. Growth is one of the most important metrics as it presents the organizational ability to constantly remain competitive in the modern day dynamic business environment (Hengartner, 2006). As a research topic however, growth has attracted mixed results mainly because of the many ways that different firms use to measure growth.

The main issue though is the fact that growth alone may not offer conclusive answers to the performance question. Firms which are in their high growth stage may not necessarily be considered to be performing well (Hengartner, 2006). This is because of the need to plough back the retained earnings onto to fund the operations of the growing firm. If the retained earnings aren't sufficient, a company is forced to either issue more equity or incur more debts to sustain the growth. On the other hand, a large firm or an organization which has had its growth cycle almost complete is considered to be more stable and in a better position to withstand a lot of pressures that come with the business environment (Herdan & Szczepanska, 2012). This is achieved because the company is able to benefit from aspects such as economies of scale or economies of scope. There has been in effect mixed results on the studies done on the relationship between growth and profitability. In some instances growth pursuit may

be have a positive correlation with profitability while in other instances there could be inverse relationship (Gabriel, 2009).

2.5 Empirical Review

Various studies have elicited mixed results on whether there is a relationship between Executive remuneration and firms' performance. Martin, Lewellen and Loderer(1992) found out that there exists a positive relationship between firm performance and CEO compensation. In addition, they also found that there exists a positive correlation between the percentage of CEO stock owned in the company and the performance of the firm as measured by the stock price. Based on the finding therefore, it can be inferred that CEO's compensation can be successfully used to align with the Murphy (1985) also found out a positive correlation between a CEO's pay and a firms increase in earning. In his paper, he concluded that one percent increase in a COE's pay led to a ten percent increase in the firm's value as measured by the stock price.

Jensen and murphy (1990) also found out that there was a significant relationship between CEO's pay and a company's financial performance. According to them, an increase in the CEO's pay by USD2.59 led to an increase in the company's value by USD1000. However, it was suggested that this relationship between CEO's pay and the firm value even though it is statistically significant, isn't significant enough to be used to provide incentives to the Executives.

Smyth and Boyles (1975) however proposed that in an environment which is regulated by the rate of return, the main reason for compensation is to increase sales and opposed to increasing profit. This therefore infers that sales growth is always positively linked to the executive compensation as also concluded by Kato and Long (2004). In addition Kato and Long found out that Chinese firms CEO's would be

penalized for negative profits as opposed to declining. This then meant that as long as the CEOs are able to keep the firm profitable they would avoid being penalized. However, they would also not get rewarded for increasing profits and as such the relationship between the two wouldn't be used to come up with compensation schemes. The other factor that has made it even harder to link the executives' compensation with the firm's performance is the rise of corporate governance requirements which now forces firms to have separate individual holding the roles of CEO and Chairman of the board of directors.

Closer home, Aduda (2011) found a negative and non-significant link between executives' compensation and Commercial banks performance in Kenya. In the Kenyan banking sector the key determinant of Executive remuneration was the size of the bank as opposed to the performance. In large banks, Aduda observed that even in periods of declining earnings, the executive compensation remained high where as in smaller one the pay remained significantly low even in periods of better performances.

2.6 Moderator Variable

Capitalization of the market is the market value of the dollar of the firm's outstanding shares. This is also referred to as 'market cap' which is obtained by multiplying the firm's outstanding shares by the present market price of a share. Investors use this approach to find out the firm's size as opposed to the utilization of sales or cumulative figures of assets. Using capitalization of the market to find out a firm's size is essential since it is a determinant of several traits which interests many stakeholders.

Listed firms are ranked in accordance to their capitalization to the market; this is grouped in 3 categories: large-cap, mid-cap and small-cap firms. Arguments have

been raised concerning the size of the firm being the basis of financial performance of the firm. Larger firms have high survival chances which are attributed to their advantages linked to the economies of scale.

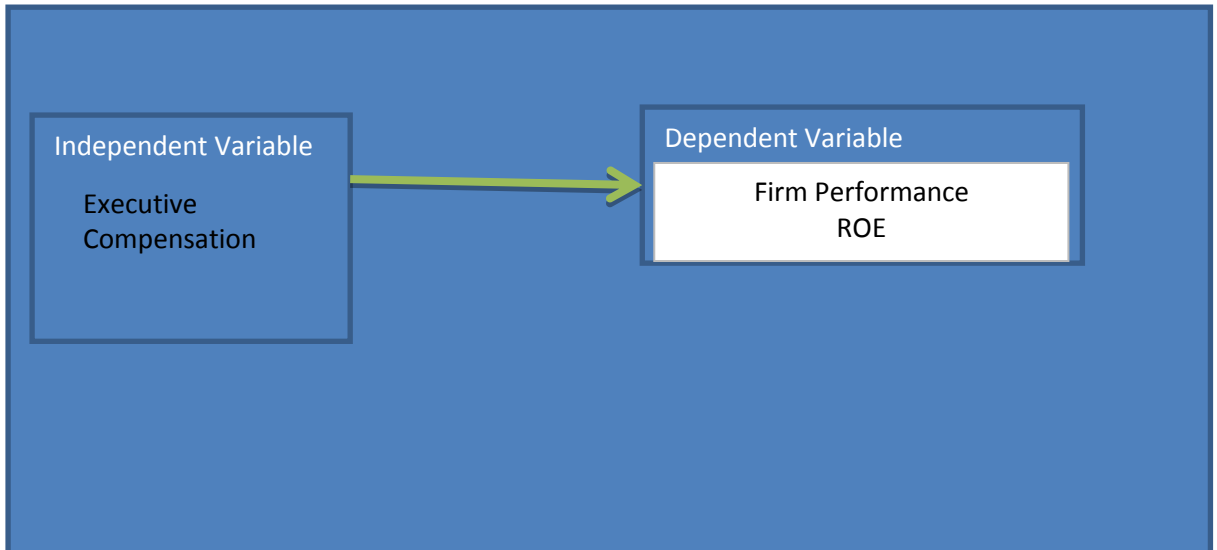
2.7 Summary of the Literature Review

Conversed in the chapter includes the theoretical and empirical views. Under the theoretical perspective much emphasis has been given on avoidance of risk, measuring performance and the role of the executive in decision making. One major contribution of the theory is agency conflicts which emanates from failure by the management to consider the interest of the stakeholder and how compensation schemes influences performance of the firm.

Empirical findings show a mix of reactions where a few scholars show that executive compensation influences firm performance while majority of the scholars find non-existence of a significant link between this variables. Aduda (2011), found a non-significant link between executive compensation and firm performance. On the other-hand, Murphy (1985) and Coughlin and Schmidt (1985) indicates the existence of a significant linkage. Going by the findings put forward, and the arguments rose concerning the executive compensation, payment structure, perks and other benefits which are perceived to influence firm performance, this study find it worthwhile to test the nexus between executive compensation and firm performance of listed firms at NSE.

2.8 The conceptual Framework

Table 2.1 the below table shows a diagram explaining the independent, dependent and the Disturbance variables to be applied in the research



The conceptual framework takes into account three variables and takes the linear equation $y=f(x_i)$ where:

- Y = the dependent variable (the firm performance measured by ROE)
- X_i = the Independent variable (Executive compensation measured by Directors fees)

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

A description of the research methodology has been given to explain how the researcher intends to make an investigation about executive compensation and firm performance.

3.2 Research Design

This study implemented descriptive survey. The choice of this design was motivated by the need to test the link between study variables and confirm the set out hypothesis. A descriptive research design is meant to detect the state of affairs of an organisation through making an establishment of how variables relate (Cooper and Schindler, 2008).

3.3 Population of the Study

Kothari (2008) defines a population as collective number of units for making inferences. Thus the group is constituted of all possible observations of traits of interest where a collection of observations that present a small portion of the population is considered to represent a sample. NSE comprises of approximately 66 listed companies with a daily trading volume of approximately Ksh.1 billion, with a market capitalization of Ksh. 2.3 Trillion. The firms that were operational in the research period were considered.

3.4 Data Collection

This study used documented data sources of data which was derived from Capital Markets Authority. This covered five years, that is, from the year 2010 to 2014. The data mainly comprised the audited financial statements and additional secondary information contained in the annual report of the companies. Secondary data was accessed based on availability.

3.5 Data Analysis

Data analysis was realized through the help of descriptive and inferential statistics were employed. Analysis was performed using Statistical Package For Social Sciences (SPSS) package. Descriptive statistics that was generated such as percentages, mean scores and proportions were presented in tables. The qualitative method was used to uncover and understand what lies behind the phenomena under study (Nachmias & Nachmias, 2008). A multiple regression equation was implemented to test the effect of executive remuneration on the financial performance on the NSE listed firms.

Table 3.1 calculation of executive compensation and financial performance ratio

Financial performance Ratio	
Return on Investment (ROE)	
Executive compensation	
Executive remuneration	Salaries and bonuses paid in cash
value of Non cash benefits	Other fringe benefits such as medical insurances, pension plans, holidays etc.

Since the financial performance (ROE) depends on the executive remuneration, the multiple regression was as below:

$$\text{ROE} = \beta_0 + \beta_1 (\text{EC}) + \beta_2 (\text{MC}) + e$$

Where e – error term.

Based on the above regression model ROE became the dependent variable whereas Executive Remuneration (EC) and our control variable Market Capitalization (MC) became the independent variables. A detail analysis was carried out with the help of above indicators. Comparisons were supported by measuring the “p-value”, that is to say, the probability level ensured the significance of the results and established that the comparisons were statistically valid (the limit of significance will be set at 0.05 or 5%).

β_0 = Constant

β_1 β_3 = Coefficient of the independent variable

(EC) = Executive Remuneration

(MC) = Market Capitalization

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSIONS

4.1 Introduction

Conversed in this chapter includes analysis of data and interpretation which is guided by the research objective. Descriptive and inferential statistics have been applied to establish the trend and the link that exists between variables under investigation.

4.2 Descriptive Statistics

In this section, the investigator established the mean and the standard deviation for all the study variables presented in Table 4.1

Table 4.1 Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
ROE	217	.00	16.25	1.7344	2.35538
Directors Fees	217	.00	7.83	.1750	.52458
Market Capitalization	217	.00	23.17	.4300	1.50001
Valid N (listwise)	217				

The outcome showed that ROE increased from .00 to 16.25, directors fees increased with a percentage of 7.83, market capitalization also increased with a percentage of 23.17.

4.3 Pearson Correlation Coefficient

The research study measured the statistical strength of a direct link between variables. The outcome realized is presented in Table 4.2 below.

Table 4.2 Pearson Correlation Coefficient

	ROE	Directors Fees	Market Capitalization
ROE	1		
Directors Fees	.094	1	
Market Capitalization	-.008	.005	1

The results found the existence of no correlation between directors' fees and market capitalization with return on equity. The scores of correlation established include .094 and -.008.

4.4 Regression Analysis

The study estimated the link between compensation schemes for top management executives and financial performance for modeling and analysis.

Table 4.3 Model Summary

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.133 ^a	.018	.009	2.42250

a. Predictors: (Constant), Market Capitalization, Directors Fees

Coefficient of determination attained a value of .018 which meant that compensation for top management executives explained an estimated 2% change in financial performance of listed firms.

Table 4.4 Analysis of Variance

ANOVA ^a						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	22.693	2	11.346	1.933	.147 ^b
	Residual	1255.856	214	5.868		
	Total	1278.549	216			

a. Dependent Variable: ROE

b. Predictors: (Constant), Market Capitalization, Directors Fees

The outcome indicated that the regression equation implemented for the study was insignificant. It is because the p-value exceeded five percent, .147.

Table 4.5 Model Coefficients

Coefficients ^a						
Model		Unstandardized Coefficients		Standardized	t	Sig.
		B	Std. Error	Coefficients		
				Beta		
1	(Constant)	1.659	.204		8.117	.000
	Directors Fees	1.489	.760	.133	1.959	.051
	Market Capitalization	-.016	.102	-.011	-.161	.873

a. Dependent Variable: ROE

The obtained regression equation is as below:

$$Y = 1.659 + 1.489X_1 - .016X_2 + \varepsilon$$

Y = Financial Performance

X₁ = Directors' fees

X₂ = Market capitalization

Directors' fees and market capitalization were insignificant in describing the nexus between directors' compensation and financial performance since their p-values were higher than five percent, .051 and .873.

4.5 Discussion and Findings

Directors' fees, market capitalization and return on equity increased in the study period with the following proportion: 16.25, 7.83 and 23.17 respectively. This growth can be attributable to an increase in directors fees which motivates them to perform hence resulting into improved performance of firms. These results abide with Tarus et al. (2014) indicated that executive compensation firm's performance increased in the study period.

Lack of existence of correlation was found between directors' remuneration and market capitalization with equity return. The correlation figures were .094 and -.008. These results tally with Kurawa (2014) who observed that there lacked a correlation between directors' compensation schemes and financial performance. To support this, Geetha et al. (2011) also found no correlation between financial performance and directors' fees.

Coefficient of determination attained a value of .018 which meant that compensation for top management executives explained an estimated 2% change in financial performance of listed firms. Capitalization of the market and directors' compensation schemes were found to be insignificant since their p-values were greater than 5%, .051 and .873. This output corresponds with the observation made by Aduda (2011) who concluded that there was non-existence between executive compensation and performance.

CHAPTER FIVE

SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

Presented in the chapters is the chapter is summarized results and conclusion for the study as per the laid down objective.

5.2 Summary of Findings

The results showed that directors' remuneration, capitalization of the market and financial performance increase in the study period. These results confirms to a research investigated by Aduda (2011) who indicated that executive compensation and firm return increased over the study period.

No correlation was established between financial performance and executive remuneration, these contradicts the outcome by Kurawa (2014) who found existence of a correlation between executive compensation and performance of Nigerian banks. On the contrary, Aduda (2011) found that there existed no correlation between executive compensation and performance.

Capitalization of the market and executive compensation were insignificant. This outcome is in line with Aduda (2011) who found a non-significant link between executive compensation and performance. Market capitalization was related negatively to firm performance, this abides to the argument raised by Nyaoga (2014) who found a negative connection between executive compensation and performance.

5.3 Conclusion

The study concluded that found non-significant nexus between directors' compensation and financial performance of listed firms. However, executive fees were positively related to financial performance. Market capitalization was also found to be insignificant but negatively to performance. The negative correlation is a suggestion of capping of directors' fees to enhance maximum gains to shareholders.

5.3 Recommendations

Listed firms should seek to boost their productivity to enhance profitability. It would be appropriate for commercial banks to tailor their compensation and reward schemes to performance to encourage employees to continuous work hard and achieve their targets this will enable listed firms to achieve desired results.

The study recommends on the need to sponsor the executive management team in specialized training and development programmes. This will polish their skills and proficiency in policy implementation, investment decisions and efficiency resulting into reduced cost of operations and improved performance.

The results of this research concluded that executive fees do not persuade managers to pay increased dividends to the stakeholders, it would therefore be necessary for top management to review their decision concerning directors' fees.

5.4 Limitations for the Study

The study was limited to secondary sources of data which is too general and vague and might not really assist the researcher to get accurate findings. This is because some of the information on the computed variables was out-dated. Raw data is more accurate because it reflects the exact needs of the researcher.

Only four study variables were utilized in this research which includes executive compensation, capitalization of the market and financial performance. Performance of a firm is affected by numerous factors such as competence of the executive management and efficiency among others.

Because of constraints of time the research was limited to listed firms at NSE. This scope cannot be utilized to make a comparative analysis. An investigation that would have allowed the researcher to make a comparison would have given room for more comprehensive results whose accuracy and reliability is certain.

5.5 Suggestions for Further Research

It would be useful for researcher to investigate the link between executive fees and other economic factors such as earnings per share and dividends per share. This will give more constructive insights to the investors when making their investment decisions.

Researchers should replicate this study in future using an exploratory research design that takes a longer duration for instance ten years. It will allow the researchers to unearth the 'cause and effect' relation that might be present between variables. More accurate results can be reached.

A study involving similar variables should be performed in another industry locally. This will give future researchers an opening to benchmark the results hence plausible findings can be drawn on the basis of a wider understanding. This will inform the most appropriate measures to apply in measuring firm performance and executive remuneration.

This paper proposes an investigation of the nexus between directors' fees including other factors that affect a firm's capital structure such as debt-equity ratio, leverage among other factors for all the listed firms. This will provide an elaborate means of establishing linkages between variables.

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APPENDICES

APPENDIX I: LETTER OF INTRODUCTION

**APPENDIX II: MEASUREMENTS FOR THE STUDY
VARIABLES**

2010	ROE	Market Capitalization	Directors Fees/Remuneration
		0.15	0.18
	0.51	0.39	(0.08)
	0.04	0.12	0.08
	5.59	0.42	(0.24)
	1.81	0.36	0.07
	1.77	0.54	(0.03)
	1.94	(0.12)	0.06
	7.57	0.03	1.84
		(0.08)	(1.00)
			(0.21)
	0.56	1.00	0.07
	0.23		(0.02)
	0.32	0.46	0.17
	0.34	0.79	0.10
	0.15	(0.05)	(0.11)
	0.26		0.06
	0.20		0.73
	0.13	0.27	-
	0.192	(0.02)	(1.00)
	0.07		0.19
	0.05	0.32	0.21
	0.14	0.95	0.44
	1.82	(0.21)	(0.00)
		-	0.05
	0.87	0.38	0.69
	1.60	0.61	0.08
		0.19	0.15
	0.48	-	(0.01)
	2.73	1.58	0.16
	3.48	1.26	0.15
	0.72	0.25	0.06
	3.92	0.48	0.09
	0.88	0.29	(0.14)
	0.12	(0.01)	#REF!
	3.13	0.66	(0.05)

	0.23	0.62	0.16
	0.29	0.43	0.29
	2.43	0.40	0.47
			0.30
	0.22		
	3.85	0.81	0.36
	3.81	0.86	0.14
	1.31	1.12	0.19
	1.31	0.56	0.84
	0.80	0.31	0.06
	0.04	0.48	(0.03)
	0.96	(0.35)	(0.03)
	2.14	0.34	(0.68)
	0.25	0.21	0.86
	0.63	(0.02)	0
	0.40	0.83	0.05
	0.17	0.16	-
		1.63	
	0.17	1.52	0.04

2011	ROE	Market Capitalization	Directors Fees/Remuneration	2012	ROE	Market Capitalization	Directors Fees/Remuneration
	1.16	(0.16)	0.06		0.89	0.51	0.13
	0.63	(0.46)	0.11		0.66	(0.05)	0.38
	(0.59)	(0.48)	(0.18)		0.33	0.18	(0.27)
	5.70	(0.17)	0.07		7.07	0.54	0.08
	1.78	(0.32)	0.47		2.29	0.21	0.29
	3.10	(0.10)	(0.32)		3.27	1.00	0.00
	1.54	(0.27)	0.45		2.02	0.03	0.11
	6.58	(0.36)	0.30		6.31	0.68	(0.51)
		(0.35)				(0.12)	
	4.50	-	(0.32)		5.41	(0.22)	(0.04)
	0.37	(0.31)	0.27		0.09	(0.03)	0.15
	0.20		0.01		0.17		0.05
	0.21	(0.37)	0.07		0.27	0.94	0.07
	0.29	(0.09)	0.36		0.26	0.23	0.06
	0.10	(0.33)	(0.04)		0.23	0.71	0.33
	(0.49)		(0.46)		0.34	0.20	0.23
	0.26		0.08		0.26	1.43	0.45
		(1.00)	-				-
	0.015	(0.49)			0.02	(0.06)	
	0.21		0.74		0.24		0.19
	0.02	(0.53)	0.05		0.03	0.11	0.48
	0.16	0.01	0.29		(0.76)	0.38	(0.24)
	2.49	(0.22)	(0.08)		4.13	0.19	0.25
	1.83	(0.30)	(0.35)		3.95	(0.30)	(0.10)
	1.11	(0.39)	0.16		1.13	1.13	0.11
	2.32	(0.22)	(0.02)		2.52	0.59	0.10
		(0.25)	0.10			0.34	(0.19)
	0.29	(0.27)	0.15		0.21	1.68	0.28
	3.20	(0.16)	0.09		0.15	0.57	(0.05)
	4.16	(0.32)	0.19		3.30	(0.17)	0.09
	0.45	(0.47)	0.00		0.46	(0.03)	0.21

	5.11	(0.11)	0.28		6.39	0.57	0.15
	1.53	(0.57)	0.06		0.72	0.82	0.22
	0.09	(0.51)	0.03		0.07	(0.10)	0.00
	3.40	(0.37)	0.15		4.42	0.60	(0.10)
	0.32	(0.44)	0.11		0.22	1.24	0.39
	0.22	(0.50)	0.28		0.10	(0.14)	0.38
	3.70	(0.24)	0.28		4.11	0.84	(0.15)
	0.88		0.64		1.43		(0.02)
	0.54				0.79	0.20	
	5.58	(0.35)	0.06		6.53	0.43	0.33
	3.83	(0.19)	0.04		4.62	0.47	0.06
	1.54	(0.37)	0.12		1.84	0.23	(0.16)
	1.20	(0.42)	(0.07)		1.52	0.49	0.24
	1.10	(0.12)	(0.22)		0.90	0.21	0.33
	0.07	(0.44)	0.05		0.14	-	0.31
	2.52	(0.12)	-		1.36	0.15	0.39
	1.73	(0.28)	0.13		1.60	0.07	0.06
	0.21	0.58	(0.22)		0.17	(0.33)	0.07
	0.27	0.13	0.64		0.42	0.26	(0.36)
	0.07	(0.02)	(0.26)		0.02	(0.61)	(0.14)
	0.19	0.25	-		0.15	(0.06)	-
		(0.31)				0.38	
	0.23	(0.12)	(0.10)		0.15	(0.01)	0.15

2013	ROE	Market Capitalization	Directors Fees/Remuneration	2014	ROE	Directors Fees/Remuneration	
	1.34	0.38	0.24		1.25	1.10	0.08
	0.55	(0.32)	(0.36)		(0.89)	(0.42)	(0.44)
	0.22	0.35	0.09		0.85	0.30	0.14
	2.85	0.10	0.13		4.34	0.05	0.17
	2.80	2.26	0.14			(0.59)	(0.01)

					1.93		
	3.39	0.21	(1.00)		4.26	0.52	0
	2.08	0.26	0.17		2.35	0.07	0.08
	11.49	1.13	0.90		8.77	(1.00)	(0.42)
	0.20		0.44		0.02	(1.00)	(0.01)
		0.21			0.23	0.21	
	4.57	0.24	(0.03)		16.25	(0.34)	0.16
	0.18	1.62	0.85		0.42	0.82	0.02
	0.36		0.21		0.21		0.21
		1.24				0.59	
	0.38	1.24	0.09		0.23	0.33	0.05
	0.17	0.73	0.08		0.17	0.47	0.66
	0.24	0.44	(0.05)		0.20	0.09	0.12
	0.16	1.44	0.76		0.12	0.87	0.25
	0.22	0.67	(0.20)		0.16	0.87	0.02
		(0.20)	-			(0.90)	-
	1.316	0.85	-		0.143	0.02	(1.00)
	0.29		0.98		0.22	0.62	0.19
	0.07	0.54	(0.14)		0.04	(0.31)	0.38
	0.07	(0.30)	0.10		0.12	(0.08)	(0.02)
	3.96	0.46	0.57		2.70	(0.09)	0.36
	0.86	0.77	(0.21)		0.69	(0.16)	(0.08)
	1.80	0.76	0.31		0.17	0.48	(0.06)
	2.72	1.00	(0.11)		2.83	(0.08)	0.36
		0.05	(0.06)			(0.28)	(0.05)
	0.27	0.02	0.49		0.29	(0.30)	0.09
	0.65	(1.00)	0.22		1.65	1.89	(0.21)
	3.67	0.35	(0.03)		0.95	(0.26)	0.00
	0.54	0.20	(0.29)		0.58	0.34	0.12
	5.37	0.68	0.09		4.87	(0.15)	(0.10)
	1.61				1.62	23.17	0.03
	1.05	0.15	(0.05)		0.45	(0.36)	0.26

							7.83
		0.11	(0.03)			0.67	0.01
	5.07	0.21	0.05		5.80	0.13	0.31
	0.26	0.52	0.16		0.36	0.16	0.08
	0.11	0.59	0.33		0.12	(0.10)	(0.44)
	4.81	0.58	0.13		5.57	0.23	(0.15)
	1.72		0.07		14.61	0.06	0.35
		1.05				0.40	
	7.17	0.29	0.08		6.62	0.54	(0.31)
	5.94	0.65	0.27		5.89	0.25	0.06
	2.17	0.44	0.55		2.23	0.24	0.22
	2.59	1.10	0.10		2.88	0.43	(0.03)
	0.60	0.13	0.10		0.87	(0.07)	(0.03)
	0.29	0.28	0.06			0.16	0.29
	(1.53)	(0.15)	(0.00)			(0.32)	0.06
	1.89	0.25	0.03		2.12	1.20	0.10
	0.16	0.20	0.05		0.11	0.04	(0.02)
	0.11	0.16	-			0.70	-
	0.01	1.95	0.05		0.00	(0.19)	(0.07)
	0.13	0.06	-		0.09	0.10	-
		(0.05)	-			0.85	-
	0.06	0.38	(0.04)		0.05	1.15	0.15