

**THE RELATIONSHIP BETWEEN PERFORMANCE AND
EXECUTIVE COMPENSATION OF FIRMS LISTED ON THE
NAIROBI SECURITIES EXCHANGE**

BY:

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DECLARATION

I, declare that this is my original work and has not been submitted to any other college, institution or university other than the University of Nairobi for an academic credit.

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

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LIST OF ABBREVIATIONS AND ACRONYMS

AGM – Annual General Meeting

CEO – Chief Executive Officer

CFO – Chief Finance Officer

CMA – Capital Markets Authority

EAT – Earnings After Tax

JSE – Johannesburg Stock Exchange

KPLC – Kenya Power and Lighting Company

NSE – Nairobi Securities Exchange

ROA – Return on Assets

ROI – Return on Investment

ROE – Return on Equity

ABSTRACT

The relationship between executive remuneration and firm performance has been widely discussed in corporate circles. The agency theory being one of the main drivers of the discussion posits that if company executives who are agents of shareholders are well remunerated, they are expected to make decisions that affect the company positively in terms of results and financial performance. This is done through aligning the interest of the executives with that of the shareholder through systems such as a pay-performance incentive scheme. This in effect also reduces the probability of the executives pursuing selfish goals. There have been mixed results in the findings of this study which has been done in different parts of the world. While some have revealed a positive relationship between executive remuneration and firm performance, others have shown a negative relationship or no relationship at all. Findings from such a study would be important in decision making both from the side of a company's board, which is charged with setting remuneration, and also for the shareholders who own the company. This research sought to study the application of this relationship in the Kenyan context, laying focus on companies listed in the Nairobi Securities Exchange. Using a sample of 30 companies, selected across the 11 main industries of the economy as categorized by the Nairobi Securities Exchange, a regression was done to determine the relationship between executive remuneration and firm performance. The dependent variable of the study was the executive remuneration while the independent variable was return on assets. The study also incorporated a control variable which was used as a proxy of other variables that affect the executive remuneration. In this case, it was firm size as measured by the average total company assets. After doing a regression of the dependent and independent variables, the study showed that there exists a positive relationship between the executive remuneration and firm performance as well as firm size. These findings point at the presence of an incentive scheme in Kenyan companies which is hinged on how the executives perform. The benefits of this study are that it opens up transparency on financial reporting of companies and in addition helps in steering the debate on issues such as fair remuneration vis a vis performance and how beneficial it is when it comes to ensuring that the shareholders goals are met. The study will also help in prompting the discussion on other factors that inform the payment of company executives and what weight should be applied to these factors when coming up with pay. Some of these considerations are: risk, level of skill, cash management, return on investment among other factors.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

The topic of compensation to executives and firm performance has gotten a lot of scrutiny and attention in the recent years. Its relationship with firm performance has been a widely researched on topic in corporate governance. In the recent years there has been lots of discussion and contributions on the agency theory with a number of writers and industry players arguing that there should be an alignment of executive compensation with the performance of a firm (Holmstrom, 1979; Jensen, 1990). Agency theory holds that contracts for executive compensation should align the manager's (agents) interests with those of the shareholder(principals). With an increased sensitization for more transparency in companies and an improved corporate governance system by companies, most organizations have had to take various measures to ensure that their regime for remuneration of executives is up to standard (Hughes, 1996). In the past we have seen cases of various companies subverting the will of the shareholders and rewarding themselves with huge perks that are not commensurate with the ability of the company in reference to its financial performance. Companies, through corporate governance, have resulted to various criterions to be adopted when it comes to coming up with an appropriate regime for remunerating its executives and directors. Among the approaches taken up include: a requirement for disclosure of details of remuneration by the companies in their financial statements, the appointment of a remuneration committee who are given the task of determining remuneration packages for the directors, linking of pay to performance so that the executives are not compensated even with failure and finally giving stockholders an opportunity to vote on the company's policy for compensating directors. This has been

witnessed in South Africa (Luiz, 2006) which made a number of recommendations including one on disclosure of executive remuneration.

The JSE securities exchange in South Africa has also adopted extensive disclosure conditions for listed companies in light of remuneration to directors. This includes a requirement that the annual report of every listed company should include a summary narrative of how the firm has implemented the principles laid down in the King Code, and should also give reasons if they do not comply with any of the principles. The United Kingdom has also taken a similar approach to that of South Africa with the adoption of the Greenbury report which set various measures pertaining director remuneration and disclosure requirements (Hughes, 1996). Some companies have also openly set out principles regarding pay to their directors.

This research attempts to look at the relationship if any between remuneration made to company executives and a firm's financial performance

1.1.1 Firm Performance

The financial performance of a company can be said to be the economic condition by the firm as at that particular time. It is measured by the net profit and value of shareholder wealth among many other metrics. To achieve the best results at the end of each financial year, owners of the company will entrust the management of the company to agents who are the directors (Jensen & Meckling, 1976). These agents have an obligation of ensuring that the company performance is top notch and that the shareholder wealth is maximized.

Other key metrics to consider when evaluating the performance by a firm are indicators such as growth in revenue, the return on assets (ROA), the return on investments (ROI),

net profit margins, earnings per share (EPS), price earnings ratio (P/E), the return on equity (ROE) and changes in share price (growth in share price).

Revenue growth as a metric is arrived at by comparing revenue from one financial year to another. As an indicator of firm performance, it would make sense if it grows while the associated costs are contained. This however should be carefully scrutinized if used as a measure of performance as it is vulnerable to manipulation especially through biased accounting. The net profit margin is another firm performance measure and is arrived at by dividing the net profit after tax by revenue. It shows the return by a firm per one unit of sales. The return on equity on the other hand measures the return that the shareholders of a firm get. It is arrived at by dividing the firm's profit after tax with the owner's equity. The return on assets is another key firm performance metric and is computed by dividing the net income with the firm's average total assets. The Return on Assets denotes the percentage of profit a firm earns in comparison to the firm's total resources. Earnings per share is another important metric through which the firm directors and management can be measured against. It is an important investor ratio and is computed by dividing a firm's profit after tax with the outstanding ordinary shares in that financial year. Finally, share price growth as a performance indicator refers to the net change in the share price of a stock. It reflects a capital gain on stock held by shareholders. This is a key metric since it signifies a growth in the shareholder wealth (Kimmel, 1998)

1.1.2 Executive Remuneration

Carola and Dirk (Frydman, 2010) from their paper on CEO compensation, list the main components of executive pay as: fixed salary, yearly bonus, payments from long-term incentive plans and restricted option grants. In addition, they also list benefits such as a defined benefit pension contribution, various non-cash benefits, and severance

packages in case of their exit. The emphasis given to executive compensation will vary in various countries, similarly how optimal a performance based compensation is, will depend on the presence of alternatives of direct monitoring (Maher, 2000).

The owners of a company who are the shareholders (principals) delegate the duties of running the company to executives (agents) who are the senior management. Usually, the shareholders lack the expertise and knowledge of the operations of the business, the managerial actions to be taken and firm opportunities in comparison to the company executives. This information advantage by the management gives them an upper hand and provides an opportunity for the managers to maximise their personal interests as well as income, instead of that of the shareholders. Soon as the principals become aware of this agency problem, they take actions such as designing compatible incentive remuneration schemes. For example, apportioning a profit share to the agents and also bonuses. Compensation to executives could partly act as a way of reducing the agency problem through ensuring that you match the interests of the senior executives and directors with that of that of the shareholder (Jensen & Meckling, 1976).

Excessive remuneration to executives and manipulation of firm financial statements have in various cases been seen as reasons that have led to the collapse of companies like in the cases of WorldCom, Parmalat and Enron (Hill, 2006). The growing concern of what can be said to be excessive remuneration to directors and executives has led to the rise of corporate governance norms which have focused on a drive for an appropriate regime for the remuneration of executives. These advocacy efforts have mainly been on disclosure of this information so as to ensure that there is a lot of awareness when it comes to what directors earn. It is however important to note that

this does not stop at mere disclosure alone. The details of what is disclosed has also become a matter of concern, many noting that enough detail should be given in the disclosure. Such details should include a distribution of the package that each director is paid, giving a breakdown on the different perks.

Conyon and Leech (1993) from their study also determined that director pay tends to be reduced in firm's that have a high concentration in ownership or those that can be said to be largely owner-controlled. Kerin (2003) from his study on remuneration notes that a good mix of executive compensation is one that will accommodate in addition to fixed payments, other incentives which include; short term and long-term incentives, entry and exit benefits and other auxiliary non-cash benefits. The constant pay like that of other employees is not dependent on a firm's performance. It will mainly include the basic salary and other fringe benefits which include medical insurance, car loan facilities among others. Short-term incentives such as cash bonuses tend to be subject to achieving one or more short-term (mainly yearly) target like a certain profit, return on assets, return on capital employed, the return on investment, or more specific targets such as reduction on costs or growth in revenue. Incentives set with a long-term perspective tend to be set so as to motivate the management to achieve, as the name suggests, longer term targets (mainly relating to shareholder wealth maximization for example five years). Their reward will mainly come in form of ways such as the award of a share of equity and/or employees stock options. Benefits given on entry (sign-on bonuses) are payments aimed at ensuring that a potential target accepts the position. This will mainly be in the form of cash or even through straight equity and/or options. Exit benefits are those done when the firm wants to release one of its executives, and this is mainly cash related. Other types of compensation are for example, those given when a merger or acquisition occurs and bonuses which are given so as to ensure that

key personnel (executives) do not leave for a certain time. There are also non-pecuniary benefits. These are non-cash benefits and they range from prestige, enjoyment of one's job, respect from other staff, and membership of exclusive clubs etc. These benefits have been determined to often impact greatly on a CEO's behaviour compared to the other incentives.

1.1.3 Firm Performance and Executive Remuneration

This above relationship has been one of the great discussion in the corporate world with many writers delving into the debate in a bid to understand if there actually exists a relationship between the pay and the emoluments paid to company executives (directors), and the financial performance of the companies that they run. A natural assumption by writers such as Jensen and Murphy (Murphy, 1990) has been that since there exists an agency problem as stated earlier, then it is prudent to ensure that directors are paid well so as to eliminate a scenario where directors act to promote self-interest. Jensen and Murphy go further to elucidate their proposition by stating that since the director's act as agents of the shareholders, then it is only reasonable that there must be a linkage between the pay made to the directors and performance of the company.

Executive compensation also tends to factor in the issue of incentive by the director to deliver results (Holmström, 1999). Holmstrom in his paper suggests that to avoid the case where senior directors are engaged in hazardous behaviour such as very risky projects, most companies will develop enhanced but optimal compensation packages that have a fixed component in form of the salary and the other component in form of ways such as bonuses and stock options. The benefit of such a package is that since the shareholder is not able to know which action is value maximizing, an incentive contract will fill in this gap because the agent is now aligned to attend to the principal's ultimate objective of safeguarding and increasing the shareholder value.

Conlon and Parks (1988) and Fama (1980) posit that executive compensation should be linked to a firm's performance. They take this position because in the long run both the company executives and the shareholders as well as other stakeholders by extension will benefit. Wolfram and Rose (2002) hold that a company should take into consideration the effect and impact of tax when determining pay since this could play a significant role in the remuneration based on performance.

It is however important to note that there are various challenges faced when effecting a compensation scheme that is pegged on a firm's performance. Murphy (1997), suggests that majority firms want to develop an executive compensation package that will attract the very talented individuals while others accordingly want to be the company that pays best. A similar position is held by Lazear and Rosen (1981) in their compensation tournament theory which states that individuals (in this case, executives) are normally in competition for promotions and other rewards and benefits. The top performing executives who have great potential and a considerable wealth of managerial experience get the promotions and commensurate high compensation. Therefore, when a firm hires company directors and executives either internally or from without, the compensation package that is initially designed is not based on performance but is instead one which aims at attracting the executives. Lazear and Rosen (1981) however also say that at the onset of most contracts, performance of the executives will tend to become an important consideration in remuneration.

Another problem that arises in implementing a pay based performance is that there lacks a proper yardstick against which you evaluate a firm's performance (Gibbons, 1999).

1.1.4 Firms Listed on the Nairobi Securities Exchange

The Nairobi Stock Exchange, as was previously known, was officially opened in the year 1953 after an approval by the London Stock Exchange which accepted to recognize it. It was later registered under the Societies Act in the year 1954 as a result of a voluntary association of stockbrokers and they were given the responsibility of laying structures and developing the securities market and regulating trading activities. The bourse has four main segments which are: the main investment segment, the fixed income securities segment, the alternative investment segment, and the futures and options market segment. Currently there are 67 companies listed with the NSE with a market capitalization of Kshs. 2,443.42 billion as at 12th September 2017 (NSE website, 2017).

A number of companies listed in the NSE have overall registered an improved financial performance after the 2008 financial crisis which affected most firms worldwide including Kenya. Data from the NSE 20 share index shows an improvement from 2,400 points in the early 2009 to a recent all-time high of 5,499.64 points in 2015. The compensation of top executives of some of the listed companies have consequently risen in the same period with recent disclosure statements released in the year 2017 revealing that the CEOs of Sameer, Kengen, NSE, Deacons, Kenol-Kobil, Kenya Re and Sanlam all received increments in their pay from their previous year (Business daily, 2017).

1.2 Research Problem

It is clear that with the acknowledgement of the agency problem, many researchers have sought to establish the presence of a relationship between executive remuneration and firm performance. Several studies have been done in the western countries notably the

UK and the USA. Many researchers have however confessed that this topic is not as straightforward as it seems, and therefore doing a peer to peer comparison between countries would be an exercise in futility since each country has its own unique circumstance and specific laws that govern the corporate environment. That notwithstanding, various studies have been done and a number have shown the presence of a positive relationship between executive compensation and the performance of a firm.

In Kenya, we have a myriad of publicly listed companies and they have directors who are very well remunerated compared to other junior employees. Past talent surveys done by PricewaterhouseCoopers(PWC) in the year 2009 revealed that in Kenya top executives earn an average of 1.03 million Kenya shillings which reflects more than 300 times, what the least paid employee earns in the same organization.

Basing my study on the agency theory, the study seeks to examine if there exists a relationship between firm performance and the executive compensation. It is however important to note that existing corporate governance measures in Kenya have not adhered to utmost level of disclosure yet, and therefore it is still difficult to establish the exact pay that each director gets and how much for each category of remuneration/ emolument.

In the Kenya scenario, the corporate environment is quite competitive, with several big firms competing against each other for bigger market share and for higher profitability. This has brought about a contest pitting top directors who have had to be highly compensated for their services. In a few cases, there has been movement by top management from one organization to another, as firms seek to consolidate staff who they consider performers and think will lead the firm to great success. This therefore

makes the Kenyan market ripe for a study to be undertaken to seek to investigate the extent of relationship between director remuneration and firm performance. While considering this, it will be important to note that directors in this case encompasses the very high-level employees such as the CEO& CFO and the board directors who influence major decisions in a company.

Past researchers on the topic in Kenya have encountered lots of setbacks as a result of the lacking detailed and candid disclosure by companies on executive compensation. Another problem that has been encountered is the lack of a definitive stance on the relationship between executive pay and firm performance.

Rupaleria (2016) who did a paper researching on the relationship between firm performance and board remuneration in Kenya's financial sector, focussing on commercial banks, insurance firms and investment companies listed in the Nairobi Securities Exchange, found that using data for the period between 2003 and 2013, there was no significant relationship between board's remuneration and return on assets, return on equity and earnings per share of these companies. Miyienda (2013) also did a study on the relationship between director remuneration and the performance of firms listed in the Nairobi Securities Exchange and concluded that there was a positive relationship between the remuneration to directors and the return on equity, earnings after tax and the Tobin Q which were his measures of firm performance.

In light of the above two studies which have yielded mixed results, this study will seek to use recent data from these companies and therefore will be an important contribution to the area. Also, with the recent push for companies in Kenya to uphold sound corporate governance practices as well as adhere to high level of disclosure in the area of executive pay, the time is ripe for a study to be done in the area. This study intends

to answer the question, “What is the relationship between the firm performance and executive pay of companies listed on the Nairobi Securities Exchange”.

1.3 Research Objective

To determine the effect of executive compensation on the financial performance of firms that are currently listed in the Nairobi Securities Exchange.

1.4 Value of the Study

The findings of this study are expected to contribute to the current discourse on corporate governance. Specifically, interested stakeholders of corporations (primarily the minority shareholders) would be able to determine whether the remuneration received by directors of the companies that they have invested in are justified in terms of it being associated with firm performance.

The remuneration committee and the firm owners using this information can make more informed decisions on hinging pay to performance knowing the relationship that these two have. Also, investors can use information from the findings of this study to make better decisions in terms of which stocks to invest in, knowing the potential that lies in executives based on their pay.

Finally, this study comes in handy in establishing the extent to which Jensen and Murphy’s assertions of the agency problem, have had on the Kenyan market.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter reviews and discusses the various school of thoughts espoused by different researchers on the topic which in this case is the relationship between executive remuneration and firm performance.

2.2 Theoretical Review

These are theories explaining the relationship between financial performance and executive compensation.

2.2.1 Agency Theory

The agency theory simply encompasses a relationship existing between two parties, a principle and an agent. It could also be defined as a mutual contract between a principal and agent, with the agent tasked to perform a service on the principal's behalf and this involves passing on(delegating) the authority to make decisions to an agent (Jensen & Meckling, 1976).

Jensen and Meckling (1990) are some of the earliest contributors of the agency theory. They both argue that managerial compensation is at the centre of agent costs. They postulate that with the existence of an agent relationship, between the management of a company and its shareholders, then points of friction would arise (Murphy, 1990). The problem they say comes in where the management who are the agents of the shareholder, and the shareholder disagree in the goals and objectives of the firm and the priorities involved. Also, when agents are tempted to promote their interests instead of that of the shareholders. Another problem comes up because it is not easy for the principal or shareholder to know what the agent is doing. They therefore deem it prudent to ensure that directors are paid well so as to eliminate a scenario where

directors act to promote self-interest. Jensen and Murphy go further to elucidate their proposition by stating that since the director's act as agents of the shareholders, then it is only reasonable that there must be a linkage between the pay made to the directors and performance of the company. To counteract the chances of the agents pursuing own interests, the principals will come up with various checks to constrain the agents' actions so that they serve the shareholder's(principal) interests (Fama, 1980).

2.2.2 The optimal Contracting Theory

The Optimal contracting theory by Michael S. Weisbach is a classic economic theory of executive compensation that is meant to minimize managerial agency costs and maximize shareholder value. In this theory, executive pay packages are developed by company boards who aim at providing the executives with efficient incentives so that they can maximize the shareholder wealth. Optimal contracts are developed either from an arm's length bargaining or as a result of constraints in the market that induce the executives to accept the contracts even without extensive bargaining. In a nutshell, this theory could be argued to be all about setting an executive pay that gives the incentives that are needed to ensure the interests and goals of risk shy executives and their behavioural outcomes are aligned with the interests and expectations of the shareholder. Optimal contracts that are outcome based are arrived at from an efficiency arguments basis and this is one of the highly efficient trade-offs between the different types of agency costs that aim at reducing the residual losses for shareholders (Jensen and Meckling, 1976).

2.2.3 Managerial Power and Governance Theory

This theory changes the earlier focus from viewing executive compensation as a consequence of the agency problem to one where there is a power balance struggle that exists between firm executives and its shareholders. The balance in power between the executives and the shareholders will therefore impact on the structure and amount of executive compensation.

The managerial power theory in addition posits that because of the principal and agent relations, the agents will tend to manipulate pay to their own advantage. The design of the contract in terms of pay is thus not a solution to the agency problems but forms part of the challenge to arriving at an optimal pay (Bebchuk, 2002). Bebchuk also asserts that the executive compensation determinants are not consistent with shareholder wealth maximization benchmarks. This is because the executives have a high bargaining power when setting their terms of employment and compensation. However, with the threat of the high level of public awareness as seen in the financial press and through other watch dog organizations, they will always seek ways of hiding the huge perks.

2.3 Determinants of Executive Compensation

Violeta (2015) analysed various determinants of executive compensation and based on their characteristics narrows down to two main distinctions namely; external and internal determinants. The groups are mainly differentiated based on the environment where the firm operates and the influence that the firm has on this factors. On the first group of determinants, she considers factors such as labor market conditions, the country's level of wages, the economic activity engaged in by the company, living

standards, the government policy, company ownership and trade unions. The second group comprises of factors such as the unique value of the task, relative value of the employee, size of company and the ability of an employer to pay a certain amount of pay. Violeta however notes that the impacts of these determinants is not the same and therefore each factor will have a different impact on wage compared to the other.

The Classical economic theory holds that the amount paid in wages is based on the labor market: if the demand of labor grows, then the wages will rise and vice versa (Kakabadse et al., 2004). The Human Capital Theory on the other hand focusses on a rationale of exchange where an employee rents out his expert knowledge, skills and experience to an employer who in return gives the employee a salary and other excellent working conditions (Laing & Weir, 1999). At the end of the day, the employer will want a return on his investment in the employee through good productivity and efficiency in execution of duties and tasks. The efficiency wage theory posits that the willingness of an organization to pay more than the current is hinged on the hope that a higher wage consequently increases the organization's productivity (Halaby, 2014).

Baker (1988) suggests that a positive relationship exists between the size of a firm and the level of compensation to executives. This positive relationship could be explained both by the firm's internal organization as well as the external labor market. Child (1973) explains that based on the internal organization argument, findings have revealed that as for the large firms, they will tend to have more hierarchical levels when compared to small firms. Consequently, high compensation levels for executives are considered important in ensuring that adequate compensation exist for the differentials between the hierarchical levels across the firm (Gomez-Mejia et al., 1989; Simon, 1957). An assumption is also made for the case of those executives who work and manage large and complex firms, claiming that since such executives require some

extra knowledge and ability in comparison to executives running smaller and less complex firms, then the managers of the larger firm should get a higher level of executive compensation (Becker,1964; Rosen, 1982).

Deckop, (1988) lists industry effects, the experience of the executive and how the executive attained that position as other factors that would determine the executive compensation. If the executive for example is recruited externally, he/ she may require a premium as an incentive for him to change firms, but for those promoted internally, they would be willing to accept even a lesser pay once they are promoted. If the executive is also a founder or owner of the firm, then due to his ownership stake, he is in a position where he can influence the amount of pay that he receives.

2.4 Empirical Review

2.4.1 Global Studies

Komera (2016) did a study on the relationship between executive performance and firm performance amongst Indian firms. Her main variables were executive compensation, return on equity and return on assets as the firm performance measures, Tobin Q and annual stock return as the market based measures and size as the control variables influencing the pay performance relationship. Using data from the Centre for Monitoring India Economy, she surveyed 21,834 companies and did a regression with executive compensation being the dependent variable. The study determined that executive compensation was influenced by past executive pay, firm size and ownership. It also revealed that there existed a pay performance relationship when one considers the firm performance measures and it lacked when the market based measures were considered.

Kibet (2014) did a study on 20 firms all public listed companies in the UK, seeking to determine the determinants of CEO compensation. His dependent variable was executive pay and CEO ownership, independence of directors and firm's profitability were the independent variables. Upon doing a regression using data from the year 2008-2010, he found out that there was a significant and positive relationship of CEO ownership on the executive compensation. He also found that the percentage of independent directors had a significant relationship with a decrease in CEO compensation. Finally he found that the profitability of a firm, which is a sign of firm performance, had a positive relationship with the CEO compensation.

Shah, Abbas and Javed (2009) surveyed 114 companies listed in the Karachi Stock Exchange in Pakistan from 2002 and 2006. They sought to investigate the determinants of executive compensation empirically, using data from Pakistani listed companies. A simple regression was done with the key variables being CEO compensation as the dependent variable and the return on assets, return on equity, firm size (total assets) and board dynamics as the independent variables. They noted that even with the existence of a positive relationship between executive remuneration and firm performance, it was not significant (weak). They also noted that firm size was a key determinant when arriving at the executive pay.

Kato and Long (2006) using a sample of 827 companies listed on China's Shanghai and Shenzhen Stock Exchanges and data from 1998-2002 conducted a study seeking to establish the extent of relationship between executive compensation and the performance of firms, with return on assets as the main measure of firm performance. From their study they established that a more statistically significant relationship and elasticity between executive compensation and firm performance exists, more than had been arrived at by Jensen and Murphy.

Aditya and Krsihnakumar (2006) also did a linear regression model on 409 Indian companies listed at the Bombay Stock Exchange as they sought to investigate the determinants of executive compensation, with firm performance, corporate governance parameters and shareholder wealth being the main variables. They concluded by noting that while the net profit margin and the return on assets, which were the main measures of performance, did not have a significant relationship with executive performance, the firm size was a significant variable that explains the CEO pay and the proportion of the incentive pay that the executives receive.

Salleh Hassan (2003) did a study on the relationship between directors' remuneration and firm performance in Malaysia. The study which involved doing a regression using a sample of 100 listed companies from the period 1996 - 1998 found the relationship to be a positive one. The relationship was however not strong and this could be attributed to the prevailing structures of corporate governance that exist in the country. The results further showed a much weaker relationship between remuneration to directors and the financial performance compared to that between directors' remuneration and internal growth measures for all the three years from 1996 to 1998. In this case, internal growth measure will include total assets and the turnover made by the firm. Financial performance was then measured using measures such as firm's net profit, EPS and ROE & ROA.

2.4.2 Local Studies

Butoro (2014) studied commercial banks in Kenya seeking to study the relationship between their financial performance and compensation to its executives. Using a sample of 17 banks and data from the year 2009 - 2013, he found out that the return on equity as a measure of financial performance has a positive but insignificant

relationship with the remuneration of directors in the case of commercial banks in Kenya.

Injeni (2010) studied Directors Remuneration and Firm performance, limiting his study to 37 companies listed in the NSE from the years 2003 - 2008. From his study, he noted that remuneration to executives has been on a rise but the performance of firms has tended to stagnate and even declined in some cases. His regression analysis yielded mixed relationships in the comparison of executive remuneration and the different firm performance measures. He used revenue growth, net profit margin, return on investment, return on equity, earnings per share and share price growth with some being positive and others negative. Also to note is that, most of the companies yielded a positive relationship between executive remuneration and all the performance indicators (except for share price growth). However at the end, the null hypothesis which was "*There is no strong positive relationship between executive remuneration and firm performance*" could not be rejected. The study therefore concluded by saying that there a strong positive relationship between executive remuneration and firm performance lacked.

Mululu (2005) using data from 48 listed companies from the year 1998-2003 examined the relationship between board activity and firm performance of firms listed at the NSE. She did a regression on the variables which included the board size, number of directors and the total compensation and she found that the corporate governance structures of a firm are positively correlated to the executive compensation and also tend to be more subject to influence from the CEO. She also noted that the activities of the board are positively related to the financial performance of firms which suggests that they are a relevant component of value creation. Finally she notes that the CEO is able to

determine his/her benefits through interference with the appointment of non-executive directors and also members of the remuneration committee

Ogoye (2002) did an empirical study on the relationship between management compensation, firm performance and sales using 41 publicly listed companies in Kenya between the years 1994 -1998. Through regression and using the Return on Asset and Return on Equity ratios as proxies for performance, he established that the relationship between the management's compensation and firm performance was negative and statistically insignificant. He further determined that sales had a strong and positive relationship to management compensation.

2.5 Conceptual Framework

This study is carried with the agency theory as a key assumption and reason for the relationship between company executives and the shareholder. Due to the separation in the control and ownership of a firm, a conflict exists between a firm's executives who are charged with management and its shareholders will often tend to exist (Jensen and Meckling, 1976). If these directors and executives are not monitored and checked, they will tend to selfishly pursue their own needs while in the company while ignoring the needs of the shareholder. In this study, executives refers to the directors and the very senior managers directly involved in the management of a company. This includes all the directors in the board and company chief executive officers.

Also to note is that executive remuneration incorporates all the benefits earned by the executives. Bonuses and stock options will be expected to be other common forms of executive remuneration.

Below is an illustration of the conceptual framework:

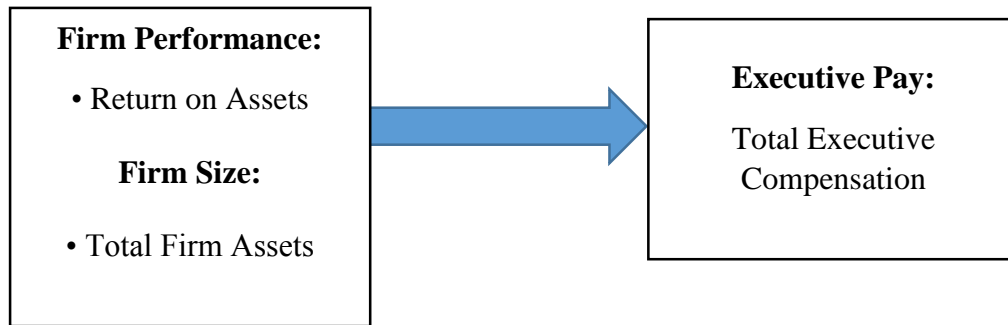


Figure 1: Conceptual Framework

From the illustration, the Executive pay is the dependent variable while firm performance and Firm size are the independent variables.

Other control variables that influence the executive compensation include factors such as sales, age of the executives, wealth of experience of the executives and qualifications.

2.6 Summary of Literature Review

The three theories mentioned above: the agency theory, optimal contracting and the managerial power and governance theory have at length helped in expounding on the relationship between executive pay and a firm's performance all majorly giving different perspectives on how the executive pay is arrived at. The theories however differ on the basis of executive pay and the extent to which any basis is relied on when it comes to arriving at the final pay to executives. Different studies conducted all over the world have yielded mixed results either randomly or through methodology and timing differences. The effect of other firm specific factors like board size and CEO quality have also continued to gain ground in explaining the pay performance

sensitivities (Bebchuk, 2002). This study will aim at checking the pay performance relationship in Kenya using recent data as obtained from the NSE and firms' books of accounting.

CHAPTER THREE: RESEARCH METHODOLOGY

This chapter gives the criteria and method used to address the research objectives and questions. This chapter also includes the research design, the researchers target population, the sample and sampling methods used, the methods of data collection and other procedures used, and finally the method used to do the data analysis as well as the procedure used when testing your hypothesis.

3.1 Research Design

The research design used is of a descriptive cross-sectional nature. This is where data is systematically gathered over a period of time with the aim of answering your research objective and questions. The descriptive cross-sectional design is suitable for this study because of the need to establish any causal relationship between executive compensation and financial performance. In seeking to establish this relationship, an analysis of the financial information (quantitative) will be done. This method is justifiable since it is possible to quantitatively get the remuneration and performance variables.

Data collection was mainly through referring to the company's financial statements which are readily available and also data from the Nairobi Securities Exchange.

3.2 Target Population

The target population in this case was companies that are listed on the Nairobi Securities Exchange (NSE). This study chose these companies since for one their information is readily available due to corporate governance requirements by the CMA. Also by virtue of being publicly listed, they have several shareholders thus meeting the principal agent criteria.

The firms that are listed in the Nairobi Securities Exchange have several sources of regulation. For this study the important regulations that will be considered are those that have a condition for locally listed firms to prepare annual reports and present them to the shareholders at the AGM. These financial statements will be critical in providing information about the firm's performance as well as the remuneration to executives.

Companies that are listed in the NSE bourse as part of the requirements of the International Financial Reporting Standards (IFRSs) and the Companies Act normally prepare their financial statements on annual basis. The Kenya Companies' Act also provides requirements for disclosure by companies by which the firms should provide information on directors and executive remuneration. As opposed to comprehensive disclosure requirements in other countries such as the UK and USA, companies listed in the Kenya bourse simply give an aggregate amount on the directors' remuneration, only making a separation on fees paid as well as other emoluments. The consolidated figure in addition, includes a component of non-executive directors' fees and remuneration.

3.3 Sample and Sampling Method

This study worked with a sample of 30 companies listed in the NSE spanning across the 11 industries as categorized in the bourse: Agricultural, Automobiles and Accessories, Banking, Commercial and Services, Construction, Energy and Petroleum, Insurance, Investments, Investment Services, Manufacturing and Allied & Telecommunication and Technology.

In order to arrive at the sample, at least 2 companies will be picked from each of the 11 industries of the economy as per listing in the Nairobi Securities Exchange. Companies which are heavily government owned such as KPLC and KENGEN will be excluded

from the sample. The sample is therefore a representation of the economy since each economic sector is represented.

3.4 Data Collection

Data on director remuneration was mainly obtained from the financial statements of the respective companies which are published and also submitted to the CMA annually. This is a secondary data source since data collected is as reported by the company. The data collected was from the years 2011 to 2016.

3.5 Data Analysis

The main method used to analyse the relationship between executive remuneration and firm performance was through a simple linear Regression. This is because of its suitability when studying relationships between variables. Through this, we are able to test if the relationship is positive or negative, and the strength of the relationship if any.

The data collected was then examined for completeness and consistency before the actual data analysis. The cleaned data was entered into SPSS for analysis as a cross-sectional time series data. The study applied a multiple linear regression model on the measures of performance listed below as used in this study. The firm performance measures used in this study was the Return on Assets (ROA). Total Assets was used as a control variable that modelled for firm size which is a determinant of Executive Compensation.

Executive compensation was to then be regressed against each of the above-mentioned variables. Data used was obtained from each of the companies spanning for a period of 6 years, from 2011 to 2016.

The simple regression equation was:

$$\text{REM (Total Compensation)} = \alpha + \beta_1 \text{ ROA} + \beta_2 \text{ Firm size (Total Assets)} + \varepsilon$$

REM (Total Compensation) – is the pay to executives and is given by the fixed salary plus any fees and emoluments paid.

Coefficients β_1 and β_2 will be used to measure the sensitivity of the dependent variable to unit changes in the explanatory variables.

Alpha (α) - is the fixed component of the executive compensation

Beta (β) - reflects part of the executive compensation that measures the sensitivity of the executive pay to the measures of performance

(ε) – denotes an error term.

| Dependent Variable | Independent Variables | Control Variables |
|---|--|--|
| Total Compensation = (Fixed Salary + Emoluments) Use annual figure | Return on Assets = (Profit After Tax/ Total Assets) | Firm Size (Total Assets) = Average Total Assets |

A test of significance was to be done thereafter. After data collection, statistical inference allows researchers to assess evidence in favour of some claim about the population parameters under analysis. The R^2 will be used to predict future outcomes and also to test the hypotheses. It tells you how well-observed outcomes are replicated by a model and also the proportion of total variation of outcomes will be explained by the same model. Other statistical inference tools to be used are collinearity diagnostics, correlation, regression analysis and ANOVA.

CHAPTER FOUR: DATA ANALYSIS, FINDINGS AND DISCUSSIONS

4.1 Introduction

This chapter gives the results and findings of the study as per the research objectives and in accordance to the research methodology as elaborated in the previous chapter. The summary of results that will be represented will be in the form of both descriptive and inferential analysis. Later, the findings will be discussed to give a clear picture of the results as obtained from the study.

The data used for analysis was secondary data obtained from the annual reports of 30 companies (as shown in the appendix of this research study).

4.2 Descriptive Analysis

In this section the number of observations, mean and standard deviation are given in a tabular form as seen below:

Table 4.1: Descriptive Statistics

| | N | Minimum | Maximum | Mean | Std. Deviation |
|---------------------|-----|---------|---------|-------|-------------------|
| Ln of Exec Rem. | 176 | 6.00 | 14.90 | 11.88 | 1.59 |
| ROA | 176 | (0.20) | 0.50 | .07 | .10 |
| Ln of Total Assets | 176 | 12.20 | 20.20 | 17.14 | 1.74 |
| Valid N (list-wise) | 176 | | | | |

The above results show that the results as measured by the Return on Assets(ROA) have a mean of 0.07 and a standard deviation of 0.10. The mean Executive Remuneration is Kshs. 144,350,550.70 and the mean Total Assets is Kshs. 27,784,809,270.00. The ROA ranged from -0.20% - 0.50%

The total number of observations was 180 but in 4 cases there were missing data points for the case of Sanlam and Deacons E.A, giving 176 data points. This was caused by the lack of data in certain years for two companies because the companies had not been listed at the NSE bourse in those specific years. (Data was collected in Deacons E.A from the year 2014 and from 2012 in Sanlam as opposed from 2011)

4.3 Correlation Analysis

A correlation analysis was done to measure the degree of relationship between the various variables. Another reason why this is important is to reduce the chance of multicollinearity between the Independent Variables.

Table 4.2: Correlation analysis

| | | Ln of Exec Rem. | ROA | Ln of Total Assets |
|---------------------------|---------------------|------------------------|------------|---------------------------|
| Ln of Exec Rem. | Pearson Correlation | 1 | .013 | .782** |
| | N | 176 | 176 | 176 |
| ROA | Pearson Correlation | .013 | 1 | -.147 |
| | N | 176 | 176 | 176 |
| Ln of Total Assets | Pearson Correlation | .782** | -.147 | 1 |
| | N | 176 | 176 | 176 |

** . Correlation is significant at the 0.01 level (2-tailed).

From the above results it is evident that there is no significant relationship between the Return on Assets, which is a measure of firm performance, and the Total Assets which was a control variable measuring the firm size.

The results also reveal that there is a weak positive correlation of (0.013) between the ROA and the Executive Remuneration.

The results further show that there is a positive correlation of 0.782 between the Total Assets and the Executive Remuneration.

4.4 Regression Analysis

A regression analysis was done to establish the link between the Executive Compensation and firm performance. The findings of the regression are as shown below:

Table 4.3: Model Summary^b

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
|-------|--------------------|----------|-------------------|----------------------------|
| 1 | 0.789 ^a | 0.623 | 0.619 | 0.9810589 |

a. Predictors: (Constant), Ln of Total Assets, ROA

b. Dependent Variable: Ln of Exec Rem.

From the findings, the value of R^2 is 62.30%. This indicates that the ROA and the Total Assets (independent variables) explain 62.30% of the variation of the dependent variable, that is the executive compensation. The figure of 62.30% shows that this is a good model since the R^2 value is more than 50% as per the goodness fit model. We can consequently also conclude that 37.70% of the Executive Compensation is explained

by other variables that are not included in this model. The reduced value of the adjusted R^2 (61.90%) shows that the two independent variables have a mixed impact on the dependent variable with the Total Assets having a higher impact than the ROA. The computed ANOVA (Analysis of Variance) results are as shown below:

Table 4.4: ANOVA^a

| Model | | Sum of Squares | Df | Mean Square | F | Sig. |
|-------|------------|----------------|-----|-------------|---------|-------------------|
| 1 | Regression | 275.098 | 2 | 137.549 | 142.911 | .000 ^b |
| | Residual | 166.508 | 173 | .962 | | |
| | Total | 441.606 | 175 | | | |

a. Dependent Variable: Ln of Exec Rem.

b. Predictors: (Constant), Ln of Total Assets, ROA

The above results in table 4.4 show that the model is statistically significant since the p value of 0.000 is less than 0.05. We fail to accept the null hypothesis that the regression coefficients are equal to 0 since p-value is less than the significance level of 0.05. A linear regression, therefore established that independent variables could statistically predict the executive compensation, $F(2, 173) = 142.911$ where $p = 0.000$ and the predictor variables accounted for 61.90% of the explained variability in the dependent variable.

Table 4.5: Coefficients^a

| Model | Unstandardized Coefficients | | Standardized Coefficients | t | Sig. | |
|-------|-----------------------------|------------|---------------------------|------|--------|------|
| | B | Std. Error | Beta | | | |
| 1 | (Constant) | -.806 | .756 | | -1.066 | .288 |
| | ROA | 1.619 | .730 | .105 | 2.218 | .028 |
| | Ln of Total Assets | .734 | .043 | .798 | 16.904 | .000 |

a. Dependent Variable: Ln of Exec Rem.

There is a 1.619 increase in Executive remuneration for every unit increase in the Return on Assets holding other variables constant. The coefficient for ROA is significantly different from 0 using alpha of 0.05 because its p-value is smaller than 0.05.

There is a 0.734 increase in Executive remuneration for every unit increase in the Total Assets holding other variables constant. The coefficient for the Total Assets is significantly different from 0 using alpha of 0.05 because its p-value is smaller than 0.05.

The obtained regression is as below:

$$\hat{Y} = - 0.806 + 1.619 X_1 + 0.734 X_2$$

$$\hat{Y} = \text{Executive Compensation}$$

$$X_1 = \text{Return on Assets (ROA)}$$

$$X_2 = \text{Total Assets}$$

4.5 Discussion of the Results

The study shows that there is a significant positive relationship between Executive compensation and the unit of firm performance which in this case is the Return on Assets(ROA). However, the linear relationship between the ROA and the Executive Compensation could be described as very weak based on the correlation coefficient of 0.013%. Further, the results also show a significant relationship between Executive Compensation and the firm's Total Assets. The linear relationship between the Executive compensation and the total assets was strong based on the correlation coefficient of 78.20%.

The results of the study are consistent with the findings of (Yatim, 2013) who found that there was a significant and positive relationship (coefficient=1.232; $p < 0.01$) between the director's remuneration and a firm's accounting performance (ROA) after studying 428 listed companies in Malaysia. This is generally in line with the agency theory which posits that company executives should be well compensated based on the positive results they get from the company just as an incentive for keeping on the good performance, and to avoid the case of them pursuing selfish interests. Awuor (2012) investigated the relationship between director remuneration and performance of firms listed in the Nairobi Securities Exchange using data from the years 2006 – 2010. Her units of performance were the Return on Equity(ROE), Earnings After Tax(EAT) and the Tobin's Q. She found that the relationship between director remuneration and the three units of firm performance were positive but weak in ROE and the Tobin's Q and strong as measured by the EAT

Other researchers like (Rupaleria, 2016) did a similar study seeking to establish Board Remuneration and the firm performance and she found that there was no existing positive significant relationship. This is similar to (Miyianda et al, 2012) who similarly

found no relationship between director remuneration and performance for firms listed at the NSE for the period 2006-2010.

CHAPTER FIVE: SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter looks into the summary of the study as well as conclusion derived from it. It then discusses limitations of the study and lastly, recommendations for further research.

5.2 Summary

The objective of the study was to determine the relationship between firm performance and the executive remuneration of firms listed in the Nairobi Securities Exchange. To achieve this, an appropriate measure of firm performance was arrived at, in this case the Return on Assets (ROA). A control variable was also included in the model and in this case the total firm assets, which is an indicator of firm size, was used. Data from 30 companies listed at the NSE was collected, and these served as a representative sample of the entire industry. The specific data collected was the Director's fees & bonuses as well as Key management compensation, the Total Comprehensive income and finally the Total assets of these companies. The data collected which was from 2011-2016 was thereafter cleaned and input to the SPSS application for further analysis.

Results from the analysis as earlier mentioned showed that there exists a positive but weak relationship between Executive remuneration and the Return on Assets. As for the firm size, the relationship between the executive remuneration and total assets was positive and strong.

5.3 Conclusion

The study concluded that there is a positive but weak relationship between the executive remuneration and firm performance as measured by the Return on Assets. This is in line with the agency theory that executives who act as agents of the firm owners (shareholders) are remunerated well to compensate for their time and deter them from pursuing selfish behaviour.

The findings of this study will be helpful to researchers who wish to conduct a similar study on the same area. Through the results of the study it is now possible to determine the extent of Kenyan companies listed in the NSE adhering to the Agency theory as a way of remunerating its directors.

5.4 Limitations of the Study

The study only focussed on a sample of 30 companies listed in the NSE. Which means that it is just a representative of the entire industry. Results therefore obtained from the study cannot be a perfect representation of the situation in the various companies in the country.

This specific study in its model, had a small figure for its ROA in comparison to the natural logs of the other variables (Executive remuneration and total assets). The small size of the variable impacted negatively to the model in that it portrays the presence of a strong relationship between the ROA and the executive remuneration in the regression model while in real sense the relationship is weak.

Another limitation of the study has been that there is little disclosure done by companies when it comes to giving a breakdown of the director emoluments and the perks which form the compensation. This blurriness therefore reduces clarity and transparency of the real picture when it comes to the executive compensation.

This study also suffered a limitation when it came to arriving at the best unit of measuring firm performance. The study used the Return on Assets as the measure of firm performance which is different compared to other units of firm performance such as the Return on Equity(ROE) or the Earnings After Tax (EAT) which would have given a different picture based on the company's industry, its policies or strategies when it comes to issues such as investing in more assets over time. Such policies or plans may have an impact on a company's actual ROA.

5.5 Recommendations for Further Research

The study can be improved further by using other measures of firm performance that are more indicative of the profitability in majority companies and that tend to have a firm's long-term perspective in them.

Another area of study would be to use other measures of firm performance and regress them against executive remuneration. Such parameters would include things such as the debt ratio or working capital ratios which are different from profitability yet could one way or another have an impact on the director remuneration.

Finally, there's a need for a more comprehensive study on the area that spans for a longer period, more than the 6 years covered in this study.

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APPENDIX I: List of Sampled Companies

- 1 Kakuzi
- 2 Limuru Tea Co. Ltd
- 3 Sasini Ltd
- 4 Car and General (K) Ltd
- 5 Sameer Africa Ltd
- 6 Barclays Bank Ltd
- 7 CFC Stanbic Holdings Ltd
- 8 KCB Group Ltd
- 9 National Bank of Kenya Ltd
- 10 Standard Chartered Bank Ltd
- 11 Equity Group Holdings
- 12 The Co-operative Bank of Kenya Ltd
- 13 Nation Media Group
- 14 Standard Group Ltd
- 15 Deacons (East Africa) Plc
- 16 Athi River Mining
- 17 Bamburi Cement Ltd
- 18 E.A.Portland Cement Ltd
- 19 KenolKobil Ltd
- 20 Total Kenya Ltd
- 21 Sanlam Kenya PLC
- 22 Kenya Re-Insurance Corporation Ltd
- 23 Britam Holdings Ltd
- 24 CIC Insurance Group Ltd
- 25 Centum Investment Co Ltd
- 26 Trans-Century Ltd
- 27 Nairobi Securities Exchange Ltd
- 28 British American Tobacco Kenya Ltd
- 29 Safaricom Ltd
- 30 East African Breweries Ltd