A SURVEY OF STOCK BASED COMPENSATION SCHEMES FOR EMPLOYEES OF PUBLIC COMPANIES IN KENYA

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DECLARATION

I Caroline W. Kodo declare that this study is my original work and has not been presented for academic purposes in any other institution of learning.

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DEDICATION

I dedicate this project to my wonderful parents Mr. and Mrs. Kodo.

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ABSTRACT

This is a survey seeking to establish the extent to which stock based employee compensation schemes are used in public companies in Kenya. The study covered a sample of thirty-nine companies listed in the Nairobi Stock Exchange under the main investment market segment (MIMS). A questionnaire was administered to all the companies in the sample. However only twenty-six companies responded giving a response rate of sixty seven percent which was considered adequate for the study.

From the survey it is evident that only thirty one percent of the firms that responded have stock based compensation. These firms are both local and foreign owned and have their compensation schemes operating from their parent countries and covering only the top-level executives and to a small extent the middle level management.

Therefore we can deduce that stock based compensation is a recent development in Kenya with most schemes being less than five years old. The schemes in use include incentive stock options, discount stock options, premium stock options and employee stock purchase plans.

1 INTRODUCTION

1.1 BACKGROUND

1.1.1 Goals Of The Firm

Every organization exists to fulfil certain goals. These goals include; growth, survival, market leadership, profit maximisation, cost minimisation and /or maximising Shareholder's wealth. Any of these goals can be a driving force for the management of the organization such that all decisions of an organization are aimed directly at fulfilling the chosen goal. The most superior goal recognised in Finance, as a driving force for the operations of the firm is maximisation of shareholder's wealth. However, as the firm grows, the shareholders find it difficult to personally manage their resources. They hire a management team which is then charged with the responsibility of maximising shareholder's wealth. According to Lambert and Lacker (1985) this forms the foundation of the agency theory.

1.1.2 Agency Relationship And Shareholder's Wealth Maximisation

In the modern firm there is a significant separation between the ownership and control of the firm (Nzomo 1995). This is due to the size of the organization, complexity of the business, lack of necessary skills and lack of time, which make it difficult for the owner to manage the firm. Therefore the owner provides the funds to the management, who in undertaking the day-to-day operations of the firm, are expected to put these to best use. As they are contracted to utilise the resources on behalf of the shareholders, the managers are the "agent" and owners are the "principal".

In the shareholders /management relationship there is the agency problem brought about by the divergence of interests between the agent and the principal. In this case the shareholders would want their wealth to be maximised whereas the management would be keen to increase their personal wealth. This creates conflict. For example the management would demand for more perquisites like bigger cars, bigger carpeted offices and personal assistants, they soldier and shirk, engage in creative accounting like window-dressing, take actions to increase short-term profits like exploiting employees and customers, empire building etc at the expense of the shareholders.

To reduce the divergence of the interests, many firms try to answer the question " Do managers have the correct incentive to maximise shareholders' wealth?"
Weston and Copeland (1988) state that in most agency relationships the owner will incur non-trivial monitoring costs to keep the agent in check. These costs are in the form of audit fees, reporting requirements costs and contractual restraints costs. Consequently, the owner faces a trade-off between monitoring costs and forms of compensation that will cause the manager to act in the owner's best interests.

At one extreme, if the agency compensation were all in the form of shares in the firm, then monitoring costs will be zero. This is practically impossible because the agent will always be able to receive some compensation in the form of larger office spaces, executive cars and expensive lunches. At the other extreme the owner would have to incur inordinate monitoring costs in order to guarantee that the agent always makes decisions in the owner's interests. Somewhere between these two extremes lies an optimal solution.

As firms search for an optimal solution, they look for the best compensation package design to give executives the incentives to increase profits and control expenditures while at the same time encouraging them to pursue risky though profitable investment strategies.

1.1.3 Ways Of Addressing The Agency Problem

There are several ways that have been suggested to help in sorting out the agency problem. According to Lambert and Lacker (1985) the solutions include:

- Designing appropriate executive compensation plans.
- Having a competitive market for executive labour. This brings about the alignment of the two groups of executives i.e. those who act in the interest of shareholders and those who do not. The first group will win.
- Market for corporate control – (take- overs) those management teams that do not act in the interest of shareholders will be taken over.
- Corporate governance by the board of directors.

Pandey (1989) suggested the following solutions to the agency problem:

- Use of legislation like the company law, stock exchange regulations, articles of association.
- Voluntary code of good conduct
- Additional monitoring costs.
- Threat of firing due to poor performance.
- The threat of take-overs in the event a company's shares are undervalued.
- Tying management compensation to the company's performance through issue of stock options plans.

1.1.4 Executive Compensation Plans As A Way Of Solving Agency Conflict

Compensation plans are vehicles of delivery of pay to the executives in a manner that motivates them to maximise shareholder's wealth .The primary function of the executive compensation plan is to control the kind of conflicts of interests between management and shareholders.

Objectives of executive compensation plans.

- The plan should be easy to monitor because it is based on objective criteria easily observed by all concerned parties and incapable of being manipulated.
- The plan should prevent excessive perquisites to management and should minimise shirking thus making expenditure decisions that benefit shareholders.

- The plan should have a long horizon to match the perspective of the shareholders.
- The plan should attempt to match managers' risk to that of shareholders while recognising that shareholders can diversify away from idiosyncratic risk of the firm more easily than managers who have their human capital tied to the firm's future.
- Management compensation should be tied to changes in the shareholders wealth and if possible to management's specific contribution to changes in shareholders wealth. For example it is conceivable that a firm can under perform relative to its competition but still experience an increase in share price simply because the market went up.
- The tax efficiency of plans should be compared. If two plans are alike in most aspects but one is designed to minimise the tax liability of the firm and its management, then its tax efficiency may become the decisive factor.

1.1.5 Types Of Compensation Plans

Bonus plans

These are awards given to managers if a given benchmark is achieved. The most Common measures for bonuses are based on accounting data. Example of these Measures are earnings per share, return on investments, individual objectives, sales growth, and other discretionary measures.

Bonus plans have a minimum threshold and a maximum payout. For example, pay bonus if net income is 5 percent of total capital employed. Maximum bonus cannot exceed certain percentage of executive's salary.

Bonus plans based on earnings or earnings growth distort investment decision e.g many positive projects lose money during the gestation period. Managers who typically are myopically pursuing short-term goals may milk through the firm inorder to get better bonuses.

Bonus plans are inferior from the tax point of view because they are taxable just like any other income.

Bonus plans have a risk dimension to them in that a bonus is only earned when a minimum threshold is exceeded and if there is no maximum threshold.

Bonus plans also suffer from a ratcheting effect, that is, if management does not reach their target for two years consecutively, then no bonus is paid for that period. This creates a high risk of turnover. To discourage turnover and thus maintain managers, firms are forced to lower the performance standards.

Executive Share Option Plans (ESOPS)

An executive share option is a call option that gives a manager the right to purchase a given number of shares at a specified period and specified price. According to Stewart (1998) there are three forms of stock based compensations namely Non -qualified stock options, Incentive stock options and Stock appreciation rights. Moran A (2002) states that the three widely used option arrangements are -non-statutory stock options, incentive stock options (ISOs) and employee stock purchase plans (ESPPs). Option plans offer the optionee the right to buy shares of a company at a set price (the "exercise" or "strike" price).

Non-statutory stock options, ISOs, and ESPPs differ primarily in their tax consequences and the tax rules defining the options. ISOs and ESPPs are perceived as enjoying better tax results for the optionees, but the "price" of those advantages is decreased flexibility in the form of rules governing the structure of those plans.

Non-statutory stock options, as their name implies, are not subject to as many rules regarding their structure, but have fewer tax advantages.

Option plans are often approved by shareholders. Non-statutory stock option plans may or may not require approval depending on the applicable securities laws.

ESPPs give employees an opportunity to purchase employer stock through a formal plan. (Sometimes rights under an ESPP are called purchase rights rather than options but the economic effect is the same.)

Incentive Stock Option plans must specify the maximum number of options that may be offered as ISOs. Many plans will offer both ISOs and non-ISOs and merely state the maximum number of shares that may be offered as ISOs, non-ISOS, or a combination of the two.

Non-statutory Stock Options are more flexible than either ISOs or ESPP options. However, there are some limitations on these options as well. Generally, securities or corporate governance laws require that the option be granted pursuant to some sort of plan authorizing the provision of shares to be offered under the options, and the general practice is to have the shareholders approve the plan.

Other Features of Option Plans

Option plans often offer special features in connection with the option grant. One of the major reasons for these features is that often executives or other optionees do not have the financial resources to exercise the option, thus losing the benefits of the option compensation tool. Employers have found a variety of ways to deal with this problem. Stock appreciation rights (SARs) are often offered in connection with stock options and avoid the need to spend funds to exercise the option. A stock appreciation right gives the employee the right to receive the appreciated value of the employer's stock rather than the stock itself. The appreciation is measured as the difference in value of the stock on the date of grant of the right and the value of the stock on the date that the right is exercised. Often the exercise of a stock appreciation right results in a cancellation of any option that is issued in tandem with that right. Sometimes the value of the appreciation right can be received in employer stock; this in effect allows the optionee to receive stock without spending any of his or her own funds.

Another possible feature in an option plan is the automatic grant of a new option (a "reload option"). The reload option may be granted automatically to an eligible individual when he or she exercises an option, in whole or in part, by surrendering previously acquired shares of common stock or a portion of the shares being acquired upon exercise of the option. Any such reload option will be for the number of shares delivered upon the employee's exercise of an option, and is usually exercisable only in the event shares purchased upon exercise of the original option are held for the holding period specified in the stock option agreement or meet other criteria set forth in that agreement. Often the shares purchased will be forfeited if such shares are sold prior to the expiration of the holding period. For ISOs, the purchase price of shares subject to each reload option cannot be less than the fair market value on the date of the reload option grant. Some companies hesitate to offer reload options because they believe they dilute the employee's incentive to make the company share price grow.

Finally, companies offering options have faced some pressure to reprise when share prices fall. While reprising is popular with employee/optionees, it has been criticized as giving optionees little or no incentive to improve share performance. Companies are often reluctant to disclose reprising of options, particularly since accounting rules generally require that reprising be charged against earnings.

Advantages

- Stock options align the risk profiles of the manager to the risk profiles of the shareholder.
- They broaden the decision- making time horizon for the management as they have a future time span.
- Stock options have a direct connection to shareholders wealth.
  According to Hall and Liebman (1998) pay for performance sensitivity has increased since 1990 due to an increase in stock based pay.
- Stock options compensation is taxed at a lower rate or at tax free thus its tax efficient.
- Stock options are not subject to accounting manipulations.

Lambert and Larcker (1985) report that greater stock compensation is used when accounting measures are noisy and when the firm is in the early stages of investment with rapid growth in assets and sales.

Yermack (1995) says that executive pay is more sensitive to stock value in the companies with noisy accounting data or in companies facing cash constraints and less sensitive in regulated companies.

Disadvantages

- Tying management compensation to share price movements exposes management to more market risk hence management asks for more pay as compensation for the added risk.
- Management may become reckless, taking risks that are not justified in a bid to increase the stock price.
- The noise in the stock price movement may not be attributed to management action.
- There is accounting disclosure problem of such items as they are treated as non balance sheet items.
- Options do suffer from the ratcheting effect i.e. if a company is under-performing year after year, the top management will be rewarded for their substandard work by granting them a new set of stock options with lower exercise price.
- Stock options dilute the earnings and voting powers of shareholders. Carol M. Bowie, the director of corporate governance services, says" Every time you issue stock, you dilute the voting power, as well as the earnings and assets per share, of

the current shareholders. You slice the pie into thinner pieces, and that's bound to cause concern among those sitting at the table. "

Salary

This is a fixed amount of money drawn monthly by the management and is subject to periodic review. It is normally based on the level of management, experience, type of industry and prevailing market conditions. In some instances, it is negotiated

1.2 STATEMENT OF THE PROBLEM

Tying a manager's compensation to a firm's performance usually by making a significant percentage of total pay equity based is one way to overcome agency costs and to motivate value maximising behaviour. (Hierscheifer and Suh 1992).

Mehran (1995) finds that firm performances increase considerably when firm managers have a higher percentage of stock based compensation. Established manufacturers and retailers, threatened by the flight of executives, are using a variety of stock-based compensation plans to help retain their management talent. In an annual study by Frederic W. Cook & Co (2002), Timmerman one of the firm's consultant's concluded that "When you share equity ownership with employees it sends a powerful message that motivates people to work hard, create new ideas, and build company value." Gray (2000) also echoes the positive effect on an organisation performance for using stock based compensation by noting that Use of stock incentive compensation aligns employees' interests with those of management.

On the other hand stock based compensation has negative effects. According to Daily, and Danton (2001) executives should not benefit from market upswings for which they can take no credit. For instance, stock buy-backs, stock dilution, and stock reloads may all unfairly advantage executives and officers holding stock options. When option exercise prices dip below the trading prices of firms' stock, options become what is colloquially known as "underwater." An increasingly popular tactic for "expediting" a return to value for underwater options is for boards to approve options reprising packages, which restore options by resetting the exercise price, typically to the price at

which the firm's stock is currently trading. The same remedy is not afforded to firms' shareholders. When the stock price declines, shareholders' real wealth also declines. Reprising programs, however, protect executives from any decline in firms' stock prices. Another consideration is that directors are paid advisors. Their primary function is the protection of shareholder interests. Directors are ostensibly appointed by the shareholders, for the shareholders. Other professionals serving the firm (i.e., legal counsel, consultants) are not compensated in equity, nor are they required to hold equity in the firms they serve in their professional roles. Why, then, would we impose such requirements on directors?
Bliss and Rosen (2001) noted that banks where the CEOs receive stock compensation are less likely to acquire other banks. This may imply that mergers, which could otherwise profitable, could be forgone because of the effect of value on stock options. Thus equity-based pay encourages managers to make sub-optimal decisions.

In its most recent survey of 345 member companies, released late in 2000, the National Association of Stock Plan Professionals (NASPP) found that the trend toward extending stock option grants further down the organization ladder continues. The stock exchange is asking corporations to obtain shareholder approval only for executive stock option plans, but some parties want stockholders to have the right to vote on all stock option proposals.

Employee stock based compensation schemes can be applied in various forms as is evident in the Cook study (2001). This study identifies 12 different types of stock-based compensation schemes used by the 250 largest market-capitalized U.S. companies. These include performance stock options, restoration (reload) stock options, premium and discount stock options.

Its apparent that there exists many different schemes and practices for stock options compensation and thus this study aims at finding out to what extent, in what forms and for what reasons the stock based compensation is applied in public companies in Kenya.

1.3 OBJECTIVES OF THE STUDY

The study is expected to

1) Ascertain the extent of use of stock based compensation schemes in public limited companies in Kenya.
2) Identify the forms of stock based compensation schemes in operation among the public limited companies in Kenya.
3) Identify the attributes of the organisations that use stock based compensation schemes in Kenya.

1.4 IMPORTANCE OF THE STUDY

Companies all over the world experience the agency problem and spend a great deal in trying to seek solutions for the same. This study explores in depth the extent to which stock based compensation has been used as a solution to the said problem. It will help:

Academicians

This study will provide academicians with some literature to aid in their study and analyses of the agency problem and Stock based compensation as a means of solving this problem.

Current and prospective investors

The study will provide them a basis for decision making on how best to compensate their managers and come up with the optimal executive compensation plan.

.Students of research

The study will expand their knowledge base and form the basis for further research.

Policy makers

The study will enlighten policy makers on the extent of application of stock based compensation plans in the country.

The public

The study will create awareness on the issues of executive compensation plans, how and why firms in Kenya apply it.

2 LITERATURE REVIEW

2.1 AGENCY THEORY

According to Lambert and Larker (1985), this is a theory that focuses on the separation of ownership from control in large public corporations. In the context of this theory, the three principal kinds of conflict are

- Shareholders primary interest is to maximise their financial return whereas the executives may derive non-pecuniary benefits from their control over the corporate resources.
- Management and shareholders differ in their risk attitude with managers being more risk averse.
- Management and shareholders have different decision- making time horizons with management being biased towards short -term decisions and shareholders being biased towards long-term decisions.

Several means of reducing potential conflict of interest between management and shareholders proposed by Lambert and Larcker (1985) include:

- Management incentive compensation plans.
- The existence of a market for corporate control, which disciplines inefficient managers through threat of take over.
- A market for executive labour which in theory weighs an executive's past service to shareholders when determining his or her opportunities for alternative employment.

The agency framework identifies the sources of conflicts between the shareholders and the management and assist in determining the optimal design of a compensation plan.

2.2 ADDRESSING THE AGENCY PROBLEM

2.2.1 Using Performance Based Compensation

This refers to compensation plans that compensate management on the basis of proven performance, which is measured by earnings per share, return on equity return on investments and other return ratios.

Gitman (1997) gives the following examples of performance based compensation plans; cash bonus, stock options, stock appreciation rights, performance shares.

Cash bonus is cash paid to management for achieving certain performance goals.

Performance shares are shares given to management on meeting stated performance goals.

Mcmenamin (1999) gives the following classifications for the performance based compensation plans; Executive share option schemes and performance incentive plans which may either be equity shares granted to management as a result of their performance related to realisation of specific targets or cash bonuses.

He alsosuggests other measures as discussed below:-

2.2.2 Hostile Take Overs

External threat of take-over can also be used to control the agency problem especially where the predator (acquiring) company considers the target company to be badly managed or undervalued. Mc menamin (1999) states that the existing management, which is considered inefficient, will be replaced with an efficient management. This threat of job loss will influence managers to be alert to shareholders and market expectations concerning value creation thus reducing agency problems.

2.2.3 Legal Constraints

According to Mc menamin (1999) Under the UK company law, directors must act bonafide in the best interest of the company as a whole, exercise reasonable care and skill in the management of the company and not allow personal interests to conflict with their duties to the company.

Pandey (1989) also emphasises that articles of association, memorandum of association, stock exchange rules and regulations combined with legal debt contracts may act as a control of managers interests thus upholding shareholders interests.

2.2.4 Monitoring And Controlling Arrangements

This entails introducing control systems and procedures in the organisation to limit the satisficing and minimal risk behaviour of managers. It involves establishing strong internal control systems like segregation of duties, rotation of staff, surprise checks, authorisation and verification procedures and use of management audits to ensure that the said controls are working as they should.

2.2.5 Bonding Arrangements

These are similar to insurance contracts in which a third party like insurance/bonding company will in return for a premium, underwrite the risk of loss to the firm in case of defalcation or dishonesty by managers. This cushions the shareholders from any loss by management negligence.

2.2.6 Corporate Governance

Unlike the above measures, which directly relate only to shareholders protection, corporate governance encompasses all those affected by corporate behaviour.

It seeks to protect all those who have a legitimate interest in the goals of the firm and will benefit or suffer according to the fate of the firm. This is achieved by recognising the rights of the diverse stake holders namely consumers, suppliers, employees, general public and even the government, and setting specific goals that managers need to accomplish. This reduces the agency problem.

2.3 EMPIRICAL EVIDENCE ON EMPLOYEE COMPENSATION SCHEMES

2.3.1 Do compensation contracts matter?

Evidence documents a positive relationship between senior executives income and annual shareholder returns. Studies by Larcker (1983) have shown that stock prices rise when companies announce the adoption of long-term compensation contracts.

This favourable reaction could be because of

- Incentive hypothesis - the benefits of the compensation plan will exceed the costs of the compensation.
- Signalling hypothesis – management will initiate an executive stock. Options plan when prospects are good. . "When you share equity ownership with employees it sends a powerful message that motivates people to work hard, create new ideas,

and build company value," says Robert S. Timmerman, a consultant with Frederic Cook (2002).

- Tax hypothesis – the pay offs of a salary plus stock option plans dominate those of salary plus bonus consequently the value of the firm rises on the inception of ESOP because of the total costs decline.

2.3.2 Risk Aversion

Amihud and Lev (1985) hypothesized that executives are more risk averse than shareholders. Due to the difference in risk aversion, the executives undertake conglomerate mergers to decrease the variability of the value of the firm. By so doing executives effectively diversify their own undiversifiable portfolios consisting of their compensation plans on the firms and their human capital.
Lambert and Larcker (1985) hypothesized that management and shareholders differ in their attitude towards risk. Whereas shareholders can diversify their wealth by spreading it among different assets, a large portion of managers wealth (human capital compensation earned and stock in the firm) is tied to the fortunes of the company thus managers are more risk averse.
They analysed whether the adoption of a stock option plan contract motivates managers to increase the variability of the value of the firm.

The results indicate that managers risk aversion can be partially offset if his compensation contract is designed to make the adverse consequences associated with the "downside" less severe, or to make the favourable consequences of the "upside" more attractive. Properly designed stock options may be the answer to neutralising a manager's risk aversion.

Options may be effective in encouraging management to invest in riskier projects because , while they carry no downside risk , their value generally increases as the volatility of the company's stock price rises, and they allow managers to share in the upside potential of the firm.

2.3.3 Long time horizon

Lambert and Larcker (1985) There is a potential conflict between the decision-making time horizons of executives and shareholders. For example the compensation committee may evaluate an executive's investment decisions over a shorter time period than shareholders use in assessing the eventual outcome of the same investment decision. This pressure may in turn cause the manager to evaluate projects based on their immediate impact on profits rather than according to the present value of cash flows over the life of the investment. A fore shortened decision making horizon may motivate management to turn down profitable long-term investments.

To lengthen the time horizon of management

- ✓ Management should be compensated on the basis of stock options. If the executive is compensated on the basis of share price he will be more likely to accept a long-term project because he expects it to have a favourable impact on his compensation. This is because management believe that the long-term performance measure will eventually if not immediately reward him by reflecting the long term consequences of his investment decisions.

- ✓ Defer the pay -offs earned by executives to some future time. For example some firms may defer annual bonus and may require that the deferred bonus be paid in terms of ordinary shares.
- ✓ Performance plans may be used. These provide pay offs to the executives if the growth in a specified benchmark over 3-5 years exceeds some target. An important feature of this plan is that the compensation earned from this contract is deferred until the end of the specified period. Therefore manager's time horizon is extended through the duration of performance period.

Larcker (1983) examined whether the adoption of "long-term" compensation contracts was associated with increases in "long-term" investment. The specific focus of this study was the adoption of "performance plans". He found out that the relative amount of capital investments of companies adopting the plan increased substantially compared to those firms without such plans.

Miller *(1981)* demonstrated that compared with salaries, SARs (stock appreciation rights) are tax neutral from the firm's point of view and tax dominant according to the manager's point of view.

2.3.4 Linking performance/ pay to compensation proportion

Much of the controversy surrounding executive compensation tends to focus on whether executive compensation is related to corporate performance, i.e. are current compensation contracts really designed to " Pay for performance?"

Though no statistical analysis has been done most articles conclude that there is little or no relationship between executive compensation and corporate performance or Shareholder's wealth.

In the early 1990's corporate boards became convinced that the surest way to align the interests of management to those of shareholders was to make stock options a large component of executive compensation. As the stock market began its ascent executive pay mounted but the correlation between a CEO'S pay and the stock market did not prove that the company was enjoying superior performance. In practice any increase in stock price will reward the holder of a stock option regardless of his performance.

This huge gain from options for below average performers has led to debates on executive compensations.

Rappaport (1999) suggests the following ways of bridging the gap between existing compensation practises and need to promote higher levels of achievement.

- Rewarding top managers only when they out perform competition.
- Determining the real contribution of each business unit to the overall share price.
- Involving frontline managers and workers in the quest for higher shareholders value.

Just as executives should not be punished for market downturns beyond their control, they should not benefit from market upswings for which they can take no credit. Daily suggests the following measures

Index executive options. As remedy, we strongly encourage indexing option strike prices to the overall market (or a relevant subset of the market). Indexing retains the risk intended to encourage executives to operate in the long-term best interests of shareholders, particularly when options are indexed to market upturns, as well as downturns. Indexing options to market downturns is not unusual, especially in the volatile technology sector. And it is akin to practices such as reprising. When there is a dramatic downturn in the firms' stock price, the options are recalled and new options with lower strike prices are granted. Options must also be indexed to market upturns. However, if the issue is rewarding executives for their performance, not the market's performance then Boards must decouple market-based swings (up and down) from executive (firm) performance.

Rethink reprising. Clearly, executives remaining with the firm greatly benefit when options are reprised, but the attendant benefits to shareholders are far less certain. Why should the board provide another incentive (reprised options) to the same group of managers who ushered the company into that position wherein reprised options were considered to be necessary?

Discontinue equity-based director pay. Compensating directors with equity has not yielded anticipated firm performance results. In fact, equity holdings might cause directors to adopt a short-term time horizon as they focus on the value of their equity holdings at present, rather than in the longer-term. Do we expect equity-holding directors to dispassionately consider major strategic initiatives?

Morgan and Poulsen (2001), examine four questions:

Are pay for performance compensation plans beneficial to shareholders?

What are the immediate wealth effects of compensation plans?

Plans proposals are accompanied by increases in shareholders wealth especially for those plans that target executives or top management. This is consistent with the agency and signalling hypotheses.

Are pay for performance plans associated with firms where they are most beneficial?

Firms with agency conflicts may include growing firms, firms dealing with intangible assets etc. using regression analysis to identify firm characteristics associated with firms proposing or revising the compensation plans.

Proposing firms are more likely to have lower book to market ratios in the year receiving the announcement. Firms with higher institutional holdings are more likely to propose performance plans.

Whether stockholders perception of stock based compensation plans is a function of various plans and firm's characteristics?

Shareholders have a more positive perception of plans in larger firms. Negative plan features like higher dilution ratios lead to lower % approval of plans.

Whether wealth effects related to plans announcements provide a signal about a firm's future performance?

Firms proposing compensation plans have significantly higher one year prior to stock price performance than do the firms on proposing plans, and that the proposing firms have significantly higher price performance in the year following the proposal.

2.3.5 Pay and size

Many studies report strong links between firm size and managerial rewards. Agrawal (1981) Compensation can be used to motivate effort among lower level managers who view the top job as spoils that goes with the winner of an intra firm tournament. The bigger the firm, the bigger the tournament and the more the Compensation. The bigger firm may also involve more skill than managing smaller firm. Compensation is used to solve the adverse selection in choosing a manager. Larger firms may also have more diffuse ownership after stock based mergers, managers may be able to consume more perquisites including compensation with lower probability that the shareholders will monitor and discipline them.

2.3.6 Risk and pay

Hermalin and Wallace (2001) observed that firms pay their CEOs significantly more, ceteris paribus, the greater the firm's riskness. This is consistent with the agency theory that agents expected compensation to rise as risk rises to compensate for the extra risk burden.

2.3.7 Corporate governance, CEO compensation and firm's performance.

Core, Hortheusen, and Lakhan (1999) found out that firms with weaker governance structure have greater agency problems. CEOs in companies with greater agency problems receive greater compensation yet firms with greater agency problems perform worst. Green span (1999) I find that a lot of what is being paid to individual CEOs is not directed to the value they are producing for the shareholders who are paying the bill. Jensen and Murphy (1990) say that compensation of the top executive is independent of performance.

2.3.8 Ownership Variables And Executive Compensation.

- The amount of shares owned by the CEO and his immediate family has an effect on the CEOs compensation.

- The presence of another executive on the board who owns more than 5% of equity is associated with reduction in CEOs compensation.

- There is a significantly negative association between the existence of an external party or a block holder who owns at least 5% of shares on ordinary compensation.

2.3.9 Compensation Debate

In the recent past the executive compensation has generated a lot of heated discussions for example the pay of Gareth George former CEO of KCB.

Jarell (1980) identifies three categories of critics in this debate.

- *Political activists*

These include shareholders rights organisations, institutional investors and their lobbying associations, politicians and regulators.

Each of these groups have called for new policies to correct an assumed market failure in the labour market. They believe that there is need for a rigorous reward and punishment system for top management. This has led to introduction of new disclosure rules from 1993.these rules mandated the use of tables, graphs and reports to describe and justify executives compensation alongside the present stock performance graph. This was aimed at promoting a stronger link between pay and performance.

- *Financial Economists*

Murphy in 1985 using 1200 firms showed that executive pay was positively and significantly correlated to shareholders returns. He concluded that top executives are worth every nickel they get. Jensen And Murphy in 1990 found that pay and turnover rates are significantly linked to shareholders return but changed their focus from relationship to a new measurement of pay to performance.

- *Accounting economists*

According to Watts and Zimmerman accounting measures of earnings are the universal measures of performance because they are most efficient and cost effective. They argue that earnings shield executive compensations from market wide fluctuations in equity values that are not caused by expected changes in fundamentals.
Lorreta J M and Dorkey F also support accounting performance measures as these are not influenced much by macro economic noise and are highly correlated with market adjusted individual firm stock returns.

"Over the past 10 years there's been a knee-jerk reaction to designing incentive programs. Now there will be a lot more analysis of stock option programs," says Blair Jones, a senior vice president at Sibson Consulting in New York. "The fact that this is now 'costing' them something will mean that they will have to do more of a cost/benefit analysis to see which design will give them the best return for their dollar." According to Elayne " The allure of "free" options meant that most HR professionals did not analyse their purpose within incentive plans. "When something doesn't cost you anything, you tend to put less thought into how you use it," she says. What are the costs associated with employee stock options?

Sturges of the Benefits and Compensation Design Group in New York, suggests ways of limiting these costs e.g. offering restricted stock, which allows the company to set specific conditions for awarding stock shares to employees.

Another approach is offering stock appreciation rights, which allow workers to receive the appreciation on company stock without a cash investment.

Another alternative is "phantom stock"-actually an incentive award akin to a gift certificate that is given to employees when the business reaches a specific financial goal. "Tie bonuses to the book value of the company, it gets you out of stock land," says Robert Heneman, a professor of management and HR at Ohio State University.

And there are non-monetary solutions, notes David Balkin, chair of management at the University of Colorado at Boulder.

"There are all kinds of reward and recognition programs. You can make heroes out of your people who are taking chances and innovating." Adds Ellig: "Companies ought to revisit the statutory stock option," which is more advantageous to the employee than the popular non-qualified stock option because it is not taxed at the time it is purchased. This, says Ellig, encourages employees to hold on to stock. How do Kenyan firms deal with the costs associated with options if any?

3 RESEARCH METHODOLOGY

3.1 POPULATION

The population covered all the companies listed in main investment market segment of the Nairobi Stock Exchange, as at 31st may 2003, representing the different sectors of the economy namely the Agricultural, Commercial and Services, Finance and Investments and Industrial and Allied sectors.

3.2 DATA SAMPLING TECHNIQUE

The study was a survey that is it covered all the thirty-nine companies in the four sectors of the Nairobi stock exchange excluding the alternative investments sector. The decision to include all the organisations was due to the size of the population being too small such that sampling would not have been representative enough. The response rate was sixty seven percent that is twenty-six out of the thirty-nine firms responded.

3.3 DATA COLLECTION TECHNIQUE

Data was collected using questionnaires, (see appendix i) which were delivered to the CEO, chief finance officer or head of human resources of the identified organisations. Follow-ups were done through telephone calls and personal visits. The filled questionnaires were collected after a maximum period of a fortnight.

The data collected was on the general background of the firms, the compensation schemes employed, types of options used, reasons for use, positive and negative effects of options used, remedies for problems resulting in use of options and criteria for giving options.

3.3 **DATA ANALYSIS**

This is by use of tables and graphs combined with percentages and averages.

4 DATA ANALYSIS AND FINDINGS

4.1 INTRODUCTION

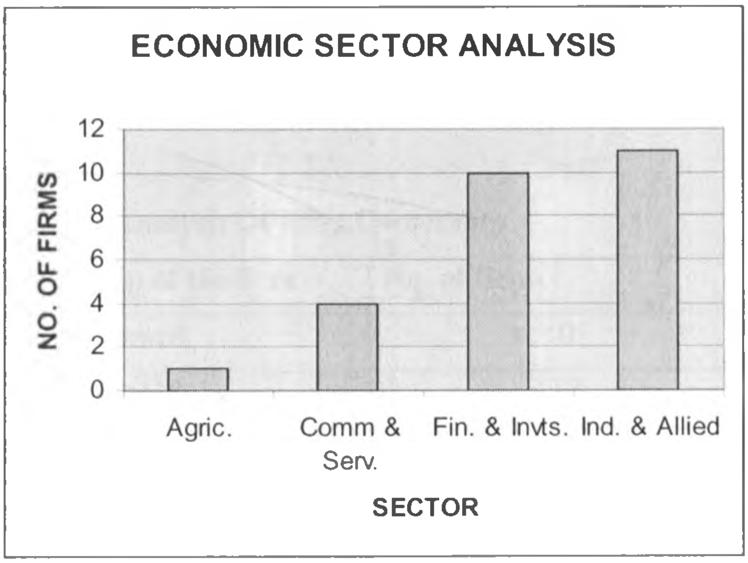
Though the population targeted was thirty-nine firms only twenty-six firms responded.

The table and graph below show the composition of the firms that responded.

Table 1 : Types Of Responding Firms

Market segment	no. of firms
Agricultural	1
Commercial and services	4
Finance and investments	10
Industrial allied	11
Total	**26**

Graph 1: Sector Analysis



For most of the organisations, the heads of the human resources who are senior managers of the firms filled the forms. Only four were filled by managers in the Finance / accounting department and one by a manager in the office of the CEO. The information can is reliable as the persons filling in the forms are well versed with the organisations policies and procedures.

Table 2: Analysis Of Number Of Employees In The Firm

No. of employees	No. of firms	percentages
Less than 100	2	8%
100-500	11	42%
500-1000	7	27%
1000and above	6	23%
total	**26**	**100%**

Most of the firms that responded have between 100 and 500 employees thus can be said to be medium size.

None of the firms that responded are fully foreign owned. This is because of the CMA requirement that for a company to be listed in the NSE, at least 20% of the shares should be locally owned. Majority of the firms are controlled by local shareholders.

Table 3: Analysis Of Firm Ownership

Ownership of the firm	No. of firms	percentage
Foreign owned	0	0%
Locally owned	17	65%
Both locally and foreign owned	11	35%
total	**26**	**100%**

The oldest company among the respondents has been in Kenya for 155yrs while the youngest is about 25yrs old. The modal age is about 40years

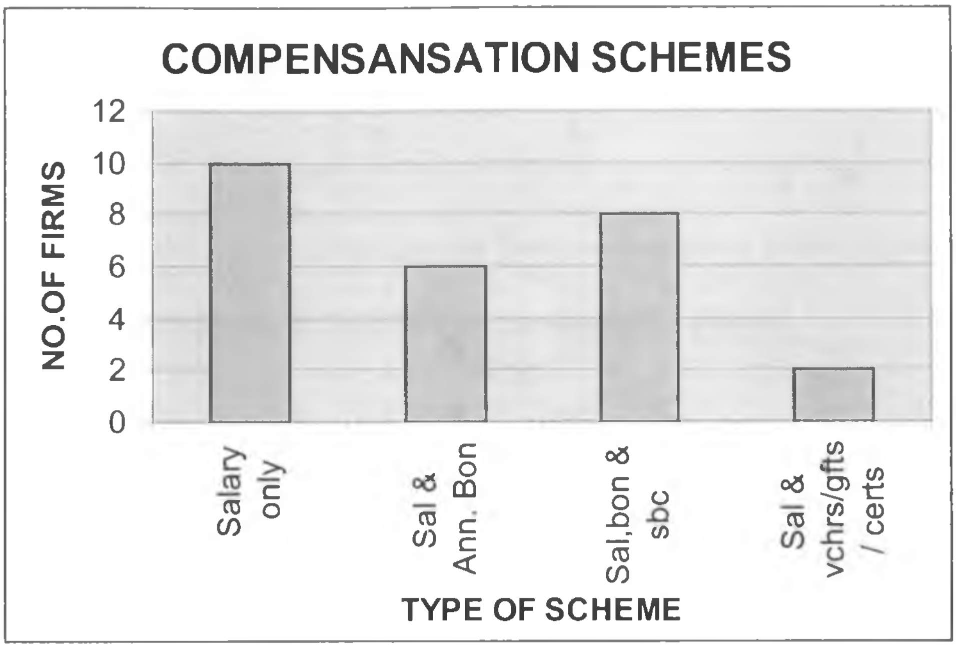
4.2 EXTENT OF USE OF STOCK BASED COMPENSATION IN KENYA

From the survey its evident that stock based compensation is a recent development with only 31% of the respondents embracing it. Majority of the existing schemes are below five years old.

Table 4: Compensation Schemes In Kenya

Compensation schemes	**No. of firms**	**Percentage**
Salary only	10	38%
Salary and annual bonus	6	23%
Salary, bonus and stock based compensation	8	31%
Salary and vouchers / gifts / certificates	2	8%
total	**26**	**100%**

Graph 2: Analysis Of Extent Of Use Of Stock Based Compensation Schemes In Kenya



Out of the firms that responded only eight (31%) have stock based compensation schemes. Of the eight, one is from the commercial and services sector, three from financial and investment sector and four from industrial and allied sector.

All the firms indicated that stock based compensation was introduced in Kenya in the last five years with the exception of one in which the scheme has existed since 1984. It is therefore evident that stock based compensation is a recent development in Kenya.

All the firms indicate that the decision to use stock based compensation was by the board of directors subject to shareholders approval.

Proportion Of Each Component in Compensation

Most firms avoided this question with only two giving the answer as depending on the level of management and performance of an individual.

Table 5: Employee levels up to which stock based compensation is applied

Level	No. of firms	percentage
Top executives only	6	75%
Top and middle level	2	25%
total	**8**	**100%**

Majority of the firms only apply stock based compensation to their top-level executives with few firms giving the middle level management a chance.

4.3 FORMS OF STOCK BASED COMPENSATION IN KENYA

Table 6: Scheme Types Applied In Kenya

Type	no of firms	percentage
Discount stock options	2	14%
Incentive stock options	6	43%
Stock appreciation rights	1	7%
Employee stock purchase plans	4	29%
Premium stock options	1	7%

From the above incentive stock options are the most commonly used scheme in Kenya. A good number of firms also use employee stock purchase plans and few firms use discount and premium options stock options.

The results indicate that most firms in the NSE are locally owned and do not have stock based compensation schemes; they rely mostly on salary and annual bonuses

Table 7: Analysis of Criteria used in Awarding Stock based compensation

Criteria		No. of firms	percentage
A	Individual target performance level being achieved	3	27%
B	Departmental targets being achieved	2	18%
C	The firm achieving some target goal	5	46%
D	Level of management/employment	0	0
E	High Potential Employee	1	9%

From the above its evident that, once the firm decides which levels the compensation schemes cover, the most common criteria used in awarding stock based compensation is the firm achieving a certain target, which is a result of the individual targets and departmental targets being achieved.

Reasons for stock based compensation

All firms offer stock based compensation to motivate managers which leads to improved financial performance and low management turnover.

Effects of Employee stock based compensation Schemes

The most popular positive effect was increasing financial performance of the firm, which was mentioned by all the eight firms.

The most unpopular negative effect was awarding or punishing employees for results they are not responsible for.

Measures to mitigate negative effects

The following measures were mentioned

- -Plan local schemes to include the lower level and middle level staff
- -Indexing employee options to overall market.

Costs of Stock based Compensation schemes

The costs associated with the operation of the stock based compensation schemes are: -

- Financial depending on ratio of stock based compensation to the total compensation.
- Administrative in terms of the human resources deployed to man these schemes.

Methods used to minimise Costs of Stock based Compensation schemes

- Use of phantom stocks: - certificates given if specified goals are achieved.
- Restricted stocks: - stocks given under conditions set by the firm

4.4 ATTRIBUTES OF THE ORGANISATIONS THAT USE STOCK BASED COMPENSATION

The firms that use stock based compensation schemes in Kenya have the following attributes

- ❖ They are big companies with a capital base in excess of kshs 15 billion.
- ❖ They are long established firms with a mean age of around 25 years since incorporation in kenya.
- ❖ Their performance in the local market is far above average with six of them among the top twenty firms in terms of turnover and high share prices.
- ❖ Most of them (about sixty three percent) are foreign controlled and those that are locally controlled have a significant foreign influence.

5. CONCLUSIONS AND RECOMMENDATIONS

5.1 SUMMARY AND CONCLUSIONS

From the above study it is evident that all fully locally owned firms do not have stock options. The closest they come to is the use of employee stock purchase plans. All the eight firms that have stock based compensation have both local and foreign ownership with the schemes being extensions of the parent companies.

It is also evident that stock based compensation is a recent development in Kenya with most schemes being less than five years old and including only the top level executives. The most common scheme is use of incentive stock options to compensate the executives, though the use options like the discount and premium options is picking up. For those firms including the middle level employees employee stock purchase plans are more common.

5.2 RECOMMENDATIONS

a) Firms that use stock based compensation schemes appear to have high share prices and are very profitable. With these positive effects in mind I would recommend that all firms that endeavour to reduce the effects of agency problem should use stock based compensation.

b) Firms should extend stock based compensation schemes down the ladder to include the lower level managers and other employees.

c) Companies would use stock based compensation schemes more if a market for options and futures existed locally. The capital markets authority and the Nairobi stock exchange should establish and develop the futures and options market (FOM) segment.

d) The knowledge on stock based compensation in Kenya is very limited and thus there is need for the Capital Markets Authority , the Nairobi stock exchange and the government to educate the general public to enhance the use of stock based compensation in Kenya.

5.3 LIMITATIONS OF THE STUDY

1) Limited time for data collection due to pressure from the office and the responding companies.
2) Some quoted companies are based up-country making it difficult to access them.
3) Some companies considered questions in the questionnaire against their policy hence could not fill therefore reducing number of respondents.
4) Most people have a negative attitude towards filling questionnaires thus takes a lot of time to convince them and they may not give true information.
5) Some of the terms in the questionnaire were not easy to explain and thus answers given may not be accurate.

5.4 SUGGESTIONS FOR FURTHER STUDY

1) The extent to which stock based compensation schemes are applied in Kenyan companies that are fully foreign owned and locally owned companies that are not listed in the Nairobi stock exchange.
2) The relationship if any of the stock based compensation versus financial performance of the firm.

3) How local shareholders perceive stock based compensation schemes and how this affects the use of these schemes in kenya
4) Local legislation on stock based compensation versus the development of stock based compensation in kenya.

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APPENDIXI: QUESTIONNAIRE

SECTION ONE

General information

NAME OF COMPANY: ....

POSITION OF PERSON FILLING FORM: ....

1.Which of these best describes the ownership of your firm? (Tick where appropriate)

a. Foreign owned company { }
b. Locally owned company { }
c. Both local and foreign owned { }
d. Others (specify)

2. When did you start your business in Kenya?
....

3. How many employees do you have? (Tick where appropriate)

a. Less than 100 { }
b. 100-500 { }
c. 500-1000 { }
d. above 1000 { }

SECTION TWO

1) What compensation scheme do you use for your employees? (Tick where appropriate)

   a. salary only { }
   b. salary plus annual bonus { }
   c. salary , bonus and stock based compensation { }
   d. others (specify)

2) What is the proportion of each component in the compensation Scheme?

3) To which employees do you apply stock based compensation? (Tick where appropriate)

   a. Top executives only { }
   b. Top and Mid –level management only { }
   c. Across the board { }
   d. Others (specify)

4) What criteria do you use in awarding the stock based compensation to your employees? (Tick where appropriate)

	most times	some times	never
a. Individual target performance level being achieved	{ }	{ }	{ }
b. Departmental targets being achieved	{ }	{ }	{ }
c. The firm achieving some target goal	{ }	{ }	{ }
d. Level of management/employment	{ }	{ }	{ }
e. Others (specify)	{ }	{ }	{ }

5) What forms of stock based compensation do you have in your firm?

   Rank according to the extent of use that is 5 for commonly used and1 for not used

   a) performance stock options (Options linked to EPS or ROE/ROI) { }

   b) Reload stock options (using already existing shares to get options) { }

   c) Premium stock options (exercise price above an appreciated future value) { }

   d) Discount stock options (exercise price below an appreciated future value) { }

e) Stock appreciation rights
(difference btn price at exercise of option and guarantee date) { }

f) Non-statutory stock options { }

g) Incentive stock options { }

h) Performance Shares(shares denominated in performance units and awarded over time based on EPS and ROI/ROE) { }

i) Others (specify) { }

6) Why do you offer stock based compensation to your employees?

Rank in order of importance that is 5 for most important and 1 for least important

a) To motivate managers to maximise shareholder's wealth. { }

b) To increase firm's financial performance. { }

c) To reduce management turnover. { }

d) It is tax efficient. { }

e) To reduce the agency problem. { }

f) Others (specify). { }

7) When did you *first* include stock based compensation as part of your compensation scheme?

....

8) How was the decision to use stock based compensation to compensate staff arrived at?

a) Board decision entirely { }

b) Board/executive decision subject to Shareholders approval { }

c) Shareholders only { }

9) What would you consider to be the positive effects of employee stock based compensation schemes to your firm?
   a) Matching the risk levels of the employees and those of the shareholders. { }

   b) Matching the decision-making time horizon of management and shareholders. { }

   c) Increasing the financial performance of the firm. { }

   d) Motivation to employees. { }

   e) Others (specify)

10) What are the negative effects of stock based compensation to the firm?

   a) Dilution of shareholder's earnings and their voting power. { }

   b) Awarding or punishing employees for results they are not responsible for. { }

   c) Ratcheting effect ie lowering standards in a bid to reward employees even when performance is low. { }

   d) Sub optimal decision –making on the part of managers. { }

   e) Others (specify)

11) What measures are in place to mitigate these negative effects?

   a) Stop reprising of options/Shares. (reducing share/option prices to reflect current market situaion esp during a downturn) { }

   b) Indexing employee options to the overall market { }

   c) Discontinuing equity based pay to employees. { }

   d) Others (specify)

12) What are the costs associated in operating employee stock based compensation schemes?

....

13) What methods do you use to minimize these costs?

a) Phantom Stocks (gift certificates given if a specific goal is achieved) { }

b) Stock appreciation rights (shares given to employees due to share value appreciation without cash payment.) { }

c) Restricted stocks (Stocks given under conditions set by firm) { }

d) Others (specify)

THANKS FOR YOUR COOPERATION