A SURVEY OF PERFORMANCE MEASURES FOR EXECUTIVE COMPENSATION SCHEMES IN PUBLIC LISTED COMPANIES IN KENYA

BY MOHAMMED ZENA, D61/P/8370/2001

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DECLARATION

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

Name: Zena Mohammed-D61/P/8370/2001

Signature: ………………………..

Date: …

SUPERVISOR

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

Name: Mr. Moses Anyangu

Signature: ……………………….

Date: ………………………….. 21/12/2004

DEDICATION

To my entire family especially my wonderful parents Mr Mohammed Khamis and the late Mrs Osila Mohammed Khamis, whose support, encouragement and inspiration has seen me this far in pursuit of knowledge.

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LIST OF ABBREVIATIONS

CEO: CHIEF EXECUTIVE OFFICER

NSE: NAIROBI STOCK EXCHANGE

MIMS MAIN INVETMENT MARKET SEGMENT

AIMS ALTERNATIVE INVESTMENT MARKET SEGMENT

ABSTRACT

This is a survey seeking to establish the performance measures for executive compensation schemes in public listed 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-four companies responded giving a response rate of sixty two percent which was considered adequate for the study.

Attributes of the companies that responded were obtained from the audited financial statements covering the period 1998 to 2002. There was no great distinction on the attributes of the companies that use various performance measures.

From the survey it is evident that most firms use both financial and non financial measures of performance (balanced score card) in designing executive compensation schemes for senior management. These firms are both local and foreign owned.

It is also evident that growth in earnings is the most common financial measure of performance while increase in market share is the most common non financial measure of performance.

Most companies prefer using accounting based measures of performance because they are measurable and quantifiable as opposed to market based measures of performance. Therefore we can deduce that measures of performance are key to deciding the basis of compensation used for senior managers and companies in Kenya use these measures in designing executive compensation schemes. Measures of performance are therefore instrumental in alleviating the agency problem between shareholders and managers.

CHAPTER 1 INTRODUCTION

1.1 BACKGROUND

1.1.1 Goals of the Firm

Organizations exist to fulfill certain goals. These goals include: maximizing shareholders' wealth, growth, survival, social responsibility, ethics, market leadership, profit maximization and cost minimization (Pandey 1989). Managers in organizations strive to fulfill the finance functions with an aim of achieving the goals set above. All decisions of an organization are therefore aimed at fulfilling the chosen goals.

Financial management is that managerial activity which is concerned with the planning and controlling of the firm's financial resources. Finance functions include:

- Investment or long term asset mix decisions
- Financing or capital mix decision.
- Dividend or profit allocation decisions.
- Liquidity or short term asset mix decision.

The most important goal recognised in Finance is the maximisation of shareholder's wealth (Bringham and Gapenski). Shareholders normally prefer managing their resources on their own as the case is with sole proprietorship. However, as a firm expands, the shareholders find it difficult to personally manage their resources. They are therefore obliged to hire a management team, which is then charged with the responsibility of maximising shareholder's wealth.

This however is normally not the case because the objective of shareholders is very different from the objectives of management. This forms the foundation of the agency theory proposed by Lambert and Larcker (1985).

1.1.2 Principal agent relationship and shareholders' wealth maximisation

The relationship that exists between shareholders and managers is the principal-agent relationship. There is a significant separation between the ownership and control of the firm in the modern Limited Company. (Nzomo 1995). This is mainly because as organizations expand and become complex, it becomes difficult for owners to manage the firms themselves because they lack the necessary skills and time to do so. In addition to this, it is often advisable to separate ownership and control in a world where specialized skills leads to more efficient production.

Owners therefore hire managers who are charged with the responsibility of the day to day running of the business and making strategic decisions to maximize shareholders wealth while the owners are the providers of funds.

In the shareholders /management –principal/ agent relationship, there is the agency problem brought about by the divergence of interests between the agent and the principal. This problem is mainly brought about by the fact that shareholders sole interest is to maximize their wealth while management's sole interest is to increase their personal wealth which take the form of management demanding for more perquisites like bigger cars, carpeted offices, membership in clubs and personal assistants. They engage in creative accounting like window-dressing, soldier and shirk, take actions to increase short-term profits like exploiting employees and customers at the expense of the shareholders.

Managers may use their discretion to benefit their private interests in a variety of ways (Shleifer and Vishny, 1997). For example, managers may engage in empire building

(Jensen, 1974 and Williamson 1964). They may, as Jensen (1986) suggests, fail to distribute excess cash when the firm does not have profitable investment opportunities. Managers also may entrench themselves in their positions, making it difficult to oust them when they perform poorly (Shleifer and Vishny, 1989). All these create conflict.

To reduce this conflict, which is caused by divergence of interest, owners usually take appropriate measures to keep the managers in check.
The owners therefore introduce checks and balances, which include monitoring costs such as audit fees, monthly management accounts, and best compensation packages for managers and stringent reporting measures. 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.

According toWeston and Copeland (1988), to reduce divergence of interests, owners and managers need to strike a balance so that the owners offer managers the best compensation package to motivate managers to gear their efforts towards maximization of shareholders wealth.

1.1.3 Suggested solutions to the agency problem

Several ways of addressing the agency problem have been proposed by various authors. According to Pandey (1989), some of the ways of addressing this problem include:

- Owners can use legislation like the company law, stock exchange regulations, capital market authority regulations and articles of association to impose various standards that must be observed by managers in Organizations.
    - Managers can be implored to observe voluntary code of good conduct
    - Owners can incur additional monitoring costs like audit fees.
    - Owners can put performance benchmarks and threaten to fire executives due to poor performance.

- Managers should be made to understand that there exists a threat of take over and potential losses of jobs if shares of the firm they are working for are undervalued.
- Owners can also tie management compensation to the company's performance through issue of stock options plans.

According to Lambert and Lacker (1985) the solutions include:

- Owners can design appropriate executive compensation plans based on appropriate performance measures.
- Having a competitive market for executive labor, which implies that with competition for various positions, only the best performers 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 initiatives.

1.1.4 Executive Compensation Plans vis a vis Agency Conflict

Compensation plans are rewards given to executives to motivate them to maximise shareholder's wealth (Atchinson, Belchen & Thomsen 2000). The primary function of the executive compensation plan is to control the kind of conflicts of interests between management and shareholders.

All compensation elements exist to achieve some purpose. Some of the compensation objectives include:

- Competitiveness-This means that the renumeration should match the industry level.
- Motivation-The compensation should enhance performance by motivating staff to work hard.

- Administrative effectiveness and cost control- 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.
- Internal equity-The plans should be fair to employees of all cadres in the Organization.
- Cost benefit efficiency- The plan should prevent excessive perquisites to management and should minimise shirking thus making expenditure decisions that benefit shareholders.
- Tax considerations- 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.
- Capital accumulation- The plan should have a long horizon to match the perspective of the shareholders. 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.
- Align risks- 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.

1.1.5 Types of Compensation Plans (Atchinson, Belchen & Thomsen 2000)

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 10 percent of total capital employed. Maximum bonus cannot exceed certain percentage of executive's salary.

Set backs of bonus plans

- 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 in order 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 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 price within a specified period. 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 (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).

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

1.1.6 Performance measures used in designing executive compensation schemes

Performance measures are quantitative or qualitative ways to characterise and define performance. They provide a tool for Organizations to manage progress through achieving pre-determined goals, defining key indicators of Organizational performance and customer satisfaction. Performance measures are a central component of management control systems.

In today's modern firm, performance measures most commonly used include: profitability measures, customer satisfaction measures, internal measures of efficiency, quality and time and innovation measures amongst others.

Performance measures can either be financial or non financial. Financial measures can either rely on internal financial information such as operating income or external financial information such as stock prices. Internal non-financial information measures used include defects, manufacturing lead time and number of new patents. External non-financial information measures include customer satisfaction ratings and market share.

Executive compensation plans are based on both financial and non-financial performance measures. Designers of executive compensation plans emphasize three factors. These are:

- Achievement of Organizational goals.
- Administrative ease.
- The likelihood that the affected executives will perceive the plan as fair.

Well designed plans also ensure that performance measures align the interests of managers and the interests of shareholders and can actually alleviate the agency conflict.

1.2 STATEMENT OF THE PROBLEM

Tying a manager's compensation to a firm's performance usually by designing appropriate performance measures is one way to overcome agency costs and to motivate value maximising behaviour. There exist great diversity in performance measures both theoretically and in practice.

The number of firms using non-financial performance measures for incentive purposes is increasing (Banker et al. 2000). Although there are a number of reasons why firms use non-financial performance measures, the primary reason is that some of them are leading indicators of financial performance (Kaplan and Norton 1992; 2001).

Both the practitioner literature (Kaplan and Norton 1992) and the theoretical literature on agency theory (Feltham and Xie 1994; Hemmer 1996) emphasize that non financial performance measures change the effort allocation of managers, in the sense that these managers become more focused on the long-term impact of their actions. However, despite the increased use of non-financial performance measures and the above 'claims', there is only little empirical evidence of the effects of these performance measures on the effort allocation of managers.

Furthermore, the accounting literature on incentives predominantly focuses on the use and effects of performance measures and neglects another important component of incentive systems, performance targets (Ittner and Larcker 2000). Firms usually set explicit targets for managers and evaluate performance compared to target (Merchant et al. 2000). The type of target used can have a significant impact on managerial behavior. For example, Merchant et al. (2000) state that the effect of incentives is likely to be dependent on performance target difficulty. Alternatively, more difficult targets increase the risk the managers have to bear and less difficult targets may be the outcome of the trade-off between incentives and risk sharing when managers are risk averse (Merchant and Manzoni 1989).

However, the empirical evidence of the use and effects of difficult performance targets in general is limited.

The main purpose of a control system is to align the goals of managers with those of the organization. One way to achieve this is through the design of incentive contracts. In general, incentive contracts consist of three primary elements (Merchant 1989): performance measures, performance targets and rewards.

Each of these elements has an effect on the type of incentives provided to managers. The design of incentive contracts, and the use of performance measures is the basic problem addressed by agency theory. In general, agency models analyze the situation in which a principal design an incentive contract to motivate a risk and work averse agent to provide effort. These incentive contracts are traditionally based on one or more noisy measures of performance. The assumption underlying these agency models is that the incentive contract and, more specifically, the performance measures used affect the agent's behavior. That is, the agent directs his attention to those aspects of the job that are being measured (Holmström and Milgrom 1991; Feltham and Xie 1994).

The findings in the empirical accounting literature on the effects of incentive systems are consistent with the agency predictions. For example, Banker et al. (1996), Wallace (1997), and Banker et al. (2000) all find that (measured) performance increases after the implementation of an incentive plan and that the decisions made by management are consistent with the incentives provided (Wallace 1997). Further, the empirical accounting literature pays a considerable amount of attention to the effects of earnings-based incentive plans on earnings management. In general, the studies by Healy (1985), Gaver et al. (1995), and Holthausen et al. (1995) provide mixed evidence with respect to the extent to which earnings-based incentive plans provide CEOs with incentives to make accrual decisions that maximize their bonus.

In general, the empirical literature substantiates the agency prediction that 'what you measure is what you get'.

It is apparent that performance measures used by Organizations are key to deciding managers' efforts in trying to maximize shareholders wealth. Therefore, this study aims at finding out performance measures used in compensation plans to managers in public listed companies in Kenya.

1.3 OBJECTIVES OF THE STUDY

The objectives of this study are:

1) Ascertain the performance measures used in compensation schemes for chief executives in public listed companies in Kenya.
2) Identify the attributes of the organisations that use specific performance measures in executive compensation schemes in Kenya.
3) Ascertain whether Public Listed Companies use market based or accounting based measures of performance.
4) Ascertain whether Public Listed Companies uses financial or non-financial measures of performance.

1.4 IMPORTANCE OF THE STUDY

The agency problem is experienced by companies from all walks of life. Companies have realised that unless this problem is tackled, Organizations would not be able to fulfil the most important goal of maximizing shareholders wealth. This study explores in depth the performance measures used in designing executive compensation for managers as a means of alleviating the agency problem.
The study will therefore benefit:

The Academic community

This study will provide a body of knowledge regarding analyses of the agency problem and performance measures as a means of solving this problem.

Investors

Confidence is only available to those market participants who have access to all relevant information. The study will provide both current and prospective investors with 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 provide insight on performance measures used in designing executive compensation plans in the country and will be of use to labour Organizations and the Federation of Kenya Employers.

The public

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

CHAPTER 2 LITERATURE REVIEW

2.1 AGENCY THEORY

There is apparent conflict of interest between the different interest groups in a Company. Although nearly all the interest groups want the company to grow and prosper, they are likely to hold different views on how these should be achieved and how the resulting wealth would be shared.

Agency relationship therefore arises when one or more parties contracts another to perform on his behalf a service and then delegates decision making authority to that hired party. The party hired is the agent where as the hirer is the principal. Common agency relationship in business involve:

- Owners of the firm and the managers.
- Owners of the firm and creditors.
- Government and the owners of the company.

(Weston and Brigham 1981)

Agency problem

This refers to the divergence of interests between a principal and his agent.

Agency costs

These are the costs of establishing and monitoring systems, which establish goal congruence between the principal and the agent.

Stakeholders involved in the Agency dilemma

i) Management and Shareholders (Weston and Brigham 1981)

In the modern firm, there is significant separation between ownership and management of the firm (Nzomo 1995). The owner provides funds and expects the management to put this to best use. The management undertakes the day to day operations of the firm hence they are agents to the owners.

This poses agency problem that is exemplified by management:

- Working less hard.
- Taking actions to increase short term profits.
- Creative accounting.
- Not investing for the future.
- Management concentrating on prestige, esteem and power goals.

ii) **Shareholders and creditors** (Weston and Brigham 1981)

Creditors lend funds to the firm that are based on:

- The riskiness of the firm's existing assets.
- Expectations concerning the riskiness of future asset additions.
- The firms existing capital structure.
- Expectations concerning future capital structure.

The position of the loan creditors can be prejudiced if:

- High dividends are paid out therefore decreasing the assets available as security for corporate lenders.
- Assets on which the loan is secured is sold.
- The funds are invested in projects, which are riskier than those originally described to the loan creditor there by increasing the creditors exposure.
- Further money is borrowed especially if it has a right to prior payment in the event of liquidation.
- Exceeding borrowing powers.
- Witholding information such as internal organizational weaknesses that may injure firm's performance in the market.

This problem is addressed by including restrictive covenants in the loan agreements to prevent divergence of interests by shareholders.

iii) Government and Shareholders

The Government expects a company and by extension its shareholders to operate in a manner beneficial to the entire economy and society. The position of the Government can be prejudiced by shareholders as follows:

- Failure to give an accurate picture of earnings of a company so as to minimise liability to tax.
- Possibility of businesses engaging in illegal business.
- Lukewarm response to social responsibility calls.
- Avoiding certain business and locations though coveted by the Government.
- Lack of adequate interest in safety and environmental awareness concerns.

This problem can be addressed by undertaking the following measures:

- Inculcating a sense of social responsibility.
- Providing incentive for compliance or accepting to undertake Government preferred projects.
- Legislation to govern Company operations and protect certain interests.
- Guidelines on minimum disclosure requirements for the shareholder.
- Monitoring costs such as statutory audits, inspections and investigations.
- Government lobbying for directorship in a company on grounds such as "company is operating in strategic activities and services''

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, and in relation to the conflict between management and shareholders, three principal kinds of conflict exist. These 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) and Pandey (1989) include:

- Management incentive compensation plans.
- Legislation like company law, stock exchange regulations etc
- Voluntary code of good practice
- Additional monitoring costs
- 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 SOLUTIONS TO THE AGENCY PROBLEM

2.2.1 Using Performance Based Compensation

These are compensation plans that compensate management on the basis of proven performance, which is measured by financial measures of performance such as earnings per share, return on equity, return on investments and other return ratios or non-financial performance measures such as Customer satisfaction and innovations.

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

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 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. Specifically, the board of directors and senior management are now under a lot of public scrutiny especially after the 'ENRON' scandal and all their actions and decisions are closely monitored. They are expected to comply with corporate governance standards and all the decisions they make are binding on them. In other words, the buck stops with them and they are accountable to all interested stakeholders. These recent developments go a long way in reducing the agency problem.

2.3 FINANCIAL AND NON FINANCIAL PERFORMANCE MEASURES

The financial performance measures are defined as the 'traditional' financial performance measures, such as return-on-assets, net income, and cash flows The non-financial performance measures are defined as those measures that reflect performance in the market, such as market share, market growth, and customer satisfaction. Empirical research indicates that non-financial performance measures are leading indicators of financial performance and should therefore provide managers with long-term incentives (Ittner and Larcker 1998a; Banker et al. 2000).

Choosing performance measures is a challenge. Performance measurement systems play a key role in developing strategy, evaluating the achievement of organizational objectives and compensating managers. Concerns have been raised about traditional performance measures and most managers feel that they do not work because they do not emphasize on drivers of value such as customer and employee satisfaction, innovation and quality. Inadequacies in financial performance have led to innovations ranging from non-financial indicators of ‘intangible assets ‘and ‘intellectual capital’to ‘balanced scorecards’of integrated financial and non-financial performance.

The Balanced Score card

A growing number of firms are replacing their financially based performance measurement and compensation systems with a "balanced scorecard" incorporating multiple financial and non-financial indicators. Proponents of the balanced scorecard concept contend that this approach provides a powerful means for translating a firm's vision and strategy into a tool that effectively communicates strategic intent and motivates performance against established strategic goals (Kaplan and Norton, 1996). However, the balanced scorecard literature provides little discussion of the scorecard's role in compensation decisions, despite the fact that the majority of adopters use the scorecard for this purpose (Towers Perrin, 1996).

The limited discussion of performance evaluation and compensation issues raises a number of questions regarding how the multiple performance measures and their relative weights are chosen to ensure "balance" in the compensation plan, the appropriate role of subjective versus formula-driven performance evaluations, the choice of qualitative versus quantitative performance measures, and the extent to which managers' understanding of strategic objectives and managerial actions vary with different forms of scorecard-based incentive plans.

These questions are all the more interesting because, in the past, firms have sought to simplify performance measures by adopting multiunit organizational designs, decentralizing operational decisions to individual business units, and holding business units accountable mainly for bottom-line financial results.

Advantages of non financial measures (Ittner & Larcker 2000)

- They provide a closer link to long term organizational strategies. Financial measures generally focus on annual or short term performance against accounting yardsticks. They do not deal with progress relative to customer requirements or competitors that are important in achieving profitability, competitive strength and long term strategic goals.
- Drivers of success in many industries are intangible assets such as intellectual capital and customer loyalty rather than the hard assets allowed on the balance sheet. By excluding these intangible assets, financially oriented measurements encourage managers to make poor decisions.
- Non-financial measures are better indicators of future financial performance because they provide forward-looking information on accounting or stock performance.

Disadvantages of non financial performance (Ittner & Larcker 2000)

- It is time consuming and expensive to develop an appropriate measure as it requires a lot of investment in information systems to enable the company to draw information from multiple databases.
- Non-financial data are measured in many ways as there is no common denominator. Evaluating performance or making trade offs between attributes is difficult when some are denominated in time, quantities or percentages.
- Lack of casual links. Companies adopt non-financial measures without articulating the relations between the measures or verifying that they have a bearing on accounting or stock price performance. Unknown or unverified casual links create two problems when evaluating performance: incorrect

performance measures focus attention on wrong objectives and improvements cannot be linked to later outcomes.

- Lack of statistical reliability. It is difficult to say whether a measure actually represents what it purports to represent.

2.3.1 Performance targets

Performance targets are a part of the incentive system that is neglected in basic agency models. Traditionally, the outcome of an agency model presents an optimal incentive contract based on some measure of performance and the agent is told to 'do his best'. The behavioral literature on goal setting, however, indicates that goals have significant effects on behavior and performance. Goal setting theory predicts that when goals become more difficult, performance increases and that specific, hard goals lead to a higher level of performance than vague goals, such as 'do your best' or no goals at all (Locke an Latham 1990). The primary mechanisms that ensure that goals improve performance are the so-called universal task strategies, which consist of
(1) direction of attention,
(2) effort, and
(3) persistence.
First, goals direct attention to those activities for which goals have been assigned. Activities for which no goals have been assigned are interpreted as less relevant and the attention of the individual is therefore focused on goal-relevant activities. Furthermore, more specific goals make it easier for individuals to direct their attention than more general goals. Second, assuming sufficient ability, the more demanded from an individual, i.e., the more difficult a goal, the greater the expended effort. Third, given goal commitment, individuals continue to expend effort until the assigned goal is achieved. That is, goals lead to a persistence of effort over a certain period of time, where more difficult goals lead to greater persistence and thus higher performance.

The empirical accounting literature only pays a limited amount of attention to the effect of target setting on performance and managerial behavior (Ittner and Larcker 2000).

Most of the evidence to date stems from experimental studies, which find results consistent with goal setting theory, i.e., more difficult targets increase performance (e.g., Chow 1983; Hirst and Yetton 1999). Using a survey questionnaire methodology, Simons (1988) shows that difficult budget goals increase firm performance, while Van der Stede (2000) finds that budgetary slack increases managerial short-term orientation. Overall, the results of the empirical studies investigating target setting indicate that the degree of target difficulty affects performance and managerial behavior.

2.4 EMPIRICAL EVIDENCE ON EMPLOYEE COMPENSATION SCHEMES

2.4.1 Agency Theory and Incentive Compensation Schemes

Agency theory suggests that compensation policy tying executive pay to corporate performance or shareholder wealth provides incentives for executives to exert appropriate efforts on behalf of shareholders. There are many mechanisms through which compensation policy can provide value-increasing incentives.

Executive compensation is one of those internal control mechanisms. Performance-based bonuses, share options and share ownership schemes are examples of incentive compensation schemes (Jensen and Meckling (1976), Jensen and Murphy (1990), and Byrd, Parrino and Pritsch (1998).

Baker, Jensen, and Murphy (1988) note that the level of compensation determines where executives work, and the compensation structure determines how hard they work.

Shareholders who are well diversified and risk-neutral are more likely to prefer a compensation package with maximum variability based on corporate performance. However, a risk-averse executive's natural tendency is to desire a compensation package with maximum certainty.

Therefore, in deciding the extent to which the compensation is contingent on corporate performance, a balance must be struck between the interests of both shareholders and executives (Mehran 1995, Byrd et al. 1998).

Innovations in compensation policy have received considerable attention in the past decade. These innovations have frequently sought to adjust the balance between long-term and more immediate forms of compensation, or between certain and performance contingent elements.

2.4.2 Executive compensation and corporate performance

Numerous empirical studies have been conducted to examine the association between executive compensation and corporate performance. However, the findings have failed to offer a strong consensus.

An early investigation by Lewellen and Huntsman (1970) suggests that there is a significant correlation between performance and executive pay levels. Moreover, they find that long-term elements of compensation had little effect on this reward-performance link.

Murphy (1985) concludes that corporate performance, as measured by shareholders' realised returns, is strongly and positively related to executive compensation.

Similar results are obtained by Coughlan and Schmidt (1985), who identify a positive relationship between the real rate of change in executive salary plus bonus and share price performance. Abowd (1990) shows that the sensitivity of executive compensation to corporate performance in one year is positively related to corporate performance in the next year.

This relationship is found to be much stronger for market measures of performance than for accounting measures. Lewellen, Loderer, Martin and Blum (1992) find that the total compensation of the three highest-paid officers is positively related to differences in both the common share returns and operating profitability of the firms.

Mehran (1995) documents a positive relationship between corporate performance using 153 US manufacturing firms and the percentage of equity-based compensation received by managers over 1979 and 1980.

Main, Bruce and Buck (1996) employ a broad measure of executive pay and include data on the share options for executives in 60 of the largest Companies in the United Kingdom (UK) during the 1980s. They find executive compensation to be significantly sensitive to corporate performance. McKnight and Tomkins (1999) find that a pronounced link existed between performance and pay over both the short- and long-term for their sample of 109 UK companies over the period of 1991 to 1995.

Changes in the value of executive share options is found to be strongly and Significantly associated with shareholder returns.

Although the studies above provide evidence supporting the link between executive compensation and corporate performance, other studies report the opposite findings.

Jensen and Murphy (1990) examine the sensitivity of pay of 1,688 US executives to corporate performance over the period of 1974 to 1986. They suggest that executive pay rose (and fell) by about $3 per every $1000 change in the wealth of a firm's shareholders and interpret their findings as evidence of inefficient compensation arrangements.

Leonard (1990) examines the effects of executive compensation policy and organizational structure on the performance of 439 large corporations in the US between 1981 and 1985. He finds that accounting measures of corporate success are not significantly related to the level of, or degree of equity in, executive pay, or to the steepness of pay differentials across executive ranks.

Gregg, Machin and Szymanski (1993) utilise a market-based measure of returns to equity-holders (ROE) to study the relationship between executive compensation and corporate performance on 288 UK companies over the period of 1983-1991. Their results do not suggest a distinct relationship between performance and pay. A similar finding is reported by Conyon and Gregg (1994) who utilize the same measure of ROE as Gregg, et al. (1993) and a measure of company operating profit.

2.4.3 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.

2.4.4 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.

2.4.5 Long time horizon

According to 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:

- 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.

- 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.

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.

2.4.6. 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.

Morgan and Poulsen (2001), examine the following questions:

i) Are pay for performance compensation plans beneficial to shareholders?

ii) 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.

iii) 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.

iv) 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 percentage approval of plans.

v) 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.

2.4.7 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.

2.4.8 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.

2.4.9 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) finds 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.

2.4.10 Compensation Debate

In the recent past the executive compensation has generated a lot of heated discussions. Of late is the issue of the compensation of the former CEO of the New York Stock Exchange. On September 17 2003, chairman and chief executive Richard Grasso stepped down as a result of controversy concerning the size of his deferred compensation package.

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 has 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.

CHAPTER 3 RESEARCH METHODOLOGY

3.1 POPULATION

The population covered all the 49 companies listed on the Nairobi Stock Exchange as at 30th April 2004, representing the different sectors of the economy namely the Agricultural, Commercial and Services, Finance and Investments and Industrial and Allied sectors.

3.2 SAMPLING

The sample comprised the thirty-nine companies in the Main Investment Market Segment. The decision to include the companies in the Main Investment Market Segment was mainly because the companies in the Main Investment Market Segment represented all the main sectors in the economy and data collected was therefore representative enough. This sample was therefore very convenient for the purposes of the study.

3.3 DATA COLLECTION TECHNIQUE

Data was collected using both primary and secondary data. Primary data was collected using the questionnaires, which were delivered to the CEO, chief finance officer or head of human resources of the identified organisations.

Secondary data, which mainly covered the attributes of the sampled companies was collected from the audited financial statements of the companies in the population. Information collected was mainly on the Companies profitability, assets turnover and debt ratio.

The data collected mainly covered: general background of the firms, attributes of the firms, the compensation schemes employed, performance measures used by the organizations, reasons for use and extent of use of specific performance measures.

3.3 DATA ANALYSIS

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

The study also used financial ratios and spearman's correlation coefficient to find out if there is an association between the performance measures used by specific companies vis a vis the attributes of the Companies such as profit before tax, turnover, shareholders funds and earnings per share.

Spearman's correlation coefficient uses an ordinal scale where two variables are ranked then we determine the strength of the association of the two variables.

Spearman's correlation coefficient is given by:

$$Rs = 1-(6 \sum Di * Di/ (n*n*n-n))$$

Where rs= Strength of the relationship

$Di=Yi-Xi$

N= no of paired observations

Yi= The first variable (Companies that use financial measures)

Xi= The second variable(Companies that use balanced score card)

CHAPTER 4 DATA ANALYSIS AND FINDINGS

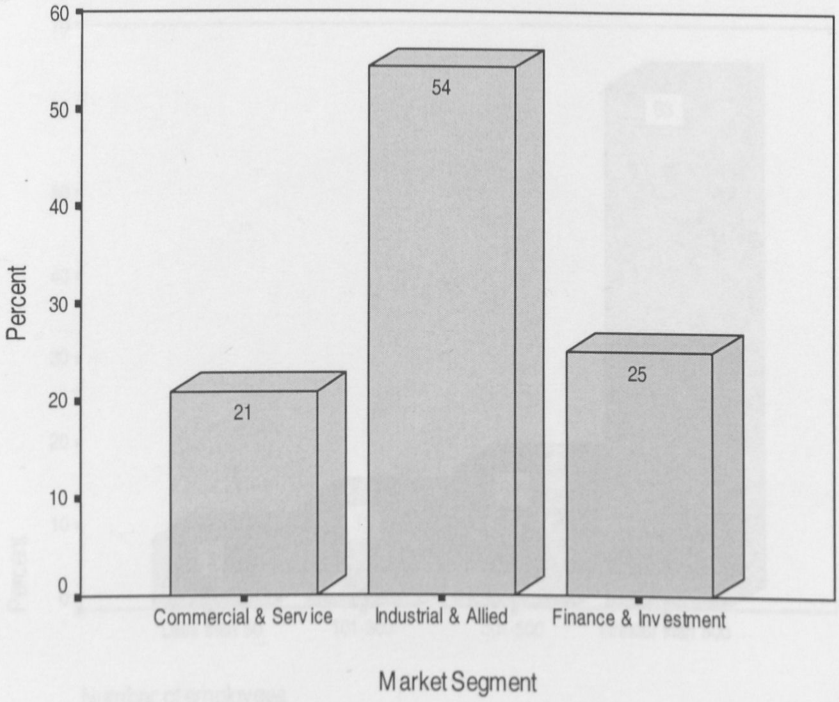
4.1 BACKGROUND INFORMATION ON RESPONDENTS

Though the sample targeted was thirty-nine firms only twenty-four 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 responding**	**No of firms targeted**
Agricultural	0	4
Commercial and services	5	8
Finance and investments	6	11
Industrial allied	13	16
Total	24	39

Graph 1: Sector Analysis

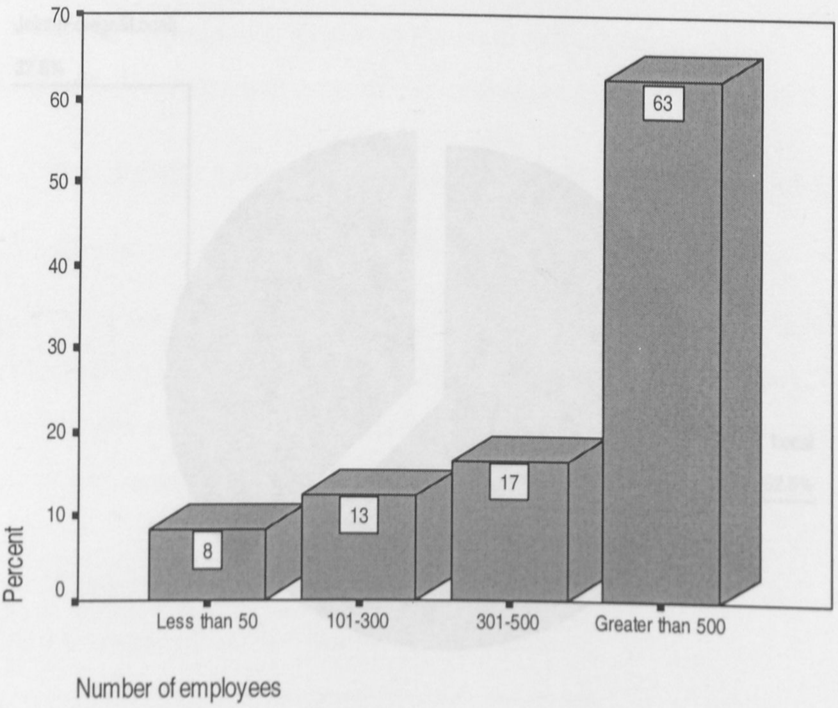


For most of the organisations, the heads of the human resources and heads of finance who are senior managers of the firms filled the forms. Only one was filled by a manager in the production department and one by a procurement manager who is also in charge of the human resources function. The information obtained can therefore be relied on 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 50	2	8%
101-300	3	13%
301-500	4	17%
Greater than 500	15	63%
Total	**24**	**100%**

Graph 2: Analysis of number of employees in the firm



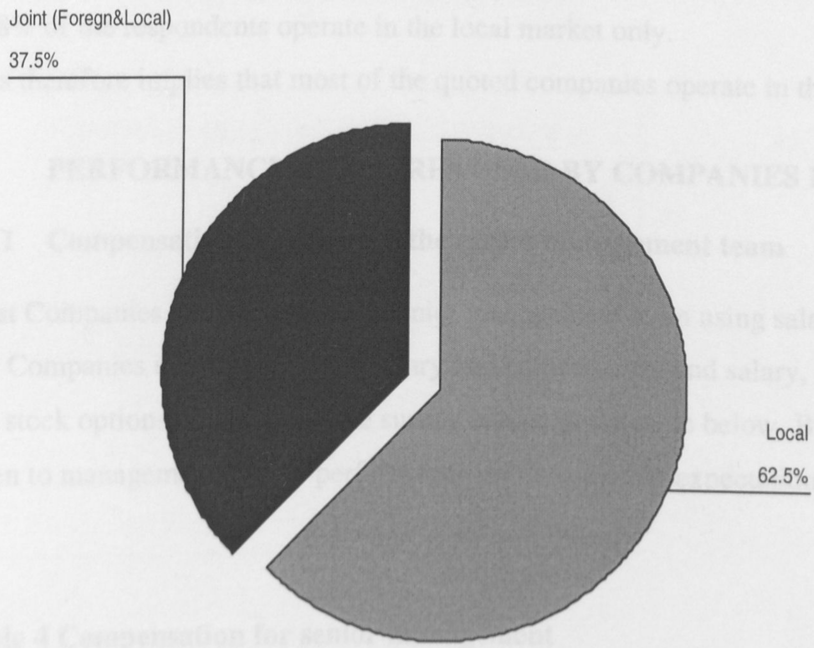
Most of the firms that responded have greater than 500 employees thus can be said to be between medium size and large sized firms.

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. Local shareholders control majority of the firms.

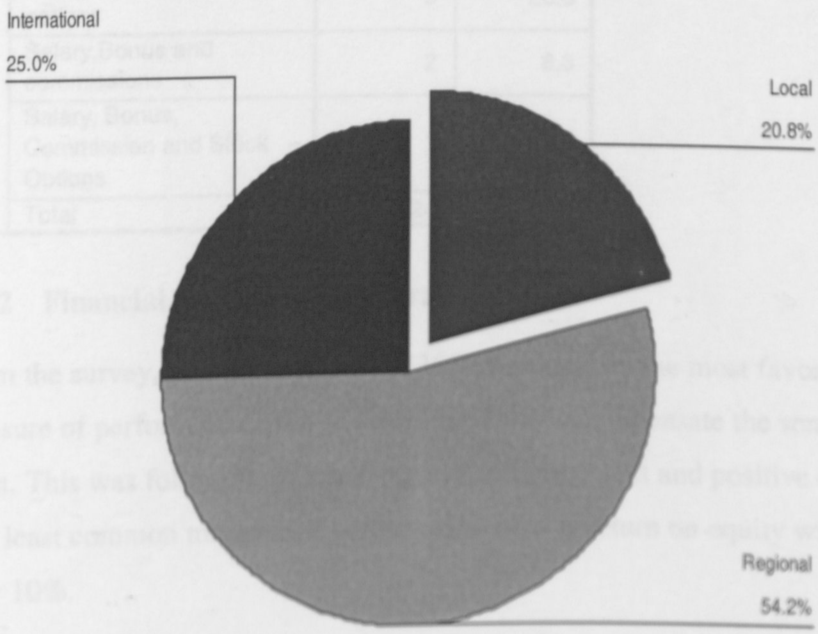
Table 3: Analysis Of Firm Ownership

Ownership of the firm	**No. of firms**	**Percentage**
Foreign owned	0	0%
Locally owned	15	62.5%
Both locally and foreign owned	9	37.5%
Total	**24**	**100%**

Pie chart 3: Analysis of firm ownership



Pie chart 4 Analysis of firm's operations



Most of the companies who responded operate within the regional market and this was followed by companies that operate internationally.
20.8% of the respondents operate in the local market only.

This therefore implies that most of the quoted companies operate in the regional market.

4.2 PERFORMANCE MEASURES USED BY COMPANIES IN KENYA

4.2.1 Compensation Schemes for the senior management team

Most Companies compensate their senior management team using salary and bonus. Very few Companies use salaries only, salary and commissions and salary, bonus, commission and stock options as shown by the survey results in the table below. Bonuses are mainly given to management if their performance exceeds certain expectations.

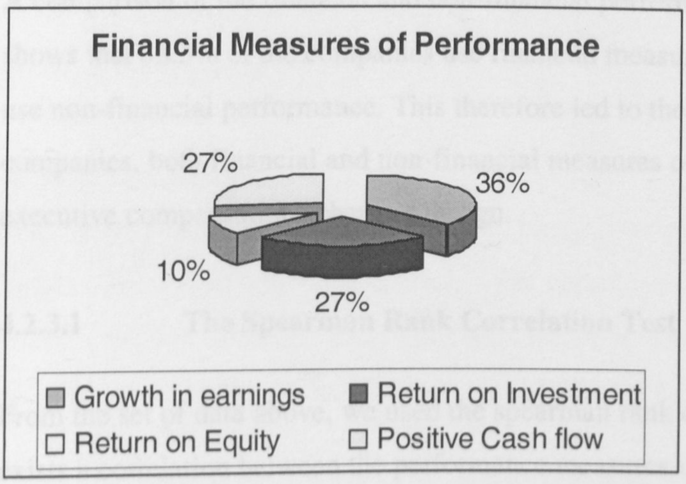
Table 4 Compensation for senior management

Compesation for the senior management	Frequency	Percent
Salary only	1	4.2
Salary and Bonus	14	58.3
Salary and Commissions	1	4.2
Salary, Bonus and Stock options	5	20.8
Salary,Bonus and commissions	2	8.3
Salary, Bonus, Commission and Stock Options	1	4.2
Total	24	100.0

4.2.2 Financial measures of performance

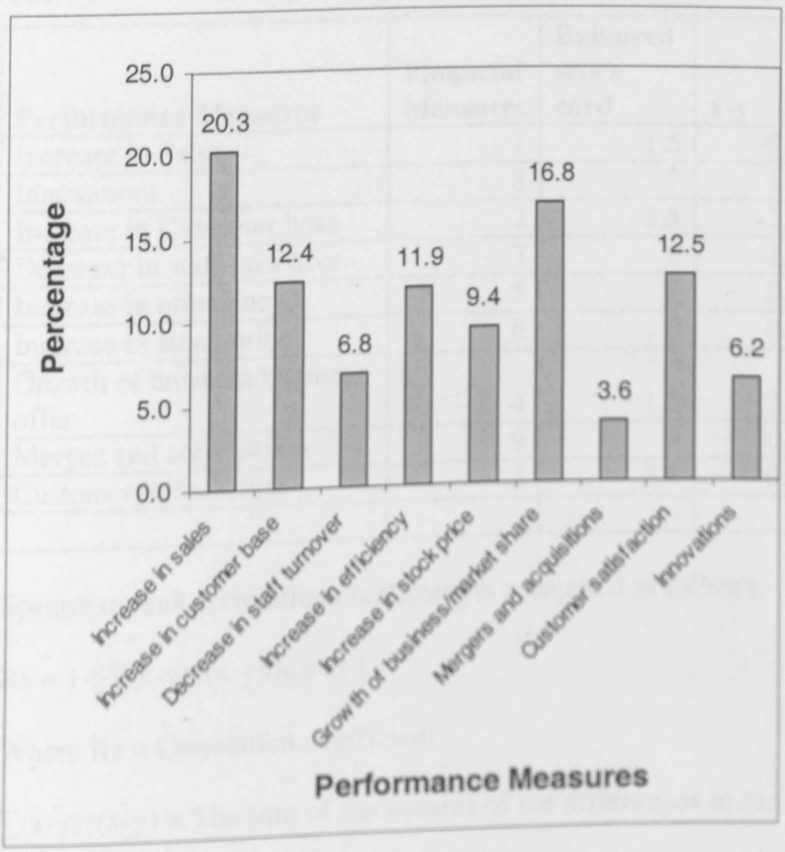
From the survey, growth in earnings (36%) seems to be the most favored financial measure of performance used to determine how to compensate the senior management team. This was followed closely by return on investment and positive cash flow(27%). The least common measure of performance used is return on equity with a percentage of only 10%.

Pie Chart 5 Financial measures of performance



4.2.3 Financial Vs Non Financial Measures of performance

Graph 6 Financial Vs Non Financial Measures of Performance



From these results, it was evident that most companies preferred using increase in sales as a measure of performance. This was followed by growth in business or market share. Mergers and acquisitions is the least favored measure of performance in use.

A comparison of the financial and non-financial performance from the graph above shows that 33.3% of the companies use financial measures while 66.7% of the companies use non-financial performance. This therefore led to the conclusion that for most companies, both financial and non-financial measures of performance are important in executive compensation scheme's design.

4.2.3.1 The Spearman Rank Correlation Test

From the set of data above, we used the spearman rank correlation to find out if there exists a correlation between the performance measures used by Companies that selected financial measures and the balanced score card as measures of performance.

The various rankings are as shown on the table below:

Table 5 Rankings of performance measures

Performance Measures	Financial Measures	Balanced score card	x-y	(x-y)2
Increase in Sales	1	1.5	-0.5	0.25
Innovations	8	7	1.0	1
Increase in Customer base	2	3.5	-1.5	2.25
Decrease in staff turn over	7	8	-1.0	1
Increase in effeciency	5	5	0.0	0
Increase in stock price	6	6	0.0	0
Growth of business/business offer	4	1.5	2.5	6.25
Merges and acquisitions	9	9	0.0	0
Customer Satisfaction	3	3.5	-0.5	0.25
				11

Spearman rank correlation coefficient is computed as follows:

Rs = 1-6∑(x-y)*(x-y)/n(n*n-1)

Where Rs = Correlation coefficient

∑(x-y)*(x-y) = The sum of the squares of the differences in the rankings

n = Number of pairs to be ranked
In our case, Rs = 1-(6*11/9(81-1))= 0.90833

Interpretation

Rs in this case is closer to 1 indicating that there exists a high positive correlation between the rankings.

Tests of significance

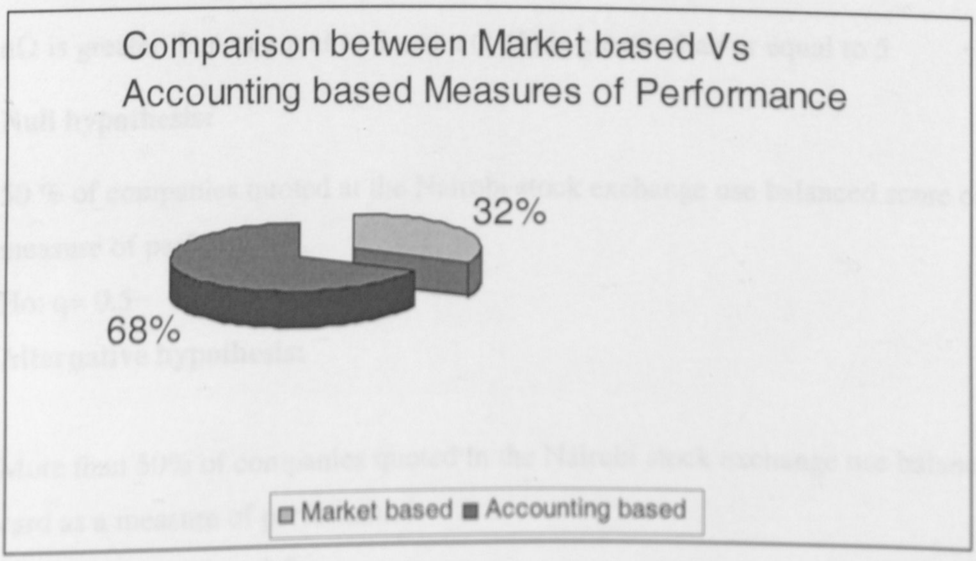
We compare the computed value of Rs to the critical value of spearman's correlation. In this case, the critical value at 5% level of significance based on n=9 is 0.683

In this case, the value of Rs is greater than the critical value hence we conclude that there is a high correlation between the rankings of the two performance measures.

4.2.4 Market Based Vs Accounting Based Measures of Performance

From the survey, it was evident that most of the respondents use accounting based measures of performance in executive compensation schemes.

Pie Chart 7 Comparison between Market Based Vs Accounting Based Measures of Performance



4.2.5 Financial Vs Non Financial Measures of Performance

Table 6 Measures of Performance

The most common measure of performance

The most common measure of performance	Frequency	Percent
Financial measures	9	37.5
Non financial measures	1	4.2
Balanced scorecard	14	58.3
Total	24	100.0

From the survey, it was evident that most companies use both financial and non-financial measures (the balanced score card) in executive compensation schemes.

To ascertain the significance of this assertion, we carried out a hypothesis test of proportions.

Hypothesis tests of proportion

The distribution sample proportion is approximately normal provided that:

$n\Omega$ is greater than or equal to 5 and $n(1-\Omega)$ is greater than or equal to 5

Null hypothesis:

50 % of companies quoted at the Nairobi stock exchange use balanced score card as a measure of performance.

Ho: q= 0.5

Alternative hypothesis:

More than 50% of companies quoted in the Nairobi stock exchange use balanced score card as a measure of performance.

Ha: q is greater than 0.5

N= 24

X=14

Therefore p =14/24=0.583 and since

24*0.5=12 which is greater than 5 and,

24*0.5=12 is also greater than 5

The distribution of sample proportions is approximately normal with a mean of 0.5 and standard deviation ((0.5*0.5)/24)*1/2=0.102

This is a one tailed test at a significance level of 5%

Tests of significance

Critical value for t at significance level of 5% and n of 24=1.711

T value for proportion is computed by:

T= q-u/S.D

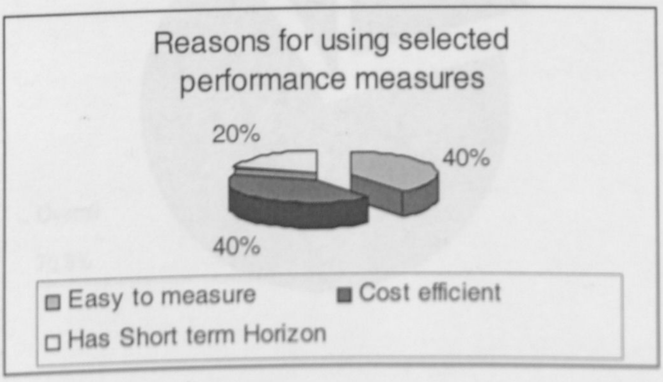
(0.583-0.5/0.102) = 0.814

Interpretation

From the analysis, the critical value of 1.711 is greater than the computed t value hence we reject the null hypothesis and accept the alternative hypothesis which states that over 50% of companies quoted in The Nairobi Stock Exchange use the balanced score card as a measure of performance.

4.2.6 Reasons for using selected performance measures

Pie Chart 8 Reasons for using selected performance measures



From the survey, it was evident that most Companies used selected performance measures because they were easy to measure and cost efficient.

4.2.7 Effectiveness of Performance Measures

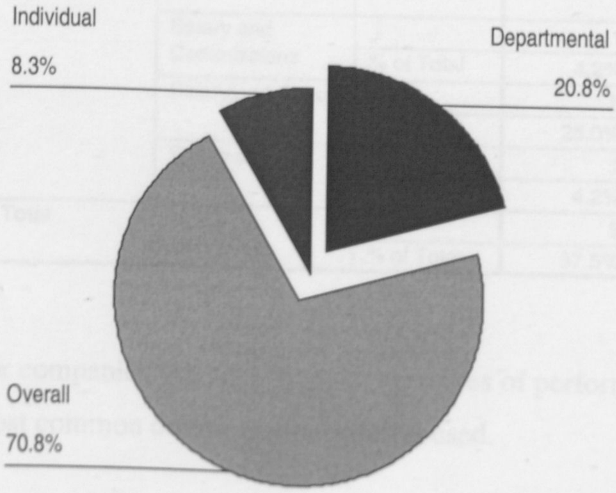
Table 7 Effectiveness of performance measures

Effectiveness of performance measures		Frequency	Percent
	Very Effective	12	50.0
	Effective	7	29.2
	Moderately Effective	5	20.8
	Total	24	100.0

From the survey, 50% of the respondents stated that the performance measures they used were very effective, 29.2% effective and 20.8% moderately effective in achieving the Organization's objectives.

4.2.8 Basis of assessing performance

Pie Chart 9 Assessing performance



From the results of the study, we noted that most Organizations use the overall Company performance in determining employee performance and any compensation thereafter.

4.2.9 Analysis of compensation scheme versus performance measures

Table 8 Comparison of compensation for senior management Vis a Vis measures of performance used.

Compesation for the senior management team * The most common measure of performance Crosstabulation

			The most common measure of performance			
			Financial measures	Non financial measures	Balanced scorecard	Total
Compesation for the senior management team	Salary, Bonus, Commission and Stock Options				1	1
		% of Total			4.2%	4.2%
	Salary,Bonus and commissions		1	1		2
		% of Total	4.2%	4.2%		8.3%
	Salary, Bonus and Stock options				5	5
		% of Total			20.8%	20.8%
	Salary and Commissions		1			1
		% of Total	4.2%			4.2%
	Salary and Bonus		6		8	14
		% of Total	25.0%		33.3%	58.3%
	Salary only		1			1
		% of Total	4.2%			4.2%
Total			9	1	14	24
		% of Total	37.5%	4.2%	58.3%	100.0%

For companies that use financial measures of performance, salary and bonus was the most common compensation scheme used.

Only one Company uses non financial measures of performance and the most common compensation scheme in use was salary, bonus and commission.

For companies that use the balanced score card, 33% of the companies use salary and bonus while 20.8% of the Companies use salary, bonus and stock options.

4.2.10 Analysis of number of employees versus company ownership

Table 9 **Comparison of number of employees Vis a Vis Company ownership.**

			Company Ownership		Total
Number of employees			Local	Joint (Foreign and Local)	
	Greater than 500		7	8	15
		% of Total	29.2	33.3	62.5
	301-500		4	0	4
		% of Total	16.7	0	16.7
	101-300		2	1	3
		% of Total	8.3	4.2	12.5
	Less than 50		2	0	2
		% of Total	8.3	0	8.3
Total			**15**	**9**	**24**
Total		**% of Total**	**62.5**	**37.5**	**100**

From the survey, it was evident that the local Companies had the largest number of employees accounting for about 62.5% of the total employees.

4.2.11 Analysis of executive compensation versus company ownership

Table 10 Comparison of Executive Compensation Vis a Vis Company ownership.

			Company Ownership		Total
			Local	Joint (Foreign and Local)	
Compensation for the senior management team	Salary, Bonus, Commission and Stock Options		1	0	1
		% of Total	4.2	0	4.2
	Salary,Bonus and commissions		0	2	2
		% of Total	0	8.3	8.3
	Salary, Bonus and Stock options		2	3	5
		% of Total	8.3	12.5	20.8
	Salary and Commissions		1	0	1
		% of Total	4.2	0	4.2
	Salary and Bonus		11	3	14
		% of Total	45.8	12.5	58.3
	Salary only		0	1	1
		% of Total	0	4.2	4.2
Total			15	9	24
			62.5	37.5	100
		% of Total	62.5	37.5	100

The results of the survey indicated that most locally owned companies compensate their executives using salary and bonus

However, Companies with joint ownership compensate their senior executives using salary, bonus and stock options or salary and bonus.

The most favored compensation scheme in use is therefore salary and bonus as evidenced by the results in the table above.

4.3 ATTRIBUTES OF THE ORGANISATIONS THAT USE VARIOUS PERFORMANCE MEASURES

Generally, there was no great distinction on the attributes of the companies that use various measures of performance. However, a few notable attributes for specific categories of companies using various performance measures are as highlighted below:

(i) Firms that use financial measures of performance in Kenya have the following Attributes:

- They are a mix of big and medium sized companies with a capital base of between Kshs 6.5 billion to 132 million.
- Most of the Companies that use financial measures of performance are in the commercial and services sector.
- They are long established firms with a mean age of around 48 years since incorporation in Kenya.
- Their performance in the local market is not so good with three of them having negative earnings per share.
- About forty four percent are locally controlled while the rest are jointly controlled and have a significant foreign influence.

There were very few firms that use non-financial measures of performance alone. Most of the Companies use the balanced scorecard.

(ii) Firms that use non financial measures of performance in Kenya have the following Attributes:

- They are medium sized companies with a capital base of over 1 billion.

- They are long established firms with a mean age of around 36 years since incorporation in Kenya.
- Their performance in the local market is above average and most of the Companies have good turnover and positive earnings per share.
- Most of the Companies are jointly owned.

58.3% of the firms use the balanced score card in assessing performance in Organizations.

(iii) Firms that use both financial and non financial (balanced score card) measures of performance in Kenya have the following attributes:

- They are a mix of big, medium and small sized companies with a capital base of between kshs 10 billion to 78 million.
- Most of the Companies that use the balanced score card are in the Finance and Investment and Industrial and Allied Sector.
- They are long established firms with a mean age of around 60 years since incorporation in Kenya.
- Their performance in the local market ranges from firms that perform very well and firms that are not doing so well. The earnings per share range from an average of Shs 15 per share to an average of negative twenty-two shillings per share.
- Most of the Companies are jointly owned.

CHAPTER 5 CONCLUSIONS, RECOMMENDATIONS AND LIMITATIONS OF THE STUDY

5.1 SUMMARY AND CONCLUSIONS

From the above study it is evident that most firms use both financial and non financial measures in assessing and rewarding performance and salary and bonus is the most common compensation scheme for executives.

Balanced score card was the most favoured measure of performance because it combines the strengths and weaknesses of financial and non financial measures of performance. In my opinion, most companies preferred the balanced score card because it captures all aspects of an Organization's performance. Financial measures of performance are measurable and quantifiable while non financial measures of performance captures other important variables such as efficiency, innovation and customer satisfaction.

In today's modern world, it is not enough for companies to just measure financial results but they must also look at factors that contribute towards retention of market share and growth in business such as customer satisfaction. Companies are therefore able to come up with strategies after evaluating their competitive advantage and this is mainly captured by non financial measures of performance.

Majority of Companies that use both financial and non financial measures (balanced scorecard) have been in existence for a number of years and most of them continue showing good results in the market.

Growth in earnings was the most popular financial measure of performance while increase in market share was the most common non-financial measure of performance. Mergers and acquisition was the least favored financial measure of performance and this is mainly attributable to the fact that our financial markets are still at the infancy stage and mergers and acquisitions are not so common in Kenya today.

Most companies preferred using accounting based measures of performance as opposed to market based measures of performance. This is mainly because accounting based measures of performance are quantifiable and measurable while it is not very easy to measure the market based measures of performance because they are subject to fluctuations depending on political, economical, social and technological factors in the environment.

5.2 RECOMMENDATIONS

a) Firms that use both financial and non-financial measures of performance appear to have high share prices, positive earnings per share 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 a combination of both financial and non-financial measures of performance.

b) There is still need for firms to institutionalise various measures of performance and have clear-cut guidelines of how performance can be assessed and rewarded. Measures of performance exist in companies but employees are not aware of how these measures reflect on their performance.

5.3 LIMITATIONS OF THE STUDY

1) It was difficult to access quoted companies that have their head offices up country. This restricted the responses for the study.

2) There was generally limited time for data collection due to pressure from the office and the responding companies.
3) Some companies considered questions in the questionnaire against their policy or too sensitive hence could not fill therefore reducing number of respondents.
4) Most people have a negative attitude towards filling questionnaires and treat questionnaires with a lot of suspicion making it difficult to obtain a good response rate.
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 financial and non-financial measures of performance 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 between performance measures and other areas of the agency conflict like shareholders and creditors.
3) The relationship between performance measures and corporate governance and how performance measures can be used to enhance corporate governance practices.
4) This study can also be carried out in predominant Government institutions and the results can be of great help in streamlining performance in Government institutions and alleviating the agency problem

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APPENDIX II: QUESTIONNAIRE

Performance measures used in Executive Compensation Schemes

N/B

This study regards performance measures used in executive compensation schemes and the information obtained will be confidential and will be used for academic purposes only.

SECTION 1: Background information on the firm

1. Company Name ____________________________________(optional)

2 Company Ownership (Please tick as appropriate)

a) Local ( )

b) Foreign ( )

c) Joint (foreign and local) ( )

3 Please indicate the industry that you are primarily involved in.

a) Manufacturing ( )

b) Service ( )

c) Any other, specify ( )

4 Please indicate the main scope of your company's operations

a) Local ( )

b) Regional ( )

c) International ( )

5 Please indicate the number of employees in your company

a) less than 50 ( )

b) 50-100 ( )

c) 101-300 ( )

d) 301-500 ( )

e) Greater than 500 ( )

SECTION 2

1) How does your company compensate the senior management team? (Please tick as appropriate)

a) Salary only ( )

b) Salary and Bonus ( )

c) Salary and Commissions ( )

d) Salary, Bonus and Stock options ( )

e) Salary and stock options ( )

e) Others (Please specify) ( )

2) How do you measure performance in your organization? (Please tick as appropriate)

a) Growth in earnings ( )

b) Return on investment ( )

c) Return on equity ( )

d) Increase in market share ( )

e) Positive cash flow position ( )

f) Others (Please specify) ( )

3) Is the compensation scheme ticked in 1 above related to the performance measure ticked in question 2 above? (Please tick as appropriate)

a) Yes ( )

b) No ( )

4) In measuring performance, companies use the following variable. Please rank what your Organization uses to measure performance in order of importance starting with 1,2,3

a) Increase in sales ( )

b) Innovations ( )

c) Increase in customer base ( )

d) Decrease in staff turn over ( )

e) Increase in efficiency ( )

f) Increase in stock price ( )

g) Growth of business/market share ( )

h) Mergers and acquisitions ( )

i) Customer satisfaction ( )

j) Other(please specify) ( )

5) What would you say is the most common measure of performance used by your Organization? (please tick as appropriate)

a) Financial measures ( )

b) Non financial measures ( )

c) Balanced scorecard ( )

Balanced score card-(use of both financial and non financial performance measures)

6) If your answer to question 5 above is (a), please tick the reasons for using financial measures listed below in order of importance starting with I,2,3…..

a) It is easy to measure ( )

b) Cost efficient ( )

c) Has a short term horizon ( )

d) Others (please specify) ( )

7) If your answer to question 5 above is (b), please tick the reasons for using financial measures listed below in order of importance starting with I,2,3…..

a) It is easy to measure ( )

b) Cost efficient ( )

c) Has a long term horizon ( )

d) Not easy to manipulate ( )

e) Others (please specify)

8) How effective has the performance measure used by your firm been in evaluating manager performance and compensation. Please tick the effectiveness in order of importance starting with I,2,3…..

a) Very effective ( )

b) Effective ( )

c) Moderately effective ( )

c) Not effective at all ( )

9) What is the basis of assessing performance? (please tick as appropriate)

a) Use of individual performance ( )

b) Use of departmental performance ( )

c) Use of overall firm wide performance ( )

Thank you for your time and effort in filling this questionairre.

Position in the Organization ____________________

Signature ____________________

APPENDIX III

Companies Listed at the Nairobi Stock Exchange

- **Main Investment Market Segment (MIMs)**

Agricultural

2. Brooke Bond Ltd Ord.10.00
3. Kakuzi Ltd Ord.5.00
4. Rea Vipingo Plantations Ltd Ord. 5.00
5. Sasini Tea and Coffee Ltd Ord. 5.00

Commercial and Services

1. Car and General (K) Ltd. Ord 5.00
2. CMC Holdings Ltd. Ord.5.00
3. Hutchings Biemer Ltd Ord.5.00
4. Kenya Airways Ltd. Ord.5.00
5. Marshals (E.A) Ltd. Ord.5.00
6. Nation Media Group. Ord.5.00
7. Tourist Promotion Services Ltd. Ord.5.00
8. Uchumi Supermarket Ltd. Ord.5.00

Finance and Investment

1 Barclays Bank Ltd Ord. 10.00
2 CFC Bank Ltd. Ord 5.00
3 Diamond Trust Bank Kenya Ltd. Ord.4.00
4 Housing Finance Co. Ltd Ord.5.00
5 I.C.D.C Investments Co. Ltd. Ord.5.00
6 Jubilee Insurance Co. Ltd. Ord.5.00
7 Kenya Commercial Bank Ltd Ord.10.00
8 National Bank of Kenya Ltd. Ord.5.00
9 NIC Bank Ltd. Ord.5.00
10 Pan African Insurance Ltd. Ord.5.00
11 Standard Chartered Bank Ltd. Ord.5.00

Industrial and allied

1 Athi River Mining Ltd Ord. 5.00
2 BOC Kenya Ltd. Ord 5.00
3 Bamburi Cement Ltd. Ord.4.00
4 British American Tobacco Kenya. Ltd Ord.5.00
5 Carbacid Investments Investments Co. Ltd. Ord.5.00
6 Crown Berger Ltd. Ord.5.00
7 Dunlop KenyaLtd Ord.10.00
8 E A Cables Ltd. Ord.5.00

9 E A Portland Cement Ltd. Ord.5.00
10 East African Breweries Ltd. Ord.10.00
11 Firestone East Africa Ltd. Ord.5.00
12 Kenya Oil Company Ltd. Ord.5.00
13 Mumias Sugar Company Ltd. Ord.2.00
14 Kenya Power and Lightning Co Ltd. Ord.5.00
15 Total Kenya Ltd. Ord.5.00
16 Unga Group Ltd Ord.5.00

Alternative Investment Market Segment

1 A Baumann and Company Ltd Ord. 5.00
2 City Trust Ltd. Ord 5.00
3 E A Packaging Ltd. Ord.4.00
4 Eaagads Ltd Ord.5.00
5 Express Ltd. Ord.5.00
6 Williamson Tea Kenya Ltd. Ord.5.00
7 Kapchorua Tea Company Ltd Ord.10.00
8 Kenya Orchards Limited Ord 5.00
9 Limuru Tea Co Limited Ord. 20.00
10 Standard Newspapers Group Ord 5.00

APPENDIX IV-RATIOS

1) Return on total assets = Profit before taxes/ Total assets*100%

2) Total assets turnover = Total assets/ Turnover

3) Debt Ratio= Total Liabilities/Total Assets

4) Earnings per share = Earnings attributable to shareholders/ No of outstanding shares.

APPENDIX VI

LIST OF RESPONDENTS

Commercial and Services

1.Car and General (K) Ltd. Ord 5.00
2.Hutchings Biemer Ltd Ord.5.00
3.Kenya Airways Ltd. Ord.5.00
4.Marshals (E.A) Ltd. Ord.5.00
5.Tourist Promotion Services Ltd. Ord.5.00

Finance and Investment

6. Barclays Bank Ltd Ord. 10.00
7. Diamond Trust Bank Kenya Ltd. Ord.4.00
8. I.C.D.C Investments Co. Ltd. Ord.5.00
9. Jubilee Insurance Co. Ltd. Ord.5.00
10. Kenya Commercial Bank Ltd Ord.10.00
11. National Bank of Kenya Ltd. Ord.5.00
12. Pan African Insurance Ltd. Ord.5.00
13. Standard Chartered Bank Ltd. Ord.5.00

Industrial and Allied

14. BOC Kenya Ltd. Ord 5.00
15. Crown Berger Ltd. Ord.5.00
16. Dunlop Kenya Ltd Ord.10.00
17. E A Cables Ltd. Ord.5.00
18. E A Portland Cement Ltd. Ord.5.00
19. East African Breweries Ltd. Ord.10.00
20. Firestone East Africa Ltd. Ord.5.00
21. Kenya Oil Company Ltd. Ord.5.00
22. Kenya Power and Lightning Co Ltd. Ord.5.00
23. Total Kenya Ltd. Ord.5.00
24. Unga Group Ltd Ord.5.00