THE IMPACT OF PERFORMANCE CONTRACTING ON THE PERFORMANCE OF COMMERCIAL STATE OWNED ENTERPRISES

BY

JOSEPH MAINA MWANIKI

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DECLARATION

This is to declare that this paper is my own original work and has not been presented for the award of any degree in any University.

Mwaniki Joseph Maina

Signed:______________________________Date:_________________________

Supervisor

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

Mirie Mwangi

Signed:______________________________Date:_________________________

DEDICATION

I dedicate this paper to my dear parents Mr. and Mrs. Charles Mwaniki for bringing me into this world, bringing me up and always believing in me.

Above all I wish to thank the Almighty God who has brought me this far and from whom all good things come.

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Lastly, I offer my regards and blessings to all those who supported me in any respect while I was undertaking my project.

ABSTRACT

This paper examines the impact of performance contracts in the financial performance of commercial State Owned Enterprises (SOE's) since they were introduced in 2004 .

According to Prajapati (2010), there is a widespread perception in Kenya that ever since its independence performance of the Kenyan public service has been deteriorating. This state of affairs has resulted largely from systems of management in government which put emphasis on compliance with processes rather than results. Even when the top leadership of the country wants to deliver results to the citizens, often they are not able to do so. Usually, there are two main reasons for this; first many government officials are confronted with multiple principals (bosses) with multiple goals (political, non-political, efficiency, equity, etc.) that are often conflicting and they really do not know what is really expected of them. They are unclear about their real responsibilities. In most cases, these officials resolve the trade-offs to serve their personal interests and not the interests of the nation. Secondly, most government official feel they are not responsible for results and thus do not accept the responsibility. It is for this reason that the government of Kenya in 2003, introduced and implemented performance contracts as management tools to create accountability to the public for targeted results. Kenya is one of the few countries to use this approach across the entire pubic sector.

The performance contracts approach shows mixed results with some performance indicators exhibiting growth after the implementation of performance contracts while others declining after implementation of the performance contracts.

This paper highlights areas for further research relating to the implementation of performance contracting in commercial State Owned Enterprises (SOE's) in Kenya so as to make them more effective in ensuring the SOE's perform.

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ABBREVIATIONS

APE's	-	Autonomous Public Enterprises
BSC	-	Balanced Score Card
CIMA	-	Chartered Institute of Management Accountants
DGI	-	Directorate General for Taxes
EBIT	-	Earnings before Interest and Tax
KenGen	-	Kenya Electricity Generating Company
KPC	-	Kenya Petroleum Company
KPI	-	Key Performance Indicator
KPLC	-	Kenya Power and Lighting Company
KSI	-	Key Success Indicators
MT	-	Metric tonnes
MOU	-	Memorandum of Understanding
NPM	-	New Public Management
NSE	-	Nairobi Stock Exchange
OECD	-	Organization for Economic Co-operation and Development
PC	-	Performance Contract
PE	-	Public Enterprise
PSRP	-	Public Service Reforms Programme
ROI	-	Return on Investment
SOE's	-	State Owned Enterprises
SPSS	-	Statistical Package for the Social Sciences

CHAPTER ONE
INTRODUCTION

1.1 Background of the Study

Chartered Institute of Management Accountants (CIMA) (2005), defines performance measurement as the process of assessing the proficiency with which a reporting entity succeeds by the economic acquisition of resources and their efficient and effective deployment in achieving its objectives. Performance measures may be based on non-financial as well as on financial information.

According to Jensen and Meckling (1976) an agency relationship is a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal. The principal hires or retains the agent because of the agent's specific talents, knowledge and capabilities to increase the value of an asset.

According to Dulacha *et al.* (2006), a major issue with respect to the firm is the information asymmetry between managers and shareholders. In this agency relationship, insiders (managers) have an information advantage. Owners therefore face moral dilemmas because they cannot accurately evaluate and determine the value of decisions made. Thus, the agent takes advantage of the lack of observability of his actions to engage in activities to enhance his personal goals.
Agency theory raises a fundamental problem in organizations—self-interested behaviour. A corporation's managers may have personal goals that compete with the owner's goal of maximization of shareholder wealth. Since the shareholders authorize managers to administer the firm's assets, a potential conflict of interest exists between the two groups.

According to Mihnea and Roger (2001), the separation of ownership and control is a fundamental problem of the modern public corporation. The modern public corporation is a relatively new organizational form in the history of societies, dating back to the beginning of this century. Its distinguishing characteristic is the separation of ownership of the assets of the corporation from control of those assets. While ownership of the assets is vested in the shareholders of the corporation (the government), control over these assets is in the hands of professional managers of the corporation. Hence, managers take actions whose consequences are largely carried by the shareholders of the corporation (the government). They identified two kinds of managerial failures that prevent the managers from acting as perfect agents of the shareholders. The first one is failure of managerial competence. This relate to unwitting mistakes in the discharge of managerial control. The other one is failure of managerial integrity, i.e. lies, fabrications, embezzlement and self-dealing. These relate to wilful behaviour on the part of managers that negatively impact the value of the firm's assets.

One of the ways to solve the challenges associated with the agency relationship between the State owned enterprises and the managers of the state owned enterprises is the performance contract. Contracts are mechanisms for resolving, problems that arise from the imperfect alignment of interests. Hence, agency theorists describe the modern corporation as a nexus of contracts (Jensen and Meckling, 1976). These contracts delineate or specify agency relationships between shareholders (principals) and managers (agents).

According to the Kenyan Public Sector Reforms and Performance Contracting guidelines (2009), a Performance Contract (PC) is a freely negotiated performance agreement between the Government, acting as the owner of an Agency, and the management of the Agency. The PC specifies the intentions, obligations and responsibilities of the two contracting parties.

According to Commonwealth Secretariat (1994), the PC system originated in France in the late 1960's. It was later developed with a great deal of elaboration in Pakistan and Korea as a 'signalling system' and was introduced in India in 1986. In pursuit of the goal of performance improvement within the public sector, the adoption of private sector practices in public institutions (Balogun, 2003). Private sector practices have therefore been seen through the public service reform initiatives in many developing countries as the solution to reversing falling service delivery. In quest of this same goal, Kenya introduced performance contracting not only improve service delivery but also to re-focus the mind set of public service away from a culture of inward looking towards a culture of business focused on customer and results.

The performance of the Kenya state owned enterprises had deteriorated by the year 2002. According to Kenya National Bureau of Statistics, the economy grew by an annual average of only 1.5% between 1997 and 2002. After the 2002 general elections; there was a change in leadership. The new government came with a number of reforms aimed at turning around the economy and also improving the performance of the state owned enterprises in their servicedelivery to Kenyans. One of those reforms was introduction of performance contracts. In 2003, the government of Kenya introduced and implemented performance contracts as management tools to create accountability to the public for targeted results. Performance Contracts expanded from a pilot group of 16 financial public enterprises in 2004, to eventually cover the entire public service in Kenya. Performance Contracting forms part of the broader public sector reforms aimed at improving efficiency and effectiveness in the management of the public service in Kenya.

According to Prajapati (2010), PCs were introduced in Kenya's 16 commercial state owned enterprises on a pilot basis on October 1, 2004. In 2006 all Ministries and all state owned enterprises signed PCs. This extended the PCs to the entire public service.

The performance contracts model in Kenya constitutes of a range of performance indicators that cut across the responsibilities and expectations between the government and the government agency to achieve mutually agreed results. It is a useful tool for articulating clearer definitions of objectives and supporting innovative management, monitoring and control methods and at the same time imparting managerial and operational autonomy to public service managers.

The basis of setting performance goals is the strategic plan of the state corporation which is also linked to the Government policy priorities and objectives as set out from time to time. These may include such policy publications as the National Development Plan and the Kenya Vision 2030. If there are public institutions which do not have strategic plans in place at the time of preparing a performance contract, development of a strategic plan is usually included as a performance indicator.

1.2 Statement of the Problem

In pursuit of the goal of performance improvement within the public sector, New Public Management emphasizes on the adoption of private sector practices in public institutions (Balogun, 2003). Performance Contract (PC) establishes general goals for the agency, sets targets for measuring performance and provides incentives for achieving these targets. They include a variety of incentive-based mechanisms for controlling public agencies— controlling the outcome rather than the process. This paper examines the impact of implementing performance contracts in the Kenyan commercial State Owned Enterprises on their financial performance since their introduction in 2003.

According to Commonwealth Secretariat (1994), the introduction of the PC system may be a prelude to privatisation, as it might reduce the accumulated losses of the Public Enterprise (PE) and improve its overall image in the market. Performance contracts are therefore globally used to improve the performance of public enterprises.

According to the Kenya performance Contracts Steering Committee Secretariat (2007), the use of Performance Contracts has been acclaimed as an effective and promising means of improving the performance of public enterprises as well as government departments. Performance contracts represent a tool for improving public sector performance. They are now considered an essential tool for enhancing good governance and accountability for results in the public sector.

Studies have been carried out globally to assess the impact of performance contracts on performance. These studies show varied results. According to Pedersen *et al.* (1999), the Danish Government experience with performance contract is that they led to increased agency performance in terms of improved efficiency and service quality as well as provision of information to the public and users was strengthened. The PC proved to be a useful tool for changing agency priorities in line with changed external demands. In Spain, performance contracting achievements are improved savings, efficiency and customer service. Performance contracts are also used as a tool for transparency and precision of objectives, and to clarify roles and financial responsibilities of the contract parties.

According to Commonwealth Secretariat (1994), in Canada the performance contract provides clarity, transparency and specificity in the roles and responsibilities of the parties for carrying out the partnership agreement. The agreement clearly identifies inputs, outputs and expected outcomes as well as establishes mechanisms for measuring results. In New Zealand, quasi-contractual arrangements are a key piece of a larger reform programme of the public sector management system. Contracts are used to pursue several goals; cost and service, accountability achieving key results, and management/corporate capacity. Reforms have been concerned with structures and systems, as well as roles, responsibilities and relationships in pursuit of performance improvement.

Studies undertaken to assess the impact of performance contracting on performance in Kenya show positive results. According Korir (2003) there has been improvement in the ROI and cement production of East African Portland Cement Company limited since the introduction in 2005. According Kirathe (2008), there has also been varied positive impact on the performance of state owned enterprises in the energy sector. He assessed the impact in three companies namely KenGen, KPC and KPLC.

Studies carried out globally show that performance contracts have positively impacted on the performance of corporations where they have been adopted as management tools. Studies done locally also indicate that performance contracts have had positive impact on performance of selected state owned enterprises. Despite the performance of these companies having improved, they are not representative of all the financial state owned enterprises. There are also no studies done to assess the impact of the performance contracts on the financial performance state owned enterprises listed in NSE since their introduction in 2003. There is therefore need for further study to assess the impact of the performance contracts on the financial performance of commercial State Owned Enterprises in Kenya listed in NSE. This is the gap that this management research proposal seeks to address.

1.3 Objective of the Study

This study seeks to establish the impact of performance contracting on the financial performance of the Kenyan commercial State Owned Enterprises.

1.4 Importance of the Study

This study is important as it will help the government identify whether there is any improvement in the performance of the commercial State Owned Enterprises listed on NSE can be directly attributed to performance contacts.

The study is also important as it will enable management of state owned enterprises highlight areas that need to be improved so as to make the performance contacting in Kenya more successful.

The other importance of the study is that it will enable scholars identify areas for further research in the area of performance contracting in Kenya.

The study will also enable investors understand the management of commercial State Owned Enterprises in Kenya and the measures the government have taken to ensure their performance improves.

CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction

This chapter explores various studies carried out on performance contracting to establish the relationship between performance contracting and performance of state owned enterprises (SOE's).

2.2 Agency Theory

Jensen and Meckling (1976), define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers, there is a good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring some cost.

According to Mihnea and Roger (2001), contracts are mechanisms for resolving problems that arise from the imperfect alignment of interests. Hence, agency theorists speak of the modern corporation as a nexus of contracts (Jensen and Meckling, 1976). These contracts specify agency relationships; between shareholders (principals) and managers (agents), between debt holders (principals) and managers (agents), between shareholders (principals) and directors (agents) and between the directors (principals) and various board committees and task groups (agents). These contracts may be based on unspoken mutual expectations, cultural norms, individual roles, organizational 'common law' or 'culture') or based upon written representations that are legally binding, such as corporate by-laws, shareholders' agreements, subscription agreements and employment contracts. Agency theory is concerned with devising structural and behavioural measures that minimize inefficiencies in the contractual structure of the firm that arise from imperfect alignment of interests between principals and agents.

The elements of agency models of business relationships are decision rights or the rights to exercise control over a particular asset, which come in two different types (Fama and Jensen, 1983). The decision management rights which include the right to initiate a decision and the right to implement a decision. The decision control rights include the right to ratify (give final approval for) a decision, decision monitoring rights (the right to measure the performance of the agent) and sanctioning rights (the right to reward or punish an agent according to the outcomes of his or her decisions).The other right is the knowledge that is critical to the activities of the agent (and sometimes to the activities of the principal), which also comes in two types (Jensen and Meckling, 1976).

The other right is the right of incentives that motivate the agent to act in one way rather than another, given the choice, and are of two kinds (Jensen and Meckling, 1976). It is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint. In most agency relationships the principal and the agent will incur positive monitoring and bonding costs (non-pecuniary as well as pecuniary) and in addition there will be some divergence between the agent's decisions and those decisions which would maximize the welfare of the principal.

According to Mihnea and Roger (2001), pecuniary incentives relate the observable effort level of the agent to a set of monetary rewards for the agent (such as salaries and bonuses), or a set of rewards that can be easily turned into monetary rewards (such as stock grants and warrant and option grants). Non-pecuniary incentives relate the observable effort level of the agent to a set of non-monetary rewards, such as intra-organizational power and prestige, benefits and privileges and market-wide visibility and reputation. Jensen and Meckling (1976) define agency costs as the sum of the monitoring expenditures by the principal, the bonding expenditures by the agent and the residual loss.

2.3 The Balanced Scorecard

Performance contracts structure is also similar to that of the Balanced Scorecard (BSC). According to Maisel (1992), the balanced scorecard was originally developed as a performance measurement system in 1992 by Dr. Robert Kaplan and Dr. David Norton at the Harvard Business School. Unlike earlier performance measurement systems the BSC measures performance across a number of different perspectives; financial, customer perspective, internal business process , innovation and learning.

Through the use of the various perspectives, the BSC captures both leading and lagging performance measures, thereby providing a more "balanced" view of company performance.

Leading indicators include measures, such as customer satisfaction, new product development, on-time delivery, employee competency development, etc. Traditional lagging indicators include financial measures, such as revenue growth and profitability. The BSC performance management systems have been widely adopted globally, in part, because this approach enables organizations align all levels of staff around a single strategy so that it can be executed more successfully.

Organizations have adapted the BSC to their particular external and internal circumstances. Both financial and not for-profit organizations have successfully used the BSC framework. Since 1992, Drs. Kaplan and Norton have studied the success of various applications of the BSC in different types of organizations. Companies have used as few as four measures and as many as several hundred measures when designing a BSC performance measurement system. Based on this research, it has been found that a BSC framework using about 20–25 measures is the usual recommended best practice. Smaller organizations might use fewer measures, but it is generally not advisable to go beyond a total of 25 measures for any single organization, holding company, or conglomerate group of holding companies.

The core characteristic of the balanced scorecard and its derivatives is the presentation of a mixture of financial and non-financial as well as leading and lagging measures each compared to a 'target' value within a single concise report. The report is not meant to be a replacement for traditional financial or operational reports but a concise summary that captures the information most relevant to those reading it. It is the method by which this 'most relevant' information is determined (i.e. the design processes used to select the content) that most differentiates the various versions of the tool in circulation. Performance contracts way of determining key performance indicators borrows from this BSC characteristic.

2.4 Performance Management

Performance is referred to as being about doing the work, as well as being about the results achieved (Otley, 1999). Performance is a multidimensional construct, the measurement of which varies, depending on a variety of factors that comprise it (Fitzgerald and Moon, 1996). Rogers (1994) argue that performance should be defined as the outcomes of work because they provide the strongest linkage to the strategic goals of the organization, customer satisfaction, and economic contributions.

According to Saumya (2004), the primary goal of corporate governance is to solve the agency problem when ownership is separated from management and to assure investors a return on their investment. People who sink the capital need to be assured that they get back the return on this capital. Corporate governance mechanisms provide this assurance. With the absence of direct control over day-to-day managerial decisions, shareholders have to resort to other mechanisms to make sure that managers act in their interests.

2.5 Performance Contracting

Contracts are mechanisms for resolving, problems that arise from the imperfect alignment of interests. Hence, agency theorists speak of the modern corporation as a nexus of contracts (Jensen and Meckling, 1976). These contracts outline agency relationships between shareholders (principals) and managers (agents).

The Kenyan Public Sector Reforms and Performance Contracting guidelines (2009), defines a Performance Contract (PC) as a freely negotiated performance agreement between the Government, acting as the owner of an Agency, and the management of the Agency. The PC clearly specifies the intentions, obligations and responsibilities of the two contracting parties.

Suresh (1994), defines performance contract as a Memorandum of Understanding (MOU). MOU is rooted in an evaluation system, which not only looks at performance comprehensively but also ensures improvement of performance managements and industries by making the autonomy and accountability aspect clearer and more transparent.

According to commonwealth secretariat (2004), PC is a contract between the owner of an enterprise on one side and the management of the enterprise on the other, setting out certain targets/results to be achieved in a given time frame. It also enumerates the mutual obligations of the two parties in achieving the targets set in the contract. The PC system originated in France in the late 1960's and was later developed with a great deal of elaboration in Pakistan and Korea as a 'signalling system' and was introduced in India in 1986.

According to Mihnea and Roger (2001), agency theorists suggest three different principles for redressing inefficiencies imposed on the modern corporation. The first is to align decision rights with specific knowledge useful in order to competently exercise those rights. This principle suggests that decision rights be pushed downward in the organizational hierarchy to the levels at which they reside in the same people (managers or employees) that have the specific knowledge to competently use those rights) (Fama and Jensen, 1983). The other one is to align incentives with decision rights. This principle suggests that the incentive packages given to board members, managers and employees match the decision rights given these people (Jensen and Murphy, 1990). The last one is to design efficient monitoring mechanisms based on observable performance measures on which basis cash bonuses, stock options and stock warrants are awarded. These principles are found in the performance contracts. Performance contracts are therefore expected to improve performance of state owned enterprises.

Rationale for Performance Contracts

According to Prajapati (2010), just like in many other developing countries, there is a widespread perception in Kenya that ever since its independence performance of the Kenyan public service has been deteriorating. This state of affairs has resulted largely from systems of management in government which put emphasis on compliance with processes rather than results. Even when the top leadership of the country wants to deliver results to the citizens, often they are not able to do so. Usually, there are two main reasons for this; first many government officials are confronted with multiple principals (bosses) with multiple goals (political, non-political, efficiency, equity, etc.) that are often conflicting. Therefore, in essence they really do not know what is really expected of them. They have only a fuzzy notion of their real responsibilities. In most cases, these officials resolve the trade-offs to serve their personal interests and not the interests of the nation. Secondly, most government official feel they are not responsible for results and thus do not accept the responsibility. They suffer from the so called "Not-Me" syndrome: if you ask them about a problem, they would say they are not in control.

Over the years, Kenyan government implemented various strategies to address these challenges. Strategies tried include structural adjustments, privatization, financialization, contracting-out, new budgeting and planning systems. Even after implementing these strategies, the performance of the public service did not improve. Subsequently, Kenyan government changed tact and in the Economic Renewal Strategy it decided that performance contracting process be adopted as a management tool in the management of public resources. Thus, all permanent secretaries and chief executives of public enterprises were placed on performance contracts. Today, Performance Contracts cover all the government ministries, all state owned enterprises (including 6 public universities) and all local authorities. Performance Contracts are known variously as Performance Agreements, Program Agreements, Memorandum of Understanding, Contratos de Rendemientos, etc. They are expected to achieve the following; the first is to promote transparency**.** Performance Contract documents list the obligations of all public. PCs also include specific criteria and targets to evaluate success. In addition, they prioritize the success indicators to clearly convey government's priorities to its managers. These documents are put on the internet for all to see and hold the agencies accountable.

The second achievement is to promote accountability**.** At the end of the year, the performance of all government agencies is assessed against the commitment made by them in their respective PCs. The methodology allows the ranking of all public agencies on a scale of 1 through 5. Thus, the evaluation is not descriptive but precise and quantitative. It allows the ranking all public agencies according to their performance. Another key aspect of PC system is that its focus is on enforcing accountability. It is based on the assumption that accountability for results trickles down (but does not trickle up).

The third expected achievement is to promote responsiveness**.** Many countries talk of improving their delivery of services but they do not put any accountability mechanism behind their good intentions ensure that their rhetoric is converted into reality. Kenyan PC policy requires each public agency to design its Service Delivery Charter (Citizens Charter, Client Charter, etc) and then holds the agency accountable for implementing its charter. This is a major innovation and is likely to be a trend setter.

The fourth expected achievement is to transform administration of public agencies by ensuring the have a strategic plan to specify the correct direction. In addition, each agency is required to get an ISO certification. This is a revolutionary concept in government but is common practice in many countries.

According to Kobia and Mohammed (2004), in order to move the implementation of the Public Service Reforms Programme (PSRP) forward, the Government developed and launched the Strategy for Performance Improvement in the Public Service in 2001. The Strategy sought to increase productivity and improve service delivery. They further state that Performance Contracts originated from the perception that the performance of the Public Sector has been consistently falling below the expectations of the Public. The fundamental principle of performance contracting is the devolved management style where emphasis is management by outcome rather than management by processes.

According to Kobia and Mohammed (2004), performance contracting is part of broader Public sector reforms aimed at improving efficiency and effectiveness in the management of Public service. The problems that have inhibited the performance of government agencies are largely common and have been identified as excessive controls, multiplicity of principles, frequent political interference, poor management and outright mismanagement.

According to the Public Sector Reforms and Performance Contracting guidelines (2009), the performance contracts model in Kenya constitutes of a range of performance indicators that cut across the responsibilities and expectations between the government and the government agency to achieve mutually agreed results. It is a useful tool for articulating clearer definitions of objectives and supporting innovative management, monitoring and control methods and at the same time imparting managerial and operational autonomy to public service managers. The basis of setting performance goals is the strategic plan of the state corporation which is also linked to the Government policy priorities and objectives as set out from time to time. These may include such policy publications as the National Development Plan and the Kenya Vision 2030. If there are public institutions which do not have strategic plans in place at the time of preparing a performance contract, development of a strategic plan is usually included as a performance indicator.

Performance contracts in Kenya are designed to have performance indicators which are categorized as Finance & Stewardship, non-Financial, Service Delivery, Operations and

Dynamic/Qualitative. The performance indicators look at the aspects of the performance of the organization to ensure no aspect of the organization is ignored.

According to sensitization /training manual on performance contracts in the public service (2005), financial criteria measures attainment of financial objectives. In the case of financial and other revenue generating agencies the following indicators are used to measure the extent of achievement on gross profit margin, net profit and return on capital employed.

Non-financial performance indicators address issues that have direct bearing on financial outcome but which cannot be quantified in monetary form. They include performance indicators like the market share and compliance with business plans.

Operational performance indicators focus on the effectiveness and efficiency with which an agency achieves its core business. It entails such indicators as output, capacity utilization and total assets turn over.

Dynamic performance indicators address activities which entail expenditure outlays in the present but which benefits can only be realized in the future. They include such indicators as research and development, repairs and maintenance, customer satisfaction and employee training.

Service delivery performance indicators focus on the expected service delivery expectations by the consumers of the service. This is usually a measure of adherence to the service delivery charter.

Each of the performance indicators is allocated a weight which determines the relative importance of each of the indicators. The following weighting system is used for the financial state owned enterprises;

Table 1: Performance Criteria Weights

Performance criteria category	Performance criteria weights
Service Delivery	30
Operations	25
Finance & Stewardship	20
Non-Financial	10
Dynamic/Qualitative	15
Total	**100**

Source: Public Sector Reforms and Performance Contracting Guidelines 2009

2.6 Empirical Studies of Performance Contracts

According to Bouckaert, *et al.*, (1999) performance contracting in Belgium was introduced in the beginning of the nineties in the Belgian public sector. Since their introduction performance contracts have had a number of effects. On human resource management, the new personnel statutes have improved the performance orientedness of human resources management and increased the flexibility of allocating the right person to the right job. Incentives for the public servants to perform better are; promotions made according to performance criteria rather than to seniority, the threat of being dismissed after two negative evaluations, and limited performance-related pay. On the financial management and cost consciousness, the use of performance-based contracts has induced an increased cost consciousness. The organizations have to develop cost-accounting systems and provide yearly financial statements. On the internal organization the use of contracts and the accompanying increase of operational autonomy have also induced some developments in the internal structure. Several organizations are introducing types of internal devolution of management capacities or internal contracting. On the external relations and with respect to changes in customer relations, new interfaces and instruments are installed, resulting in increased client-orientedness. Most federal Autonomous Public Enterprises (APE's) and several para-departmental organizations at regional level now have an ombudsman service.

Bouckaert *et al.* (1999) on their study on public sector performance contracting in Belgium and Flanders found out that in general, performance contracting had induced the organizations to become more oriented towards customers, markets and performance, without putting the provision of essential public services into jeopardy. The increased operational autonomy resulting from the introduction of contracts and management by results was used to increase the performance orientedness of the human resources management. The financial management systems seemed to shift, although in an incoherent way, from an input focus to an output focus. First steps to create a flexible, market-oriented internal structure were taken by the introduction of business units and internal decentralization. The organizations paid more attention to their external relations with their customers by establishing new interfaces.

In Denmark and Finland, performance contracting supports a focus on outputs and results instead of on inputs and rules. It is used to improve target setting and follow-up on results. Performance contracting is seen as a decentralized and flexible way of making agencies more cost-conscious, responsible and accountable. It is also seen as a key instrument for enhancing the strategic thinking and prioritization among the ministries. As a management tool, use of the contractual model aims to reducing principal-agent type problems, such as moral hazard and adverse selection by building a mutual trust relationship instead of strict ex-ante controls of the detailed budget appropriations.

Pedersen *et al.* (1999) studied the impact of performance contracts on performance of state owned enterprises in various countries. In the Danish Government, the experience with performance contract is that firstly, a substantial number of the barriers to efficient agency working fell away. In general, the participating agencies were seen to have fulfilled the targets and result-related requirements established in the contracts. Thus, the result-based contracts did lead to increased agency performance in terms of improved efficiency and service quality. To a large extent the contracts acted as a hub for agency reorganization processes and efficiency activities such as development of internal management and control tools and targeted developmental activities in the personnel domain. In addition, contract establishment often served to increase personnel awareness of work place objectives. In many cases, agency performance was found to be better than the contract specifications. This might suggest that in some cases the requirements were set too low.

Secondly, the findings showed that provision of information to the public and users was strengthened. The contracts generally focused strongly on level of service, case handling times and information. The views and satisfaction of the public and users were directly incorporated in the contracts, partly in conjunction with the need analyses on which the required results were based and partly in conjunction with requirements for user surveys.

Thirdly, the contract management project generally resulted in an improved dialogue between agencies and departments. The intensive contract negotiations led to the creation of a network of contacts between the parties at all levels. The departments gained improved insight into the workings of the agencies, which led to a more holistic, all-round dialogue rather than the traditional ad hoc dialogue focusing on detailed issues. In addition, the reporting provided improved documentation of agency activities, something that in turn improved the quality of communication.

Fourthly, contract management proved to be a useful tool for changing agency priorities in line with changed external demands. The potential for policy control was improved as a result of the improved information platform. At the same time, better integration of programme management and financial management was achieved, something that was very largely lacking in the normal one-year budget negotiations. However, there was criticism in the evaluation that the excellent strategic control potential of contract management was not adequately used by ministers and departments. Nevertheless, positive results were achieved, even with the limited departmental strategy participation to date.

Finally, the project showed that it was possible to develop the necessary methodology for measuring and documenting even highly complex activities. As well as the conventional quantitative measures (efficiency, savings), success was achieved in developing systems for measuring the quality of case handling. In addition, two agencies succeeded in establishing requirements for quality improvements. Examples of “soft” measuring tools contained in the contracts include user surveys and image analyses. This was one of the most important results in the project.

According Peter *et al.* (1999), in Denmark and Finland, performance contracting supports a focus on outputs and results instead of on inputs and rules. It is used to improve target setting and follow-up on results. Performance contracting is seen as a decentralized and flexible way of making agencies more cost-conscious, responsible and accountable. It is also seen as a key instrument for enhancing the strategic thinking and prioritization among the ministries. As a management tool, use of the contractual model aims at reducing principal-agent type problems, such as moral hazard and adverse selection by building a mutual trust relationship instead of strict ex-ante controls of the detailed budget appropriations.

Christine (1999) carried case studies in Spain, Canada and New Zealand. In Spain, performance contracting occurs in an ad hoc, rather than systematic way. The most common objectives for performance contracting appear to be improved savings, efficiency and customer service. Performance contracts are also used as a tool for transparency and precision of objectives and to clarify roles and financial responsibilities of the contract parties.

In Canada performance contracting is used to manage Federal-Provincial partnerships for the design and delivery of active labour market development measures. The objectives of the partnerships include addressing duplication and overlap, improving client services, remedying lack of decision making flexibility at the local level, and the need to monitor, assess and evaluate results more closely. The performance contract provides clarity, transparency and specificity in the roles and responsibilities of the parties for carrying out the partnership agreement. The partnership agreements are unique within the Canadian administration. The agreement clearly identifies inputs, outputs and expected outcomes as well as establishes mechanisms for measuring results. It is designed to give structure to the demands and expectations of both parties and the public, for efficient and effective management, value for money, accountability and mutual agreement on governance arrangements, results and assessment.

In New Zealand, quasi-contractual arrangements are a key piece of a larger reform programme of the public sector management system. Contracts are used to pursue several goals; cost and service, accountability (achieving key results) and management/corporate capacity. Reforms have been concerned with structures and systems, as well as roles, responsibilities and relationships in pursuit of performance improvement.

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Sonja (1999), did a study on public sector performance contracting in New Zealand. It was on case studies of the ministry of justice and department for courts. Since 1984, New Zealand had undertaken a bold and rapid programme of reforms of both its economic policy and its public sector management systems. Changes to economic policy were driven by a need to address the faltering economy and move away from the pervasive and rigid government interventions and controls in the economy that were characteristic, particularly in the early 1980s. Public sector reforms were driven by a growing concern that the government's own management practices were adversely affecting macroeconomic performance and the achievement of its own priorities.

The New Zealand public sector reforms had been concerned not only with structures and systems, but also with roles, responsibilities, and relationships in pursuit of performance improvement. Improving the system was an evolutionary process, and, as the environment within which public sector management took place was continually changing, arrangements should be the subject of continual review and assessment. Nearly ten years after, the performance system adopted in New Zealand had shown pleasing results. It continued to be reviewed and adapted to assist managers to improve their performance and that of their organizations in meeting the government's objectives.

Studies on the impact of performance contracts on performance of public institutions in Kenya have also been undertaken. According Korir (2003), East African Portland Cement Company limited signed the first performance contract in March 2005. The company's ROI rose from 4% in 2001 to 11% in 2006. Its cement production increased from 417,575 MT in the year 2001 to 703,220 MT in 2006. Its domestic market share increased from 35% in 2001 to 38% in 2006. Performance contracts have therefore impacted positively in the performance of the company.

According Kirathe (2008), in a study which was assessing the impact of performance contracting on the performance of companies in the energy sector states that performance contracts have had a varied positive impact on the performance of state owned enterprises in the energy sector. He assessed the impact in three companies namely KenGen, KPC and KPLC. In this study the impact was assessed on financial perspective, employee/people perspective, customer/stakeholder perspective and internal business perspective. There was growth in the four perspectives with the highest impact being on the financial perspective.

Kobia and Mohammed (2006) also did a paper on the Kenyan experience with performance contracting. They concluded that, performance contracting had induced the public service to become more oriented towards customers, markets and performance, without putting the provision of essential public services into jeopardy.

According to Shirley (1997), the logic of performance contracts is persuasive, but the reality has been disappointing. Two empirical studies—one analyzing the effect of such contracts on profitability and productivity in twelve companies in six countries and the other examining statistically the correlation between performance contracts and productivity in hundreds of state enterprises in China—found no evidence that performance contracts had improved efficiency. The first study analyzed the effects of contracts in monopoly enterprises (in water, electricity, telecommunications, and oil and gas) in Ghana, India, the Republic of Korea, Mexico, Philippines, and Senegal. It found no pattern of improvement associated with the performance contracts in productivity or profitability trends. The second study used a much larger sample in manufacturing but in only one country, China. The results showed that the increasing use of performance contracts in China could not stem the fall in productivity among state enterprises. More important, the study found no robust, positive association between performance contracts and productivity. A comparison of a sample of state enterprises that had signed performance contracts with a sample of firms that had not found any significant difference between the two groups. Although the studies did not measure social benefits, the weights that contracts assigned to productivity targets (two-thirds on average) and the stated goals of the parties to the contracts suggest that improving operating efficiency was the prime objective. Moreover, most social and political goals imposed constant costs on state enterprises during the period and so should not have affected the trends being measured.

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Kobia and Mohammed (2006) also did a paper on the Kenyan experience with performance contracting. In their study, data was gathered from 280 senior public officials. Data were collected from the course participants who were central in the implementation of performance contract in their ministries. They noted that there was remarkable and unprecedented improvement in profit generation for commercial State Owned Enterprises and unprecedented improvement in service delivery and operations by the bulk of state owned enterprises and statutory boards.

A majority of the respondents 179 (63.9%) felt that the performance contract has helped improve communication with the public while 164 (68.6%) agreed that performance contract would increase accountability among public officers. A majority 217 (77.5%) of the respondents felt that performance contracts had introduced setting of the individual job expectations and staff performance plans. They concluded that, performance contracting had induced the public service to become more oriented towards customers, markets and performance without putting the provision of essential public services into jeopardy.

In conclusion, these studies show that performance contracts have worked in countries that they have been implemented. However their is a gap in that none of these studies done globally and locally concentrated on the financial performance of financial state corporations.

CHAPTER THREE
METHODOLOGY

3.1 Introduction

This chapter outlines the research approach used to gather data for analysis. It also describes how the data collected was analysed so as to assess the impact of performance contracts on financial performance of financial SOE's listed in the NSE.

3.2 Research Design

The study aimed at establishing the impact of performance contracting on the financial performance of the Kenyan commercial State Owned Enterprises since their introduction in 2004.

It was is a quantitative research and data was collected to assess the relationship between performance contracts and financial SOE's listed in the NSE. It covered the financial SOE's listed in the NSE that has signed performance contracts. The period covered in data collection was three years before the signing of the performance contracts and three years after the signing the performance contracts. The reason for this was to collect sufficient data for analysis.

3.3 Population and Sample

The target population for the study was the 134 SOE's in Kenya. The sample was the 16 commercial SOE's which signed performance contracts when they were introduced in 2004. This sample was expected to give credible results after the data analysis is done since data was gathered three years prior to signing of performance contracts and three years after the signing of performance contracts.

3.4 Sampling

The criteria for choosing that sample were that the SOE was commercial and it signed a performance in 2004 when they were introduced. The study was on 16 commercial SOE's who signed performance contracts when they were introduced in 2004. The reason for choosing this sample was to ensure that a high number of respondents were arrived at so as to increase the accuracy of results got from the analysis of the data as data was gathered three years prior to signing of performance contracts and three years after the signing of performance contracts.

3.5 Data collection

The financial statements provided the data for analysis. Different financial ratios were computed so as to measure different aspects of financial performance. For profitability, net profit margin and Return on investment (ROI) was computed. To measure liquidity, acid test ratio and cash ratio was computed. To measure level of activity, assets turnover was be computed. The data collected for analysis was three years prior to the signing of the performance contract and three years after signing of performance contracts. The reason for this was to establish the trend in their performance before they signed performance contracts and after the signing of performance contracts. The above financial ratios are good indicators of how well a given state owned financial enterprise is performing financially as they measure profitability, liquidity leverage and activity. A data collection form was used to collect the ratios to be analysed.

3.6 Data Analysis

The variables analyzed were net profit margin, ROI, current ratio, cash ratio and assets turnover. The average of each of these was computed for the SOE three years before the signing of the first performance contract and three years after the signing of the performance contracts. The year of signing the performance contract was the base year such that; x was the performance before the introduction of performance contracts and y represented the performance after the introduction of performance contracts. The z statistics was used to test the hypothesis that there has been improvement in the performance of the state owned financial enterprises quoted in the NSE after the signing of performance contracts at 95% confidence level.

The data analysis was done using procedures within the Statistical Package for the Social Sciences (SPSS) Statistics 17 because the software has many features and is easy to use. It also enabled findings to be presented in bar graphs, line graphs and pie charts. Line graphs were used to show the trend in the financial performance of the SOE’s.

CHAPTER FOUR

4.1 Data Analysis and findings

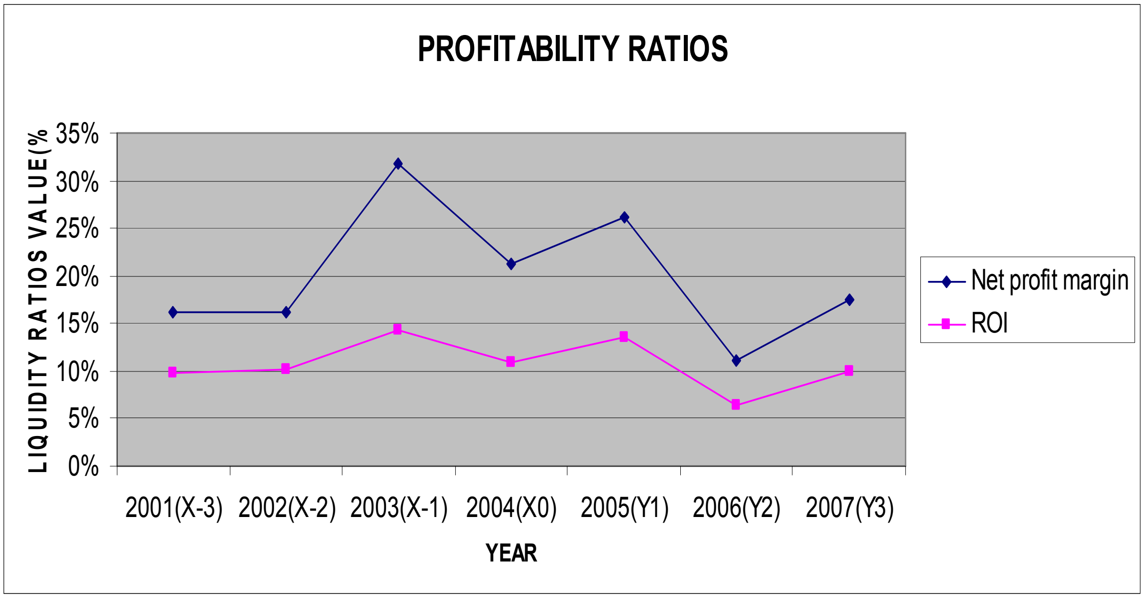
The variables to be analyzed were net profit margin, ROI, current ratio, cash ratio and assets turnover. The average of each of these was computed for each SOE three years before the signing of the first performance contract and three years after the signing of the performance contracts. The year of signing the performance contract was the base year such that; x was the performance before the introduction of performance contracts and y represented the performance after the introduction of performance contracts at 95% confidence level.

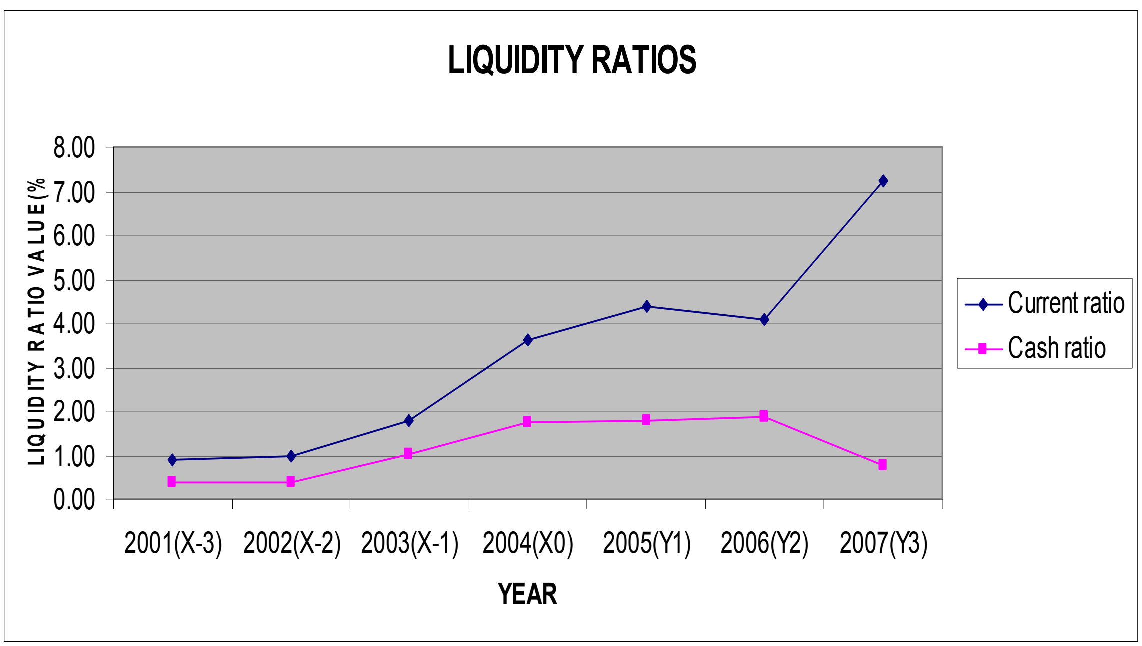
The following table summarises the three years average financial ratio performance before the signing of performance contracts and three year average performance after the signing of performance contracts. The table also indicates the standard deviation of the various financial ratios three years before signing of performance contracts.

Table 2: Kenya Reinsurance Corporation Ltd's Financial Performance

Kenya Re	**Three years Average (Before PC) (2001-2003)**	**Three years Average (after PC) (2005-2007)**	**Standard deviation (before PC)**
Net profit margin	21%	18%	9%
ROI	11%	10%	2%
Current ratio	1.20	5.24	0.50
Cash ratio	0.61	1.48	0.37
Assets turnover	22%	29%	2%

The following graphs show the trend on financial ratios of Kenya Reinsurance Corporation Ltd three years before the signing of performance contracts and three years after the signing of performance contracts.





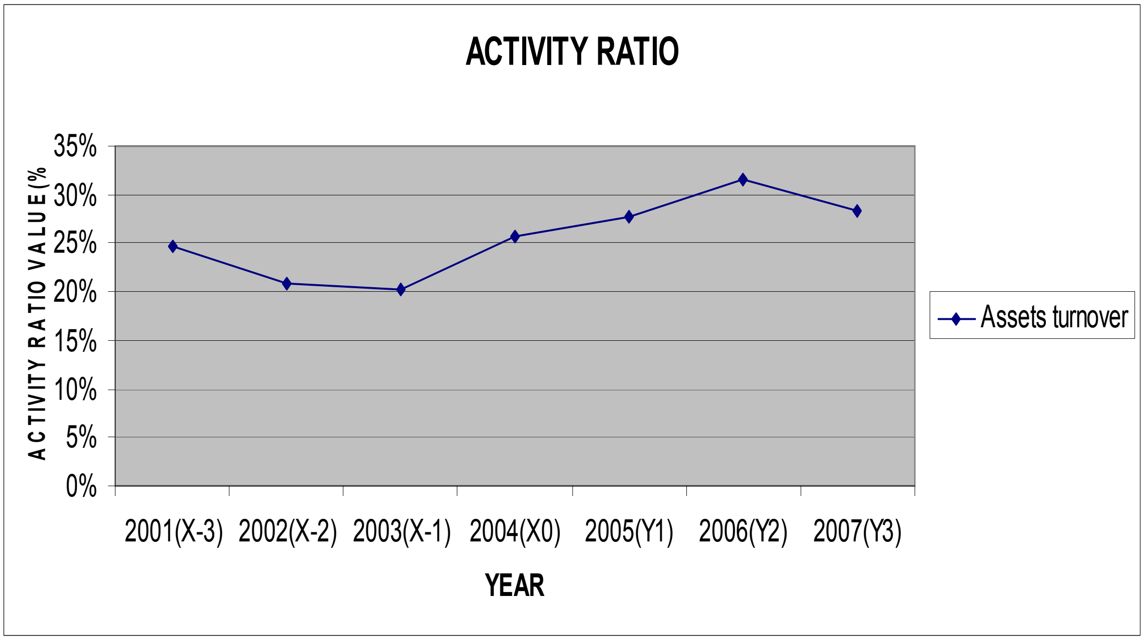


Table 3: Kenya Reinsurance Corporation Ltd PC's Impact Significance Testing

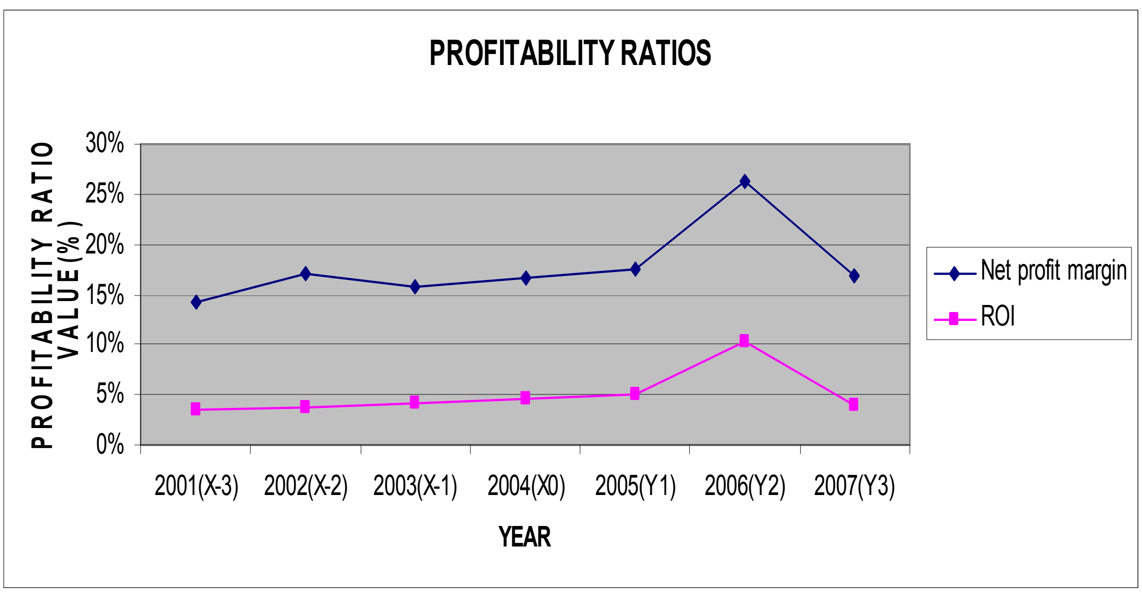
	Z score	Z value	Significance test
Net profit margin	0.35	0.6368	64%
ROI	0.58	0.719	72%
Current ratio	2.12	0.99086	99%
Cash ratio	2.36	0.99086	99%
Assets turnover	2.08	0.9989	99.9%

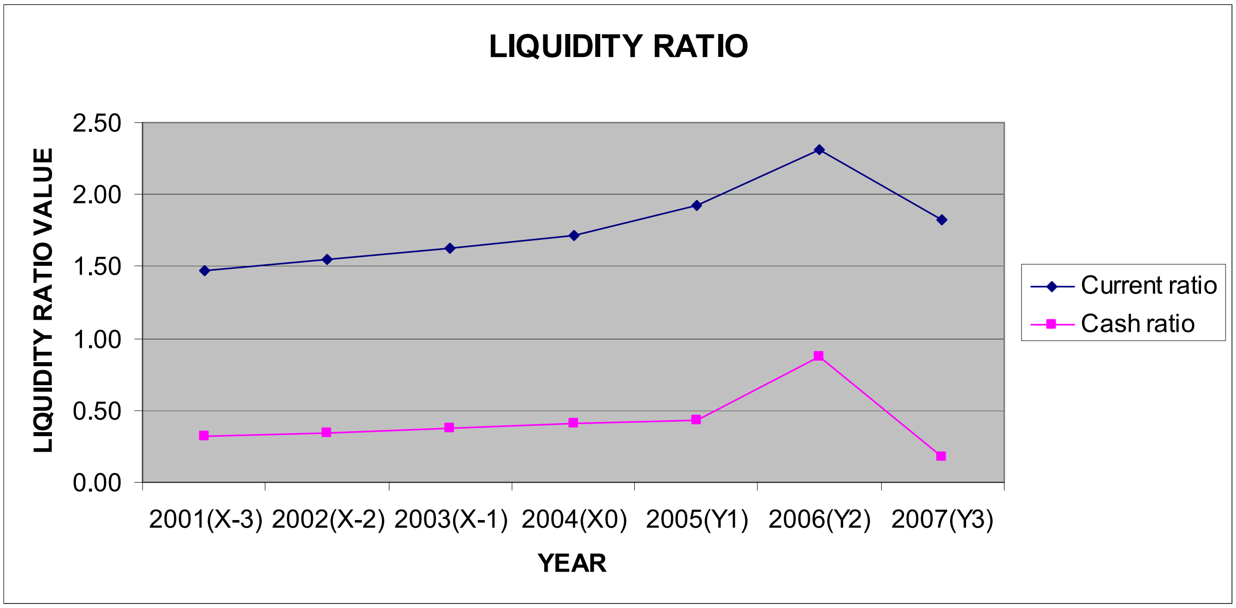
In the above table there is significant improvement in the current ratio, cash ratio and assets turnover. However there is no significant improvement in the net profit margin and ROI.

Table 4: Kengen Ltd's Financial Performance

Kengen	Three years Average (Before PC) (2001-2003)	Three years Average (after PC) (2005-2007)	Standard deviation (before PC)
Net profit margin	16%	20%	1%
ROI	4%	6%	0.37%
Current ratio	1.55	2.02	0.08
Cash ratio	0.35	0.49	0.03
Assets turnover	14%	17%	1%

The trend in the financial ratios of Kengen three years before the signing of performance contracts and three years after the signing of performance contracts is represented in the following graphs.




LIQUIDITY RATIO
LIQUIDITY RATIO VALUE
2.50
2.00
1.50
1.00
0.50
0.00
2001(X-3) 2002(X-2) 2003(X-1) 2004(X0) 2005(Y1) 2006(Y2) 2007(Y3)
YEAR
Current ratio
Cash ratio

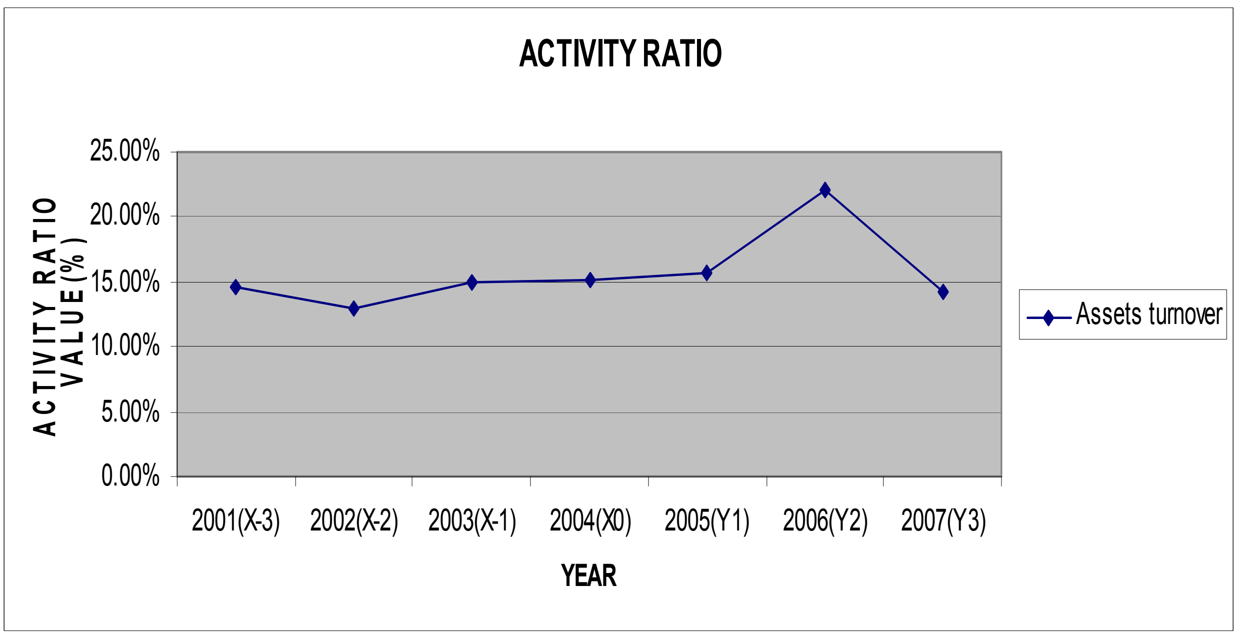

ACTIVITY RATIO
ACTIVITY RATIO VALUE(%)
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
2001(X-3) 2002(X-2) 2003(X-1) 2004(X0) 2005(Y1) 2006(Y2) 2007(Y3)
YEAR
Assets turnover

Table 5: Kengen PC's Impact Significance Testing

	Z score	Z value	Significance test
Net profit margin	2.12	0.983	98.30%
ROI	2.17	0.985	98.50%
Current ratio	2.94	0.9984	99.84%
Cash ratio	2.76	0.9971	99.71%
Assets turnover	2.87	0.9979	99.79%

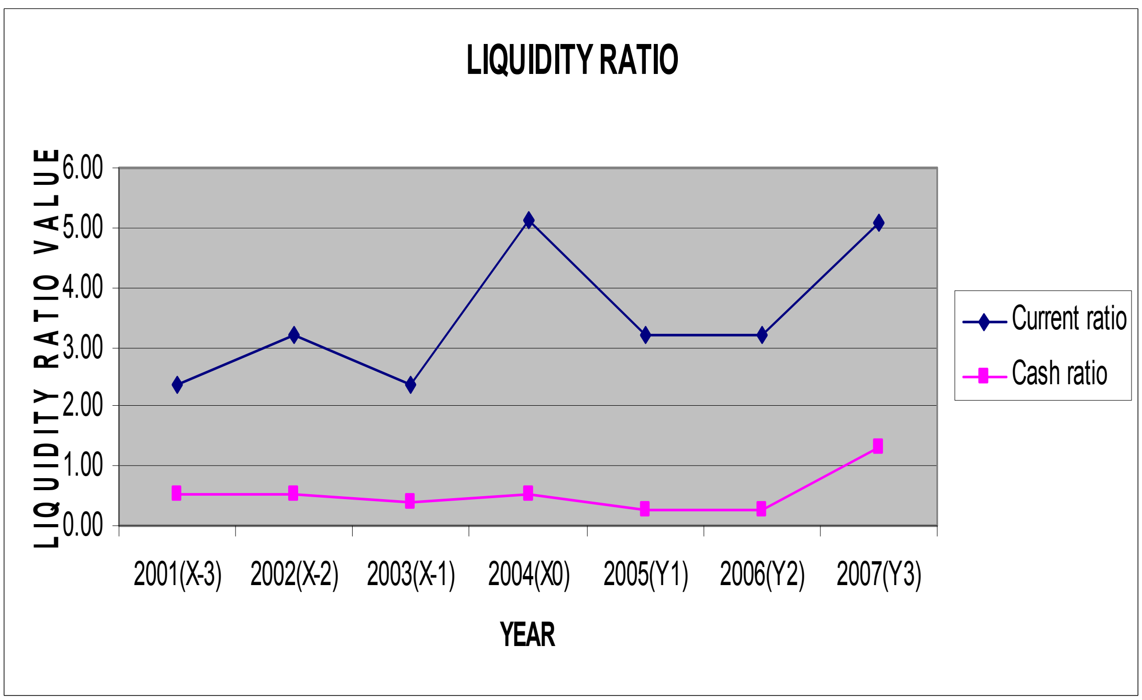
In the above table there is significant improvement in the net profit margin, ROI, current ratio, cash ratio and assets turnover.

Table 6: Kenya Pipeline Corporation Ltd's Financial Performance

Kenya Pipeline Corporation Ltd	Three years Average (Before PC) (2001-2003)	Three years Average (after PC) (2005-2007)	Standard deviation (before PC)
Net profit margin	23%	33%	4%
ROI	16%	18%	2%
Current ratio	2.65	3.83	0.47
Cash ratio	0.47	0.62	0.08
Assets turnover	38%	43%	8%

Kenya Pipeline Corporation Ltd's trend on financial ratios three years before the signing of performance contracts and three years after the signing of performance contracts is illustrated below.


PROFITABILITY RATIO
PROFITABILTY RATIO VALUE(%)
40%
35%
30%
25%
20%
15%
10%
5%
0%
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Net profit margin
ROI


LIQUIDITY RATIO
LIQUIDITY RATIO VALUE
6.00
5.00
4.00
3.00
2.00
1.00
0.00
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Current ratio
Cash ratio

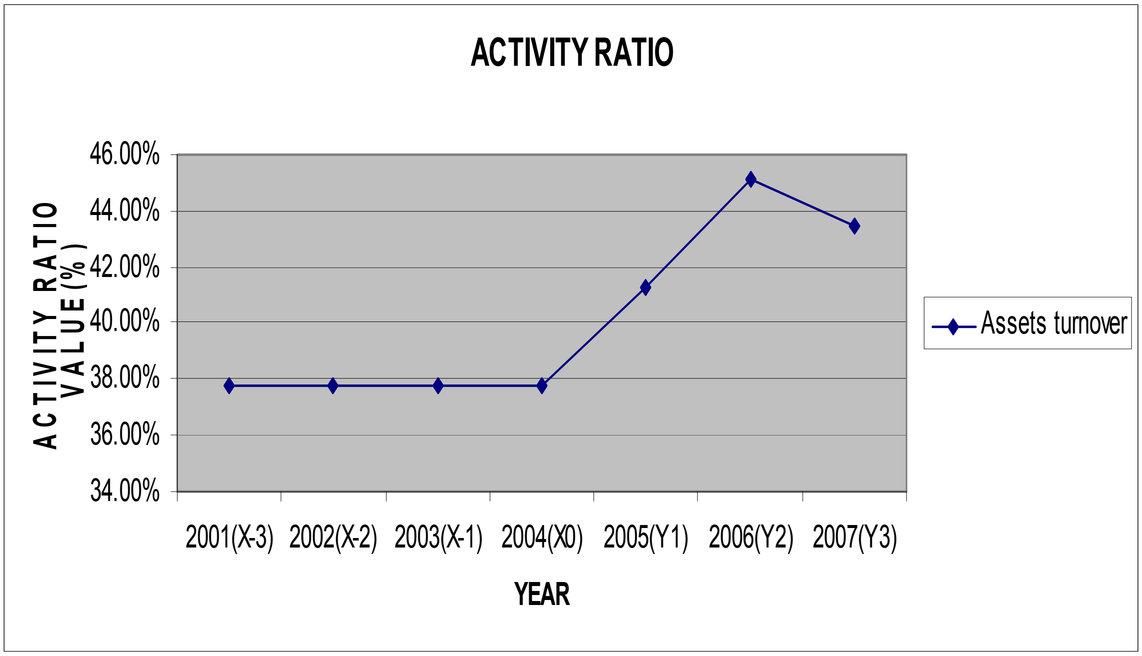


Table 7: Kenya Pipeline Corporation Ltd PC's Impact Significance Testing

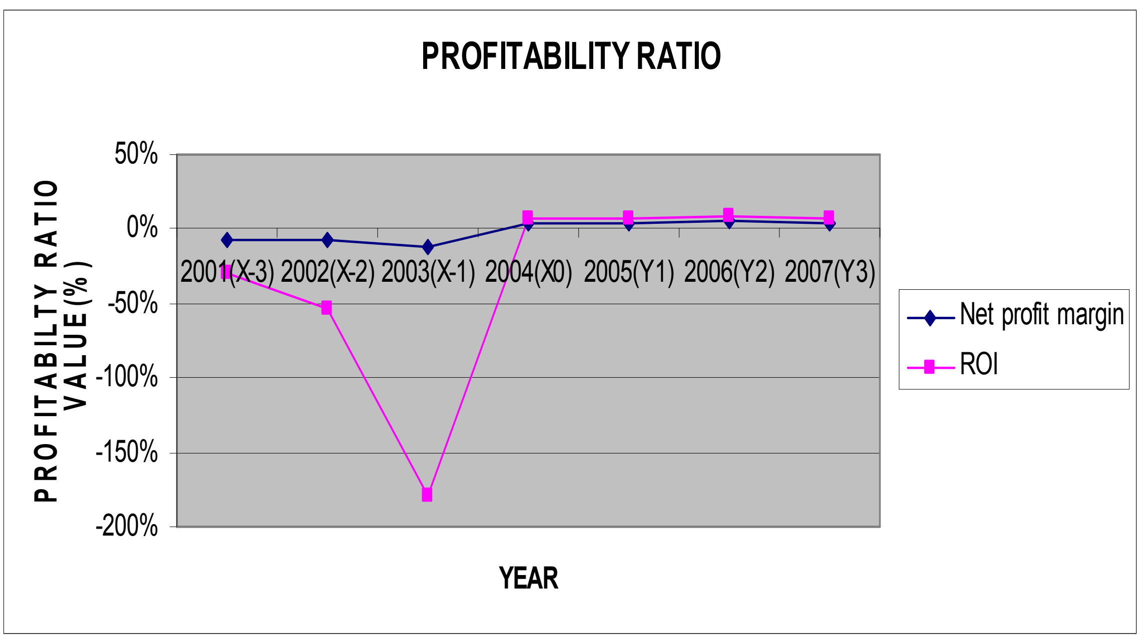
	Z score	Z value	Significance test
Net profit margin	2.18	0.6368	63.68%
ROI	1.01	0.719	71.90%
Current ratio	2.53	0.99086	99.09%
Cash ratio	1.95	0.99086	99.09%
Assets turnover	0.73	0.9989	99.89%

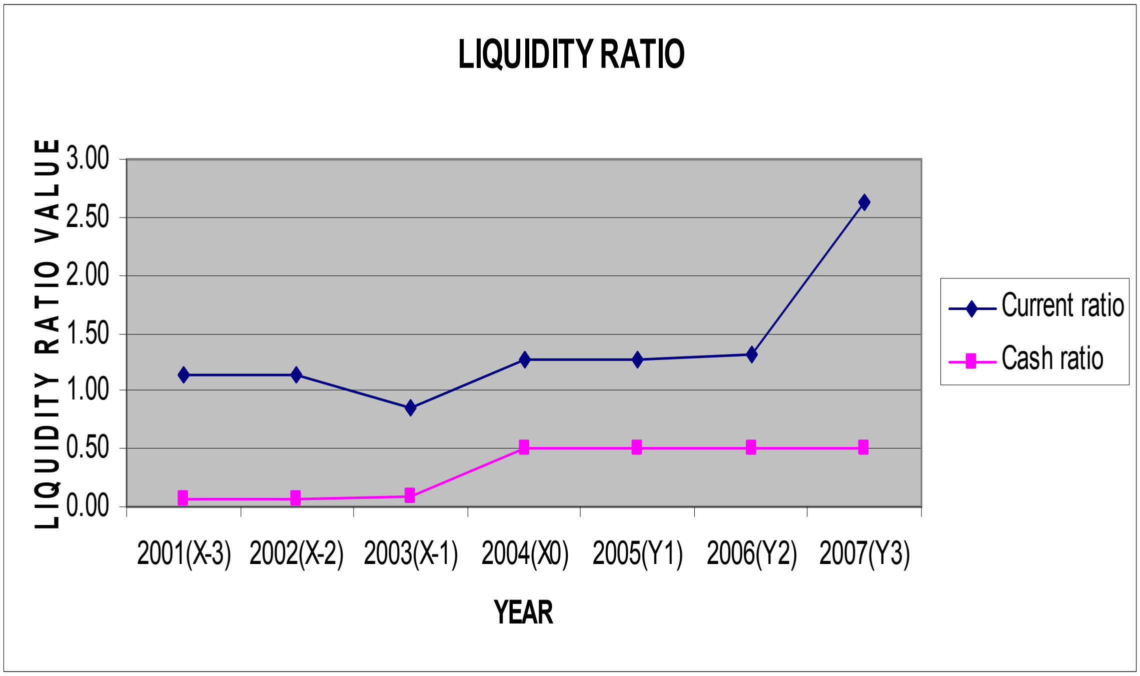
In the above table there is significant improvement in the current ratio, cash ratio and assets turnover. However there is no significant improvement in the net profit margin and ROI.

Table 8: Kenya Power and Lighting Company's Financial Performance

Kenya Power and Lighting Company Ltd	Three years Average (Before PC) (2001-2003)	Three years Average (after PC) (2005-2007)	Standard deviation (before PC)
Net profit margin	-8%	5%	3%
ROI	-87%	7%	80%
Current ratio	1.04	1.74	0.16
Cash ratio	0.07	0.51	0.02
Assets turnover	85%	84%	2%

Kenya Power and Lighting Company Ltd's trend on financial ratios three years before the signing of performance contracts and three years after the signing of performance contracts is illustrated below.




LIQUIDITY RATIO
LIQUIDITY RATIO VALUE
3.00
2.50
2.00
1.50
1.00
0.50
0.00
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Current ratio
Cash ratio

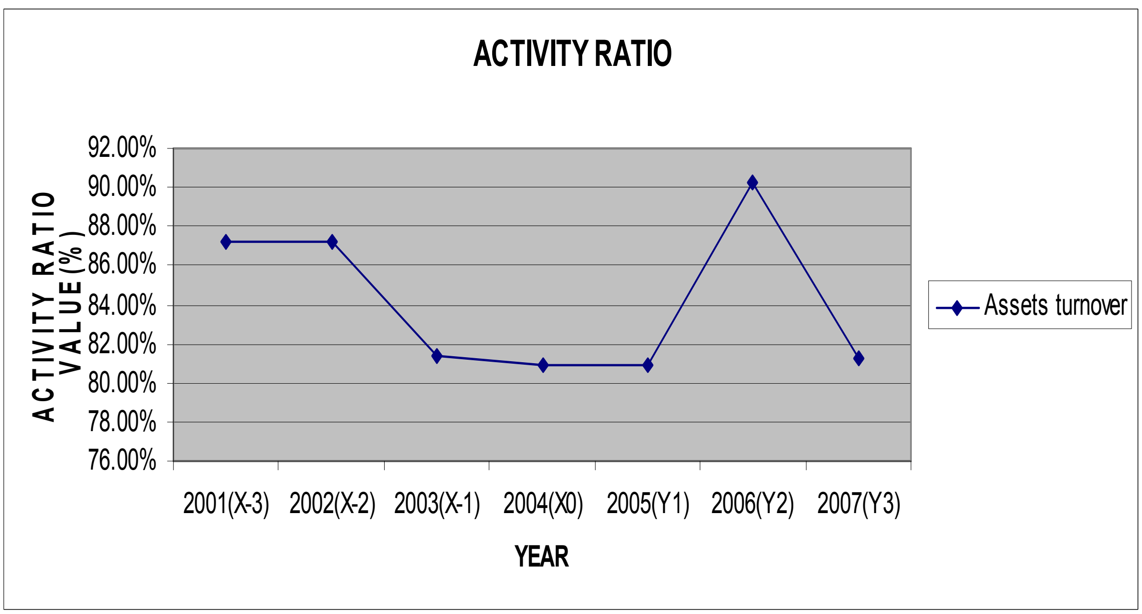

ACTIVITY RATIO
ACTIVITY RATIO VALUE (%)
92.00%
90.00%
88.00%
86.00%
84.00%
82.00%
80.00%
78.00%
76.00%
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Assets turnover

Table 9: Kenya Power and Lighting Company Ltd PC's Impact Significance Testing

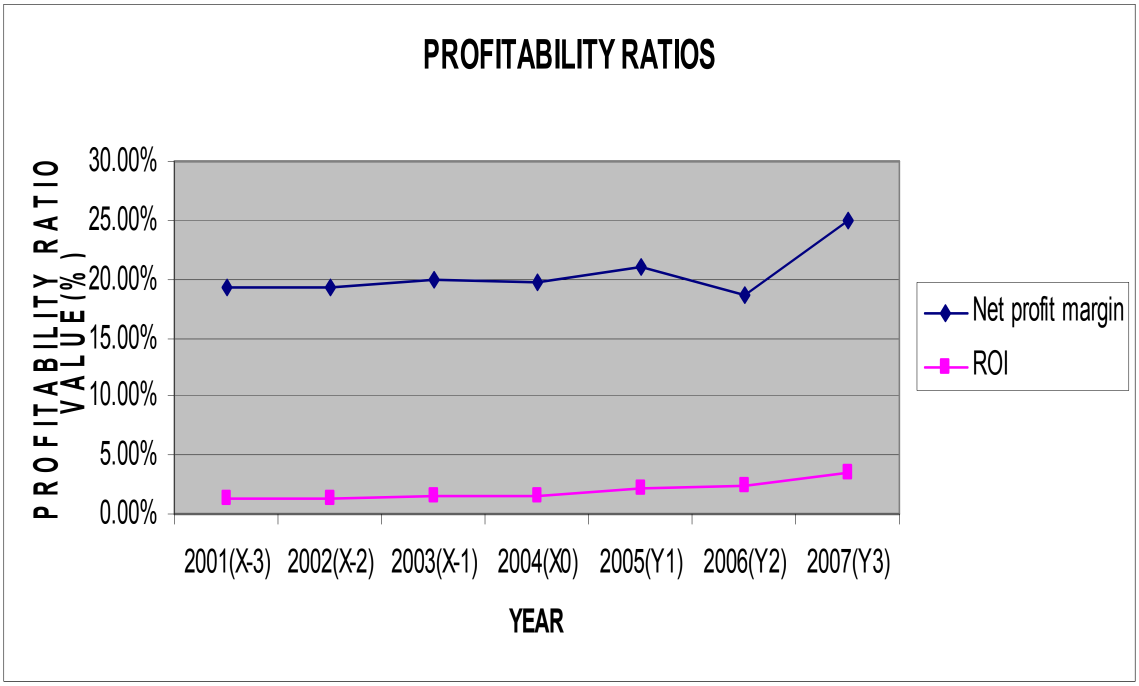
	Z score	Z value	Significance test
Net profit margin	2.86	0.9979	99.79%
ROI	1.19	0.883	88.30%
Current ratio	2.30	0.9393	93.93%
Cash ratio	2.35	0.9906	99.06%
Assets turnover	0.60	0.7257	72.57%

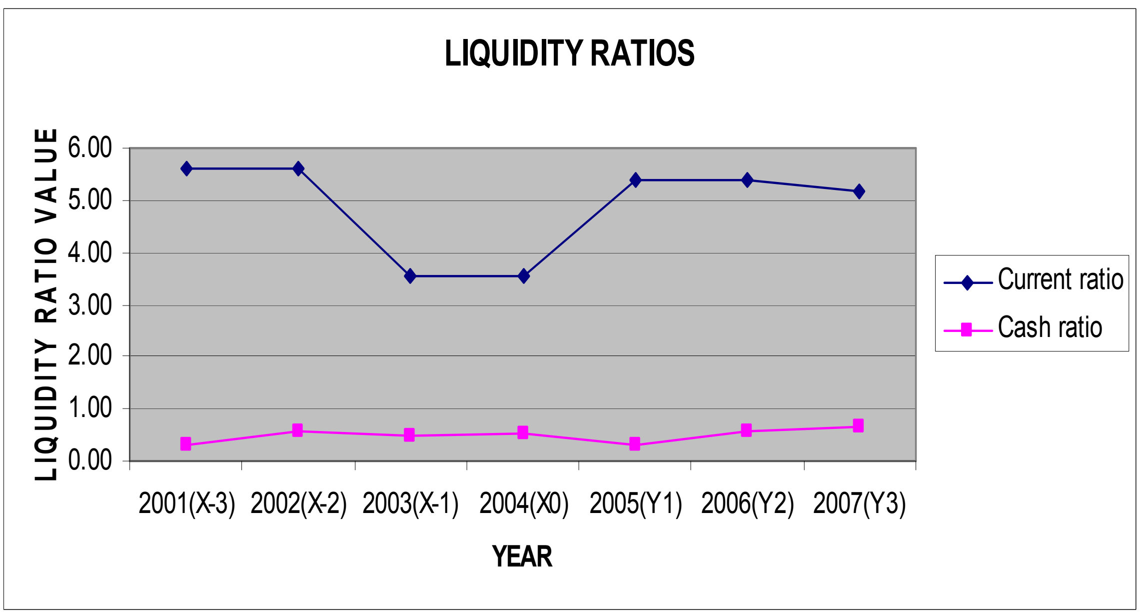
In the above table there is significant improvement in the net profit margin and cash ratio. However there is no significant improvement in the assets turnover, current ratio and ROI.

Table 10: National Housing Corporation Financial Performance

National Housing Corporation	**Three years Average (Before PC) (2001-2003)**	**Three years Average (after PC) (2005-2007)**	**Standard deviation (before PC)**
Net profit margin	23%	33%	4%
ROI	16%	18%	2%
Current ratio	2.65	3.83	0.47
Cash ratio	0.47	0.62	0.08
Assets turnover	38%	43%	8%

The National Housing Corporation's trend on financial ratios three years before the signing of performance contracts and three years after the signing of performance contracts is illustrated below.


PROFITABILITY RATIOS
PROFITABILITY RATIO VALUE(%)
30.00%
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Net profit margin
ROI


LIQUIDITY RATIOS
LIQUIDITY RATIO VALUE
6.00
5.00
4.00
3.00
2.00
1.00
0.00
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Current ratio
Cash ratio

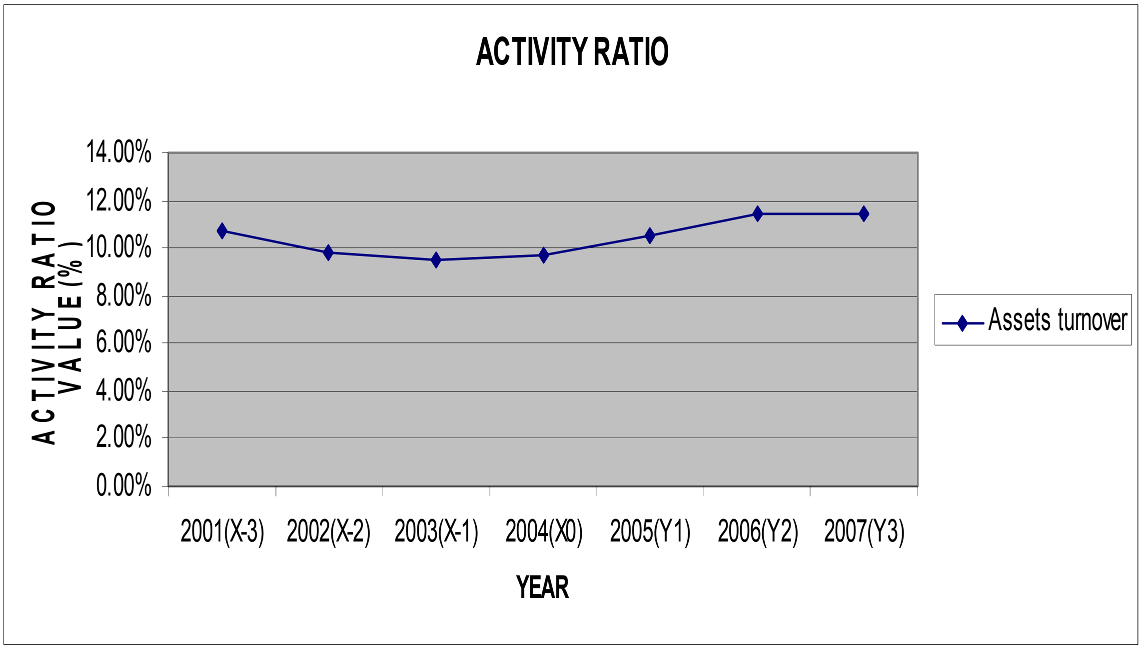


Table 11: National Housing Corporation PC's Impact Significance Testing

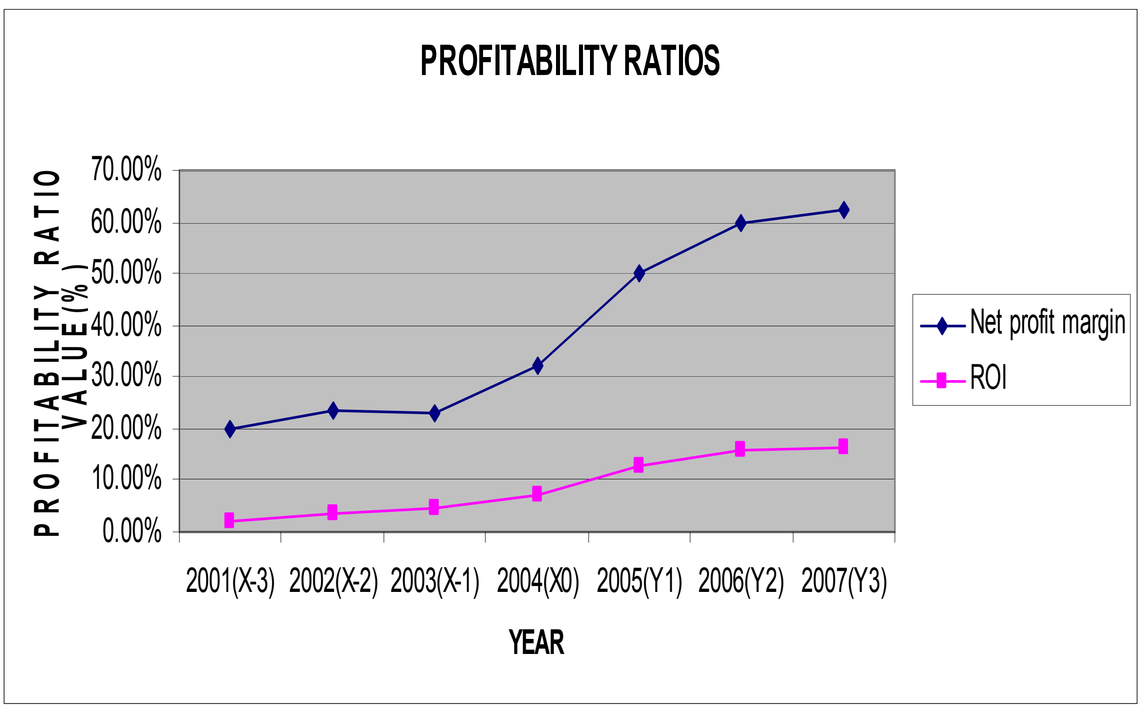
	Z score	Z value	Significance test
Net profit margin	2.41	0.992	99.20%
ROI	2.91	0.9982	99.82%
Current ratio	0.34	0.6331	63.31%
Cash ratio	0.64	0.7389	73.89%
Assets turnover	0.09	0.5359	53.59%

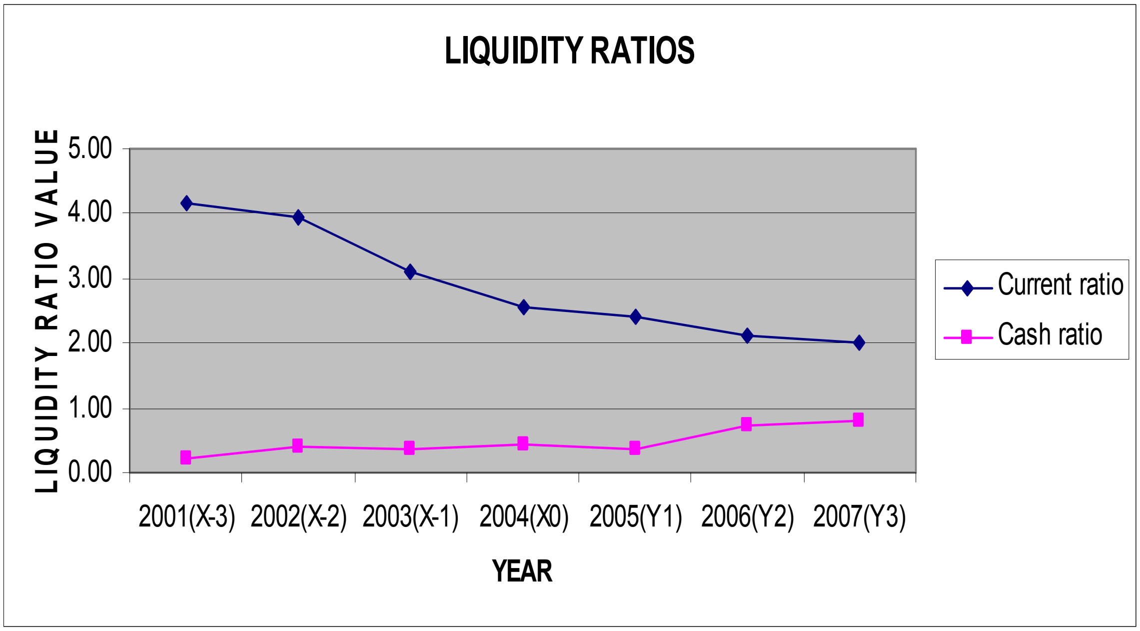
In the above table there is significant improvement in the net profit margin and ROI. However there is no significant improvement in the current ratio, cash ratio and assets turnover.

Table 12: Industrial and Commercial Development Corporation Financial Performance

Industrial and Commercial Development Corporation	Three years Average (Before PC) (2001-2003))	Three years Average (after PC) (2005-2007)	Standard deviation (before PC)
Net profit margin	22%	58%	2%
ROI	3%	15%	1%
Current ratio	3.74	2.18	0.55
Cash ratio	0.32	0.64	0.10
Assets turnover	12%	21%	10%

The Industrial and Commercial Development Corporation's trend on financial ratios three years before the signing of performance contracts and three years after the signing of performance contracts is illustrated below.




LIQUIDITY RATIOS
LIQUIDITY RATIO VALUE
5.00
4.00
3.00
2.00
1.00
0.00
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Current ratio
Cash ratio

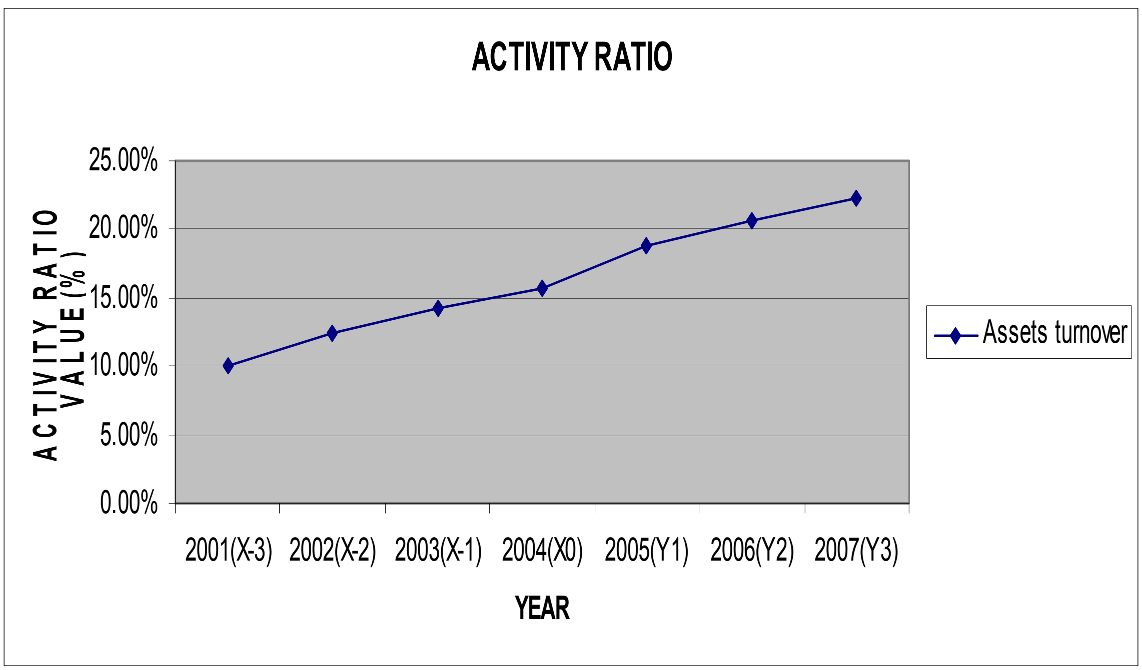

ACTIVITY RATIO
ACTIVITY RATIO VALUE (%)
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Assets turnover

Table 13: Industrial and Commercial Development Corporation PC's Impact Significance Testing

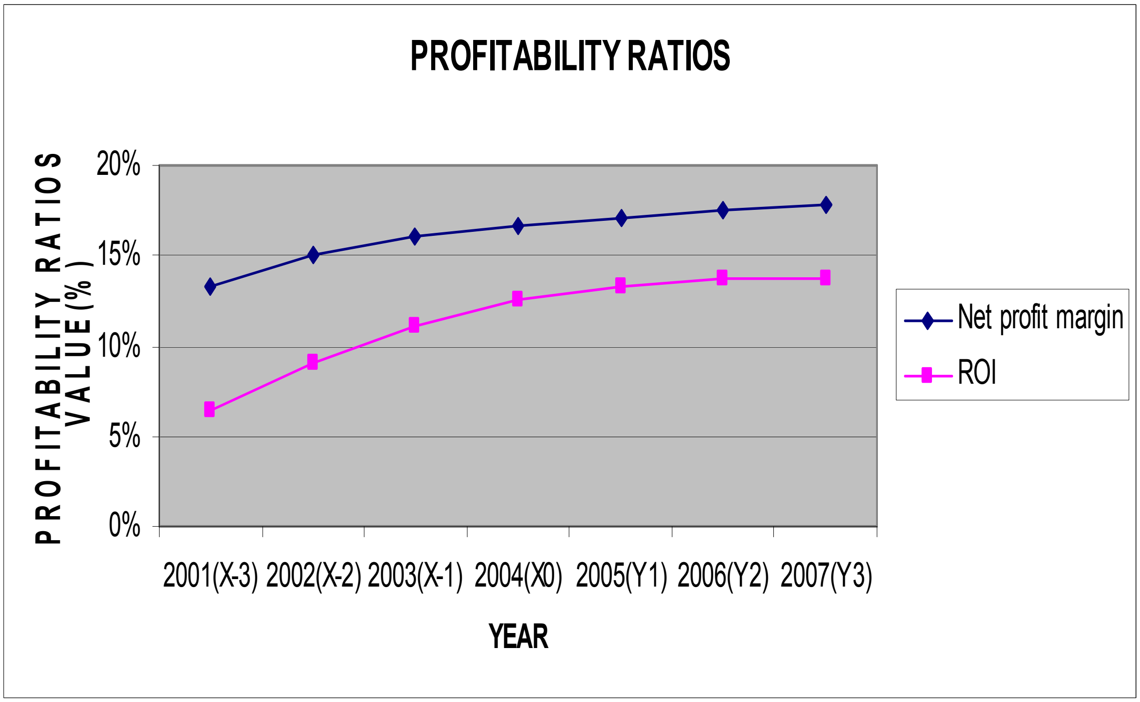
	Z score	Z value	Significance test
Net profit margin	2.28	0.9887	98.87%
ROI	2.79	0.9974	99.74%
Current ratio	0.15	0.5596	55.96%
Cash ratio	2.18	0.9854	98.54%
Assets turnover	0.83	0.7967	79.67%

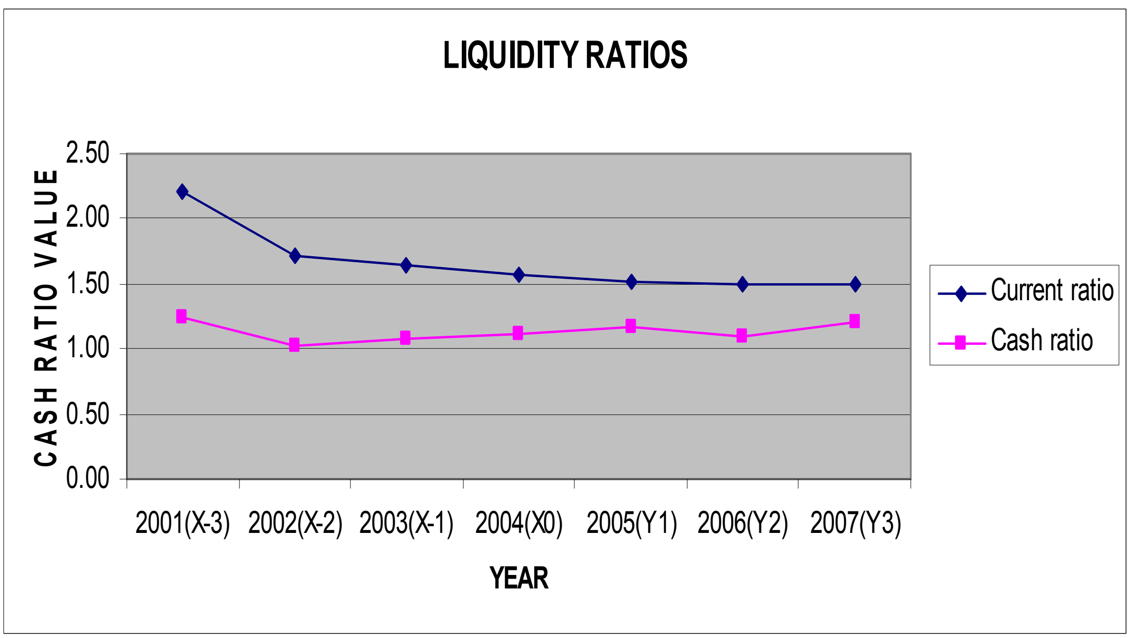
In the above table there is significant improvement in the net profit margin, ROI and cash ratio. However there is no significant improvement in the ratio current ratio and assets turnover.

Table 14: Kenya Broadcasting Corporation Financial Performance

Kenya Broadcasting Corporation	**Three years Average (Before PC) (2001-2003)**	**Three years Average (after PC) (2005-2007)**	**Standard deviation (before PC)**
Net profit margin	15%	17%	1%
ROI	9%	14%	2%
Current ratio	1.85	1.50	0.30
Cash ratio	1.11	1.16	0.12
Assets turnover	8%	18%	12%

The Kenya Broad Casting Corporation's trend on financial ratios three years before the signing of performance contracts and three years after the signing of performance contracts is illustrated below.


PROFITABILITY RATIOS
PROFITABILITY RATIOS VALUE (%)
20%
15%
10%
5%
0%
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Net profit margin
ROI


LIQUIDITY RATIOS
CASH RATIO VALUE
2.50
2.00
1.50
1.00
0.50
0.00
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Current ratio
Cash ratio

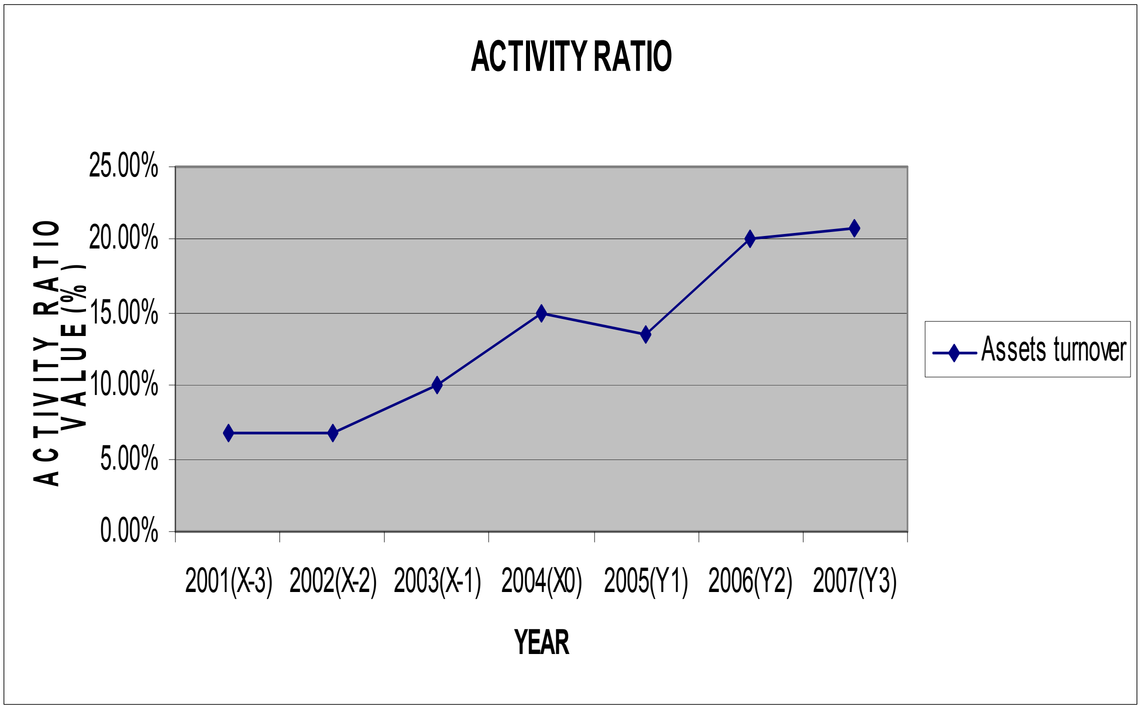


Table 15: Kenya Broadcasting Corporation PC's Impact Significance Testing

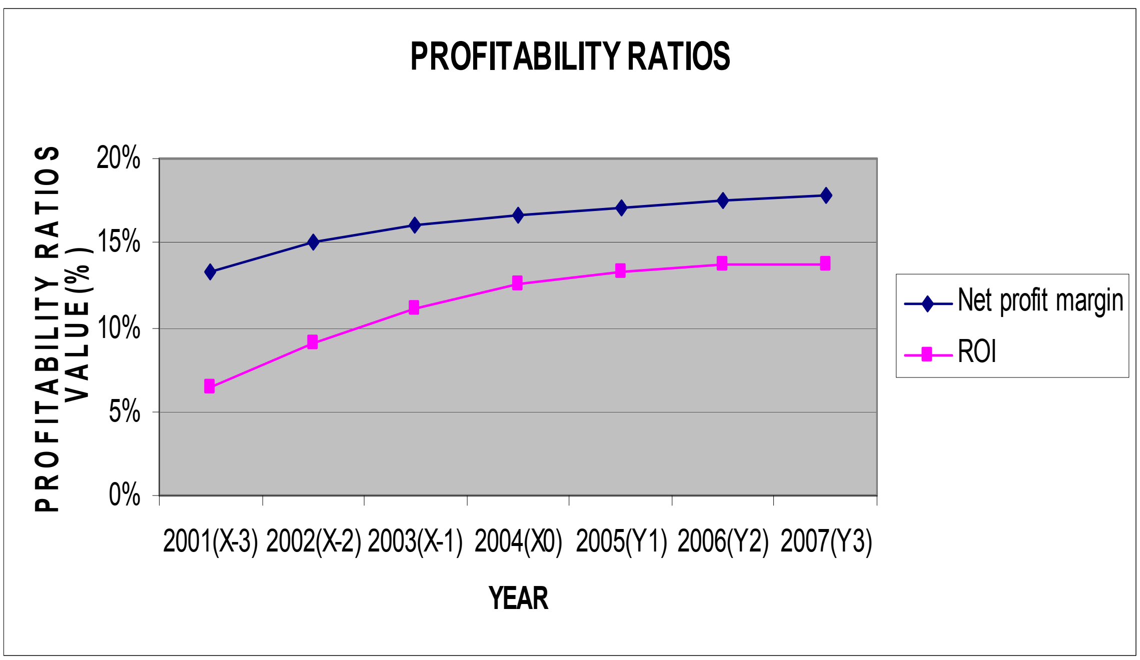
	Z score	Z value	Significance test
Net profit margin	2.00	0.9772	97.72%
ROI	2.03	0.9783	97.83%
Current ratio	1.14	0.8729	87.29%
Cash ratio	0.35	0.6368	63.68%
Assets turnover	0.86	0.8051	80.51%

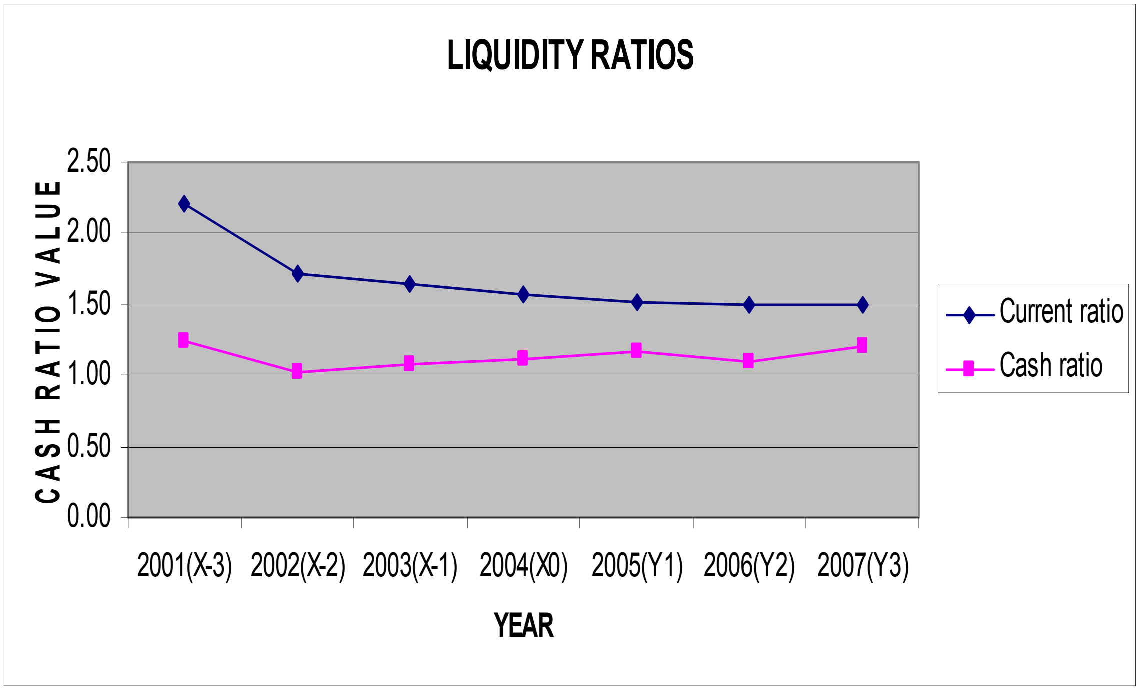
In the above table there is significant improvement in the net profit margin and ROI. However there is no significant improvement in the current ratio, cash ratio and assets turnover.

Table 16: Telkom Kenya's Financial Performance

Telkom Kenya	Three years Average (Before PC) (2001-2003))	Three years Average (after PC) (2005-2007)	Standard deviation (before PC)
Net profit margin	15%	17%	1%
ROI	9%	14%	2%
Current ratio	1.85	1.50	0.30
Cash ratio	1.11	1.16	0.12
Assets turnover	8%	18%	12%

The Telkom's trend on financial ratios three years before the signing of performance contracts and three years after the signing of performance contracts is illustrated below.




LIQUIDITY RATIOS
CASH RATIO VALUE
2.50
2.00
1.50
1.00
0.50
0.00
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Current ratio
Cash ratio

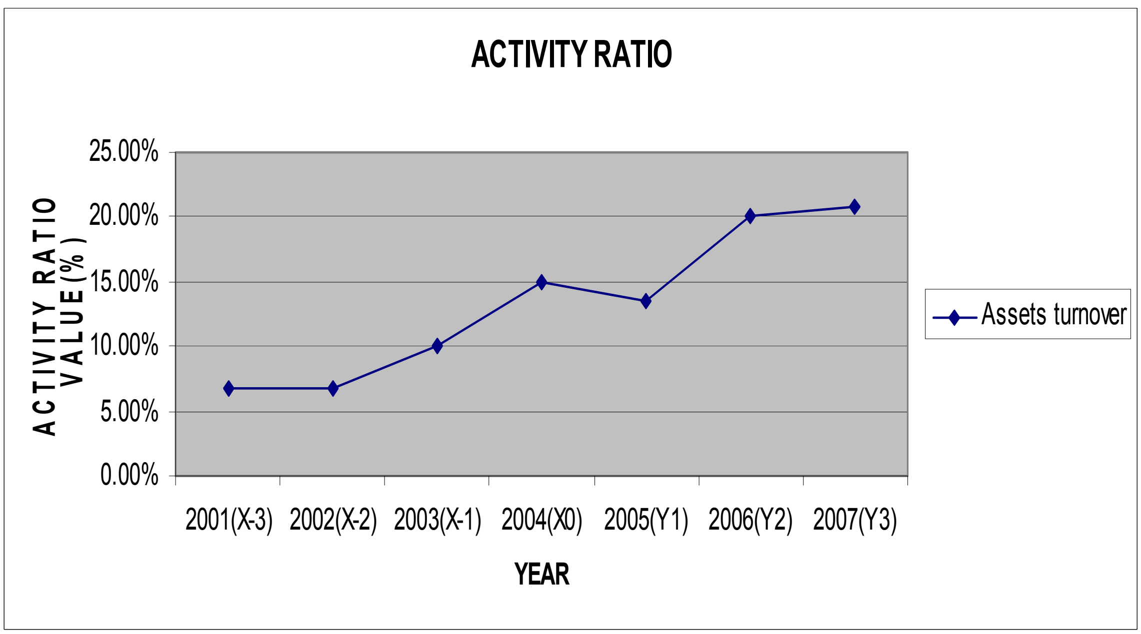

ACTIVITY RATIO
ACTIVITY RATIO VALUE(%)
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Assets turnover

Table 17: Telkom Kenya PC's Impact Significance Testing

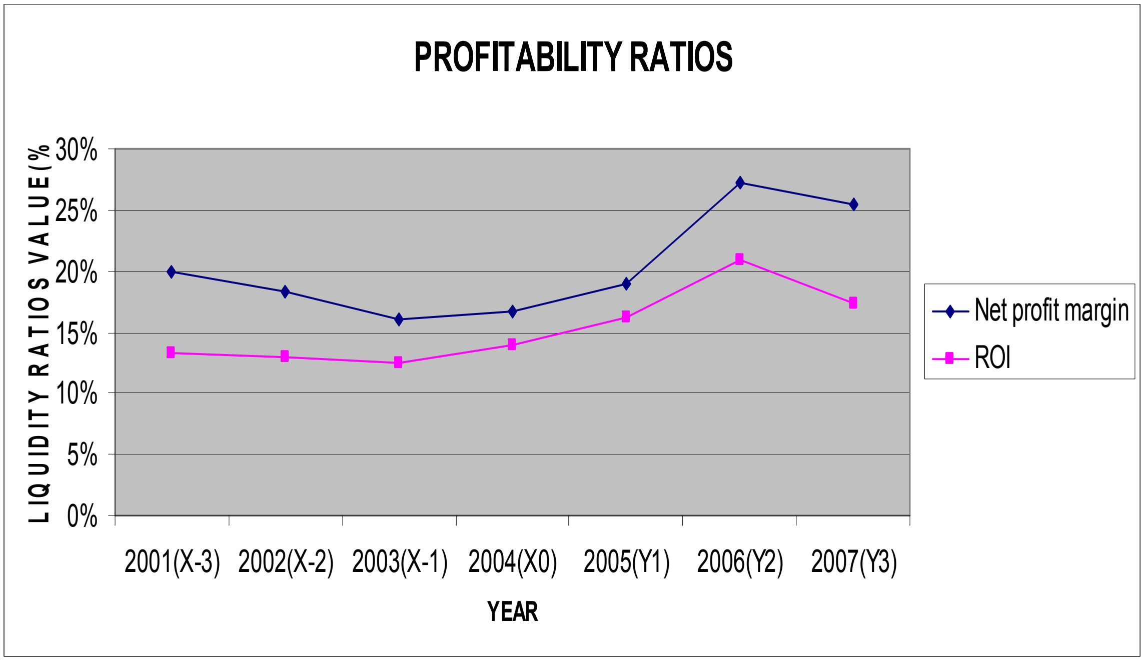
	Z score	Z value	Significance test
Net profit margin	1.61	0.9463	95%
ROI	1.47	0.9292	93%
Current ratio	0.45	0.6736	67%
Cash ratio	0.92	0.8212	82%
Assets turnover	1.51	0.9345	93%

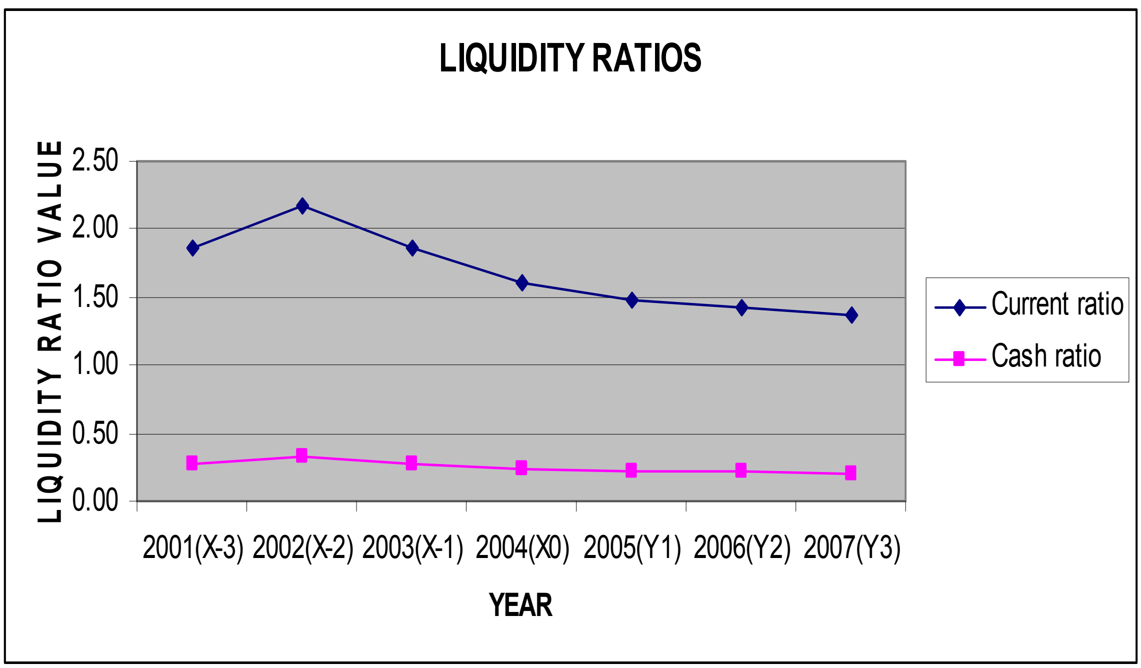
In the above table there is significant improvement in the net profit margin. However there is no significant improvement in the current ratio, cash ratio, assets turnover and ROI.

Table 18: Kenya Institute of Education's Financial Performance

Kenya Institute of Education	Three years Average (Before PC) (2001-2003))	Three years Average (after PC) (2005-2007)	Standard deviation (before PC)
Net profit margin	15%	17%	1%
ROI	9%	14%	2%
Current ratio	1.85	1.50	0.30
Cash ratio	1.11	1.16	0.12
Assets turnover	8%	18%	12%

The trend on financial ratios three years before the signing of performance contracts and three years after the signing of performance contracts of Kenya Institute of Education is illustrated below.


PROFITABILITY RATIOS
LIQUIDITY RATIOS VALUE (%
30%
25%
20%
15%
10%
5%
0%
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Net profit margin
ROI


LIQUIDITY RATIOS
LIQUIDITY RATIO VALUE
2.50
2.00
1.50
1.00
0.50
0.00
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Current ratio
Cash ratio

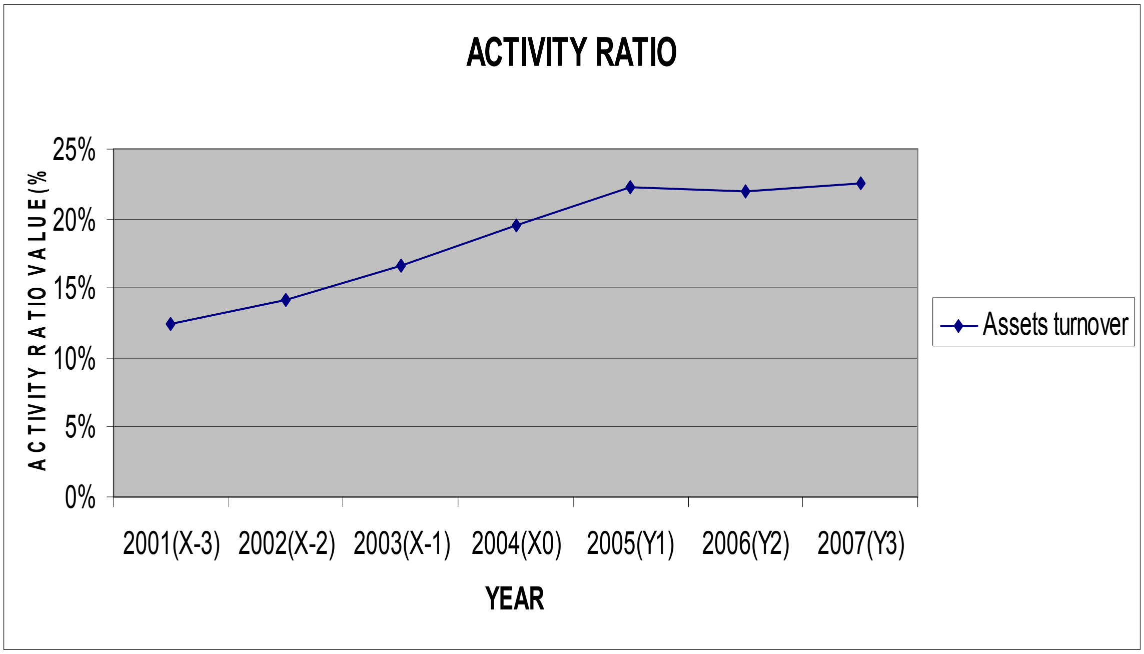


Table 19: Kenya Institute of Education PC's Impact Significance Testing

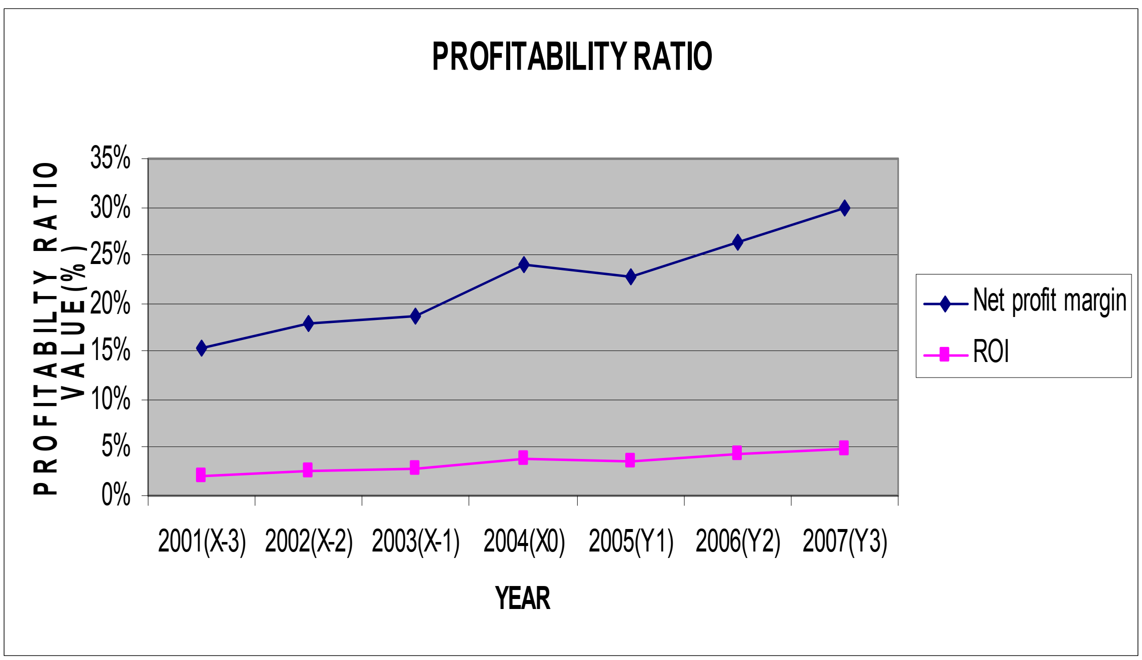
	Z score	Z value	Significance test
Net profit margin	2.87	0.9979	99.79%
ROI	2.64	0.9959	99.59%
Current ratio	0.05	0.5199	51.99%
Cash ratio	0.05	0.8389	83.89%
Assets turnover	2.71	0.9966	99.66%

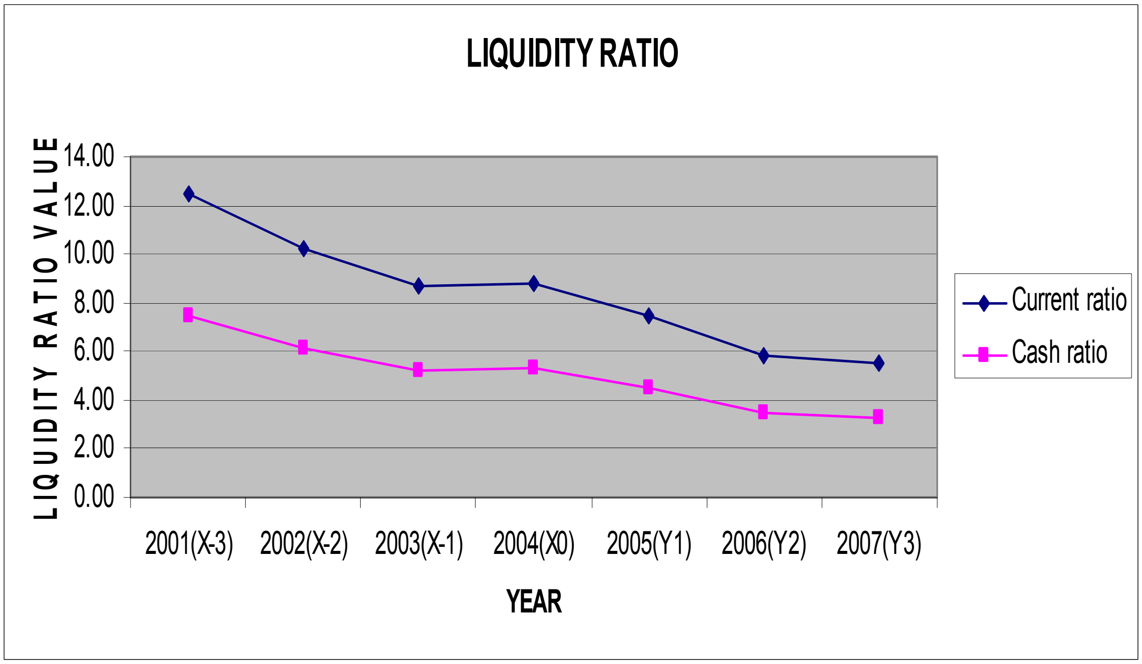
In the above table there is significant improvement in the net profit margin, ROI and assets turnover. However there is no significant improvement in the current ratio and cash ratio.

Table 20: Kenya Wine Agencies Limited's Financial Performance

Kenya Wine Agencies Limited	Three years Average (Before PC) (2001-2003))	Three years Average (after PC) (2005-2007)	Standard deviation (before PC)
Net profit margin	17%	26%	2%
ROI	2%	4%	0.44%
Current ratio	10.47	6.23	1.91
Cash ratio	6.28	3.74	1.15
Assets turnover	16%	18%	1%

The trend on financial ratios three years before the signing of performance contracts and three years after the signing of performance contracts of Kenya Wine Agencies Limited is illustrated below.




LIQUIDITY RATIO
LIQUIDITY RATIO VALUE
14.00
12.00
10.00
8.00
6.00
4.00
2.00
0.00
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Current ratio
Cash ratio

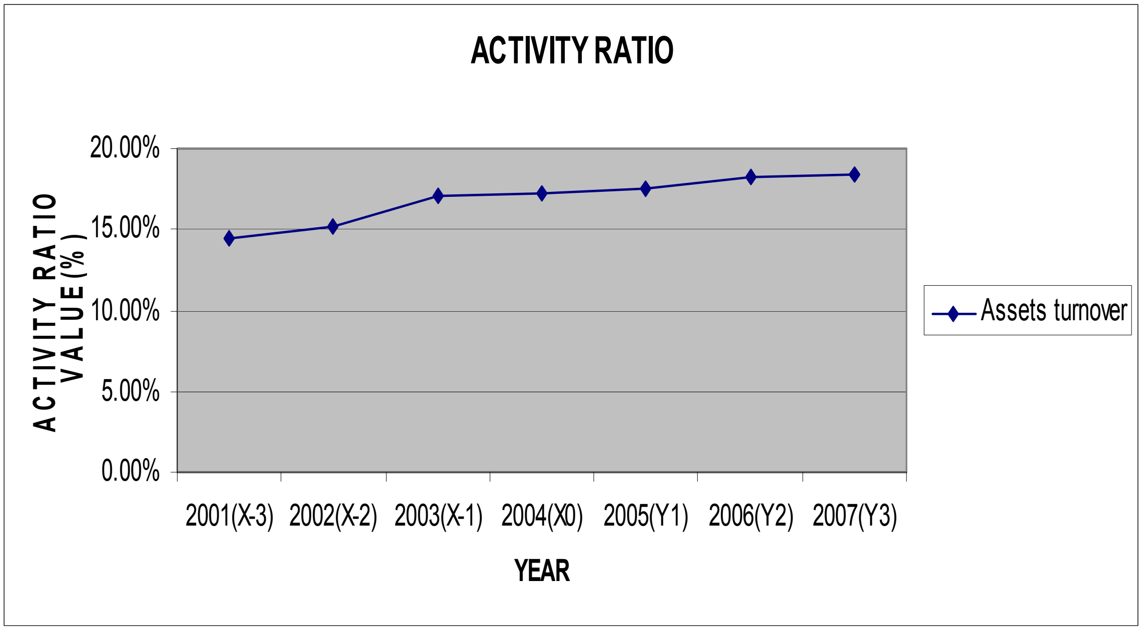

ACTIVITY RATIO
ACTIVITY RATIO VALUE(%)
20.00%
15.00%
10.00%
5.00%
0.00%
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Assets turnover

Table 21: Kenya Institute of Education PC's Impact Significance Testing

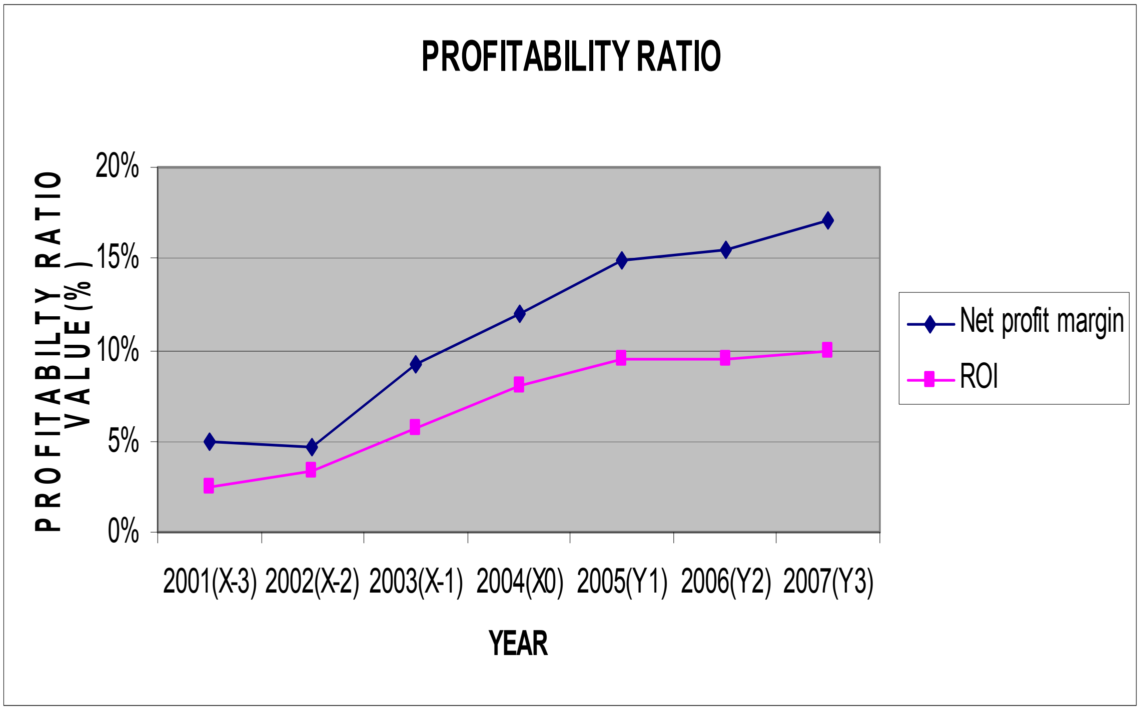
	Z score	Z value	Significance test
Net profit margin	2.66	0.9961	99.61%
ROI	2.27	0.9884	98.84%
Current ratio	0.28	0.684	68.40%
Cash ratio	0.28	0.684	68.40%
Assets turnover	1.93	0.9732	97.32%

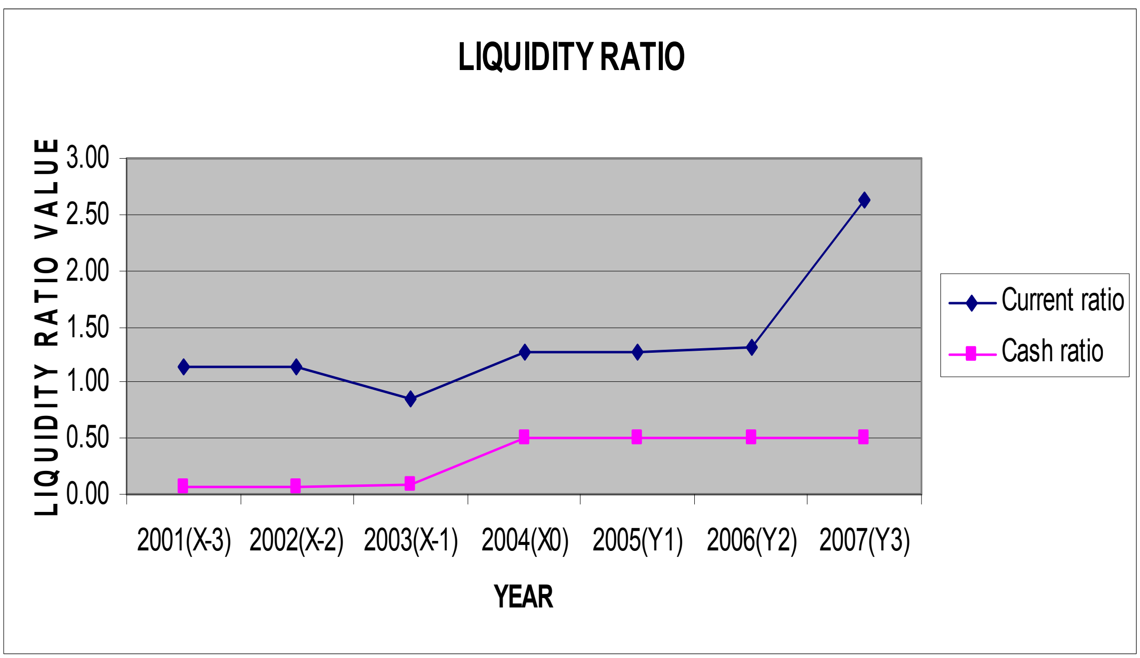
In the above table there is significant improvement in the net profit margin, assets turnover and ROI. However there is no significant improvement in the current ratio, cash ratio.

Table 22: National Oil Corporation of Kenya's Financial Performance

National Oil Corporation of Kenya	Three years Average (Before PC) (2001-2003))	Three years Average (after PC) (2005-2007)	Standard deviation (before PC)
Net profit margin	6%	16%	3%
ROI	4%	10%	2%
Current ratio	1.04	1.74	0.16
Cash ratio	0.07	0.51	0.02
Assets turnover	21%	26%	2%

The trend on financial ratios three years before the signing of performance contracts and three years after the signing of performance contracts of National Oil Corporation of Kenya is illustrated below.


PROFITABILITY RATIO
PROFITABILTY RATIO VALUE(%)
20%
15%
10%
5%
0%
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Net profit margin
ROI


LIQUIDITY RATIO
LIQUIDITY RATIO VALUE
3.00
2.50
2.00
1.50
1.00
0.50
0.00
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Current ratio
Cash ratio

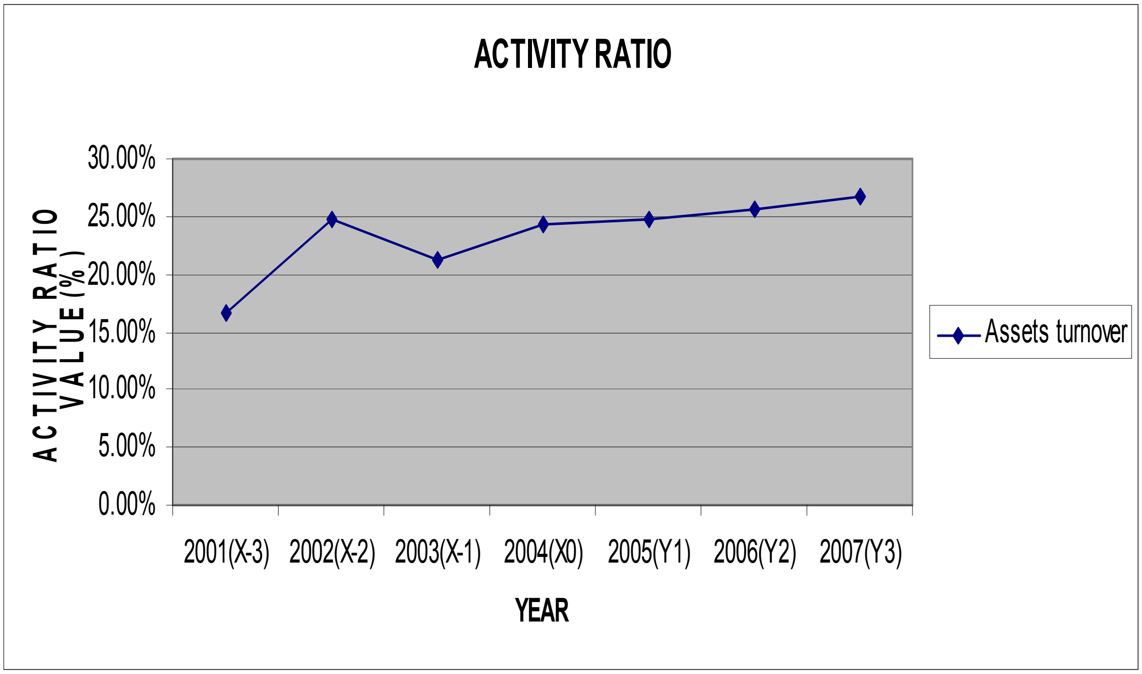


Table 23: National Oil Corporation of Kenya PC's Impact Significance Testing

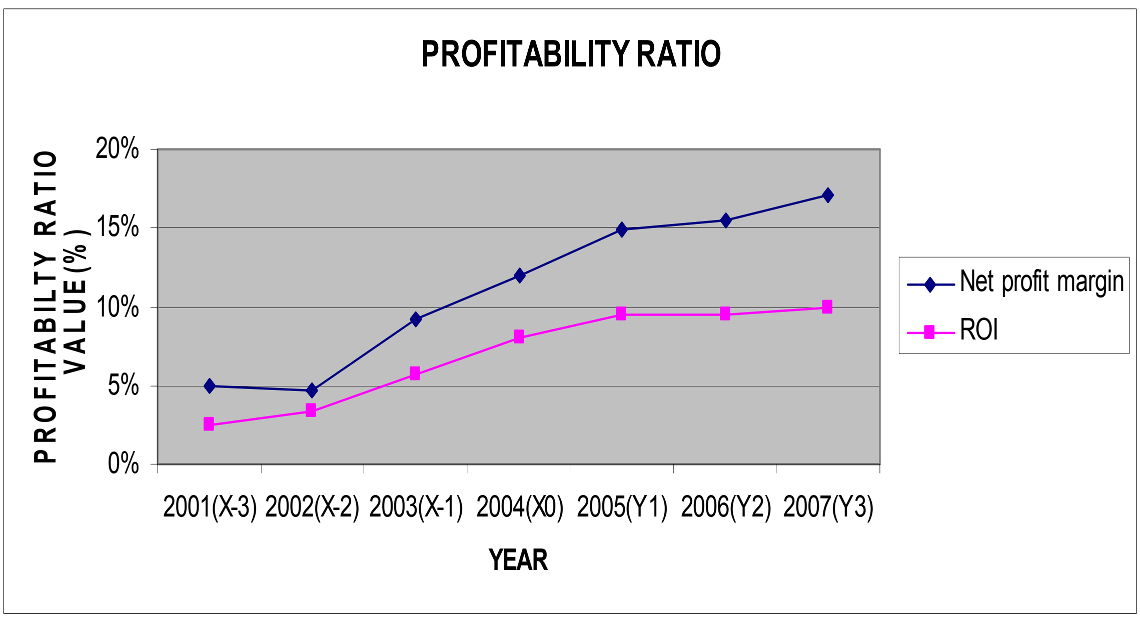
	Z score	Z value	Significance test
Net profit margin	2.72	0.9967	99.67%
ROI	2.56	0.9948	99.48%
Current ratio	2.80	0.9974	99.74%
Cash ratio	2.35	0.9906	99.06%
Assets turnover	2.60	0.9953	99.53%

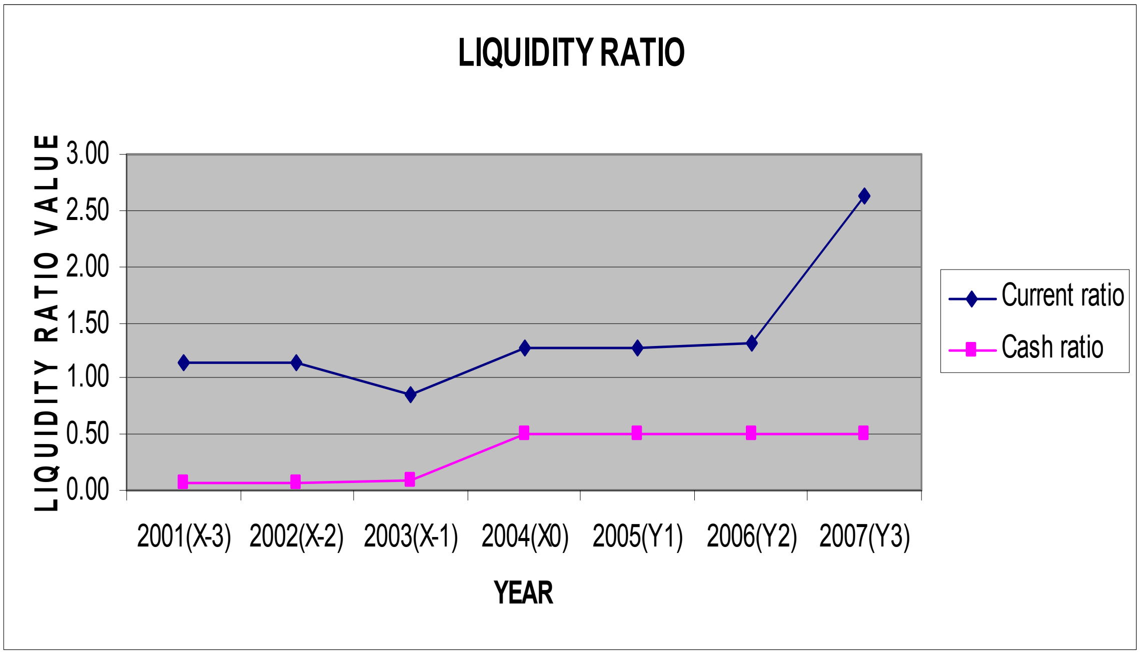
In the above table there is significant improvement in the net profit margin, ROI, assets turnover, current ratio and cash ratio.

Table 24: Utalii College Financial Performance

Utalii College	Three years Average (Before PC) (2001-2003))	Three years Average (after PC) (2005-2007)	Standard deviation (before PC)
Net profit margin	21%	23%	1%
ROI	14%	16%	3%
Current ratio	1.69	1.88	0.17
Cash ratio	1.35	1.50	0.13
Assets turnover	22%	25%	13%

The trend on financial ratios three years before the signing of performance contracts and three years after the signing of performance contracts of Utalii College is illustrated below.




LIQUIDITY RATIO
LIQUIDITY RATIO VALUE
3.00
2.50
2.00
1.50
1.00
0.50
0.00
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Current ratio
Cash ratio

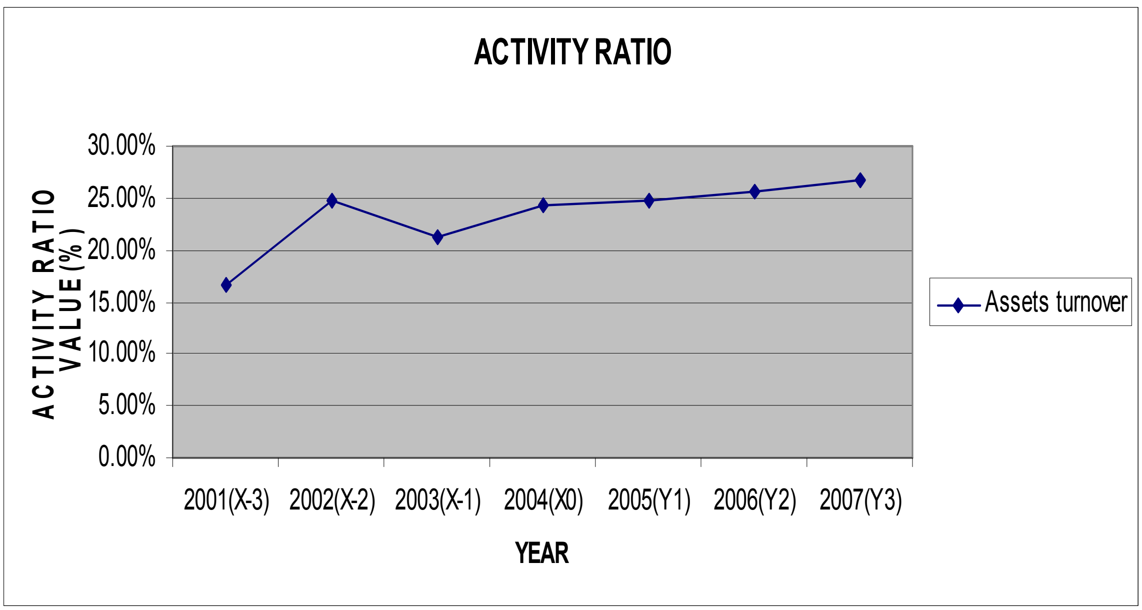

ACTIVITY RATIO
ACTIVITY RATIO VALUE (%)
30.00%
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Assets turnover

Table 25: Utalii College PC's Impact Significance Testing

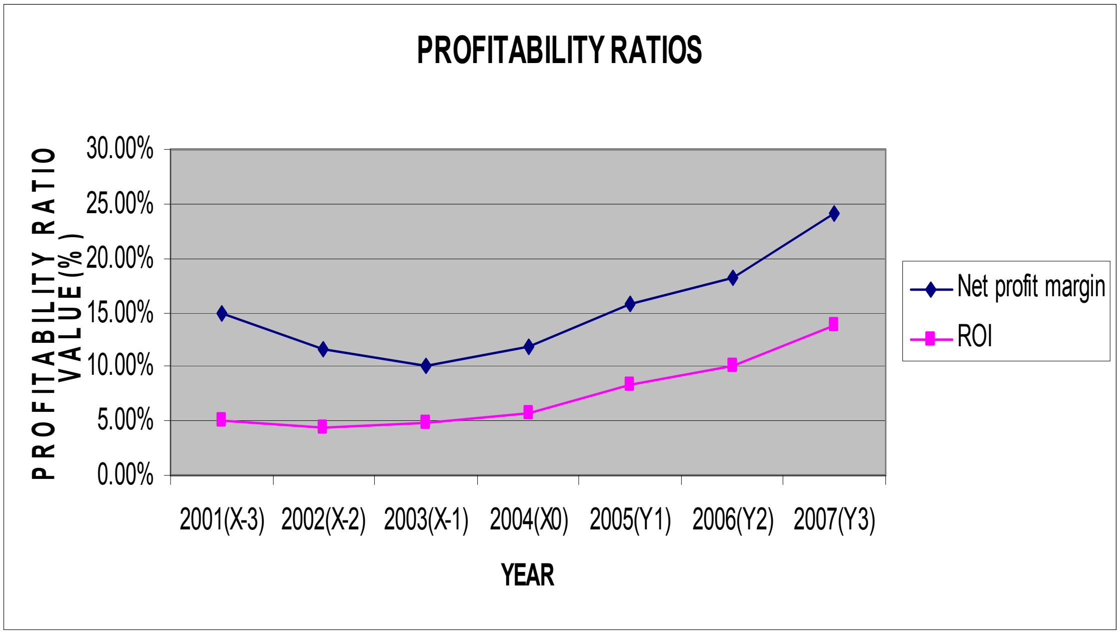
	Z score	Z value	Significance test
Net profit margin	0.96	0.8315	83.15%
ROI	0.58	0.719	71.90%
Current ratio	1.09	0.8621	86.21%
Cash ratio	1.09	0.8621	86.21%
Assets turnover	0.26	0.6026	60.26%

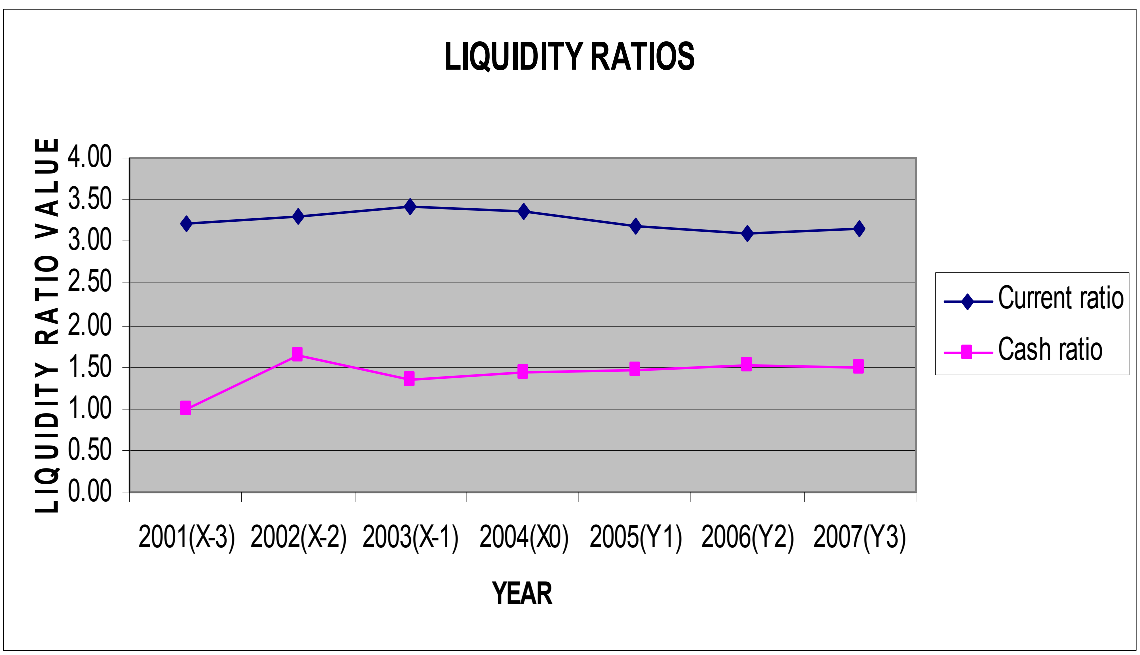
In the above table there is no significant improvement in the current ratio, cash ratio, net profit margin, assets turnover and ROI.

Table 26: Chemelil Sugar Company Financial Performance

Chemelil Sugar Company	Three years Average (Before PC) (2001-2003))	Three years Average (after PC) (2005-2007)	Standard deviation (before PC)
Net profit margin	12%	19%	3%
ROI	5%	11%	0.29%
Current ratio	3.31	3.15	0.11
Cash ratio	1.33	1.49	0.31
Assets turnover	19%	23%	31%

The trend on financial ratios three years before the signing of performance contracts and three years after the signing of performance contracts of Chemelil Sugar Company is illustrated below.


PROFITABILITY RATIOS
PROFITABILITY RATIO VALUE (%)
30.00%
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Net profit margin
ROI


LIQUIDITY RATIOS
LIQUIDITY RATIO VALUE
4.00
3.50
3.00
2.50
2.00
1.50
1.00
0.50
0.00
2001(X-3)
2002(X-2)
2003(X-1)
2004(X0)
2005(Y1)
2006(Y2)
2007(Y3)
YEAR
Current ratio
Cash ratio

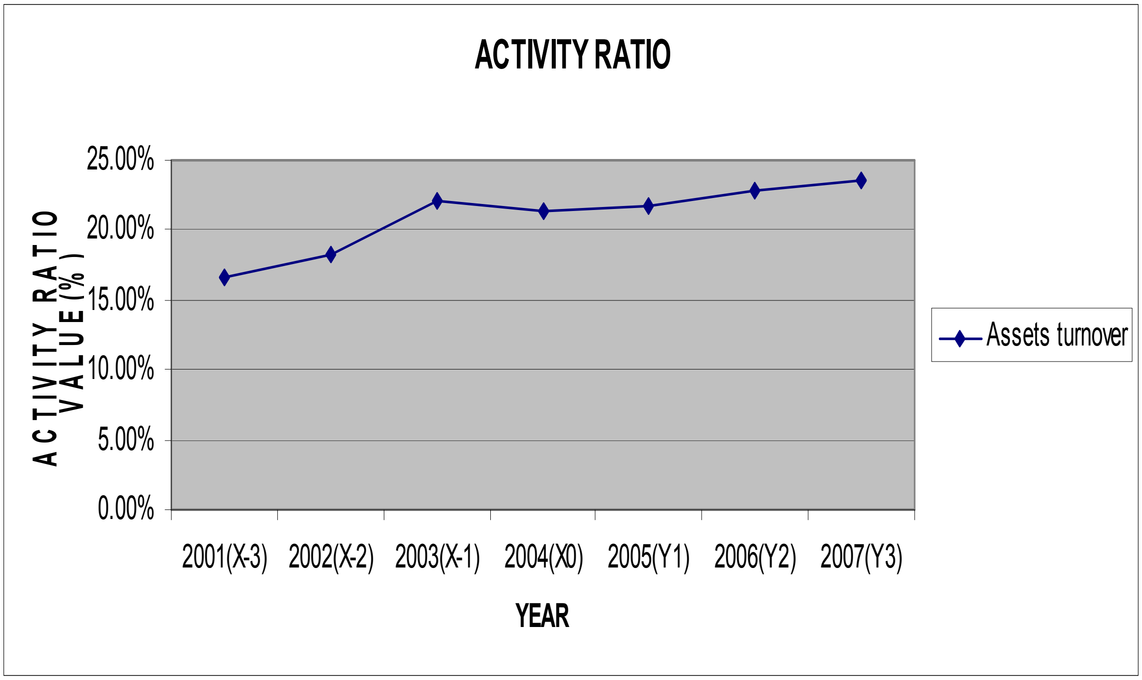


Table 27: Chemelil Sugar PC's Impact Significance Testing

	Z score	Z value	Significance test
Net profit margin	2.79	0.9974	99.74%
ROI	2.53	0.9941	99.41%
Current ratio	0.52	0.6985	69.85%
Cash ratio	0.51	0.695	69.50%
Assets turnover	0.12	0.5478	54.78%

In the above table there is significant improvement in the net profit margin and ROI. However there is no significant improvement in the current ratio, cash ratio and assets turnover.

4.2 Summary of findings and interpretations

The hypothesis of the study was that that there has been significant improvement in the performance of commercial SOE's after the signing of performance contracts. From the analysis of significance test done, there is significant change in some indicators while there is no significant change in some financial indicators.

The profitability ratio of 10 SOE's showed significant improvement while, the profitability ratios of 3 SOE's did not show significant improvement after the signing of the performance contracts in 2004. However, despite there being no significant improvement of the profitability ratios of 3 SOE's there was an increase in both their net profit margin and the ROI. This means that the performance contracts had some impact even if not significant.

The liquidity ratios of 6 SOE's showed significant improvement while, the liquidity ratios of 7 SOE's did not show significant improvement after the signing of the performance contracts. However, despite there being no significant improvement of the liquidity ratios of 7 SOE's there was an increase in both their cash ratio and quick ratio. This means that the performance contracts had some impact even if not significant.

The activity ratio of 6 SOE's showed significant improvement while, the liquidity ratios of 7 SOE's did not show significant improvement after the signing of the performance contracts. However, despite there being no significant improvement of the activity ratio of 7 SOE's there was an increase in both their assets turnover ratio. This means that the performance contracts had some impact even if not significant.

From the above analysis, there were mixed results from the sample analysed but majority of the studied show significant change in the profitability ratios while the majority of the SOE's did not have any significant improvement in the liquidity ratios and activity ratio.

What was apparent from the study was that the designers of performance contracts gave a lot of emphasis to the profitability ratios as measures of financial performance and ignored other parameters that can also measure financial performance. The result of this was that SOE's put a lot of effort in increasing profitability but there was no much effort in improving liquidity and activity levels.

The other issue that was observed from the study was that SOE's had changed their strategies as strategic planning was also a requirement of performance contracting. Some of the strategies which involved marketing and improving customer service may not have paid off immediately and hence full benefits of the strategy change may not have been felt during the period under study.

Prior to the implementation of the performance contracts SOE's business was being run without proper panning. After the performance contracts, all SOE's whose financial performance was studied had a business plan and a strategic plan which was guiding the financial and other decisions that were being made. This in had an impact in the financial performance of the SOE's. They have financial goals to achieve and this has brought about improvement in financial performance. Performance contracting has also brought competition as there is annual ranking of all SOE's. This competition has also made the SOE's be more responsive to customer needs and they all even have service charters.

We can therefore conclude that there is significant impact of performance contracts in the financial performance of SOE's with regard to the profitability ratios but there is no significant impact of performance contract in the liquidity and activity ratios.

CHAPTER FIVE

5.1 Conclusion and Recommendations

Based on the findings on chapter four, there is significant impact of performance contracts in the financial performance of SOE's with regard to the profitability ratios but there is no significant impact of performance contract in the liquidity and activity ratios. This is because a majority of the SOE's had significant improvement in their profitability ratios while for a majority of the SOE's there was no significant improvement in their liquidity ratios and activity ratios.

The explanation of this is that the SOE's are paying a lot of emphasis to profitability and ignoring other financial indicators of performance. This is because the performance contracts only have selected ratios as measures of financial performance in commercial SOE's (ROI and Net profit margin) while other ratios that measure liquidity and activity are ignored.

Despite the fact that there is no significant improvement in both the liquidity ratios and the activity ratio, there was some positive change in the parameters. None of the SOE's studied had a decline in their financial performance and hence there was some impact of the performance contracts.

All SOE' whose financial performance was studied had new strategic plans which they had developed as a requirement of the performance contract implementation and they had strategies if increasing financial growth. Some of the strategies It may not have been significant because the strategies that had been adopted had not yet started to show results.

From the results of this study, I recommend that to measure financial performance comprehensively, more financial ratios should be used or at least each aspect of financial performance should have a ratio which is used to assess it. Financial ratios which measure liquidity and activity as well as gearing should be used in the design of performance contracts. This will ensure that no area of financial performance is ignored and hence the performance of the commercial SOE's will not be skewed towards improving profitability.

5.2 Limitations

The study focused on the 16 SOE's who signed performance contracts on pilot basis in 2004. However not all these had results for all the years of study and hence only 13 SOE's were assessed. The ideal could have been if all the 16 SOE's were studied though the 13 SOE's studied was representative.

The study only focused on the financial performance whereas the performance contract focuses on other aspects of performance e.g. market share and implementation of strategic plans. The results of the study therefore may not conclusively determine the impact of the performance contracts as it only focused on one aspect assessed by performance contracts.

Some of the measures put in place to increase financial performance eg. Change in strategy does not take effect immediately. The results of such may be visible after three years and hence fall out of the scope of the study. Such results may have been missed by this study.

5.3 Suggestion for further research

There is need for further research is to assess the impact of performance contracts in other SOE's in other sectors of the economy. This is because there other SOE's who have signed performance contracts and are not commercial.

There is also need to carry out further research to assess whether the financial indicators that are measured in the performance are sufficient to assess financial performance of SOE's. There is a lot of emphasis on profitability and other indicators of financial performance such as liquidity are ignored.

There is also need for further research to assess the impact of performance contracts on the share prices of listed SOE's. These include both financial, commercial as well as industrial SOE's which are listed in the Nairobi Stock Exchange.

Further research should also be done to assess the impact of performance on the entire performance of SOE's since they were introduced. This would enable the Government see whether the performance contracting has had any impact in the performance of SOE's

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APPENDIX 1: DATA COLLECTION FORM

SOE's name :	**Year**						
	2001	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**
Performance indicators	$\mathbf{X_{-3}}$	$\mathbf{X_{-2}}$	$\mathbf{X_{-1}}$	$\mathbf{X_0}$	$\mathbf{Y_1}$	$\mathbf{Y_2}$	$\mathbf{Y_3}$
Net profit margin							
ROI							
Current ratio							
Cash ratio							
Assets turnover							

APPENDIX 2: LIST OF STUDIED SOE'S

Organisation Name
1. East African Portland Cement Company
2. National Housing Corporation
3. Industrial and Commercial Development Corporation
4. Kenya Pipeline Corporation
5. Kenya Power and Lighting Company
6. Kenya Broadcasting Corporation
7. Kenya Ports Authority
8. Telkom Kenya Limited
9. Kenya Institute of Education
10. Kenya Wine Agencies Limited
11. National Oil Corporation of Kenya
12. Kenya Utalii College
13. Chemelil Sugar Company