THE RELATIONSHIP BETWEEN PERFORMANCE CONTRACTS AND FINANCIAL PERFORMANCE IN STATE CORPORATIONS;

A COMPARATIVE STUDY OF THE KENYA RAILWAYS CORPORATION AND KENYA AIRPORTS AUTHORITY

PRESENTED BY

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DECLARATION

This management research paper is my original work and to the best of my knowledge, has not been presented for the award of any degree in any University.

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ABBREVIATIONS

AAPAM	African Association for Public Administration and Management
BEM	Business Excellency Models
CACG	Commonwealth Approach to Corporate Governance
CBK	Central Bank of Kenya
CMA	Capital Markets Authority
CSO	Community Social Organization
CWSA	Community Water Supply Agency
DPM	Directorate of Personnel Management
ERSWEC	Economic Recovery Strategy for Wealth and Employment Creation
FP	Financial Performance
FPI	Financial Performance Indicator
FY	Financial Year
GoK	Government of Kenya
ICPAK	Institute of Certified Public Accountants of Kenya
KAA	Kenya Airports Authority
KMs	Kilometres
KNBSC	Kaplan and Norton’s Balanced Scorecard
KPLC	Kenya Power & Lighting Co; Ltd
KRA	Kenya Revenue Authority
KPI	Key Performance Indicator
KRC	Kenya Railway Corporation
MDG’s	Millennium Development Goals
MoT	Ministry of Transport
MOU	Memorandum of Understanding
MTEF	Medium Term Expenditure Framework
NCPB	National Cereals & Produce Board
NGO	Non Governmental Organization
NPM	New Public Management
OECD	Organization for Economic Co-Operation and Development

PAS	Performance Appraisal System
PBM	Performance Based Management
PC	Performance Contracting
PCSC	Performance Contracts Steering Committee
PE’s	Public Enterprises
PP	Performance Prism
PSO	Public Service Office
PSR	Public Service Reforms
RBM	Result Based Management
ROM	Results Oriented Management
RTI	Railways Training Institute
RVR	Rift Valley Railways (K) Ltd
SAPs	Structural Adjustment Programs
SC	State Corporation
SNM	Skandia’s Navigator Model
SPSS	Statistical Package of Social sciences
SWOT	Strengths, Weaknesses, Opportunities and Threats
Yr	Year

ABSTRACT

This study sought to establish the relationship between performance contracts (PCs) and financial performance (FP) of two key state corporations (SCs) in the transport sector; the Kenya Railways Corporation (KRC) and the Kenya Airports Authority (KAA). In addition, the study sought to compare the measures and indicators of performance as well the extent of government subsidies after the introduction of PCs. A comparative study research design was used to establish the relationship between PCs and FP. The period of study was from 30th June, 2000 to 30th June, 2009 (which covers before and after the introduction of PCs).

This study has established that after the introduction of PCs in 2005, the FP for the two state corporation's significantly improved (particularly noted in the case of KAA) there was drastic decline in dependence on recurrent subsidies from the government of Kenya (GoK). The study has shown that KRC experienced a significant reduction in revenue after the introduction of PC as a result of the restructuring/concession in November, 2006 but however, the combined effect of the restructuring and PC seems to have ensured that earnings were always above operating expenditure at all times. In the year 2008/2009, it was found out that KRC met its target on pre-tax profit and return on capital while it was off-target in terms of development index and non conceded asset revenue. On the other hand, KAA achieved its target in terms of PBT and ROI and failed to achieve the Equity Ratio (D/E) ratio and DI. The study has also shown that the dependency on government subsidies as a means of survival has reversed after the introduction of PCs. It was also observed that KRC and KAA used the DI, Return on Investments (ROI), Debt Equity Ratio (D/E) for measuring financial stewardship. However, with regard to profitability, there was a difference between KRC and KAA; whereas KAA used the traditional Profit before tax (PBT), KRC made used the operating profit (OP) to report its profitability. Variance analysis is used by both Corporations in reporting actual performance against targets.

This study has clearly demonstrated that PCs are effective tools for improving FP in SCs but this could also be affected by historical and pre-existing factors which are beyond the control of management. Using various financial ratios and t-tests, it was found that there has been reduced dependency on GoK subsidies and the FP of KRC and KAA improved after the introduction of PC's in 2005 and this trend is likely to be sustained as a result of annual targets which are incremental.

CHAPTER ONE: INTRODUCTION

1.1 Background of the Study

According to the World Bank Journal on Millennium Development Goals, (MDGs), the ongoing socio-economic reforms in recent times have been triggered by globalization, liberalization and marketization which has contributed to an expansion of the private sector and a decline of the public sector. As a consequence, many PE's have either been divested or disbanded as a result of poor performance making them not only uncompetitive but also economic burdens. Experience shows that these measures have helped in reducing budget deficits for most governments, thus generating cash flows for priority investments in social services and infrastructure development. However, despite the challenges, it has been noted that PEs still continue to contribute significantly to exchequer revenues in developed and developing economies- ranging from as high as 60% in Algeria to 6% in China which is one of the largest economies. In addition, PE's still remain principal providers of a vast array of social services deemed vital to the attainment of the MDG's, also generating a significant portion of employment. These conditions help to explain the continued existence of PE's in developed and developing countries. The important point is that PE's, regardless of their social-economic justification, must operate efficiently and effectively under given market conditions to guarantee their long term survival.

Christensen, (1999), while studying Public Sector Performance Reporting in Australia, established that State Corporations (SC) in developed countries are expected to play an indispensable role in the effective delivery of public services that are key to the functioning of the economy. Such corporations were created to support an import-substitution development strategy and provide services and infrastructure that was considered essential to the national, regional or local development in order to accelerate economic and social development by accelerating the pace of development, redressing regional imbalances, increasing citizens participation in economic development, promoting indigenous entrepreneurship and promoting foreign investments. However, after many decades of poor performance, most of these SC's were characterized by wastefulness and inefficiency which has resulted in poor financial and operational performance, necessitating exchequer support in form of recurrent loans and grants, (Schacter, 2006). Increasing evidence indicates that most SC's depend on government subsidies for their survival which to a large extent, has been an impediment to economic growth and recovery, raising concerns by respective governments on whether the corporations are actually contributing to social and economic development as expected; why most of them have failed to deliver effective services to their customers and how they could be improved, (Bahl and Linn, 1992). Given this dependency relationship, there is a high risk of government manipulation as evidenced by the way appointments are made, tenders are awarded and funding of political activities around electioneering.

Public services in many African countries are confronted with many challenges which constrain their delivery capacities but nevertheless, with competitive forces in the liberalized market, performance is inevitable; thus the management of PE's must be proactive, goal setters and creative so as to survive in the market. Lienert (2003), studying Civil Service Reform in Africa for ten years, concluded that the challenge facing many organizations today is how to match and align performance measures with business strategy, structures and corporate culture, the type and number of measures to use, the balance between the merits and costs of introducing these measures and how to deploy the measures so that the results are used and acted upon.

1.1.1 Conditions necessary for improved Financial Performance under Performance contracting framework

According to the Organization for Economic Co-operation and Development, (OECD) 1999, each country has its unique legal, institutional and cultural environment requiring an original vision and mission. Accordingly, it is important to have a customized approach to its own needs and circumstances. A structured approach similar to the one used in the USA, which focuses on strategic performance objectives a mechanism for accurate reporting, brings all stakeholders into planning and evaluation of performance, provides a mechanism for linking performance to budget expenditure, provides a framework for accountability and shared responsibility for performance improvement, (DPM, 2004). A six-step process is suggested for establishing a successful program; this includes the definition of an original vision, mission, strategic objectives, establishment of an integrated performance measurement system and an accountability system. Besides, it involves the collection of performance data for analyzing and deriving improvement, (PBMSIG, 2001). A PC does not necessarily mean that there is improved FP; for any meaningful improvement in performance, the management must put in place strategies that will create a conducive environment for improved performance such as ; internal audit system, employee motivation and technical know how for successful program.

Performance measures are recognized as an important element of all managers and supervisors directing the efforts of an organization or a group, (Kamuna, 2007). As a result, financial management is increasingly moving out of the traditional focus on using key indicators like profit, gross margin, return on investment, and revenue growth for measuring financial performance (which has been challenged as limiting approach which looks at outcomes rather than "drivers" of performance), into broad based frameworks which incorporate non-financial measures. The reason for this trend is the realization that value creation comes from all parts of the business and requires the measurement of non-financial parts of the business. Accordingly, it is necessary to include the real drivers behind financial performance such as: Process efficiency, Human resource development, Leadership effectiveness, Customer retention and growth, Product and service innovation, and Brand image and reputation.

Two studies; Njogu, (2007) - the management of strategic change in the implementation of PC's among SCs in Kenya and Odundo, (2007) - the extent to which Kenya Revenue Authority (KRA) satisfied conditions necessary for successful implementation of PC, mostly focused on the qualitative factors which could only help in analyzing operational efficiency and customer service thus falling short of highlighting the extent to which PC's have imparted on the financial performance. The reason for poor performance in many SCs has been attributed to strategic plans not being part of the management culture, non-existent measurable targets, budgets not linked to outputs, lack of sufficient capital, inadequate funding, inability to keep up with technological changes, lack of defined and consistent performance evaluation and exemption from accountability requirements (Odundo, 2007).

In view of the foregoing, the GoK first introduced the concept of PC in the management of SCs in 1989 as an attempt to improve their FP and operational efficiency. The first two corporations to be on PC were KRC and the National Cereals and Produce Board (NCPB). KRC signed PC's in April 1989 while the NCPB signed in November 1990.

1.1.2 Kenya Railways Corporation

KRC is a state corporation which was incorporated in 1978 by an Act of parliament to provide rail and inland waterways transport services to serve the country and the neighboring regions. Regulated under The Kenya Railways Corporation Act Cap 397 and the State Corporations Act, KRC is supervised by the government through the Ministry of Transport (MoT). The corporation has recently implemented PC as part of the GoK policy.

As per the Economic Survey of Kenya (2006), despite the strategic importance of KRC in the National economy, it's financial performance was on a declining trend in the period 2001 to 2006, after posting operating losses for many decades. For instance, the total revenue hardly improved from KSh. 5,237 million in 2001/02 to KSh. 5,231 million in 2005/6 financial year against an expenditure of KSh. 5,277 million in 2001/2 and KShs 4,431 million in 2005/6 in the same period respectively. In other areas of operations including freight volumes, manpower level, passenger journeys etc KRC hardly showed encouraging financial performance or better management. Compared with other modes of transport in the sector, the Railway transport's contribution to the country waned from 3.2% in 2001 all the way to 1.9% in 2006.

According to KRC's annual reports and Strategic Plan (June, 2006 - June 2011), past attempts have been made to reduce the wage bill through retrenchment, but this does not seem to have had any impact on the Corporation's performance. Apparently, KRC's financial and operational performance has been declining for many decades as a result of inadequate investments in the railway system, poor management, an inadequate legal framework, competition from other modes of transport and increasing operational costs. This forced KRC to rely on the exchequer for financial support for several years. Due to competition from the road sector, KRC market share declined from 3.2% to 1.8 % between 2001 and 2005 despite the growth of the general growth in the transport sector.

1.1.3 Kenya Airports Authority

KAA was established as SC by an act of parliament in to develop and manage all the airports in Kenya. KAA is a strategic SC with a monopolistic mandate to manage all airport facilities in Kenya and it's financial performance is highly dependant on the local and global economy which dictates passenger and freight volumes. However, the biggest challenge on KAA's performance is it's competitiveness, restrictions on tariff adjustments, requirement to comply with the Public Procurement and Disposal Act, 2005 and the infrastructural capacity and the ability to modernize.

1.2 Statement of the Problem

According to the World Bank Journal on Millennium Development Goals, (MDGs), the ongoing socio-economic reforms in recent times have been triggered by globalization, liberalization and marketization which have contributed to an expansion of the private sector and a decline of the public sector, which has resulted in poor performance of PEs, making them not only uncompetitive but also economic burdens. PC's have been adopted as one of the measures for performance improvement in addition to in divestiture, disbandment or restructuring. PCs are generally expected to improve financial and operational performance in PE's but whereas this is generally the case in developing countries, empirical studies and experience shows that these measures have shown mixed results in developing countries; in some countries, there has been a sustained improvement in service delivery, a reduction in budget deficits for most governments, and thus, generation of cash flows for priority investments in social services and infrastructure development. In other countries, PE's have not responded as expected in other countries which could be explained by the Organization for Economic Co-operation and Development, (OECD) 1999, which noted that each country has its unique legal, institutional and cultural environment requiring an original vision and mission. Accordingly, it is important to have a customized approach to its own needs and circumstances. A structured approach similar to the one used in the USA, which focuses on strategic performance objectives a mechanism for accurate reporting, bringing all stakeholders into planning and evaluation of performance, linking performance to budget expenditure, provides a framework for accountability and shared responsibility for performance improvement, (DPM, 2004).

Despite the challenges, extensively studies done in developed countries shows that PE’s still continue to contribute significantly to exchequer revenues in developed and developing economies- ranging from as high as 60% in Algeria to 6% in China which is one of the largest economies. In addition, PE’s still remain principal providers of a vast array of social services deemed vital to the attainment of the MDG’s, also generating a significant portion of employment. These conditions help to explain the continued existence of PE’s in developed and developing countries. The important point is that PE’s, regardless of their social-economic justification, must operate efficiently and effectively under given market conditions to guarantee their long term survival.

The GoK, recognized the need to improve the performance of PE’s and introduced the second phase of PC’s in 2003 when an inter-ministerial Committee was appointed in 2003. KRC being a commercial state Corporation was among the first 16 sc to undertake PC. The same was cascaded through the Boards of SC’s, management and lower staff. KRC, is a commercial SC which restructure it’s operations in November, 2006 after many decades of poor financial and operational performance. The greatest challenge facing KRC has been the declining market share in the transport sector, pressure from stakeholders, government and the public to deliver, retrenchment of staff (which means reduced operational capacity), aging fleet and obsolete technology, expectations on the new concession being the first one in Kenya. On the other hand, both KRC and KAA have regulated tariffs, restrictions on tariff adjustments on passenger services,; is subject to the Public Procurement and Disposal act, the State Corporations act, faces the challenge. Due to the heavy capital outlay requirements, KRC and KAA’s infrastructure assets are usually funded by the GoK yet the profitability and liquidity has been a problem, forcing the GoK to subsidize recurrent expenditures – A major problem which was to be addressed by the introduction of PC's.

Local studies like Odadi, (2002) have been carried out on the process and experience in the implementing pc's but this was restricted to the balanced score card, did not delve into a detailed analysis of the relationship between PC's and financial performance. Korir Peter, 2006 studied the impact of PC's in state Corporations – case study of EAPCC while Othieno J. O., (2006) studied the process of implementation PC's with a case study of KPLC while Kirathe C., (2008) focused on the impact of PC'S on the performance of companies in the energy sector.

Thus, this study will serve as a springboard and an attempt to explain the relationship between PCs and FP thus striving by confirming or disapproving the null hypothesis: There is no relationship between PC's and Financial Performance in State corporations and more precisely, the transport sector. The study will also compare the performance of the two SC's which will set a stage for further qualitative and analytical studies by other researchers.

The study will strive to find out whether;

i) There has been improved finance performance in KRC and KAA after introduction of PC's and whether the level of dependency on government subsidy has reduced since the introduction Of PC's.
ii) KRC and KAA use similar measures and targets for PC' reporting.

1.3 Research Objectives

The objective of this study is to understand the relationship between performance contracting and financial performance in developing countries using a comparative study with the following objectives;

i) To establish the relationship between PC and FP for in KRC and KAA as key SC's in the transport sector;

ii) To compare the level GoK subsidies before and after the implementation of PC's; and

iii) To identify the similarities and differences in the types of measures and targets used by KRC and KAA in PC reporting.

1.4 Importance of the Study

This study will be important to the following;

1.4.1 KRC and KAA Management

KRC and KAA's ability to achieve its Mission and Vision will largely depend on the strategies to turn around the current financial performance i.e. from pre-tax losses to profits. This study will assist KRC to re-align its PC framework towards the achievement of its objectives of improving efficiency in service delivery and profitability thus reducing the level of reliance on exchequer subsidies.

1.4.2 Public Service

The findings of the study will be of greater use and application to the wider public service by addressing the many bottlenecks in many organs of the government. The study will help identify key strategies that will constitute tools that will aid in consolidating lost financial ground.

1.4.3 Scholars

The Study will be of value to researchers and those in academics as a basis for future empirical and conceptual research, which will be helpful in refining and validating findings especially with regard to the ongoing rapid changes and restructuring within organizations. In addition, the role of stakeholders in helping re-engineer performance contracting through appropriate tools will be made clear.

CHAPTER TWO: LITERATURE REVIEW

2.0 Performance Contract

According to the Performance Contracts Steering Committee (PCSC), Kenya (2005), the PC system originated in France in the late 1960's and later developed with a great deal of elaboration in Pakistan and Korea and thereafter introduced in India. It has now been adopted in developing countries in Africa, including Nigeria, Gambia, Ghana and now Kenya. On the other hand, the definition of PC's has been a subject of considerable debate among scholars and human resource practitioners. Performance Contracting is a branch of management science referred to as Management Control Systems. A Performance Contract is a freely negotiated performance agreement between Government, organization and individuals on one hand and the agency itself (Kenya, Sensitization Training Manual, 2004). It is an agreement between two parties that clearly specifies their mutual performance obligations, and the agency itself. Korir, (2006), studying the impact of PC in State Corporations, at East African Portland Cement, using linear regression noted performance contract as a Memorandum of Understanding (MOU). An MOU is rooted in an evaluation system, which not only looks at performance comprehensively but also ensures forces improvement of performance managements and industries by making the autonomy and accountability aspect clearer and more transparent. PC is the methodology by which the workforce is structured with the aim of realizing efficient and effective production and delivery of services.

The Organization for Economic Corporation and Development (OECD) 1999, defines a PC as a range of management instruments used to define responsibility and expectations between parties to achieve mutually agreed results. While Smith (1999), argues that a common definition of a PC can be found, there are a considerable variety of uses and forms for quasi-contractual arrangements. In this paper, PC is used as a management tool to help public sector executives and policy makers to define responsibilities and a PC ensures individual commitment on the overall achievement of the firm. However, some commitments can not be measurable; especially in the service industry.

The importance of performance measurement has increased in the recent past with the realization that the prosperity of any organization requires the meeting of the needs of all stakeholders which includes customers, consumers, employees, suppliers, local community stakeholders, and shareholders, (Williams, B. 1998). Since the early 1980's, there has been a general move away from the traditional financial measurement which is generally irrelevant for decision making. This was accelerated in the 1990's and 2000's by the worldwide acceptance of the "Business Excellence Models (BEM)" and performance measurement frameworks that address all stakeholders' needs. BEM's encourage the use of performance measures and more importantly, consider the design of performance measurement systems to ensure that measures are aligned to strategy, while ensuring that the system is working effectively in monitoring, communicating, and driving performance. In as much as the result of performance should be of emphasis; matching the expected and the actual results, the workforce should be properly equipped and appropriate systems be put in place.

PCs establish the obligations and commitment on two or more parties through a contract and help to create market-like conditions by establishing performance goals consequently helping to improve the efficiency of service delivery regardless of the sector, (Smith, 1999). In addition, a PC contributes to creating a result-oriented culture in the public sector creating an environment for accountability and transparency. The initiatives to adopt PCs in public institutions have been driven by changes in the political environment as citizen's demand for value-for-money in public services, greater openness and accountability and improvements in service delivery, (OECD, 1999). PCs are useful for setting clear goals of organization, determining priorities, setting targets, monitoring progress and designing and implementing incentive systems. Also, the contracts require greater clarity of responsibilities and targeted performance level; hence, they can serve as a basis of a dialogue between contracting parties.

Most performance measurement schemes focus on short-term determinants the activities that bear returns only after many years cannot be included in the performance measures because of the limited timeframe for performance review cycles (often one year or three to five years at most). The experience in the use of PCs shows that quantitative performance targets are less important than the process of preparing and negotiating them, (Korir, 2006). The agreements can help both parties translate vague intentions into realistic goals, make the costs of achieving objectives more apparent, and allow for a more rational consideration of costs and benefits. Also, the collaborative nature of the negotiations improves each side's understanding of the other's operations and constraints. Both the management and the workforce should be involved from the inception of any strategic plan; whether short term or long term in nature. This will ensure that the people who are expected to carry out the work are aware of the causes and the impact of the operation undertaken.

In implementing PCs, the common issues that were being addressed included the improvement of performance to deliver quality and timely services to the citizens, the improvement of productivity in order to maximize shareholders wealth, reducing or eliminating reliance on the exchequer, instilling a sense of accountability and transparency in service delivery and the utilization of resources and giving autonomy to government agencies without being subjected to the bureaucracies and unnecessary procedures, (Smith, 1999). The ultimate goal of any performance contract is the increased efficiency in terms of service delivery to the customers and excellence in production.

2.1 Public Sector Reforms

The "public" in any country or region is usually a group (or groups) of people who inhabit the public domain (Bovaird et al, 2004). The public sector on the other hand, is broadly synonymous with Government. Basically, it comprises of Government ministries/departments that are staffed by public servants. The entire public sector reports ultimately to the Head of State, although the day to day operation is normally the responsibility of the Head of Government (Schacter, 2006). In some countries, the heads of state and Government are combined in one office like, in the case of Kenya while in others, the two are distinct.

The public sector is divided into organizational units, each with a particular functional specialization and related set of responsibilities and authorities. Two types of organizational units exist: Central agencies/parastatals and ministries/departments. Line ministries/departments are specialized around programs and policies that relate to a particular economic or social sector e.g. Ministry of Transport, Ministry of Finance, Ministry of Health, Ministry of Agriculture, Department of Adult Education etc. Central agencies parastatals are specialized around functions that affect the entire Government e.g. a Cabinet Office that manages the flow of policy and program proposals from all ministries/departments into cabinet decision, and in recent years, there has been increasing tendencies by Governments to take certain well defined functions out of line ministries/departments and place them under specialized agencies e.g. in the case of Kenya, the KRA, KAA, (GoK, 2001). Such agencies have the responsibility of managing their human and financial resources than in line ministries/departments.

The key role of the public sector in the social and economic aspect of a country includes: making economic and social policies that cover virtually all that Government does; designing and implementing public programs – policies are realized through the design and delivery of public programs in the delivery of public services, production of goods, or transfers of resources to individuals, organizations or other levels of Government; Raising revenue – The Government must raise funds to implement its programs, (Opiyo, 2006). The public sector collects taxes and other levies from the citizens – such taxes and levies are used as a means to pursue social and economic development; Managing accountability – citizens demand accountability in return for the powers granted to the Government to raise and spend revenue, (Mann, 1995). The public sector responds by enforcing internal accountability measures and by reporting to citizens on how money is spent on the successes/failures of public programs. Governments typically sustain independent public institutions of accountability that are empowered to oversee its actions and demand explanations. Such key institutions of accountability may include: Auditor-General, Judiciary, legislature, and the Human Rights Commissions, (Lienert, 2003).

What then is Public Service Reforms (PSR)? The Public Service Office (PSO) of Australia defines PSR as a "planned intervention to raise the level of public service performance. It must have carefully defined goals and a strategy to attain those goals" (PSO, pg. 2). The ultimate aim of PSR is to see remarkable improvements in public service outputs, such as more effective and responsive service delivery. The whole PSR program is generally concerned with the implementation of coordinated management initiatives to transform delivery of these services for better efficiency and effectiveness in serving the public.

2.2 An Overview of Public Service Reforms

The last two decades have been a time of worldwide economic pressures and widespread technological, social and political change. To secure their future, governments have been forced to seek ways of cutting costs and becoming more productive and service focused. In this environment of constant change and increasing complexity, new management thinking and approaches have emerged which identify the need for continuous learning and improvement. In most countries, this new management thinking has been accompanied by social and legislative changes as well as new ways of managing the public sector. Thus, public sector organizations have embarked on major reform programs and restructuring, African Association for Public Administration and Management (AAPAM, 2006). Change is inevitable; the public sector has to embrace these changes constructively. Technology for instance, makes work easier, and is cost effective in the long run. However, replacing all the human resources with the technology might be immoral and unethical and unacceptable by the labor laws.

Generally speaking, most of the public service reforms programs that have taken place especially in developing countries during the last two decades were introduced as part of the Structural Adjustment Programs (SAPs) of the World Bank in the 1980s. However, most of the recent reforms, under the influence of the New Public Management (NPM), have been driven by a combination of economic, social, political and technological factors which have triggered the quest for efficiency and for ways to cut the cost of delivering public service (Economic Commission of Africa).

Politically, since the 1980s, domestic and external forces started to exert pressure on Governments to liberalize the political space. Consequently, democratic systems were introduced which embarked upon ambitious programs of political, institutional and economic reforms. The objective of the reforms involved changing the role of government, creating an enabling environment for the private sector and civil society to flourish and establishing an efficient civil service by increasing its competence, efficiency, fairness and quality of services, (Shah, 1994). The core paradigm which can be discerned as leading to the development of PSR in the two decades, especially in Africa was that the public sector provision of services was inefficient and ineffective. Meanwhile, the public/citizens were becoming more enlightened and were demanding for better service provision. It was then believed that both the public and the private sectors could be managed in fundamentally the same way. The focus of the NPM was then on creating institutional and organizational contexts which mirrored the critical aspects of private sector modes of organizing and managing. This was aimed at improving performance of the public sector for more efficiency, effectiveness and accountability, (Zeithaml et al, 1990). The role of the media in terms of being informative, has greatly improved; this has been facilitated with the media freedom. The public is therefore aware of their rights and expectations from the public service.

Further, the debate on good governance and its requirement provided an impetus for new approaches to the public sector management reforms. Some of the changes that have taken place have been aimed at tackling some of the worst forms of governance abuses and failures in the world over: the personalized nature of rule in which key political actors exercise of unlimited power, misuse of Government resources and institutionalized corruption. Good public management and administration, with emphasis on accountability and responsiveness to customer needs, has been seen as an aspect of good governance by donor agencies supporting reforms especially in developing countries (Schacter, 2006). To most of the donor agencies, good governance entails a public service that is effective and efficient, a judicial system that is reliable and an administration that is accountable to the public (Economic Commission for Africa, 2006). Feedback from the customers in any organization is very important since it helps gauge the performance of the management. Satisfied customers will always give additional trial to the service or product and finally acquire loyalty.

The performance of the public sector management reforms in many parts of the world especially in the developing countries and in Africa in particular, have been hampered by a myriad of factors including lack of efficiency, lack of accountability, ineffective management practices and corruption. It is critical, however, developing countries learn from each other's experiences in order to improve on the implementation of the public service reforms.

2.3 Service Delivery in Public Sector

The results of PC have been mixed with some countries showing a general and sustained improvement in PE Performance in service delivery while in other countries, some PE's have not responded due to restrictive government policies. Ideally, the provision of quality service requires that such services exceed customer's expectation whereby customers are able to compare the perceived service with the expected services. If the perceived service is below expectation, they loose interest with the provider while the opposite creates loyalty. Parasuraman, et al (1995) formulated a service delivery model that highlights requirements for high quality service delivery. It identifies five gaps that cause unsuccessful delivery namely, gaps between consumer expectation and management perception, gaps between management specification and service quality specifications, gaps between quality specification and service delivery, gaps between service delivery and external communication, gaps between perceived service and expected service, (AAPAM, 2005). They also came up with five determinants of service quality by order of importance i.e., reliability, responsiveness, (willingness to help customers and prompt service assurance), the ability to convey trust, empathy and individualized attention to customers. Studies have found that well managed service companies have the following practices; strategic concept, top management support, high standards of service delivery, service monitoring systems, satisfying customer's complaints and an emphasis on employee's satisfaction. For an effective service delivery in the public sector, there is need to develop an appropriate and prompt mode of communication amongst all the stakeholders responsible in the delivery of services.

According to Kotler (2002), service companies face three tasks i.e. competitive differentiation, service quality, and productivity. Differentiation is where the service provider adds secondary service features to the primary service. Delivery differentiation is where the company hires and trains better people to deliver the service or through image differentiation by symbols and branding. Tax and Brown (1998), found that companies that encourage customers to complain achieve higher profits. Well-managed service companies carry internal marketing providing employees with support and rewards for good performance. Karl Albrecht (1992) observed that unhappy customers could be "terrorists" while Berry and Parasuram (1992), concluded that in order to exceed customer expectations, companies need to present a realistic picture of their service by checking the promotional messages for accuracy, performing the service right to customers, by stressing to employees to provide reliable service, effectively communicating with customer to ascertain their needs by using the service delivery process as an opportunity to impress on customers and also continuously evaluating and improving their performance against customers expectations. In as much as the public sector would wish to please and satisfy her clients, there is need to set realistic goals that are easily attainable within the stipulated time period. This helps to avoid unnecessary embarrassments or rush hour fixation of assignment.

According to Kotler (2002), there are seven approaches to increasing service productivity, these are having skilful workers through the process of recruitment and selection, increasing quantity of service by surrendering quality, industrializing the service, reducing or making obsolete the service need by inventing a product solution, designing of more effective services, presenting customers with incentives to substitute own labour with company labour and also harnessing the power of technology to give customers superior services. Public sectors should come up with creative strategies that will enable them actualize enhanced productivity. Quality people deliver quality work, thus frequent training and work induction is necessary to keep the workers updated and functional.

2.4 Performance Contracting and Financial Performance

Successful stories of PC (OECD, 1999) show that performance management strategies pursue three objectives namely, saving, internal management improvement and better accountability. The following table shows issues, commensurate objectives and strategies that have proved versatile in handling PC as far as general and financial performance are concerned.

The relationship between the various intervening factors on KRC's performance is as below;

Table 2.1: Issues, Objectives and Strategies that have proved versatile in handling Performance Contracting

Identified Issues	**Objective**	**Strategy**
Governance	Develop solid legal framework	Set out the basic premises and status of the contract.
Resources	Stabilize resources	Enhance the motivating effect of the contract
Politics	Develop political good will	Operational autonomy of contract
Contract management	Performance oriented change	i). Empower staff to embrace and manage change by focusing on performance and cost in the field of human resource and financial management (ii).Apply Best Management practices. (iii).Practice transparency and accountability
Performance	Good definition of outputs and solid performance measures	(i). Execute well defined training programs (ii). Be Innovative and creative for future performance improvement
Evaluation and audit	Regular overall evaluation and audits	Learn from experiences

In order to move the implementation of the Public Service Reform Program, 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. It outlined the actions that were necessary to imbed long lasting and sustainable change in the way public services are offered, (APAM, 2005). As the Strategy was unraveled it became clear that objectives, outputs and results would constitute predetermined variables. Thus the strategy spelled out what became commonly known as "Results Oriented Management (ROM) approach". However to achieve results via this approach meant that all participants i.e. line managers, workers, stakeholders, parties etc. needed a complete turn-around or paradigm shift. More sacrifice was needed. For example the lukewarm, somewhat non-receptive workers also had to change to being pro-active, outward looking and results oriented. In other words, there was need for effectiveness and efficiency in managing work, (Kamuna, 2007).

In addition, the "Results Based Management (RBM) System" was introduced to ensure that the public sector is transformed into a more focused and responsive outfit to the needs of those it serves. Targeted sectors were meant to synergize towards delivering targeted results for Kenyans and utilizing resources more productively, (RBM Guide, Kenya, 2005).

2.5 Quality of Service

According to Thomas (1978), a service is any act or performance that one party can offer to another that is essentially intangible and does not result in the ownership of anything and it's production may not be tied to a physical product. Zeithamal et al, (1990) defines service quality as a measure of how well the service level matches customer expectations. An organization must be consistent in delivering quality service in conformity with the turbulence of its internal and external environment. The quality of a service offered is of significant and strategic concern, since it is an important indicator of customer satisfaction, which is the basis of customer loyalty for continual profitability of the public sector.

Consequently, the user/customer of the product or service is an important consideration in the achievement of the organization's objectives, Rust and Zahorik (1996). Tom and Austin, (1985) upheld that "The Customer has all the votes" and there is a role for marketing, and strategy formulation, but ultimately, it all boils down to perceived, appreciated and consistently delivered service and quality to customers. Increasingly, it is recognized that even the service quality of government/public institutions, credibility and the quality of service delivery, matters a great deal for a country's economic performance (Njoroge, 2003).The core issue as to why business exists is to make profit; however, no returns can be realized whatsoever when there is no contact between the product or service deliverer and the customers, both prospective and existing clients.

2.6 Determinants of Quality of Service

Defining and modeling the quality of services is generally acknowledged to be more difficult than modeling the quality of goods due to the intangible nature of services themselves (Bergman & Klefsjo, 1994). Kotler, (2003) summarized the generic determinants of service quality into five as: reliability, responsiveness, assurance, empathy and tangibility. According to Palmer (1992), service quality technique is applicable across a broad range of service industries and can be modified to take into account the specific requirements of an organization. The determinants of service quality were derived from Service Quality Models through an extensive research; The generic determinants can be used as the basis for the measuring service performance as a starting point and then expanded to the industry or markets of study, (Njoroge, 2003). Generally speaking, a quality substance must be of a fair standard as compared to its substitutes in the market produced by other suppliers. Issues such as; taste, after use effects, convenience of use and mode of display or packaging is a reflection of the quality of service offered.

2.7 Measures of Quality of Service

The conceptualization and measurement of service quality have been well described and researched by Parasuraman, et al (1985). They provide an explanation of the concept of service quality and identify the various “gaps” that affect service quality as perceived by consumers. Among them, the difference between customers’ expectations of service and their perceptions of the service is defined as the “perceived service quality”. They developed service quality as a scale for measuring customer perceptions of service. This scale has been subject to criticism and refinement and there is a continuing debate about the measurement of service quality and the determinants, which should be used (Mathews, 1995). PEs has to identify the appropriate measure to apply in the measurement of service quality so as to avoid significant deviations from the standard. This will also call for comparison between the measuring used by other competitors’ in the same industry, probably experiencing similar working conditions.

Due to the unique nature of services, service quality is not easy to measure. Several researchers are in agreement that service quality consists of the comparison between expectations and performance. Zeithaml et al (1990), states that service quality are the consumers’ judgment about an entity’s overall excellence or superiority. It is a form of attitude and results from the comparison of expectations to perceptions of performance received. Gronroos (1982) model, analyses service quality on the basis of expectations and the perception of the service. In addition, Christopher et al (1991) confirms that perceived performance is more important than the reality of performance. Measurement of the quality of service is not easy from the outward look, though, the better way to do this could be to analyze the existing variance between the expected and the actual performance. This calls for the feedback from the customers and beneficiaries of the services.

Consequently, as Tom and Austin (1985), stated that the real issue is what is perceived reality is what counts. Since services are characterized by experience and credence qualities, consumers use various cues and trough their experiences develop attitudes towards the services offered by an organization. Service quality dimensions are mainly based on the attitudes of the consumers. Therefore to measure perceived service quality, attitude measures are applicable. Some of the measures of attitudes are the Guttmann Scalogram analysis developed by sociologist Louis Guttmann in 1950, the Thurstone

Scale designed by Thurstone and Clare in 1929, the Osgood's Semantic Differential Scale developed by Osgood et al in 1957 and the Likert scale developed by Likert in 1935. Perception being the state of mind, a PE has a duty to convince the customers, even through manipulation so as to win the attitude of the customers towards the services offered by the public sector.

According to Chava (2003), measuring service quality with the Likert Scale would be appropriate. The Likert scale involves determining the scale items and administering them to a random number of respondents. A total score of each respondent for each item is then computed and the discriminative power of the items determined. The scale items are then selected and reliability tested. The scale has been applied successfully by researchers in the field of service quality, (Njoroge, 2003) as a system of measuring service quality and adopting scientific methodology that can be trusted and relied on. However, great care should be taken since the response to be analysed as put in the scale can be easily manipulated by the data analyst so as to suit the demands of the management.

2.8 Customer Satisfaction

Satisfaction is defined as the "customer's fulfillment response," a judgment that a product or service provides a pleasurable level of consumption related fulfillment, including under or over fulfillment. The key to achieving customer satisfaction is linking buyer's needs with the organization's product or service planning process. Success in creating high quality products and services depends most importantly on finding out which dimensions of product and service quality drive customer satisfaction, (Gilbert, 2004). Customer satisfaction is not the easiest outcome to measure; the manager and the sales agents of the marketing department can continuously improve methods for receiving feedback from customers. The customer service personnel can be trained to observe and report feedback from customers. Customer feedback is an opportunity for the bank industry to communicate with its customers. Njoroge (2003), Studying Customers Perception of the Service Quality in a Decentralized System in the Public Utility Sector in Kenya at the Kenya Power & Lighting Co; Ltd (KPLC), using linear regression observed that the distinction between customer satisfaction and service quality is a very important one. The level of customer satisfaction is result of a customer's comparison of expected service quality with perceived service quality. By consistently meeting and exceeding customer needs and satisfaction, there is a tendency for an organization to build customer relationships that will retain the loyalty of existing customers and enable the new customer segments and markets to be served efficiently and effectively translating into repeat purchases, increased turnover and ultimate into improvement in the bottom-line.

2.9 Elements of a Proper Service Delivery using Performance contract

These include an adequate enabling environment; assignment of an appropriate set of functions to public sector; assignment of an appropriate set of own-source revenues to the governments; the establishment of an adequate intergovernmental fiscal transfer system; and the establishment of adequate access of public sector to development capital. Each of these is discussed in turn, first outlining principles, then turning to commonly encountered problems and possible ways to mitigate them.

2.10 An Adequate Enabling Environment

An enabling environment for fiscal decentralization can begin with constitutional or legal mandates for some minimum level of autonomy, rights and responsibilities for the governments. This provides a foundation on which to build decentralization, but it does not by any means, guarantee successful service delivery. There are many countries with constitutional clauses and laws on the government that have not managed to decentralize successfully. A good example is Indonesia, which became more fiscally centralized after a major decentralization law was passed in 1974, (Smoke and Lewis, 1996). With decentralization, an organization is in a better position to expand its market share and reach the customers at the door step at ease. Nevertheless, a proper feasibility study is necessary before adopting decentralization system.

A number of elements appear to be critical in establishing a sustainable enabling environment for fiscal decentralization. This is illustrated in the context of Ethiopia and Uganda, two often-cited cases of recent good performance, (Cohen, 1995). First, in both countries, emerging political conditions have led to a strong national will to decentralize. Ethiopia and Uganda adopted decentralization in response to a perceived need to surrender certain powers to their regions as a way of holding their ethnically fragmented nations together. This domestic political interest has taken the initiative away from the international donor community, which has driven recent decentralization efforts in many developing countries. In Ethiopia and Uganda, donor agencies were invited to assist only after the respective governments laboriously determined the general direction in which they intended to move. As long as the citizen embraces the political call for decentralization, there is a sustainable enabling environment for fiscal decentralization process.

Second, both countries have recently developed unusually robust and clearly defined constitutional and legal provisions to support decentralization and the strengthening of decentralized levels of government. The 1995 Ethiopian Constitution provided for a federal system, with different service provision and revenue responsibilities for the federal and regional governments. In Uganda, Governments Statute of 1993, the 1995 Ugandan Constitution and the Governments Act of 1997 provide considerable detail about the service and revenue powers of public sector offices.

Third, fiscal decentralization programs in many developing countries are under the direction of fairly bureaucratized, often competing, and poorly coordinated central agencies with a direct stake (loss of power) in decentralization. These include broad-purpose ministries, such as Local Government, Home Affairs, Finance and Planning, as well as various sectoral ministries (Smoke, 2000). In contrast, both Ethiopia and Uganda have developed special-purpose, some-what more neutral and high-level mechanisms to oversee and co-ordinate decentralization and public sector reform. In Ethiopia, the Regional Affairs Department in the Office of the Prime Minister has substantial overall responsibility in this regard, and a Decentralization Secretariat was set up for similar purposes in Uganda. Although the Secretariat reports to the Permanent Secretary for public sector, staff members are not civil servants, and they are in principle detached from the normal government bureaucracy. In addition, the public sector Finance Commission, a broad-based, constitutionally mandated, independent body that reports directly to the President, has considerable control over public revenue and intergovernmental transfer design. Unnecessary red tape in the process of decentralization, poses a threat. The protocols observe system should be real and not burdened in any way.

Fourth, function off-loading and public revenue inadequacy are major concerns in effective service delivery by public sector. Both Ethiopia and Uganda recognize that effective public governments must have adequate resources to meet their responsibilities under decentralization. Accordingly, both countries have developed significant transfer programs that account for substantial proportions of total central revenues (around 30 per cent in Uganda and more than 40 per cent in Ethiopia).

2.11 Assignment of appropriate functions to public sector

Central government agencies rarely have a desire to decentralize services they have been providing, particularly if decentralization involves a loss of prestige and resources to these agencies and they perceive each other as competitors. Thus, they almost invariably try to slow the process. However, should too many sectors be decentralized too rapidly and the government does not have the capacity to handle these new responsibilities, they will perform poorly.

Although poor fiscal performance of the government is often a genuine problem, this does not necessarily prove that fiscal decentralization is inappropriate. It may simply mean that the fiscal decentralization or government reform program is giving governments too much functional responsibility too rapidly and without appropriate capacity building and governance development support from the central government.

2.12 Assignment of Appropriate Revenues to the Public Offices

The fiscal federalism principles for assignment of revenues to the governments, like the service assignment principles discussed above, are well defined and generally appropriate. Many developing countries basically follow these principles, with a few prominent exceptions, such as the infamous South Asian *octroi*e (Bahl and Linn, 1992; Shah, 1994). Thus, central governments generally attempt to assign ministerial revenue bases that are relatively immobile and should therefore not lead to serious spatial efficiency effects that do not compete seriously with central tax bases. The basis for revenue allocation to the public offices should factor in the nature of the service offered, content of the service, responsibilities and roles of the public sector, so as to assign the appropriate revenue.

Four particularly problematic concerns remain on the revenue side. First, assigned revenues are almost never adequate to meet the ministerial expenditure requirements. This means that central government transfer programs are inevitably required. Second, public sector often uses too many unproductive revenue sources that barely cover the costs of collecting them. Third, the same lack of attention to implementation discussed above in relation to service decentralization also plagues the revenue side. Fourth, individual revenue sources suffer from some serious design problems, such as static bases, overly complex structures and ineffective collection mechanisms. Issues related to transfers are discussed below, focusing on own-source revenue design and implementation strategy.

One of the most critical international lessons of public sector tax reform is that ministries should focus their energies on a few local sources of revenue that can provide substantial yields and pay less attention to the many minor taxes that they typically have access to (Bahl and Linn, 1992; Shah, 1994). A cost-benefit analysis done on the public sector tax that finds it costly to raise tax, suggests that better manage the major and substantial tax revenue sources than concentrating on what makes the public sector a loss maker.

2.13 Theoretical Frame work

This paper considers the relationship between public sector performance contracting as an NPM technique against financial performance. NPM proves useful as an initial theoretical framework for this cross-country examination of public sector performance reporting for two reasons. Firstly, the NPM literature provides a broad contextual base upon which performance reporting can be considered and research hypotheses identified. Secondly, NPM changes have been pervasive but have not followed a strictly consistent path across nations (Hood, 1995). Thus analysis of public sector performance contracting as an NPM technique will add to the available data related to this issue.

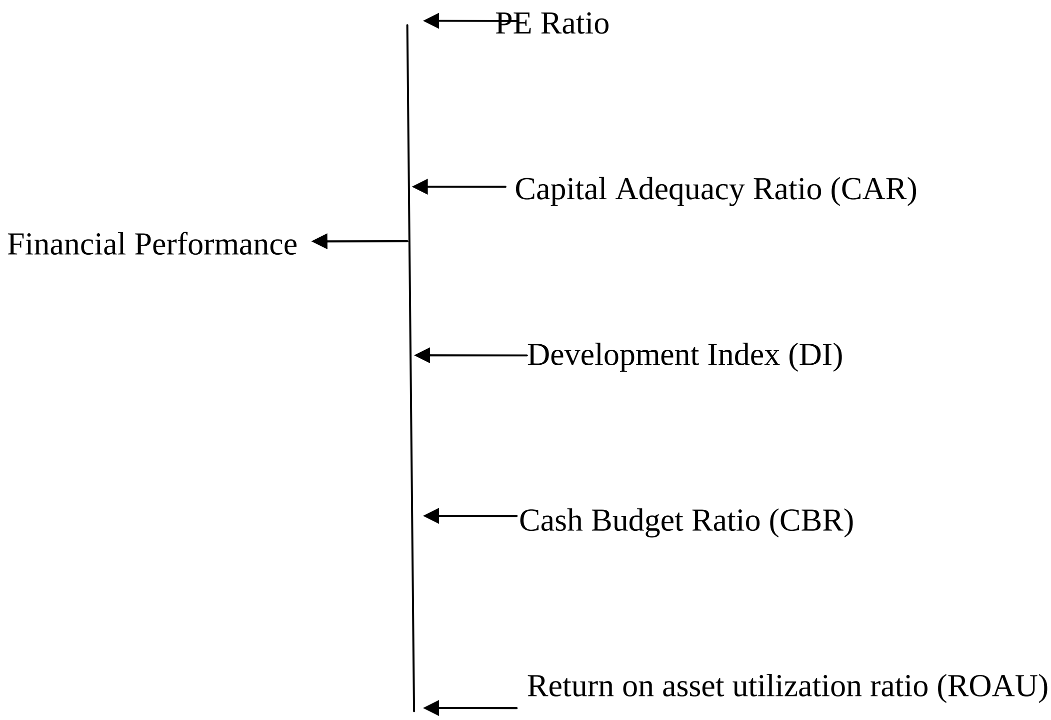
Herein, the definition of NPM as applied is provided by Hood (1995), working from two cardinal elements: the degree of distinctiveness from the private sector and the extent of rules operating to maintain buffers against political and managerial discretion. The hypothesis that there is lack of political goodwill to drive the public sector performance contracting process as it is perceived as foreign-driven rather than a home-grown solution for service delivery improvement.

By arguing for a “new global paradigm” in public sector management, Osborne and Gaebler (1992) sowed the seeds for a growing body of literature which examined the phenomenon known as NPM. The literature on NPM is now quite wide and includes official exhortations to adopt various elements of NPM, academic considerations of the advantages and disadvantages of NPM and various texts dealing with specific elements of NPM techniques. Most views of NPM note that it accords significant importance to service delivery. However, there is evidence of a “crisis of confidence with performance measurement” (Williams, 1998) showing “considerable turmoil” in the selection of performance contract (Carlin and Guthrie, 1996) and probable selective reporting (Walker, 2002). Clearly, there is a need for further research on performance contracting which deals with service delivery in public sector and more specifically, the relationship with financial performance. In this study, the Staff Budget Ratio (SBR), Personnel

Emoluments (PE) ratio, Capital Adequacy Ratio (CAR), Development Index (DI) ratio, Cash Budget Ratio

(CBR) and Return on asset utilization ratio (ROAU) will be used as the independent variable as a basis on which KRC's management is able to leverage to achieve specified financial and non-financial targets in the annual PC's.

2.14 Conceptual Frame work



Dependent Variables **Independent Variables**

Definition of Variables:

i) Financial Performance = Ratio or performance indicator which is a dependant variable

ii) PE Ratio = $\dfrac{\text{Actual Personnel Expenses}}{\text{Total Operating Expenses}}$

iii) **Capital Adequacy Ratio (CAR)** = $\dfrac{\text{Working Capital(Cash+Stores/ Inventories+ S.t. investments)}}{\text{Turnover}}$

iv) **Cash Budget Ratio (CBR)** = $\dfrac{\text{Total cash inflows}}{\text{Total Operating budget ratio}}$

v) **Development Index (DI)** = $\dfrac{\text{Actual Capital Expenditure}}{\text{Recurrent Expenditure}}$

vi) **Return on asset utilization ratio (ROAU) =** $\dfrac{\text{Operating profit}}{\text{NBV at the beginning of the year}}$

2.15 Gap Analysis

Performance Contracts originated from the perception that the performance of the Public Sector has been consistently falling below the expectations of the Public and it was necessary to institute a framework for improving efficiency and effectiveness in the management of Public service as part of broader Public sector reforms. 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 (RBM Guide, 2005).

While several approaches have been used to address these challenges, existing studies indicate that there has been mixed results. The fundamental principle of performance contracting is the devolved management style where emphasis is management by outcome rather than management by processes. It therefore provides a framework for changing behaviors in the context of devolved management structures.

The implementation of the second phase of PCs in Kenya began only in 2004 implying that the real impact of the process is yet to be fully visible. However, there is clear evidence of radical improvement in some aspects of the management of Public Service. In spite of these tremendous achievements, there has been limited scholarly studies and documentation of the impacts of Performance Contracts on service delivery in the Kenyan Civil Service. Whereas existing studies have focused on the PC implementation process and the impact on the delivery of public services, there has been no attempt to analyze the relationship between PCs and the financial performance of state corporations.

This study, therefore intends to investigate the relationship of performance contracting on the financial performance of KRC and KAA in the context of developed management structures in the Kenyan Government ministries and departments.

2.16 Empirical Studies /Conclusion

In conclusion, chapter two reviewed the literature on the definition and historical background of PCs. A detailed description of PCs in the Kenyan context in the entire public service was reviewed as well. The empirical evidence on the worldwide experience of Performance Contracting was done. The study is trying to fill the gap is the lack of documentation on the relationship between PCs and FP in the public sector after the introduction of PCs in Kenya as seen from studies by Njogu, (2007, studying the management of strategic change in the implementation of PC’s among state corporations in Kenya and Odundo, (2007), studying the extent to which KRA satisfied conditions necessary for successful implementation of PC.

CHAPTER THREE: RESEARCH METHODOLOGY

3.0 Introduction

The purpose of this study was to establish the relationship between performance contracting and financial performance in the public sector. In this chapter, the research design, target population, data collection methodology and procedures as well as data analysis and data interpretations are covered. Liquidity, Gearing, Asset utilization, Development Index and Profitability ratios were used in the study.

3.1 Research Design

A research design is the plan and structure of investigation so conceived as to obtain answers to research questions. The plan is the overall scheme or program of the research. According to Cooper & Schinder (2003), there are many definitions of research design but no one definition impacts the full range of important aspects.

The research design used in this study was a comparative study on the relationship between PC and Financial Performance for KRC and KAA. For purposes of in-depth analysis and understanding, the study was limited to two key state Corporations in the transport sector which have implemented PC for the last four years, leaving out other players. It also sought to understand the type of indicators used to measure performance in the PC framework and the quantitative factors behind the differential performance between the two SC's in the same sector.

3.2 Population and Sampling

The population of interest in this study, was KRC and KAA's audited financial statements for the years from 30th June, 2000 to 30th June, 2009 (which covers before and after the introduction of PCs) and the annual PC reports to the Inspector of SC's. Initially, the study was designed to look at various state corporations in the different categories/sectors for the period 2003-2008 but it was later noted that it was very difficult to get in-depth information from all the selected organizations. The researcher therefore decided to select the two State Corporations, which were commercial and monopolistic players in the air and railway transport sectors. The period of coverage was also increased form 5 years to 10 years between 2000- 2009 for improved analysis.

3.3 Data Collection

This study was a quantitative analysis of past financial records; it was felt that the use of questionnaires and interviews would be inappropriate due to the subjectivity associated with personal opinions by respondents which may conflict or distort facts, hence, the entire population of data from for the period of study (Yr 2000 – 20009) was consodered.

The source of data for the study was secondary data as derived from audited financial statements and annual PC reports gathered from the KRC, KAA and the Kenya National Audit office (KENAO). The data collected was from the audited financial statements and annual reports analyzed in accordance with performance perspectives propounded by Kaplan and Norton, (1992). This includes; relevant budget, staff levels, cash flows, profitability and balance sheet figures. All relevant Financial Performance Indicators (FPI) in the years of study were analyzed. The number of years suggested is a period of 5 years before and 4 years after the implementation of PC with 2004/2005 being the base year when PCs were introduced at KRC and KAA. This period was considered sufficient enough to provide variables to assist in ascertaining a trend on PC and FP.

3.4 Data Analysis

Data on the ninth year sample period was analyzed by use of key performance indicators (KPI) like financial ratios to confirm whether there has been a real change in financial performance. The FP was measured using OP, PTP, GoK subsidies and ratios like DI, Return ROAU and CAR computed annually. T-test for the sample means of KRC and KAA was carried out to test the hypothesis that there was no significant difference in the FP of KRC as a result of PC.

CHAPTER FOUR: DATA ANALYSIS AND FINDINGS

4.1 Introduction

This chapter presents data analysis and interpretation of the research study on the relationship between PC and FP in the transport sector. The findings are represented in tables and figures. The period of study comprised of ten years. PC was introduced in the FY 2004/2005. Therefore, this study compares the performance of KAA and KRC before and after the period when PC was introduced. Analysis is carried out first with each company then a comparison is made between KRC and KAA.

4.2 Summary Statistics of data

This section illustrates the summary of statistics of the companies involved in the study.

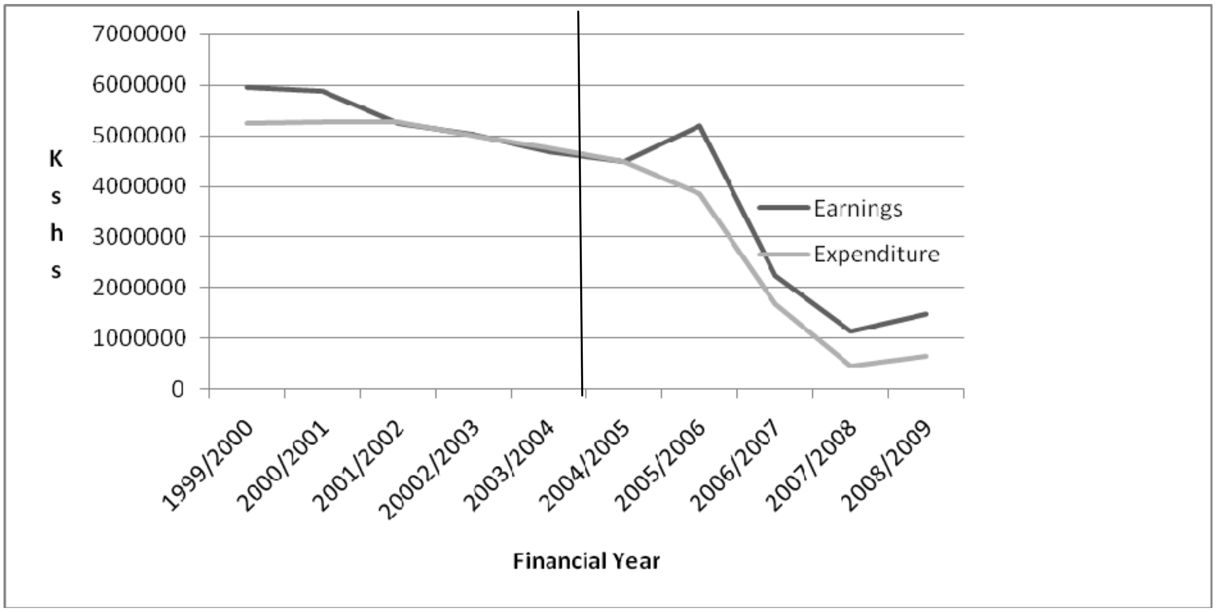
Table 4.2.1 KRC Financial Information

Year	**1999/2000**	**2000/2001**	**2001/2002**	**20002/2003**	**2003/2004**
Earnings '000'	5,954,320	5,878,276	5,237,097	5,020,501	4,670,182
Expenditure'000'	5,251,413	5,273,361	5,276,711	5,012,405	4,758,697
Operating profit '000'	702,907	604,915	-39,614	8,096	-88,515
Surplus/deficit 000'	-851,461	-633,858	-1,431,163	130,097	-1,940,884
Year	**2004/2005**	**2005/2006**	**2006/2007**	**2007/2008**	**2008/2009**
Earnings '000'	4,484,827	5,185,649	2,237,126	1,130,239	1,484,625
Expenditure'000'	4,479,684	3,865,653	1,677,688	443,245	647,546
Operating profit '000'	5,143	1,319,996	559,438	686,994	837,079
Surplus/deficit 000'	-852,234	360,942	-909,071	-481,288	-2,123,653

Table 4.2.2 KAA Financial Information

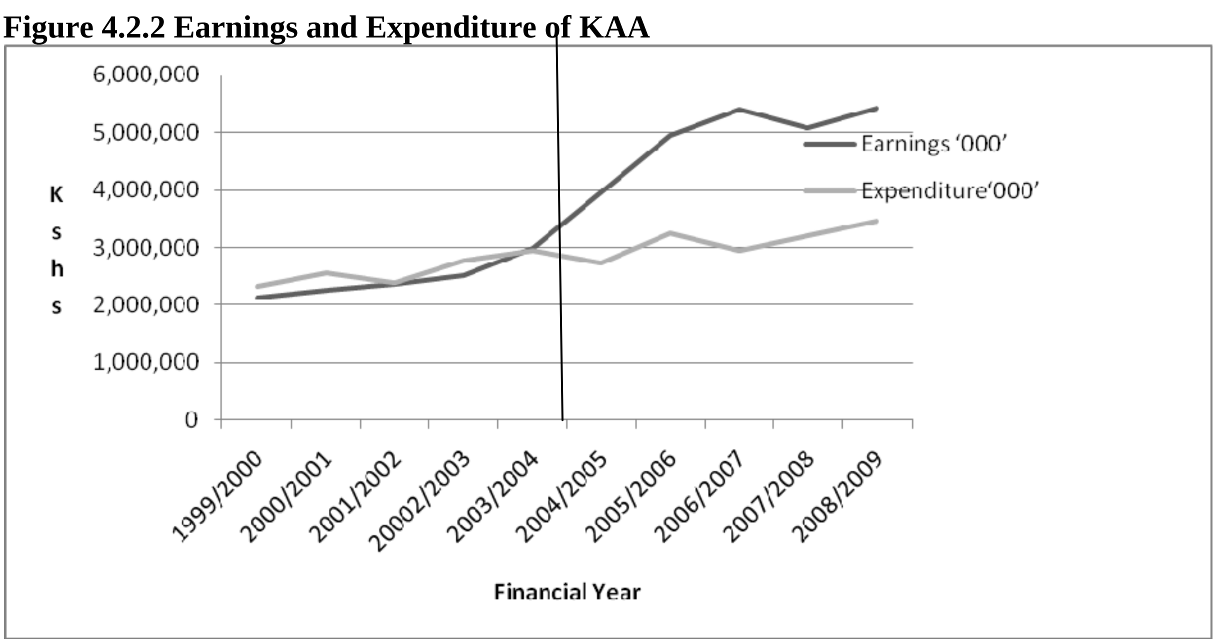
Year	**1999/2000**	**2000/2001**	**2001/2002**	**20002/2003**	**2003/2004**
Earnings '000'	2,127,032	2,261,078	2,371,613	2,504,334	2,979,782
Expenditure'000'	2,316,797	2,544,030	2,390,781	2,772,892	2,939,061
Operating profit '000'	(189,765)	(282,952)	(19,168)	(96,100)	40,721
Surplus/deficit 000'	(246,312)	(282,952)	(626,021)	(422,425)	(184,884)
Year	**2004/2005**	**2005/2006**	**2006/2007**	**2007/2008**	**2008/2009**
Earnings '000'	3,951,177	4,958,070	5,391,037	5,071,301	5,423,231
Expenditure '000'	2,718,112	3,242,070	2,949,614	3,202,117	3,456,806
Operating profit '000'	1,233,065	1,716,000	2,441,423	1,869,184	1,966,425
Surplus/deficit '000'	911,527	1,292,747	1,787,100	1,252,663	1,281,798

Figure 4.2.1 Earnings and Expenditure of KRC



As can be seen from figure 4.2.1, there has been a general decline in both the level of expenditure and revenue. The downward trend generally becomes more noticeable after 2004/2005 when PC was introduced. This can be attributed to the KRC becoming learner and concentrating on its core business of transportation. Even though introduction of PC reduced the revenue, it however ensured that earnings were greater than expenditure at all times for KRC.

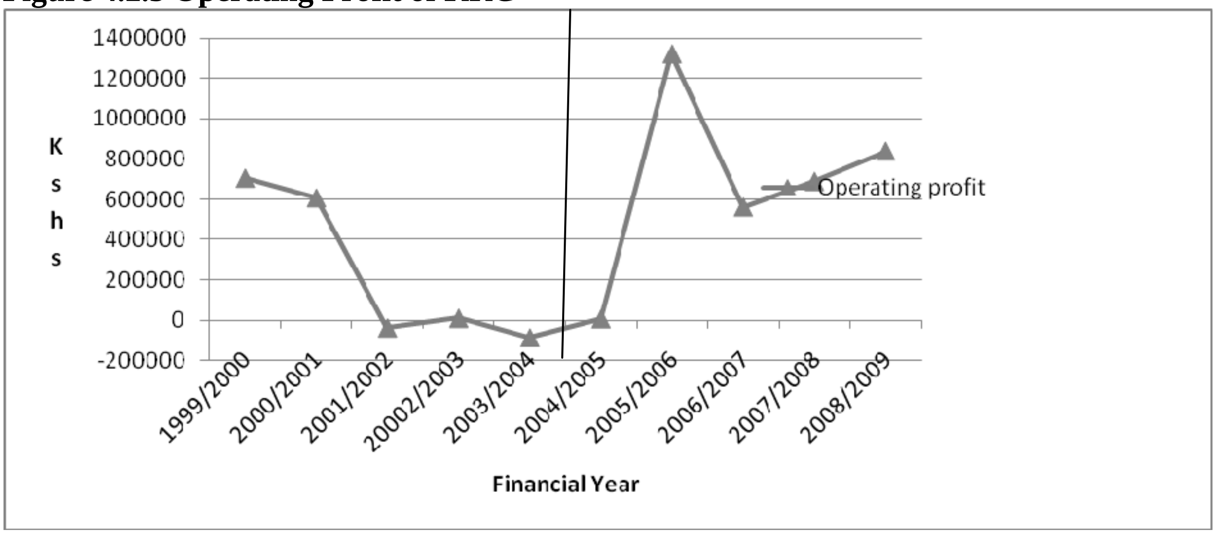
Figure 4.2.2 Earnings and Expenditure of KAA



From figure 4.2.2, it can be seen that before the introduction of PC, KAA's performance had was at the lowest with successive records of losses but FP changed dramatically after the introduction of PC in year 2004/2005, and recorded consecutive increase in revenue with a slight slowdown in the year ending 30th June 2008 before picking up.

The decline in 2008 may be explained by the post-election violence that rocked the country after the disputed presidential elections results were announced.

Figure 4.2.3 Operating Profit of KRC



It can be seen from the graph in figure 4.2.3 that the there was a decline in the operating profits from Kshs 650 M to a deficit of about 50M KRC between Yr 1999-2002. This was maintained for the three years to June 2005 when PCs were introduced. From the year 2004/2005, there was a record jump in the operating profits to reach a record of Kshs 1.3 billion which was followed by a decline in Yr 2006/07 when the concession took place. It is clearly noted that there has been a steady and sustained improvement in the operating profits since Yr 2006.

Figure 4.2.4 Operating Profit of KAA

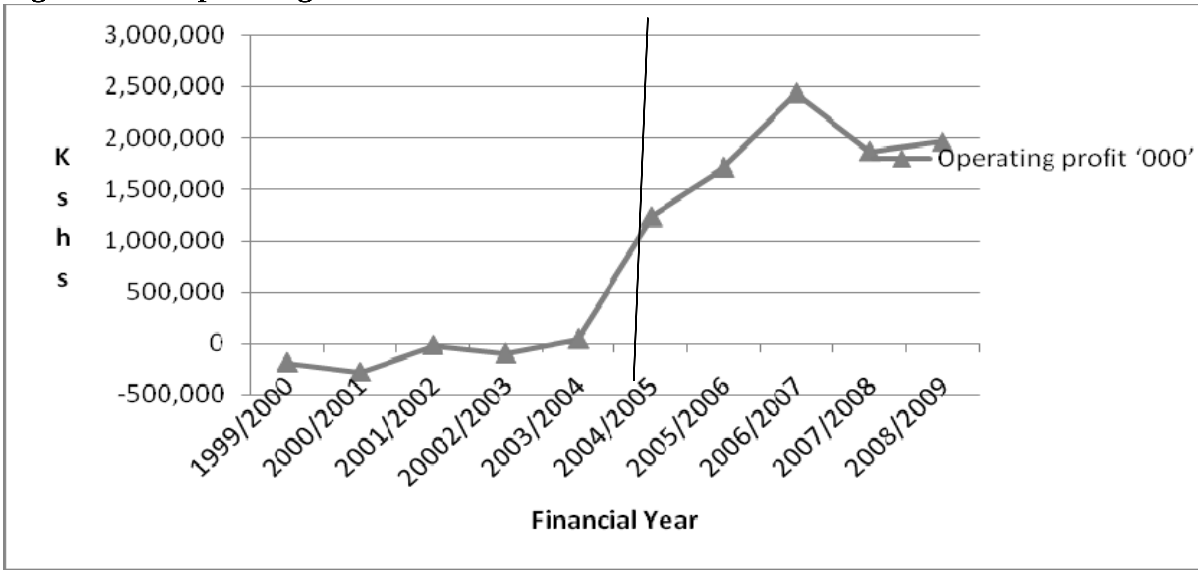


Figure 4.2.4 shows that prior to the FY 2004/05, KAA recorded losses before the introduction of PCs. However, imediately after performance contracting was introduced the company recorded a jump in profits and this continued in an upward trend except for a slowdown in the year 2007/2008 when there was post-election violence in the country.

Figure 4.2.5 Surplus/Deficit of KRC

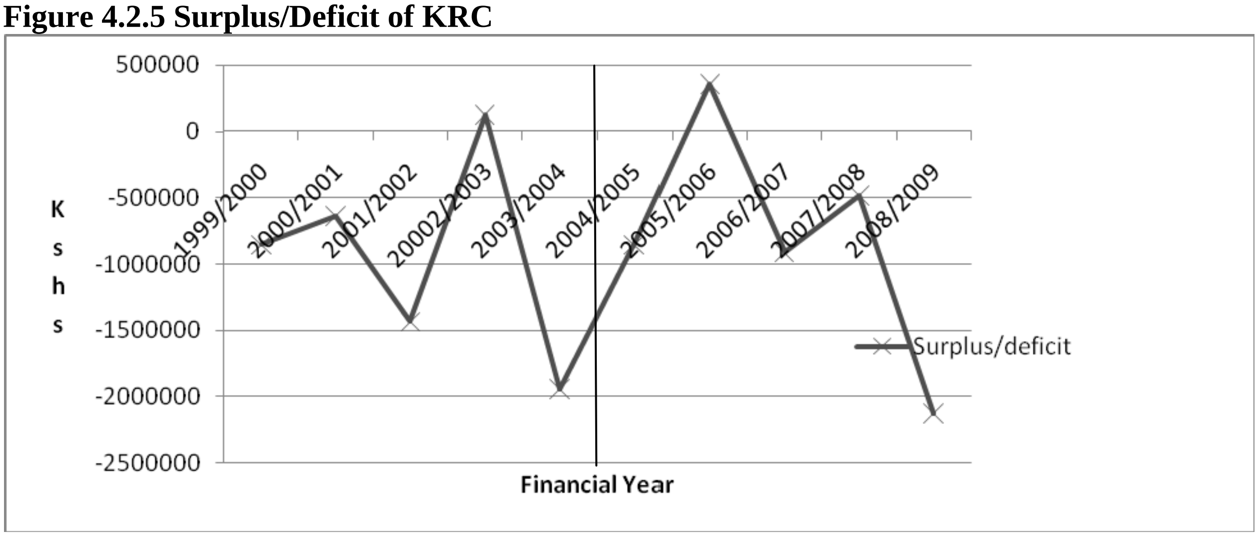
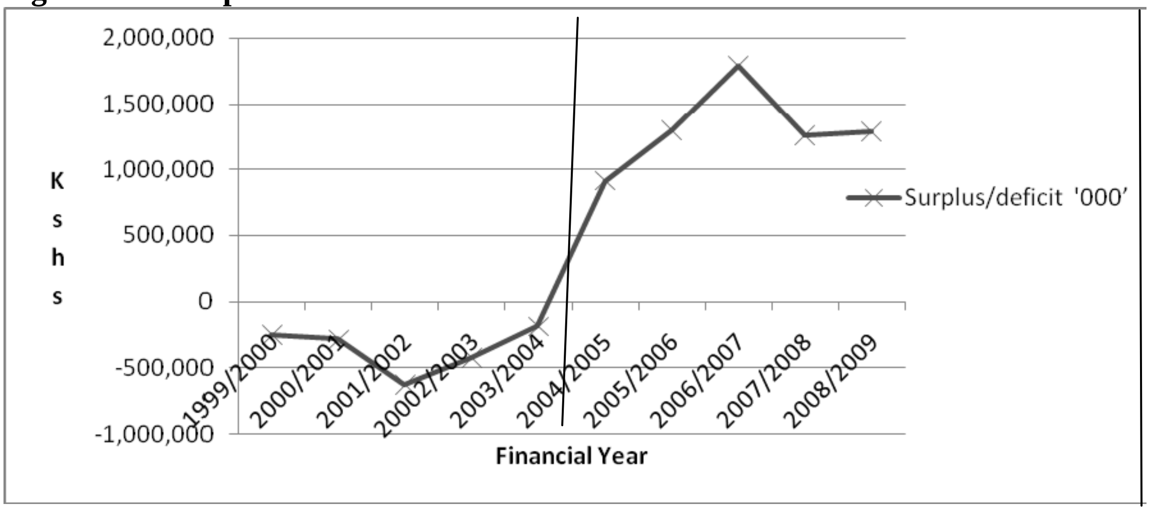


Figure 4.2.5 shows erratic movements in the surplus/deficit of KRC over the ten year period. It is worthy to note that KRC recorded mostly deficits with a significant surplus just after the introduction of PCs in the year ending 2006 and this attributed to the GoK grant which was given to sustain the Corporation just before the concession. However

in the years that followed, the deficit kept increasing and this can be attributed to the effects of the annual penalties and interest on foreign loans combined with the exchange gains and losses. From the FS, there seems to be a mis-match between KRC's revenue and the magnitude of the non-operating expenses and this has forced the management to negotiate for a special target based on OP.

Figure 4.2.6 Surplus/Deficit of KAA



The first five years under study saw KAA record deficits hitting its lowest point in the year ending 30th June 2003. Nevertheless after 2004/2005 KAA recorded successive profits with an all time high of Kshs. 1.79 Billion being recorded in the year 2006/2007.

4.3 Capital Adequacy Ratio (CAR)

Capital adequacy ratio (CAR), is a ratio of a company's capital expenditure to its recurrent expenditure. *CAR* can be used to ensure that it can absorb a reasonable amount of loss and are complying with their statutory Capital requirements. Capital expenditures are expenditures creating future benefits. A capital expenditure is incurred when a business spends money either to buy fixed assets or to add to the value of an existing fixed asset with a useful life that extends beyond the taxable year.

The formula for CAR is given as

$$\textbf{CAR} = \frac{\text{Working Capital(Cash+Stores/ Inventories+ S.t. investments)}}{\text{Turnover}}$$

Table 4.3.1 KRC Capital Adequacy Ratio

Year	1999/2000	2000/2001	2001/2002	20002/2003	2003/2004
Working capital	-1,894,124,911	-2,635,776,204	-3,541,317,760	-3,550,794,834	-5,430,493,547
Turnover	5,954,320,424	5,878,276,302	5,237,097,231	5,020,501,003	4,670,182,368
CAR	**(0.32)**	**(0.45)**	**(0.68)**	**(0.71)**	**(1.16)**
Year	2004/2005	2005/2006	2006/2007	2007/2008	2008/2009
Working capital	-6,104,235,395	-5,540,422,429	-10,889,038,753	3,366,683,529	3,076,165,007
Turnover	4,484,827,020	5,185,649,026	2,237,126,079	1,130,239,099	1,484,624,861
CAR	**(1.36)**	**(1.07)**	**(4.87)**	**2.98**	**2.07**

Table 4.3.1 shows that KRC recorded negative CAR for most all the years under study except for the years 2007/2008 and 2008/2009. This is caused by negative working capital. The introduction of performance contracting in the year 2004/2005 saw the improvement of CAR ratio to an eventual positive figure in the last two years.

Table 4.3.2 KAA Capital Adequacy Ratio

Year	**1999/2000**	**2000/2001**	**2001/2002**	**20002/2003**	**2003/2004**
Working capital	2,191,112.00	2,014,047.00	1,457,958.00	1,213,258.00	1,940,018.00
Turnover	2,127,032,000	2,261,078,000	2,371,613,000	2,504,334,000	2,979,782,000
CAR	**0.00103**	**0.00089**	**0.00061**	**0.00048**	**0.00065**
Year	**2004/2005**	**2005/2006**	**2006/2007**	**2007/2008**	**2008/2009**
Working capital	2,636,597.00	4,153,115.00	5,028,109.00	3,213,836.00	3,295,469.00
Turnover	3,951,177,000	4,958,070,000	5,391,037,000	5,071,301,000	5,423,231,000
CAR	**0.00067**	**0.00084**	**0.00093**	**0.00063**	**0.00061**

Table 4.3.2 shows the KAA capital adequacy ratio which recorded a positive but a marginal figure. After the introduction of performance contracts in the year 2004/2005, there was a noted increase in CAR before a slowdown in the last two years. This can be attributed to the increase in current liabilities.

4.4 Development Index (DI)

This is calculated as:

$$DI = \frac{\text{Actual Capital Expenditure}}{\text{Recurrent Expenditure}}$$

Table 4.4.1 Development Index (DI) for KRC

Year	**1999/2000**	**2000/2001**	**2001/2002**	**20002/2003**	**2003/2004**
Capital Expenditure ‘000’	114925.198	364700.922	838812.605	1145194.952	20248.59
Recurrent expenditure ‘000’	5,954,320	5,878,276	5,237,097	5,020,501	4,670,182
DI	**1.93%**	**6.20%**	**16.02%**	**22.81%**	**0.43%**
Year	**2004/2005**	**2005/2006**	**2006/2007**	**2007/2008**	**2008/2009**
Capital Expenditure ‘000’	81652.314	81652.314	111193.45	28022.27574	283913.9546
Recurrent expenditure ‘000’	4,479,684	3,865,653	1,677,688	443,245	647,546
DI	**1.82%**	**2.11%**	**6.63%**	**6.32%**	**43.84%**

From table 4.4.1 it can be seen that KRC recorded successive increase in its Development Index ratio for the first four years under study before recording, the lowest figure of 0.43% in the year 2003/2004 just before the introduction of performance contracts. After the introduction of performance contracts the DI ratio mapped a continuous upward trend.

Table 4.4.2 Development Index (DI) for KAA

Year	**1999/2000**	**2000/2001**	**2001/2002**	**20002/2003**	**2003/2004**
Capital Expenditure '000'	463,529.00	638,361.00	1,753,268.00	99,372.00	9,313.00
Recurrent expenditure '000'	2,316,797	2,544,030	2,390,781	2,772,892	2,939,061
DI	**20.01%**	**25.09%**	**73.33%**	**3.58%**	**0.32%**
Year	**2004/2005**	2005/2006	2006/2007	2007/2008	2008/2009
Capital Expenditure '000'	403,516.00	402,682.00	1,326,348.00	735,968.00	1,980,006.00
Recurrent expenditure '000'	2,718,112	3,242,070	2,949,614	3,202,117	3,456,806
DI	**14.85%**	**12.42%**	**44.97%**	**22.98%**	**57.28%**

Table 4.4.2 shows erratic but significant movements' development index especially in the period before performance contracts were introduced. From 2004/2005 onwards it can be seen that there was a steady increase in the development index of KAA.

4.5 Return on asset utilization ratio (ROAU)

$$ROAU = \frac{\text{Operating profit}}{\text{NBV at the beginning of the year}}$$

Table 4.5.1 Return on asset utilization ratio (ROAU) for KRC

Year	**1999/2000**	**2000/2001**	**2001/2002**	**20002/2003**	**2003/2004**
Operating profit	702,907,426	604,915,192	-39,613,827	8,096,402	-88,514,904
NBV of assets	8,075,261,865.00	7,809,586,390.00	7,670,558,593	7,433,919,575	7,211,898,933
ROAU	**8.70%**	**7.75%**	**-0.52%**	**0.11%**	**-1.23%**
Year	**2004/2005**	**2005/2006**	**2006/2007**	**2007/2008**	**2008/2009**
Operating profit	5,143,312	1,319,995,669	559,437,585	686,994,071	837,078,629
NBV of assets	7,043,678,134.00	6,912,600,384.00	6,760,810,194.86	6,585,623,878	6,679,815,176
ROAU	**0.07%**	**19.10%**	**8.27%**	**10.43%**	**12.53%**

Table 4.5.1 shows KRC impressive ROAU figures for the first two years under study then thereafter the company started recording marginal and negative returns. However, in the year 2004/2005 when performance contracts were introduced the company's ROAU steadily increased before finally recording an all time high figure 12.53%.

Table 4.5.2 Return on asset utilization ratio (ROAU) for KAA

Year	1999/2000	2000/2001	2001/2002	20002/2003	2003/2004
Operating profit	(189,765)	(282,952)	(19,168)	(96,100)	40,721
NBV of assets	17,009,940.00	16,422,429.00	15,675,302.00	18,215,470.00	17,367,431.00
ROAU	**-1.12%**	**-1.72%**	**-0.12%**	**-0.53%**	**0.23%**
Year	2004/2005	2005/2006	2006/2007	2007/2008	2008/2009
Operating profit	1,233,065	1,716,000	2,441,423	1,869,184	1,966,425
NBV of assets	8,152,763.00	7,816,607.00	8,643,043.00	11,786,371.00	12,685,132.00
ROAU	**15.12%**	**21.95%**	**28.25%**	**15.86%**	**15.50%**

KAA's ROAU figures show an upward increase as can be seen in table 4.5.2. It can be seen that there was a dramatic increase in ROAU figures after the introduction of performance contracts, from 0.23% in the year 2003/2004 to 15.12% in the year 2004/2005. Thereafter ROAU figures maintained an upward trend for two years before stabilizing in the last two years under study.

4.6 Performance Indicators

Table 4.6.1 Performance indicators of KRC

CUMULATIVE-TO-DATE June 2009			
	ACTUAL	**TARGET**	**VARIANCE**
Pre-Tax Profit/(Deficit)	703,873	**400,000**	303,873
Return on Capital	**5%**	**2%**	3%
Development index	9%	**13%**	-4%
Non conceded asset Revenue	-1.4%	**-1.0%**	-0.4%

The pre-tax profit for the quarter was Kshs 140 M above target for the quarter and 303 M on cumulative and lower budgeted staff costs basis as result of; reduced/controlled spending in the 4th quarter and savings on tenders. The return on capital was above target by 1.2 % for the quarter and **3 %** on cumulative basis as a result of improved profitability attributed to reduce spending in the quarter and for the period. The development index for the quarter was 22% above the target and **4%** below target on cumulative basis as a result of higher Capital expenditure in the quarter and restricted spending as occasioned by cash flow constraints.

Table 4.6.2 **Performance indicators for KAA**

CUMULATIVE-TO-DATE June 2008					
	Ksh '000'	**Weight**	**Actual**	**Target**	**Variance**
Pre-Tax Profit/(Deficit)	%	**10**	2058416	1953416	105000
Debt/Equity Ratio	%	**10**	6	13	-7
Return on Investment	%	**15**	8.9	8	0.9
Development index	%	**15**	120	125	-5
Weight sub-total	%	**50**	178,558		

KAA achieved its target in terms of pre-tax profit and return on investment. On the other hand it did not achieve its target in terms of debt/equity ratio and development index.

4.7 T test statistics

The Two-Sample t-Test analysis test for equality of the population means underlying each sample. The three tools employ different assumptions: that the population variances are equal, that the population variances are not equal, and that the two samples represent before treatment and after treatment observations on the same subjects.

Table 4.7.1 T test statistics for KRC

	Earnings		*Expenditure*		*Operating profit*		*Surplus/deficit*	
	Before PC	*After PC*	*Before PC*	*After PC*	*Before PC*	*After PC*	*Before PC*	*After PC*
Mean	5.35E+09	2.9E+09	5.11E+09	2.22E+09	2.38E+08	6.82E+08	-9.5E+08	-8E+08
Variance	3.07E+17	3.33E+18	5.18E+16	3.43E+18	1.47E+17	2.26E+17	6.22E+17	8.04E+17
Observations	5	5	5	5	5	5	5	5
Pearson Correlation	0.936386		0.725119		-0.13495		0.731634	
df	4		4		4		4	
t Stat	4.14678		3.813906		-1.52878		-0.51616	
P value	0.007149		0.009438		0.100523		0.316483	

Table 4.7.1 shows that KRC recorded improvement in its operating profit after the introduction of performance contracts and a slight improvement in its deficit as can be

deduced from the mean values. It is only earnings that recorded reduced variance in its earnings after the introduction of performance contracts. From the Pearson Correlation it can be seen that the profits in the post PC period is negatively and marginally related to the period when PC had not been introduced. On the other hand, the other performance indicators show significant relationships between the two periods. T statistic measures the strength of the pre and post Performance Contracts performance and it can be seen that earnings and expenditure exhibited stronger relationships during the two periods as compared to operating profit and surplus. The p value is the probability of obtaining a result at least as extreme as the one that was actually observed, given the null hypothesis is true. It can be seen that the p-value for earnings and expenditure are the only ones below 0.05 which means that performance contracts had a significant impact on the two and not on operating profit or surplus/deficit all with p-values in higher than 0.05.

Table 4.7.2 T test statistics for KAA

	Earnings		***Expenditure***		***Operating profit***		***Surplus/deficit***	
	Before PC	***After PC***	***Before PC***	***After PC***	***Before PC***	***After PC***	***Before PC***	***After PC***
Mean '000'	2448768	4958963	2592712	3113744	-89374.8	1998258	-379071	1403577
Variance '000'	1.07E+11	3.58E+11	6.79E+10	8.14E+10	1.98E+10	9.79E+10	3.66E+10	6.57E+10
Observations	5	5	5	5	5	5	5	5
Pearson Correlation	0.693622		0.910696		0.624558		-0.83271	
Df	4		4		4		4	
t Stat	-12.772		-9.88795		-16.6721		-8.31369	
P value	0.000108		0.000294		0.000235		0.001823	

It can be seen from table 4.7.2 that mean values for the various performance indicators were far much better after the introduction of performance contracts than before. However it can be seen that variance increased because of the increased deviations from the mean. Pearson correlation shows that expenditure was the one that was affected the most after the introduction of performance contracts followed by surplus/deficit even though it was a negative relationship. Income and operating profit closed the list with 69.4% and 62.4% respectively. From the t statistic it can be seen that though it is negative, operating profit and earnings exhibited the strongest relationship for KAA. Given that all figures for P-value are below 0.05 it can be concluded PC had a significant impact on all the performance indicators shown above with earnings recording the most significant relationship.

CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECCOMENDATIONS

5.1 Introduction

This chapter looks at the foregoing discussions, conclusions and recommendations were made. The response was based on the objectives of the study.

5.2 Summary of the findings

The study aimed at achieving three objectives, namely; To establish the relationship between performance contracting and financial performance for KRC and KAA; to determine if there was a change in the level of GoK subsidy to KRC and KAA after the implementation of PC's and to identify the similarities and differences in the types of measures and targets used by KRC and KAA in PC reporting.

This study has established that after the introduction of PCs the KRC and KAA improved their FP. This is especially noticeable for KAA which registered a significant improvement in the PTP in the FY 2004/05. For KRC, introduction of PC in the FY 2004/05 was followed an improved surplus in the FY 2005/06 due to GoK subsidies, but this was reversed in the FY 2006/07 when the revenues reduced substantially (due to the concession) before a steady increase from 2008. However, during the post PC period, earnings were greater than expenditure at all times. Using various financial ratios it was found that the performance of the two corporations improved after the introduction of performance contracts. For example after the introduction of PCs the DI for KRC ratio mapped a continuous upward trend. While over the same period KAA saw as steady increase in its development index of KAA.

For KRC, it was noted that its earnings recorded reduced variance after the introduction of performance contracts. T statistic was used to measure the strength of the pre and post Performance Contracts performance and it was found out that for KRC that earnings and expenditure exhibited stronger relationships during the two periods as compared to operating profit and surplus. For KAA, its t test values indicated that, operating profit and earnings exhibited the strongest relationship between the two periods.

In terms of government subsidies, it was found that KRC's subsidies were at the peak in the year 2006 when the restructuring/concession took place but this has gradually reduced to a low of Ksh 51 M in 2009. With regard to KAA, it is observed that the Corporation has managed to survive without subsidies by recording pretax profits and paying income tax to GoK since the introduction of PC's in 2005. Hence, both KRC and KAA have achieved self sustainability and it is clear that this is associated with the introduction of PC's.

With regard to the different types of measures used by state corporations in performance contracting, it was found that both KRC and KAA used the DI, ROI, and D/E ratio to report their FP. However, there was a variation on the pre-tax profits; whereas KAA reported against the accounting profits before tax, KRC made an adjustment and reported using OP. Both KRC and KAA used variance reporting by setting targets and comparing this to the actual figures. In the year 2008/2009 it was found out that KRC met its target on pre-tax profit and return on capital while it was off target in terms of development index and non conceded asset revenue. KAA achieved its target in terms of pre-tax profit and return on investment. On the other hand it did not achieve its target in terms of DE ratio and DI.

5.3 Conclusion

This study has shown that PC's have been largely successful tools in improving the FP of KRC and KAA. It can be seen for instance, that KAA's FP improved tremendously after the introduction of performance contracts in yr. 2005. For KRC, the OP improved marginally after the introduction of PCs but the PBT continued declining. From these observations, it may be argued that even though PCs help in re-directing the efforts and focus of an organization, there is a limit to which this can be achieved by the management. KRC declining performance can be attributed to the legacy problems like the heavy debt burden, the continued accrual of penalties and interest (beyond the control of the current management) in the books of account, inadequate investments in the railway system, poor management in the past, lack of an inadequate legal framework, competition from other modes of transport and increasing operational costs. Due to this reasons, KRC market share has continued to decline despite the growth in the transport sector. For both KRC and KAA, it can be seen that PC's has helped to wean off from reliance on GoK subsidies as a means for survival which means tax payers money is being saved for investment in other priority projects.

Just like any other corporate strategy, performance contracts cannot be used in isolation because value creation comes from all parts of the business and requires the measurement of both financial and non-financial parts of the business. The fundamental principle of improved performance in any organization is a wholesome management style where emphasis is both on outcomes and processes.

5.4 Limitations of the Study

In carrying out this study, various limitations were encountered. Principal among them was obtaining appropriate data from the SC's as originally planned. Attempts by the researcher to compile data from various SC's in different categories were unsuccessful. It also took some time to get PC reports from KAA. The two SC's, KRC and KAA had different formats and classification of items their FS and it became necessary to make some adjustments to make them comparable. This study was a desk research which did not involve questionnaires and it is possible that some additional data would have enhanced the quality of the report. The researcher experienced problems with time due to official duty engagements.

5.5 Recommendations

This study was basically quantitative and more qualitative studies needs to be under-taken to analyze the reasons for the differential performance between KRC and KAA after the introduction of PC's and how it affects the morale of employees. In addition future studies should evaluate PC measures and indicators to establish whether they are appropriate and reflect the management's efforts in financial stewardship or not. Other possible studies on this subject could include establishing the relationship between PCs and the market share and core business of the company.

Lastly, it could also be interesting to carry out a study on the effect of factors which are considered to be beyond the control of management affect the achievement of PC targets.

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