

**EFFECT OF MANAGERIAL COMPENSATION SCHEMES ON FIRM  
PERFORMANCE FOR INVESTMENT FIRMS LISTED AT NAIROBI SECURITIES  
EXCHANGE**

**BY  
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**DECLARATION**

I declare that this research project is my original work and has not been previously published or submitted elsewhere for award of a degree. I also declare that this contains no material written or published by other people except where due reference is made and author duly acknowledged.

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## ABSTRACT

Previous studies on effects of executive pay have produced mixed results. Many studies on managerial compensation schemes focused on examination of relationship between managerial compensation schemes and firm performance, in developed countries but very little is known about managerial compensation schemes in developing nations particularly Kenya. This study has examined the effect of managerial compensation schemes on firm performance for investment firms listed at Nairobi Securities Exchange. The study has been guided by four objectives: To examine the effect of cash based compensation on firm performance for investment firms listed at Nairobi Securities Exchange, to determine the effect of stock based compensation on firm performance for investment firms listed at Nairobi Securities Exchange, to examine the effect of deferred compensation on firm performance for investment firms listed at Nairobi Securities Exchange and to find out the effect of long-term incentive plan on firm performance for investment firms listed at Nairobi Securities Exchange. The findings of this study will help the industry to understand how to regulate managerial compensation schemes to enhance firm performance. Three theories are utilized in explaining managerial compensation schemes and firm performance and these includes: Agency theory, Theory of competitive compensation and Goal Setting theory. The study has been conducted on all investment firms listed at NSE in 2017 and a sample of 53 has been used. A descriptive research design was employed with questionnaires as data collection instruments. A stratified sampling technique was adopted in selecting the required sample. Regression analysis was carried out and data entered into the computer and analyzed using SPSS. Results have been presented using frequency tables, pie charts and graphs. The study concludes that compensation based on cash, stock based, deferred compensation and long term incentive plan are associated with growth in profits, market share or generally performance of the investment firms. Regression analysis show that all the variables were less than 0.05 and this demonstrates that increase in firm's profits is linked to managerial compensation.

**Key words:** Firm Performance, Cash Based Compensation, Stock Based Compensation, Deferred Compensation, Long-Term Incentives Plan

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## **DEDICATION**

I dedicate this work to God Almighty, for His grace my source of inspiration, my pillar, and my fountain of knowledge and wisdom. I also thank my family and daughter who stood affected by this quest in every possible way. Their encouragements and support will go a long way in seeing me finish what I started.

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## **ACRONYMS AND ABBREVIATIONS**

<b>2SLS:</b>	Two-Stage Least Squares Regression
<b>CEO:</b>	Chief Executive Officer
<b>CFOs:</b>	Chief Financial Officers
<b>CO:</b>	Company
<b>CSRC:</b>	Chinese Securities Regulation Committee
<b>EU:</b>	European Union
<b>FE:</b>	Fixed Effects
<b>HR:</b>	Human Resource
<b>LTD:</b>	Limited
<b>NSE:</b>	Nairobi Stock Exchange
<b>ROA:</b>	Return on Assets
<b>SPSS:</b>	Statistical Package for Social Sciences
<b>UK:</b>	United Kingdom
<b>USA:</b>	United States of America

## **OPERATIONAL DEFINITION OF TERMS**

- Firm performance–** In this study, firm performance is a measure of an organization's efficiency and market where it operates (Wagner, 2012).
- Cash Based Compensation –** Is the salary, any cash bonus that is paid under a plan offered by the firms that permits such amounts to be deferred, and any other amounts designated (Graham, Li, & Qiu, 2012).
- Stock Based Compensation –** This is a way through which a firm uses stock options to reward employees in this case the managers (Core & Guay, 2001).
- Deferred Compensation –** This is a portion of an employee's compensation that is set aside to be paid at a future or later date (LaBrecque & Teetor, 2016).
- Long term Incentive Plan –** This is a reward mechanism to executives for achieving objectives of their companies, such as performance shares (Derthoo, 2017).

# **CHAPTER ONE**

## **INTRODUCTION**

### **1.1 Background of the Study**

In the last two decades, the academic literature regarding agency theory and managerial compensation was aligned to performance of the firm (Pepper& Gore, 2015; Geletkanycz& Boyd, 2011; Jensen & Murphy, 1990). Further research has shown that the relationship between pay and performance is derived from agency theory (Grossman& Hart, 1983). Based on this argument compensation contracts should be structured to align the interests of managers with those of the shareholders.

There has been an increased focus on the relationship between managerial compensation and firm performance (Feldman, 2016). Prior studies have generally found a positive relationship between Entrepreneurial Orientation (EO) and firm performance (Brick, Palmon& Wald, 2006; Zajac, 1990). However, there are also studies where such a relationship has not been found (Hahn &Lasfer, 2011). One reason might be that the measure that has been used to assess the firm performance has typically been a combination of both profitability and growth measures (Wiklund, 1999; Avlonitis&Salavou, 2007). This study provided evidence on the relation for Kenyan companies over the sample period 2012-2017.

Many companies worldwide have routinely provided their top management and Chief Executive Officers (CEOs) with incentives so as to concentrate on and improve customer satisfaction. According to an annual report on UK top management pay prepared by Price Waterhouse Coopers (2007), the proportion of managerial compensation designed to influence non-financial

performance measures has increased from approximately 35% in 2006 to almost 57% in 2007. Similarly, a recent survey of managerial compensation plans drawn from a sample of Fortune magazine according to Epstein and Roy (2005) indicates that customer satisfaction is the top-most non-financial criteria that companies consider when setting CEO compensation. Therefore, companies in the USA and abroad have clearly established the practice of structuring CEO compensation to influence customer satisfaction.

In addition, there is a growing disparity between senior management and employees pay across many countries worldwide. For example, the average compensation of CEOs in USA increased by 175% compared to an average increase of 0.6% a year for normal USA workers (Graham, Li, & Qiu, 2011). Similar trends were observed in UK in that CEO compensation increased by 149 percent in the wake of economies crises, there is public demand for legislation against managerial compensation (Ozkan, 2011). In Canada, Germany and Netherlands regulation requires all boards to pay explicit attention to scenarios that may lead to large payouts to managerial team. Even though there is restriction on managerial pay legally binding standards such as reduced risk-taking and the resultant rewards for mediocre performers (Dittmann *et al.*, 2011).

Manager's total compensation package comprises of several components and these includes bonus, stock option grants, base salary as well as the restricted stock grants offered in the firm. Normally, pay for managers is expressed as fixed pay (salary) that is not dependent on explicit performance objects including customer satisfaction and incentive pay such as bonus, stock options and restricted stock grants. By providing incentive pay, the organization seeks to tie the



executives' interests to long-term shareholder wealth maximization and the strategies adopted in achieving the same.

Several studies in economics and finance have established how CEO's and manager's incentives affect firm performance. According to agency theory, separation of firm ownership and control in companies suggests that CEOs and managers tend to engage in non-shareholder wealth maximizing activities since; shareholders are too busy to monitor them (Bergen et al., 1992). Consequently, Jensen and Meckling (1976) proposed that CEOs and managers could be given more ownership in the company to correct this principal-agent problem between CEOs or managers and shareholders. The basic idea is that a greater ownership stake in the firm should help align the interest of CEOs and managers with shareholders' interests. Some studies examined CEO and manager's entrenchment at higher levels of firm's ownership and found out that firm value first increases and then decreases with increasing levels of CEO or managerial ownership (Murphy & Over, 2001).

Studies on agency theory has attempted to link compensation structure to performance. For example, Murphy (1999) provides a general overview of the executive compensation study in the finance literature. Over the course of 20 years, finance and economic studies have examined the relationship between compensation and firm performance and the sensitivity of executive compensation to changes in the stock price or revisions in compensation contracts following poor performance (Pepper, 2016; Jensen & Murphy, 1990).

As argued by Bebchuk and Grinstein (2005) executive pay has raised up beyond levels that can only be defined by the growth in the size of the firm and performance observed between 1993-

2003. This can be attributed to CEO and other top-level management pay and hence firm profitability are directly related to each other.

In Kenya, the executive compensation has come under a massive spotlight perhaps due to the nature of CEO compensation. Companies Act 2015 in Kenya general framework is used in financial accounting and reporting by all companies that are registered in Kenya. Studies focusing on managerial compensation and firm performance are recent (Erick,*et al.*, 2014). With these studies it clearly shows a gap over the pay performance link. Researchers have different opinions on whether managerial compensation affects firm performance. Therefore, this study aims to find out whether managerial compensation schemes affect performance of listed investment firms in Kenya.

### **1.1.1 Managerial Compensation Schemes**

Compensation schemes are assumed to serve motivational and informational roles (Merchant, 1998). Compensation schemes are motivational because they encourage individuals to set and commit themselves to higher goals and performance levels (Liccione, 1997). Larkin et al. (2012) suggested that compensation is strategic not only in its ability to motivate and attract the employee being compensated but also in its effect on peer employees and the firm's complementary activities. In addition, compensation schemes are informational because they can direct subordinates' efforts toward gathering task-relevant information that will enhance their performance (Merchant, 1998). However, as stated, empirical evidence has found that compensation schemes do not always enhance subordinates' task performance (Kohn, 1993)

while some studies have found that compensation schemes decrease performance (Bonner et al., 2000).

The performance effects of three different types of compensation schemes on employees' task performance have been examined in prior studies (Webb et al., 2013; Bailey and Fessler, 2011). They are fixed-pay, piece-rate and goal attainment bonus. Fixed-pay compensation scheme provides a fixed amount of reward regardless of output. Fixed-pay compensation scheme is usually categorized, as non-contingent pay scheme because the amount of payment made under this scheme is not contingent upon performance. On the contrary, piece-rate and goal attainment bonus compensation schemes are termed collectively as contingent pay schemes because the payments made under these schemes are either directly or indirectly contingent upon performance. The major difference between these two forms of contingent pay schemes is that a piece-rate compensation scheme provides reward for a pre-defined amount of money for each unit of output, while a goal attainment bonus compensation scheme withholds rewards until the budget goal is achieved.

The performance effects of different types of compensation schemes vary because they have different abilities in increasing their commitment to achieve the assigned goals set (Wright, 1994). It is expected that contingent pay schemes (piece-rate or goal attainment bonus) would strengthen the interaction between performance feedback and assigned goal levels to affect task performance. This is because contingent pay scheme is relatively more effective than their non-contingent counterpart (e.g. fixed-pay) in encouraging individuals to commit to goals (Webb et al., 2013). Sprinkle (2000) argued that incentive-based compensation schemes motivate individuals to exert higher effort, and use feedback to make choices that maximize total expected profit.

Farrell et al., (2008) have found that compensation schemes can affect individuals' performance by inducing a higher level of effort (that is effort-inducing effect). Farrell et al. (2008) suggested that performance is a function of effort. They argued that higher effort leads to higher performance. Chong and Eggleton (2007) found that compensation schemes motivate employees to exert higher effort to improve their performance.

Proponents of goal-setting theory, on the other hand, argue that compensation schemes are motivational because they encourage individuals to commit themselves to higher performance goals, which, in turn, enhance their task performance (Chen et al., 2013). Chen et al. (2013) revealed that when employees are contracted based on more challenging but attainable goals (i.e. goal achievability); feedback increases their level of effort, which has a significant positive impact on their task performance. Taken together, the existing theories and empirical evidence suggest that the use of compensation schemes is more likely to enhance subordinates' task performance.

However, such a general conclusion should not be drawn because a number of empirical evidence find that compensation schemes do not always enhance individuals' task performance (Kohn, 1993). Other studies (Bonner et al., 2000) find that the reliance on compensation schemes even degrades performance sometimes. These mixed results in the literature suggest the need to examine the connection between the extent of reliance on compensation schemes and individuals' task performance.

### **1.1.2 Firm Performance**

The concept of firm performance is different from the broader construct of organizational effectiveness. According to Venkatraman and Ramanujam, (1986), the broader construct

cover three overlapping concentric circles, with the largest representing organizational effectiveness. The organizational effectiveness covers all aspects related to the functioning of the organization (Cameron, 1986). Firm performance is a subset of organizational effectiveness that covers both operational and financial outcomes.

Firm performance in control research has concentrated on two types of indicators: accounting and market (Dalton, Daily, Ellstrand & Johnson, 1998). Accounting performance has been criticized because it can be manipulated, has potential of undervaluing assets, it is a creation of accounting distortions from policies such as depreciation and inventory treatment, and lacks standardization. On the other hand, market-based performances are often subjected to forces beyond management's control (Hambrick & Finkelstein, 1995). Meanwhile there is no agreement on effective type of firm performance and hence studies have incorporated both (Bonn, Yoshikawa & Phan, 2004).

### **1.1.3 Investment Firms Listed at Nairobi Securities Exchange(NSE)**

NSE has been providing stock market indexes since its formation in 1953. The NSE 20-share index was developed to provide a review of weighted movement in price of major counters. The index was revised in the year 2007 with an aim to ensure that it was a true barometer of the market since it was felt that the stocks which used to comprise the index had since lost their prominence in the market and that some sectors such as telecommunication market segments were not represented. Further NSE was introduced in the year 2008 as an alternative index which was an overall indicator of the market performance since it includes all the shares quoted in the market provided there was activity in the specific stock for the day. NSE has not gained prominence since its launch and therefore the NSE 20-share index still remains as the main

market index (Asava, 2013). At the heart of the Exchange is market liquidity enhancement by fostering transformational and utmost ethical practices amongst the participants so that more investors are assured of free and fair information for their trade related decision making (Ngugi, 2003).

Therefore, the Kenyan Government has initiated reforms at the NSE aiming to transform the exchange to be the vehicle to mobilize domestic savings and to attract foreign capital investments (Barako, 2007). Consequently, corporate financial reporting and especially enhanced voluntary disclosures is an important ingredient of enhancing confidence and trust of the market by both local and foreign investors (Ngugi, 2003). Since the year 2008, the exchange has greatly emphasized on corporate governance with some participants punished for faulting the acceptable market regulations (Asava,2013).

Amongst other changes are enhanced communications by and within the NSE itself. In November 2011, the exchange launched the FTSE NSE Kenya 15 and FTSE NSE Kenya25 Indices, as a result of extensive market consultations with local asset owners and fund managers. The launch of the indices reveals the interest of growth into the domestic investment and diversification opportunities in the East African region. The NSE becoming a member of Financial Times Services Division (FISD) of the Software and Information Industry Association (SIIA) in March 2012 followed this. By providing the indices in its website, the initiative provides the investors with current information of reliable indication of the Kenyan equity market's performance during trading hours (Asava, 2013).

With its emphasis on attracting more investors, NSE has to encourage all the participants in the market to provide as much information as is practically possible. Barako (2007) postulates that the level of disclosures including voluntary disclosures amongst the participants in the NSE has increased over the years. Definitely, with the CMA emphasizing on tightening corporate governance amongst the market participants, the extent of disclosure including voluntary disclosure is bound to be enhanced at the NSE.

## **1.2 Statement of the Problem**

Managerial compensation schemes in many companies have attracted considerable attention in Kenya in the last 10 years. There are occasions in the corporate history that the top-level managers receive higher compensation disproportional to the performance of their firms. For example, CEOs have been taking home an average pay of 431 times higher than what average workers receive (Clarke, 2009). Moreover, managerial compensation levels are known to increase even when companies demonstrate poor performance on earnings and according to shareholder's rights group stock-based compensation can be linked to managerial pay for performance (Feldman, 2016). More evidence suggests that equity based, salary based and stock-based compensations most certainly increase top-level manager's accountability to shareholders. In Kenya and other countries in East Africa, top management's pay has gained the attention of research from scholars.

It is worth noting that available studies on managerial compensation and firm performance have found positive relationship between managerial compensation and firm performance (Narayanaswamy *et al.*, 2012; Cheng & Farber, 2008). A stronger relationship between pay and

performance leads to selection and retention of more productive managers. Ghosh (2006) in a research of Indian firms also found out that CEO compensation is positively affected by firm performance.

On the other hand, there have been a lot of critics on the concern that the rising salaries of executives do not increase firm profits (Bogle, 2008). Some studies have concluded that managerial compensation has no effect on firm performance (Boyd, 1994). Additionally, some studies have found negative relationship between CEO compensation and performance of a firm (Coree *et al.*, 1999). In another study, Sen and Sarkar (1996) using a cross-sectional examination of large companies in India reported the existence of increasing pay differentials across hierarchies. In conclusion, there is inconclusive debate on this topic among scholars and hence this study examines the effect of managerial compensation on firm performance for investment firms listed at NSE.

### **1.3 Research Objectives**

To examine the effect of managerial compensation schemes on firm performance for investment firms listed at NSE.

The following are the specific objectives:

- i. To examine the effect of cash based compensation on firm performance for investment firms listed at Nairobi Securities Exchange.
- ii. To determine the effect of stock based compensation on firm performance for investment firms listed at Nairobi Securities Exchange.



- iii. To examine the effect of deferred compensation on firm performance for investment firms listed at Nairobi Securities Exchange.
- iv. To find out the effect of long-term incentive plan on firm performance for investment firms listed at Nairobi Securities Exchange.

#### **1.4 Research Questions**

- i. What is the effect of cash based compensation on firm performance for investment firms listed at Nairobi Securities Exchange?
- ii. What is the effect of stock based compensation on firm performance for investment firms listed at Nairobi Securities Exchange?
- iii. What is the effect of deferred compensation on firm performance for investment firms listed at Nairobi Securities Exchange?
- iv. What is the effect of long-term incentive plan on firm performance for investment firms listed at Nairobi Securities Exchange?

#### **1.5 Significance of the Study**

The study will highlight the determinants of compensation systems in investment companies in Kenya. It would also help business owners to understand the benefits of sound employee compensation systems to performance of their businesses. The study will further guide investment companies especially on improving on the factors that would contribute to the improvement of the firm.

The study will benefit the Kenyan government regulating the sector in formulating policies and regulations that will effectively address the compensations management and human resources functions. The human resource managers will also use the findings in implementing the stipulated remuneration policies within their respective financial institutions. The study will help the management of other organizations to have the opportunity to be more aware about the different determinants of a compensation system. This would assist the management in creating effective compensation systems that would motivate their staff and encourage top performance.

For academicians, this study will form the foundation upon which other related and replicated studies can be based on. The study will benefit future scholars who will identify the information gap that needs to be filled and also to the business community who will use in further studies or ventures related to employee compensation in other sectors especially the service sector. Lastly, the researcher will hope that this knowledge would further contribute to the body of knowledge and be a useful source of information including for future research regarding this subject matter.

### **1.6 Scope of the Study**

According to Nairobi Securities Exchange (NSE) database, there are five (5) investment companies with their head offices in Nairobi County. Therefore, this study will focus on managerial compensation schemes in across all the five companies (Olympia Capital Holdings Ltd, Centum Investment Co Ltd, Trans-Century Ltd, Home Afrika Ltd and Kurwitu Ventures). Specifically, the study will cover five years (2012-2017). Moreover, the study will examine the compensation schemes and firm performance of the selected investment companies.

### **1.7 Limitations of the study**

According to Price and Murnan (2004), limitations are conditions, which go beyond control of any researcher, which may restrict study conclusions and their applications to other situations. Considering the nature of the topic especially where top managers are mentioned, the researcher can encounter non-responsive staff from the participants of the selected companies who will participate in the study and be non-committal in discussing about issues in their institution due to embarrassing situations. The researcher will assure the respondents that their names will not be disclosed in carrying out the exercise.

The researcher can be limited by time and inadequate funds. This can hinder the researcher from exploiting the target sample. The researcher can also experience non-co-operation from the respondents who upon realizing that they are being interviewed can give false information. To overcome this limitation, the researcher will assure the respondents that the findings would only be used for academic purposes.

### **1.8 Chapter Summary**

This chapter has been divided into eight sections with each section highlighting different segment of the study. Section one, provided a background of the study which broadly discusses managerial compensation schemes on a global and local perspective, section two is the statement of the problem in which the study sought to address. Additionally, the chapter presented four objectives, which guided the study and at the same time the research questions. Last but not least, the chapter discussed the significance of the study, scope of the study and finally limitations of the study focusing on factors that are likely to hinder the study.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter reviewed detailed information and provided literature relevant to corporate finance. The chapter provided the theoretical framework that underpinned corporate finance, empirical review, conceptual framework and operationalization of variables.

#### **2.2 Theoretical Review**

In the examination of the effects of managerial compensation on firm performance, this study utilized three theories – agency theory, theory of competitive compensation and goal setting theory. Previous studies conducted in the same research area suggested that there is linked evidence that supported existing theories and explained particular business survivals to some extent. The contribution of this research to the earlier studies was to get a deeper understanding of this particular area in firm performance and test it in the context of the Kenyan firms. In the following sections, the study discusses some of these theories and its relevance to the present study.

##### **2.2.1 Agency theory**

Agency theory was developed by Jensen and Meckling in 1976 to explain how lower managerial team lead to the increase of non-pecuniary spending by the managers as they do not fully internalize the costs (Laiho, 2011). This theory explains the relationship between two people, a principal and an agent. This relationship in its contract is where one person (principal) engages another person (agent) to perform some tasks on behalf (Jensen & Meckling, 1976). According to the agency theory, compensation contracts should be designed to align the interests of managers

(agents) with those of shareholders (principals). A stronger relationship between executive pay and performance also results in the selection and retention of more productive managers. Since these factors are difficult to observe while selecting managers, providing top executives with performance related compensation could reduce the adverse selection problems (Arya&Mittendorf, 2005).

The agency theory predicts that policies for executive compensation will depend on changes in shareholder's wealth. In order to align the interests of CEOs with the interests of shareholders, executive compensation should be tied to firm performance. This can be realized by giving managers stock options or cash bonuses depending on return on stocks, because these methods reward executives for good stock return performance. So, rewarding executives on stock performance is good for shareholders, although executives cannot totally control the stock price. As seen before, stock options also bring risk since CEOs are only partly penalized for bad performance. Moreover, executives are also looking at private benefits and may have other incentives other than maximizing shareholders' wealth.

It must be noted that these agency relations are found within a company's different hierarchical levels. Pavliket *al.*, (1993) in their analysis of agency theory suggests that compensation has to be contingent on more than one performance measure and further predicts that the relative importance of substitute performance measures can be a function of its precision and sensitivity to the manager's performance. They defined agency costs as the sum of monitoring costs, bonding costs, and residual loss.

Several studies that have been carried out on agency theory attempts to link compensation structure to performance. Murphy (1999) provides a broad overview of the executive compensation research in the finance literature. Over the course of 20 years, finance researchers have investigated the relationship between compensation structure and firm value, as well as the sensitivity of executive compensation to changes in the stock price or revisions in compensation contracts following poor performance (Jensen & Murphy, 1990).

Kaplan and Norton (1997) argue that firms should consider a more holistic approach to performance because the factors that affect market value may be endogenous with those that positively impact non-financial performance measures. The “balanced scorecard” approach to performance measurement not only takes into account the financial performance metrics but also the customer perspective, internal business perspective and the learning and growth perspective. In particular, the balanced scorecard system requires the board and top management team to assess the drivers of overall performance and link it to compensation. Therefore, from the balanced scorecard approach, incentives to engage in strategies that enhance customer satisfaction through governance choice, including the structure of executive compensation, would be positively related to customer satisfaction per se and it will also improve the overall firm performance.

Additionally, there is an increasing need to understand the conflict between the different classes of principals. As some owners might have different incentives/strategies to monitor and they may also have better know-how of the market, whether it may result in increased firm performance. The different class of owners may have different ‘network effect’, for example: group vs. stand-

alone firms. There may be ‘spillover effect’ resulting from diversified owners. Same owners can have holdings in firms that provide inputs for other firms and lower cost than the market, reducing the costs incurred for the ‘middle man’.

Increasing managers’ ownership stake in a firm reduces the agency conflicts, however, managerial ownership beyond a certain point gives rise to another problem, known as managerial entrenchment. Studies have shown that higher managerial ownership makes the managers entrenched from job market risks or take-over threats. Entrenched managers are better placed to extract rents in the form of special dividends, perks, or bonuses. Managerial entrenchment effects and rent extraction costs are assumed to be greater in countries where protection of investors’ and property rights are weak, and judicial efficiency is low (Chnget *al.*, 2012).

Agency theory holds a central role in the corporate governance literature. It describes the fundamental conflict between self-interested managers and owners, when the former have the control of the firm but the latter bear most of the wealth effects. Its predictions relating to agency problems are central to the topic of this thesis. However, as the theory abstracts away from all other frictions except the one between managers and owners, the empirical model we will build later on is significantly different. The theory, nevertheless, demonstrates well the fundamental conflict of interest between managers and owners.

### **2.2.2. Theory of competitive compensation**

Theory of competitive compensation was pioneered by Hart (2009), and Hart and Holmstrom (2010) and assumes that the unfair allocation of surplus from renegotiation of an incomplete contract can sour the relationship and makes it less efficient. For instance, the employee will always perform the job less diligently in the future. The central assumptions are that valuable

employees have some bargaining power in case a contract needs to be renegotiated in order to fend off attractive outside offers.

It is important to recognize that one of central characteristics of modern economies is the role played by competition. According to Barney, and Zajac (1994), competition is the force that provides work incentive within the company or even to a company in a competitive marketplace seldom takes the pure piece rate. As such, optimal compensation takes the form of an option contract, with the fixed salary being due to the employee's risk aversion and pay is attributed to employee's inability to commit to staying with the present employer when external opportunities are attractive. Nonetheless, where Holmstrom and Ricart Costa (1986) emphasize uncertainty about employee characteristics and the study emphasizes uncertainties about future market conditions.

This theory has been selected for this study because it explains why plain stock options are used to reward employees whose talents are well known and whose effort does not greatly affect the value of the firm; in their model, the option is instead tied to what is revealed about the specific skills of individual employees, for which the stock price is typically a less precise indicator.

### **2.2.3 Goal-setting theory**

Goal setting theory as first published by Graham Latham and Edwin Locke in 1975 and it explain effects of monetary incentives on performance (Locke & Latham, 1994). According to the theory, managers under contingent pay schemes set goals more suddenly and commit more on the goals they have set for themselves. Bonner et al., (2000) have suggested that a piece-rate compensation scheme can lead to a higher performance if compared to a goal attainment bonus compensation scheme. They proposed that a piece-rate compensation scheme is likely to be more



motivating than a goal attainment bonus scheme because some managers may not be able to achieve their set goals and, therefore, they would not have the economic incentive to exert more effort on the task.

According to this theory, goals are performance enhancing because they motivate individuals (in this case managers) to build a strong desire to succeed (Roberts & Reed, 1996). A goal has been defined as something employees are consciously trying to do in the company (Locke, & Latham, 1994). They postulated that a difficult but attainable goal has a greater motivating effect compared to an easy goal on managerial performance because the difficult goal raises the manager's aspiration to perform better, and acquire a sense of accomplishment. It is also important to note that if the goal can be attained too easily, the associated performance ceiling may discourage employees from performing. This performance-ceiling effect is recognized by Jeffrey et al. (2012) who discovered that setting ability-based goals is more effective for improving task performance than a one-goal-for-all approach.

Locke and Latham (1990) have asserted that the assigned goal levels are positively associated with firm performance until goals become excessively difficult. Prior studies report that a combination of assigned goal levels and compensation schemes affects firm performance (Fatseas&Hirst, 1992). The justification for this expectation is that higher goals yield higher performance to the extent that the goals are perceived as attainable and are accepted by the individual. Sprinkle (2000) found that compensation schemes improve performance only after considerable feedback has been provided. Hirst and Lowy (1990) found that performance feedback and assigned goal levels are necessary, but neither is sufficient for improvement in performance. Goal-setting theory-based studies argue that assigned goal levels without performance feedback have little or no effect on performance (Ashford and De Stobbeleir, 2013).

This theory states has been selected for this study because it helps in understanding importance of goal setting in firm performance. According to the theory, specific and challenging goals along with appropriate feedback contribute to higher and better firm performance. Compensation has been described as the systematic approach of providing monetary value to employees to influence their performance (Lam et al., 2013). Compensating and providing rewards to managers enhances job performances and satisfaction and an ideal compensation scheme helps the firm boost its performance significantly while at the same time creating more engaged workforce willing to contribute more or go an extra mile for the firm.

### **2.3 Empirical Review**

This section presented an empirical review of studies as guided by the objectives. Studies have shown that employees who share similar working characteristics feel attracted to different compensation schemes (Dohmen& Falk 2011; Wozniak *et al.*, 2010). A study by Dohmen and Falk (2011) showed that firms must align their compensation and reward systems with firm's performance because compensation increases productivity and achieve sustainable growth. A performance based compensation scheme practice helps companies in developing effective strategies, which reflect employees' performance, and contributions in terms of increased productivity and measurable outcomes (Kehoe & Wright, 2013). Furthermore, it has been shown that linking compensation to performance tends to introduce equity and consistency in the compensation structure and enables the organization to attract qualified managers who will contribute to performance of the firm (Lazear *et al.*, 2000). In summary, there is relationship between managerial compensation schemes and firm performance and the study in the following fields discusses four variables and related them with performance of the firm.

### **2.3.1 Cash Based Compensation and Firm Performance**

The practice of cash based compensation is based on financial targets taken by firms. In this case, the financial targets for a year can be above, equal to, or below the previous year's available performance measures based on the prevailing economic conditions (Matolcsy, 2000). Therefore, during economic recession, a flat relationship between changes in the cash based compensation and modest changes in firm performance such as annual profits or return on equity, is predicted, while in economic growth, a positive relationship is projected among changes of management cash compensation and corporate performance measures (Matolcsy, Shan and Seethamraju, 2012).

Mehran (1995) investigated 153 manufacturing firms in 1979 and 1980 that were randomly selected. According to the author, cash payouts were at the opposite end of the scale of those receiving equity-based compensation. The author found a positive association between the amount of total compensation in cash and the amount of shares that are held by firm managers. Additionally, there was a strong association between the amount of total compensation paid in cash and amount of shares that are held by all external block holders in the regression analysis for CEOs. On the other hand, the author found a negative relationship between amount of total compensation in cash and both amount of external directors and the ratio of research and development (R&D) to sales.

In a study, Mehran (1995) found a positive relationship between percentage of total compensation in cash (salary and bonus) and percentage of shares held by managers. Ungson and Steers (1984) in their study of CEO compensation noted that in firms where the CEOs have large shareholdings, long tenure, control of top management team, or other means, a CEO can largely

shape their pay. Similarly, Finkelstein and Hambrick (1988) believed that the relative power of managers might affect the height of the hurdles that are set to qualify for the contingent pay. In addition, they also believed that executives who own significant portions of their firms are likely to control not only operating decisions but the board decisions as well. As such, executives would be in a position to essentially set their own compensation. In addition, they believed that stronger family's position in the firm, the stronger will be the executive's position, despite the family shareholders may not be as active as the independent directors might be. They also found that managerial compensation and shareholdings are related in an inverted-U manner, with compensation highest in situations of moderate ownership.

### **2.3.2 Stock Based Compensation and Firm Performance**

As put forward by Ittner *et al.*, (2003) in a study, among the dimensions that distinguishes the old and new companies is the scarcity of company cash flow of the latter matched with the former. Since there is relative lack of financial resources, Core and Guay (2001) has shown that new low-cost firms make better use of stock options as a form of compensation. The justification for this is perhaps that the only economic cost that is incurred by the grantor is the price in which an external investor can pay for the option, as there is no accounting cost or cash expenditure associated with it. Based on Black-Scholes approach, the exercise of the option leads to tax deduction for the variance that exists between stock and exercise prices: Stock-based pay includes stock grants and stock... executive Compensation values options using an "expected life" and equal to 70% of the actual term (Murphy, 2003, p.131).

Extensive use of stock options as a means of compensating CEOs and managers is therefore related to the principal-agency theory. By tying managerial pay to stock prices, both the principal

and the agent are connected to a common reward, stock price, hence perfecting possible goal inconsistencies (Chan, *et al.*, 2014). The problem with this theory is that it only works for agents, which can affect the short-term stock prices. A complication can arise whilst an exogenous body such as a regulatory commission disrupts the free market association between enterprise and concomitant return. The regulation can inhibit any investment choices or opportunities available to agents by optimizing returns, or it may offer an artificial room for profits in the form of guaranteed Return on Assets (ROA) (Carroll & Ciscel, 1982).

In other studies, Hogan and Robinson (1995) reported mixed results in a study of the electric utilities industry. Their study revealed that growth in sales or stockholder returns was unrelated to managerial compensation, but found a positive relationship to earnings, book value and per share dividends. Conversely, Agrawal, Makhija and Mandelker (1991) in their study established that total compensation is positively linked to stock prices, but according to Abdel-Khalik (1988) managerial compensation is associated with organizational slack and capital inefficiency, underscoring the need for sales maximization over profits. The latter point was also found by studies that amplified that compensation could certainly be linked to growth of sales as a reward to managers who obtain rate increases from regulators (Ozdemir & Upneja, 2012).

Equally, Van Essen, Otten and Carberry (2015) detected that political constraints inhibited the level and structure of managerial compensation. A strong argument for the effect on managerial compensation before and after the passage of deregulatory legislation in 1992 is found in Arya and Sun (2004) in their study. The authors found significant increases in compensation accompanied by a shift from salary to bonus and long-term incentive payments.

To motivate managers to concentrate more on company's long-term share price maximization rather than accounting package, they are compensated with stock options that require time to assign, as well as controlled stock grants; this is particularly pronounced for "high-growth" companies characterized by high information asymmetry (Bolton, Mehran & Shapiro, 2015). According to the authors, compensation structures are characterized by greater sensitivity to long-term stock price fluctuations, which leads to greater capital investment. Boards take into account research and development (R&D) expenditures when they adjust compensation contracts to discourage underinvestment and myopic behavior in general (Hogan & Robinson, 1995). Compensation packages that rely on permanent shocks to managerial compensation are more effective than those that use "short-term shocks" (such as bonuses) because they discourage top management from diverting assets to short-term earnings maximization tactics (Kim & Zhang, 2016).

Additionally, Ryan and Wiggins (2004) in a study found that long term compensation package with a nonlinear payoff profile, which limits managers' downside risk (option compensation), encourages investments in R&D, while the long term compensation with a linear payoff profile, including restricted stock grants, tend to expose managers to downside risk and exacerbates underinvestment. Ryan and Wiggins (2004) confirms this result and finds that firms with high levels of intangibility and earnings uncertainty drive it.

The levels of managerial compensation have been known to increase even whenever the firm shows poor performance with regard to earnings or stock returns (Stock, 1994). Investors' rights groups have often argued that stock based compensation can be linked to the manager's pay-for-performance (Metha, 1997). Accordingly, stock based compensation may increase managers' accountability to shareholders but critics have argued that top management compensation has no,

or at best, a limited relationship with their shareholders' wealth. The notable difference in the level of top management compensation in many countries has recently gained increased attention (Arya& Sun, 2004).

Vieito, Khan, Cerqueira and Brandao (2008) carried out 79,650 observations of compensation, which were related to five highly paid top managers working in 1,500 firms between 1992 and 2004. The authors found that after 2002, firms provided statistically significant fewer stock options and more restricted stocks as well as bonuses. Another notable observation is that the factors determining managers' and CEOs' compensation of S&P 500, S&P Mid Cap, and S&P Small Cap listed firms were not similar at all. Moreover, ROA showed positive influence on total compensation for CEOs and managers, but has a negative influence on the number of stock options that were granted to managers working in small firms. The mean manager compensation, along with the activity weights, is significantly different in across the companies (S&P 500, S&P Mid Cap, and S&P Small Cap) indexes.

### **2.3.3 Deferred compensation and Firm Performance**

Studies have shown that deferred compensation in labor contracts include pensions, insurance, shares, stock options, etc (Askildsen et al., 2003). Practically all deferred compensation schemes have one specific trait: Their expected magnitude depends on the "success" of the firms, "risk taking" attitude, and the fact that the employees remain attached to the firm in the future (Askildsen et al., 2003). They observed that a firm can decrease payments by changing a compensation scheme, by going bankrupt and firing employees, or simply by renegeing on its promises

Many companies grant stock options not only to top managers, but also to the majority of high-skilled personnel (Oyer& Schaefer, 2005). Moreover, quite a few authors observe the broader employee options plans in firms with liquidity problems (Core and Guay, 2001). Although employees are not always the cheapest source of credit for a firm facing cash constraints, other effects of stock option make this practice common.

Wang et al., (2010) find that managers with larger pensions and deferred compensation are able to obtain bank loans at significantly lower spreads. Wei and Yermack (2011) confirm that high levels of pension compensation correspond to lower-risk levels and a decline in the firm's enterprise value. Cassell et al., (2012) find empirical support for the notion that top management with large compensation leverage actively manages the firm's assets in order to reduce the firm's overall financial risk. Brisker and Wang (2017) find that higher managers inside debt is correlated with lower firm leverage and faster leverage adjustments.

Anantharaman et al., (2013) use a smaller sample of pension data (2006-2008) from Executive compensation, and observe that managers with higher compensation leverage obtain outside debt at a lower cost, with less restrictive debt covenants. Eisdorfer et al., (2013) report that differences (positive or negative) between compensation leverage and firm leverage lead managers to take larger deviations from the optimal investment policy. On their part, Cadman and Vincent (2015) consider the role of pension compensation to gauge the relative power of the managers, while Kwak and Mo (2017) consider the earnings management and default risk.



Despite studies on managerial compensation which continue to proliferate and determinants of managerial compensation having received increased attention from both scholars and practitioners, there is still no consensus on the key forces that shape observable patterns of managerial compensation (Baxamusa, 2012). Elsewhere Saravanan et al., (2017) observes that an effective compensation enhances individual employee's performance when making critical compensation planning decisions.

Saravanan et al., (2017) carried out a study to examine compensation of top management, corporate governance and firm performance of Indian family owned companies. Their sample included 284 companies (both family and non-family), which were listed in the National Stock Exchange of India limited. They conducted the study between 2005-2014 and most of these companies were manufacturing firms. They found out that executive compensation and corporate governance influences firm performance. They concluded that managerial compensation has a significant positive effect on performance of the family and non-family firms suggesting participation of top management in decision-making process to improve the firm performance. The contribution of their findings is that it helps us understand the influence of compensation on firm performance. However, the shortcomings are that the study concentrated on family and non-family owned firms but we are not told which these non-family owned firms are.

#### **2.3.4 Long-term incentive plan and Firm Performance**

Literature has shown that long-term incentives cover periods of more than one year and these incentive plans are typically based on the cumulative performance of the firm between 3-5 years (Murphy, 1999). The managers are encouraged to undertaking activities on behalf of the firm

shareholders by being granted either stock based compensation or cash based compensation that is linked to long-term objectives of the firm (Baeten, 2007). When managers are offered shares, they become a partial owner of the company. Therefore, they obtain the same shareholder rights as the other shareholders and as such they are expected to take actions in order to positively influence the value of the shares.

In utilizing cash based incentives, performance units can be used. In this case, the manager is individually given a number of units that are related with one or more key performance indicators (Baeten, 2007). Finally, cash is linked to long-term objectives in the form of a performance cash grant (Baeten, 2007). Therefore, the “incentive zone”, indicating the range where bonuses can be obtained, as described in short-term incentives is applicable as well (Murphy, 1999).

Hanlon et al., (2003) have demonstrated a positive relationship between incentive payments and future operating earnings. Executive stock options were used to align shareholder and managerial preferences. In addition, a study by Kuo et al., (2013) concluded with a positive relationship between equity incentives and subsequent firm performance. In the latter respect, moderate levels of manager stock-based pay would have a more beneficial impact.

As activities of managers affect the future firm performance, any components that can influence the firm’s strategies are considered to be an important factor. Managerial compensation holds great power to influence manager’s activities (Dow & Raposo, 2005). It is important to note that if compensation for executives are considered in such a manner that differences in compensation are connected with those of firm performance, the managers’ decision making process will be more affected as this decision will be tied to the personal benefits of the managers.

To illustrate the relationship between managerial compensation and firm performance, Jensen and Meckling (1976) explained why most managers would always engage in firm activities that make the company value less than what it would have if they were the sole owners of the firm. Managers seem to be more cautious if they have considerable amount of wealth tied to the firm. The attached wealth discourages them to misuse firm resources and encourages them to engage in behaviors that will improve the firm value. When a manager's wealth is not tied to the firm, agency conflicts arise. Therefore, executive incentive compensation may potentially play a vital role in reducing agency conflicts and increasing shareholders' wealth.

Shim and Kim (2015) conducted an empirical examination of the relationship between executive compensation and firm performance in the post Sarbanes–Oxley period in USA. Using a sample of 232 firms for eight years between 2003–2010, they collected data related to cash compensation (salary and bonuses), long term compensation and used descriptive research design. The researchers utilized multiple regression analysis to test the significance of the relationship between managerial compensation and firm performance. They found out that firm size is statistically significant and positively associated with cash compensation and long-term compensation, which determine managerial compensation. They concluded that the larger the firm to which a managers administers, the higher the managerial compensation. Their results suggest that manager's total compensation in USA is significantly and positively associated with return on assets (ROA). Their finding contributes to the study of the link between compensation and firm performance especially focusing on managers, because these findings can be generalized into other sector. The shortcomings from this study are that it only studied a specific period and hence the findings might be relevant to Kenya's case.

Henry (2010) while examining effects of executive compensation on firm performance posit the question – Does equity compensation induce executive to maximize firm value or their own personal wealth: His study adopted a literature review of previous similar studies. He found that equity compensation is not an answer in itself to providing executives with the incentive to maximize firm value but rather has become a means of maximizing their own wealth. Arguably, one would argue that despite it being relevant in the study of compensation and firm performance, Henry's study did not find any positive relationship between executive compensation and firm performance. Approach taken by the author provides the opportunity to examine the topic in a quantitative research framework that certainly complements it. Brown and Lee (2006) in their study on equity compensation found that firms that cut back on stock option compensation experienced larger improvements in performance. Carter et al., (2009) reported no evidence that firms changed compensation contracts to compensate executives for assuming risks.

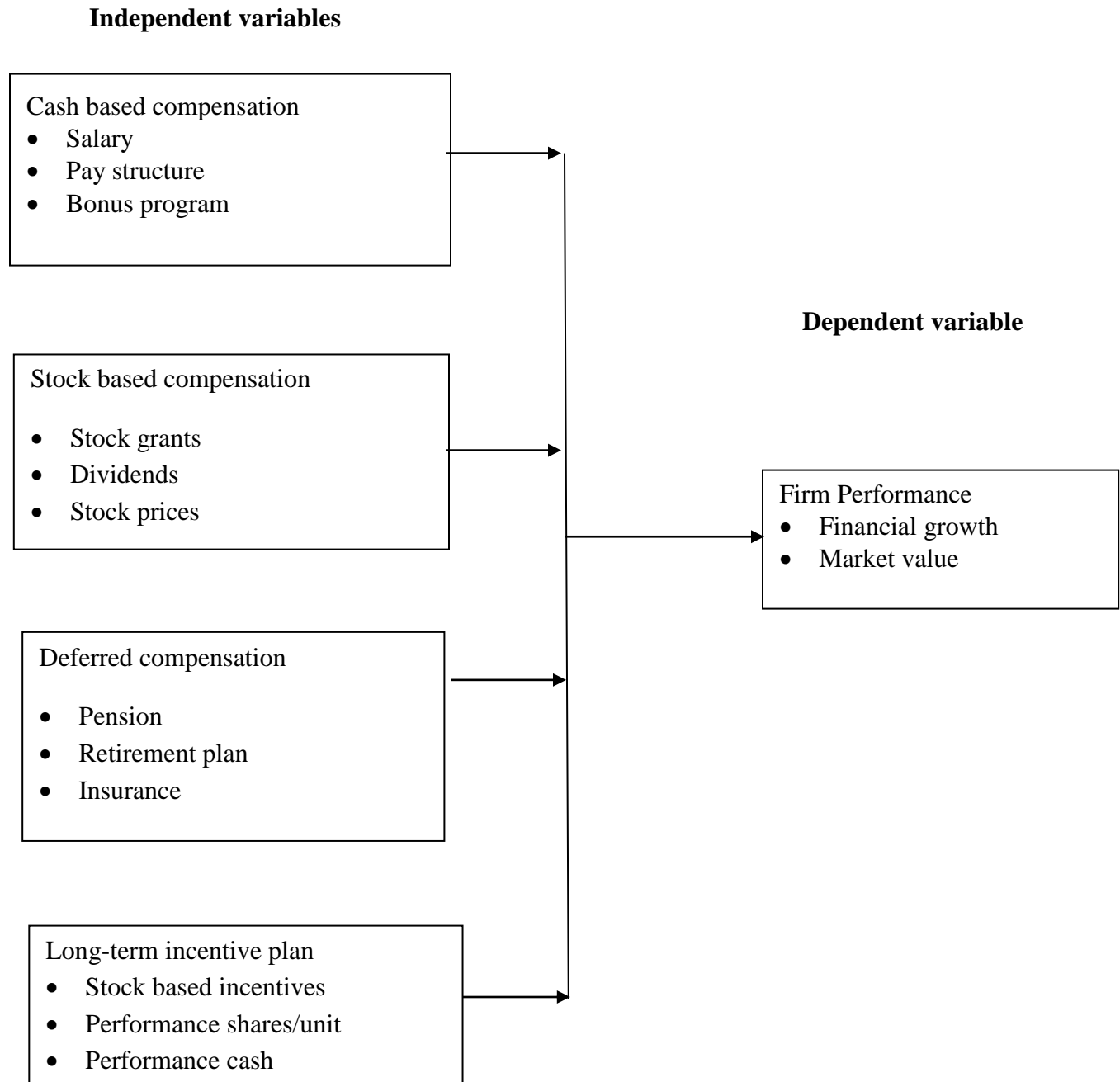
## **2.4 Knowledge Gap**

Although previous studies have examined managerial compensation, they have not conclusively explained how it affects firm performance. From the review of the literature, serious doubts emerge on the effectiveness of executive pay and while managerial compensation seems to be efficient in many cases, research also provides ample evidence of managerial self-dealing, abuse of managerial power and various forms of hidden compensation. Research gaps that emerge from the literature review include wide variation of pay performance sensitivities derived within agency models, minimal evaluation of explanatory values of alternative paradigms, the undefined relations between pay performance sensitivity and the performance metric that are applied.

While available studies have focused on the relationship between executive compensation and firm performance by measuring these performances with operating variables, it did not address specific issues such as franchises or manager's experience. As stock price performance reflects the expectations by the stock market, operating performance provides an insight into the accounting performance of the firm. Moreover, other studies on firm performance suggest that Tobin's Q and return on assets are positively related to the percentage of executive's total compensation that is equity-based. Therefore, these studies conclude that top manager's incentives are affected by compensation and can have measurable impacts on corporate efficiency. In addition, it has been shown in the literature above that pay-performance sensitivity affect firm performance but few of these studies focused on Kenya firms. These findings point out the importance of compensation as another measure to evaluate firm performance.

## 2.5 Conceptual framework

**FIGURE 1**  
**Conceptual Framework**



Source: Author(2018)

## 2.6 Operationalization of Variables

**TABLE 1**  
**Operationalization of Variables**

Objectives	Type of Variables	Indicators	Method of Data Collection	Data Analysis Technique
To examine the effect of cash based compensation on firm performance for investment firms listed at Nairobi Securities Exchange.	<b>Independent variable:</b> Cash based compensation <b>Dependent variable:</b> Firm performance	<ul style="list-style-type: none"> <li>• Salary awarded</li> <li>• Bonus programme</li> <li>• Manager's turnover</li> </ul>	<ul style="list-style-type: none"> <li>• Questionnaires</li> </ul>	<ul style="list-style-type: none"> <li>• Quantitative analysis</li> </ul>
To examine the effect of stock based compensation on firm performance for investment firms listed at Nairobi Securities Exchange.	<b>Independent variable:</b> Stock based compensation <b>Dependent variable:</b> Firm performance	<ul style="list-style-type: none"> <li>• Stock grants</li> <li>• Dividends based</li> <li>• Stock prices</li> </ul>	<ul style="list-style-type: none"> <li>• Questionnaires</li> </ul>	<ul style="list-style-type: none"> <li>• Quantitative analysis</li> </ul>
To examine the effect of deferred compensation on firm performance	<b>Independent variable:</b> Deferred compensation	<ul style="list-style-type: none"> <li>• Pension</li> <li>• Retirement plan</li> </ul>	<ul style="list-style-type: none"> <li>• Questionnaires</li> </ul>	<ul style="list-style-type: none"> <li>• Quantitative analysis</li> </ul>

for investment firms listed at Nairobi Securities Exchange.	<b>Dependent variable:</b> Firm performance	<ul style="list-style-type: none"> <li>• Insurance</li> </ul>		
To find out the effect of long-term incentive plan on firm performance for investment firms listed at Nairobi Securities Exchange.	<b>Independent variable:</b> Long-term incentive plan  <b>Dependent variable:</b> Firm performance	<ul style="list-style-type: none"> <li>• Stock based incentives</li> <li>• Performance shares/units incentive</li> </ul>	<ul style="list-style-type: none"> <li>• Questionnaires</li> </ul>	<ul style="list-style-type: none"> <li>• Quantitative analysis</li> </ul>

**Source: Author (2018)**



## **2.7 Chapter Summary**

This chapter has reviewed previous literature related to managerial compensation from globally, nationally and locally. First the chapter presents theories that help explain effects of managerial compensation schemes on firm performance. Secondly, it presents empirical review of scholarly work done on this topic and relating it with the present study.

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This chapter presented the methodology that was used to carry out the study. The chapter discussed the research design, target population, sample and sampling procedure, data collection methods and instruments, validity and reliability tests, pilot study, data analysis, model specification and ethical considerations.

#### **3.2 Research Design**

Descriptive research design was used to obtain information from the various departments. Orodho (2003) describes descriptive survey as a method of collecting information by interviewing or administering a questionnaire to a sample of individuals. It can be used to when collecting information about people's attitudes, opinions, habits or any of the variety of education or social issues (Orodho&Kombo, 2003). The research adopted descriptive study aimed at finding out the effects of managerial compensation on firm performance for investment firms listed at Nairobi Securities Exchange. Primary data were collected by use of questionnaires and the information gathered will be used to determine the possible answers to the research questions and provide relevant information needed to achieve the research objectives.

For this study, the research used qualitative and quantitative research methods where qualitative method permits a flexible and interactive approach, for example, data was in form of text rather than numbers and these words often be grouped into categories (Mugenda&Mugenda, 2003), while the quantitative research method includes designs, techniques and measures that will produce discrete numerical or quantifiable data. The value of qualitative research can best be

understood by examining its characteristics. One of the primary advantages of qualitative research is that it is more open to the adjusting and refining of research ideas as an inquiry proceeds.

### **3.3 Target Population**

Hale (2006) defines target population as the individuals to whom the study refers or applies. In this study, the targeted populations were managers working at investment firms listed at Nairobi Securities Exchange in different employment cadre. Specifically, the targeted population was CEOs, Directors and Managers with a total population of 165 (Human Resource Database, 2018).

**TABLE 2**  
**Target Population**

Category	Population
CEOs	5
Directors	40
Managers	120
Total	165

**Source: Human Resource Database (2018)**

The total population was gathered from the HR database.

### **3.4 Sampling Procedure and Sample Size**

This section presents the sampling design and procedures, which were used in arriving at the sample size.

### **3.4.1 Sampling Procedure**

Sampling is a procedure, process or technique of choosing a sub-group from a population to participate in the study (Ogula, 2005). The study utilized stratified random sampling technique in selecting the desired sample from a list of all employees working at the investment firms listed at NSE. Stratified random sampling involved division of a population into smaller groups known as strata and a sample was selected by some design within each stratum. Stratified random was selected in this study because it reduced selection bias and ensured a sample that accurately reflects the population being studied in terms of the criteria used for stratification. In stratified random sampling subjects were selected in such a way that the existing sub-groups in the population were more or less represented in the sample (Mugenda & Mugenda, 2003).

### **3.4.2 Sample Size**

A sample has been described as a smaller group or sub-group obtained from the accessible population (Mugenda, 1999). This subgroup is carefully selected so that it has to be representative of the whole population with the relevant characteristics and each member or case in the sample is referred to as subject, respondent or interviewees. A representative sample of at least 30% of the target population was considered viable for the study (Mugenda, 1999). Therefore, this study selected a sample of 53 respondents from listed investment institutions at NSE who participated in providing the required information. A sample size of five companies was under investigation and they included: Olympia Capital Holdings Ltd, Centum Investment Co Ltd, Trans-Century Ltd, Home Afrika Ltd and Kurwitu Ventures.

**TABLE 3**  
**Sample Size**

Category	Population	Sample size	Percentage
CEOs	5	5	100%
Directors	40	12	30%
Managers	120	36	30%
Total	165	53	

**Source: human Resource Database (2018)**

The total population was gathered from the HR database.

### **3.5 Instrumentation and Data Collection**

The study used questionnaires as data collection instrument. Few questionnaires were pretested to understand the questions. This was done before the actual fieldwork. The questionnaires contained both open and closed ended questions and were divided into two sections. Section one focused on general and demographic information of the targeted respondents while section two covered the main area of the study. During the actual data collection process, questionnaires developed were administered by the researcher while others were dropped at the offices of the respondents who had busy schedules to be filled later but with monitoring from the researcher to increase responsiveness of the data collection process.

The study participants included selected employees working at the investment firms in Nairobi County. The researcher in accordance with what will be more conducive and comfortable for the study participants scheduled the date, time, and place for each data collection instrument. Five research assistants were employed to assist in data collection process. These research assistants were trained for five days on data collection procedures, ethical considerations in research and other related activities. Each research assistant were given a number of questionnaires with the researcher herself leading the process.

In this study, there was a pilot study, which followed after the researcher had a clear vision of the research topic and questions, the techniques, and methods, which were to be applied, and what the research schedule would look like. In conducting the pilot study, the researcher selected ten groups who participated. Their responses were entered into the computer and an analysis was conducted.

### **3.6 Validity and Reliability of Research Instruments**

Validity is the ability of an instrument to measure what it says it measures. It deals with the extent to which a measure adequately samples various aspects of the construct of interest. On the whole, validity is seen as a unitary concept. An example would be if various researchers had to examine one specific research study and also come up with the same conclusion, then the research study would be internally valid. Conversely, with external validity the results and conclusions can be generalized to other situations or with other subjects. The researcher sought opinions of scholars, experts and the supervisor to establish the validity of the instrument thus allowing for any modifications.

According to Fraenkel and Wallen (2003), reliability is seen as the degree to which a test is free from measurement errors, since the more measurement errors occur, the less reliable is the test. Reliability is also the consistency or repeatability of an instrument when measuring the same phenomenon over time. It tests the extent to which the same individuals score similarly on a measure that is given at two different points in time. Additionally, a test is viewed as being reliable when it can be used by a number of different researchers under stable conditions and still yielding consistent results, which are not varying.

The researcher used Cronbach's Alpha to measure the reliability. Cronbach's Alpha is a measure of internal consistency, which is, how closely related a set of items is as a group. Alpha was developed by Lee Cronbach in 1951 to provide a measure of the internal consistency of a test or scale. It is expressed as a number between 0 and 1.

### **3.7 Data Analysis and Presentation**

Data collected from the questionnaires were checked, coded, cleaned and entered into SPSS software for analysis. Analysis of quantitative data was done using the Statistical Package for Social Sciences (SPSS) version 22.0. In addition, for the qualitative data, analysis of data was carried out using a seven-step analytic process delineated by Marshall and Rossman (2006). These include: organizing the data; coding the data; immersion in the data; generating categories and themes; offering interpretations through analytic memos; searching for alternative understanding; and presenting the study. Descriptive summary statistics such as frequencies, percentages, means and standard deviation will be used to describe effects of managerial compensation on firm performance.

Upon completion of the data entry and analysis, data was presented using frequency tables, charts and graphs. The qualitative data generated from open ended questions was categorized in themes in accordance with research objectives and will be reported in narrative form along with quantitative presentation.

### **3.8 Model Specification**

A simple regression model was used in determining the level of influence the independent variables have on dependent variable as shown below:

$$Y = b_0 + b_1X_1 + b_2X_2 + b_3X_3 + b_4X_4 + \varepsilon$$

Where:

Y = is dependent variable y (firm performance)

$b_0 = b_3$  are the sample estimates of the coefficients

$X_1$  = Cash based compensation

$X_2$  = Stock based compensation

$X_3$  = Deferred compensation

$X_4$  = Long-term incentive plan

$\varepsilon$  = Standard Error

### **3.9 Diagnostic Tests**

The diagnostic test used in this study is regression diagnostics which includes linearity, Normality, Multicollinearity and Homoscedasticity of the relationship between the dependent and independent variables.



Linearity means that the predictor variables in the regression have a straight-line relationship with the outcome variable. It assumes that the expected value of dependent variable will be a straight-line function of each of the independent variable, holding the others fixed.

Normality test is a test of whether the residuals are normally distributed. This study used Shapiro-Wilk and quantile-quantile plots (Q-Q plots) to test for normality owing to its usefulness in comparing two samples to see if they arise from the same distribution.

Multicollinearity refers to when the predictor variables are highly correlated with each other. This is an issue, as the regression model might not be able to accurately associate variance in the outcome variable with the correct predictor variable, leading to muddled results and incorrect inferences. Statistical inferences made about the data may not be reliable if multicollinearity is present in the data (Brook,2008). The study used variance inflation factor (VIF) to test for Multicollinearity. Absence of multicollinearity is confirmed when the VIF values are less than 10.

Homoscedasticity refers to the assumption that the dependent variable exhibits similar amounts of variance across the range of values for an independent variable. This study used Breusch Pagan test to test for homoscedasticity. For variance to be homoscedastic, the test statistic should have a p value greater than 0.05.

To test the strength of the model, the researcher will perform analysis of variance (ANOVA). Analysis of Variance (ANOVA) is often used to test three or more groups for mean differences based on a continuous (i.e. scale or interval) response variable (dependent variable) (Anselin, Bera, AFlorax& Yoon, 1996). On extract ANOVA table the research will look the significance value and it will be test 95% confidence level and 5% significance levels.

### **3.9 Ethical considerations**

According to Hall (2008), “ethical considerations are an integral part of the planning stage of all social research projects”. To effectively adhere to necessary ethical guidelines and regulations, an information sheet was provided to participants prior to the investigation. This sheet will provide an oversight as to what the study will be focusing on and inform the participants that they will have the right to withdraw from the study at any moment, for any reason they feel necessary.

In this regard, full cooperation of respondents was required if the study was to achieve its objectives. Some of the ethical considerations that were observed to win the trust and support of respondents included; confidentiality, whereby all responses received from respondents would be treated with confidentiality and will not be divulged to any third parties.

Secondly, transparency, whereby respondents were not kept in the dark regarding the use of data collected from them. As such, they were informed adequately on the objectives of the study; Thirdly, data collected for the purposes of the research would not be used for any other reason other than meeting the research objectives; Lastly, the research findings would be of great interest to NSE and other interested stakeholders, thus they may be availed to any of these interest groups but the identity of correspondents will remain confidential.

### **3.10 Chapter summary**

This chapter looked at the research methodology that was adopted in this research study. Specifically, it provided justifications on why the study chose to use this methodology. For

instance, the study used descriptive research design; sampling design and data collection techniques which included questionnaires as the main method of data collection used to gather relevant data to achieve the research objectives.

## **CHAPTER FOUR DATA ANALYSIS AND PRESENTATION**

### **4.1 Introduction**

The study sought to carry out a study on effect of managerial compensation schemes on firm performance for investment firms listed at Nairobi Securities Exchange. The data was collected

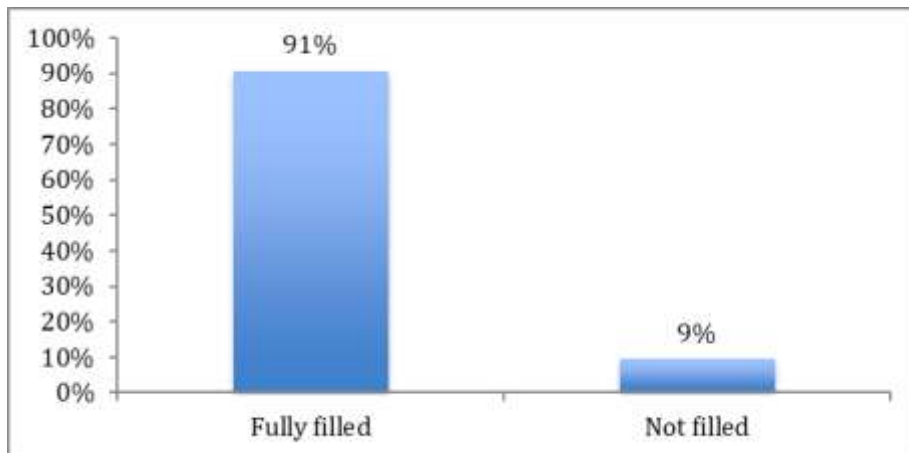
through structured questionnaire with both closed and open ended questions from the surveyed respondents. Data editing and reconciliation were undertaken before data analysis was done. Data was entered using excel sheets to get the required data for presentation.

#### 4.2 Response Rate

During data collection, 53 questionnaires were constructed and administered where the researcher collected all of the questionnaires after close of the activity. At the end of the study, only 48 questionnaires were returned with 5 returned unfilled and hence the researcher discarded them. The researcher utilized the returned questionnaires by coding them and entering into the computer and analyzed and the study's overall response rate was 91%. It is worth mention that the relatively high response rate for this type of study was thought to be attributed mainly, to three factors: a clear and simple design questionnaire translated into ordinary Kenyan system, respondents were briefed about the content and purpose of the survey and were guaranteed that their replies would be treated in strictest confidence.

**FIGURE 2**

**Response rate**



### 4.3 Demographic Information

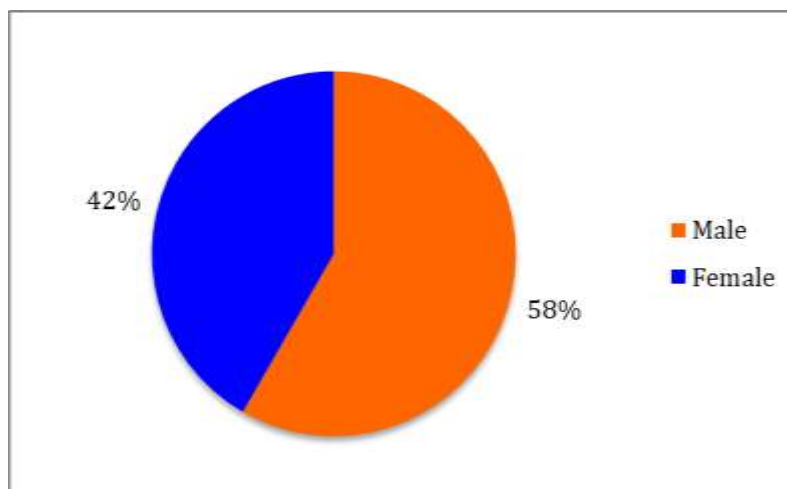
This section presents a breakdown of demographic characteristics of respondents who participated in this study. Specifically, the section presents distribution of respondents by gender, academic qualification and number of years the respondents had worked in their respective institutions.

#### 4.3.1 Gender

The study established that majority 58% of the respondents who participated in this study were male compared to 42% female respondents. This means that in terms of gender representation, both male and female respondents were fairly well.

**FIGURE 3**

**Distribution respondents by Gender**



#### 4.3.2 Highest level of education

Regarding highest level of academic qualification, most of the respondents had bachelor's degree (48%), followed closely by those with diploma (25%) of the total respondents. In addition, the study shows that respondents with masters were 19% with PhD comprised 8% and this means respondents were knowledgeable enough to fill the questionnaire without difficulties.

**TABLE 4**  
**Highest level of education**

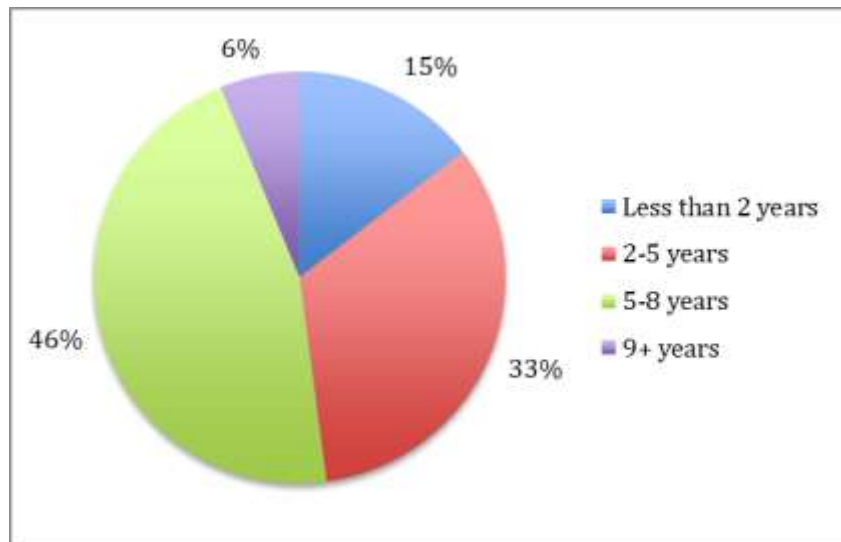
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	PhD	4	8.0	8.0	8.0
	Masters	9	18.2	18.2	26.2
	Bachelors	23	48.0	48.0	74.6
	Diploma	10	21.8	21.8	96.0
	Other	2	4.0	4.0	100.0
	Total	48	100.0	100.0	

#### **4.3.3 Number of years in the firm**

With regard to number of years the respondents had worked in their respective institution, most of them had worked in the institution for 5-8 years (46%) with one-third working for 2-5 years. Additionally, 15% of the respondents were new and that is less than 2 years in the institution while 6% had worked for over 9 years meaning few had stayed in the company for longer.

**FIGURE 4**

**Number of years in the firm**



**4.3.4 Would you say that your investment company has a compensation policy?**

Generally, most of the investment companies, which participated in this study, had compensation policy according to majority (48%) but nearly a quarter (23%) of the respondents could neither agree nor disagree that their companies have such policies. However, 30% of the respondents indicated their companies don't have compensation policies and this becomes a challenge when allocating rewards.

**TABLE 5**

**Compensation policy**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly agree	13	26.4	26.4
	Agree	10	21.1	47.5
	Neutral	11	23.9	71.4
	Disagree	8	14.7	86.1
	Strongly disagree	6	13.9	100.0
	Total	48	100.0	100.0

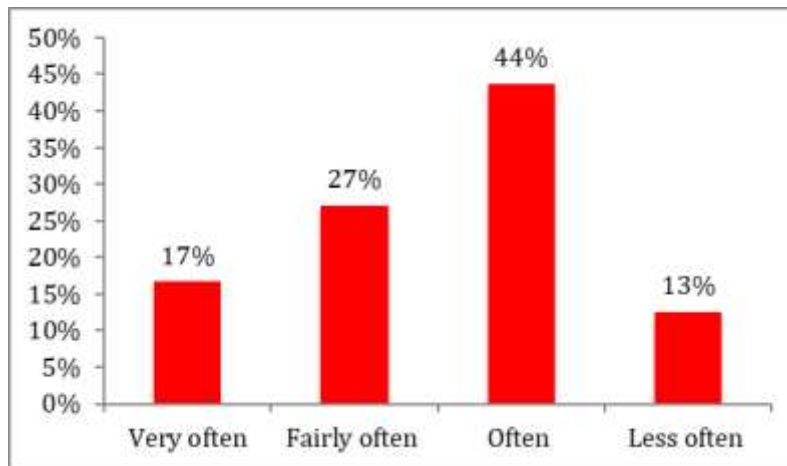
**4.3.5 Frequency of compensating managers for their outstanding performance**

As shown in figure 3, respondents were asked to state frequency at which their companies compensate managers for their exemplary performance in the company. The results show majority 44% indicated often with 27% favouring fairly often and while 17% indicated very often and only 13% stated less often. This reveals that different companies' different compensation schedules in rewarding its managers for their performance.



**FIGURE 5**

**Compensating managers for outstanding performance**



**4.4 CASH BASED COMPENSATION**

**4.4.1 Firm performance is determined by salary awarded to managers**

Results show that majority of the respondents suggested that salary awards determined the performance of investment firms. This was evident when 48% of the respondents indicated agree while 21% favoured strongly agree. Further it showed that while 4% indicated neither agree nor disagree, 17% and 10% indicated disagree and strongly disagree respectively.

**TABLE 6**

**Firm performance is determined by salary awarded to managers**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly agree	10	21.0	21.0
	Agree	23	47.7	68.7
	Neutral	2	3.8	72.5
	Disagree	8	17.5	90.0
	Strongly disagree	5	10.0	100.0
	Total	48	100.0	100.0

**4.4.2 Strong bonus programme, motivates managers**

Most of the respondents were in agreement that their companies offered strong bonus programmes, which consequently motivates managers in increasing performance (see table 4).

While only 4% could neither agree nor disagree, 6% and 10% indicated strongly disagree and disagree respectively.

**TABLE 7**

**Strong bonus programme, motivates managers**

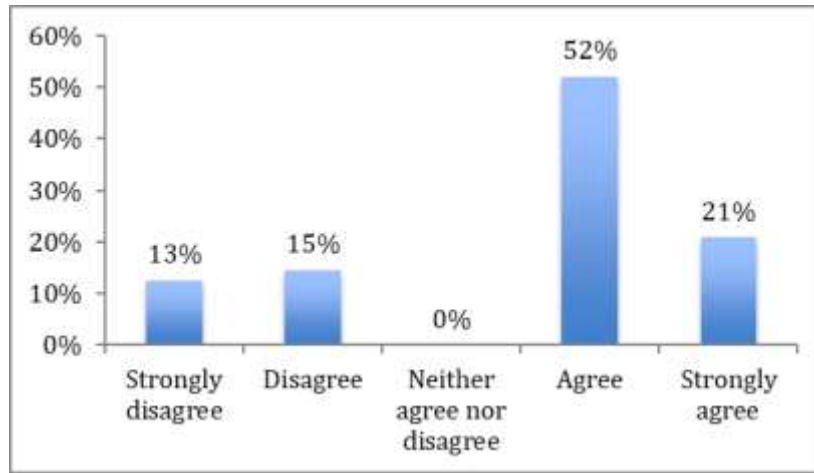
	Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly agree	3	6.0	6.0
	Agree	5	9.9	15.9
	Neutral	2	4.0	19.9
	Disagree	25	52.1	72.0
	Strongly disagree	13	27.0	99.0
	Total	48	99.0	99.0

**4.4.3 Pay structure influences manager's turnover**

Results from this study show 73% (52% agree and 21% strongly agree) of the respondents observed that the pay offered by their company influenced manager's turnover with 28% who suggested that compensating managers doesn't influence their performance. Generally, pay structure is important for the company especially managers who take up management roles.

**FIGURE 6**

**Pay structure influences manager's turnover**



**4.5 STOCK BASED COMPENSATION**

**4.5.1 Our firm increases stock grants which attracts highly qualified managers**

Most of the respondents indicated that increased stock grants plays an important role in enhancing performance of the company as it attracts qualified managers to the company (see table 5). However, nearly 30% of the respondents were in disagreement with 13% who could neither agree nor disagree raising more questions on how these companies motivate their managers.

**TABLE 8**

**Increased stock grants attract highly qualified managers**

	Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly agree	2	4.0	4.0
	Agree	11	22.9	26.9
	Neutral	6	13.0	39.9
	Disagree	5	10.1	50.0
	Strongly disagree	24	50.0	100.0
	Total	48	100.0	100.0

**4.5.2 The firms provide dividends based on manager’s performance**

There were diverse views on whether companies provide dividends based on individual manager performance. As shown in table 6, 48% of the respondents agreed that the dividends are based performance compared to 43% whose companies pay dividends without considering individual manager’s performance. Lastly, 10% of the total respondents could neither agree nor disagree. This means that most dividends has played a crucial role in motivating managers in working towards the growth of the company.

**TABLE 9**

**The company provides dividends based on individual performance**

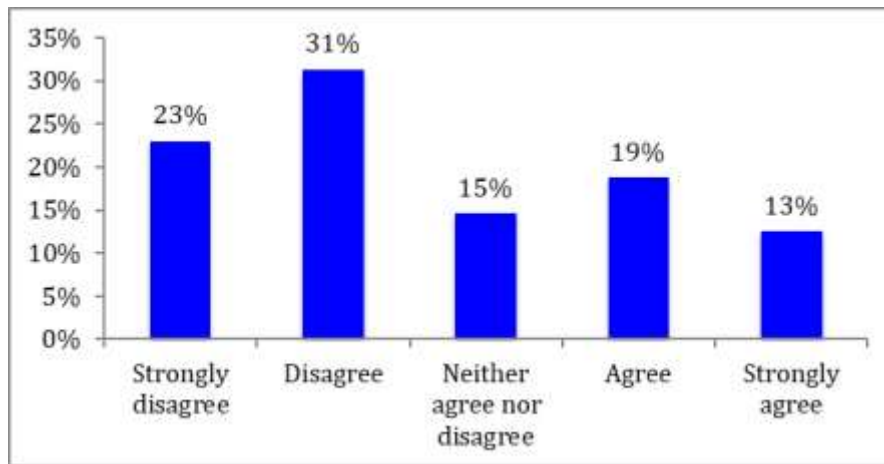
	Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly agree	9	19.0	19.0
	Agree	11	23.0	42.0
	Neutral	5	10.0	52.0
	Disagree	10	21.0	73.0
	Strongly disagree	13	50.0	123.0
	Total	48	123.0	123.0

**4.5.3 Stock prices determine manager’s performance**

Figure 6 presents a breakdown of respondent’s views with regard on whether stock prices determines performance of the managers, which can have positive effect on the overall company performance. It is clear from the findings that respondents didn’t find this an important determinant but nearly one-third were in agreement that stock prices encourage managers to devote more time and energy to the company and hence enhancing company performance. The findings further established that 15% of the respondents could neither agree nor disagree.

**FIGURE 7**

**Stock prices determines manager's performance**



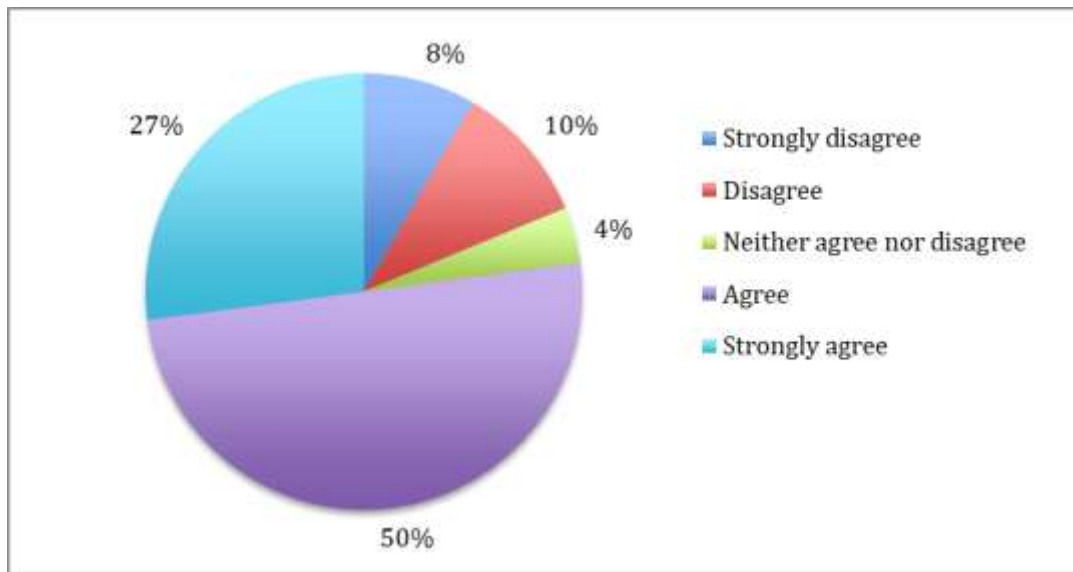
**4.6 DEFERRED COMPENSATION**

**4.6.1 Pension fund has become effective in increasing manager's savings**

The study found that most of the investment companies utilizes pension funds in enhancing managerial performance. Figure 7 shows that nearly 80% of the respondents were in agreement compared to 18% who were in disagreement. The findings demonstrate that managers are given opportunity to own certain shares which makes them feel part of the company increasing their commitment.

**FIGURE 8**

**Pension fund has become effective in increasing manager's savings**



**4.6.2 Would it be beneficial to the firm if managers are provided with retirement plan?**

It is shown in table 7 that most of the investment company's performances were better because managers with retirement plan as it enhances their motivation and productivity and hence increased performance in the company. On the other hand, 21% of the respondents don't find any relationship between having retirement plan and their productivity, which doesn't consider having manager retirement plan in the company.



**TABLE 10**

**Would it be beneficial to the firm if managers are provided with retirement plan**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly disagree	5	10.0	10.0	10.0
	Disagree	2	4.0	4.0	14.0
	Neutral	8	17.0	17.0	31.0
	Agree	22	46.0	46.0	77.0
	Strongly agree	11	23.0	23.0	100.0
	Total	48	100.0	100.0	

**4.6.3 Our firm provides good insurance cover to managers to achieve high growth**

With regard to good insurance cover, majority 46% of the respondents could neither agree nor disagree that it increases firm performance but 29% were in agreement that increases performance. Additionally, the study found that a quarter (2% strongly disagree and 23% disagree) of the respondents were disagreement and this means some companies does not consider any costs that are related to agencies.

**TABLE 11**

**Our firm provides good insurance cover to managers to achieve high growth**

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly disagree	1	2.0	2.0	2.0
	Disagree	11	23.0	23.0	25.0
	Neutral	22	46.0	46.0	71.0
	Agree	9	19.0	19.0	90.0
	Strongly agree	5	10.0	10.0	100.0
	Total	48	100.0	100.0	

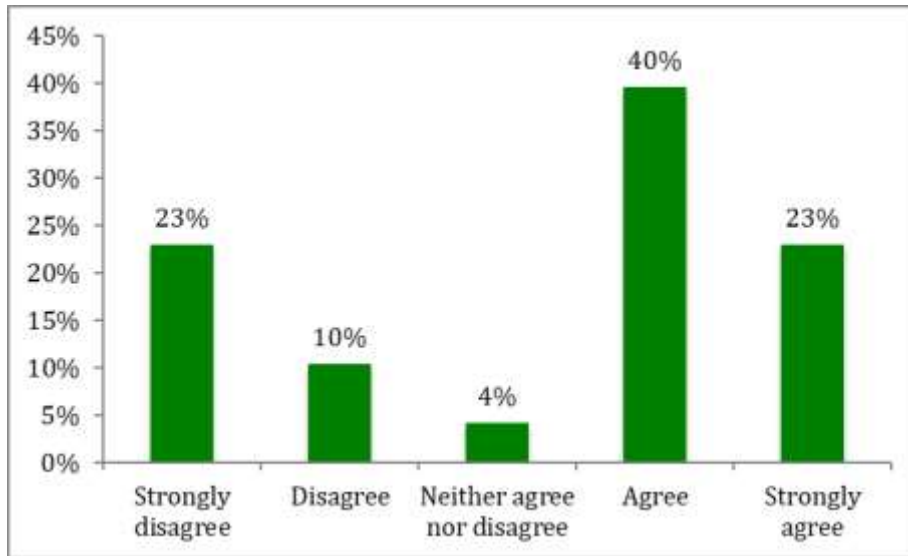
**4.7 LONG-TERM INCENTIVE PLAN**

**4.7.1 Enhancing restricted stocks among managers**

Asked to state whether enhancing restricted stocks among managers were likely to reduce agency cost, majority 40% indicated agree while 23% stated strongly agree. The study also established that 23% indicated strongly disagree while 20% disagree with only 4% of the respondents indicating neither agree nor disagree.

**FIGURE 9**

**Enhancing restricted stocks among managers**



**4.7.2 Increasing performance shares among managers encourages retention**

The study findings reveal that most of the respondents were in agreement that when companies increase performance shares among their managers, there is likelihood that high and quality team of managers will be retained. It is evident in table 9 that majority 34% indicated strongly agree with 30% stating agree. However, 36% could not believe on such arguments suggesting it needs more than performance shares. Based on this findings, the study suggests that performance shares are aligned to strategies of the investment firms.

**TABLE 12**

**Increasing performance shares among managers encourages retention**

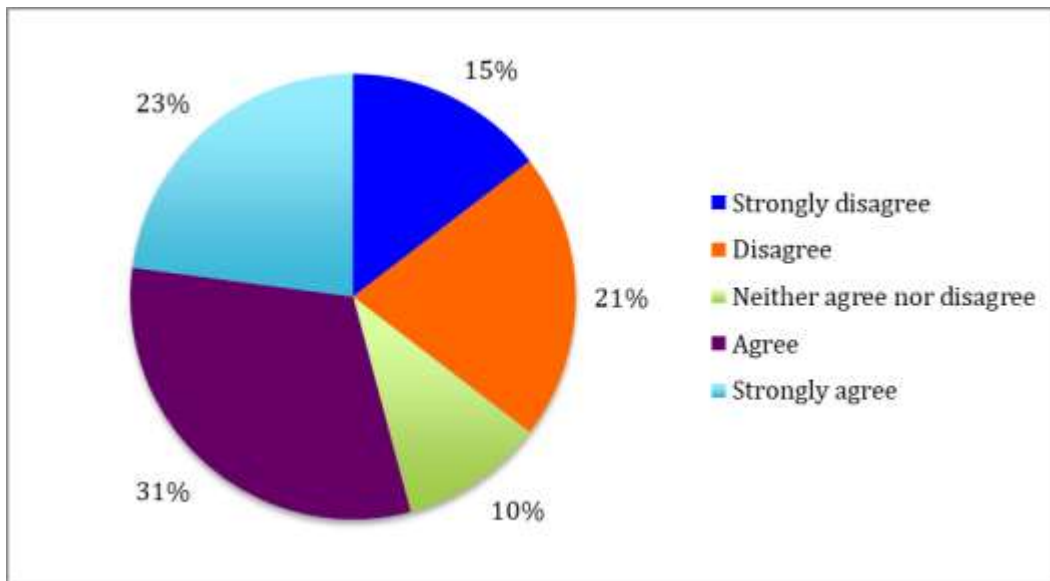
		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	Strongly disagree	6	13.0	13.0	13.0
	Disagree	11	23.0	23.0	36.0
	Neutral	0	0.0	0.0	36.0
	Agree	14	30.0	30.0	66.0
	Strongly agree	16	34.0	34.0	100.0
	Total	47	100.0	100.0	

**4.7.3 Provision of cash sum based achievement of key performance indicators**

With regard to whether managers are offered cash sum subject to achievement of key performance indicators or a share in the growth in value of the company, most of the respondents were in agree (agree 31% and strongly agree 23%). On the other hand, 36% could not agree that the wealth of managers can increase performance of the company.

**FIGURE 10**

**Provision of cash sum based achievement of key performance indicators**



**4.8 Reliability Tests**

Reliability refers to the consistency of the measurement. Cronbach's  $\alpha$  (alpha) was used to inspect the internal consistency of test items. When alpha equals 0, the true score is not measured and there is only an error component. When alpha equals 1.0, all items measure only the true score, and there is no error component. By convention, a lenient cut-off of 0.60 is common in explanatory research. A Cronbach's  $\alpha$  of 0.7 is a rule-of-thumb as an acceptable level of agreement, but many researchers require a cut-off of 0.80 for a "good scale".

The Cronbach's  $\alpha$  of our items varied, depending on which set of items were used and the number of items used. When administered as pre-test item sets of four items all yielded a value of 0.879. Since this number was above what is generally considered acceptable, there was no

review on the variables. The alpha coefficient for the four items is 0.879, suggesting that the items have relatively high internal consistency. According to Kottner, et al (2011) a reliability coefficient of 0.80 or higher is considered “acceptable” in most social science research situations.

**TABLE 13**  
**Case Processing Summary**

		N	%
Cases	Valid	48	100.0
	Excluded <sup>a</sup>	0	.0
	Total	48	100.0

a. Listwise deletion based on all variables in the procedure.

**TABLE 14**  
**Reliability Statistics**

Cronbach's Alpha	N of Items
.879	4

#### **4.9 Validity**

In order to measure the validity of the test as a whole, construct validity was assessed, by comparing the study's test. Construct validity refers to "the extent to which an assessment actually measures the proposed trait in the populations of interest, and thus what can be appropriately inferred from individuals' scores on it" (Gottfredson, 2010). One means of measuring construct validity is to measure the extent to which a test correlates with another test that measures the same set of skills, referred to as convergent validity (Shuttleworth, 2009).

Based on value significant obtained by the sig (2-tailed) of  $0.000 < 0.05$ , it can be concluded that all items were valid. Based on the count value obtained Pearson  $0.613 > r$  table product moment  $0.312$ , it can be concluded that all the items were valid. It is important to note that for value  $r$  table product moment, can be searched on the distribution of the  $r$  table product moment 5% significant with  $N=48$  then the value will be  $r$  table product moment equal to  $0.312$ .

#### **4.10 Correlation of Study Variables**

Correlation tests were carried out on the original data to show the extent or strength and direction of the relationship between variables. It should be noted that correlation does not show causality between independent and dependent variables. It only informs on the magnitude with which a dependent variable changes due to a unit change in the independent variable. The table below shows correlation of study variables.

The researcher analyzed the variables using Pearson correlation which is used to test the direction, strength and significance of the bivariate relationship among all the variables that have been measured at interval or ratio level (Sekaran and Bougie, 2012). As shown in table 12 all the predictor variables had a mildly strong and positive correlation between themselves. The positive correlation means that the variables vary together in the same direction; when any of the variables increase the others increase and when any decrease the others decrease and the correlation were all significant at 0.01 two tailed.

**TABLE 15**  
**Correlation of Study Variables**

	Cash based compensation	Stock based compensation	Deferred compensation	Long-term incentive plan	Firm performance
Cash based compensation	1				
Stock based compensation	0.815	1.000			
Deferred compensation	0.424	0.468	1.000		
Long-term incentive plan	0.544	0.617	0.175	1.000	
Firm performance	0.642	0.751	0.268	0.344	1.000



## 4.11. Regression Analysis

### 4.11.1 Model summary

This table provides the R, R<sup>2</sup>, adjusted R<sup>2</sup>, and the standard error of the estimate, which can be used to determine how well a regression model fits the data. The column represents the value of R, the multiple correlation coefficient. In this case, R can be considered to be one measure of the quality of the prediction of the dependent variable; in this case firm performance. The R Square column represents the R<sup>2</sup> value (also called the coefficient of determination), which is the proportion of variance in the dependent variable that can be explained by the independent variables (technically, it is the proportion of variation accounted for by the regression model above and beyond the mean model). It can be seen from the value of 0.685 that the independent variables explain 68.5% of the variability of our dependent variable, firm performance. However, you also need to be able to interpret "Adjusted R Square" (adj. R<sup>2</sup>) to accurately report your data.

**TABLE 16**

#### **Model summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.738 <sup>a</sup>	.685	.594	3.645

a. Predictors: (Constant), CBC, SBC, DC, LIP

b. Dependent Variable: FP

### 4.11.2 ANOVA

The F-ratio in the ANOVA table (see below) tests whether the overall regression model is a good fit for the data. The table shows that the independent variables statistically significantly predict the dependent variable,  $F(4, 79) = 32.393$ ,  $p < .000$  (that is the regression model is a good fit of the data).

**TABLE 17**

#### Anova

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	10.677	4	2.669	3.2393	.000 <sup>b</sup>
	Residual	26.205	75	.416		
	Total	36.882	79			

a. Dependent Variable: FP

b. Predictors: (Constant), CBC, SBC, DC, LIP

### 4.11.3 Coefficient of Determination

As shown in table 15, the unstandardized coefficients indicate how much the dependent variable varies with an independent variable when all other independent variables are held constant. Consider the effect of age in this example. The unstandardized coefficient, B1, for cash based compensation is equal to 0.027 (see table 15). This means that for each one year increase in cash

based compensation among the investment firms, there is an increase in firm performance of 0.027.

**TABLE 18**  
**Coefficient of Determination**

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.	95.0% Confidence Interval for B	
	B	Std. Error	Beta			Lower Bound	Upper Bound
1 (Constant)	2.247	.248		9.072	.000	1.752	2.742
Cash based compensation	.027	.099	.051	.268	.002	.224	.171
Stock based compensation	.223	.109	.418	2.051	.001	.440	.006
Deferred compensation	.029	.564	.657	.519	.003	.04	.316
Long-term incentive plan	.033	.087	.057	.378	.001	.02	.207

a. Dependent Variable: Firm performance

### Overall interpretation

A multiple regression was run to predict firm performance from Cased Based Compensation (CBC), Stock Based Compensation (SBC), Deferred compensation (DC), and Long-term Incentive Plan (LIP). These variables statistically significantly predicted firm performance, F (4,

79) = 32.393,  $p < .000$ ,  $R^2 = .685$ . All four variables added statistically significantly to the prediction,  $p < .05$ .

#### **4.12 Discussion of findings**

To assess the significance of each independent variable on the dependent variable, the researcher established that all the variables (cash based performance, stock based performance, deferred compensation and long-term incentive plan) were significant and affected level of firm performance as their P values were less than 5% (see table 15).

Generally, cash compensation affects firm performance and this concurs with studies Murphy (1999) in a study who found that the bonuses offered to managers are mostly linked to the previous year's accounting numbers. In other study similar to this study, Smith and Watts (1982) reported that long-term incentive plans are linked to manager's performance which in turn translates to changes in firm value.

The findings from this study are similar to Jensen and Murphy (1990) who found that managerial compensation is directly related to increases in shareholder wealth, and that the pay increases as shareholder wealth increase. Furthermore, the study found that earnings and stock returns in manager's cash compensation translate to increase in firm productivity. This results concurs with Core et al. (2003) who reported a positive relationship between earnings and managerial compensation.

The findings from this study demonstrate that pension fund can significantly reduce the risk-shifting agency costs associated with pension compensation. Based on these results, the researcher observes that pension fund generates substantial confidence among the managers of investment firms in achieving maximum pension entitlement, and can also neutralize the

traditional tendencies of the high compensation control manager. Therefore, firms tend to utilize such information to create contracts that are suited to the goals of the firm.

The study also shows that long-term incentive plans including options are aimed at aligning the objectives of company more closely with those of the firm's shareholders. This demonstrates that the rapid growth in the use of long-term incentive plans, for example, on top of established option arrangements, and the potentially lavish rewards to managers, seem to support the view that shareholder's interests are now very much to the forefront of managerial agendas.

According to the regression equation established, taking all factors (cash based performance, stock based performance, deferred compensation and long-term incentive plan) constant at zero, firm performance of the investment firms as a result of these independent factors was 2.247. The data findings analyzed also shows that taking all other independent variables at zero, a unit increase in cash based compensation will lead to a 0.027 increase in firm performance. A unit increase in cost of sharing information will lead to a 0.223 increase in effect on market performance while a unit increase in information security will lead to a 0.033 increase in effect on market performance. This therefore implies that all the three variables have a positive relationship with firm performance and the variables voluntary disclosure and rate of inflation having the most effect.

## **CHAPTER FIVE**

### **SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS**

#### **5.1 Introduction**

This chapter discusses a summary of findings based on the objectives set out in chapter one as presented in the findings section. In addition, the chapter provides conclusion and recommendations as observed in the above sections.

#### **5.2 Summary of findings**

This study examined the effects of managerial compensation schemes on firm performance for investment firms listed in the Nairobi Securities Exchange. In this section, the study presents a breakdown of two key areas: demographic characteristics of respondents and the findings. First, the study presents the demographic information and this shows that majority 58% of the study participants were men compared to 42% women. Out of the total participants, most had bachelor's degree and diploma respectively and majority had worked in the firms for more than two years. All the investments firms compensate their managers for their performance and only 30% of the firms didn't show commitment to having policy to inform such compensations.

##### **5.2.1 To examine the effect of cash based compensation on firm performance for investment firms listed at Nairobi Securities Exchange.**

The findings reveal that majority 69% of the study participants indicated that performance is determined by salary awarded to the managers in across the firms studied. According to the respondents (79%), strong bonus gives employees a certain share of the company profits, or perhaps a bonus to the entire company. They encourage employees to understand how their work

affects the company's performance and to improve the company's profitability. In addition, a significant number of these firm's value pay structure which positively affects firm performance.

### **5.2.2 To explore the effect of stock based compensation on firm performance for investment firms listed at Nairobi Securities Exchange**

Although majority of the respondents believed that in most of the investment companies in Kenya, there is increasing stock grants among managers, 27% could not find any relevance. This suggests that managers are commitment in ensuring the companies perform well in its growth.

Majority of the study participants were in agreement that dividends has played an important role in enhancing performance of the firms as managers feel part of the firm. In this case, the results suggest that dividend payout ratio, form of dividend payments and timing of dividend payments affects firm performance.

### **5.2.3 To examine the effect of deferred compensation on firm performance for investment firms listed at Nairobi Securities Exchange**

This study found that pension fund increases manager's savings which in turn translates to the performance of the firm. For example, as shown in figure 7, about 77% of the respondents were in agreement that in the investment firms, pension funds had become very effective in increasing firm's performance as managers become commitment in performing their duties which in turn raises productivity in the firm.

In addition, most of the investment firms had been utilizing retirement plans as one factor to enhances it performance. According to majority of the respondents, managers received various forms of retirement plans based on employer's contribution. Moreover, having good insurance cover was mentioned as another important contributor to firm performance.

#### **5.2.4 To find out the effect of long-term incentive plan on firm performance for investment firms listed at Nairobi Securities Exchange**

Most investment firms use restricted stocks to promote productivity among its managers who provide with wealth. However, some 33% of the respondents didn't agree in the statement that restricted stock results to high performance in the companies. The study found that increasing performance shares among managers in investment firms encourages retention of high performing managers.

### **5.3 Conclusions**

This study sought to examine effect of managerial compensation schemes on firm performance for investment firms listed at Nairobi Securities Exchange. The study concludes that compensation based on cash, stock based, deferred compensation and long term incentive plan are associated with growth in profits, market share or generally performance of the investment firms. Regression analysis show that all the variables were less than 0.05 and this demonstrates that increase in firm's profits is linked to managerial compensation. The results show that the value of financial incentives is measureable.

### **5.4 Recommendations**

Based on the findings presented in the above section, this study recommends that for investment firms to leverage managerial abilities, they need to utilize various forms of compensation such as cash, stock or even long-term incentive. These provide the managers an opportunity to increase their commitment towards the firm which in turn promotes financial growth and overall performance of the firm.



The findings in this study show that some investment firm's compensation policy were not clear. As such, this study recommends that all firms can develop their compensation policies and also ensure their managers and employees are aware to encourage them.

### **5.5 Recommendation for future studies**

This study recommends that future studies can focus on other managerial compensation in other firms in Kenya to provide comparative analysis. In addition, future studies can examine investment in other major towns in Kenya =.

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## **APPENDICES**

### **APPENDIX I: LETTER TO THE RESPONDENTS**

Dear Respondents,

I am a student at KCA University pursuing Master of Commerce in Finance and Investments and I am conducting a study entitled “Effect of Managerial Compensation Schemes on Firm Performance for Investment Firms Listed at Nairobi Securities Exchange”. In the regard, I am asking for your precious time, and effort to answer all the questions in the questionnaire that are important and helpful for the completion of the study. I assure you that all the data gathered from you will be kept in the highest level of confidentiality.

Your positive response in this request will be valuable contribution for the success of the study and will highly appreciate. Thank you very much for your cooperation.

Yours Sincerely,

Pamellah Odingee

Researcher



**APPENDIX II: QUESTIONNAIRE**

**SECTION A: DEMOGRAPHIC INFORMATION**

1. Name of your company -----
2. What is your position in the firm?  
 CEO ( ) Director ( ) Management ( )
3. What is your highest level of education?  
 PhD ( ) Masters ( ) Bachelors ( ) Diploma ( ) Others ( ) specify.....
4. Would you say that your investment company has a compensation policy?  
 Strongly agree ( ) Agree ( ) Neutral ( )  
 Strongly disagree ( ) Disagree ( )
5. How often does your institution compensate employees for their outstanding performance?  
 Very often ( ) Fairly often ( ) Often ( ) less often ( )
6. How long have you been working in the institutions?  
 Less than 2 years ( ) 2-5 years ( ) 5-8 years ( ) 9-13 years ( )

**SECTION B: CASH BASED COMPENSATION**

No	Statement on Firm Performance	Strongly disagree	Disagree	Neither agree nor	Agree	Strongly agree
1.	Our firm performance is primarily determined by salary awarded to managers.					

2.	We provided strong bonus programme which enhances manager's performance.					
3.	Our pay structure influences manager's turnover contributing to overall firm performance.					

### SECTION C: STOCK BASED COMPENSATION

No	Statement on Firm Performance	Strongly disagree	Disagree	Neither agree nor	Agree
1.	Our firm increases stock grants which attracts highly qualified managers.				
2.	We provide a dividend based on manager's performance and hence enhances firm performance.				
3.	In our company, stock prices determine manager's performance and hence enhanced company performance.				

**SECTION D: DEFERRED COMPENSATION**

No	Statement on Firm Performance	Strongly disagree	Disagree	Neither agree nor	Agree	Strongly agree
1.	In our firm, pension fund has become effective in increasing manager's savings and hence high performance.					
2.	Would it be beneficial to the firm if managers are provided with retirement plan?					
3.	Our firm provides good insurance cover to managers to achieve high growth.					

**SECTION E: LONG-TERM INCENTIVE PLAN**

No	Statement on Firm Performance	Strongly disagree	Disagree	Neither agree nor	Agree	Strongly agree
1.	Enhancing restricted stocks among managers reduces agency cost.					
2.	Increasing performance shares among managers					

	encourages retention.					
3.	Managers a cash sum subject to achievement of key performance indicators or a share in the growth in value of the company.					