CORPORATE GOVERNANCE AND DIVIDEND POLICY IN KENYA: A SURVEY OF COMPANIES LISTED AT THE NAIROBI STOCK EXCHANGE

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DECLARATION

I, the undersigned, hereby declare that this project is my original work and that it has not been presented in any other University for academic purposes.

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DEDICATION

This research project report is dedicated to SumayyahAasiya, MuhammadArafat and SuheylahAisha – the joys of my life.

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I would like to express my gratitude to my supervisor, Mr. Luther Otieno, for making this project a meaningful learning process. His guidance and encouragement throughout the process and his ability to view things pragmatically was critical and priceless to the success of this study, and therefore needs to be commended.

I am forever indebted to my wife FatimaZahra and my children SumayyaAasiya, MuhammadArafat and SuheylahAisha, for their unconditional love, support and encouragement. They are always my true inspiration. I also thank my entire family for their understanding and support throughout my studies. May God bless you all.

Finally and most important of all, I thank Allah, the Lord of the Universe, for giving me the health, strength and perseverance to continue and finish this study.

ABBREVIATIONS

CGI	-	Corporate Governance Index
DPR	-	Dividend Payout Ratio
DPS	-	Dividends Per Share
EPS	-	Earnings Per Share
ICPAK	-	Institute of Certified Public Accountants Kenya
NSE	-	Nairobi Stock exchange
TDI	-	Transparency Disclosure Index

ABSTRACT

Corporate governance exists to provide checks and balances between shareholders and management and thus to mitigate agency problems. Hence, firms with better governance quality should incur less agency conflicts, and managers should be less likely to adopt a sub-optimal dividend policy. As a result, the quality of corporate governance should have an impact on dividend policy.

There has been renewed interest in the corporate governance practices of modem corporations, particularly due to the high-profile collapses of a number of large U.S. firms. There is evidence in the finance literature that tends to support the hypothesis that the patterns of corporate dividend payout policies vary tremendously between developed and transition markets. In developing countries, little studies have been done to establish the correlation between corporate governance and dividend policy. For these reasons, a study on this relationship between dividend policy and corporate governance in a transition economy offers an interesting subject and complements the existing corporate governance literature.

The fundamental premise of this study is that there ought to be an economic association between corporate governance quality and dividend payouts. This study provides empirical evidence on the association between aggregate governance quality and dividend payouts. Review of the literature provides a theoretical framework on corporate governance and dividend policy. To test whether corporate governance practices determine the dividend policy in the companies listed in the Nairobi Stock Exchange, we compose quantitative measures on the quality of the corporate governance for these companies.

The regression research design methodology was used to assess the relationship level between corporate governance standards and dividend policy. The study sampled 38 companies listed in the Nairobi Stock Exchange (NSE), and used secondary data obtained from financial reports, and companies' annual reports. The data obtained were qualitatively analyzed to establish the level at which the company Transparency Disclosure Index (TDI) affects dividend payouts. These were summarized in form of research findings, recommendations, conclusions and suggestions of areas for further research. The findings demonstrate that an increase in the TDI, representing corporate governance practices, brings about a statistically significant increase in the dividend payout ratios.

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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

In order to attract investors, firms must enforce corporate governance standards which provide protection of the interests of new and existing shareholders. Corporate governance in companies and stock market development is relatively new in Kenya. The Kenya Government has realized the importance of corporate governance and its importance on corporate financing and performance, and is requiring its organs, like Capital Markets Authority, to enforce corporate governance standards. Therefore, there is a need to evaluate the impact of corporate governance practice on corporate management practices.

The purpose of this project is to test whether corporate governance practices impact on the dividend policy for the companies listed on the Nairobi Stock Exchange (NSE), and to determine the nature of this correlation.

This project is expected to contribute to the literature that uses agency theory to explain dividend behavior (La Porta Lopez-de-Silanes, Shleifer, and Vishny 2000, Hu and Kumar, 2004, Officer, 2007 and John and Knyazeva, 2006). The project will also add to the literature in corporate governance by showing whether a firm's overall quality of corporate governance has a palpable effect on critical corporate decisions such as dividend policy. We thus contribute to the literature that examines how corporate governance affects corporate outcomes (Gompers Ishii and Metrick 2003, Bebchuk and Cohen, 2005, Cremers and Nair, 2005 and Brown and Caylor, 2006).

Gabrielle O'Donovan (2003), defines corporate governance as 'an internal system encompassing policies, processes and people, which serves the needs of shareholders and other stakeholders, by directing and controlling management activities with good business savvy, objectivity, accountability and integrity. Sound corporate governance is reliant on external marketplace commitment and legislation, plus a healthy board culture which safeguards policies and processes'.

O'Donovan (2003) goes on to say that 'the perceived quality of a company's corporate governance can influence its share price as well as the cost of raising capital. Quality is determined by the financial markets, legislation and other external market forces plus how policies and processes are implemented and how people are led. External forces are, to a large extent, outside the circle of control of any board. The internal environment is quite a different matter, and offers companies the opportunity to differentiate from competitors through their board culture.

To date, too much of corporate governance debate has centered on legislative policy, to deter fraudulent activities and transparency policy which misleads executives to 'treat the symptoms and not the cause.' Therefore corporate governance is a system of structuring, operating and controlling a company with a view to achieve long term strategic goals to satisfy shareholders, creditors, employees, customers and suppliers, and complying with the legal and regulatory requirements, apart from meeting environmental and local community needs.

Report of Securities and Exchange Board of India (SEBI) committee on Corporate Governance defines corporate governance as "the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company." The definition is drawn from the Gandhian principle of trusteeship and the Directive Principles of the Indian Constitution. Corporate Governance is viewed as ethics and a moral duty.

A number of problems relating to corporate governance have been identified in Kenya. The problems range from errors, and mistakes, to outright fraud. The origins of the problem range from concentrated ownership, weak incentives, poor protection of minority shareholders, to weak information standards. For example, a negative feature of the corporate sector in Kenya is the dominance of business by a family.

A number of quoted firms at Nairobi Stock Exchange are either managed by block shareholders or generally held and managed by majority (family) interests. Furthermore, the Government of Kenya is a controlling or influential shareholder in a number of listed companies that include National Bank of Kenya, Kenya Power & Lighting Company and Kenya Commercial Bank. With such an environment in the background, together with the weak judicial system, the interest of both the minority shareholders and creditors could be compromised.

Whenever the ownership in a firm is highly diffused, legal environment is weak and the corporate governance practically non-existent, then the shareholders are unlikely to take action against non value maximization behavior of management (Jensen and Meckling, 1976).

Dividend policy is quite important in the valuation process of companies, but the issue still remains scarcely investigated in developing economies such as Kenya. Elsewhere, studies often fail to find statistically significant effects of corporate governance on firm performance in developed countries. Even when significant results are reported, they are often economically small (Gompers, Ishii and Metrick, 2003). In contrast, developing economies may offer more fertile ground for study.

The agency theory points that dividends may mitigate agency costs by distributing free cash flows that otherwise would be spent on unprofitable projects by the management (Jensen, 1986). It is argued that dividends expose firms to more frequent scrutiny by the capital markets as dividend payout increase the likelihood that a firm has to issue new common stock more often (Easterbrook, 1984). On the other hand, scrutiny by the markets helps alleviate opportunistic management behavior, and, thus, agency costs. Agency costs, in turn, are related to the strength of shareholder rights and they are associated with corporate governance (Gompers, Ishii, and Metrick 2003).

Furthermore, agency theory suggests that shareholders may prefer dividends, particularly when they fear expropriation by insiders. This suggests that dividend payouts are determined by the strength of corporate governance. Empirical results also demonstrate that corporate governance is an important determinant in explaining the dividend policy of Kenyan public companies (Jensen, 1986)

Previous studies suggest a positive association between dividend payouts and corporate governance practice, indicating that firms pay higher dividends if shareholder rights are better protected, and that in companies providing strong minority shareholder rights, the power is often used to extract dividends, especially when investment opportunities are poor (Gompers, Ishii and Metrick, 2003 and Easterbrook, 1984). As a result, companies with weak shareholder rights pay dividends less generously than do firms with high corporate governance standards.

The fundamental premise of this study is that there ought to be an economic association between corporate governance quality and dividend payouts due to their relations with agency costs. It is not theoretically obvious, however, what the exact relation should be. Prior literature suggests two possible hypotheses: based on the free cash flow hypothesis (Jensen, 1986); and substitution hypothesis (John and Knyazeva, 2006).

1.2 Problem Statement

The lack of effective corporate governance impact adversely on firm policy and that translate into poor firm performance. Dividend policy is central to effective financial management in any firm. There is evidence in the finance literature that tends to support the hypothesis that the patterns of corporate dividend payout policies vary tremendously between developed and transition equity markets. Glen, Karmokolias, Miller and Shah (1995) assert that the payout ratios in developing countries are about two thirds that of developed countries, while Ramcharan (2001) reports lower dividend yields for the emerging markets. However, the literature has not provided a uniform explanation for these existing differences.

There has been renewed interest in the corporate governance practices of modern corporations since 2001, particularly due to the high-profile collapses of a number of large U.S. firms such as Enron Corporation and MCI Inc. (formerly WorldCom). In 2002, the U.S. federal government passed the Sarbanes-Oxley Act, intending to restore public confidence in corporate governance. The experience in Russia show that the dispersion of ownership and the weakness of the corporate governance led to an extensive pillaging of assets by managers of many privatized firms (Boycko, Schleifer and Vishny, 1995).

In many of the listed companies at the NSE, ownership is significantly concentrated, (e.g. Barclay PLC in London owns over 60% of shares in Barclays Kenya Ltd.). The increased concentration of ownership put to risk the interest of minority shareholders (Shleifer and Vishny 1986). At risk is lack of board independence. With the lack of board independence, many companies could open themselves to financial abuse. Gugler and Yurttoglu (2003) assert that largest equity holder reduces the dividend payout ratio in Germany, whereas the power of the second largest shareholder increases dividend payout.

Therefore, in an emerging economy due to corporate governance issues, the main conflict could be between a large, foreign controlling owner and a small, domestic minority shareholder. Therefore, at macro level, the emerging hypothesis is that the preference for dividends should be even stronger in emerging economies as shareholders encounter a great risk of expropriation by insiders. At micro level, we expect visible differences in dividend payout in line with variations in levels of corporate governance among firms listed at NSE.

If the protection of minority shareholders has a positive impact on dividend payouts, then shareholder protection represented by the corporate governance standards should help explain differences in dividend payouts on firm-level. While country-level investor protection is an important factor in preventing expropriation, firm-level corporate governance could carry equal or greater importance. Besides, corporate governance practices can vary widely even among firms in the same country (Bebchuk and Cohen, 2005, Bebchuk, 2004, Cremers and Nair, 2005 and Brown and Caylor, 2006).

Whenever professionalism is low, the management cannot be expected to be independent (Cremers and Nair, 2005). As the case in many emerging economies with weak legal environment and heavily concentrated ownership structures, the main conflict in many listed companies is between controlling owners and minority shareholders. Black (2001) argues that substantial effects are likely to be found in emerging economies, which often have weaker rules and wider variations among firms in corporate governance practices.

For the above reasons, a study on the determinants of dividend policy and its association to corporate governance in a transition economy both offers an interesting subject and complements the existing corporate governance literature. The other related question is whether under such environment shareholders are able to get returns in the form of dividends.

In developing countries, little studies have been done to establish the correlation corporate governance with dividend policy (Mitton, 2004). In Kenya, while many studies have been done on corporate governance, no study has been aimed at establishing the correlation between corporate governance and dividend policy, a knowledge gap of which this study seeks to fill. Muriithi (2004), Ngure, (2007) and Juliana, (2006), conducted a study on relationship between corporate governance mechanisms and performance and established a strong-positive correlation, Gatauwa (2008), conducted a study on the relationship between corporate governance practices and stock market liquidity for firms and found out that, though corporate governance influences market liquidity positively, they had no strong correlation. Other studies done on corporate governance are Jebet, (2001) and Mitton, (2004).

Corporate governance exists to provide checks and balances between shareholders and management and thus to mitigate agency problems. Hence, firms with better governance quality should incur less agency conflicts. In such firms, managers should be less likely to adopt a sub-optimal dividend policy. As a result, the quality of corporate governance should have an impact on dividend policy.

This study provides empirical evidence on the association between aggregate governance quality and dividend payouts. The purpose of this study, therefore, is to test whether corporate governance practices impact on the dividend policy for the companies listed on the Nairobi Stock Exchange (NSE).

1.3 Objectives of the Study

This study provides empirical evidence on the association between aggregate governance quality and dividend payouts. The purpose of this study, thus to test whether corporate governance practices impact on the dividend policy for the companies listed on the Nairobi Stock Exchange (NSE). The objective of this paper, therefore, is to determine the nature of correlation that exists between corporate governance and dividend policy in Kenya.

1.4 Importance of the Study

This paper is expected to explain the relevance of corporate governance quality, which affects the severity of agency costs, to the determination of dividend policy. This relationship between governance quality and dividend payout is important because the US industrial firms experienced a much lower propensity to pay dividend in 80's and 90's (Fama and French, 2001).

The study is intended to provide useful insight to managers, who seek for low cost capital to finance their business projects, and would want to know the extent to which corporate governance impact on dividend payout ratios.

The study will be instrumental for governments in formulating policy issues affecting the performance and governance of corporations. It will also benefit investors, who wish to know the level of corporate governance in their firms, in their quest for wealth maximization.

The study will also be appreciated by academicians, as they seek to increase the body of knowledge and relate dividend payout ratios to corporate governance, and also as a basis of further research into this field.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter provides a summary of literature on research carried out on corporate governance and dividend policy. This provides the theoretical framework for understanding the current study as well documenting empirical research with a view to formulating a correct basis for further study into this field.

The problem at hand is about protecting shareholder and other investors interest in firms listed at Nairobi Stock Exchange. This requires research on levels of corporate governance and corporate management practices at micro and macro level. Such firm level findings add confidence to previous country-level findings regarding investor protection and dividends. Given that country-level measures of investor protection can be correlated with other important variables, some uncertainty remains about which country level variables impact dividend policy. The major impact variable in this study is level of corporate governance. Showing that differences in shareholder protection at the firm level also impact dividend policy helps confirm that investor protection is a significant factor affecting dividend policy (Gugler and Yurtoglu, 2003 and Gugler and Peev, 2006).

In developing countries, little studies have been done to establish the correlation corporate governance with dividend policy (Mitton, 2004). In Kenya, while many studies have been done on corporate governance, no study has been aimed at establishing the correlation between corporate governance and dividend policy, a knowledge gap of which this study seeks to fill. Muriithi (2004), Ngure, (2007) and Juliana, (2006), conducted a study on relationship between corporate governance mechanisms and performance and established a strong-positive correlation, Gatauwa (2008), conducted a study on the relationship between corporate governance practices and stock market liquidity for firms and found out that, though corporate governance influences market liquidity positively, they had no strong correlation. Other studies done on corporate governance are Jebet, (2001) and Mitton, (2004).

Corporate governance exists to provide checks and balances between shareholders and management and thus to mitigate agency problems. Hence, firms with better governance quality should incur less agency conflicts. In such firms, managers should be less likely to adopt a sub-optimal dividend policy. As a result, the quality of corporate governance should have an impact on dividend policy.

2.2 Corporate Governance and Dividend Policy Theories

The fundamental premise of this study is that there ought to be an economic association between corporate governance quality and dividend payouts due to their relations with agency costs. It is not theoretically obvious, however, what the exact relation should be. Prior literature suggests two possible hypotheses.

2.2.1 Outcome Hypothesis

The origin of this concept is the agency problem that is inherent in firms. This hypothesis is fundamentally based on the free cash flow hypothesis (Jensen, 1986). It posits that managers of firms with weak governance are more likely to retain cash within the firm as it allows them to consume perquisites, engage in empire building, and invest in projects and acquisitions that may enhance their personal prestige but not necessarily provide shareholders with adequate returns. However we expect that firms with strong governance are less likely to abuse the free cash flow, thus raising the attractiveness of paying out cash to shareholders. The expected dividend policy is thus the outcome of the governance regime in this view. The empirical prediction of this hypothesis is that firms with strong governance should pay larger dividends. In other words, there is expected to be a positive association between corporate governance quality and dividend payouts.

Previous studies provide empirical evidence consistent with this free cash flow hypothesis and outcome model. Ronneboog and Szilagyi (2006) conclusion is that Dutch firms with strong shareholders post higher dividend payouts. Michaely and Roberts (2006), using data on private firms in the U.K, observe that strong governance encourages higher and more consistent payouts. La Porta, Lopez-De Salinas, Shleifer, and Vishny (2000), on examining over 4,000 firms in 33 countries, find strong support for the outcome model. The observation is that firms pay more dividends in countries where minority shareholder rights are better protected (Schleifer and Vishny, 1986).

2.2.2 Substitution Hypothesis

Dividends and specifically dividend payout policy is suggested as useful for alleviating the manager-shareholder conflict. However, the effectiveness of payout policy in reducing agency costs pivots largely on the degree of restriction on managerial actions. Without pre-commitment, poorly-monitored managers can ex post deviate from the payout policy and use free cash flow to finance negative net present value or marginal investments (Morck, Shleifer and Vishny, 1988).

John and Knyazeva (2006), suggestion is that given the negative market reaction to dividend cuts and infrequent deviations from dividend policy, dividends help constrain the manager through high cost of deviation and constitute an effective pre-commitment mechanism in the presence of a severe agency conflict.

As shareholders observe that firms with weak governance may be more prone to managerial entrenchment and rationally anticipate the larger extent of the free cash flow problem, the necessity for dividends should be stronger for firms with poor governance, than for firms with strong governance. Dividend payment imposes a tax cost on the payer firm. Moreover, dividend paying firms also incur the cost of forgone positive-NPV projects or the additional cost of external financing to fund them when internal cash flow is inadequate. Since dividends are costly, firms that are less vulnerable to managerial entrenchment (i.e. firms with strong governance) should be less inclined to pay dividends and should pay lower dividends on average (Michaely and Roberts, 2006).

Conversely, firms more susceptible to agency costs (i.e. those with weak governance) are expected to show a stronger propensity to pay dividends and should pay larger dividends on average. In other words, larger dividends substitute for weaker governance.

2.3 Dividend Policy

Dividend policy refers to the decision regarding the magnitude of the dividend payout, that is, the percentage of earnings paid to the stockholders in the form of dividends. Allen and Michaely (2002) offer an exhaustive literature review on dividend policy.

Since the pioneering works of Gordon (1959), Lintner (1962), and Miller and Modigliani (1961) there is an ongoing debate on dividend policy, which has been a controversial issue to this day. Black (1976) finds no convincing explanation of why firms pay cash dividends and talks about a "dividend puzzle". Authors have produced extensive and sometimes conflicting research, with several alternative theories trying to explain why firms pay dividends, or why they should not pay dividends, or even why this decision may be irrelevant.

Through the years, the empirical evidence did not clearly favour any of the proposed alternatives. In the United States, the "dividend puzzle" is even deeper, as historically dividends have been generally taxed higher than capital gains, and this makes it even more difficult to understand why dividends are favoured. Taxes and investor clienteles (Elton and Gruber, 1970) have spawned a very extensive body of work, but mostly favouring the view that firms should not pay dividends.

Perhaps the most influential work in this field is the seminal paper of Miller and Modigliani (1961), who show that, in perfect markets, the payout decision is irrelevant because it neither creates nor destroys value for shareholders. If the investment decision is held constant, higher dividends result in lower capital gains, leaving the total wealth of shareholders unchanged. However, contrary to this theory, firms have been for the past decades following very clear rules in setting their dividend policy (Lintner, 1956; Brav et al., 2005), which would be incomprehensible, if they believed this decision to be irrelevant.

In the real world, with market imperfections such as taxes and transaction costs, and other issues such as information asymmetries and agency problems, dividend policy seems to be very relevant, both for the managers of the firms, shareholders, prospective investors and market analysts. Not only do managers show extra care in their payout decisions, especially in changing payout decisions, but also the markets react strongly to dividend changes, and more so, to dividend omissions and initiations, as proved by Aharony and Swary (1980) and Michaely, Thaler and Womack (1995).

Information asymmetry and signalling (Bhattacharya, 1979; John and Williams, 1985; Miller and Rock, 1985) have been proposed as explanations for positive dividends, with some supporting evidence. However, the signalling hypothesis has been losing ground, as more recent research (DeAngelo and Skinner, 1996; Benartzi, Michaely and Thaler, 1997) shows that dividend changes are not very good predictors of future earnings changes. If the signal does not work, why send it? Furthermore, in an extensive enquiry, Brav et al. (2005) find that financial managers do not have a signalling purpose, when they decide on payout policy. How can dividends be a signal, if managers do not mean them to be one?

One theory that has garnered strong empirical support is the agency theory. Jensen & Meckling (1976) defined an agency relationship as "a contract under which one or more persons (the principal(s) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent" (p.308). The theory models the relationship between the principal and the agent. In the context of the firm, the agent (manager) acts on behalf of the principal shareholder (Eisenhardt, 1989; Fox, 1984; Jensen & Meckling, 1976; Ross, 1973).

According to the agency theory, dividend policy is set so as to minimize agency costs - costs arising from the divergence of ownership and control. The literature in this area is predicated on the early work by Grossman and Hart (1980), Easterbrook (1984), and Jensen (1986). Dividend payouts have been argued to mitigate agency conflicts by reducing the amount of "free" cash flow available to managers, who do not necessarily act in the best interests of the shareholders (Grossman and Hart, 1980, Easterbrook, 1984, and Jensen, 1986). Furthermore, Easterbrook (1984) argues that dividends help alleviate agency conflicts by exposing firms to more frequent monitoring by the primary capital markets because paying dividends increases the probability that new common stock has to be issued more often.

Myron Gordon and John Lintner argued that investors have a trade-off between high dividend payout (D1) and low capital gains (g) or vice versa. They argued that investors value a dollar expected dividends more highly than a dollar expected capital gains. Litzenberger and Ramanswany (1979), argued that imposition of tax produces differential effect on divided income and on long term capital gain.

2.3.1 Dividend relevance theories

Bird in hand theory of Myron and John litner (1963) implies that shareholders are risk averse and therefore would prefer to receive dividend payment rather than capital payments in future. Tax differential theory, (Litzenberger and Ramasawamy, 1979), suggests that investors prefer one dividend policy other than another because of tax effect; while dividend signaling theory proposed by Stephen Ross (1977) suggests that signals are acted upon by investors. Clientele effect theory of Richardson Petit (1977) and Elton and Gruber (1970), assumes that investors may develop with distinct preferences for dividend or non dividend paying stocks.

2.3.2 Dividend Irrelevance Theories

Modigliani and Miller's divided irrelevance theory (1961) implies that the dividend policy decision is irrelevant, that is dividend policy have no impact on the shareholders wealth. However, MM argument is based on a number of key assumptions, some not attainable in the real world. The assumptions includes, no corporation or personal taxes on income, no stock floatation or taxation costs, the firm's investment policy is independent of its dividend policy; the market is efficient and therefore investors have the same set of information regarding future investment opportunities. MM argued that under a set of assumptions if a firm pays a higher dividend then it must sell more stock to new investors and hence the value of the firm given up to the new investors is exactly equal to dividend payout.

From MM analysis emerged the residual theory that suggests that the management can distribute all or part of earnings or retain them from earnings that are earnings left over after all suitable investment opportunities have been financed. With the residual earnings, the primary concern of firm's management is investment. Dividend policy becomes irrelevant; it is treated as a passive rather active decision. Fama (1977) and Miller (1986) have also brought strong evidence suggesting no relationship between dividends and investments and the firm value.

2.3.3 The determinants of dividend policy

In the USA, Canada, U.K., Germany, France, and Japan, the propensity to pay dividends is higher among larger, more profitable firms, and those for which retained earnings comprise a large fraction of total equity. Although there are hints of reductions in the propensity to pay dividends in most of the sample countries over 1994 to 2002 periods, they are driven by a failure of newly listed firms to initiate dividends when expected to do so (Allen and Michaely, 2003).

Dividend abandonment and the failure to initiate by existing non-payers are economically unimportant except in Japan. Moreover, in each country, aggregate dividends have not declined and are concentrated among the largest, most profitable firms. Finally, outside the U.S. there is little evidence of a systematic positive relation between relative prices of dividend paying and non-paying firms and the propensity to pay dividends. Overall, these findings cast doubt on signaling, clientele, and catering explanations for dividends, but support agency cost-based lifecycle theories (David and Osobov, 2003).

Traditionally, finance scholars have emphasized explanations for dividends that are based on the desire to communicate information to shareholders or to satisfy the demand for payouts from heterogeneous dividend clienteles (Allen and Michaely, 2003). Recently however, DeAngelo, DeAngelo and Skinner (2004) cast doubt on the signaling and clientele considerations as first-order determinants of dividend policy by reporting that dividends in the U.S. are increasingly concentrated among a small number of large players.

An alternative view of dividends, proposed by DeAngelo and DeAngelo (2006), is that optimal dividend payout policy is driven by the need to distribute the firm's free cash flow. They propose a life-cycle theory that combines elements of Jensen's (1986) agency theory with evolution in the firm's investment opportunity set of the type discussed in Fama and

French (2001) and Grullon, Michaely, and Swaminathan (2002). In this theory, firms optimally alter dividends through time in response to the evolution of their opportunity set. The theory predicts that in their early years, firms pay few dividends because their investment opportunities exceed their internally generated capital. In later years, internal funds exceed investment opportunities so firms optimally pay out the excess funds in order to mitigate the possibility that the free cash flows will be wasted.

Black's (1976) dividend puzzle has sparked a long-standing academic debate on why firms distribute huge sums of cash to their shareholders. Existing research has had some success in explaining dividend payouts by a variety of market imperfections such as agency problems, informational asymmetries, and taxes. Nonetheless, DeAngelo and DeAngelo (2006) argue that Miller and Modigliani's (1961) irrelevance theorem is largely misinterpreted, as even in frictionless markets rational expectations require firms to make large payouts.

The importance of shareholder control in achieving optimal payout levels cannot be sufficiently emphasized. There is evidence that strong shareholders actively pursue specific payout outcomes (Allen et al., 2000), and to some extent make dividends redundant as a managerial control or monitoring device (La Porta et al., 2000; Goergen et al., 2005). That dividends need not be used to contain free cash flow has been argued for stakeholder-oriented governance systems in particular, on the basis of the fact that firms in these regimes tend to have low and flexible dividend payouts as well as highly concentrated ownership structures.

2.4 Corporate Control and Corporate Governance

The Global Corporate Governance Forum notes in its mission statement that Corporate Governance has become an issue of worldwide importance and corporations have a vital role to play in promoting economic development and social progress. It notes further that corporate governance is the engine of growth internationally and increasingly responsible for providing employment, public and private services, goods and infrastructure. The efficiency and accountability of the corporation is a matter of both private and public interest, and governance has, thereby, come to the head of the international agenda (Global Corporate Governance Forum Secretariat, 1999). The Commonwealth Association for Corporate

Governance, (1999), states that globalization of the market place within the context of principles of corporate governance has ushered in an era where the traditional dimensions of corporate governance defined within local laws, regulations and national priorities are becoming increasingly challenged by circumstances and events having an International Impact (Commonwealth Association for Corporate Governance, 1999)

The agency problem as advanced by Jensen and Mecklin (1976) implies that managers may maximize their own utility curve to the disadvantage of shareholders. In many emerging economies, minority shareholders have little incentive to collect costly information they need to monitor management. Under such a set up management enjoy absolute controls of the firms. An unchecked management could ultimately engage in asset stripping. There are many mechanisms of controls that ensure that the investors' interests are protected. The list of such controls includes the legal protection, ownership structure (large shareholders and creditors), the use of leverage and takeovers. However where control fails the investors have no alternative but to dispose their share holding in the firm.

A prerequisite for effective control is information efficiency. Firms should disclose information that enable investors appraise their performance. Several prior studies have investigated various determinants of companies' voluntary disclosure practices. A consistent finding is that size is an important predictor of corporate reporting behaviour. In meta-analysis of 29 disclosure studies, conducted by Ahmed and Courtis (1999), size, listing status and financial leverage were found to have a significant impact on disclosure level. Other company attributes associated with corporate disclosure include, industry type (Cooke, 1989 and 1992), performance (Singhvi and Desai, 1971), multinationality (Raffournier, 1995), and country of origin (Meek, Roberts and Gray, 1995). Similarly, a number of studies documented a significant relationship between ownership and the extent of disclosure (Chau and Gray 2002, Haniffa and Cooke 2002 and Singhvi and Desai 1971).

2.5 Corporate Governance

Corporate Governance is the manner in which power is exercised in the management of economic and social resources for sustainable human development. It has assumed critical importance in these days of political pluralism because it is a balance between the need for order and equality in society, the efficient production and delivery of goods and services, accountability in the use of power, the protection of human rights and freedoms, and the maintenance of an organized corporate framework within which each citizen can contribute fully towards finding innovative solutions to common problems (Private Sector Initiative for Corporate Governance, 1999).

Classical economists, from Adam Smith (1776) to Berle and Means (1932), were concerned with the separation of ownership and control, which is with the agency relationship between a "principal" (investors, outsiders) and an "agent" (manager, entrepreneur, and insider). There is now widespread awareness that managers, say, may take actions that hurt shareholders.

Governance is concerned with the processes, systems, practices and procedures – the formal and informal rules – that govern institutions, the manner in which these rules and regulations are applied and followed, the relationships that these rules and regulations determine or create, and the nature of those relationships (Bebchuk, Cohen and Ferrell, 2004)

Essentially, governance addresses the leadership role in the institutional framework. Corporate Governance, therefore, refers to the manner in which the power of a corporation is exercised in the stewardship of the corporation's total portfolio of assets and resources with the objective of maintaining and increasing shareholder value and satisfaction of other stakeholders in the context of its corporate mission. It is concerned with creating a balance between economic and social goals and between individual and communal goals while encouraging efficient use of resources, accountability in the use of power and stewardship and as far as possible to align the interests of individuals, corporations and society (Gugler and Yurtoglu, 2003).

Corporate governance is a multi-faceted subject. An important theme of corporate governance is to ensure the accountability of certain individuals in an organization through mechanisms that try to reduce or eliminate the principal-agent problem. A related but separate thread of discussions focuses on the impact of a corporate governance system in economic efficiency, with a strong emphasis shareholders' welfare. There are yet other aspects to the corporate governance subject, such as the stakeholder view and the corporate governance models around the world (La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 2000).

2.5.1 Principles of Good Corporate Governance

Corporate Governance is concerned with the establishment of an appropriate legal, economic and institutional environment that would facilitate and allow business enterprises to grow, thrive and survive as institutions for maximizing shareholder value while being conscious of and providing for the well-being of all other stakeholders and society (Haniffa and Cooke, 2002).

Good Corporate Governance requires that the State puts in place and maintains an enabling environment in which efficient and well-managed companies can thrive. It is therefore expected that companies will continue to play their part in encouraging dialogue between the public and private sectors in promoting good public governance and an enabling business environment (Private Sector Initiative for Corporate Governance, 1999).

It is the responsibility of the owners of the corporation to elect competent directors and to ensure that they govern the corporation in a manner consistent with their stewardship. Good corporate governance dictates that the Board of Directors governs the corporation in a way that maximizes shareholder value and in the best interest of society. It is not in the long-term interest of the enterprise, or society, to short-change customers, exploit labour, pollute the environment or engage in corrupt practices.

The guidelines which follow set 21 principles of good corporate governance, aimed primarily at the Board of Directors in corporations with a unitary Board structure. These are followed by a sample code which expounds on these principles (Commonwealth Association for Corporate Governance, 1999).

The real fear is that managers may collect private benefits by building empires, enjoying perks, or even stealing from the firm by raiding its pension fund, by paying inflated transfer prices to affiliated entities, or by engaging in insider trading (Global Corporate Governance Forum Secretariat, 1999). Last, they may entrench themselves by investing in mature or declining industries that they are good at running, by taking risk that is either excessive (as when their position is endangered) or insufficient (as when it is secure), or by bending over backwards to resist a takeover.

The agency problem suggests a possible definition of corporate governance as addressing both an adverse selection and a moral hazard problem. A good governance structure is then one that selects the most able managers and makes them accountable to investors. This widely-held view can, for example, be found in Shleifer and Vishny's (1997) survey of the topic; they define corporate governance as "the ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment.

Key elements of good corporate governance principles include honesty, trust and integrity, openness, performance orientation, responsibility and accountability, mutual respect, and commitment to the organization (Commonwealth Association for Corporate Governance, 1999). Directors and management should develop a model of governance that aligns the values of the corporate participants and then evaluate this model periodically for its effectiveness. Furthermore senior executives should conduct themselves honestly and ethically, especially where conflicts of interest is apparent. The accepted principles of corporate governance include: Interests of other stakeholders; rights and equitable treatment of shareholders; role and responsibilities of the board; Integrity and ethical behavior and disclosure and transparency (Haniffa and Cooke, 2002).

The principle employed in this study relate to disclosure and transparency. The principle requirement is that organizations should clarify and make publicly known the roles and responsibilities of board and management to provide shareholders with a level of accountability. They should also implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Disclosure of material matters concerning the organization should be timely and balanced to ensure that all investors have access to clear, factual information. In Kenya, the following is a summary of the principles of good corporate governance as stipulated by Private Sector Initiative for Corporate Governance, (1999):

Members or shareholders of the corporation shall jointly and severally protect, preserve and actively exercise the supreme authority of the corporation in general meetings. According to Private Sector Initiative for Corporate Governance, (1999), shareholders have a duty jointly and severally, to exercise that supreme authority of the corporation to ensure that only competent and reliable persons, who can add value, are elected or appointed to the Board of Directors, the Board is constantly held accountable and responsible for the efficient and effective governance of the corporation so as to achieve corporate objectives, prosperity and sustainability and change the composition of a Board that does not perform to expectation or in accordance with the mandate of the corporation.

Every corporation should be headed by an effective Board that should exercise leadership, enterprise, integrity and judgment in directing the corporation so as to achieve continuing prosperity and to act in the best interest of the enterprise in a manner based on transparency, accountability and responsibility. Appointments to the Board of Directors should, through a managed and effective process, ensure that a balanced mix of proficient individuals is made and that each of those appointed is able to add value and bring independent judgment to bear on the decision-making process, (Private Sector Initiative for Corporate Governance, 1999).

The Board of Directors should determine the purpose and values of the corporation, determine the strategy to achieve that purpose and implement its values in order to ensure that the corporation survives and thrives and that procedures and values that protect the assets and reputation of the corporation are put in place. The Board should ensure that a proper management structure, organization, systems and people, is in place and make sure that the structure functions to maintain corporate integrity, reputation and responsibility (Gugler and Yurtoglu, 2003).

The Board should monitor and evaluate the implementation of strategies, policies and management performance criteria and the plans of the corporation. In addition, the Board should constantly review the viability and financial sustainability of the enterprise and must do so at least once every year. The Board should ensure that the corporation complies with all relevant laws, regulations, governance practices, accounting and auditing standards (Haniffa and Cooke, 2002).

The Board should ensure that the corporation communicates with all its stakeholders effectively. The Board should serve the legitimate interests of all members and account to them fully. The Board should identify the corporation's internal and external stakeholders; agree on a policy or policies determining how the corporation should relate to, and with them, in creating wealth, jobs and the sustainability of a financially sound corporation while ensuring that the rights of stakeholders, whether established by law or custom, are respected, recognized and protected.

The Board should ensure that no one person or group of persons has unfettered power and that there is an appropriate balance of power on the Board so that it can exercise objective and independent judgment. The Board should regularly review systems, processes and procedures to ensure the effectiveness of its internal systems of control so that its decision-making capability and the accuracy of its reporting and financial results are maintained at the highest level at all times. The Board should appoint the Chief Executive Officer and participate in the appointment of all senior management, ensure motivation and protection of intellectual capital crucial to the corporation, ensure that there is appropriate and adequate training for management and other employees and put in place a succession plan for senior management. The Board must recognize that to survive and thrive it has to ensure that the technology, skills and systems used in the corporation are adequate to run the corporation and that the corporation constantly reviews and adopts the same in order to remain competitive (Private Sector Initiative for Corporate Governance, (1999).

The Board must identify key risk areas and key performance indicators of the corporation's business and constantly monitor these factors. The Board should define, promote and protect the corporate ethos, ethics and beliefs on which the corporation premises its policies, actions and behaviour in its relationships with all who deal with it. The Board should recognize that it is in the enlightened self-interest of the corporation to operate within the mandate entrusted to it by society and shoulder its social responsibility. The above reason, Private Sector Initiative for Corporate Governance, (1999), contends that a corporation does not fulfill its social responsibility by short-changing beneficiaries or customers, exploiting its labour, polluting the environment, failing to conserve resources, neglecting the needs of the local community, evading taxation or engaging in other anti-social practices.

The Board should recognize and encourage professional development and, both collectively and individually, have the right to consult the corporation's professional advisers. Where necessary, the Board should seek independent professional advice at the corporation's expense in the furtherance of their duties as directors (Commonwealth Association for Corporate Governance, 1999).

2.5.2 Transparency Disclosure Index (TDI)

Corporate governance studies employ Transparency Disclosure Index (TDI) to measure the quality of corporate governance. Since the pioneering work of Cerf (1961), several different approaches have been adopted to measure disclosure quality and quantity, but there is no general theory that offers guidance on the selection of items to measure the extent of voluntary disclosure (Marston and Shrives, 1991). Disclosure, by its very nature, is an abstract construct that does not possess inherent characteristics by which one can determine its intensity or quality (Wallace and Naser, 1995).

Of primary importance is the definition of voluntary disclosure. For the purpose of this research, voluntary disclosure is defined as the discretionary release of financial and non-financial information through annual reports over and above the mandatory requirements, either with regard to the Kenyan company laws, professional accounting standards or any other relevant regulatory requirements.

Two important and contentious issues are often debated in the literature on the construction of disclosure indices. The first issue is whether some items should be weighted more heavily than others. The second is whether the weights should be externally generated (for example, with the aid of a user group such as financial analysts and bank loan officers), or researcher generated. Both weighted (Botosan, 1997, Chow and Wong-Boren, 1987, Eng, Hong, and Ho, 2001 and Firer and Meth, 1986) and unweighted (Cooke, 1989, 1991, Hossain et al., 1994 and

Owusu-Ansah, 1998) disclosure indices have been used in accounting research studies. Both approaches have shortcomings.

The use of an unweighted disclosure index has been criticised on its fundamental assumption that all items are equally important, and the use of a weighted disclosure index has been criticised because it may introduce a bias towards a particular user-orientation. Notwithstanding the subjectivity in weighting, all items cannot be of equal importance. In this research therefore, a weighted disclosure index is adopted on the premise that all items disclosed in firms' annual reports are not of equal importance. However, the tests were also conducted for an unweighted index and the results were consistent with those obtained for the weighted index (Cooke, 1989, 1991, Hossain et al., 1994 and Owusu-Ansah, 1998).

It is difficult in practice to establish the applicability of the disclosure items to every company in advance. At the item-selection stage, to control for this effect, the guiding principle was to ensure that the selection process was devoid of industry inclination (Barako D., Hancock P and Izan H, 2006). However, important disclosure items may still be inapplicable to an industry. For example, Research and Development disclosure may not be applicable to the banking industry as it is to agriculture or manufacturing industry. Thus, companies in this industry should not be penalised for non-disclosure of Research and Development information.

2.5.3 Corporate Governance in Africa

The Africa Capital Markets Forum is undertaking a study on the state of Corporate Governance in Africa. The King's Committee Report and Code of Practice for Corporate Governance in South Africa published in 1994 continue to stimulate corporate governance in Africa (Institute of Directors in Southern Africa, 2002).

Zimbabwe, Ghana, Uganda and South Africa have put in place national institutional mechanisms to promote good corporate governance. Training, technical and awareness raising support has been extended by the World Bank and the Commonwealth Secretariat to various African countries such as Botswana, Senegal, Tunisia, Mali, Mauritania, Cameroon, Gambia, Mozambique, Mauritius, Sierra Leone and Zambia to help them put in place appropriate mechanisms to promote good corporate governance (Mensah, 2000)

2.5.4 Corporate Governance in East Africa

Regional conferences were held in Kampala, Uganda, in June 1998 and September 1999 to create awareness and promote regional co-operation in matters of corporate governance. At the June 1998 Conference, it was resolved that each member state be encouraged to develop both a framework and a code of best practice, to promote national corporate governance, and that efforts be made to harmonize corporate governance in the East African region under the auspices of the East African Cooperation, and through the establishment of a regional apex body to promote corporate governance. At the September 1999 Conference, the earlier resolutions were re-affirmed and recommendations made, encouraging the member states to collaborate with other African initiatives in promoting good corporate governance (Private Sector Initiative for Corporate Governance, 1999).

Uganda has established the Institute of Corporate Governance of Uganda, and is formulating a national code of best practice for corporate governance. Tanzania is in the process of organizing an East African Regional Workshop on corporate governance early in the year 2000. In Kenya, the Private Sector Initiative for Corporate Governance continues to liaise with Uganda and Tanzania towards the establishment of a Regional Center of Excellence in Corporate Governance

2.5.5 Corporate Governance in Kenya

Consultative Corporate Sector seminars held in November 1998 and March 1999 resolved that a Private Sector Initiative for Corporate Governance be established to formulate and develop a code of best practice for corporate governance in Kenya; and to explore ways and means of facilitating the establishment of a national apex body [the National Corporate Sector Foundation] to promote corporate governance in Kenya co-ordinate developments in corporate governance in Kenya with other initiatives in East Africa, Africa, the Commonwealth and globally (Private Sector Initiative for Corporate Governance, 1999).

On October 8, 1999 the Corporate Sector at a seminar organized by the Private Sector Initiative for Corporate Governance formally adopted a national code of best practice for Corporate Governance to guide corporate governance in Kenya, and mandated the Private Sector Initiative to establish the Corporate Sector Foundation, and collaborate with the Global Corporate Governance Forum, the Commonwealth Association for Corporate Governance, the African Capital Markets Forum, Uganda and Tanzania in promoting good corporate governance (Ogola, 2000).

Like most Commonwealth countries, the Kenyan Companies Act (Chapter 486, Laws of Kenya), is based on and is substantially the same as the UK Companies Act of 1948 (Ogola, 2000). The Kenyan Companies Act sets the general framework for financial accounting and reporting by all registered companies in Kenya, and stipulates the basic minimum requirements with regard to financial reporting. Because of the limited details of the Act, financial reporting and regulation is supplemented by pronouncements of the Institute of Certified Public Accountants Kenya (ICPAK), extensively manifested in the adopted International Financial Reporting Standards (Barako, Hancock and Izan, (2006).

In fulfillment of its mandate as per the Accountants Act, the ICPAK is responsible for the development and implementation of accounting and auditing standards. The ICPAK has been engaged in the setting of Kenyan Accounting Standards (KASs) since the early 1980s. In order to enforce adherence to the highest standards of financial reporting, the ICPAK maintains a close working relationship with regulatory institutions such as the Central Bank of Kenya, and the Capital Markets Authority (Ahmed, 2003).

Also, the ICPAK is represented on the Disclosure and Standards Committee of the Capital Markets Authority. With respect to corporate governance, the Kenyan Centre for Corporate Governance (CCG), an affiliate of the Commonwealth Association for Corporate Governance (CACG) is the key institution that drives the corporate governance reforms. As a consequence, in 2002 the Kenyan Capital Markets Authority (CMA) issued a mandatory Corporate Governance code for public listed companies, modeled on the CCG principles for corporate governance in Kenya compiled in 1999. In 2005, CCG issued a draft guideline on reporting and disclosures in Kenya. The emphasis of the draft is on non-financial disclosure such as ownership structure, board composition and corporate social responsibility (Barako, Hancock and Izan, (2006).

The Kenya Government initiated reforms at the Nairobi Stock Exchange (NSE) aimed at transforming the exchange into a vehicle for mobilising domestic savings and attracting foreign capital investment. A key aspect of this reform is related to corporate governance practices. In 2000, the CMA issued draft corporate governance guidelines outlining significant changes to listed companies corporate governance practices – key among them were: establishment of an audit committee, independence of non-executive directors and separation of the roles of the CEO and board chair. Corporate financial reporting is an important part of the process for building investor confidence (Okeahalam and Akinboade (2003).

Kenya, with a Gross Domestic Product of Kenya Shillings (trillion) 1.48 (equivalent to 19.7 billion US dollars) and the largest stock market in Eastern Africa is the regional hub for trade and finance (Central Bank of Kenya, 2006). However, like other developing countries, the increasing budget deficit and the burden of non-performing state-owned corporations is predominant in the Kenyan economic context.

Given the increasing amount of focus on and the growing significance of the NSE as an important venue for attracting foreign investments and to encourage local residents to invest in shares, Kenyan companies may engage in voluntary disclosure as a means to enhance the value of their stocks. Moreover, there are empirical evidences suggesting that increased information disclosure reduces a firm's cost of capital by reducing information asymmetry (Botosan, 1997 and 2000).

However, most of the research attention is on the developed Western economies. In contrast, a limited number of research studies examined disclosure practices of companies in developing economies. In line with this assertion, Needles (1997), conducting a 32-year (1965-1996) review of 768 international accounting research articles noted that, "most attention was given to the United States (319 articles), followed by the United Kingdom (123 articles), Canada (58 articles)...over the entire period, the developing countries percentages decreased from 18% to 15%" (p. 208).

Corporate governance has become an important issue in many countries and the response has varied from a legislative response like the Sarbannes-Oxley Act in the USA to an adoption of best practice principles in countries like the UK and Australia. The results of this research may be useful for regulators in Kenya as they continue to deliberate the appropriate corporate governance requirements (Barako, Hancock and Izan, (2006).

This study also adds to the literature on voluntary disclosure in developing countries and extends that literature by including corporate governance variables as possible explanatory variables for voluntary disclosure. In addition and particularly in the governance context, after reviewing the corporate governance literature in the African context, Okeahalam and Akinboade (2003) concluded that: "there has been limited published research on corporate governance in Africa and even less rigorous academic or empirical research. There is an urgent need to embark on a meaningful analysis of corporate governance [research] in Africa" (p.28).

2.6 Corporate Governance and Firm Performance

In its 'Global Investor Opinion Survey' of over 200 institutional investors first undertaken in 2000 and updated in 2002, McKinsey found that 80% of the respondents would pay a premium for well-governed companies. They defined a well-governed company as one that had mostly out-side directors, who had no management ties, undertook formal evaluation of its directors, and was responsive to investors' requests for information on governance issues. The size of the premium that the investors were willing to pay varied by market, from 11% for Canadian companies to around 40% for companies where the regulatory backdrop was least certain (those in Morocco, Egypt and Russia).

Other studies have linked broad perceptions of the quality of companies to superior share price performance. In a study of five year cumulative returns of Fortune Magazine's survey of 'most admired firms', Antunovich, Laster and Mitnick (2000), found that those "most admired" had an average return of 125%, whilst the 'least admired' firms returned 80%. In a separate study Business Week enlisted institutional investors and 'experts' to assist in differentiating between boards with good and bad governance and found that companies with the highest rankings had the highest financial returns (Institute of Business Ethics, 2003).

On the other hand, research into the relationship between specific corporate governance controls and firm performance has been mixed and often weak. The following examples are illustrative: It is worth noting that James D. Wolfensohn, President of the World Bank, states that proper governance of companies will become as crucial to the world economy as the proper governance of countries. The International Corporate Governance Network was also established to promote and coordinate research and development in corporate governance (Ahmed, 2003).

2.7 Dividend Policy and Corporate Governance

Since Miller and Modigliani's (1961) seminal work on dividend irrelevance, a number of theories have been advanced to relax their assumptions of perfect capital markets. One crucial theory that has been extensively examined in the literature and has received supporting evidence is agency theory. Jensen's (1986) agency theory posits that dividend policy is determined by agency costs arising from the divergence of ownership and control. Due to agency costs, managers may not always adopt a dividend policy that is value-maximizing for shareholders.

Rather, they may choose dividend policy that maximizes their private benefits. Dividend payouts are argued to reduce agency conflicts by reducing the amount of free cash flow, which could be used by managers for their private benefits rather than for maximizing shareholders' wealth (Grossman and Hart, 1980, Easterbrook, 1984 and DeAngelo, DeAngelo, and Stulz, 2006). Furthermore, dividends help mitigate agency conflicts by exposing firms to more frequent monitoring by the primary capital markets as paying dividends increases the probability that new equity has to be issued more often (Easterbrook, 1984).

Motivated by agency theory, we explore the role of agency costs as an explanation of dividend payouts after controlling other determinants of dividend such as firm size, growth opportunities, life cycle, and profitability. Corporate governance exists to provide checks and balances between shareholders and management and thus to mitigate agency problems. Hence, firms with better governance quality should incur less agency conflicts. In such firms, managers should be less likely to adopt a sub-optimal dividend policy. As a result, the quality of corporate governance should have an impact on dividend policy.

Several recent notable studies investigate how dividend payouts are affected by corporate governance (Officer, 2007, John and Knyazeva, 2006 and Jiraporn and Ning, 2006). Useful though these studies may be, one critical limitation of these studies (and others in the literature) is that they do not capture the overall quality of corporate governance.

Previous studies examine only a few selected aspects of corporate governance, such as board structure and ownership structure, or simply use a narrow governance index to represent governance quality. Because specific governance mechanisms can and do interact with each other (Agrawal and Knoeber, 1996), studying individual governance mechanisms is not adequate. It is imperative to examine how the aggregate quality of corporate governance influences dividend policy.

Based on the literature, we advance two opposing hypotheses to explain the association between overall corporate governance quality and dividend payouts. First, the outcome hypothesis suggests that dividend policy is an outcome of governance quality. In firms with weak governance, opportunistic managers are able to retain more cash within the firm, making it more likely for the managers to spend cash to enhance their private benefits at the expense of shareholders. Dividend payouts are thus expected to be lower in these firms than in those with strong governance mechanisms.

This hypothesis predicts a positive association between dividend payouts and governance quality. By contrast, the substitution hypothesis argues that firms with weak governance pay larger dividends to substitute for their poor governance. Investors observe that firms with weak governance may be more prone to managerial entrenchment and rationally anticipate the larger extent of the free cash flow problem. As a result, investors demand larger dividends from firms with poor governance than from firms with strong governance. As paying dividends decrease the free cash flow and, therefore reduce what is left for expropriation by opportunistic managers. In other words, this substitution view implies an inverse association\ between dividend payouts and the quality of corporate governance.

The modern theory of dividend policy began with Miller and Modigliani (1961) who argue that dividend policy is irrelevant, holding constant the firm's investment policy. Since then, several hypotheses have been advanced to explain dividend policy.

Allen and Michaely (2002) offer an exhaustive literature review on dividend policy. One theory that has garnered strong empirical support is the agency theory. According to the agency theory, dividend policy is set so as to minimize agency costs- costs arising from the divergence of ownership and control. The literature in this area is predicated on the early work by Grossman and Hart (1980), Easterbrook (1984) and Jensen (1986).

Dividend payouts have been argued to mitigate agency conflicts by reducing the amount of "free" cash flow available to managers, who do not necessarily act in the best interests of the shareholders (Grossman and Hart, 1980, Easterbrook, 1984 and Jensen, 1986). Furthermore, Easterbrook (1984) argues that dividends help alleviate agency conflicts by exposing firms to more frequent monitoring by the primary capital markets because paying dividends increases the probability that new common stock has to be issued more often.

Agency theory suggests that outside shareholders have a preference for dividends over retained earnings because insiders might squander cash retained within the firm (Easterbrook, 1984, Jensen 1986, Myers 2000). This preference for dividends may be even stronger in emerging markets with weak investor protection if shareholders perceive a greater risk of expropriation by insiders in such countries. La Porta, Lopez-de- Silanes, Shleifer, and Vishny (LLSV, 2000) show that dividend payouts are higher, on average, in countries with stronger legal protection of minority shareholders. This finding lends support to what LLSV (2000) call the "outcome" agency model of dividends, which hypothesizes that dividends result from minority shareholders using their power to extract dividends from the firm.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter outlines the methodology which has been used in carrying out the study, to arrive at the desired research objectives. Aspects covered include research design, population, sampling design and sample selection, data collection methods and data analysis methods.

3.2 Research Design

This study adopted a regression research design to achieve the research objectives. Regression analysis refers to techniques for modeling and analyzing several variables, when the focus is on the relationship between a dependent variable and one or more independent variables. More specifically, regression analysis helps us understand how the typical value of the dependent variable changes when any one of the independent variables is varied, while the other independent variables are held fixed. Most commonly, regression analysis estimates the conditional expectation of the dependent variable given the independent variables - that is, the average value of the dependent variable when the independent variables are held fixed.

Regression analysis is widely used for prediction (including forecasting of time-series data). Regression analysis is also used to understand which among the independent variables are related to the dependent variable, and to explore the forms of these relationships. It can be used to infer causal relationships between the independent and dependent variables. Time series designs are useful for establishing a baseline measure, describing changes over time, keeping track of trends and forecasting future trends; thus, the design will be instrumental in linking corporate governance to dividend policy of companies in Kenya.

3.3 Population of the Study

The population of this study was all the public companies incorporated in Kenya and consistently listed on the Nairobi Stock Exchange's both Main Investment Segment (MIMS) and Alternative Investment Segment (AIS).

3.4 Sample Selection

Due to the relatively small number of companies listed on the NSE, all companies were considered for inclusion in the survey. However, the main criteria that were used for selecting the companies to be studied were: that the companies' annual reports must be available at the Nairobi Stock Exchange, and that the firm must have been listed for the entire period of the study – years 1999 to 2008. Of the 54 listed companies, 38 companies met the above criteria, and were elected for inclusion into the study.

3.5 Data Sources and Data Collection

The study relied on secondary data. These included accounting data, share prices, dividend payout ratio, and dividend yield of companies quoted at NSE on a yearly basis from NSE Yearbooks 1999 to 2008, business magazines, books, journals and from various published and unpublished material and companies' annual reports.

The financial data was obtained from the annual reports of the companies listed on the NSE. The statistics for the corporate governance index came from the companies' annual reports, filing with domestic regulatory agencies, and companies' corporate websites.

3.6 Data Analysis

Data analysis is a process of gathering, modeling, and transforming data with the goal of highlighting useful information, suggesting conclusions, and supporting decision making. Data analysis has multiple facets and approaches, encompassing diverse techniques under a variety of names, in different business, science, and social science domains.

The data was first edited to inspect its completeness. This was then coded, tabulated and processed using a simple computer spreadsheet to come up with statistical measures such as frequency means and modes. Tables were constructed that indicate the results obtained. These were input into SPSS, and analyzed.

CHAPTER FOUR

DATA ANALYSIS, PRESENTATION AND INTERPRETATION

4.1 Introduction

This chapter presents the analysis of the secondary data obtained from 38 sampled listed companies at the Nairobi Stock exchange for a period of ten (10) years, between 1999 and 2008. The findings were qualitatively analyzed to ascertain the level at which companies' transparency and disclosure index (TDI) affects corporate dividend policy in Kenya. These findings were presented in descriptive statistics, correlation matrix, analysis of the variance, Coefficients, Parameter and curve Estimates.

4.2 Descriptive Statistics

This gives a summary of the mean, standard deviation, minimum and maximum values of dividend payouts, Average percentage of TDI, average dividend per shares, average total earnings and average dividend paid in the previous year.

Table 4.1 Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Dividend Payout Ratios	10	27.50	49.00	38.30	7.81
Percentage Average of TDI	10	46.10	72.90	56.72	8.46
Average Dividends per share	10	0.35	1.13	0.67	0.27
Average Total Earnings Per share	10	1.26	2.31	1.68	0.37

The mean and standard deviation have been determined by taking a simple average of the 10 observations for each of these variables form 1999 to 2008. The number of observations is represented by (N). The mean value of 38.30 for dividend payout shows that Kenyan dividend payout rate has been growing at an average rate of 38.30% per year over the last 10years. However the 56.72% average TDI on the sampled companies illustrates that the corporate governance standards are on average within the listed sampled companies operating in NSE market with an average TDI of 56.72% growth rate.

The minimum value of Average percentage TDI is 46.1% and the maximum value is 72.9% showing that the level of TDI among the listed companies is still relatively low. The mean value of 1.68 for average total earnings per share shows that the inflow in dividends among the shareholders is an average of 1.68% over the last 10 years. This shows that TDI performs a major role on the corporate governance and dividend policy in Kenya.

4.3 Correlation Matrix

This has been generated to test whether there is any independent variable that affects or influences another independent variable. In any regression analysis, an assumption is made that the independent variable should not influence each other since it will be difficult to isolate the impacts of one independent variable on the dependent variable. This has determined the extent to which the study variables are correlated.

Table 4.2 Correlation Matrix

		Policy Payouts	Percentage Average of TDI per Years	Average Total Earnings Per share	Average Dividends per share
Pearson Correlation	Dividend Payouts	1.000	.951	.881	.912
	Percentage Average of TDI per Year	.951	1.000	.954	.961
	Average Total Earnings Per share	.881	.954	1.000	.979
	Average Dividends per share	.912	.961	.979	1.000

It is worth noting that the dividend payout, average TDI, average total earning and average dividend shares are highly correlated. We assume that this reflects the state and performance of the listed companies in Kenya. These companies need to enforce corporate governance standards in order to remain at the competitive edge with other companies within the globe. Furthermore, we assume that in those companies, foreign investors are guaranteed that the introduced corporate governance standards are kept with the aim to protect their own interest as well the interest of minority shareholders.

4.4 Analysis of the variance (ANOVA)

This has been used to test or determine the overall exploratory powers of the entire regression. ANOVA uses the F statistics or F ratio to test the hypothesis that the variations in the independent variables, (Average Dividends per share, Average Total Earnings Per share and Percentage Average of TDI per Years) explains the significant proportion of the variations in the dependent variable (Average dividend payout). This has used the F statistics to test the null hypothesis that all the regression coefficient are equal to zero gains the alternative hypothesis that they are not all equal to zero.

Table 4.3 Analysis of the variance (ANOVA)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.100	3	.033	23.551	.001[a]
	Residual	.008	6	.001		
	Total	.109	9			
a. Predictors: (Constant), Average Dividends per share, Percentage Average of TDI per Years, Average Total Earnings Per share						
b. Dependent Variable: Policy Payouts						

The calculated value of F statistics of 23.55 at 95% confidence level indicates that they are significantly correlated.

4.5 Coefficients of Independent variables

Here we tested the determinants of dividend policy in a regression framework to control the companies' specific characteristics other than governance. The independent variables in this analysis are Average Dividends per share, Average Total Earnings Per share, and Percentage Average of TDI per Years. Average Dividends per share has a coefficient of 0.236 which means that average dividend shares changes by an average of 0.236 per unit change in TDI, the average earnings has a coefficient of -0.062 which means that total earnings has a negative influence on TDI. TDI has a coefficient of 0.014 which means that the TDI changes by an average of 0.014 per unit change in dividend level.

Table 4.4 Coefficients of Independent variables

Model		Unstandardized Coefficients		Standardized Coefficients	t	Collinearity Statistics	
		B	Std. Error	Beta		Tolerance	VIF
1	Constant	1.425	.202		7.050		
	Percentage Average of TDI per Years	.014	.006	1.089	2.568	.073	13.776
	Average Total Earnings Per share	-.062	.055	-.653	-1.123	.039	25.873
	Average Dividends per share	.236	.293	.505	.803	.033	30.299

a. Dependent Variable: Policy Payouts

The table above gives the coefficients of the tested variables in the regression model. This shows that the TDI has appositive influence on the level of dividend payouts though the effect is not strong. The dividend payouts are positively associated with the variables such TDI, and totals earnings at 5% significant confidence level. This tested the association of corporate governance with dividend payout and Average TDI. The average total earnings was added to a certain the impacts and strength of shareholders rights on dividend policy.

From this study, it has been established that the increase in corporate governance index in terms of TDI by one point results in an increase in total earnings. At this point the study found out that the TDI is statistically significant at 1% or 5% confidence level. Therefore we assume that the TDI of corporate governance measure is a valid measure of minority shareholders protection and thus improved dividend payouts since the results presents a strong correlation between dividends payouts and companies' corporate governance ratings.

4.6 Time Series Analysis

The study used this to identify the nature of the phenomenon represented by the sequence of observations and forecasting (predicting the future values of the time series variable. The goal of this analysis requires that the pattern of observed time series data is identified and more or less formally described. Once the pattern is established, we can interpret and integrate it with other data that use it in our theory of the integrated phenomenon e.g. the average amount of dividend payouts

The Parameter Estimate

The variables parameter were estimated to minimize the sum of squared residuals, calculate new vales of the series beyond those included in the input dataset and compute confidence intervals for those predicted values.

Table 4.5 Model Summary and Parameter Estimates

Dependent Variable: Policy Payouts

	Model Summary					Parameter Estimates	
Equation	R Square	F	df1	df2	Sig.	Constant	b1
Growth	.900	71.723	1	8	.000	.502	.005
Exponential	.900	71.723	1	8	.000	1.652	.005

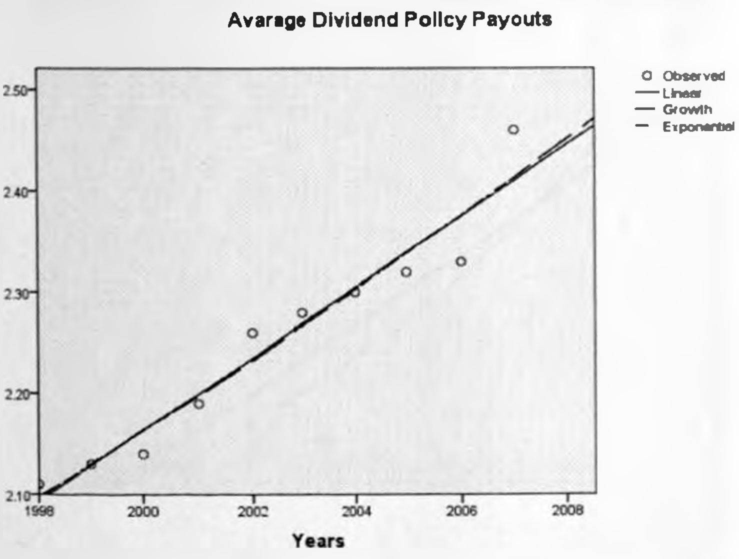
The independent variable is Percentage Average of TDI per Years.

The study used standard auto regressing and Auto Regressive Integrated Moving Average (ARIMA). The expected value of the constant 0.502 (denoted as μ) shows that there are auto regressive parameters and the value (0.502) represents the intercept or the mean of the predicted value. This also shows that the system or pattern repeats seasonally over time. This study established that the trend in data represents a general systematic linear components that changes and repeats itself over time.

Average Dividend Payout

The average divindend payout policy growth pattern is the dependent variable being stidied and the analisys has established that the dividend payout growth rates increases steadily over a period of 10years with the increase in TDI. This of evidenced by the growth pattern in the chart below

Chart 4.1 Average Dividend Payout

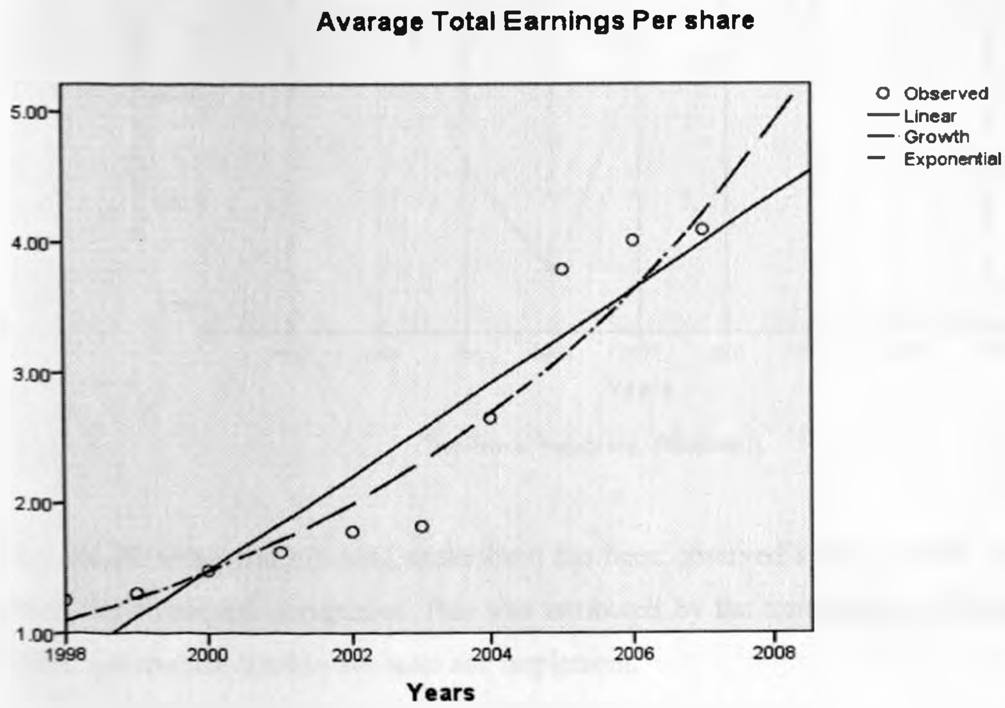


The graph also indicates that there is very steady, observable growth in the dividend payout level as it increases steadily with the increase in the level of TDI. Here the outliers were eliminated after considering the scatter plot of the dividend payout regressions involving corporate governance measure. The study still finds out that there is a significant and positive relationship between corporate governance practices (TDI) and dividend payouts.

Average Total Earnings per Share

This shows the relationship between total yearly earnings and Transparency Disclosure Index. This demonstrates that corporate governance is an important determinant in explaining the dividend policy to polish the performance of both public and private companies. In line with our predictions and influence of other factors, we find a strong positive correlation between TDI and dividend payouts.

Chart 4.2 Average Total Earnings Per Share

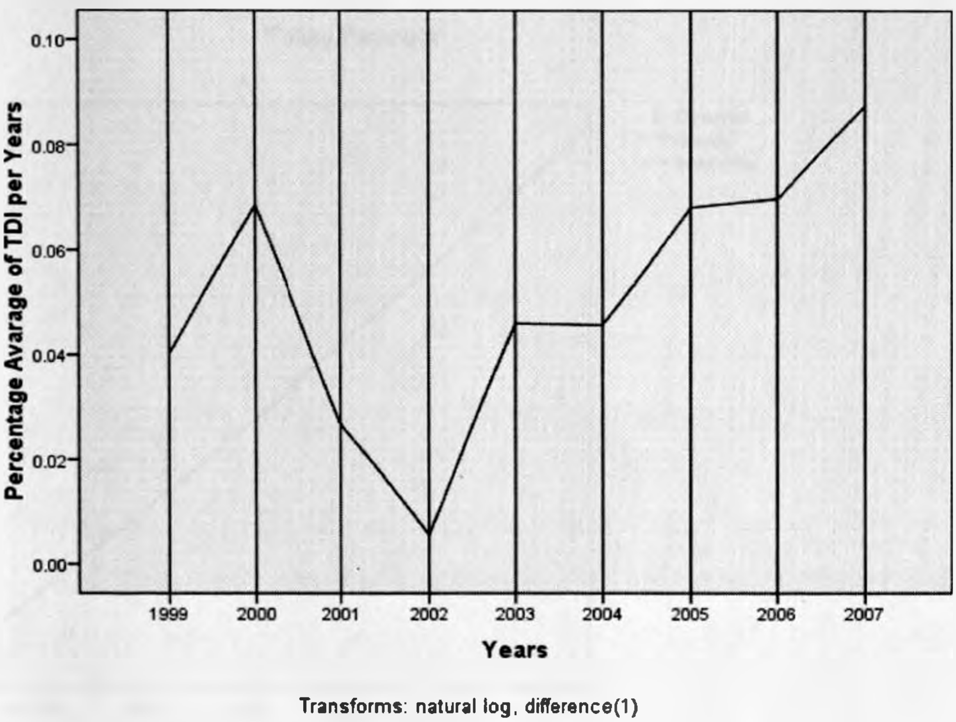


The figure illustrates the growth pattern of total earnings against Transparency Disclosure index over a period of ten years.

Average TDI Performance

This gives a summary of avarage TDI growth and performance trends for the sampled listed companies within NSE. This shows that there was observable growth in the first two yars this was followed by a very sharp drop in growth level which was attributed to efects of election euphobia with the operating companies tying not to disclose the bonafide shareholders to the public.

Chart 4.3 Average TDI Performance and Growth

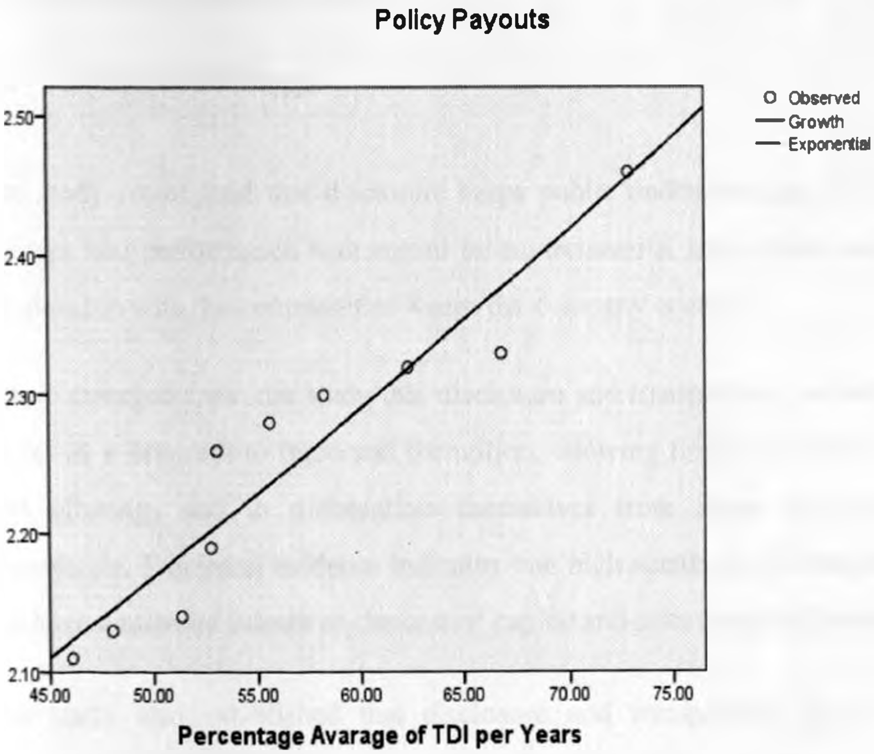


After the 2002 general election, again there has been observed steady growth in TDI index within these sampled companies. This was attributed by the transparency initiative that the NARC government tried to advocate and implement.

4.7 Relationship Between TDI and Dividend Payouts

The realtionship between this two study variables was tested using three methods; first using correlation coefficients to a certain the degree and level collinearity, second by the use of scatter lot and lastly by use of linear regression analysis. This aimed at analysing the effect of TDI and independent variable against Dividend payout as dependent variables.

Chart 4.4 Average TDI Performance and Growth



The figure above shows the summary of the scatter plot and and a linear regression line between these two variables.

CHAPTER FIVE

RESEARCH FINDINGS AND CONCLUSION

5.1 Introduction

After analysis and discussion in the foregoing pages, this section sets the summary research finding and conclusions. This chapter presents the study results in terms of introduction, research findings, study recommendations, conclusions, limitations of the study, and suggested areas for further study.

5.2 Research Findings

The study established that disclosure helps public understanding of a company's activities, policies and performance with regard to environmental and ethical standards, as well as its relationship with the communities where the company operates.

It also emerged from the study that disclosure and transparency, as well as proper auditing, serves as a deterrent to fraud and corruption, allowing firms to compete on the basis of their best offerings and to differentiate themselves from firms who do not practice good governance. Empirical evidence indicates that high standards of transparency and disclosure can have a material impact on the cost of capital and is an essential factor to risk assessment

The study also established that disclosure and transparency are the partners of good governance. They demonstrate the quality and reliability of information - financial and non-financial- provided by management to lenders, shareholders, and the public.

The study confirmed that reliable and timely information through TDI increases confidence among decision-makers within the organization and enables them to make good business decisions directly affecting growth and profitability.

It is established from the study that TDI ratings affect decision makers outside the firm e.g. shareholders, investors and lenders who must decide where and at what risk to place their money. This also shows decision-makers and outside interests whether and to what extent corporations meet legal requirements. The research has demonstrated that disclosure and transparency also enhance stock market liquidity and have material impact on the management and corporate governance practices.

5.3 Conclusions of the Study

Vibrant public securities markets rely on complex systems of supporting institutions that promote the governance of publicly traded companies. Corporate governance structures serves to ensure that minority shareholders receive reliable information about the value of firms and that a company's managers and large shareholders do not cheat them out of the value of their investments and to motivate managers to maximize firm value instead of pursuing personal objectives. Institutions promoting the governance through of firm's disclosure regimes that produce credible firm-specific information about publicly traded firms. In this paper, we discussed economics-based research focused primarily on the governance role of publicly reported financial accounting information.

Financial accounting information is the product of corporate accounting and external reporting systems that measure and routinely disclose audited, quantitative data concerning the financial position and performance of publicly held firms. Audited balance sheets, income statements, and cash-flow statements, along with supporting disclosures, form the foundation of the firm-specific information set available to investors and regulators.

Developing and maintaining a sophisticated financial disclosure regime is not cheap. Countries with highly developed securities markets devote substantial resources to producing and regulating the use of extensive accounting and disclosure rules that publicly traded firms must follow. Resources expended are not only financial, but also include opportunity costs associated with deployment of highly educated human capital, including accountants, lawyers, academicians, and politicians.

The project has added to the literature in corporate governance by showing that a firm's overall quality of corporate governance has a palpable effect on critical corporate decisions such as dividend policy. The study has also demonstrated a positive association between dividend payouts and corporate governance practice, indicating that firms pay higher dividends if shareholder rights are better protected. By extension, therefore, companies with weak shareholder rights pay dividends less generously than do firms with high corporate governance standards.

5.4 Recommendations of the Study

In line with the objectives of this study, this study proposes the following recommendations:

1. There should be well established laws that will positively influence the level of disclosure and corporate governance among companies listed within NSE, specifically governing major and minor shareholders ownership rights within the firm.

2. Corporate governance structure - in particular the division of authority between shareholders, management and board members - should be enhanced and given prominence by regulations governing the conduct and management of corporations.

3. The role of audits should be appreciated and strengthened in reporting on companies' financial and operating results. Audits should be conducted by an independent auditor in order to provide an objective assurance that the financial statements have been properly prepared and presented in accordance with the applicable accounting and reporting standards.

4. There should be market integration as this will bring consolidation of market liquidity and increase transparency level to foreign investors, hence attracting capital inflows.

5.5 Limitations of the Study

1. There was limited prior research on the relationship between corporate governance and dividend policy in Kenya.

2. The amount of information collected was enormous. The researcher had to discriminate among them through coding and deduction which greatly reduces the amount of data that can eventually be included in the final report.

3. Limited period of time and small sample size was a limitation of this study. Results may not be indicative for the entire target respondents at large.

4. The researcher's resources for these interviews were limited. A lot of time was required to prepare and collect information. Travel, appointments and logistical issues may have limited the scope of the study.

5.6 Suggestions for further research

1. The role of dividend payouts in the mitigation of agency conflicts in Kenya is a fertile area for more research.

2. Influence of Transparency Disclosure Index (TDI) on firms' governance mechanisms among the developing economies, such as Kenya.

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APPENDIX I

List of sampled companies:

1 A.Baumann & Co.Ltd
2 Athi River Mining Ltd.
3 Bamburi Cement Ltd.
4 Barclays Bank of Kenya Ltd.
5 BOC Kenya Ltd.
6 British American Tobacco Kenya Ltd.
7 Carbacid Investments Ltd.
8 City Trust Ltd
9 CMC Holdings Ltd.
10 Crown Berger (K) Ltd.
11 E.A Portland Cement Co. Ltd.
12 E.A. Breweries Ltd.
13 Eveready East Africa Ltd.
14 Express Ltd
15 Housing Finance Company of Kenya Ltd.
16 Hutchings Biemer Ltd.
17 Jubilee Insurance Co. Ltd
18 Kakuzi Ltd.
19 Kenya Airways Ltd.
20 Kenya Commercial Bank Ltd.
21 Kenya Oil Ltd.
22 Kenya Power & Lighting Co. Ltd.
23 Marshalls E.A. Ltd.
24 Mumias Sugar Company Ltd.
25 Nation Media Group Ltd.
26 National Bank of Kenya Ltd.
27 Olympia Capital Holdings Ltd.
28 Pan Africa Insurance Holdings Co. Ltd
29 Rea Vipingo Ltd.
30 Sameer Africa Ltd.
31 Sasini Tea & Coffee Ltd.
32 Standard Chartered Bank Ltd.
33 Standard Group Ltd.
34 The Co-operative Bank of Kenya Ltd.
35 Total Kenya Ltd.
36 Uchumi Supermarkets Ltd.
37 Unga Group Ltd.
38 Williamson Tea Kenya Ltd

APPENDIX II

Structure of the Transparency and Disclosure Index (TDI)

The Transparency and Disclosure Index (TDI) measures a broad set of corporate governance features for listed firms in Kenya using public information. Public sources include Annual Reports, fillings with national regulators, Internet sources, and business publications. For each feature, the company is given a value 1 if there is partial or total public information and 0 otherwise.

The Sub-Index Board measures the structure, procedures and compensation of board and top management members. The Sub-Index Disclosure measures the degree to which the company informs relevant corporate facts to outside stakeholders. Finally, the Sub Index Shareholders measures the quality of information regarding the compensation to minority shareholders.

Table 1: Transparency and Disclosure Index (TDI)

Item	% of firms with public information on each item
A. Board structure and procedures (TDI-Board)	
1. Independency criteria for directors	20.24
2. Years in office of present Directors	21.43
3. Code of Conduct for Directors	68.46
4. Manager and director fees	64.88
5. Form of manager and director fee payment (cash, stock, stock options)	47.03
6. Rationale of manager and director fees	31.55
7. Information on whether manager and director fees are performance-based	35.71
8. Shareholdings of managers and directors	67.86
9. Number and percentage of independent directors	22.62
10. Details on the nomination process of new directors	1.19
11. Report on issues by dissident directors	0.00
12. Composition of the different Board committees	5.95
13. Details on activities of the different Board committees	1.19
B. Disclosure (TDI-Disclosure)	
1. Bio of main company officers	31.55
2. Bio of Directors	25.59
3. Calendar of future events	38.10
4. English-translated corporate website	78.57
5. Financial indicators for the last 5 years	75.00
6. Strategic plan and projections for the following years	27.38
7. Publication of Board meeting resolutions	86.31
8. Publication of shareholders meeting resolutions	86.91

9. Details on the appointment process of new directors Details on attendance of minority and controlling shareholders in	0.60
10. shareholders' meetings	1.19
11. Reports on issues raised by dissident shareholders	0.00
12. Year of hiring of the external auditor	89.28
13. Report of the external auditor	89.28
C. Shareholders (TDI-Shareholders)	
1. Details of corporate ownership (principal shareholders)	86.91
2. Type and amount of outstanding shares	82.14
3. Document on internal corporate governance standards	1.19
4. Dividend policy in the past 5 years	17.26
5. Projected dividend policy for the following years	6.55
6. Rationale of the past and/or future dividend policy	10.12

Source: Kowalewski, Stetsyuk and Talavera, (2007)

APPENDIX III

The table below shows the Average Total Earnings Per Share (EPS), Average Dividends Per Share (DPS), Dividend Payout Ratios (DPR), and Average Score in Transparency Disclosure Index, for the years 1999 to 2008.

EPS is calculated as Earnings Before Interest and Tax (EBIT) divided by the total number of Shares; DPS is the average of the dividends announced once the fiscal year has ended; DPR is calculated as Dividends Paid to shareholders divided by EPS x 100%.

Years	Average Total Earnings Per Share (EPS)	Average Dividends Paid per Share (DPS)	Dividend Payout Ratio (%)	Percentage Average of TDI per year (%)
1999	1.26	0.35	27.50	46.10
2000	1.31	0.38	29.00	48.00
2001	1.30	0.40	31.00	51.40
2002	1.49	0.49	33.00	52.80
2003	1.54	0.57	37.00	53.10
2004	1.59	0.67	42.00	55.60
2005	1.88	0.81	43.00	58.20
2006	2.01	0.90	45.00	62.30
2007	2.07	0.96	46.50	66.80
2008	2.31	1.13	49.00	72.90
Sum	16.76	6.67	383.00	567.20
Mean	1.68	0.67	38.30	56.72
Max	2.31	1.13	49.00	72.90
Min	1.26	0.35	27.50	46.10
Std. Deviation	0.37	0.27	7.81	8.46