

**AN INVESTIGATION INTO THE RELATIONSHIP BETWEEN  
CORPORATE GOVERNANCE AND DIVIDEND POLICIES OF  
FIRMS LISTED IN THE NAIROBI STOCK EXCHANGE.**

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D61/P/8912/2004**

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**A MANAGEMENT RESEARCH SUBMITTED IN PARTIAL  
FULFILLMENT OF THE REQUIREMENT FOR THE AWARD OF  
MASTERS OF BUSINESS ADMINISTRATION (MBA) DEGREE,  
SCHOOL OF BUSINESS; UNIVERSITY OF NAIROBI.**


**AUGUST 2011**

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## **DEDICATION**

To my dear Dad and Mum for bringing me to this world and raising me with the greatest values and principles that have made me who I have become.

## **ACKNOWLEDGEMENTS**

First and foremost, I would like to express my deepest gratitude and appreciation to my supervisor, Mr. Lishenga who has assisted me throughout the project by way of guidance and encouragement.

I also wish to give thanks to my Parents, Brothers and Sisters who have tirelessly continued to give me both moral and financial support in my studies. They have been of great influence in my achievements.

Most importantly, I thank God the Almighty for giving me life and seeing me through to the end of my study and to where I am today.

## ABSTRACT

The effect of corporate governance on firm performance and thus dividends has long been of great interest to financiers, economists, behavioural scientists, legal practitioners and business operators. Yet there is no consensus over what constitutes an effective corporate governance mechanism that induces agents or managers to consistently act in the interest of share value optimization.

Corporate governance can influence a firm's performance whenever a conflict of interest arises between management and shareholders and/or between controlling and minority shareholders. In the management-shareholder conflict, the agency problem manifests itself in management's low effort and unproductive investments while the controlling-minority shareholder conflict, controlling shareholders use their power to benefit themselves at the expense of the minority shareholders.

The study aimed to investigate the relationship between corporate governance and dividend policies on the firms listed in the Nairobi Stock Exchange. An empirical study of the firms listed on NSE was conducted. It was facilitated by the use of secondary data, share ownership structures of the quoted firms and the dividend policies for the years 2004 and 2008 were obtained. The data collected was analyzed using regression and correlation analysis.

The findings of the study show that there is a strong positive relationship between corporate governance and dividend payout. Board of directors actually play an important role in the governance of corporations.

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## CHAPTER ONE

### INTRODUCTION

#### 1.1 Background to the Study

In a pioneering effort, Black (1976) finds no convincing explanation of why companies pay cash dividends to their shareholders. Since that introduction of the “dividend puzzle,” a voluminous amount of research offers alternative and appealing approaches to solve it. Most of them are rooted in information asymmetries between firm insiders and outsiders, and suggest that firms may indicate their future profitability by paying dividends.

The concept “corporate governance” has attracted various definitions. Metrick and Ishii (2002) define corporate governance from the perspective of the investors as “both the promise to repay a fair return on capital invested and the commitment to operate a firm, efficiently given investment”. The implication of this definition is that corporate governance has an impact on an investment and thus ultimately the dividend policies. Cadbury Committee (1992) defines corporate governance as “the system by which companies are directed and controlled” Zingales (1998) also defines a governance system as “the complex set of constraints that shape the ex-post bargaining over the quasi rent registered by the firm”.

The effect of corporate governance on firm performance and thus dividends has long been of great interest to financiers, economists, behavioural scientists, legal practitioners and business operators. Yet there is no consensus over what constitutes an effective corporate governance mechanism that induces agents or managers to consistently act in the interest of share value optimization.

Separation between ownership and control of corporations characterizes the existence of a firm. The design of mechanisms for effective corporate control to make managers act in the best interest of shareholders has been a major concern in the area of corporate

governance and finance (Allen and Gale, 2001), and continuing research in agency theory attempts to design an appropriate framework for such control. In a corporation, the shareholders are the principals and the managers are the agents working on behalf of, and for the interests of, the principals. In agency theory, a well-developed market for corporate controls is assumed to be non-existent, thus leading to market failures, non-existence of markets, moral hazards, asymmetric information, incomplete contracts and adverse selection among others. Various governance mechanisms have been advocated which include monitoring by financial institutions, prudent market competition, executive compensation, debt, developing an effective board of directors, markets for corporate control, and concentrated holdings. Developing an effective board of directors remains an important and feasible option for an optimal corporate governance mechanism.

According to Mayer (1997), corporate governance is concerned with ways of bringing the interest of investors and managers into line and ensuring that firms are run for the benefit of investors. Corporate governance is concerned with relationship between the internal governance mechanisms of corporations and society's conception of the scope of corporate accountability (Deakin and Hughes, 1997). It has also been defined by Keasey et al (1997) to include the structure, processes, cultures and systems that engender the successful operation of organizations. Corporate governance is also seen as the whole set of measures taken within the social entity that is an enterprise to favour the economic agents to take part in the productive process, in order to generate some organizational surplus, and to set up a fair distribution between the partners, taking into consideration what they have brought to the organization. It may be stated more generally that different systems of corporate governance will embody what are considered to be legitimate lines of accountability by defining the nature of the relationship between the company and key corporate constituencies.

Gómez (1996), Fluck (1998), Myers and Majluf (1984) recognize that dividend policies address agency problems between corporate insiders and shareholders. Grossman and Hart (1980) point out that the dividend payouts mitigate agency conflicts by reducing the amount of free cash flow available to managers, who do not necessarily act in the best



interests of shareholders. Jensen (1986) agrees and argues that a company with substantial free cash flows is inclined to adopt investment projects with negative net present values. If managers increase the amount of dividend, all else being equal, it reduces the amount of free cash flows, thereby mitigating the free cash flow problem. Thus, dividend payouts may help control agency problems by getting rid of the excess cash that otherwise could result in unprofitable projects. 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. This, in turn, leads to an investigation of management by investment banks, security exchanges, and capital suppliers.

Miller and Modigliani (1961) found that dividend policy is irrelevant to stock price in perfect and efficient capital markets. In that setup, no rational investor has a preference between dividends and capital gains. Arbitrage ensures that dividend policy is irrelevant. Another idea, which has received only limited attention until recently (Easterbrook, 1984, Jensen, 1986, Fluck, 1998, 1999, Hart and Moore, 1974, Myers, 1998, Gomes, 2000, and Zwiebel, 1996), is that dividend policies address agency problems between corporate insiders and outside shareholders. According to these theories, unless profits are paid out to shareholders, they may be diverted by the insiders for personal use or committed to unprofitable projects that provide private benefits for the insiders.

The so-called Dividend Puzzle (Black, 1976) has preoccupied the attention of financial economists at least since Modigliani and Miller's seminal work (see Modigliani and Miller, 1958 and Miller and Modigliani, 1961). This work established that, in a frictionless world, when the investment policy of a firm is held constant, its dividend payout policy has no consequences for shareholder wealth. Higher dividend payouts lead to lower retained earnings and capital gains, and vice versa, leaving total wealth of the shareholders unchanged. Contrary to this prediction, however, corporations follow extremely deliberate dividend payout strategies (Lintner, 1956). This evidence raises a puzzle: How do firms choose their dividend policies?

Another idea, which has received limited attention until recently (e.g., Easterbrook, 1984, Jensen, 1986, Fluck, 1998, 1999, Hart and Moore, 1974, Myers, 1998, Gomes, 2000, and Zwiebel, 1996), is that dividend policies address agency problems between corporate insiders and outside shareholders. According to these theories, unless profits are paid out to shareholders, they may be diverted by the insiders for personal use or committed to unprofitable projects that provide private benefits for the insiders. As a consequence, outside shareholders have a preference for dividends over retained earnings. Theories differ on how outside shareholders actually get firms to disgorge cash. The key point, however, is that failure to disgorge cash leads to its diversion or waste, which is detrimental to outside shareholders' interest.

Dividend policy may be one indicator of conflicts of interest between minority investors and owners or managers, but it is clearly not the only one. Agency problems may lead to overinvestment, excess resource consumption of various kinds, inflated salaries and the like (Thomsen, 2004). It is even possible that smart insiders will prefer to keep dividends high as a visible signal of good faith to the minority investors while they behave more selfishly in other respects. Nevertheless, the level of blockholder ownership may influence stock market reactions to changes in dividends (and dividend policy may influence stock market reactions to changes in blockholder ownership). Moreover, investors may be more concerned about the cumulated effects of dividend policies over a period of time (for instance the cash reserves of the company) than about pay out ratios in a given year (Thomsen, 2004).

## **1.2 Statement of the Problem**

The reasons why firms pay dividends or not has been under a heated debate for the last five decades since the seminal paper by Lintner (1956). This and many subsequent pieces of research convincingly established that firms aim to avoid drastic changes in dividends over time.

Previous research done on corporate governance, dividend policies and firm performance in Kenya include a study of corporate governance by Jebet (2001) in which she set to

determine the existing corporate governance structures in publicly quoted companies in Kenya. Her findings were that most listed firms had both executive and non executive directors as the supreme control body which is assisted by various committees. Other research studies conducted in the area of corporate governance and board of directors are: Mululu (2005), the relationship between the board activity and firm performance who concluded that those firms with active boards performed better than those with inactive boards. Mululu (2005), study found out that the frequency of board meetings is related to the number of corporate governance variables, such as the board size, the number of executive directors, number of total shares held by largest shareholders, the number of shares held by unaffiliated block holders, the number of percentage of shares held by officers and directors and the number of other directorship held by outside directors. This studies point to the agency problem and the fact that corporate governance is likely to affect performance however they are limited in so far as they do not attempt to look at the effect this is likely to have on dividend policies. Mulinge (2008) studies the effect of blockholder ownership on dividend policies of firms listed on NSE and concluded that agency problem type 2 between blockholders and minority shareholders play a big role and thus affect the dividend policies. Tonui (2009) studied the relationship between board size as a corporate governance variable with share performance and found that there exists a strong correlation between the two.

Considering the important role the directors' play in creating value for the shareholders of corporations and the associated agency problem, this research attempts to answer the questions; is there a relationship between corporate governance and the dividend policy of a firm; if so, what is the nature of the relationship?

### **1.3. Objectives of the Study**

Determine whether a relationship exists between corporate governance and the dividend policy of a firm.

#### **1.4 Justification of the study**

Dividend decisions are a concept that financial decision makers have to learn to live with. This is because it is a concept that is not optional and its effects on a firm depend largely on the financial decisions of the firm.

The findings of this project will assist in answering the following questions;

- I. Do the corporate governance practices have an effect on the dividend decisions of quoted companies?
- II. Are the Kenyan financial decision makers sensitive to the influence of corporate governance while making dividend decisions?

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

The answers to the above study questions will have a two-pronged approach to solving the disparities that are caused by the dividend policies adopted. The findings of the study may lead to one or both of the following key approaches being adopted;

- I. Financial managers will be more sensitive to the influence that the corporate governance and the agency problems have to the decisions they make with regard to the dividend policies of quoted companies. Financial Managers will further identify whether Miller's (1977) dividend policy irrelevancy is a feasible firm level policy.
- II. Alternatively the government policy makers will pursue corporate governance reforms that will influence the corporate dividend policy; in this agency problems reforms will be aimed at eliminating bias against type 2 agency conflicts by quoted companies and other firms.
- III. Scholars who will study the dividend theory will be made aware of the association between the corporate governance and the dividend policies of quoted companies.

## CHAPTER TWO

### LITERATURE REVIEW

#### 2.1 Introduction

This chapter looks into the various empirical studies and previous local studies on corporate governance and dividend policies. In addition it looks at theories relevant to the study, the Significance of corporate governance on dividend policies.

#### 2.2 Theoretical Literature Review

Agents or managers may not always act in the best interest of shareholders when the control of a company is separate from its ownership. In June 1959, Simon Herbert (quoted in Baysinger and Hoskisson, 1990) proclaimed that managers might be “satisfiers” rather than “maximizers,” that is, they tend to play it safe and seek an acceptable level of growth because they are more concerned with perpetuating their own existence than with maximizing the value of the firm to its shareholders. But shareholders delegate decision-making authority to the agent (CEO) with the expectation that the agent will act in their best interest.

A comprehensive theory of the firm under agency arrangements was developed by Jensen and Meckling (1976), who show that the principals (the shareholders) can assure themselves that the agent will make the optimal decisions only if appropriate incentives are given and only if the agent is monitored. Incentives include such things as stock options, bonuses and prerequisites which are directly related to how well the results of management’s decisions serve the interests of shareholders. Monitoring consists of bonding the agent, systematic reviews of management prerequisites, financial audits, and placing specific limits on management decisions. These involve costs, which are an inevitable result of the separation of corporate ownership and control. Such costs are not necessarily bad for shareholders, but the monitoring activity they cover needs to be efficient.

In contrast, Demesetz (1983) and Fama and Jensen (1983) suggest that the primary monitoring of managers comes not from the owners but from the managerial labour market. It is argued that management control of a large corporation is completely separate from its security ownership. Efficient capital markets provide signals about the value of a company's securities and thus about the performance of its managers. If the managerial labour market is competitive both within and outside the firm, it will tend to discipline the manager. Therefore, the signals given by changes in the total market value of the firm's securities become very important.

Kaplan and Reishus (1990) find evidence consistent with this argument: directors of poorly performing firms, who therefore may be perceived to have done a poor job overseeing management, are less likely to become directors at other firms. On the other hand, reputational concerns do not correct all agency problems and can, in fact, create new ones.

A great deal of attention has been given to understanding how corporate governance and ownership structures affect firm performance. Corporate governance can influence a firm's performance whenever a conflict of interest arises between management and shareholders and/or between controlling and minority shareholders. In the management-shareholder conflict, the agency problem manifests itself in management's low effort and unproductive investments, usually known as perquisites. In the controlling-minority shareholder conflict, controlling shareholders use their power to benefit themselves at the expense of the minority shareholders, in what is called expropriation or private benefits of control. The root of both conflicts is the fact that the manager in the first case, and the controlling shareholders in the second case, receives only a portion of the firm's net revenue, while they fully appropriate the resources diverted. Thus, it is conceivable that, in light of this incentive structure, insiders will maximize their (pecuniary and non-pecuniary) utility even when the firm as a whole will not.

Of course, the ability to fulfill these goals is conditioned on the power insiders have in the company's decision-making process. Managers will enjoy more power as they are

part of the board or act in connivance with the board and the controlling shareholders. In turn, the power of controlling shareholders relies in how effectively they can manipulate board decisions by way of voting majorities and other means; distortionary policies will then increase as the ratio of voting to cash flow rights is higher (see La Porta et al., 1999, and Claessens et al., 1999). Outsiders have two main instruments to counterbalance this power: the enforcement of adequate corporate governance standards and the quality of the regulatory and legal environment, which should discourage detrimental actions by insiders and, once committed, allow affected stakeholders to challenge them through corporate and judicial channels.

While a wedge between control and cash flow rights is likely to harm minority shareholders and corporate valuation, Jensen and Meckling (1976) and Morck, Shleifer and Vishny (1988) make the point that concentrated ownership may actually have an ambiguous effect: on one hand, there may be a beneficial effect on performance and valuation (the so-called “incentive effect”) in that higher cash flows rights in the hands of a few shareholders tends to reduce the free riding problem associated with dispersed ownership when it comes to monitoring and punishing opportunistic managers; on the other hand, the negative effect (the “entrenchment effect”) above mentioned may take place whenever there is high concentration of control rights and/or separation between control and cash flow rights (Claessens et al. 1999).

The concept “corporate governance” has attracted various definitions. Metrick and Ishii (2002) define corporate governance from the perspective of the investors as “both the promise to repay a fair return on capital invested and the commitment to operate a firm, efficiently given investment”. The implication of this definition is that corporate governance has an impact on an investment Cadbury Committee (1992) defines corporate governance as “the system by which companies are directed and controlled” Zingales (1998) also defines a governance system as “the complex set of constraints that shape the ex-post bargaining over the quasi rent registered by the firm”.

According to Mayer (1997), corporate governance is concerned with ways of bringing the interest of investors and managers into line and ensuring that firms are run for the benefit of investors. Corporate governance is concerned with relationship between the internal governance mechanisms of corporations and society's conception of the scope of corporate accountability (Deakin and Hughes, 1997). It has also been defined by Keasey et al (1997) to include the structure, processes, cultures and systems that engender the successful operation of organizations. Corporate governance is also seen as the whole set of measures taken within the social entity that is an enterprise to favour the economic agents to take part in the productive process, in order to generate some organizational surplus, and to set up a fair distribution between the partners, taking into consideration what they have brought to the organization. It may be stated more generally that different systems of corporate governance will embody what are considered to be legitimate lines of accountability by defining the nature of the relationship between the company and key corporate constituencies. Thus, corporate governance systems may be thought of as mechanisms for establishing the nature of ownership and control or organizations within an economy. In this context, "corporate governance mechanisms are economic and legal institutions that can be altered through the political process – sometimes for the better (Shleifer and Vishny, 1997).

International evidence has greatly increased in the last few years. Claessens et al. (1999), Klapper and Love (2002) and La Porta et al. (2002) are prominent efforts in proving the nexus between corporate governance and performance using cross-country data, while other studies look at individual countries, such as the United States (see Gompers, Ishii and Metrick, 2003), Korea (see Black, Jang and Kim, 2003) and Germany (see Drobetz, Schillhoffer and Zimmermann, 2003). By aiming to analyze the relationship between corporate governance and ownership structure with performance (as measured by the return on assets and Tobin's q) in Argentina in 2000-2003, the present work forms part of the latter country-level line of research.



### 2.2.1 Agency Problem and Dividend Policies

The so-called dividend puzzle (Black, 1976) has preoccupied the attention of financial economists at least since Modigliani and Miller's seminal work (see Modigliani and Miller, 1958; and Miller and Modigliani, 1961). This work established that, in a frictionless world, when the investment policy of a firm is held constant, its dividend payout policy has no consequences for shareholder wealth. Higher dividend payouts lead to lower retained earnings and capital gains, and vice versa, leaving total wealth of the shareholders unchanged. Contrary to this prediction, however, corporations follow extremely deliberate dividend payout strategies (Lintner, 1956). This evidence raises a puzzle: How do firms choose their dividend policies?

Recent empirical research indicates that in many countries the relevant corporate finance issue is not the traditional agency problem between management and shareholders, but rather the agency problem between the controlling shareholders and the minority shareholders. This problem may arise in some countries for two reasons: I) the corporate governance structure of public companies insulates large shareholders—that is, those with a majority of the votes and often with an involvement in the firm's management—from takeover threats or monitoring; (La Porta et al, 1999 for evidence from 27 countries comprising countries from European Union and United States, and Franks and Mayer, 1990, 1994 for evidence in Germany and France and ii) the legal system does not protect minority shareholders because of either poor laws or poor enforcement of laws. Despite the lack of protection for minority shareholders, the average ratio of stock market capitalization held by minorities to gross national product is greater than 40 percent in a sample of 49 countries. This raises the question of why people are willing to be minority shareholders when they know that neither corporate governance mechanisms, such as takeovers and monitoring, nor laws protect them from expropriation by large shareholders. This paper seeks to determine whether dividends could provide a simple answer to this puzzle.

In Kenya and other countries, the puzzle is even deeper since shareholders are taxed more heavily on their dividend receipts than on capital gains. The actual magnitude of this tax

burden is debated (Poterba and Summers, 1985 and Allen and Michaely, 1997), but taxes generally make it even harder to explain dividend policies of firms.

Economists have proposed a number of explanations of the dividend puzzle. Of these, particularly popular is the idea that firms can signal future profitability by paying dividends (Bhattacharya, 1979; John and Williams, 1985; Miller and Rock, 1985; and Ambarish, John, and Williams, 1987). Empirically, this theory had considerable initial success, since firms that initiate or raise dividends experience share price increases, and the converse is true for firms that eliminate or cut dividends (Aharony and Swary, 1980; Asquith and Mullins, 1983). Recent results are more mixed, since current dividend changes do not help predict firms' future earnings growth (DeAngelo et al, 1996).

Another idea, which has received only limited attention until recently (e.g., Easterbrook, 1984; Jensen, 1986; Fluck, 1998, 1999, Hart and Moore, 1974; Myers, 1998; Gomes, 2000, and Zwiebel 1996), is that dividend policies address agency problems between corporate insiders and outside shareholders. According to these theories, unless profits are paid out to shareholders, they may be diverted by the insiders for personal use or committed to unprofitable projects that provide private benefits for the insiders. As a consequence, outside shareholders have a preference for dividends over retained earnings. Theories differ on how outside shareholders actually get firms to disgorge cash. The key point, however, is that failure to disgorge cash leads to its diversion or waste, which is detrimental to outside shareholders' interest.

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 et al, 2003). Furthermore, agency theory

suggests that shareholders may prefer dividends, particularly when they fear expropriation by insiders. As a consequence, we hypothesize in this paper that dividend payouts are determined by the strength of corporate governance.

The literature suggests that minority shareholders may be at risk in companies controlled by strategic stakeholders (Shleifer and Vishny, 1986). Additionally, with the lack of board independence, many companies are open to potential expropriation. Such situation is typical to most European countries.

The agency approach moves away from the assumptions of the Modigliani–Miller theorem by recognizing two points. First, the investment policy of the firm cannot be taken as independent of its dividend policy, and, in particular, paying out dividends may reduce the inefficiency of marginal investments. Second, and more subtly, the allocation of all the profits of the firm to shareholders on a pro rata basis cannot be taken for granted, and in particular the insiders may get preferential treatment through asset diversion, transfer prices, and theft—even holding the investment policy constant. Insofar as dividends are paid on a pro rata basis, they benefit outside shareholders relative to the alternative of expropriation of retained earnings.

La Porta et al (2000) in their study on agency problem conclude that firms in common law countries, where investor protection is typically better, make higher dividend payouts than firms in civil law countries do. Moreover, in common but not civil law countries, high growth firms make lower dividend payouts than low growth firms. These results support the version of the agency theory in which investors in good legal protection countries use their legal powers to extract dividends from firms, especially when reinvestment opportunities are poor.

The agency approach moves away from the assumptions of the Modigliani–Miller theorem by recognizing two points. First, the investment policy of the firm cannot be taken as independent of its dividend policy, and, in particular, paying out dividends may reduce the inefficiency of marginal investments. Second, and more subtly, the allocation of all the profits of the firm to shareholders on a pro rata basis cannot be taken for

granted, and in particular the insiders may get preferential treatment through asset diversion, transfer prices, and theft—even holding the investment policy constant. Insofar as dividends are paid on a pro rata basis, they benefit outside shareholders relative to the alternative of expropriation of retained earnings.

The role of large owners in the economy is one of the most important topics in corporate governance. Theoretically, large owners (blockholders) may play a valuable role by reducing the (type 1) agency problems between shareholder and managers, but recent research has emphasized that large blockholdings give rise to a second (type 2) agency problem between blockholders and minority investors (Shleifer and Vishny, 1997, Becht et al 2002). Type 1 agency problem is the traditional conflict of interest between managers and shareholders for instance awarding themselves large perks. Type 2 agency problem involves conflicts of interest between corporate insiders, such as managers and controlling shareholders (blockholders), on the one hand, and outside investors, such as minority shareholders, on the other hand (Jensen and Meckling, 1976). The insiders who control corporate assets can use these assets for a range of purposes that are detrimental to the interests of the outside investors. They can divert corporate assets to themselves, through outright theft, dilution of outside investors through share issues to the insiders, excessive salaries, asset sales to themselves or other corporations they control at favorable prices, or transfer pricing with other entities they control ( Shleifer and Vishny, 1997). Alternatively, insiders can use corporate assets to pursue investment strategies that yield them personal benefits of control, such as growth or diversification, without benefiting outside investors (Baumol, 1959; Jensen, 1986).

One of the principal remedies to agency problems is the law. Corporate and other law gives outside investors, including shareholders, certain powers to protect their investment against expropriation by insiders. These powers in the case of shareholders range from the right to receive the same per share dividends as the insiders, to the right to vote on important corporate matters, including the election of directors, to the right to sue the company for damages. The very fact that this legal protection exists probably explains why becoming a minority shareholder is a viable investment strategy, as opposed to just

being an outright giveaway of money to strangers who are under few if any obligations to give it back.

Since the early 1980s, a host of papers offer alternative and appealing approaches to disentangle this enigma, most of them rooted in information asymmetries between firm insiders and outsiders and bounded rationality of the latter (see Baker et al., 2003, for a survey and Bebchuk, 2003, for a textbook presentation). One of such recent hypotheses is that firms pay dividends to credibly signal their quality to the market in order to mitigate the undervaluation that arises in an adverse selection context. By paying high and stable dividends, high-quality companies might distinguish themselves from low-quality competitors for funds (see, for example, Miller and Rock 1985), which may be unable to mimic the first group—unlike poor-performance companies, profitable firms can replace the diminished retained earnings with the more expensive external funds. Another strand of literature focuses on agency problems between managers and shareholders, making the point that higher dividends partially prevent managers from risking moral hazard at the expense of shareholders, by reducing the free cash flow at the disposal of those running the firm (see Jensen, 1986). Finally, other scholars have put forward behavioral explanations that support the investor preference for cash dividends, such as the psychological (but not necessarily rational from a purely financial standpoint) loss derived from the principal reduction of selling stock or regret at liquidating stock just before its price rises.

## **2.3 Agency and Dividends**

### **2.3.1. The Role of Dividends in an Agency Context**

In a world of significant agency problems between corporate insiders and outsiders, dividends can play a useful role. By paying dividends, insiders return corporate earnings to investors and hence are no longer capable of using these earnings to benefit themselves (La Porta et al, 2000). Dividends (a bird in the hand) are better than retained earnings (a bird in the bush) because the latter might never materialize as future dividends (can fly away). Additionally, the payment of dividends exposes companies to the possible need to come to the capital markets in the future to raise external funds, and hence gives outside

investors an opportunity to exercise some control over the insiders at that time (Easterbrook, 1984).

Unfortunately, there are no fully satisfactory theoretical agency models of dividends that derive dividend policies as part of some broad optimal contract between investors and corporate insiders, which allows for a range of feasible financing instruments. Instead, different models, such as Fluck, (1998; 1999), Myers, (1998), and Gomes, (2000), capture different aspects of the problem. Moreover, the existing agency models do not fully deal with the issues of choice between debt and equity in addressing agency problems, the choice between dividends and share repurchases, and the relationship between dividends and new share issues. La Porta et al, (2000), attempts to distill from the available literature the basic mechanisms of how dividends could be used to deal with agency problems. In particular, they distinguish between two very different agency “models” of dividends. The predictions of these models that they test are however, necessarily limited by the fact that they do not look at all the financing and payout choices simultaneously.

### **2.3.2 Dividends as an Outcome of Legal Protection of Shareholders (Outcome Model).**

Under the first view, dividends are an outcome of an effective system of legal protection of shareholders. Under an effective system, minority shareholders use their legal powers to force companies to disgorge cash, thus precluding insiders from using too high a fraction of company earnings to benefit themselves. Shareholders might do so by voting for directors who offer better dividend policies, by selling shares to potential hostile raiders who then gain control over non-dividend paying companies, or by suing companies that spend too lavishly on activities that benefit only the insiders. Moreover, good investor protection makes asset diversion legally riskier and more expensive for the insiders, thereby raising the relative attraction of dividends for them. The greater the rights of the minority shareholders, the more cash they extract from the company, other things equal (La Porta et al, 2000).

It is important to recognize that this argument does not rely on minority shareholders having specific rights to dividends per se, but rather on their having the more general rights of voting for directors and protesting wealth expropriation. A good example from the United States is Kirk Kerkorian forcing Chrysler Corporation to disgorge its cash by paying dividends in 1995 to 1996. As a large shareholder in Chrysler, Kerkorian had no specific rights to dividends, but used the voting mechanism to put his associates on the board and then force the board to sharply raise dividends. Another good example is Velcro Industries, the producer of the famous “touch fastener” incorporated on the island of Curaçao in the Netherlands Antilles, “where shareholders have no right of dissent” (*Forbes*, October 15, 1990). Two-thirds of the shares of Velcro Industries are controlled by the Cripps family that runs Velcro (*Forbes*, May 23, 1994). In 1988, despite having a large cash reserve, the company suspended dividends “for the foreseeable future” (*Forbes*, October 3, 1988), delisted itself from the Montreal Stock Exchange, and aggressively wrote down assets to slash earnings, evidently to “buy out Velcro minority holders cheap” (*Forbes*, May 23, 1994). The share price dived and, in 1990, with dividends remaining at zero, the Crippses offered to repurchase minority shares at slightly above the market price.

Minority shareholders sued in New York and “when a New York judge ruled that the United States was the proper jurisdiction, secretive Sir Humphrey Cripps decided to call off his offer rather than go under the light of U.S. court of law” (*Forbes*, May 23, 1994). The company subsequently resumed its dividend payments. This case illustrates that, in a high protection country like the United States, in contrast to a low protection country like the Netherlands, shareholders are able to extract dividends from companies by virtue of their ability to resist oppression rather than having any specific dividend rights per se (La Porta et al, 2000).

### 2.3.3. Dividends as a Substitute for Legal Protection of Shareholders (Substitute Model).

In an alternative agency view, dividends are a substitute for legal protection. This view relies crucially on the need for firms to come to the external capital markets for funds, at least occasionally (La Porta et al, 2000). To be able to raise external funds on attractive terms, a firm must establish a reputation for moderation in expropriating shareholders. One way to establish such a reputation is by paying dividends, which reduces what is left for expropriation. For this mechanism to work, the firm must never want to “cash in” its reputation by stopping dividends and expropriating shareholders entirely. The firm would never want to cash in if, for example, there is enough uncertainty about its future cash flows that the option of going back to the capital market is always valuable (Bulow and Rogoff, 1989).

A reputation for good treatment of shareholders is worth the most in countries with weak legal protection of minority shareholders, who have little else to rely on (La Porta et al, 2000). As a consequence, the need for dividends to establish a reputation is the greatest in such countries. In countries with stronger shareholder protection, in contrast, the need for a reputational mechanism is weaker, and hence so is the need to pay dividends. This view implies that, other things equal, dividend payout ratios should be higher in countries with weak legal protection of shareholders than in those with strong protection.

Additionally, in this view, firms with better growth prospects also have a stronger incentive to establish a reputation since they have a greater potential need for external finance, other things equal. As a result, firms with better growth prospects might choose higher dividend payout ratios than firms with poor growth prospects. However, firms with good growth prospects also have a better current use of funds than firms with poor growth prospects (La Porta et. al., 2000). The relationship between growth prospects and dividend payout ratios is therefore ambiguous.



#### **2.3.4. Tax Issues**

Economists are divided on the effects of taxes on the valuation of dividends (Poterba and Summers, 1985). The so-called traditional view holds that heavy taxation of dividends at both the corporate and personal levels—at least in the United States—is a strong deterrent to paying out dividends rather than retaining the earnings. There are two important objections to this view. One objection, raised by Miller and Scholes, (1978), states that investors have access to a variety of dividend tax avoidance strategies that allow them to effectively escape dividend taxes. This objection does not closely correspond to what investors actually do (Feenberg, 1981). Another objection, the so called new view of dividends and taxes (King, 1977; Auerbach, 1979), holds that cash has to be paid out as dividends sooner or later, and therefore paying it earlier in the form of current dividends imposes no greater a tax burden on shareholders than does the delay. According to this theory, taxes do not deter dividend payments. Harris, Hubbard, and Kemsley, (1997) support this new view.

#### **2.4 Agency Problems and Legal Regimes**

Conflicts of interest between corporate insiders, such as managers and controlling shareholders, on the one hand, and outside investors, such as minority shareholders, on the other hand, are central to the analysis of the modern corporation (Berle and Means, 1932), Jensen and Meckling, 1976). The insiders who control corporate assets can use these assets for a range of purposes that are detrimental to the interests of the outside investors. Most simply, they can divert corporate assets to themselves, through outright theft, dilution of outside investors through share issues to the insiders, excessive salaries, asset sales to themselves or other corporations they control at favorable prices, or transfer pricing with other entities they control (Shleifer and Vishny, 1997). Alternatively, insiders can use corporate assets to pursue investment strategies that yield them personal benefits of control, such as growth or diversification, without benefiting outside investors (Baumol, 1959, Jensen, 1986). This problems may be mitigated by having a bigger than a smaller board.

What is meant by *insiders* varies from country to country. In the United States, the U.K., Canada, and Australia, where ownership in large corporations is relatively dispersed, most large corporations are to a significant extent controlled by their managers. In most other countries, large firms typically have shareholders that own a significant fraction of equity, such as the founding families (La Porta et al, 1999). Then controlling shareholders can effectively determine the decisions of the managers (indeed, managers typically come from the controlling family), and hence the problem of *managerial* control per se is not as severe as it is in the rich common law countries. On the other hand, the controlling shareholders can implement policies that benefit themselves at the expense of minority shareholders. Regardless of the identity of the insiders, the victims of insider control are minority shareholders. It is these minority shareholders who would typically have a taste for dividends.

One of the principal remedies to agency problems is the law. Corporate and other law gives outside investors, including shareholders, certain powers to protect their investment against expropriation by insiders. These powers in the case of shareholders range from the right to receive the same per share dividends as the insiders, to the right to vote on important corporate matters, including the election of directors, to the right to sue the company for damages. The very fact that this legal protection exists probably explains why becoming a minority shareholder is a viable investment strategy, as opposed to just being an outright giveaway of money to strangers who are under few if any obligations to give it back (La Porta et al, 2000).

Maug(1998) in their paper analyzed the incentives of large shareholders to monitor public corporations. They investigated the hypothesis that a liquid stock market reduces large shareholders' incentives to monitor because it allows them to sell their stocks more easily. Even though this is true, a liquid market also makes it less costly to hold larger stakes and easier to purchase additional shares. They showed that this fact is important if monitoring is costly: market liquidity mitigates the problem that small shareholders free ride on the effort of the large shareholder. They conclude that liquid stock markets are beneficial because they make corporate governance more effective.

## 2.5 Agency Costs and Dividend Policies

Agency problems result when members of one group of stakeholders (such as managers) place their own interests before the interests of the group they represent (such as the stakeholders). How well the company controls the losses associated with the agency problems (either through incentive plans, monitoring, or covenants) can have a dramatic impact on its dividend policies and value. As Mehran (1992) explains, "Although the findings presented do not necessarily suggest that agency theory provides a complete explanation for corporate dividend policies, they do indicate that any theory that ignores agency issues is seriously incomplete."

Bondholders are protected by some covenants against the possibility of managers trying to take advantage of them. According to Jensen (1976) these covenants hamper the corporation's legitimate operations to some extent. He further puts it that the costs of lost efficiency plus those incurred by monitoring the covenants are what are referred to as agency costs. Agency costs increases the cost of debt and at the same time reduces the value of equity as noted by Musili (2005).

Kamere (1987) noted that agency problems may bring about an optimal ratio of debt and equity financing when agency costs related to debt and equity financing are considered. Costs associated with protective covenants are substantial and rise with the amount of debt financing. Shareholders incur monitoring costs to ensure manager's actions are based on maximizing the value of the firm. Jensen and Meckling (1976) noted that with increasing costs associated with higher levels of debt and equity, an optimal combination of debt and equity may exist that minimizes total agency costs.

## 2.6 Corporate Ownership Structure, Corporate Governance, Firm Performance, and Capital Structure

It is well recognized by now that good corporate governance creates value. Studies by Gompers et al (2003), Durnev and Kim (2005), Black et al (2005), Black et al (2006a), Klapper and Love (2004) and several other papers show that in various countries better corporate governance is associated with a higher firm's market value. Ultimately, sound

corporate governance practices help channeling private sector funds into profitable projects and, thus, contribute to the economic development of a country (Claessens (2006)). While many of the economies of the former Soviet republics have been growing relatively fast over the last years, they still have a long way to go to catch up with the OECD countries. One of the likely impediments to growth in these countries is poor corporate governance. Therefore, it is important to understand where the incentives of managers and controlling owners to adhere to high corporate governance standards can come from and what should be done to improve these incentives.

Theoretically, one of the main incentives to establish good corporate governance practices is the need for outside finance. Corporate governance helps establish commitment mechanisms that ensure adequate return for outside investors (Shleifer and Vishny 1997) and, hence, lowers the cost of outside finance for a firm. Chen et al (2004) and Skaife et al (2004) provide evidence that better governance reduces the cost of equity capital. Sengupta (1998) and Bhojraj and Sengupta (2003) find that better corporate governance is associated with a lower cost of debt capital.

Most theorists and practitioners agree that improving the quality of corporate governance and increasing transparency would help firms in CIS countries to attract outside finance and would eventually accelerate the development of CIS economies. Unsurprisingly, corporate governance has recently become one of the widely debated issues in Russia and other CIS countries. However, there has been no solid empirical evidence that firms with better corporate governance in transition countries are indeed more successful in attracting outside finance.

Firms in transition economies are characterized by high degree of ownership concentration. Empirical studies suggest that ownership concentration is related to firms' corporate governance, financing and investment policies. In a sample of firms from 27 mostly developing and transition economies, Durnev and Kim (2005) find a positive association between ownership concentration and corporate governance. Guriev et al (2003) find a similar effect for Russia. Filatotchev et al. (2001) show on a sample of

Russian firms that ownership concentration is negatively related to investment. Filatotchev et al. (2007) demonstrate for a sample of Hungarian and Polish firms a hump-shaped relationship between ownership concentration and the management's expectations of relying on public equity finance.

Some governance features may be motivated by incentive-based economic models of managerial behavior. Broadly speaking, these models fall into two categories. In agency models, a divergence in the interests of managers and shareholders causes managers to take actions that are costly to shareholders. Contracts cannot preclude this activity if shareholders are unable to observe managerial behavior directly, but ownership by the manager may be used to induce managers to act in a manner that is consistent with the interest of shareholders. Grossman and Hart (1983) describe this problem. Adverse selection models are motivated by the hypothesis of differential ability that cannot be observed by shareholders. In this setting, ownership may be used to induce revelation of the manager's private information about cash flow or her ability to generate cash flow, which cannot be observed directly by shareholders. A general treatment is provided by Myerson (1987).

In the above scenarios, some features of corporate governance may be interpreted as a characteristic of the contract that governs relations between shareholders and managers. Governance is affected by the same unobservable features of managerial behavior or ability that are linked to ownership and performance. At least since Berle and Means (1932), economists have emphasized the costs of diffused share-ownership; that is, the impact of ownership structure on performance. However, Demsetz (1983) argues that since we observe many successful public companies with diffused share ownership, clearly there must be offsetting benefits, for example, better risk-bearing. Also, for reasons related to performance-based compensation and insider information, firm performance could be a determinant of ownership. For example, superior firm performance leads to an increase in the value of stock options owned by management which, if exercised, would increase their share ownership. Also, if there are serious divergences between insider and market expectations of future firm performance then

insiders have an incentive to adjust their ownership in relation to the expected future performance. Himmelberg, Hubbard and Palia (1999) argue that the ownership structure of the firm may be endogenously determined by the firm's contracting environment which differs across firms in observable and unobservable ways. For example, if the scope for perquisite consumption is low in a firm then a low level of management ownership may be the optimal incentive contract

The role of large owners in the economy is one of the most important topics in corporate governance. Theoretically, large owners (blockholders) may play a valuable role by reducing the (type 1) agency problems between shareholder and managers, but recent research has emphasized that large blockholdings give rise to a second (type 2) agency problem between blockholders and minority investors (Shleifer and Vishny, 1997, Becht et al 2002). Type 1 agency problem is the traditional conflict of interest between managers and shareholders for instance awarding themselves large perks. Type 2 agency problem involves conflicts of interest between corporate insiders, such as managers and controlling shareholders (blockholders), on the one hand, and outside investors, such as minority shareholders, on the other hand (Jensen and Meckling, 1976). The insiders who control corporate assets can use these assets for a range of purposes that are detrimental to the interests of the outside investors. They can divert corporate assets to themselves, through outright theft, dilution of outside investors through share issues to the insiders, excessive salaries, asset sales to themselves or other corporations they control at favorable prices, or transfer pricing with other entities they control ( Shleifer and Vishny, 1997). Alternatively, insiders can use corporate assets to pursue investment strategies that yield them personal benefits of control, such as growth or diversification, without benefiting outside investors (Baumol, 1959; Jensen, 1986).

The link between ownership and corporate governance is not well understood by economists. On the one hand, higher ownership concentration creates incentives for the principal owner to increase firm value, which may induce him to practice good governance. On the other hand, greater accumulation of control allows the controlling shareholder ignore the rights of minority shareholders and eliminates pressures of the

market for corporate control. Another possible reason why higher ownership concentration may lead to worse corporate governance is that the two may be substitutes: a large stake of a controlling shareholder signals his commitment to the mechanisms. The combination of these (and possibly other) factors may potentially lead to a non-monotonic link between ownership concentration and corporate governance. A separate problem is that ownership structure may be endogenous and may itself depend on the firm's corporate governance.

One of the reasons, why managers and major shareholders may practice good corporate governance is a discipline imposed by the market for corporate control (Darren, 2008). Darren, 2008 in their surveys collected data on takeovers, takeover attempts and threats in Russia and Kyrgyzstan. They did not find any robust evidence that hostile takeovers have a discipline effect in the two countries: neither improvements in corporate governance lead to fewer takeover threats, nor takeover threats lead to subsequent improvements in corporate governance.

The absence of a relationship between the market for corporate control and corporate governance according to Darren, 2008, may be explained by high ownership concentration, underdeveloped capital markets and weak legal environment. Controlling shareholders having stakes above 50% are effectively immune to a hostile acquisition through stock purchases, which reduces incentives to treat minority shareholders well. Moreover, underdeveloped capital markets make financing acquisitions more difficult. Finally, weak legal environment gave rise to a variety of "grey" and "black" takeover schemes, based on illegal or pseudo-legal means. Good corporate governance may be of little help to prevent such takeovers.

In an important and oft-cited paper, Gompers, Ishii, and Metrick (GIM, 2003) study the impact of corporate governance on firm performance during the 1990s. They find that stock returns of firms with strong shareholder rights outperform, on a risk-adjusted basis, returns of firms with weak shareholder rights by 8.5 percent per year during this decade. Given this result, serious concerns can be raised about the efficient market hypothesis,

since these portfolios could be constructed with publicly available data. On the policy domain, corporate governance proponents have prominently cited this result as evidence that good governance (as measured by GIM) has a positive impact on corporate performance.

There are three alternative ways of interpreting the superior return performance of companies with strong shareholder rights. First, these results could be sample-period specific; hence companies with strong shareholder rights during the current decade of 2000s may not have exhibited superior return performance. In fact, in a very recent paper, Core, Guay and Rusticus (2005) carefully document that in the current decade share returns of companies with strong shareholder rights do not outperform those with weak shareholder rights. Second, the risk adjustment might not have been done properly; in other words, the governance factor might be correlated with some unobservable risk factor(s). Third, the relation between corporate governance and performance might be endogenous raising doubts about the causality explanation.

There is a significant body of theoretical and empirical literature in corporate finance that considers the relations among corporate governance, management turnover, corporate performance, corporate capital structure and corporate ownership structure. Hence, from an econometric viewpoint, to study the relationship between any two of these variables one would need to formulate a system of simultaneous equations that specifies the relationships among these variables.



## CHAPTER THREE

### RESEARCH METHODOLOGY

#### 3.0 Introduction

This chapter details out the research methodology used in the study. The sections presented here include research design, population, sample description, data collection and data analysis.

#### 3.1 Research Design

An empirical study of the firms listed on NSE was conducted due to the fact that these listed firms are required by law to make disclosures that made data on them readily available. The aim of the study is to explore whether the relationship between corporate governance and dividend policies of Firms Listed on NSE.

#### 3.2 Population

The population of this study consisted of all the 52 companies quoted at the Nairobi Stock Exchange for the years 2004 to 2008. However firms that were not listed for the entire period under study were left out of the sample. The five years have been chosen because this is the period in which NSE was automated and thus easy availability of data. The study used annual reports that are available at the Nairobi Stock Exchange.

#### 3.3 Sample

The study followed stratified sampling technique in obtaining a viable set of stocks. The two main reasons for using a stratified sampling design are to ensure that particular groups within a population are adequately represented in the sample, and to improve efficiency by gaining greater control on the composition of the sample. The firms in the population were categorized into those with majority blockholders and those where ownership is widely dispersed to a large number of small shareholders. A sample of ten firms from each category was be used.

### **3.4 Data Collection**

This study was facilitated by the use of secondary data. The share ownership structures of the quoted firms and the dividend policies for the years 2004 and 2008 were obtained from the NSE database. To determine whether corporate governance affects dividend policies the dividends paid by each firm was collected together with information on their ownership structures in terms of percentages and earnings. In order to achieve the set objectives, the researcher collected data from the Nairobi stock exchange database and from the financial statements of the individual companies under study. The collected data was captured in form of tables.

### **3.5 Data Analysis**

The data collected was analyzed using regression and correlation analysis. In the first instance to establish whether or not a relationship exists between the corporate governance and dividend policies. This objective was accomplished by use of a linear regression model. The model was also test for statistical significance at a level of significance of 95%. Secondly establish the magnitude and direction of the relationship between corporate governance and dividend policies. This was accomplished by use of correlation analysis.

Finally to establish the possible existence relationships that may exist from sector groupings. This objective was accomplished by use of descriptive statistics.

The dividend payout ratio (DPOR) was computed as a determinant of the dividend policies. Average DPOR was determined for each firm as a ratio between total dividends and earnings attributable to equity holders and the high average and low DPOR was placed in the respective ownership categories in regard to high and low DPOR before the analysis.

The data was analyzed using Ms. Excel and SPSS. The sample mean and standard deviation was calculated to describe and establish the variance in share returns due to changes in board sizes.

The corporate governance mechanisms which were used are the board size, outside representation on the board and debt. The means for the board sizes that had been computed for the years 2004 to 2008 was regressed against the computed average DPORs for the respective years. This will be to establish the variance in dividend policies as a result of the corporate governance.

The regression equation contains DPOR as the independent variable and it refers. Assuming that all relations are linear then we have:

$$DPOR_i = \alpha_0 + \alpha_1 \cdot BOARD\_SIZE_i + \alpha_2 \cdot LEV_i + \alpha_4 \cdot SIZE_i + \alpha_5 \cdot GOV_i + \alpha_6 \cdot ROA_i + e_i$$

A large board is one with more than 7 members, large firms naturally have larger boards hence we expect a positive relationship between BOARD SIZE and SIZE, where SIZE is measured as the natural logarithm of total sales. The dummy variable GOV is one if the state owns more than 5% of the firm's equity, and zero otherwise. These variable accounts for the possibility that political influences lead to larger boards with a disproportionate number of government representatives. As stated by Yermack (1996), small boards could contribute to better performance, or companies might adjust board size in response to past performance in order to increase managerial capacity. To capture possible relationships between operating performance and board size, the current year ROA is included. This variable is defined as the operating income over total assets. The industry classification is from the NSE. The other internal governance mechanism is the firm leverage, denoted by LEV, is the ratio of total (non-equity) liabilities to total assets.

Finally to establish the magnitude and direction of the relationship between blockholders of quoted firms and their dividend policies was accomplished by use of correlation analysis. The variables of the study were computed as follows:

The change in dividends was averaged across all firms in the sample and a standard error computed. The abnormal change was then tested if it's statistically different from zero by estimating the t statistic for each year, by dividing the average excess change by the standard error. T-statistic was computed using standard error that account for non-

dependence of the data collected. (95% confidence level of estimate will be used). The t-statistic value was considered significant if the P value is less than 0.05. Significance of differences in means of dividends of firms with differing block holder ownership was also computed.

## CHAPTER FOUR

### DATA ANALYSIS, RESULTS AND DISCUSSION

#### 4.1 Introduction

This study has examined whether there exists a relationship between corporate governance and dividend policies. The data consists of all listed companies at NSE over the period 2004- 2008 with exception of a few outliers. In this case outliers include those companies that have not been listed during the entire 8-year period like Mumias Sugar Company is excluded. The data collected were analyzed using descriptive statistics, regression and correlation analysis.

#### 4.2 Descriptive statistics of the DPOR

The Tables below indicates the summary statistics and the 95% confidence intervals for DPOR for each firm sampled by rank of the blockholders for the years under study. The highest mean return during the period is - 0.244 recorded by industry one with a standard deviation of 0.557.

**Table 4.2.1**

Table 4.2.1 below presents the average market returns and the associated standard deviation for the years under study.

<b>Descriptive Statistics: AvR2000 by RankCr</b>				
Variable	RankCr	N	Mean	StDev
AvR2000	0	22	-0.244	0.557
	1	13	-0.298	0.402
<b>Descriptive Statistics: AvR2000 by RankCQr</b>				
Variable	RankCQr	N	Mean	StDev
AvR2000	0	23	-0.259	0.540
	1	12	-0.273	0.432
<b>Descriptive Statistics: AvR00-01 by RankCr</b>				
Variable	RankCr	N	Mean	StDev
AvR00-01	0	22	-0.221	0.491

1	13	-0.300	0.411
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**Descriptive Statistics: AvR00-01 by RankCQr**

Variable	RankCQr	N	Mean	StDev
AvR00-01	0	23	-0.243	0.487
	1	12	-0.265	0.417

The table indicates the mean and standard deviations of the returns for the years 2004 to 2008. The mean return for all the years range between -0.221 to -0.300 with standard deviation ranging from 0.402 to 0.540.

**4.3 Comparison between DPOR and Dividend Policy**

The study used Analysis of variance (ANOVA), which is similar to regression in that it is used to investigate and model the relationship between a response variable and one or more independent variables. However, analysis of variance differs from regression in two ways: the independent variables are qualitative (categorical), and no assumption is made about the nature of the relationship (that is, the model does not include coefficients for variables). In effect, analysis of variance extends the two-sample t-test for testing the equality of two population means to a more general null hypothesis of comparing the equality of more than two means, versus them not all being equal. Several of Minitab’s ANOVA procedures, however, allow models with both qualitative and quantitative variables.

The default one-way output contains an analysis of variance table, a table of level means, individual 95% confidence intervals, and the pooled standard deviation. The F-test p-value of 0.101 indicates that there is not quite sufficient evidence (at  $\alpha = 0.10$  or less) to claim that not all the means are equal. However, examinations of the multiple comparison results, which use family error rates of 0.10, because the methods used (Tukey, MCB) indicate a built in protection against false positive results.

The output labeled “Hsu’s MCB” compares each mean with the best of the other means. Here, “best” is the default or largest of the others. The means of carpets 1, 2, and 3 were

compared to the level 4 mean because the carpet 4 mean is the largest of the rest. The level 4 mean was compared to the carpet 1 mean. Carpets 1, 3, or 4 may be best, since the corresponding confidence intervals contain positive values. There is no evidence that carpet 2 is the best because the upper interval endpoint is 0, the smallest it can be.

**Table 4.3.1: One-way ANOVA: AvDPOR2000 versus Ranked Dividends**

Analysis of Variance for AvR2000					
Source	DF	SS	MS	F	P
RankCr	1	0.024	0.024	0.09	0.762
Error	33	8.448	0.256		
Total	34	8.472			

Individual 95% CIs For Mean Based on Pooled StDev						
Level	N	Mean	StDev	-----+-----+-----+-----		
0	22	-0.2437	0.5568	(-----*-----)		
1	13	-0.2977	0.4019	(-----*-----)		
Pooled StDev = 0.5060				-0.48	-0.32	-0.16

The table contains an analysis of variance, a table of level means indicating a  $-0.2437$  and  $-0.2977$ , individual 95% confidence intervals, and the pooled standard deviation. The F-test p-value of 0.101 indicates that there is not quite sufficient evidence (at  $\alpha = 0.10$  or less) to claim that not all the means are equal. The p value is 0.792, which is above the 0.5 threshold indicating that there is a significant relationship between return and current ratio in the first year under study.

#### 4.4 Corporate Governance and Dividend Policies

Of the firms studied, the mean board size was 7.18 suggesting that firms in Kenya have relatively moderate board sizes. With a maximum of thirteen and deviation of 2.85, the implication is that firms in Kenya have relatively similar board sizes. This is essentially good for firm performance according to researchers such as Jewen (1993).

However, there are pronounced differences between firms with and without government influence. Specifically, there are nine firms in the sample where some state authority owns more than 5% of the firm's equity. On average, board size for these firms is 9.77.

The difference in board size is statistically significant. The average value of Tobin's Q is 0.52, the median 0.32. This indicates that Kenyan firms on average do not invest in positive NPV projects.

On the average, most of the firms appear not to be doing well with regards to Tobin's Q as a performance variable. By implication most of the firms do not break even on this front. While the maximum performance is about 4.75, the minimum performance is -0.15. With regards to return on assets (ROA), there is a wide deviation between the firms. Showing a mean performance of 4.8%, the maximum of 20.8% and the minimum of -11.5% with a relatively high deviation of 7.6% between the firms.

**Table 4.4.1 Descriptive Statistics**

Variable	Board size	Outsider	Ownership	Gov	Lev	Tobin q	ROA
Mean	6.18	4.55	0.79	0.25	0.47	0.52	0.048
Median	8.00	4.50	0.78	0.00	0.39	0.32	0.035
S.D	2.85	2.72	0.12	0.44	0.19	0.79	0.076
Maximum/minimum	15/3	10/2	0.98/0.54	1/0	0.80/0.07	4.75/ -0.15	0.208/ -0.115

The table indicates the mean, median and standard deviation for the five Corporate Governance variables, the Tobins Q and the return on assets.

Lipton and Lorsch (1992) and Jewen (1993) argue that for a board size beyond seven or eight the benefits of increasing monitoring capacities is outweighed by such costs as slower decision making. 78.9% of the firms in the sample have a board size equal to or less than eight. Figure 1 shows the values of Tobins, Q for companies sorted by size. There is no obvious relationship between the two variables i.e. in a univariate analysis larger board sizes are not associated with lower valuations. This is a sharp contrast to the results in Yermack (1996) for US data. Plotting board size against average Tobin's Q, he find that Tobins Q values decline almost monotonically over the range of board size. For



board sizes, below six, however, he also reports no consistent association between board size and firm value. In contrast, Eisenberg Sundgren and Wells (1998) present a figure with a negative relationship between the two variables for their sample of finish firms, even though average board size is only 3.7.

**Figure 1: Tobin's Q and board size**

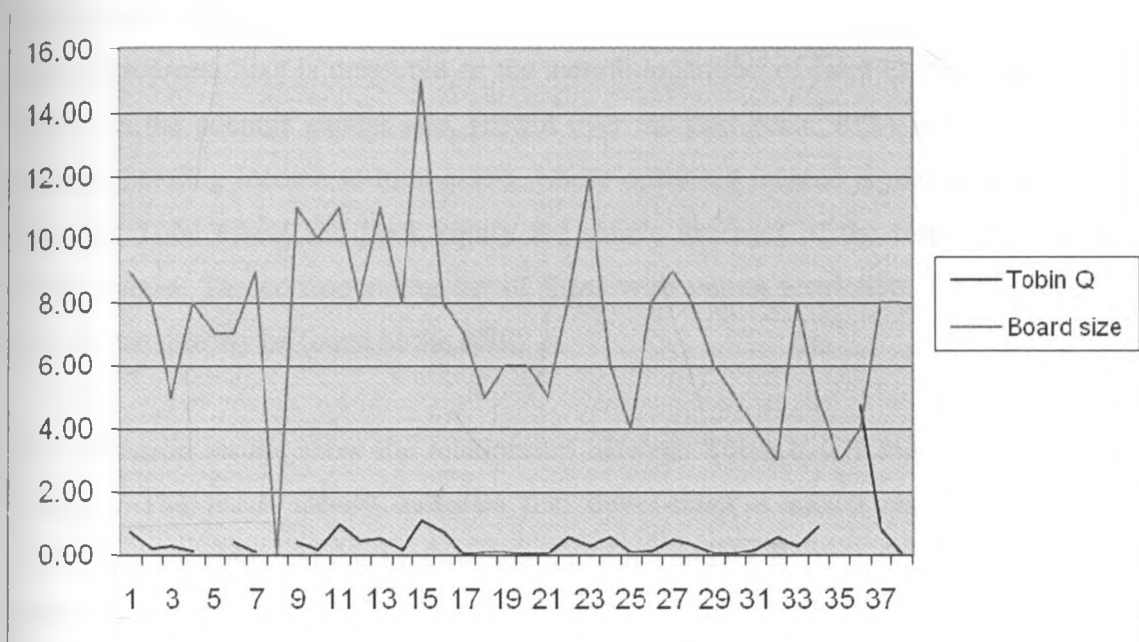


Table 4.4.1 further shows that the average of outsider is 4.55 (0.63), which is in contrast to the results of Yermack (1996). He reports a lower value of 0.54 for US firms. The average leverage ratio (LEV) is 44% and the average of ownership is 0.79

**Table 4.4.2: Correlation matrix between control mechanisms**

	Board size	Tobin Q	Lev	Ownership %	Outside directors %
Board size	1	-0.063	0.298	-0.279	0.094
Tobin Q	-0.063	1	0.050	0.314	-0.191
LEV	0.298	0.050	1	-0.051	0.154

Ownership %	-0.279	0.314	-0.51	1	-0.311
Outside Directors	0.094	-0.191	0.154	-0.311	1

#### 4.5 Correlation Coefficients between Tobin's Q and Board Size

All correlations are relatively small; expect the correlation between board size and LEV (0.298), and Tobin Q and ownership (0.314). The controlling variable is gathered from different sources. Size is measured as the natural logarithm of sales in 2002. Growth is defined as the average annual sale, growth over the past years. ROA is defined as the ratio of operating income to total assets, where operating income is measured as at the year end. Total assets and book equity are simple averages of the respective starting ending values. The corresponding list of firms with voting restriction, for the variable RESTR can directly be found in the NSE.

The regression results show the relationship between Tobin q (Q) and the governance variables. The result clearly indicates that there exists a mixed result between the governance variables and this performance variable and DPOR.

Table 4.5.1: Tobin Q

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	2.989	3.149		.949	.352
Board size	-.011	.112	-.036	-.101	.921
LEV	.929	.962	.186	.966	.344
Share Return	0.62	.322	-.344	-1.78	.059
Outside Directors	.072	.154	.188	.470	.643

Ownership	.020	.015	.296	1.390	.178
%					
Size	-.200	.165	-.437	-1.217	.236
Growth-3					
years					
sales	.000	.000	.300	.979	.338
average					
ROA	4.157	3.158	.292	1.316	.201
IND	-.442	.222	-.444	-1.988	.059

The results support the studies by Jensen (1993), Lipton and Lorsch (1992), Yermack (1996), the study shows that there is a relationship between the size of the board and the share performance, thus board size is not highly significant in explaining Tobin's q for firms in Kenya. The board composition has a larger positive relationship with Tobin's Q implying that when there are more external board members, performance of the firm tend to be better. This supports other empirical studies by Weisbach (1988) that outside director support is beneficial in the monitoring and advisory functions to form shareholders. Markets also reward firms appointing outside directors. However, this is not consistent with the findings of Agrawal & Knoeber (1996) who suggest that boards expanded for political reasons of ten results in too many outsiders on the board which does not help share performance.

The study also suggests that the size of the firm has a negative impact on Tobin's q. This could however, be explained by the fact that the size of the firm measured by its asset base does not necessarily enhance performance if this is not put to efficient use. The implication therefore is that most firms in Kenya are not utilizing their size to enhance their performance. However, the contrary results obtained from the asset structure suggest that, the more fixed assets there are the better the performance of Tobin's q. Firms that mostly have huge proportions of debt in their assets portfolio perform better. The significantly positive regression coefficient for total debt implies that, an increase in the debt position is associated with increase in performance. The results conform to the

findings by Hadlock & James (2002), who found out that profitable firms use more debt. Again, this suggests that profitable firms depend more on debt as their main financing option. Studies by Fama and Jensen (1983) have asserted that the effectiveness of a board depends on the optimal mix of inside and outside directors. A situation where the CEO doubles as the board chairman leads to conflict of interest and increases agency costs as pointed by Fama & Jensen (1983) who argue that concentration of decision making and control in one individual reduces board's effectiveness in monitoring top management thereby having a negative impact on profitability. It was noted that the one-tier board structure type leads to leadership facing conflict of interest and agency problems.

The board size is positively related to outside directors, leverage, ownership, GOV and ROA. It suggests that firms should have larger board sizes, especially when considering ROA. This contradicts findings made by researchers such as Jewen (1993) and Lipton & Lorsch (1992). In the light of the foregoing analysis, should boards thus be increased indefinitely? The fundamental problem is really to have an optimal board size for effective performance and thus dividends of firms in Kenya.

**Table 4.5.3: Board Size**

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	-2.337	2.525		-.925	.364
Outside Directors	1.029	.159	.842	6.480	.000
LEV	1.793	1.665	.113	1.077	.292
Ownership %	.051	.027	.232	1.885	.072

Gov	1.068	.876	.179	1.22 0	.234
ROA	3.538	6.156	.078	.575	.571
Tobin Q	-.223	.386	-.070	-.577	.569
IND	-.320	.493	-.101	-.649	.523

#### 4.6 Dependent variable leverage

The asset structure, the size of the firm and the debt structure are all positively related to Tobin Q. by implication, the findings suggests that forms in Kenya rely on debt, with a huge composition of fixed assets in their portfolio tend to perform better likewise firms that have more debts in their capital structure. Thus firms in Kenya should lean towards having more debts and increase in size to enjoy economies of sale. The results are presented in the table below.

Table 4.6.1: Leverage

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	.167	.683		.245	.808
Board size	.028	.025	.443	1.130	.270
Ownership %	.000	.003	-.013	-.056	.956
Outside Directors	-.035	.034	-.450	-1.035	.311
Size	.011	.035	.125	.331	.743
Age	-.002	.002	-.201	-.987	.334
Growth-3 years sales average	.000	.000	.166	.534	.598

IND	.008	.041	.038	.186	.854
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## CHAPTER FIVE

### 5.0 SUMMARY, CONCLUSION & RECOMMENDATIONS

The major contribution of this study has been the determination of whether corporate governance has an effect on dividend policy of listed firms on NSE. The results have important implications because corporate governance has played an important role in the stock market and agency problems should be addressed too.

The study used a large data set of dividend payments, earnings per share, board sizes and ownership from the NSE and individual company's database, to examine the effect of corporate governance on dividend policies. First, the results indicate that the board size is negatively related to Tobin's Q and ownership but positively related to leverage and outside directors. Like other studies, the findings of the study support the fact that a two-tier board structure enhances firm's performance, though it insignificantly has a positive impact on ROA.

Secondly the results show a strong positive relationship between corporate governance and dividend payout with a P value of 0.78 indicating that the board of directors actually plays an important role in the governance of corporations; it is generally acknowledged that the legal and contractual settings as well as the structure and activities of the board of directors have an impact on the share performance.

The results of the study agree with the findings of Guest, 2009 who found out that the relationship between board size and performance may differ not just by firm-specific characteristics but also by national institutional characteristics. In countries with different institutional backgrounds, the functions of boards are different, and therefore the expected board size-performance relation may be expected to differ. Therefore, examination of other countries is useful in more fully understanding the relation between board size and performance.

The results of the study seem to suggest that the influence of the state shareholders, individuals, and foreigners to dividend policies is insignificant if not completely irrelevant. This finding is consistent with Eckbo and Verma (1994) observation that large institutional stakes are associated with higher payout, similarly Shleifer and Vishny (1986) observe that dividends are used as a way of communicating better share performance. Compared to previous studies on cross sectional data there are clear advantages to using dynamic panel data, in particular the ability to filter out firm effects and to include a cleaner test of causality using lagged values of the dependent variable as an instrument. However, the aggregate level of the board size variable also creates problems, since for example owner identities and the distribution of ownership rights between them may be important. Gugler and Yurtoglu (2003) present interesting results, which indicate that large external shareholders may act as watchdogs on incumbent controlling shareholders.

The results are also consistent with recent empirical research, which indicates that in many countries the relevant corporate finance issue is not the traditional agency problem between management and shareholders, but rather the agency problem between the board and the minority shareholders. This problem may arise for two reasons; the corporate governance structure of public companies insulates large shareholders—that is, those with a majority of the votes and often with an involvement in the firm's management—from takeover threats or monitoring; and the legal system does not protect minority shareholders because of either poor laws or poor enforcement of laws.

It is likely that the significance of the share performance variable might have something to do with the representation on the board of directors, as one of their corporate decisions is dividend payment policy. Therefore, local individual investors' minority ownership limits their role in dividend payment policy decisions, as they are not represented on the board of directors.

The study also suggests that the size of the firm has a negative impact on Tobin's  $q$ . This could however, be explained by the fact that the size of the firm measured by its asset



base does not necessarily enhance performance if this is not put to efficient use and thus the dividend policies. The implication therefore is that most firms in Kenya are not utilizing their size to enhance their performance. However, the contrary results obtained from the asset structure suggest that, the more fixed assets there are the better the performance of Tobin's q. Firms that mostly have huge proportions of debt in their assets portfolio perform better. The significantly positive regression coefficient for total debt implies that, an increase in the debt position is associated with increase in performance. The results conform to the findings by Hadlock & James (2002), who found out that profitable firms use more debt. Again, this suggests that profitable firms depend more on debt as their main financing option. Studies by Fama and Jensen (1983) have asserted that the effectiveness of a board depends on the optimal mix of inside and outside directors. A situation where the CEO doubles as the board chairman leads to conflict of interest and increases agency costs as pointed by Fama & Jensen (1983) who argue that concentration of decision making and control in one individual reduces board's effectiveness in monitoring top management thereby having a negative impact on profitability. It was noted that the one-tier board structure type leads to leadership facing conflict of interest and agency problems.

Corporate governance embraces a broader set of variables, such as economic and legal environment, progressive practices, existence of internal control measures, ownership and compensation structures within an institution, the nature and quality of information flow and the level of involvement of staff in the day to day decisions of corporate entity.

### **5.1 Policy Implications**

The capital Markets regulatory framework recognizes the need for corporate governance regulations. There is need to ensure that this takes into account the boardsizes, ownership structures and leverage as it has an impact on the ultimate dividend policies. The regulatory framework further recognizes various categories of investors, namely; foreign investors, local blockholder investors and local minority investors. However, there is no policy framework to encourage the minority investors' participation in corporate governance given their unique role in supporting the development of the capital markets.

The role of small savers in economic development cannot be overemphasized. Therefore, appropriate policy measures to encourage both block holder and minority investors to participate in the capital markets are important. In view of the important role played by the block holder investors in promoting international best corporate governance practices, it is necessary that appropriate policy and fiscal measures are put in place to strengthen their participation.

## **5.2 Limitations of the Study**

This study may have some limitations. *Firstly*, the data was mainly collected from the company annual report. As the accounting is under management control, the annual report may not truly represent the company's state of the affairs and performance. *Secondly*, the data are collected from the large number of observation of different corporate entities ignoring the underlying differences in organizations as in no way two organizations are same (Deegan, 2006). The extreme value of some observed variables such as, EBIT; accumulated profits of a few firms for certain years may severely impact the outcome of this study. *Finally*, there was possible omission of governance variables that may be relevant in performance equation or with strong relations to other governance mechanisms. The extent to which some firms rely on subordinate debt may help them reduce agency problems between managers and shareholders, and possibly rely less on other governance mechanisms. Therefore, the system of equations may be mis-specified.

## **5.5 Suggestion for Further Research**

This paper examines the relationship between corporate governance and dividend policy: Evidence from listed firms in Kenya. Because of data unavailability, it was not possible to include firms not listed in our sample. Therefore I suggest further research on the relationship between board structure and financial performance in companies that are not listed in the NSE.

Although "there is universal agreement on the need for outsiders, preferably independent, to be involved in the direction of companies" (Clarke, 1998, p 118), this study could not

find a relationship between outside independent directors and firm performance. The finding of this study is surprising. It may be due to several reasons; firstly, there was no outsider representation in the board before 2006 which led to smaller data size, secondly, the cost and benefits of different board structures may vary across firms or industry (Mak and Li, 2001). Therefore, it can be argued 'outside directors do not have expertise' is still a speculation and further study may be conducted by increasing the sample size and examining the industry specific impact of board structure and firm performance.

It is important that a similar study with a bigger sample, time horizon and taking into account more data be conducted by using advanced time series models to enhance our understanding of the association between the board size and share performance of the NSE firms.

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## **APPENDICES**

Appendix 1: list of companies quoted at N.S.E. as at 1<sup>st</sup> January 2006

### **MAIN INVESTMENT MARKET**

#### **AGRICULTURAL**

Uniliver Tea Kenya  
Kakuzi Ord.  
Rea Vipingo Plantations  
Sasini Tea & Coffee Ltd.

#### **COMMERCIAL AND SERVICES**

Car & General (K) Ltd  
CMC Holdings ltd  
Hutchings Biermer  
Kenya airways ltd  
Marshalls E.A  
Nation media group  
Scan group ltd  
TPS Eastern Africa  
Uchumi supermarket

#### **FINANCE AND INVESTMENT**

Barclays bank ltd  
C.F.C bank Ltd  
Diamond Trust Bank Kenya  
Equity Bank Ltd  
Housing Finance Co.  
I.C.D.C Investment Co. Ltd  
Jubilee Holdings Ltd  
Kenya Commercial Bank  
National Bank of Kenya Ltd

NIC Bank Ltd  
Jubilee holdings ltd  
Kenya commercial Bank Ltd  
National Bank of Kenya Ltd  
NIC Bank Ltd  
Pan Africa Insurance Holding  
Standard Chartered Bank

### **INDUSTRIAL AND ALLIED**

Athi River Mining  
B.O.C Kenya Ltd  
Bamburi Current Ltd  
Bat Kenya ltd  
Carbacid Berger Ltd  
Crown Berger  
E.A. Cables Ltd  
E.A. Portland cement  
East African Breweries  
Kenya Oil Co. Ltd  
Kenya Power & Lightning Ltd  
KenGen Ltd.  
Mumias Sugar Company  
Olympia Capital Holdings Ltd  
Sameer Africa Ltd  
Total Kenya Africa Ltd  
Total Kenya Ltd  
Unga Group Ltd

### **ALTERNATIVE INVESTMENT MARKET SEGMENT**

City Trust Ltd  
Eaagads Ltd

Express Ltd  
 Williamson Tea Kenya  
 Kapchorua Tea Co.  
 Kenya orchards Ltd  
 Limuru tea co. Ltd  
 Standard group Ltd

## Appendix 2

### Average DPOR (Ratio)

COMPANY	1998	1999	2000	2001	2002	2003	2004	2005	Average
Bamburi cement	0.48	0.58	0.94	0.56	1.04	0.95	1.29	0.96	0.85
BAT K	0.50	0.64	1.36	1.31	1.09	10.8	1.36	0.90	1.03
BOC K	0.45	0.62	0.93	0.92	0.81	0.56	0.55	0.52	0.67
Carbacid Invest	0.26	0.44	0.28	0.69	0.47	2.96	0.50	0.50	0.76
Crown Berger	0.95	0.94	0.56	0.46	0.58	0.55	0.00	0.52	0.57
EA Cables	0.64	4.17	0.73	1.39	-1.72	2.17	0.57	0.48	1.05
EA Portland	0.24	0.00	0.00	0.12	1.10	0.70	0.82	0.37	0.21
E A Breweries	2.64	0.61	0.58	0.61	0.54	1.09	0.51	0.62	0.90
Sameer E Africa	0.68	0.71	0.95	0.83	1.21	0.89	1.01	0.68	0.87
Kenya Oil Co	0.25	0.26	0.40	0.20	0.22	0.23	0.24	0.25	0.26
Kenya Power	0.29	0.48	-0.05	0.00	0.00	0.00	0.00	0.09	0.10
Unilever	0.85	0.91	0.65	0.44	0.98	4.72	10.8	1.42	1.38
Kakuzi	0.54	1.07	0.28	0.00	0.00	0.00	0.23	0.00	0.20
Rea Vipingo	0.00	0.00	0.00	0.00	0.61	8.00	0.37	0.39	1.17
Barclays Band	0.57	0.69	1.27	0.88	1.20	0.82	0.78	0.78	0.87
CFC Bank	0.28	0.42	0.42	0.57	0.46	0.34	0.28	0.27	0.38
Diamond Trust	0.31	0.61	0.29	0.78	0.63	0.46	0.42	0.00	0.44
Housing Finance	0.61	0.82	0.84	0.00	0.00	0.00	0.00	0.00	0.28
Kenya Comm	0.60	0.00	0.00	0.00	0.00	0.33	0.62	0.59	0.27

National Bank	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
NIC	0.21	0.49	0.48	0.51	0.72	0.77	.076	0.75	0.59
Standard Chart	0.58	0.70	1.25	0.91	0.93	0.83	0.96	0.86	0.88
ICDCI	0.57	0.35	0.51	0.60	0.45	0.76	0.68	0.56	0.56
CMC Holdings	0.08	0.11	0.15	0.21	0.16	0.14	0.19	0.21	0.16
Kenya Airways	0.35	0.48	0.21	0.43	0.32	0.58	0.24	0.19	0.35
Marshalls E A	0.038	0.00	0.00	0.00	0.00	0.00	0.00	0.32	0.09
Nation media	0.18	0.25	0.31	0.22	0.33	0.44	0.50	0.67	0.36
TPS Serena	0.68	0.49	0.51	0.44	0.40	1.69	0.33	0.25	0.60
Uchumi	0.64	0.75	0.56	1.07	0.60	0.00	0.00	0.00	0.45

### Appendix 3

### Chi - Square Test

State                      Effective                      Control                      DPOR

	1998	1999	2000	2001	2002	2003	2004	2005	Mean
High	0.6	0.48	0	0.12	1.1	0.7	0.62	0.59	0.53
Average	0.38	0.16	-0.02	0.04	0.37	0.34	-0.07	0.35	0.19
Low	0.24	0	-0.05	0	0	0	-0.82	0.09	-0.07

Average of State Effective Control DPOR = 0.19

Dividend payout ratio				
State Ownership	High	Average	Low	Total
High	1.1	0.53	0.00	
Low	0.24	-0.07	-0.82	
Total				

Table 1 - State Effective Control

Dividend payout ratio				
State Ownership	High	Average	Low	Total
High	1.1	0.53	0.00	1.63
Low	0.24	-0.07	-0.82	-0.65
Total	1.34	0.46	-0.82	0.98

Total Chi-Square now = 1.08547879802008

- >> Calculating probability (P)...
- >> Looking up critical values for Chi at df = 2
- >> Sig levels: 0.20 .010 .005 0.025 0.01 0.001
- >> Crit Vals: 3.22 4.61 5.99 7.38 9.21 13.82

Degrees of freedom: 2

Chi-Square = 1.08547879802008

For significance at the .05 level, Chi-Square should be greater than or equal to 5.99.

The distribution is not significant.

$p$  is less than or equal to 1