THE RELATIONSHIP BETWEEN PROFITS AND DIVIDEND PAYOUT OF COMMERCIAL BANKS IN KENYA

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DECLARATION

This research project report is my original work and has not been submitted in any university or college for an award of a degree

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DEDICATION

I dedicate the research project to my dear parents for their support and encouragement throughout the study period. I also dedicate this research report to my beloved wife Mrs. Jackline Kitur for her love and support especially through this research. May the Almighty God bless you abundantly.

ABSTRACT

This study analyzed the relationship between profits and dividend payout of commercial banks in Kenya. The research objective was to investigate the nature of relationship between dividend payout and profits of commercial banks in Kenya. The result assists in the understanding of how profits influence commercial banks' dividend payout. Commercial banks can then make use of such information to implement a dividend payout policy which satisfies their shareholders expectation. Two control variables i.e. liquidity position (measured by cash and balances with CBK) and inflation rate (at year end) were also studied to find out the impact they have on the relationship established between profits and dividend payout.

The research was based on the commercial banks consistently listed at the NSE for the five-year period from 2008 to 2012 inclusive. Data on listed commercial banks is readily available and regarded credible for use. For the analysis of data from the ten commercial banks, simple and multiple linear regressions were used to determine the relationship between dividend payout and profits and also the two control variables, liquidity position and inflation rate.

The key finding of the study is that there is a strong positive relationship between profits and dividend payout. However the study found out that the strength of the relationship reduced when the two control variables were incorporated in the study. The conclusion from the study was that profits and dividend payout of commercial banks are positively correlated and that a strong positive relationship exists between the two variables. This study is consistent with empirical findings of Abdi (2010) who concluded that dividend payout positively correlate with future profits of companies though the relationship is low.

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ABBREVIATIONS

BOD	Board of Directors
CBK	Central Bank of Kenya
CFO	Chief Financial Officers
CMA	Capital Market Authority
CMA	Capital Market Authority
KBA	Kenya Bankers Association
KNBS	Kenya National Bureau of Statistics
NSE	Nairobi Securities Exchange
NYSE	New York Stock Exchange
PAIT	Profits After Income and Taxes
PWC	Price Waterhouse Coopers
SACCOs	Savings And Credit Co-operative Societies

CHAPTER ONE
INTRODUCTION

1.1Background of the study

Profit is the surplus remaining after all costs including interests and taxes have been deducted from total revenue earned. Profits is said to be the most known measure of success of any given firm. It acts as a yardstick used in evaluating whether the owners investment is worth or not.

Dividend payout is basically returns to the shareholders for their capital employed in the firm. Dividend payout does not only entail cash outflow from the firm but it also have substantial signaling effect.

The profits are an important consideration to a finance manager when making the financing, investing, and dividend decisions. Financing and investing decisions entails making choices on how much of the profits will be used to finance a firm's operations and undertake new investment opportunities.

This study investigated the relationship between profits and dividend payout of commercial banks in Kenya. Since the banking sector represents a greater proportion of all the companies listed on the Nairobi Securities Exchange (with 10 listed commercial banks) representing about 18%, this study plays a major role in determining the relationship in the other sectors of the economy as well as coming up with the general pattern that exists between profits and dividend payout.

1.1.1 Dividend Payout

Dividends are the returns in form of cash or bonus shares issued to shareholders in regards to the share holding held by the shareholder. It is the return on their investment in the firm. Dividend payout is the percentage of profits paid to shareholders in dividends. It

is the ratio of annual dividend per share to profits per share of the firm (Brockington, 1993).

The dividend policy guides the finance manager to decide how much will be paid out to shareholders in form of dividends for their share capital holding in the firm (Pandey, 1999). The main types of dividend policies include; Constant payout ratio under which a firm agrees upon a constant percentage of the profits as dividends. It maintains this amount regardless of whether the firm makes more profits or not. Residual dividend policy payout; where a firm issue out dividends from the amount that remains after all investments have been undertaken. If all profits are used for investment then no dividends are to be issued out during that period. Stable dividend policy; where a constant amount of money is to be distributed to every shareholder in the firm. Occasionally firms use the Stable plus extra policy where a constant amount of money is maintained as dividend to be issued to every shareholding but an extra amount can be paid when the firm makes huge profits in a particular trading period.

Dividends can be distributed to shareholders in form of cash or stock dividends. Cash dividends involve the dividends being distributed to shareholders in form of money. The profits are divided between the number of shares outstanding in the firm. Sherfrin and Statman (1984) in their paper titled “Explaining investor’s preference for cash dividends” account for why some investors would prefer cash dividends to other forms of dividends. Stock dividends are issued when the firm intends to retain the profits for reinvestment opportunities in the future. The profits are converted into stock which is given to shareholders free of charge. It guarantees the shareholder additional revenue in the future since dividends are issued in regards to the number of shares held by an individual. The more shares held the greater the amount one receives as dividends and vice versa. Most companies however prefer payment of cash dividends rather than stock dividends. Stock dividends are often made to increase ownership of existing shareholders rather than diluting their interests through the introduction of new shareholders. This is normally the best option especially when the company is faced with serious cash flow problems.

Dividend policy regulates and guides a firm's management when issuing dividends to shareholders. Mature companies with stable cash flows and limited growth opportunities tend to return large amounts of their profits to shareholders either by paying dividends or using the cash to repurchase common stock (Brigham and Ehrdardt, 2011). Firms that are rapidly growing with good investment opportunities invest most of their available cash flows in new projects. They are likely to pay fewer dividends or repurchase their own stock.

The dividend paid out has an effect on the liquidity and profitability position of a firm. Liquidity is the ability of a firm to meet its obligations as and when they fall due. (Pandey, 1999). When a firm issues out dividends it reduces the amount of liquid cash that can be used to meet the demands of short time creditors and lenders. This can have a negative impact on the survival of a firm forcing it to an insolvency situation. Profitability of a firm can also be affected by the dividend decision. By issuing out dividends to the shareholders, the available cash that could have been used for reinvestment is drawn out of the firm.

1.1.2 Profits

Profits are basically the surplus or profits retained by a firm from its normal business operations. It is what the firm remains with after deducting the firm's expenses from the revenue it earns from its operations. A firm's profits as shown from its income statement are used to indicate the profitability and viability of a business venture (Lasher, 2008).

A firm mainly exists for the sole reason of maximizing wealth of the shareholders (Howells and Bain, 2007)). Therefore a firm aims at maximizing profits at any given point in time. Profits on the income statement of a firm are important as they show the profitability and viability of the business venture. A firm that continually makes losses is deemed to be of no value to the owners as they do not receive any returns for their capital holding while at the same time reducing the capital base of the shareholders.

The firm's profits are also used for valuation of a company. The value of equity of a firm is thereby determined by multiplying the current PAIT by a suitable multiple. The current PAIT may be adjusted onto a more representative basis to take into account such things as unusual events and owner manager policies. The suitable multiple is usually the price-earnings ratio of a listed company on the Nairobi securities exchange market (Grinblatt and Titman, 1996).

Various users of financial statements of a firm make their decisions by evaluating the performance of a firm. The firm's performance is well represented by examining the income statement which gives the balance of profits of a firm at the end of a financial period. The performance as depicted by the profitability of a firm can influence the decisions of financial statement users to invest in the firm or not.

Profits can be affected by both macro-economic and micro-economic factors prevailing. Macro factors are the factors outside the firms control while micro factors are the factors in which the firm has control over (Wolfgang, 2003). Macro factors include political, environmental, socio-cultural, technological and legal factors. Micro factors on the other hand include the firm's customers, employees, competitors, media, owners and suppliers.

Changing levels of profits indicate some level of changes in returns. This can be caused by risks involved in the industry as a whole or risks facing individual firms. For instance in Kenya in the year 2011, movements in interest rates, inflation and exchange rates presented real dangers to economic stability. Firms experienced high cost in borrowing funds and acquiring input resources. Faced by these challenges and a low consumer purchasing power meant that the earning ability of the firms was reduced.

1.1.3 Relationship between Profits and Dividend Payout

Dividends are issued out from the retained profits of a firm. When a firm makes higher profits in a given trading period, it is expected to issue out more dividends to the shareholders. The proportion of profits distributed is measured by the payout ratio which is cash dividend divided by profits per share.

From this point of view, it can be hypothesized that profits and dividend payout have positive linear relationship as discussed in the above theoretical background. However, a logical conclusion will be arrived at when this study comes to its conclusion.

1.1.4 Commercial Banks in Kenya

The Banking industry in Kenya is governed by the Companies Act, the Banking Act, the Central Bank of Kenya Act and the various guidelines issued by the Central Bank of Kenya (CBK). The banking sector was liberalized in 1995 and exchange controls lifted. The CBK, which falls under the Ministry of Finance docket, is responsible for formulating and implementing monetary policies and fostering the liquidity, solvency and proper functioning of the financial system (PWC, 2012). The banking industry in Kenya has been very dynamic and has undergone various changes. For instance several mergers and acquisitions took place between 1994 and 2001. The central bank is the regulator of commercial banking in Kenya and is in the process of ensuring that there is stability in the industry through enacting appropriate policies. Clients in the banking industry can either be retail or corporate. Retail clients usually refer to small depositors who are usually individuals or small organizations while corporate refer to bigger organizations (CBK, 2003).

There are 43 commercial banks registered with the Central Bank of Kenya. However, 10 commercial banks were continuously listed on the Nairobi Securities Exchange which is the market where quoted securities are traded in Kenya. In addition to the 10 commercial banks listed on the NSE's banking sector, the other sectors are made up as follows: Agricultural Sector (7 companies), Automobiles & Accessories (4 companies), Commercial & Services (8 companies), Construction & Allied Sector (5 companies), Energy & Petroleum (5 companies), Insurance (6 companies), Investment (3 companies), Manufacturing & Allied (7 companies) and Telecommunication & Technology (2 companies).All these have been grouped depending on the sectoral position which a company occupies in the Kenyan Economy.

As at December 2012 there were forty three banking institutions and three non-bank institutions registered with the Central Bank of Kenya. The banks have come together under the Kenya Bankers Association (KBA), which serves as a lobby for the banking sector's interests.

This study focused on the ten commercial banks listed on the NSE which are: Barclays Bank of Kenya, CFC Stanbic Bank, Co-operative Bank of Kenya, Diamond Trust Bank (Kenya) Limited, Equity Bank Limited, Housing Finance Company Limited, Kenya Commercial Bank Limited, National Bank Of Kenya Limited, NIC Bank Limited and Standard Chartered Bank Kenya Limited.

Over the period of five years under study, the ten commercial banks listed on the NSE appear to have a consistent year to year rise in profits. However, some of them appear to have a consistent year to year dividend payout while others do not. It is therefore not easy at this particular stage of study to put across that dividend payouts of commercial banks depict any pattern. Whether the trends show a clear relationship between the rising profits and dividends or not will become clear in the course of this study.

1.2 Research Problem

Dividends are distributions from profits made by businesses to their shareholders. They are seen as a distribution of the business's recent profits to its owners. Profits are an important element to a firm's liquidity position. Distributing the profits in form of dividends can impact negatively on the firm's cash flow. Modigliani and Miller (1961)argued in their dividend irrelevance theory that the value of a firm is not affected by the distribution of dividends but is depended on the firm's level of risk. Gordon (1959) and Lintner (1956) in their Dividend Preference Theory suggested that shareholders preferred current dividends to capital gains. They also suggested that with more profits, more dividends should be paid out. This would safeguard the shareholders dividend preference. Therefore, a relationship exists between profits and dividends contrary to the findings by Modigliani and Miller (1961).The theory by Ross (1977), the Information Content Theory, suggested that investors can infer information about a firms future profit

position through the signal coming from dividend announcements. This implies that a relationship exists between profits and dividend payout also contrary to the findings by Modigliani and Miller (1961).

Looking at the commercial banks listed on the NSE their profits have been rising during the years under study. However, some of them have in the past years had their dividend payout having a rising trend, some constant trend, some decreasing trend while others have not maintained any pattern at all. For example, the dividend payout per share of Co-operative Bank of Kenya rose from Kshs. 0.10 in 2008 to Kshs. 0.50 in 2012. Dividends of Diamond Trust Bank (Kenya) Limited rose from Kshs. 1.40 in 2008 to Kshs.1.90 in the year 2012.On the other hand CFC Stanbic Bank declared no dividend payout in the year 2009 and 2011 yet they made Ksh. 1,105,656,000 and Kshs. 2,798,901,000 profits respectively predicting no pattern at all. Evidently, profits earned by commercial banks in Kenya have been increasing in almost all the years under study. Due to this recorded increase in profits over the years under study banks are expected to continually increase their dividend payout. This trend has however not been depicted across all the banks. Some recorded an increasing trend, some constant trend, some a decreasing trend while others had no pattern at all. This therefore necessitated this study so as to provide the answer as to whether a relationship exists between profits and dividend payout or not.

The study by Rashid and Rahman (2008) on relationship between dividend policy and share price volatility found a positive insignificant relationship between share price volatility and dividend yield for non-financial firms listed in the Dhaka Stock exchange during the period of 1999 – 2006. The findings also depicted that debt and growth have positive but insignificant relationship with share price volatility while payout ratio had a significant negative relationship with price volatility. On the contrary Zuriawati, Joriah and Abdul (2012) studied the effect of dividend policy and share price volatility on Malaysian construction and material companies and found a negative insignificant relationship between dividend yield and share price volatility. These two studies give contradicting conclusions and both do not show whether there is any relationship between profits and dividend payout.

Njoroge (2001) examined the relationship between dividends payout and some financial ratio such as return on assets. The result obtained were that the most significant variable in making dividends decision is return on assets. This study did not give any explanation whether or not dividend payout has any relationship with profits. Ngunjiri (2010) studied relationship between payment policies and stock price volatility and indicated that payment policies had a great impact on the stock price volatility. Ngobe et al.(2013) studied the relationship between dividend policy and stock price volatility for the period 1999-2008 at NSE using correlation and multiple regression analysis and concluded that dividend yield has a positive relationship with price volatility while payout ratio has a negative relationship with price volatility, contrary to the findings of Ngunjiri (2010). These two studies only showed that payment policies had an impact on the stock price but did not suggest whether or not dividend payout itself had any relationship with profits of the companies. Mbuki (2010) studied factors that determined dividend payout ratio among SACCOs in Kenya. He found out that the dividends payout ratio was determined by different factors including availability of investments opportunities, availability of cash to pay the dividend and the sustainability of the dividend in the future. SACCOs being closely related to banks in terms of their business operations is comparable to this study. However, the study too did not mention any relationship between dividend payout and profits but only examined the different factors determining the dividend payout.

This study therefore sought to establish whether the profits earned by a company have any direct or indirect relationship with dividend payout. This is a test whether the dividends being declared by companies or payment are in any case dependent on the profits earned in a given year. The research gap here is whether a relationship exists between profits and dividend payout amongst the commercial banks. This study answered this question: “Is there any relationship between profits and dividend payout of commercial banks in Kenya?”

From the above theoretical, contextual and empirical arguments, this study hypothesizes that there is a positive linear relationship between profits and dividend payout of commercial banks.

1.3 Objective of the study

To investigate the relationship between profits and dividend payout of commercial banks in Kenya.

1.4 Value of the study

The study is important to various parties and stakeholders in the Nairobi Securities Exchange. The study is beneficial to company's Board of Directors especially in setting up an appropriate dividend payout that is satisfactory for the company's shareholders. From the conclusion made on the relationship between dividend payout and profits the BOD will be able to get information on the implications of dividend payout on future profits of the company.

This study enable investors, both local and foreign, who need to make investment decisions especially since investors' main priority is the return from their investments. The conclusion on this study is thus be of great importance to them.

Scholars and Academicians use the findings of this study to explore and research more in this particular area of study.

CHAPTER TWO
LITERATURE REVIEW

2.1 Introduction

This chapter presents five main sections. Section 2.2 discusses the theoretical literature by focusing on six dividend theories. Section 2.3 of the chapter presents the determinants of dividend payout. Empirical literature discussed under section 2.4 explores empirical studies that have been carried out by both international and local researchers that have a bearing on this particular study. Section 2.5 is a review of local research followed by section 2.6 which gives a summary of the chapter.

2.2 Theoretical Literature

The theoretical literature reviews the following six dividend theories; Dividend Irrelevance Theory, Dividend Preference Theory, Tax Effect Theory, Clientele Effect Theory, Information Content Theory and the Agency Cost and Free Cash Flow Hypothesis. The theories are discussed below.

2.2.1 Dividend Irrelevance Theory

The theory was developed by Modigliani and Miller (1961). They argued that a firm's value is determined only by its basic earning power and its level of business risk and not the dividend policy adopted. In their view, dividend payout is irrelevant. Their conclusion was that a firm value depended only on the income produced by its assets and not how this income is split. In review of this theory dividend issued out to shareholders does not determine the value of a firm hence irrelevant in regards to firm valuation. A shareholder can in theory construct his own dividend policy. If a firm does not pay dividends a shareholder who wants a 2% dividend can create it by selling 2% of his shares. If a firm that pays higher dividend than desired by shareholder, he can use the unwanted dividend to buy additional shares of the firm's shares. If he can buy and sell shares hence create his own dividend policy without incurring costs, then the firm's dividend policy is irrelevant.

MM based their argument on unrealistic assumptions of a perfect capital market and rational investors such as: (a) no differences between taxes on dividends and capital gains; (b) no transaction and flotation costs incurred when securities are traded; (c) all market participants have free and equal access to the same information (symmetrical and costless information); (d) no conflicts of interests between managers and security holders (no agency problem); and (e) all participants in the market are price takers.

The proposition of dividend irrelevancy was based on several binding assumptions about the nature of perfect capital markets. This is a 'priori' model of how markets should work if they were perfect. Naturally, once we depart M&M's world of prefect capital market and relax one or more of the assumptions of perfect capital markets, the issue of dividend policy becomes more complicated. Introducing market imperfections might change the view that dividend decision is irrelevant. Importantly, if dividend policy is relevant it may interact with other decisions made by the firm about investment and financing. In other words, there may conceivably be a range of reasons why dividend policy might matter.

2.2.2 Dividend Preference Theory or Bird in Hand Hypothesis

The propagators of this school of thought were Gordon (1959) and Lintner (1956) as a response to Modigliani and Miller's dividend irrelevance theory. Their argument is based on the uncertainty of the future hence shareholders prefer receiving dividends to not receiving them. They also prefer current dividends to future capital gains because something paid today is more certain to be received than something expected in the future. One alternative and older view about the effect of dividend policy on a firm's value is that dividends increase firm value. In a world of uncertainty and imperfect information, dividends are valued differently to retained profits (or capital gains). Investors prefer the "bird in the hand" of cash dividends rather than the "two in the bush" of future capital gains. Increasing dividend payments, ceteris paribus, may then be associated with increases in firm value. As a higher current dividend reduces uncertainty about future cash flows, a high payout ratio will reduce the cost of capital. A representative sample of that debate would include: Lintner (1962), Gordon (1963)

Walter (1963), Baumol (1963), Brigham and Gordon (1968), and Van Horn and McDonald (1971). That is, according to the so-called “bird-in-the hand” hypothesis high dividend payout ratios maximize a firm’s value.

Gordon and Lintner’s proposition was made with an assumption that investors are risk averse and will therefore prefer cash dividends now to future capital gains. With them dividend payment is assumed to be relevant to the investors.

The assumption that investors will prefer dividends now may not hold through especially considering the fact that not all investors pursue same interest in a given point in time. For example a well off investor may go for future capital gains given the circumstance while at the same time a non well off investor may pursue a different strategy altogether by going for cash dividends now. Investors also do have different risk perceptions. They may be categorized into risk takers, risk neutral or risk averse. Risk takers have not been taken into account in this particular theoretical framework since they prefer capital gains in the future to current cash dividends.

2.2.3 Tax Effect Theory

The tax-effect Theory states that taxes are important considerations for investors. It states that capital gains are taxed at a lower rate than dividends. As such, investors may prefer capital gains to dividends. This is known as the "tax Preference theory”. Additionally, capital gains are not paid until an investment is actually sold. Investors can control when capital gains are realized, but, they can't control dividend payments, over which the related company has control. Capital gains are also not realized in an estate situation. For example, suppose an investor purchased a stock in a company 50 years ago and the investor held the stock until his or her death, when it is passed on to an heir. That heir does not have to pay taxes on that stock's appreciation.

This argument is based on the assumption that dividends are taxed at higher rates than capital gains. In addition, dividends are taxed immediately, while taxes on capital gains are deferred until the stock is actually sold. These tax advantages of capital gains over

dividends tend to predispose investors, who have favorable tax treatment on capital gains, to prefer companies that retain most of their profits rather than pay them out as dividends, and are willing to pay a premium for low-payout companies. Therefore, a low dividend payout ratio will lower the cost of equity and increase the share price.

In many countries a higher tax rate is applied to dividends as compared to capital gains taxes. Therefore, investors in high tax brackets might require higher pre-tax risk-adjusted returns to hold, Fama and French (2001) found that firms with higher growth and investments tended to have lower payouts. A shilling worth of tax today is more in value than the shilling in the future hence capital gains in future are preferred to dividends today (Brigham and Ehrdardt, 2011).However, in the real world taxes exist and may have significant influence on dividend policy and the value of the firm. In general, there is often a differential in tax treatment between dividends and capital gains, and, because most investors are interested in after-tax return, the influence of taxes might affect their demand for dividends. Taxes may also affect the supply of dividends, when managers respond to this tax preference in seeking to maximize shareholder wealth (firm value) by increasing the retention ratio of profits.

2.2.4 Clientele Effect Theory

The theory states that different shareholders of a firm prefer different dividend payout policies. Retired individuals or those with no regular source of income prefer firms that pay a high dividend payout. Such investors are usually in zero or low tax bracket hence taxes are of no concern to them. However, investors with regular source of income have no urgent need for dividend issued by the firm. They prefer the firm to pay less or no dividends at all but instead offer capital gains which attracts a low tax payment as compared to the dividends. Taxes and transaction cost influence a shareholders preference for either capital gains or dividends (Petit, 1977). In their seminal paper M&M (1961) noted that the pre-existing dividend clientele effect hypothesis might play a role in dividend policy under certain conditions. They pointed out that the portfolio choices of individual investors might be influenced by certain market imperfections such as

transaction costs and differential tax rates to prefer different mixes of capital gains and dividends.

M&M argued that these imperfections might cause investors to choose securities that reduce these costs. M&M termed the tendency of investors to be attracted to a certain type of dividend-paying stocks a “dividend clientele effect”. Nonetheless, M&M maintained that even though the clientele effect might change a firm’s dividend policy to attract certain clienteles, in a perfect market each clientele is “as good as another”; hence the firm valuation is not affected; that is, dividend policy remains irrelevant.

In practice, investors often face different tax treatments for dividend income and capital gains, and incur costs when they trade securities in the form of transaction costs and inconvenience (changing portfolios). For these reasons and based on different investors’ situations, taxes and transaction costs may create investor clienteles, such as tax minimization induced clientele and transaction cost minimization induced clientele respectively. These clienteles will be attracted to firms that follow dividend policies that best suit their particular situations. Similarly, firms may tend to attract different clienteles by their dividend policies. For example, firms operating in high growth industries that usually pay low (or no) dividends attract a clientele that prefers price appreciation (in the form of capital gains) to dividends. On the other hand, firms that pay a large amount of their profits as dividends attract a clientele that prefers high dividends.

2.2.5 Information Content or Signaling Hypothesis

Ross (1977) was the propagator of this school of thought. According to this hypothesis, Ross postulated that investors can infer information about a firm’s future profits through the signal coming from dividend announcements, both in terms of the stability of, and changes in, dividends.

However, for this hypothesis to hold, managers should firstly possess private information about a firm’s prospects, and have incentives to convey this information to the market. Secondly, a signal should be true; that is, a firm with poor future prospects should not be

able to mimic and send false signals to the market by increasing dividend payments. Thus the market must be able to rely on the signal to differentiate among firms. If these conditions are fulfilled, the market should react favorably to the announcements of dividend increase and unfavorably otherwise.

As managers are likely to have more information about the firm's future prospects than outside investors, they may be able to use changes in dividends as a vehicle to communicate information to the financial market about a firm's future profits and growth. Outside investors may perceive dividend announcements as a reflection of the managers' assessment of a firm's performance and prospects. An increase in dividend payout may be interpreted as the firm having good future profitability (good news), and therefore its share price will react positively. Similarly, dividend cuts may be considered as a signal that the firm has poor future prospects (bad news), and the share price may then react unfavorably. Accordingly, it would not be surprising to find that managers are reluctant to announce a reduction in dividends. Lintner (1956) argued that firms tend to increase dividends when managers believe that profits have permanently increased. This suggests that dividend increases imply long-run sustainable profits.

This theory may not however hold through due to the fact that information asymmetry may not exist in the market. Behavioral finance also do play a major role in criticizing this particular theory as most of its contents tends to suggest otherwise.

2.2.6 Agency Costs and Free Cash Flow Hypothesis of Dividend Policy

One of the assumptions of M&M's perfect capital market is that there are no conflicts of interests between managers and shareholders. In practice, however, this assumption is questionable where the owners of the firm are distinct from its management. In these cases managers are always imperfect agents of shareholders (principals). This is because managers' interests are not necessarily the same as shareholders' interests, and they might conduct actions that are costly to shareholders, such as consuming excessive perquisites or over-investing in managerially rewarding but unprofitable activities. Shareholders therefore incur (agency) costs associated with monitoring managers'

behavior, and these agency costs are an implicit cost resulting from the potential conflict of interest among shareholders and corporate managers. The payment of dividends might serve to align the interests and mitigate the agency problems between managers and shareholders, by reducing the discretionary funds available to managers (Rozeff, 1982, Easterbrook, 1984, Jensen, 1986, and Alli, Khan and Ramirez, 1993).

Jensen (1986) provided another explanation for paying dividends based on the agency costs hypothesis. Jensen contended that firms with excess (free) cash flow give managers more flexibility for using the funds in a way that benefit themselves but not shareholders' best interests. He argued that managers have incentives to enlarge the size of their firms beyond the optimal size to amplify the resources under their control and moreover to increase their compensation, which is often related to firm size.

Another source of the agency costs problem that may be influenced by dividend policy is the potential conflict between shareholders and bondholders. Shareholders are considered as the agents of bondholders' funds. In this case, excess dividend payments to shareholders may be taken as shareholders expropriating wealth from bondholders (Jensen and Meckling, 1976). Shareholders have limited liability and they can access the company's cash flow before bondholders; consequently, bondholders prefer to put constraints on dividend payments to secure their claims. Conversely, for the same reasons, shareholders prefer to have large dividend payments.

However, accepting the notion that increasing dividends will reduce the funds available to managers and force them to be in the market to acquire funds means that shareholders should be willing to tolerate the risk of the firm being more indebted and also accept paying higher personal tax rates on dividends. In other words, shareholders have to tradeoff between the costs and benefits of acquiring more dividends Jensen (1986).

These six theories provide varied conclusions on dividend payout. Dividend Irrelevance theory propagated by Modigliani and Miller (1961) suggest that dividend payment is irrelevant in determining a firm's value which is best measured by the profits earned.

MM's argument therefore suggests that there exists no relationship between profits and dividend payout. The Dividend Preference theory by Gordon (1959) and Lintner (1956) tend to contradict with MM's hypothesis. For them, dividend payment is relevant and will impact on firm's value implying that a relationship exists between firm's profits and dividend payout. The Tax Effect theory, Clientele theory and the Agency costs and Free Cash Flow hypothesis do not in any case provide any conclusion on whether dividend payouts have any relationship both with the firm's value and profits or not. Information Content or Signaling hypothesis by Ross (1977) suggested that investors can infer information about a firms future profit position through the signal coming from dividend payment.

2.2.7 Summary of Theoretical Literature

The theoretical literature on dividend policy can generally be subdivided into two sections, namely, dividend irrelevance theories and dividend relevance theories. Dividend irrelevance theory can be borrowed widely from the publication of the dividend irrelevance theory of Modigliani and Miller (1961). These theory is however relevant only in situations where perfect capital markets exists.

Dividend relevance theory however comes in due to the fact that various market imperfections exist which include taxes, transaction costs, and information asymmetry and agency problems. The dividend relevance theories include; Dividend Irrelevance Theory propagated by Gordon (1959) and Lintner (1956) suggested that shareholders preferred current dividends since they are more certain, to capital gains which are to be received in the future. The theory suggests that with more profits, more dividends should be paid as this would safeguard the shareholders dividend preference. Tax Effect Theory, Clientele Effect Theory, Information Content Theory by Ross (1977) suggested that investors can infer information about a firms future profit position through the signal coming from dividend announcements. The Agency Cost and Free Cash Flow Hypothesis developed due to the existence of agency costs problem in the market.

2.3 Determinants of Dividend Payout

There are a number of determinants of dividend payout by companies. These factors usually cut across almost all the sectors in the economy. They include the restrictive covenants on dividend payments, company's liquidity position, availability of investment opportunities, legal rules and regulations and inflation James, C. H. (2009)

Restrictive covenants have more impact on dividend payout to other determinants discussed below. These covenants are contained in bond indentures, term loans, short-term borrowing agreements, lease contracts, and preferred stock agreements. The restrictions limit the total amount of dividends a company can pay. Sometimes they may state that dividends cannot be paid at all until a company's earnings have reached a specified level. In addition, sinking fund requirements, which state that a certain portion of a company's cash flow be set aside for the retirement of debt, sometimes limit dividend payments. Also dividends may be prohibited if a company's working capital (current assets less current liabilities) or its current ratio does not exceed a certain predetermined level James, C. H. (2009)

Liquidity position relates to the ability of the company to meet short term obligation as and when they arise. Cash is an important element in the liquidity position of the company. When a company does not have enough cash to meet its short term obligations, the management may hold the issuance of dividends to ensure that the retained funds are available when need arises James, C. H. (2009)

Availability of investments opportunities for a company is also a major factor determining dividend payments. When a company has investment opportunities it can fund them through retained profits or borrowed funds. Retained profits usually offer a cheap available source of financing compared to borrowed funds. If the management makes a decision to use the retained funds, this reduces the amount available for distribution to shareholders hence little or no dividends for that particular period and vice versa James, C. H. (2009)

According to the Companies Act of Kenya, dividends issue is discretion of the management of a company. It is not mandatory for company to issue out dividends to shareholders. However dividends can only be issued out of the current or past profits of company. A company that continually makes losses cannot declare dividends to shareholders since this would mount to distribution of the company's capital which is prohibited by the Companies Act unless during the dissolution of the company James, C. H. (2009)

In an inflationary environment, funds generated by depreciation often are not sufficient to replace a firm's assets as they become obsolete. Under these circumstances, a company may be forced to retain higher percentage of profits to maintain the earning power of its asset base. Inflation has an impact on a company's working capital needs. In an atmosphere of rising prices, actual shillings invested in current assets tend to increase to support the same volume of business. And, because the shilling amounts of current liabilities requiring cash outlays are higher with rising prices, transaction cash balances normally have to be increased. Thus, inflation can force a company to retain more profits as it attempts to maintain its same relative pre-inflation working capital position James, C. H. (2009)

2.4 Empirical Literature

The Modigliani and Miller (1961) dividend irrelevance proposition has provided the foundation for much subsequent research on dividend policy both in the international and local level. Modigliani and Miller (1961) built their conclusions on a certain set of assumptions of perfect capital markets which in reality some of them appear hard to meet. Relaxing one or more of these assumptions has formed the basis for most of international and local empirical studies.

2.4.1 International Evidence

Black and Scholes (1974) used a long-term definition of dividend yield (previous year's dividends divided by the year-end share price). Their results showed that the dividend yield coefficients are not significantly different from zero either for the entire period

(1936-1966) or for any of shorter sub periods. That is to say, the expected return either on high or low yield stocks is the same. Black and Scholes, therefore, concluded that, "we are unable to show that differences in yield lead to differences in stock prices". Black and Scholes's conclusion lent important empirical support to M&M's dividend irrelevance argument and therefore give no evidence on the relationship between profits and dividend payout.

Baker, Farrelly and Edelman (1985) surveyed the chief financial officers (CFOs) of 562 firms listed on the New York Stock Exchange (NYSE) from three industry groups (150 utilities, 309 manufacturing and 103wholesale/retail). Based on 318 responses, they found that respondents strongly agreed that dividend policy affects common stock prices.

Baskin (1989) studied firms in U.S during the period 1967 to 1986 found that the price volatility was negatively related to dividend yield and payout ratio. The findings depict that price volatility will give negative pattern of results in relation to both dividend yield and dividend payout. Baskin used multiple linear regression to arrive at his findings.

Baker and Powell (1999) surveyed 603 CFOs of US firms listed on the NYSE, and observed that 90 percent of respondents believed that dividend policy affects a firm's value as well as its cost of capital. Further studies by the same authors tend to confirm that dividend policy actually matters in the determination of firm value but do not show any relationship between profits and dividend payout.

Rashid and Rahman (2008) researched on relationship between dividend policy and share price volatility and found a positive insignificant relationship between share price volatility and dividend yield for non-financial firms listed in the Dhaka Stock exchange during the period of 1999 – 2006. The findings also depicted that debt and growth have positive insignificant relationship with share price volatility while payout ratio had a significant negative relationship with price volatility.

Khaled, Chijoke and Aruoriwo (2011) carried out a research on UK market with the objective of determining the relationship between dividend policy and stock price volatility. After applying a multiple regression analysis on the data, the research showed that there exists a positive relationship between dividend yield and stock price volatility. The research also showed evidence that debt level; firm's size and earning explain price volatility as well. The research however did not prove whether a relationship exists between profits and dividend payout.

Zuriawati, Joriah and Abdul (2012) studied the effect of dividend policy and share price volatility on Malaysian construction and material companies and found a negative insignificant relationship between dividend yield and share price volatility. This study give contradicting conclusion to the similar study done by Rashid and Rahman (2008) and both do not show whether there is any relationship between profits and dividend payout.

Yasir, Zernigah and Muhammad (2012) on dividend policy on stock price volatility who applied cross sectional regression analysis in their study concluded that dividend yield is positively related to stock price volatility in Pakistan market.

2.4.2 Local Evidence

Mulwa (2006) examined whether the signaling efficiency of dividend changes on the future profitability of quoted companies at the NSE. The population consisted of the 48 companies listed at the NSE and covered a period of 5 years (1998 - 2002). Secondary data obtained from NSE, Stockbrokers, Kenya National Bureau of Statistics (KNBS) and Capital Market Authority (CMA).The study recommends that dividend changes have no effect on future profitability and also recommends further studies to be done.

Amidu (2007) in his study that sought to establish whether dividend policy affects firm's performance used a panel regression equation to meet his objectives. His method differs from a regular time series or cross section regression by the double subscript attached to each variable. The panel pooled crossed-section regression data was used to gain the

maximum possible observations. The dependent variables were return on assets and return on equity as the main accounting measures of performance. Dividend payout was measured by the dividend payout ratio. This study recommends that dividend policy is still unresolved.

A study conducted by Abdi (2010) concluded that dividend payout ratios positively correlate with future profits of companies though the relationship is low. The study suggest that further profits be conducted on the appropriation of profits and the future profits of companies so as to bring out clearly what role dividend play in signaling future profits.

Ngunjiri (2010) studied the relationship between payment policies and stock price volatility and indicated that payment policies had a great impact on the stock price volatility. Stock price volatility being an indication of firm's profitability shows therefore that profits similarly have a relationship with dividend policies.

Kimutai (2012) revealed that there is a positive effect of liquidity on dividend payout. The findings also revealed that all other independent variables except cash flow had a positive association with dividend payout. This study harmonizes with other studies done in developing countries that portray a positive association between liquidity and dividend payout but does not state whether dividend payout is related to profits earned. For this reason, there is need to explore this matter more with various other models. These results have important implications to the shareholders.

Ngobe et al. (2013) studied the relationship between dividend policy and stock price volatility for the period 1999-2008 at NSE using correlation and multiple regression analysis and concluded that dividend yield has a positive relationship with price volatility while payout ratio has a negative relationship with price volatility. This conclusion therefore suggests that profits have a negative relationship with dividend policy. From this point of view Ngobe et al. (2013) conclusion on the negative relationship between

payout ratio and price volatility give an indication that profits and dividend payout may also have a negative relationship and needs to be explored further.

2.4.3 Summary of Empirical Literature

From the above empirical studies by both international and local researchers, there seems to be no general agreement on whether a relationship exists between profits and dividend payout. The study by Yasir et al. (2012) on dividend policy contradicts to a similar study by Baskin (1989) though the two were done in the same environment i.e. Pakistan market. Similarly, the study by Rashid and Rahman (2008) and a similar study on dividend policy by Zuriawati, Joriah and Abdul (2012) provide different suggestions. Whereas Rashid and Rahman (2008) suggest a positive insignificant relationship between dividend policy and share price, Zuriawati et al. suggests a negative insignificant relationship. On the other hand the local studies done by Ngobe et al. (2013) and a similar one by Ngunjiri (2010) on dividend payout policies provide contradicting findings. For local empirical studies; the conclusion on the study by Abdi (2010) and Ngunjiri (2010) on dividend payout policies that dividend payout ratios have positive relationship with future profits tend to contradict with the study by Ngobe et al.(2013) whose conclusion showed a negative relationship. The study by Kimutai (2012) tends to agree with the findings of Abdi (2010) though in his study liquidity aspect was used rather than profitability. There is therefore no general agreement in these local researches on the relationship between profits and dividend payout.

2.5 Summary of Literature Review

The literature on dividend policy has produced a large body of theoretical and empirical research, especially following the publication of the dividend irrelevance hypothesis of Modigliani and Miller (1961). No general consensus has yet emerged after several decades of investigation, and scholars can often disagree even about the same empirical evidence. In perfect capital markets, Modigliani and Miller (1961) asserted that the value of a firm is independent of its dividend policy. However, various market imperfections exist (taxes, transaction costs, information asymmetry and agency problems) and these market imperfections have provided the basis for the development of various theories of

dividend policy including tax-preference, clientele effects, signaling, and agency costs. The Dividend preference theory or Bird in hand theory propagated by Gordon (1959) and Lintner (1956) suggested that shareholders preferred current dividends since they are more certain, to capital gains which are to be received in the future. The theory suggests that with more profits, more dividends should be paid as this would safeguard the shareholders dividend preference. The information content or signaling effect theory by Ross (1977) suggested that investors can infer information about a firms future profit position through the signal coming from dividend announcements.

The study by Khaled et al. (2011) on UK market where they applied multiple regression analysis on the data found out that a positive relationship exists between dividend yield and stock price volatility. However, Zuriawati et al. (2012) on their study on the effect of dividend policy and share price volatility on Malaysian construction and material companies found a negative insignificant relationship between dividend yield and share price volatility. These two studies also give contradicting conclusions and both do not show whether there is a relationship between profits and dividend payout. From the study done by Ngunjiri (2010) on the relationship between payment policies and stock price volatility, he indicated that payment policies had a great impact on the stock price volatility. However, Ngobe et al.(2013) in his study on the relationship between dividend policy and stock price volatility for the period 1999-2008 at NSE using correlation and multiple regression analysis concluded that negative relationship exists between dividend policy and price volatility. Since stock price is a function of profits and dividend payout these studies implies that there is still no consensus on whether or not relationship between profits and dividend payout. These two studies by Ngunjiri (2010) and Ngobe et al. (2013) gave contradicting conclusions and therefore necessitate this study of investigating whether or not a relationship exists between profits and dividend payout.

It is evident from the above literature review that there is no conclusive position arrived at from the many studies done on the subject of the relationship between dividend payout and profits. This study therefore seeks to find out whether or not a relationship exists between profits and dividend payout of a specific sector of the firms listed on the NSE,

the banking sector. Since the sector is large compared to the other sectors listed on the NSE, the findings of this study will most likely depict the relationship existing in the other sectors in the economy.

From the empirical findings of studies on the subject of dividend policies there is no general agreement that profits may have some relationship with dividend payout. It is an observed fact that studies carried out in different environments have resulted in varying results or conclusions.

This therefore necessitated the study to be carried out to establish the relationship between profits and dividend payout of commercial banks in Kenya. This study tries to answer the research question resulting from the various theories and empirical studies i.e. "Is there any relationship between profits and dividend payout?"

CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Introduction

This chapter presents five main sections containing the methodology which was used in the study. Section 3.2 presents the research design chosen for the study followed by Section 3.3 which discussed the population and sample under study. Section 3.4 presents data and data collection instruments; this section discusses how the data was measured and also the instruments that were used to collect the data. Section 3.5 presents both the conceptual and analytical model which was adopted in analyzing the research findings.

3.2 Research Design

This study adopted descriptive research design based on the key areas of interest. Descriptive research design helps the researcher to clearly identify and describe true characteristics of a research problem without manipulation of research variables (Mugenda & Mugenda, 2003). Descriptive design seeks to portray accurately the characteristics of a particular individual, situation or a group.

This study sought to investigate whether a relationship exists between profits and dividend payout. In this study, we have two major variables of interest. The independent variable is the profits while the dependent variable is dividend payout. Liquidity position and inflation rate was however used as control variables in this study.

3.3 Population and Sample

3.3.1 Population of the Study

Population is the entire set of elements with which to generalize the study findings. The target population in this study constituted 43 commercial banks registered with the Central Bank of Kenya (Appendix 1).Mugenda and Mugenda (2003) explained that the target population should have observable characteristics to which the study intents to

generalize the result of the study. This definition assumes that the population is not homogeneous.

3.3.2 Sample and Sampling Techniques

Cooper and Scheduler (2002) defines sampling as the process of selecting element in a population for purposes of drawing conclusion on specific characteristics from the identified population.

The sample constituted commercial banks that were continuously listed during the 5 year period under study: 2008-2012. 10 commercial banks meet this criterion and will be used in the study (Appendix 2).

3.4Data and Data Collection Instruments

There are two types of data. These are the primary and secondary data. Primary data refers to data collected for the first time such as the use of questionnaires and interviews. Secondary data would however be used in this particular study. Secondary data refers to the information obtained from newspapers, magazines; journals, books and the internet just to mention a few.

This study used secondary data which was collected from NSE. Data relating to dividend payout and profits and the control variables were collected from published financial statements and reports for each financial year end of the ten sampled commercial banks listed on Nairobi stock exchange. Inflation rate data was obtained from the CBK statistics. The Nairobi Securities exchange keeps copies of financial statements and reports of all listed companies from the time they were listed.

3.5 Data Analysis

Data analysis is the most important part of the study so as to enable the reader to easily understand the context of the study. This research study used quantitative data comprising of profits, dividend payout and the two control variables i.e. liquidity position and inflation rate of commercial banks listed on the NSE.

3.5.1 Conceptual Model

Linear regression model was used to analyze the data. Regression analysis is used in finding out whether an independent variable predicts a given dependent variable (Zinkmund, 2003).The regression model to be used is of the form:

$Y = f(X1, X2, X3)$……. (1)

In this study, the independent variables were profits, liquidity position and inflation while the dependent variable was dividend payout. Liquidity position and inflation rates were used as control variables since this study aims at investigating the relationship between profits and dividend payout of commercial banks. Expected relationship between profits, liquidity position and inflation rate were determined by use of the resulting multiple linear regression model. A positive linear relationship is expected between profits and dividend payout (Yasir et al. 2012).

3.5.2 Analytical Model

Multiple linear regression model was used to show the relationship existing between dividend payout and profits, liquidity position and inflation rate. Expected dividend payout was determined by use of the market model based on the multiple linear regression as follows:

$Y=a + \beta1\ X1 + \beta2\ X2 + \beta2\ X2 + e$ ……..... (2)

This was the model used to show the relationship between dividend payout and profits, liquidity position and inflation rate of commercial banks listed on the NSE.

Where:

Y = is the dividend payout of commercial banks listed on the NSE in a given year.

X1 = is the profit before tax earned by commercial banks listed on the NSE in a given year.

X2 = is the liquidity position measured by cash and balances with Central Bank of Kenya held by the commercial banks listed on the NSE in a given year end.

X3 = is the inflation rate prevailing in the country at a given year end.

a = constant dividend payout of commercial banks. This is the dividend which is expected to be paid out whether or not the commercial banks make profits, at any liquidity position and at any inflation rate in a given year. It represents the Y intercept in the equation.

β1, β2, β3= regression coefficients calculated through regression analysis. It shows whether or not a relationship exists between dividend payout and each of the other variables. It also shows the nature of the relationship. None zero value shows a relationship exists while a zero value shows no relationship. On the other hand, a positive value shows a direct relationship whereas a negative value shows an indirect relationship.

e = the error term of the study

The study used correlation-coefficient to test the strength of the relationship between dividend payout and the other variables of the commercial banks listed on the NSE. Karl Pearson's correlation coefficient (r) which ranges from -1 to +1 was used to measure the strength existing between dividend payout and the other variables.-1 show a perfect negative relationship, a value between -0.5 and -1 show a strong negative relationship while a value between -0.5 and 0 show a weak negative relationship. On the other hand,+1 show a perfect positive relationship, a value between 0 and 0.5 show a weak positive relationship while a value between 0.5 and 1 show a strong positive relationship. The study used the t-statistic to test the level of significance between dividend payout and the other variables of commercial banks listed on the NSE at 95% level of significance. Any variable with a p-value that is less than 0.05 is deemed to have significant relationship with the dependent variable, while any variable with a p-value more than 0.05 is considered to have an insignificant relationship.

CHAPTER FOUR
DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents five main sections. Section 4.2 provides the full range of the measures of central tendency resulting from the study. Section 4.3 provides the results of data analysis. Section 4.4 provides a discussion of the findings; this is followed by a conclusive summary done under section 4.5. The analysis used regression analysis and descriptive statistics to test the relationship between dividend payout and profits of Commercial banks. These models were used to determine both the nature and strength of the relationship between the variables under study.

4.2 Summary Statistics

Tables 1, 2, 3 and 4 below give the minimum, maximum, mean and standard deviation of each specific variable from data collected for the 10 commercial banks listed on the NSE over the five year period under study: 2008-2012. Similarly, Figure 1, 2, 3 and 4 show the range for each of the variables for the five year period under study.

4.2.1 Dividend Payout

Table 1: Descriptive Statistics on Dividend Payout for Year 2008-2012

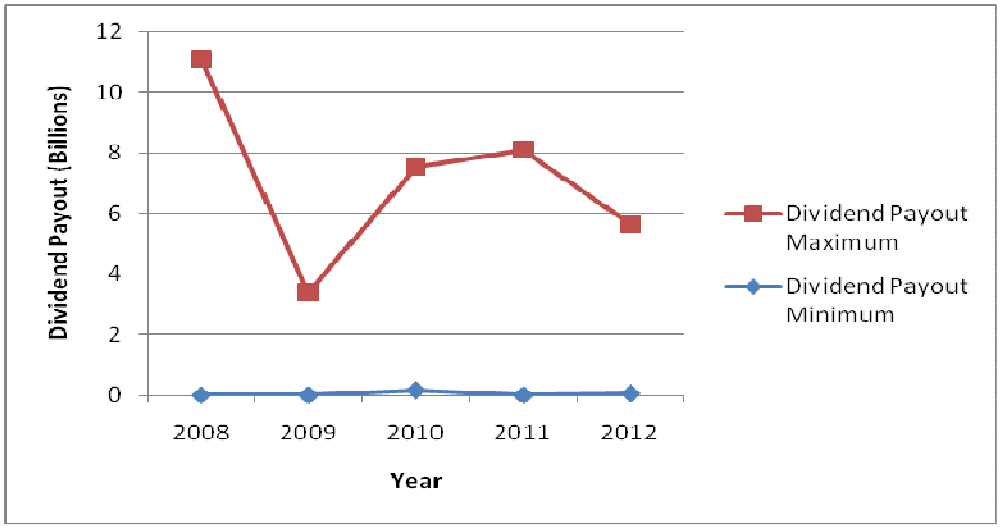
YEAR	Minimum	Maximum	Mean	Standard Deviation
2008	-	11,108,331,060	1,975,639,955	3,404,469,883
2009	-	3,395,000,000	1,169,517,591	1,343,725,050
2010	161,000,000	7,401,100,000	2,051,593,451	2,411,224,480
2011	-	8,146,500,000	2,214,829,625	2,757,743,889
2012	56,000,000	5,643,646,676	2,329,163,265	2,321,510,592

Source: Author's Computation

The descriptive results in Table 1 above shows that dividend payout by the commercial banks for the year 2008 ranged from a minimum of Kshs. 0 to a maximum of Kshs.11,108,331,060 with a mean of Kshs.1,975,639,955 and a standard deviation of Kshs. 3,404,469,883 across the 10 commercial banks. In the year 2009 dividend payout ranged from a minimum of Kshs. 0 to a maximum of Kshs. 3,395,000,000 with a mean of Kshs. 1,169,517,591 and a standard deviation of Kshs. 1,343,725,050 across the 10 commercial banks. Year 2010 however recorded a minimum dividend payout of Kshs. 161,000,000 and a maximum of Kshs. 7,401,100,000 with a mean of Kshs. 2,051,593,451 and standard deviation of Kshs. 2,411,224,480. For financial year 2011, the commercial banks minimum dividend payout was Kshs. 0 and a maximum of Kshs.8, 146,500,000 with a mean of Kshs. 2,214,829,625 and a standard deviation of Kshs.2, 757,743,889. However in the year 2012, the minimum dividend payout recorded was Kshs.56, 000,000 and a maximum of Kshs. 5,643,646,676 and a mean of Kshs. 2,329,163,265 with a standard deviation of Kshs. 2,321,510,592.

From the observations in Figure 1 below it can be noted that lowest dividend payout was experienced in the year 2008, 2009 and 2011 where the minimum dividend payout was nil. Year 2008 had both the highest dividend payout as well as the highest variation in the dividend payout.

Figure 1: Dividend Payout Range for Year 2008-2012



4.2.2 Profits of Commercial Banks Listed on the NSE

Table 2: Descriptive Statistics on Profits for Year 2008-2012

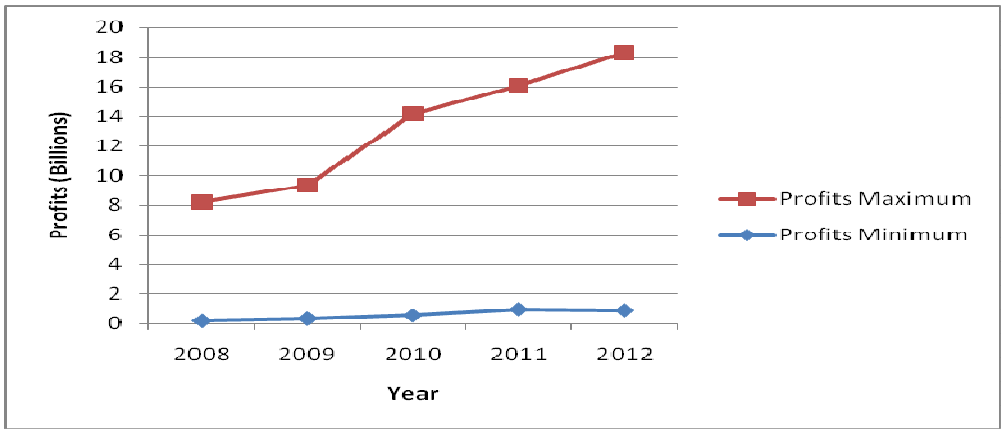
YEAR	Minimum	Maximum	Mean	Standard Deviation
2008	202,670,000	8,016,000,000	3,320,920,000	2,537,160,314
2009	351,118,000	9,002,000,000	3,811,767,800	2,878,776,801
2010	561,028,000	13,553,000,000	5,718,506,400	4,179,469,316
2011	975,795,000	15,129,374,000	6,878,341,600	4,956,988,649
2012	907,631,000	17,420,000,000	8,637,732,700	6,111,528,385

Source: Author's Computation

The descriptive results for profits before taxation for the 10 commercial banks as shown in Table 2 above shows that in the year 2008 profits ranged from a minimum of Kshs. 202,670,000 to a maximum of Kshs. 8,016,000,000 with a mean of Kshs. 3,320,920,000 and a standard deviation of Kshs. 2,537,160,314.In the year 2009 profits before taxation ranged from a minimum of Kshs. 351,118,000 to a maximum of Kshs. 9,002,000,000 with a mean of Kshs. 3,811,767,800 and a standard deviation of Kshs. 2,878,776,801 across the 10 commercial banks. Year 2010 recorded minimum profits of Kshs. 561,028,000 and a maximum of Kshs. 13,553,000,000 with a mean of Kshs. 5,718,506,400 and standard deviation of Kshs. 4,179,469,316.For financial year 2011, the commercial banks' minimum profits before taxation was Kshs. 975,795,000 and a maximum of Kshs. 15,129,374,000 with a mean of Kshs. 6,878,341,600 and a standard deviation of Kshs. 4,956,988,649.However in the year 2012,the minimum profits before taxation recorded was Kshs. 907,631,000 and a maximum of Kshs. 17,420,000,000 and a mean of Kshs. 8,637,732,700 with a standard deviation of Kshs. 6,111,528,385.

Unlike the dividend payout above the lowest profits before taxation was observed in the year 2008 while year 2012 had the highest dividend payout recorded. The highest variation as measured by the standard deviation in profits before taxation was in the year 2012 and at the same time the highest mean profits was in the same year. Figure 2 below can best present these observations.

Figure 2: Profits Range for Year 2008-2012



4.2.3 Liquidity Position

Table 3: Descriptive Statistics on Liquidity Position for Year 2008-2012

YEAR	Minimum	Maximum	Mean	Standard Deviation
2008	186,896,000	17,239,000,000	6,892,351,100	5,076,127,195
2009	319,839,000	19,871,000,000	7,796,296,300	5,086,650,982
2010	420,390,000	26,998,000,000	9,901,655,100	7,457,176,345
2011	384,034,000	42,708,016,000	13,054,990,200	11,628,077,411
2012	1,454,359,000	36,419,912,000	14,682,403,700	10,426,568,946

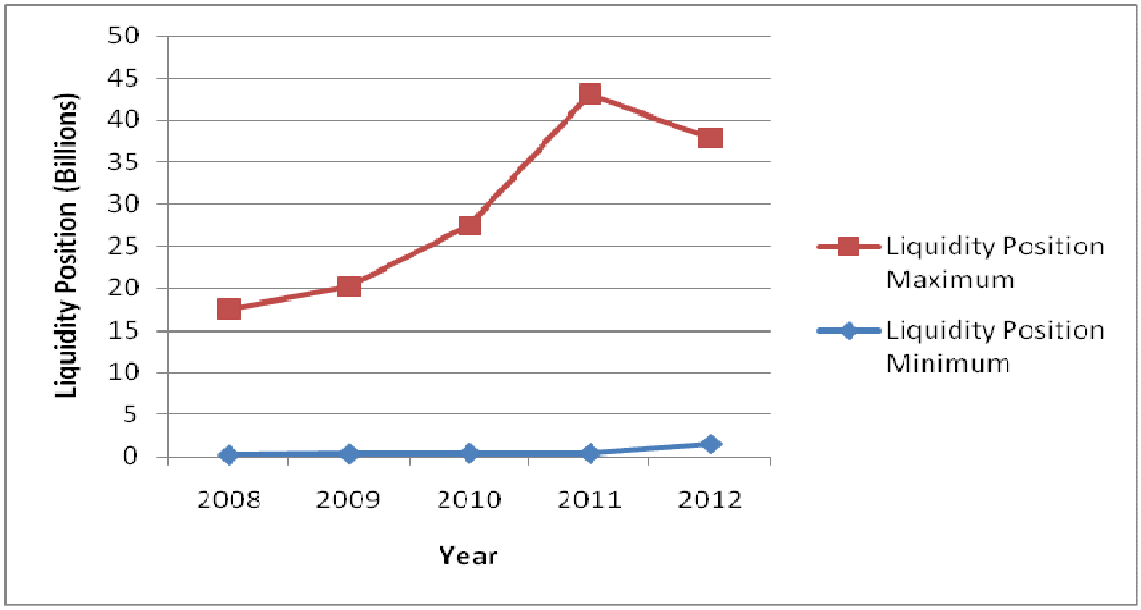
Source: Author's Computation

The descriptive statistics of liquidity position as measured by the cash and balances with Central Bank of Kenya were as per Table 3 above. Year 2008 had a minimum value of Kshs.186,896,000 with the highest value of Kshs. 17,239,000,000.Its mean was Kshs.6,892,351,100 while the standard deviation stood at Kshs. 5,076,127,195.Year 2009 recorded minimum liquidity position of Kshs. 319,839,000 and a maximum of Kshs. 19,871,000,000 with a mean of Kshs. 7,796,296,300 and standard deviation of Kshs. 5,086,650,982.For the financial year 2010, the commercial banks' minimum liquidity position was Kshs.420,390,000 and a maximum of Kshs.26,998,000,000 with a mean of Kshs. 9,901,655,100 and a standard deviation of Kshs. 7,457,176,345. For financial year 2011, the commercial banks' minimum liquidity position was Kshs. 384,034,000 and a

maximum of Kshs. 42,708,016,000 with a mean of Kshs. 13,054,990,200 and a standard deviation of Kshs. 11,628,077,411.However in the financial year 2012, the minimum liquidity position recorded was Kshs. 1,454,359,000 and a maximum of Kshs. 36,419,912,000 and a mean of Kshs. 14,682,403,700 with a standard deviation of Kshs. 10,426,568,946.

From the above observations, the lowest liquidity position as measured by cash and balances with the Central Bank of Kenya was recorded in the year 2008 with a maximum value in the year 2011.Year 2012 had the highest mean value while major variation occurred in the year 2011 as measured by the standard deviation. Figure 3 below can best present these observations.

Figure 3: Liquidity Position Range for Year 2008-2012



4.2.4 Inflation Rate

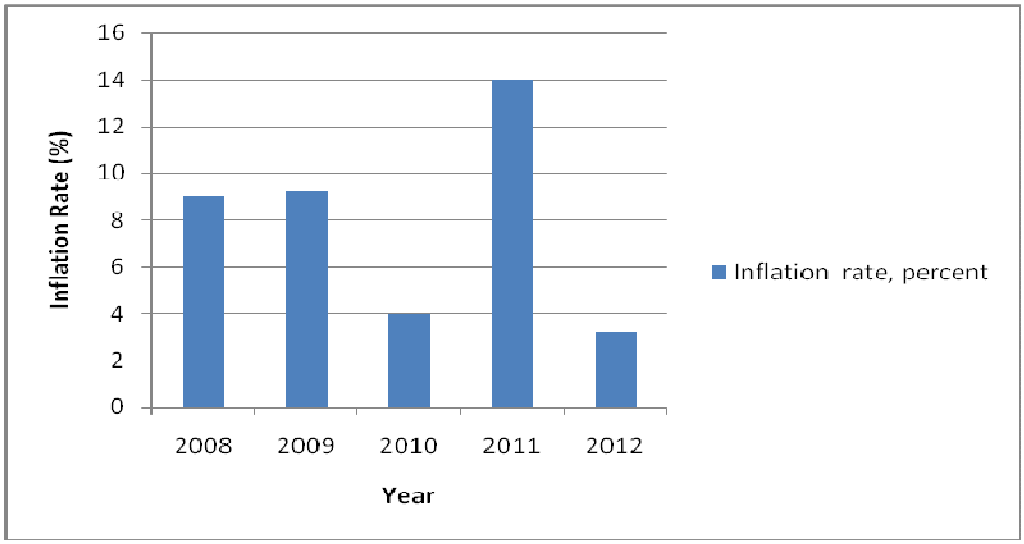
Table 4: Descriptive Statistics for Year 2008-2012

Year	2008	2009	2010	2011	2012
Inflation rate, percent	9.04	9.24	3.96	14.02	3.2

Source: Author's Computation

As per the central bank statistics, presented in Table 4 above, the highest inflation rate in the five year period was observed as at 31st December 2011 with the rate standing at 14.02% while the lowest rate was 3.2% and was recorded on 31st December 2012.The mean inflation rate as per the statistics was 7.89% while the standard deviation was 4.42% for the period. Figure 4 below can best depict this observed trend.

Figure 4: Inflation Rate Range for Year 2008-2012



4.3Profits and Dividend Payout

4.3.1Results of Correlation Analysis

Table 5: Correlation Analysis

		Dividend Payout	Profits	Liquidity
Dividend Payout	Pearson Correlation	1	0.961	0.597
	Sig. (2-tailed)		0.000	0.068
Profits	Pearson Correlation	0.961	1	0.769
	Sig. (2-tailed)	0.000		0.009
Liquidity Position	Pearson Correlation	-0.597	0.769	1
	Sig. (2-tailed)	0.048	0.009	
Inflation Rate	Pearson Correlation	0.038	0.157	0.491
	Sig. (2-tailed)	0.917	0.666	0.150

Source: Author's Computation

From the correlation analysis in Table 5 above the following observations can be deduced: Profitability of commercial banks is positively and strongly related to dividend payout as indicated by Pearson correlation coefficient of 0.9607. The relationship is also significant at 5% significance value since the p value of 0.000 is less than 0.05. Liquidity position of commercial banks is negatively related to dividend payout as shown by coefficient of correlation of -0.5970 and is significant at 95% confidence level since its p value of 0.048 is lower than the allowable value of 0.05. However, liquidity is positively related with profitability with a coefficient of correlation of 0.7685 implying higher profitability leads to higher dividend payout. Inflation is also positively related to dividend payout with coefficient of correlation of 0.038. However, the relationship is not significant at 95% confidence level since the p value is more than the allowable 0.05 i.e. the p value is 0.917.

4.3.2Results of Model Goodness of Fit Test

Table 6: Model Goodness of Fit Test

R	R Square	Adjusted R Square	Std. Error of the Estimate
0.985968	0.972133	0.9582	4.35E+08

Source: Author's Computation

From the results of the model goodness of fit analysis shown in Table 6above, the relationship between dividend payout and the independent variables; profits, liquidity position and inflation rate is very strong as shown by coefficient of correlation of 0.986. The coefficient of determination which shows how the change in the independent variable results to changes in the dependent variable had a value of 0.958 implying that the model developed could explain 96.8% of changes in dividend payout.

4.3.3Results of ANOVA

Table 7: Analysis of Variance

	Sum of Squares	Df	Mean Square	F	Sig.
Regression	3.96E+19	3	1.32E+19	69.76969	0.0000
Residual	1.13E+18	46	1.89E+17		
Total	4.07E+19	50			

Source: Author's Computation

From the results of the analysis of variance shown in Table 7 above, it is observed that at 95% confidence level, the model developed is significant as shown by the p value of 0.0000 which is less than the allowable 0.05. This implies that the model developed was reliable in making predictions.

4.3.4 Estimated Model

Table 8: Empirical Model

	Unstandardized Coefficients	Std. Error	Beta	t	Sig.
Constant	-8.1E+08	3.61E+08		-2.24242	0.066127
Profits	0.66056	0.061841	1.23889	10.68166	0.0004
Liquidity Position	-0.10377	0.037197	-0.36684	-2.78986	0.031583
Inflation Rate	-	43,477,383	0.023888	0.28043	0.788566

Source: Author's Computation

The model developed is shown from the data analysis in Table 8 above. From the empirical model coefficients, the model developed is:

$Y=-8.1E08+0.661X_1-0.104X_2+ 0X_3$

Where;

Y is dividend payout,

X_1 is the profits before taxation earned,

X_2 is liquidity position and

X_3 is the inflation rate.

From the model a unit increase in profits would lead to an increase in dividend payout by 0.661 units of commercial banks listed on the NSE. On the other hand, a unit increase in liquidity position would lead to a reduction in dividend payout by 0.104 units i.e. a negative relationship. The study shows that there was an insignificant relationship between dividend payout and inflation rate.

4.4. Discussion

The research used multiple linear regression model in interpreting the findings. The coefficient of determination, R Square, for the model was 0.958. This means that the predictor variables accounted for 95.8% of the variations in dividend payout. This implies that profits, liquidity position and inflation rate exert more pressure on dividend payout of commercial banks listed on the NSE.

The gradient of Profits in the basic model was 0.661 while liquidity position had a gradient of -0.104 and insignificant for inflation rate. From the p value results it was found out that profitability of commercial banks accounted to a greater extent to dividend payout followed by liquidity position. However, inflation rate was seen to have an insignificant effect on dividend payout.

4.5 Summary

The research sought to investigate the relationship between profits and dividend payout of commercial banks in Kenya using those listed on the NSE as a sample of the said population and incorporated both liquidity position as measured by the cash and balances with the CBK and the inflation rate at the year end. It was established that profits and the two control variables had an effect on dividend payout. The relationship between the variables was found to be a strong positive. The strong positive relationship indicated that profits and the two control variables influenced dividend payout to a statistically significant level.

Ten listed commercial banks on the NSE were analyzed by first collecting data on the profits, the two control variables and dividend payout of each commercial bank over the

five year period from the financial statements. By the use of regression analysis the correlation coefficient was obtained in order to establish the relationship between the variables under study. The variables accounted for over 96% of dividend payout of the commercial banks analyzed.

CHAPTER FIVE
SUMMARY AND CONCLUSION

5.1 Introduction

This chapter presents five main sections. It summarizes the study and makes conclusion based on the results. Section 5.2 provides summary of the research findings. Section 5.3 presents the conclusion made from the findings while section 5.4 provides the limitations of the study. Recommendations for further research are provided under section 5.5 of the chapter while section 5.6 provides recommendations of policy. The purpose of these conclusions is to answer the objective of the study.

5.2 Summary of the Study

The findings present the descriptive statistics of the variables used in the analysis: Dividend Payout, Profits and the two control variables, Liquidity Position and Inflation Rates. The findings show that there is a positive relationship between profits and dividend payout. However, the strength of the relationship is insignificantly weakened when the two control variables, liquidity position and inflation rate, are incorporated in the study.

Findings show that dividend payout of the commercial banks is highly correlated to profits earned in any given year. Dividend payout and profits are positively correlated. From this we can establish that dividend payout mostly depends on profits. It is also shown that when profits earned increases, dividend payout also increases.

It can be inferred from the study that the variables are however not perfectly positively correlated. This is because the value of positive one correlation coefficient was not obtained in any between dividend payout and profits before tax earned.

5.3 Conclusion

The objective of the study was to investigate the relationship between profits and dividend payout for commercial banks in Kenya by the use of the 10 commercial banks listed on the Nairobi securities exchange as a sample. The research findings depict that there was a strong positive relationship between profits and dividend payout. The control variables which included liquidity position and inflation rate were found to have no significant relationship with dividend payout since a higher percentage could be accounted to a great extent by profits earned in a given financial year.

The study concludes that there is a strong positive relationship between profits and dividend payout of commercial banks in Kenya.

5.4 Limitations of the Study

This research did not cover unlisted commercial banks in Kenya to see whether the same results also hold by testing similar variables as in this. It was also a little bit hard to get information especially the total number of shares which were used in the calculation of dividend payout of some listed commercial banks on the Nairobi Securities Exchange.

The data found on the Nairobi Securities exchange were also at times quoted in thousands or millions making the results not as accurate as expected. Some information not found at the Nairobi Securities Exchange was obtained from the internet. However, the information from the internet may not be necessarily 100% accurate. It is highly time consuming to get the required information from all the financial statements of the sampled commercial banks. It is also evident that other factors other than profits, liquidity position and inflation rate affect dividend payout such as the restrictive covenants, availability of investment opportunities and legal rules and regulations. This research did not take into account such other factors.

5.5 Recommendations for Further Research

Further research can be carried on all other commercial banks in Kenya registered with the Central Bank of Kenya which are not listed on the Nairobi Securities Exchange. This will establish whether there exists a different conclusion on the relationship between profits and dividend payout. It is suggested that a research be carried out to determine the relationship between dividend payout and other determinants of dividend payout of the commercial banks listed on the NSE. This research was undertaken on commercial banks listed on the Nairobi Securities Exchange. It is recommended that a similar research study be done incorporating the unlisted commercial banks. A research study where data collection relies on primary data i.e. in depth questionnaires and interviews covering all the 43 commercial banks registered with the Central Bank of Kenya is also recommended so as to compliment this research. Lastly, research study can be done on the relationship between dividend payout and profits of all companies listed on the Nairobi Securities Exchange. A similar research should be done on the institutions which are not listed on the Nairobi Securities Exchange to find out if similar results will be obtained.

5.6 Recommendations of Policy

The findings of this study indicate that profits and dividend payout have a strong positive relationship. The study therefore recommends that the BOD should declare dividends which are consistent with the profits earned in a given financial year.

On liquidity position, the study found out that a negative relationship exists between dividend payout and liquidity position. This study recommends that a comprehensive assessment of the company's immediate liquidity position should be undertaken before any dividend payout is declared to the shareholders. This is because the company's liquidity position is of high importance since it influences the company's current operations.

The study however found out that the prevailing inflation rate in the country has an insignificant relationship with dividend payout. Hence a research incorporating only the

dividend payout and inflation rate independent of other determinants of dividend payout needs to be undertaken so as to support the findings of this study.

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APPENDICES

APPENDIX 1: LIST OF LICENSED COMMERCIAL BANKS IN KENYA

1. African Banking Corporation Limited
2. Bank of Africa Kenya Limited
3. Bank of Baroda Kenya Limited
4. Bank of India
5. Barclays Bank of Kenya Limited
6. CFC Stanbic Bank Limited
7. Chase Bank Kenya Limited
8. Charterhouse Bank Limited (under Statutory Management)
9. Citibank N.A. Kenya
10. City Finance Bank Limited
11. Commercial Bank of Africa Limited
12. Consolidated Bank of Kenya Limited
13. Co-operative Bank of Kenya Limited
14. Credit Bank Limited
15. Development Bank of Kenya Limited
16. Diamond Trust Bank Kenya Limited
17. Dubai Bank Kenya Limited
18. Ecobank Limited
19. Equatorial Commercial Bank Limited
20. Equity Bank Limited
21. Family Bank Limited
22. Fidelity Commercial Bank Limited
23. Fina Bank Limited
24. First Community Bank Limited
25. Guardian Bank Limited
26. Gulf African Bank Limited

27. Giro Commercial Bank Limited
28. Habib Bank A.G. Zurich
29. Habib Bank Limited
30. Imperial Bank Limited
31. I & M Bank Limited
32. Kenya Commercial Bank Limited
33. K-Rep Bank Limited
34. Middle East Bank Kenya Limited
35. National Bank of Kenya Limited
36. National Industrial Credit Bank Limited
37. Oriental Commercial Bank
38. Paramount Universal Bank Limited
39. Prime Bank Limited
40. Southern Credit Banking Corporation Limited
41. Standard Chartered Bank Kenya Limited
42. Transnational Bank Limited
43. Victoria Commercial Bank Limited

Source: Central Bank of Kenya

APPENDIX 2: LIST OF COMMERCIAL BANKS LISTED ON THE NAIROBI SECURITIES EXCHANGE

1. Barclays Bank Of Kenya Limited
2. CFC Stanbic Bank
3. Co-operative Bank Of Kenya
4. Diamond Trust Bank (Kenya) Limited
5. Equity Bank Limited
6. Housing Finance Company Limited
7. Kenya Commercial Bank Limited
8. National Bank Of Kenya Limited
9. NIC Bank Limited
10. Standard Chartered Bank Kenya Limited

Source: Nairobi Securities Exchange

APPENDIX 3: DIVIDEND PAYOUT FOR YEAR 2008-2012

	2012	2011	2010	2009	2008
	KSHS	KSHS	KSHS	KSHS	KSHS
BBK	5,431,000,000	8,146,500,000	7,401,100,000	3,395,000,000	2,716,000,000
CFC	288,584,796	-	218,947,369	-	76,631,579
CO-OPERATIVE BANK	2,095,421,649	1,396,948,000	1,396,948,000	698,474,000	349,237,000
DTB	418,190,182	332,595,701	260,859,373	252,707,517	228,251,951
EQUITY BANK	4,628,471,275	2,962,221,616	2,962,221,616	1,481,110,808	11,108,331,060
HOUSING FINANCE	322,840,000	276,510,000	161,000,000	115,000,000	69,000,000
KCB	5,643,646,676	5,492,180,389	3,687,824,773	2,217,777,777	2,217,777,777
NATIONAL BANK	56,000,000	112,000,000	280,000,000	-	-
NIC BANK	542,984,148	271,492,074	271,492,074	271,492,074	271,492,074
STANDARD CHARTERED	3,864,493,925	3,157,848,474	3,875,541,309	3,263,613,732	2,719,678,110

APPENDIX 4: PROFITS BEFORE TAXATION FOR YEAR 2008-2012

	2012	2011	2010	2009	2008
	KSHS	KSHS	KSHS	KSHS	KSHS
BBK	13,020,000,000	12,071,000,000	13,553,000,000	9,002,000,000	8,016,000,000
CFC	4,588,088,000	2,798,901,000	2,005,967,000	1,105,656,000	991,819,000
CO-OPERATIVE BANK	9,984,000,000	6,363,000,000	5,771,000,000	3,736,000,000	3,359,000,000
DTB	6,027,899,000	4,307,413,000	3,462,999,000	1,929,862,000	1,604,296,000
EQUITY BANK	17,420,000,000	12,834,000,000	9,045,000,000	5,278,000,000	5,022,000,000
HOUSING FINANCE	907,631,000	975,795,000	561,028,000	351,118,000	202,670,000
KCB	17,208,143,000	15,129,374,000	9,797,971,000	6,300,361,000	6,012,862,000
NATIONAL BANK	1,147,408,000	2,443,850,000	2,697,823,000	2,159,441,000	1,796,565,000
NIC BANK	4,517,967,000	3,604,948,000	2,608,392,000	1,526,793,000	1,484,174,000
STANDARD CHARTERED	11,556,191,000	8,255,135,000	7,681,884,000	6,728,447,000	4,719,814,000

APPENDIX 5: LIQUIDITY POSITION FOR YEAR 2008-2012(CASH AND BALANCES WITH CBK)

	2012	2011	2010	2009	2008
	KSHS	KSHS	KSHS	KSHS	KSHS
BBK	16,486,000,000	12,212,000,000	13,131,000,000	9,751,000,000	13,695,000,000
CFC	23,366,583,000	7,104,647,000	5,444,892,000	4,606,140,000	6,289,827,000
CO-OPERATIVE BANK	22,214,066,000	14,151,049,000	14,033,477,000	8,551,464,000	6,512,684,000
DTB	7,722,752,000	12,507,416,000	7,930,638,000	7,392,025,000	5,455,435,000
EQUITY BANK	13,072,958,000	18,273,772,000	13,302,733,000	8,098,982,000	6,120,627,000
HOUSING FINANCE	1,454,359,000	384,034,000	420,390,000	319,839,000	186,896,000
KCB	36,419,912,000	42,708,016,000	26,998,000,000	19,871,000,000	17,239,000,000
NATIONAL BANK	5,460,991,000	5,564,998,000	4,845,862,000	7,888,863,000	3,373,118,000
NIC BANK	7,050,962,000	5,638,916,000	4,698,737,000	3,754,778,000	2,670,862,000
STANDARD CHARTERED	13,575,454,000	12,005,054,000	8,210,822,000	7,728,872,000	7,380,062,000

APPENDIX 6: INFLATION RATE FOR YEAR 2008-2012

YEAR	**2012**	**2011**	**2010**	**2009**	**2008**
ANNUAL AVERAGE INFLATION, PERCENT	3.2	14.02	3.96	9.24	9.04