RELATIONSHIP BETWEEN PRIOR PERIOD DIVIDENDS AND FINANCIAL PERFORMANCE OF FIRMS LISTED AT THE NAIROBI STOCK EXCHANGE

BY

MUTIE PETER KIOKO
REG: D61/60044/2010

A Management Research Project Submitted in Partial Fulfillment of the Requirements for the Degree of Masters of Business Administration (MBA), UoN

UNIVERSITY OF NAIROBI

OCTOBER 2011

DECLARATION

I, the undersigned, declare that this is my original project and has not been submitted to any other college, institution or university other than the University of Nairobi for academic credit.

Signed: —————————————— Date:——————————————

Mutie Peter Kioko (Reg No. D61/60044/2010)

This project has been submitted for examination with my approval as the appointed supervisor.

Signed: —————————————— Date:——————————————

Mr. Mirie Mwangi

Lecturer, School of Business, University of Nairobi,

ACKNOWLEDGEMENT

DEDICATION

This work is dedicated to my family whose encouragement and support gave me the motivation to carry on. And to my friends too, who are my inspiration and mentors.

ABSTRACT

Dividend behavior of firms is one of the areas of finance that has aroused the interest of financial analysts, academicians and all manner of professionals interested in finance. Along with capital structure, dividend policy has been one of the first areas of corporate finance to be analyzed with a rigorous model, and it has since been one of the most thoroughly researched issues in modern finance. In spite of the interest developed and the numerous researches undertaken, a lot remains unexplained concerning the role of dividends.

The purpose of the study is to determine the relationship between prior period dividends and the financial performance of firms listed at the NSE. The study has reviewed related literature with regards to the area of study which seems to favour the argument that dividend payment indeed leads to a better financial performance for a firm. To undertake the study, a population of all companies listed at the NSE has been considered of which a sample of 34 companies was selected. The variables in the study are the firms' financial performance (earnings per share) and the prior period dividends (dividend per share)

The study relies on secondary data collected from the companies' websites, CMA, NSE and ICPAK amongst other sources. The data has been analyzed using the applications of Statistical Package for Social Scientists (SPSS) and then presented in the form of tables and graphs.

The results of the study reveal that majority of firms enjoy a better financial performance as indicated by their EPS after issuing dividends. As such, a relationship indeed exists between prior period dividend payments and financial performance of a firm. However, the study fails to take into consideration other factors that also affect the financial performance of a firm.

TABLE OF CONTENTS   **PAGE**

LIST OF TABLES   **PAGE**

LIST OF FIGURES

LIST OF ABBREVIATIONS

ARM	:	Athi River Mining Company
BAT	:	British American Tobacco
BBK	:	Barclays Bank of Kenya
CMA	:	The Capital Markets Authority
Coop Bank	:	Co-operative Bank
DPS	:	Dividend Per Share
DRIP	:	Dividend Reinvestment Plan
DTB	:	Diamond Trust Bank
EA Cables	:	East African Cables
EABL	:	East African Breweries Limited
EAPCC	:	East African Portland Cement Company
EPS	:	Earnings Per Share
HFCK	:	Housing Finance Corporation of Kenya
ICPAK	:	Institute of Certified Public Accountants of Kenya
KBS	:	Kenya Bureau of Statistics
KCB	:	Kenya Commercial Bank
KPLC	:	Kenya Power
KQ	:	Kenya Airways
Kshs.	:	Kenya Shillings
MM	:	Modigiliani and Miller
NMG	:	Nation Media Group
NSE	:	The Nairobi Stock Exchange
NYSE	:	New York Stock Exchange
PPMC	:	Pearson Product-Moment Correlation Coefficient
SPSS	:	Statistical Package for the Social Sciences
SRC	:	Spearman's Rank Correlation Coefficient
Stanchart	:	Standard Chartered Bank
Std Group	:	Standard Group

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

One of the simplest and most effective ways to communicate the financial well-being of a firm is to pay huge dividends. Dividends send a clear, powerful message about future prospects and performance of a firm. A company's willingness and ability to pay steady dividends over time - and its power to increase them - provide good clues about its fundamentals. If a company with a history of consistently rising dividend payments suddenly cuts its payments, investors would treat this as a signal that trouble is looming. This is based on the fact that negative reaction to bad news is strong and relatively robust in the market (Gunasekarage et al, 2002).

Therefore in analyzing the future performance of a firm, dividends do matter. Evidence of profitability in form of dividend payments can help investors sleep easily. Profits on paper say one thing about a company's prospects; profits that produce cash dividends say another thing entirely.

Although firms have been distributing dividends to their shareholders for four centuries (Baskin, 1988), it is only in the recent past that companies started to put a lot of emphasis on dividend payments to their shareholders. Better financial information, cut-throat competition among companies, access to finance coupled with youthful population that desires instant results has complicated the options available for companies. As more and more investment opportunities arise, investors are constantly seeking for the best returns for their money. The perception is that these returns must be in form of dividends and should be realized sooner rather than later. Thus companies are faced with growing intensity of global competition and pervasive change. The finance managers have realized that traditional approaches of dealing with investors are inadequate for keeping

up with these changes because they do not provide the investors with the necessary incentives.

Many companies collapse due to lack of tactics for survival in the competitive market. Others though still in existence, are struggling and faced with problems such as poor cash flows, lack of customer goodwill, lack of investors, lack of supplier good will amongst others.

A number of recent studies have examined the relationship between prior period dividends and financial performance of companies. Several of these studies have found results consistent with the notion that increase in the prior period dividends leads to better financial performance of the firm in the subsequent periods. Healy and Palepu (1988) found that firms initiating dividends experience rapidly increasing earnings in the subsequent two years. Michaely (1995) report the existence of positive excess returns on the firms after the initiation of dividends. Venkaetsh (1989) report a decline in the overall volatility of return when firms commence dividend payments. Dyl and Weygand (1998) found that firm risk and earnings volatility decreases after dividend initiation. This study is therefore to confirm if prior period dividends can be a good predictor of the future financial performance.

According to Ghosh and Sirmans (2006), high dividends have been known to appease the hearts of investors, suppliers, customers, employees and hosts of other stakeholders. Though many corporations in Kenya have continuously paid dividends over the years, the impact of the dividends is one of the areas of finance that has aroused the interest of financial analysts, academicians and all manner of professionals interested in finance. Along with capital structure, dividend policy has been one of the first areas of corporate finance to be analyzed with a rigorous model, and it has since been one of the most thoroughly researched issues in modern finance. In spite of the interest developed and the numerous researches undertaken, a lot remains unexplained concerning the role of dividends on financial performance of an enterprise. Black (1976) epitomizes the lack of

consensus by stating "The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just don't fit together."

According to Kent et al (2005), dividend policy determines the division of earnings between payments to stockholders and reinvestments in the firm. Managers' task is to allocate the earnings to dividends or retained earnings. Dividend policies are the regulations and guidelines that firms develop and implement as means of splitting their earnings between distributing to their shareholders and the retained earnings. The main aim of dividends in a firm is shareholder's wealth maximization, to increase the value of the firm and to signal to stakeholders that the firm's finances are sound.

Dividend is the distribution of firms' value to shareholders, (Tajirian, 1997). A firm uses dividends as a mechanism for financial signaling to the outsiders regarding the stability and its growth prospects. By law dividends must be paid from profits and not from a corporation's capital. The law stipulates that dividend payment may not exceed the corporation's retained earnings as shown on its statement of financial position.

A more plausible explanation is that dividends are required because of the separation of ownership and management, (Hansen et al, 1994). According to one form of this argument, dividends are a signal of the sustainable income of the corporation: management selects a dividend policy to communicate the level and growth of real income because conventional accounting reports are inadequate guides to current income and future prospects. While this theory remains to be fully elaborated, it does suggest that the steadiness (or safety) of the dividend, as well as its average level, might be used in a dynamic setting.

Other corporate distributions include extra dividends which refer to an extra dividend to shareholders on a one time or infrequent basis. This could be as a result of a company having a good financial year. Spin-offs are distribution of shares of a subsidiary company to shareholders. Companies spin off unrelated or underperforming business to shareholders so that they can concentrate on the core business. Split-Offs can also be

used as corporate distribution which refers to exchange of a parent company's stock for a pro-rata share of the stock of a sub-sidearm company. Also the dividend reinvestment plan (DRIP) allows shareholders to reinvest their dividends in additional stock rather than receiving them in cash, (Geoffrey and Hirt, 1992)

For most companies, dividend payment can present a big challenge since it involves substantial amounts of cash outflows. Although a company may make profit, some of these profits may not be available for distribution as they may just be book profits. As such a company needs to assess its cash flow situation before issuing out cash dividends. A company that is able to award huge cash dividends may signal a positive cash flow, prudent financial management and the ability to meet its financial obligations to its stakeholders including employees, potential investors, creditors, government, amongst others. This would give it favorable rating with most stakeholders willing to do business with it. This in turn may lead to an increase in the company's profit in the succeeding years, (Nissim and Ziv, 2001)

The term 'Financial Performance' is used to describe a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. Measures of financial performance include measures of liquidity, solvency, profitability and financial efficiency (Solomon, 1963)

Liquidity measures the firm's ability to meet financial obligations as they come due in the short term, without disrupting the normal operations of the business. This is usually measured using the current ratio which indicates the extent to which current assets, when liquidated, will cover current obligations. Solvency gauges the farm's ability to pay all financial obligations if all assets are sold and to continue viable operations after financial adversity. Solvency is measured by debt to asset ratio, debt to equity ratio and equity to asset ratio. Financial efficiency measures the intensity with which a business uses its assets to generate gross revenues and the effectiveness of production, purchasing, product pricing and financing decisions and is measured by asset turnover ratio, operating

expense ratio, interest expense ratio and net income ratio. Profitability measures the extent to which a business generates a profit from the use of the available factors of production. Three profitability measures that are universally accepted for their value to management are return on assets, return on equity, and operating profit margin (Pandey, 2002)

All three measure the extent to which a business generates net income or profit from the use of its resources. Return on equity can best be communicated by earnings per share (EPS) which is the profit available for distribution to the ordinary shareholders after all other expenses including dividends attributable to preference shareholders have been deducted.

The Stock Exchange is a market that deals in the exchange of securities issued by publicly quoted companies and the government (NSE Website). The major role that the stock exchange has played, and continues to play in many economies is that it promotes a culture of thrift, or saving. The very fact that institutions exist where savers can safely invest their money and in addition earn a return, is an incentive to people to consume less and save more. Thus the stock exchange assists in the transfer of savings to investment in productive enterprises as an alternative to keeping the savings idle.

The Nairobi Stock Exchange provides an avenue where members of public can participate in selling and buying of shares, bonds and other stocks/securities. In return the owners of the shares get an annual reward called 'dividend' based on the dividend policy of the particular company. Currently, there are 55 companies listed at the Nairobi Stock Exchange (see appendix 3) which adopts any of the four main dividend policies outlined in the following paragraphs.

Constant payout ratio is where the firm pays a fixed dividend rate. The dividend per share would therefore fluctuate as the earnings per share changes. Dividends are directly dependent on the firm's earnings ability and if no profits are made, no dividends are paid.

Constant amount per share (fixed dividend per share) denotes that dividend per share is fixed in amount irrespective of the earnings levels. This creates certainty and is therefore preferred by shareholders who have a high reliance on dividend income. It protects the firm from periods of low earnings by fixing dividend per share at a low level.

Constant dividend per share plus extra /surplus is whereby constant dividend per share is paid every year. However, extra dividends are paid in years of supernormal earnings. It gives the firm flexibility to increase dividends when earnings are high and participate in supernormal earnings. The extra dividends are given in such a way that it is not perceived as a commitment by the firm to continue the extra dividend in the future.

Residual dividend policy is whereby dividends are paid out of earnings left after all viable investment decisions have been financed. Dividends will only be paid if there are no profitable investment opportunities available. The policy is consistent with shareholders wealth maximization, (Pandey, 2002)

1.2 Statement of the Problem

Management are in a dilemma about whether to pay or not to pay dividends. This has come about as a result of the need for management to satisfy the various needs of stakeholders. Therefore, since management are dealing with competing interests of various stakeholders, the kind of dividend policy they adopt may have either positive or negative effects on the future financial performance of the company. They are therefore unable to forecast with certainty to what extent the policy will affect their bottom line.

The questions therefore to be asked are: should the firm pay out money to its shareholders, or should the firm take that money and invest it for its shareholders? If a firm decides to pay a dividend, of what percentage of its earnings? Given the above, will this affect the subsequent financial performance of the firm? Would the company lose some stakeholders if they adopt a particular dividend policy?

Dividend is the distribution of a firm's earnings to shareholders. The determination of the amounts of dividends to be paid is an important decision that companies need to make. In coming up with a dividend policy the management may need to consider various factors such as legal restrictions, liquidity, debt contracts in place, availability of other investment opportunities among other factors. Traditional approaches to dividend policy opine that corporations distribute as much as possible of their net profits in form of dividends since shareholders prefer cash today than future capital gains. Pruitt and Gitman (1991) suggest that factors such as prior period dividends, prior period profits, current profits and variability in terms of earnings do influence the amount of dividends to be paid out.

The finance literature provides substantial support for the positive relationship between prior period dividends and financial performance of the firm. An alternative body of literature suggests that there is no relationship between prior period dividends and financial performance of the firms (Lintner, 1956; Healy and Palepu, 1988; Allen, 1992; Gunasekarage et al, 1996). On the basis on this these conflicting information, it seems impossible to come up with conclusive evidence on the subject matter.

Additionally, all research papers written in Kenya have provided conflicting conclusions. While some of them have indicated a positive relationship; Wandeto (2005), Muindi (2006), others have indicated lack of relationship while still others have questioned the sustainability of such a relationship.

The reasons for the conflicting conclusions could be because none of the researchers have taken time to study the prior period dividend movements and the corresponding earnings per share. Most researchers have concentrated on dividend signalling hypothesis and the impact of financial performance on dividends. In kenya, very few studies related to the relationship between dividends and financial performance have been carried out and even so, the vast majority have centred on the current year dividends and financial performance and the dividend payment and share prices.

Therefore, this research will contribute to the debates in this regard; fill in the study gaps identified as well as try to fit in another dividend puzzle. The research will try to correct some of the limitations of the previous studies and also provide additional relevant information concerning the relationship between prior period dividends and financial performance.

The research will examine the relationship between prior period dividends and the financial performance of a firm for companies listed at the Nairobi Stock Exchange (NSE). The problem therefore is to determine if dividends paid by a firm affect the subsequent financial performance of the same firm.

Using this information, the management of the firms will be able to know whether dividends paid in prior period affect the financial performance of the firm. This would in turn assist in deciding whether to pay dividends or not, and if to pay, by how much. Investors, employees, customers, shareholders and other stake holders will also be able to predict with relative accuracy how the company is going to perform in future periods based on the dividends paid.

The researcher shall look at the dividend trends of our sample stocks over a six year period and compare them with the financial performance of the same companies on the succeeding years.

This paper will therefore, seek to answer the question; are dividends relevant to the financial performance of a firm?

1.3 Objectives of the Study

The objective of the study is to determine the relationship between prior period dividends and the financial performance of firms listed at the Nairobi Stock Exchange.

1.4 Significance of the Study

The role of dividends provoke many areas in which research can be carried out, but this paper focuses on understanding the relationship between prior period dividends and the positive or negative response they trigger on the stakeholders of the enterprise thus affecting its financial performance. The study is expected to be of help to various groups as follows:

Potential and Current Investors will benefit from the research. Current investors would want to know if the prior period dividends are a signal that dividends will continue to flow in future. The relationship between dividends and financial performance of the firm will help the investors make informed decision on whether to dispose their shares or to buy more so as to benefit in future from the firm. The outcome of this research will also help potential investors in making decisions on where to invest their money. In case of positive relationship between prior period dividends and financial performance of the firm; potential investors will pursue investments in companies that have been paying out huge dividends.

The research would assist the financial analysts in giving timely and relevant advice to their clients. The financial analysts would be able to advise their clients on which companies to invest in and which ones to avoid. They will also be able to advise companies whether or not to pay dividends and if to pay, how much to pay.

Firms would need to know if there is a relationship between prior period dividends and financial performance so as to take corrective measures so as to improve their financial performance. If indeed there is a positive relationship between prior period dividends and financial performance of the firm, the firm would need to rethink its investment decisions and distribute its earnings so as to build investor loyalty as well as spur confidence in the market.

The study will enable company employees to know the future performance of their companies so as to align their expectation with certainty.

Establishing the relationship between prior period dividends and financial performance of a firm would assist the suppliers, bankers and other creditors to estimate the future financial performance of particular firms based on their dividend payment patterns. This would help them to know if the firm has the capacity to service its debts. Armed with this information, they would be able to decide whether to continue doing business with particular corporations or to demand for settlement of their dues. Suppliers and creditors would be lenient to firms with bright future prospects in terms of financial performance while they would wish to stop dealing with firms that are uncertain of their future financial performance. Terms of trade and credit would also be affected by this information.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This section includes a review of literature related to the research topic. It also includes a review of the empirical studies on the relationship between prior period dividends and financial performance of the firm as well as chapter summary. Various theories have been advanced to review the relationship between prior period dividends and financial performance of the firm. Some researchers believe that increase in prior period dividends leads to an increase in the profitability of companies, (Gordon, 959); others suggest that dividends are irrelevant, (Miller and Modigliani, 1961) to the financial performance of an enterprise while others argued that prior period dividends decrease the profitability of an enterprise, (Litzenberger and Ramaswamy, 1979).

2.2 Types of Dividends

Cash dividends are a form of investment income and are usually paid in cash. This is the most common method of sharing corporate profits with the shareholders of the company. For each share owned, a declared amount of money is distributed. Thus, if a person owns 100 shares and the cash dividend is Kshs. 2 per share, the person will be paid Kshs. 200 (Ross, 2002)

Stock or scrip dividends are those paid out in form of additional stock shares. They are usually issued in proportion to shares owned (for example, for every 100 shares of stock owned, 10% stock dividend will yield 10 extra shares). If this payment involves the issue of new shares, this is very similar to a stock split in that it increases the total number of shares while lowering the price of each share and does not change the market capitalization or the total value of the shares held (Solomon, 1963)

11

Like the stock dividend, a stock split is a proportionate increase in the number of outstanding shares that doesn't affect the issuing company's assets, liabilities, equity or earnings. As a matter of fact, the only difference between the two is in the area of accounting. A stock dividend of greater than 25 percent is recorded as a stock split. A 100 percent stock dividend is known as a two-for-one stock split. A company might decide to split its stock because the price is too high; with a lower price, the stock becomes more marketable. Conversely, companies may also announce reverse stock splits, which reduce the number of outstanding shares. When a corporation's stock has fallen in price, a reverse split raises the price to a more desirable level.

Stock Repurchase is a program by which a company buys back its own shares from the marketplace, reducing the number of outstanding shares. Because a share repurchase reduces the number of shares outstanding (i.e. supply), it increases earnings per share and tends to elevate the market value of the remaining shares. (Ross, 2002)

2.3 Dividend Policies

Dividend policy is based on several issues. How much dividend should a firm distribute to shareholders? What will the impact of the dividend policy be on the firm's share price? What will happen if the amount of dividend changes from year to year? Common dividend policies are the constant payout ratio, constant amount per share, constant dividend per share plus extra and residual dividend policy. (Miller & Modigiliani, 1961)

Constant payout ratio is where the firm pays a fixed dividend rate. The dividend per share would therefore fluctuate as the earnings per share changes. Dividends are directly dependent on the firm's earnings ability and if no profits are made, no dividends are paid. (Tajiriani, 1997)

In the constant amount per share (fixed dividend per share), the dividend per share is fixed in amount irrespective of the earnings levels. This creates certainty and is therefore preferred by shareholders who have a high reliance on dividend income. It protects the

firm from periods of low earnings by fixing dividend per share at a low level. (Tajiriani, 1997)

In the Constant dividend per share plus extra /surplus, a constant dividend per share is paid every year. However, extra dividends are paid in years of supernormal earnings. It gives the firm flexibility to increase dividends when earnings are high and participate in supernormal earnings. The extra dividends are given in such a way that it is not perceived as a commitment by the firm to continue the extra dividend in the future. (Pandey, 2002)

Companies using the residual dividend policy choose to rely on internally generated equity to finance any new projects. As a result, dividend payments can come out of the residual or leftover equity only after all project capital requirements are met. These companies usually attempt to maintain balance in their debt/equity ratios before making any dividend distributions, which demonstrates that they decide on dividends only if there is enough money left over after all operating and expansion expenses are met. Thus dividends will only be paid if there are no profitable investment opportunities available. The policy is consistent with shareholders wealth maximization, (Pandey, 2002)

2.4 Factors Influencing Dividend Payments

The nature of business has an important bearing on the dividend policy. Industrial units having stability of earnings may formulate a more consistent dividend policy than those having an uneven flow of incomes because they can predict easily their savings and earnings. Usually, enterprises dealing in necessities suffer less from oscillating earnings than those dealing in luxuries or fancy goods. (Ghosh & Sirmans, 2006)

Age of the corporation counts much in deciding the dividend policy. A newly established company may require much of its earnings for expansion and plant improvement and may adopt a rigid dividend policy while, on the other hand, an older company can formulate a clear cut and more consistent policy regarding dividend. Availability of cash and sound financial position is also an important factor in dividend decisions. A dividend represents a cash outflow, the greater the funds and the liquidity of the firm the better the

ability to pay dividend. The liquidity of a firm depends very much on the investment and financial decisions of the firm which in turn determines the rate of expansion and the manner of financing. If cash position is weak, stock dividend will be distributed and if cash position is good, company can distribute the cash dividend. (Fama & Babiak, 1968)

A closely held company is likely to get the assent of the shareholders for the suspension of dividend or for following a conservative dividend policy. On the other hand, a company having a good number of shareholders widely distributed and forming low or medium income group, would face a great difficulty in securing such assent because they will emphasize to distribute higher dividend. (Jensen, 1986)

Companies retain a part of their profits for strengthening their financial position. The income may be conserved for meeting the increased requirements of working capital or of future expansion. Small companies usually find difficulties in raising finance for their needs of increased working capital for expansion programmes. They having no other alternative, use their ploughed back profits. Thus, such Companies distribute dividend at low rates and retain a big part of profits. (Lintner, 1956)

Business cycles also exercise influence upon dividend policy. Dividend policy is adjusted according to the business oscillations. During the boom, prudent management creates food reserves for contingencies which follow the inflationary period. Higher rates of dividend can be used as a tool for marketing the securities in an otherwise depressed market. The financial solvency can be proved and maintained by the companies in dull years if the adequate reserves have been built up. (Pettit, 1972)

The earnings capacity of the enterprise is widely affected by the change in fiscal, industrial, labour, control and other government policies. Sometimes government restricts the distribution of dividend beyond a certain percentage in a particular industry or in all spheres of business activity as was done in emergency. The dividend policy has to be modified or formulated accordingly in those enterprises. High taxation reduces the earnings of the companies and consequently the rate of dividend is lowered down.

Sometimes government levies dividend-tax of distribution of dividend beyond a certain limit. It also affects the capital formation.

In deciding on the dividend, the directors take the legal requirements too into consideration. For example, a company is required to provide for depreciation on its fixed and tangible assets before declaring dividend on shares, dividends should not be distributed out of capital or reserves and contractual obligation should also be fulfilled such as payment of dividend on preference shares in priority over ordinary dividend. (Litzenberger & Ramaswamy, 1979)

Well established and large firms have better access to the capital market than the new Companies and may borrow funds from the external sources if there arises any need. Such Companies may have a better dividend pay-out ratio. Whereas smaller firms have to depend on their internal sources and therefore they will have to build up good reserves by reducing the dividend pay-out ratio for meeting any obligation requiring heavy funds. (Miller & Modigiliani, 1961)

Policy of control is another determining factor is so far as dividends are concerned. If the directors want to have control on company, they would not like to add new shareholders and therefore, declare a dividend at low rate. Because by adding new shareholders they fear dilution of control and diversion of policies and programmes of the existing management. So they prefer to meet the needs through retained earnings. If the directors do not bother about the control of affairs they will follow a liberal dividend policy. Thus control is an influencing factor in framing the dividend policy. (Jensen, 1986)

2.5 Previous Studies

2.5.1   Dividend Irrelevance School of Thought

Dividend irrelevancy theory asserts that a firm's dividend policy has no effect on its market value or its cost of capital. Modigliani and Miller (1961) argued that dividends

policy is irrelevant since it has no effect on either the price of the firm's stock or its cost of capital. They argued that a firm's value is determined by its basic earnings power and its risk class.   They argued that dividend policy is a "passive residual" which is determined by a firm's need for investment funds. This is determined by the firm's investment policy and the manner in which the earnings stream is split between retained earnings. We can therefore opine that dividend payments do not affect the financial performance of a firm.

Modigliani and Miller demonstrated that under a particular set of assumptions set out below if a firm pays high dividends then it must issue new stocks. The value of the firm given out to the new investors is exactly equal to the dividend paid. MM argued further that investors are able to replicate any dividends pattern that the firm might pay. If the dividends are lower than desired, investors can sell part of their shares to obtain the desired cash distribution. If dividends are higher than required, they can use the extra money to purchase additional shares in the company. Since investors can manufacture homemade dividends then dividend policy is irrelevant. As a result, one dividend policy is as good as the other.

The assumptions of MM argument were perfect capital markets, assumed that there are no transaction costs; there are no personal or corporate income taxes; Information symmetry, that is, all investors and managers has the same set of information regarding future investment opportunities; dividend policy has no effect on firm's cost of equity and the firm's capital investment policy is independent of its dividend or financing policy.

On the basis of the above assumptions the firm has no incentive to pay higher dividends since the shareholders are indifferent to the amount of dividends paid. Paying higher dividends by a firm would not attract investors, lenders or creditors. Employees would also be indifferent as to the amount of dividends paid and hence these would not affect the financial performance of the firm.

The MM theory was criticized on the basis that the conclusions on dividend irrelevancy may not hold under real world conditions. The existence of imperfections such as firms' and investors paying taxes; firms' incurring floatation costs whenever they sell additional shares and investors paying brokerage/transaction costs whenever they buy or sell shares make dividends policy relevant.

2.5.2   Dividend Relevant Theories

2.5.2.1 Lintner' Model

The first empirical study accomplished in the dividend policy domain was performed by Lintner (1956). In his study Lintner showed that managers tend to smooth dividends over time. He argued that managers tend to follow a stable dividend policy since they are afraid of sending mixed signals to the market or paying dividends which may need to be reversed in future. Thus companies would only adjust the level of dividends if their sustainability is feasible and if the future prospect of the firm is bright. Lintner selected a list of 28 companies and analyzed them for a period of 7 years (1947-1953). He surveyed the views of the firm's managers with regards to dividends and concluded that managers attach importance to dividend policies; the amount of earnings is the biggest factor affecting dividends; managers believe that shareholders prefer stable dividends or steady increase in dividends and the markets attaches a premium on stable dividends; Firms prefer sticky long term dividend payout ratio that can be slightly adjusted periodically. They are reluctant to reverse dividends payout ratios; managers avoid making dividend changes that have a probability of being reversed in future.

2.5.2.2 "Bird – in – the – hand" Theory: Gordon and Litner (1963)

One of the critical assumptions of MM model is that dividend policy does not affect investors required rate of return on equity. Gordon and Litner argued that investors prefer to receive dividends today since current dividends are more certain than future capital gain that may result from investing retained earnings in growth opportunities. They

argued that investors prefer a dollar of expected dividends more than a dollar of expected capital gains. They argued that the cost of capital should decline as the payout ratio increases.

According to Gordon & Litner (1963) dividend policy is relevant to the value of the firm since as the value of a shilling received now is always higher than the value of a shilling received later, shareholders prefer current dividend payments to retention of earnings and since dividend received now is certain income whereas reinvested in corporate assets may be uncertain income, the income likely from retained earnings will be discounted by investors to reflect the uncertainty as to whether and when it will be received in cash in the future as either a capital gain or dividend.

The bird in the hand theory was criticized due to its short comings in the sense that if the firm were to reinvest the retained earnings at high enough rate of return to compensate for the risk borne by shareholders, the theory might not be valid; or if the shareholders only alternative in using dividends received were to reinvest in assets of equal or greater risk, the theory might not be valid. (Miller & Modigiliani, 1961)

2.5.2.3 Litzenberger and Ramaswamy (1979)

Litzenberger and Ramiswamy argued that investors may prefer one dividend policy over another because of the tax effect on dividend receipts. Investors may pay taxes at the time dividends are received. Capital gains are not taxed until the investment is sold. Depending on the investors tax position he may prefer either receipt of past dividends to be taxed or receipt of capital gains to delay the impact of tax. In many countries, dividends are taxed at rates which are higher than the tax rates on capital gains. In Kenya there is no tax on capital gains. Investors therefore prefer to receive capital gains in order to minimize the burden.

The tax advantage of capital gains over dividend income may make shareholders prefer earnings retention to payout. The tax advantage of capital gains over dividend income

arises for two reasons. First the personal tax rate on dividend income is greater than the personal tax rate on capital gains, and secondly by not selling shares, the investor could defer realization of the capital gains and hence payment of the tax. Deferring payment of tax benefits the tax payer due to the time value of money. Thus firms that do not pay dividends would attract more investors and confidence from the public. Public and investor confidence are paramount to the financial performance of firms. As such, the firms that do not pay dividends would have better financial performance.

2.5.2.4 Solomon Ezra (1963)

According to Solomon Ezra (1963) dividend action may offer tangible evidence of the firm's ability to generate cash flows. As a result, dividend action may affect the financial performance. He states ''In a certain world in which verbal statements may be misinterpreted or ignored, the dividend action provides a clear cut means of making a statement that speaks louder than a thousand words''. Thus shareholders and other stakeholders would align their interests to the firms that pay dividends since they expect such a firm to generate sufficient cash flows to meet its obligations. In this case, the firm is likely to benefit from better credit facilities, extended loan repayment periods, customer retention as well as high employee morale. Such a firm would have better financial performance due to the confidence shown by its stakeholders and the benefits accruing from such confidence.

2.5.2.5 Clientele Effect of Dividend Policy

This was advanced by Richardson Petit in 1974. Clientele effect is the tendency of a firm to attract investors who prefer its dividend policy. Different groups or clientele of shareholders prefer different payout policies. Retired investors would prefer current income hence the need to invest in companies that payout a higher percentage of earnings as dividends. Investors in their peak earnings years have no need for current investment income therefore reinvest the dividends received after paying the applicable taxes.

Dividend policy has a clientele effect whereby investors shift their investments among firms depending on the dividend policy set by various firms. This has been confirmed by various scholars. MM however argued that one clientele is as good as any other and the existence of clientele effect does not suggest that one dividend policy is better than any other dividend policy.

We can therefore opine that the relationship between the financial performance of a firm and its dividend policies would highly depend on the target client. Firms targeting youthful population would have a positive relationship between the amounts of dividend paid and future profitability since payments of such dividends would attract the target clientele. On the other hand, firms targeting old/retired clientele would have a negative relationship between dividends paid and their financial performance since payment of dividends would make the investors shy away.

2.5.2.6 Residual Theory

The residual theory of dividend hypothesizes that the amount of dividends should not be the focus of the company. The amount of earnings retained, depend on the number and size of acceptable capital budgeting projects and the amount of earnings available to finance the equity portion of the funds need to pay for these projects.

Myers et al (1991) argued that firms will only pay dividends from residual earnings. Accordingly, dividends are a passive decision variable because they are only to be paid out if the firm cannot make better use of the funds for the benefit of the shareholders. The theory assumes that paying dividends would signal to the market that the firm has no viable investment alternatives. Such a perception would injure the firms profile in the eyes of the stakeholders. Investors would shy away from such a firm while lenders, creditors, customers and employees would lose confidence, thus affecting its profitability. Residual theory has been criticized because it gives no recognition to how investors feel about dividends. The issue is not only whether reinvestments of retained earnings or dividends provide the highest return, but also how investors react to the two alternatives.

2.5.2.7 Agency Theory

The theory implies that firms that adopt high dividend payout will have a high value. This is because the dividend policy can be used to resolve the agency problem by reducing the agency cost between owner managers and outside owners of the firm. Payment of dividends solves the agency problem since management would have to ensure continued profitability of the firm so as to maintain steady dividends. Steady dividends also remove excess cash from the hands of the management which would have been misused or led to complacency in the generation of income. Payment of dividends thus would force management to enhance the future financial performance of firm since they would be forced to pay maintain if not increase the dividends payments in future. Thus firms that pay more dividends outperform their counterparts who do not pay in terms of financial performance in the subsequent periods. (Jensen, 1986)

2.6 Empirical Studies on the Relationship between Prior Period Dividends and Financial Performance of a Firm

Dividends convey information about future earnings. Modigliani-Miller (1959) and Miller Modigliani (1961) hypothesized that dividend reductions convey information that future earnings prospects are poor. Various studies have examined the relationship between dividends and financial performance as detailed below:

Healy and Palepu (1988) found that firms initiating dividends experience rapidly increasing earnings in the subsequent two years. In their study on effect of dividends on earnings, they established a positive relationship between amount of dividends paid and future financial performance of the firm. However, this relationship is only valid for the two subsequent years after the dividend issue.

Michaely (1995) report the existence of positive excess returns on the firms after the initiation of dividends. The firms that paid dividends experienced much higher profits in the subsequent periods than the firms that did not pay. However, Macquiera (1998) found no evidence of increasing earnings after dividend initiations.

Venkaetsh (1989) report a decline in the overall volatility of return when firms commence dividend payments.
Dyl and Weygand (1998) found that firm risk and earnings volatility decreases after dividend initiation. However, the earnings per share of initiating firms were found to be no higher than a year after the first payment.

Gwilym et al (2004) investigated the firms that have suffered a decline in earnings after periods of sustained earnings growth. It was established that over three-quarters of firms increased their dividends despite the fall in profits. Thus poor financial performance will not necessarily lead to a decrease in dividends.

Grullon et al (2003) found that dividend changes are uncorrelated with future earnings. They also found that, regardless the models of earnings expectation, model that include dividend changes do not outperform those that do not include dividend changes.

Taking a different perspective, DeAngelo et al (1992) investigated the dividend policy of US firms that suffered a loss after a sustained period of both profitability and dividend payments. They found that a loss is a virtual necessity for a dividend to be cut, although a loss does not guarantee a reduction. Hence for firms to reduce the amount of dividends paid there must be evidence of poor financial performance.

Marsh et al (1987) studied an aggregate stock market dividend over an extended period. His research concluded that managers systematically change the dividend payout following unexpected changes in permanent earnings by partially adjusting dividend amounts.

Bhat et al (1994), argue that dividends depend on current and expected earnings as well as the patterns of past dividends. They also argue that dividends help in signaling the future prospects of the firm and dividends are paid even if the firm has profitable investment opportunity.

DeAngelo-DeAngelo-Skinner (1996) studied the signaling content of managers' dividend decisions for 145 NYSE firms whose annual earnings decline after nine or more consecutive years of growth. They found no support for the notion that dividend decisions help identify firms with superior future earnings.

Muindi (2006) studied the relationship between earning per share and dividend per share of for companies listed at the NSE. He established that there was a positive relationship between earnings per share and dividend per share.

Njoroge (2001) conducted a study on the relationship between dividend policies and return on assets and return on equity for companies listed at the Nairobi Stock Exchange and found that there was a positive correlation between dividends paid and both return on equity and return on Abdul (1993) conducted a research to find out the determinants of dividend payments by publicly quoted companies in Kenya and concluded that liquidity is the most important factor in determining dividends.

Kioko (2006) analyzed the relationship between dividend changes and future profitability of companies quoted at the NSE and established that at least in the year of dividend change, there existed a relationship between dividend changes & future profitability. However, for the first and second after dividend change, an insignificant relationship was observed.

Tiriongo (2004), conducted a study on dividend policy practices for the companies listed at the Nairobi Stock Exchange. He concluded that there was a positive relationship between dividend paid and factors such as financial performance of the firm and general economic performance.

Karanja (1987) studied dividend practices of publicly quoted companies in Kenya and investigated the kind of dividend policies that were being followed the quoted companies. He found out that the most critical factors considered were cash, liquidity and earnings per share. He also found out that most firms followed a stable dividend payout ratio.

Wandeto (2005) conducted an empirical investigation of the relationship between dividend changes and earnings and established, using a simple regression model, that there was a strong positive relationship between dividends per share and earnings per share with a correlation coefficient of 25.3% and concluded that dividend change is most sensitive to earnings.

2.7 Summary of the Empirical Studies

This chapter has aimed at presenting a review of the literature related to the purpose of the study. The purpose has been to study the relationship between prior period dividends and the financial performance of the firm. The vast majority of studies conducted tend to point towards a positive relationship between prior period dividends and the financial performance of the firm. From the studies conducted so far, it is evident that the most critical factors considered by a firm in coming up with a dividend policy are the expected cash flows, liquidity and profitability of the firm. However, there are varied opinions as to the role of the prior period dividends on the earnings per share. Though, most researchers tend to believe that there is a positive relationship, there are a few others who believe that there is no such relationship and hence prior period dividends do not affect the financial performance of the firm.

This chapter therefore reveals that dividend payment is a critical factor to the performance of the company in that it propels the firm to higher levels in terms of goodwill as compared to its peers. For instance, high dividend is the single most factor considered by most stakeholders in deciding whether to trust their investments in a company. Hence dividends are the surrogates when the company offers no financial statements to analyze, no cash flow statement to be considered by suppliers, no balance

sheet to be scrutinized by lenders, no statement of changes in equity to be studied by investors, no bonuses to pacify employees and no corporate social responsibility budget to assure the customers.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter systematically researches the relationship between prior period dividends and financial performance of firms listed at the Nairobi Stock Exchange. The chapter will highlight the various methods and procedures the researcher will adopt in conducting the research and is organized in the following structure: the research design, population, sample, data collection methods and data analysis methods.

3.2 Research Design

The nature of this study will be a causal study. This is because we have at least two major variables of interest, the cause and the effect. The cause is the prior period dividends and the effect is the outcome that we wish to study, that is, the financial performance of a firm.

In this study, the area of interest is the effects of prior period dividends on financial performance of a firm. Therefore, the major components in this study are the research problem; the cause; the sample; the outcomes (effect) and the design.

3.3 Population

The population will consist of all the companies listed at the Nairobi Stock Exchange. Currently there are 55 companies listed at the Stock Exchange and therefore these shall form the population.

3.4 Sampling Design

For this study, a sample consisting 34 companies (see appendix 2) out of the 55 companies listed at the NSE will be used. This is because these are the companies that have issued dividends consistently in the past six years. Indeed a few of the companies have been under suspension for a number of years. Therefore, sample statistical techniques will be used to analyze the data. Information from the 34 companies will be collected through interviews with the finance managers (see attached a sample letter for the interview as appendix 1), from companies' websites, from the Financial Statements of these corporations as well as from regulatory bodies like the Nairobi Stock Exchange, the Capital Markets Authority and the Institute of Certified Public Accountants of Kenya.

3.5 Data Collection Methods

The study will use secondary of companies listed at the Nairobi Stock Exchange. The secondary data will be sourced from the financial market regulators like NSE and CMA, the companies' finance departments, the website and financial analysts amongst other sources. The data to be sourced would include the published financial statements of the companies, statements of the board of directors, finance journals, and any other relevant material. The firms to consider must have been listed on the Nairobi stock exchange 20 share indexes for the period between 2005 and 2010.

3.6 Variable Measurement

3.6.1 Independent Variables

The independent variable is the earnings per share (EPS), which is defined as the profit in Kenyan shillings attributable to each equity share after deducting preference dividend, divided by the number of equity's share in issue.

3.6.2 Dependent Variables

The dependent variable in this research is the amounts of dividends per share (DPS).

3.7 Data Analysis

The data collected was edited, coded and tabulated into manageable summaries. This study used the quantitative method of data analysis which was conducted using descriptive statistics. These include measures of central tendency (mean, median, and mode) and the measures of dispersion (standard deviation, range, and variance). A correlation between variables was also calculated. This analysis was also conducted using both parametric and non-parametric statistical techniques.

The data was fed to a workbook (SPSS/Excel) for quick and efficient analysis. Inferences will be drawn using judgment from the descriptive statistical data. The results from the analysis will be presented by use of descriptive statistics including graphs, scatter diagrams and tables.

3.8 Research Model

In this research both the Spearman's Rank Correlation Coefficient (SRC) and Pearson Product-Moment Correlation Coefficient (PPMC) will be used. This is because the research will be testing for linear dependence between two variables and how well a relationship between these variables can be described by a monotonic function. While taking into consideration the fact that financial performance is affected by factors other than dividends, such as; innovations adopted by the organization, exploration of new markets, corporate governance amongst others, it is noteworthy that these factors are qualitative in nature and therefore may not be applicable in this research.
The control variables in this regard will be the general economic growth; government subsidies; change in legal environment, that is, new tax laws, amongst others.

3.8.1 Pearson Product- Moment Correlation Coefficient

Pearson Product-Moment Correlation Coefficient is a measure of the linear dependence between variables X (being the independent variable) and variable Y (being the independent variable).

3.8.2 Spearman's rank Correlation Coefficient

Spearman's Rank Correlation Coefficient (Spearman's Rho) is a non-parametric measure of statistical dependence between two variables. It describes how well the relationship between two variables can be described using a monotonic function. It is the correlation between ranked variables where the ranks will be assigned as (X_i, Y_i) and the deviation will be the difference between the ranks $(d_i = x_i - y_i)$. The expression to calculate the coefficient is as follows:

$$\rho = 1 - \frac{6 \sum d_i^2}{n(n^2 - 1)}.$$

Where:

ρ =Spearman's correlation coefficient

n =number of values or elements

d=difference between rank X_i and Y_i

CHAPTER FOUR

DATA ANALYSIS AND FINDINGS

4.1 Introduction

This chapter contains the results obtained from the analyzed data and is presented in both tables and graphs. Notes are included to explain the relationship between prior period dividends and current period financial performance of firms listed at the Nairobi Stock Exchange. It is also at this point that the results of the data collected are matched with the objectives stated previously in the research.

4.2 Data Presentation and Analysis

The following table shows dividend per share (DPS) and earnings per share (EPS) for the 34 listed companies targeted, between the periods of 2005 to 2010. This is the data obtained from the secondary sources:

Table 4.2.0

company	BBK		BAT		EABL		WILLIAMSON TEA		NATION MEDIA		TPS SERENA	
year												
DPS-EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS
2005	2.1	2.7	12.5	13.82	2.15	4.57	5	10.08	6	10.04	0.4	-0.28
2006	1.65	3.3	12	12.01	4.95	6.82	0.5	-6.29	3.5	4.98	1.25	3.6
2007	1.65	3.6	17	13.86	7.34	7.76	5	15.95	5.25	6.93	1.25	3.91
2008	2	4.09	17	17.01	8.05	9.55	4	12.62	5.5	8.25	1.25	2.1
2009	2.5	4.449	19.39	12.82	8.05	8.71	0.5	-9.91	5.5	7.02	1.25	3.6
2010	5.54	7.8	17.5	17.67	8.75	9.08	6.25	96.42	8	9.77	1.25	2.1

company	CROWN BERGER		MUMIAS		EAPCC		COOP BANK		NIC BANK		DTB	
year												
DPS-EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS
2005	1	1	1.75	2.99	2.5	6.75	0.1	0.66	2.5	0.95	0.7	2.04
2006	1	3.03	1.5	2.7	2.6	4.58	0.05	0.3	2.7	1.58	1.6	11.68
2007	1	1.74	1.5	0.91	2.6	8.49	0.08	0.54	0.8	2.57	1.55	6.39
2008	1	1.2	0.4	0.79	0	5.96	0.1	0.8	0.5	3.18	1.4	5.24
2009	1.25	3.64	0.4	1.05	1.3	20.38	0.2	0.85	0.5	3.01	1.4	3.53
2010	1.25	3.85	0.4	1.03	0	-3.25	0.4	1.31	0.5	5.06	1	2.49

Source:

company	REA VIPINGO		BAMBURI		EA CABLES		ARM		JUBILEE		TOTAL	
year												
DPS-EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS
2005	0.8	1.88	5.3	5.52	0.5	1	0.75	2.1	2.9	7.03	2.2	3.01
2006	0.8	2.07	5.5	7.2	0.7	1.4	1	2.76	3.1	10.67	2.5	2.78
2007	0.8	1.92	6	9.91	0.9	1.85	1.25	4.26	3.86	12.46	2.5	2.99
2008	0.2	2.8	6	11.54	1	1.94	1.25	5.08	3.86	12.85	2.5	4.02
2009	0.5	2.48	7	14.41	1	1.52	1.5	6.52	4.1	16.67	1	1.62
2010	0.8	1.12	8.5	14.02	1	1.12	1.75	8.06	5.5	35.47	1.05	3.07

company	HFCIC		KPLC		KCB		CAR AND GENERAL		STARNCHART		SASINI	
year												
DPS-EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS
2005	0.3	0.79	1.5	16.05	0.4	0.7	0.67	8.71	7.5	0	0	-10.17
2006	0.25	0.64	1.5	20.78	0.6	1.2	0.67	6.09	8.5	8.89	1	1.04
2007	0.25	0.64	2	21.72	0.7	1.5	0.67	7.71	10	11.9	0	-0.15
2008	0.3	0.79	4	22.3	1	1.97	0.67	9.5	10	11.11	0	3.84
2009	0.5	1.02	8	40.76	1	1.84	0.67	8.8	12	16.45	0.4	2.3
2010	0.7	1.65	8	46.97	1.25	2.76	0.8	10.7	13.5	18.85	0.5	4.3

company	KAKUZI		STD GROUP		KQ		CMC MOTORS		CFC GROUP		KENOL	
year												
DPS-EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS
2005	0	3.36	0	1.01	1.25	8.4	1.5	7	2	6	8.56	8.15
2006	0	6.79	0	2.09	1.75	10.45	2.3	1.43	6	11	1.55	6.45
2007	0	9.68	1	3.01	1.75	8.87	0.35	2.03	8	11	1.8	8.74
2008	1	9.23	1.1	3.57	1	9.91	0.45	1.59	1	3.35	2.5	10.06
2009	2.5	17.34	0.5	3.25	1	-8.84	0.35	0.93	0	-0.39	0.33	0.88
2010	2.5	15.87	0.5	3.39	1.5	7.65	0.2	0.7	0.804	-0.22	0.52	1.21

company	PAN AFRICAN LIFE		CENTUM		KENGEN		BOC	
year								
DPS-EPS	DPS	EPS	DPS	EPS	DPS	EPS	DPS	EPS
2005	1.2	3.68	4	0.54	0.23	0.8	6.8	10.26
2006	1.44	8.87	4	1.1	0.55	1.71	11.3	11.57
2007	1.6	3.06	0.45	2.03	0.8	1.11	9.25	13.62
2008	0	-1.99	0	1.58	0.9	2.19	6.8	10.26
2009	1.7	2.89	0	0.57	0.5	0.94	6.8	7.88
2010	3	12.28	0	1.62	0.5	0.89	9.4	4.06

Source: ICPAK, NSE, CMA and Companies' websites

4.2.1 Data Analysis: Stage One

The first stage of the data analysis is to determine the relationship (if any) between prior period dividend payments and financial performance of the firm using descriptive statistical techniques such as Pearson Product-Moment Correlation Coefficient (PPMC), Spearman's Rank Correlation Coefficient (SRC).

The data above shows the earnings per share capital and prior period dividends per share capital for all 34 companies targeted by the research. The data was compiled in such a way that it was convenient to compare previous period dividend payments per share (DPS) and subsequent period earnings per share (EPS). The data was then fed to a workbook (Excel) to determine the Pearson Product-Moment Correlation Coefficient and Spearman's Rank Correlation coefficient for each of the 34 listed companies from 2005 to 2010. The analysis period for DPS was between 2005 and 2009, while the analysis period of EPS was between 2006 and 2010 for each of the 34 listed companies sampled.

The coefficients will be interpreted using a scale that shows the strength of correlation between two variables within a certain coefficient range (see appendix 4)

The distribution obtained is the following scatter diagram:
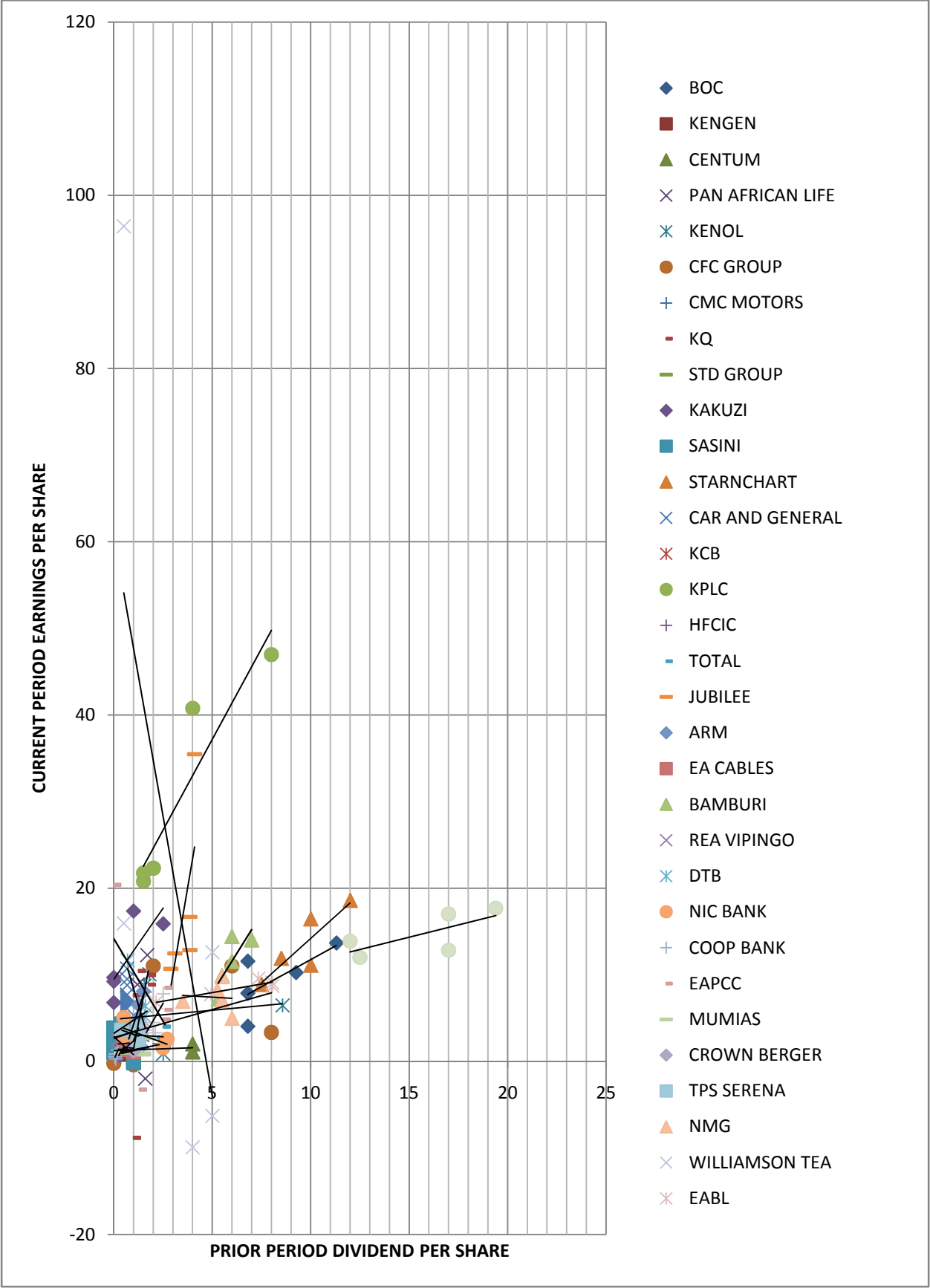
The PPMC values and SRC values are used to show whether a linear relationship exists between Prior period DPS and Subsequent period EPS, the strength of such relationship and whether the relationship is monotonic in nature. But due to the complexity and the large scale of the data, no comprehensive interpretation could be made. Further analysis and simplification of the data needed to be done.

4.2.2 Data Analysis: Stage Two

The second stage of the data analysis is to compile data obtained from the use of earlier mentioned descriptive statistical methods (for all the 34 companies), and use statistical techniques such as measures of central tendency to analyze and interpret the data.

Table 4.2.2.0

	FIRM	PPMC VALUES	SRC VALUES
1	BBK	0.778162497	0.363803438
2	BAT	0.717556571	0.577350269
3	EABL	0.925236676	0.618718434
4	WILLIAMSON TEA	-0.693606503	-0.521286035
5	NMG	-0.073343892	-0.096225045
6	TPS SERENA	-0.338968411	-0.25
7	CROWN BERGER	0.552744693	0.707106781
8	MUMIAS	0.439949107	0
9	EAPCC	-0.513327186	0
10	COOP BANK	0.764240613	0.481125224
11	NIC BANK	-0.729626798	-0.727606875
12	DTB	-0.779711643	-0.213200716
13	REA VIPINGO	0.067519342	0.162221421
14	BAMBURI	0.801073354	0.866025404
15	EA CABLES	-0.136280922	-0.265165043
16	ARM	0.961182374	0.962250449
17	JUBILEE	0.688921476	0.962250449
18	TOTAL	-0.10134788	-0.081110711
19	HFCIC	0.935119613	0.657411243
20	KPLC	0.935277066	0.9701425
21	KCB	0.812588176	0.795495129
22	STARNCHART	0.872049437	0.769800359

23	SASINI	-0.489453108	-0.353553391
24	KAKUZI	0.788328133	0.707106781
25	STD GROUP	0.718948717	0.606339063
26	KQ	0.558501833	0.521286035
27	CMC MOTORS	0.76264015	0.606339063
28	CFC GROUP	0.38524256	0.530330086
29	KENOL	0.161677135	-0.1
30	PAN AFRICAN	0.18855948	0.3
31	CENTUM	0.331095878	0.312771621
32	KENGEN	-0.050083599	0
33	BOC	0.688915081	0.707106781
	MEAN	**0.331205455**	**0.320510082**
	MEDIAN	**0.552744693**	**0.481125224**

Because of an arithmetic error (divide by zero error) data from one company, Car and General could not be included for further analysis.

The table above shows all the PPMC and SRC values calculated for 33 of the 34 sampled companies. The PPMC values and SRC values will be used to show whether a linear relationship exists between Prior period DPS and Subsequent period EPS, the strength of such relationship and whether the relationship is monotonic in nature. An arithmetic mean for all the values has been obtained for a clear analysis of the data. The median for the data was also obtained to further aid in the interpretation of the analyzed data. The PPMC values and SRC values will be interpreted as guided by Table 3.7 (which shows the strength of a linear or monotonic relationship between two variables within various PPMC/SRC coefficient ranges).

The Mean PPMC value for 33 listed companies is 0.3312 while the Median PPMC value for the 33 companies is 0.5527. A Mean PPMC value of 0.3312 means that a linear relationship exists between prior period DPS (independent variable) and subsequent period EPS (dependent variable). The strength of the relationship is medium. Using the Median PPMC value of 0.5527, a linear relationship between prior period DPS and subsequent period EPS exists. The strength of the relationship is large.

4.3 Summary of Findings and Interpretations

The Mean SRC value for 33 listed companies is 0.32051 while the Median SRC value for the 33 companies is 0.48112. A mean SRC value of 0.32051 means that a monotonic relationship exists between prior period DPS (independent variable) and subsequent period EPS (dependent variable). The strength of the relationship is medium. Using the Median PPMC value of 0.48112, a monotonic relationship between prior period DPS and subsequent period EPS exists. The strength of the relationship is large.

From the analyzed data we can conclude that both a linear and a monotonic relationship between prior period DPS and subsequent period EPS exist. The strength of the relationship is medium, which could mean that prior period DPS is one among many other factors that affect subsequent period EPS.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This chapter discusses a summary of the compiled report from the research findings, a discussion of the major findings in the light of comparable studies, theoretical or practical implications, achievements, constraints, conclusions, recommendations and suggestions for further work.

5.2 Conclusion and Recommendations

The results of the study reveal majority of firms enjoy a better financial performance as indicated by their EPS after issuing dividends. As such, a relationship indeed exists between previous period dividend payments and financial performance of a firm. The factors analyzed in the previous chapter: prior period DPS and subsequent period EPS were used as the basis for establishing whether or not the relationship exists and its magnitude.

The magnitude of the relationship is medium, which means that the payment of dividend in the previous period has a considerable impact on a company's financial performance. The analysis shows that the relationship is positively monotonic, meaning that an increase in prior period paid dividends will result to an increase in financial performance of the firm by a certain factor/function and vice versa, holding all other factors constant.

Though the exact relationship has not been established, it can be concluded that a positively monotonic function does relate financial performance of a firm to payment of dividends in the previous period.

Consequently, it would be prudent for firms not paying dividends to initiate payment of dividends to their shareholders so as to realize a better financial performance. The firms paying dividends also need to determine the optimal dividend payments for the model to remain relevant. These dividends should only be paid from past profits and reserves. However, care need to be taken to avoid incurring heavy finance costs which may reverse the benefits associated with payment of dividends. Hence dividends should not be paid from loans or funds that attract interests.

5.3 Limitation of the Study

The major limitation of the study was lack of qualitative evidence or material on the relationship between payment of dividends in the previous period and financial performance of a firm, the scope of the research was limited.

The research data was large in scale such that the study could not ascertain a definite function relating payment of dividend in the previous period to financial performance of the firm. The 6 year time period was also long, as many fundamentals could have changed within various companies including mergers, acquisitions, suspension and reinstatement at the stock market, change of business, etc. This has further complicated the research and data collection.

Lastly, the study does not take into account the prevailing economic and political environment that may affect the financial performance of firms. For example the global financial crises may have affected some firms negatively regardless of their dividend policies while government legislation could have created an enabling environment for other corporations especially in companies where government is a major shareholder.

5. 4 Recommendations for Further Study

This study focused on the relationship between prior period dividends and the financial performance of firms listed at the NSE. A different study can be done to test the

relationship between gearing and financial performance. This study can be carried out with a larger population and for a shorter time period, that is one year. The study also focused mainly on the effect of dividends on financial performance. A further study can be done to find the effect of prior period dividends on share pricing and business valuation.

REFERENCES

Abdul, F. (1993). "An Empirical Study to Identify Parameters Which are Important in the Determination of Dividends by Publicly Quoted Companies", *Unpublished MBA Project*, University of Nairobi.

Baker, H. K., Farrelly, G. E. & Edelman, R. B. (1986). Corporate Dividends: Views of the Policy Makers. *Akron Business and Economic Review*,

Baskin, J B (1988). The development of corporate financial markets in Britain and the United States, 1600–1914: Overcoming asymmetric information. *Business History Review* 62:2, 199–237.

Benartzi, S., Michaely, R. & Thaler, R. (1997). Do Changes in Dividends Signal the Future or the Past? *The Journal of Finance* 52,

Bhat, R, and Pandey I, (1994). Dividend decision: A Study of Managers' Perceptions. *Decision 21, 67–86.*

Bitok, J. (2004). "The Effect of Dividend Policy on the Value of the Firms Quoted at the Nairobi Stock Exchange", *Unpublished MBA project*, University of Nairobi.

Black, F (1976). The dividend puzzle. *Journal of Portfolio Management* 2:2, 5–8

Black, F (1990). Why firms pay dividends. *Financial Analysts Journal* 46:3, 5.

Block S B and Hirt G A, *Foundations of Financial Management*, (6th Ed), Von Hoffman Press Inc.

Blume, M.E. (1980). Stock Returns and Dividend Yields: Some more Evidence. *Review of Economics and Statistics, 62, pp.567-577.*

Brealey, R. A. & Myers, S. C. (1991). *Principles of Corporate Finance,* 5th edition, Irwin-McGraw-Hill

DeAngelo, H., De Angelo, L. & Skinner, D. J. (2000). Special Dividends and the Evolution of Dividend Signalling,' *Journal of Financial Economics* 57 (3). 309-354

Dyl, E. and R. Weigand (1998). The information content of dividend initiations: additional evidence. *Financial Management Association,* Autumn.

Fama, E .F. & Babiak, H. (1968). Dividend Policy: An Empirical Analysis, *Journal of American Statistical Association.*

Ghosh C & Sirmans C, (2006). Do Managerial Motives Impact Dividend Decisions in REITs? *The Journal of Real Estate Finance and Economics,* Springer, vol. 32(3), pages 327-355.

Gordon, M. J. (1959). Dividends, Earnings and Stock Prices, *The Review of Economics and Statistics*, Vol. 41 No.2, pp.99-105.

Grullon et al (2003). Dividend changes do not signal changes in future profitability. *Journal of Business (forthcoming)*.

Gwilym et al (2004), International Evidence on Payout Ratio, Returns, Earnings and Dividends. *Financial Analysts Journal (forthcoming)*.

Hansen et al (1994), Dividend policy and corporate monitoring: evidence from the Regulated electric utility industry. *Financial Management (Financial Management Association)*.

Healy, P.M., Palepu, K.G., (1988). Earnings information conveyed by dividend initiations and omissions. *Journal of Financial Economics 21*, 149-176.

Jensen M (1986). Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers. *American Economic Review*, 76: 323-329.

Karanja, (1987). "Dividend Practices of Publicly Quoted Companies in Kenya", *Unpublished MBA Project*, University of Nairobi.

Kent B, TK Mukherjee, and G Powell (2005). Distributing Excess Cash: The Role of Specially Designated Dividends. *Financial Services Review* 14:1, 111-131.

Kioko, M. (2006). "An Analysis of the Relationship between Dividend Changes & Future Profitability of Companies Quoted at the Nairobi Stock Exchange", *Unpublished MBA project,* University of Nairobi.

Lintner J. (1956), Distribution of income of corporations among dividend, retained earnings and taxes, *American economic review*, Vol 46, pp 97-113.

Litzenberger, R. H. & Ramaswamy, K. (1979). The Effects of Personal Taxes and Dividends on Capital Asset Prices: Theory and Empirical Evidence. *Journal of Financial Economics*, 7, 163-195.

Marsh, T.A. and Merton, R.C. (1987). Dividend Behaviour for the Aggregate Stock Market. *Journal of Business,* 60, pp.1-40.

Miller, M. H. & Modigliani, F. (1961). Dividend Policy, Growth and the Valuation of Shares. *The Journal of Business*, vol. 34, pp. 411-433.

Mundi, H. (2006). "The relationship between Earning Per Share and Dividend Per Share of Equities for Companies Listed at the Nairobi Stock Exchange", *Unpublished MBA Project,* University of Nairobi.

Nissim, D. and A. Ziv. (2001). Dividend changes and future profitability. *Journal of Finance* 56:2111-2133.

Njoroge, (2001). "A Study of Dividend Policies, Growth in Assets, Return on Assets and Return on Equity at the Nairobi Stock Exchange", *Unpublished MBA project*, University of Nairobi.

Pandey I.M (2002). *Financial Management*, Vikas publishing House, New Delhi, India.

Pettit, R. R. (1972). Dividend Announcements, Security Performance, and Capital Market Efficiency. *The Journal of Finance*, 27 (5). 993-1007

Pruitt SW, and Gitman L, (1991). The Interactions between the Investment, Financing and Dividend Decisions of Major U.S. Firms. *Financial Review* 26:3, 409-430

Ross, S, A. (1977). The Determination of Financial Structure: The Incentive Signaling Approach, *Bell Journal of Economics 8 (1). 23- 40*

Solomon, E (1963). *The Theory of Financial Management*, Columbia University Press, New York

Tajirian, A. (1997). Dividend Policy: a Review Article. *Journal of Business*, Vol.17, pp.4-17.

Tiriongo T. K. (2004). "Dividend Policy Practices of the Companies Listed at the Nairobi Stock Exchange", *Unpublished MBA Project*, University of Nairobi.

Wandeto, P. (2005). "An Empirical Investigation of the Relationship between Dividend Changes and Earnings", *Unpublished MBA project*, University of airobi

Weston and Brigham (1978). *Managerial Finance*, (6th Ed); Holt, Rinehart& Winston, New York.

APPENDICES

APPENDIX I: INTRODUCTION

Peter Kioko Mutie,
University of Nairobi,
P.O. BOX 30197-00100,
NAIROBI.

Dear Sir/Madam,

RE: REQUEST FOR INTERVIEW AND INFORMATION

I am carrying out a research on the relationship between prior period dividends and the financial performance of a firm for companies listed at the Nairobi Stock Exchange. This is in partial fulfillment of the requirement of the Masters of Business Administration (MBA) degree program at the University of Nairobi.

The purpose of this study is to find out if there is indeed a relationship between prior period dividends and financial performance of a firm and if there is, then the significance of such relationship. The results of this study will provide useful information to companies in developing their dividend policies and the financial advisors in selecting the best companies to invest in.

This is an academic research and confidentiality is strictly adhered to. Kindly spare some time to answer my interview questions.

Thank you in advance,

Yours faithfully,

Peter Kioko

APPENDIX 2 : LIST OF FIRMS CONSIDERED FOR THE STUDY

1	ARM
2	BAMBURI
3	BAT
4	BBK
5	BOC
6	CAR AND GENERAL
7	CENTUM
8	CFC GROUP
9	CMC MOTORS
10	COOP BANK
11	CROWN BERGER
12	DTB
13	EA CABLES
14	EABL
15	EAPCC
16	HFCK
17	JUBILEE
18	KAKUZI
19	KCB
20	KENGEN
21	KENOL
22	KPLC
23	KQ
24	MUMIAS
25	NIC BANK
26	NMG
27	PAN AFRICAN
28	REA VIPINGO
29	SASINI
30	STARNCHART
31	STD GROUP
32	TOTAL
33	TPS SERENA
34	WILLIAMSON TEA

APPENDIX 3 : FIRMS LISTED AT THE NAIROBI STOCK EXCHANGE AT END OF AUGUST 2011

1	A BAUMANN	33	KENYA REINSURANCE
2	ACCESSKENYA	34	KPLC
3	ARM	35	KQ
4	BAMBURI	36	LIMURU TEA CO
5	BAT	37	MARSHALLS EAST AFRICA
6	BBK	38	MUMIAS
7	BOC	39	NIC BANK
8	CAR AND GENERAL	40	NMG
9	CARBACID	41	OLYMPIA CAPITAL
10	CENTUM	42	PAN AFRICAN
11	CFC GROUP	43	REA VIPINGO
12	CITY TRUST	44	SAFARICOM
13	CMC MOTORS	45	SAMEER AFRICA
14	COOP BANK	46	SASINI
15	CROWN BERGER	47	SCAN GROUP
16	DTB	48	STARNCHART
17	EA CABLES	49	STD GROUP
18	EAAGADS	50	TOTAL
19	EABL	51	TPS SERENA
20	EAPCC	52	TRANSCENTURY LTD
21	EQUITY BANK	53	UCHUMI SUPERMARKET
22	EVEREADY EAST AFRICAN	54	UNGA GROUP
23	EXPRESS LTD	55	WILLIAMSON TEA
24	HFCK		
25	HUTCHINGS BIEMER		
26	JUBILEE		
27	KAKUZI		
28	KAPCHORUA TEA		
29	KCB		
30	KENGEN		
31	KENOL		
32	KENYA ORCHARDS		
33	KENYA REINSURANCE		

APPENDIX 4: THE GUIDE FOR INTERPRETATION OF THE CORRELATION BETWEEN VARIABLES

Correlation	Negative	Positive
None	-0.09 to 0.0	0.0 to 0.09
Small	-0.2 to -0.1	0.1 to 0.2
Medium	-0.5 to -0.2	0.2 to 0.5
Large(strong)	-1.0 to -0.5	0.5 to 1.0

Source: www.wikipedia.org