

**THE EFFECT OF DIVIDEND POLICY ON FUTURE FINANCIAL
PERFORMANCE OF FIRMS LISTED AT THE NAIROBI SECURITIES
EXCHANGE**

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DECLARATION

I declare that this Project is my original work and has not been submitted for an award of a degree in any other University for examination/academic purposes.

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This Project has been submitted for examination with my approval as the University Supervisor

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DR. J.O ADUDA

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DEDICATION

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

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ABBREVIATIONS

AIMS – Alternative Investment Market Segment

CDSC – Central Depository and Settlement Corporation

CEO – Chief Executive Officer

CFO – Chief Finance Officer

CMA –Capital markets Authority

FISMS - Fixed Income Securities Market Segment

IFC – International Finance Corporation

MIMS – Main Investment Market Segment

MM – Miller & Modigliani

NASDAQ – National Association of Securities Dealers Automated Quotation

NPV – Net Present Value

NSE –Nairobi Securities Exchange

REO – Return on Equity

REA – Return on Assets

ABSTRACT

What a company does with its profits is important in assessing a business's potential to create wealth in the future. Re-investing profits wisely results in increased profitability of the company in the long run, which to the shareholders is important. Retained earnings on the company's books are not just earning higher returns, it also adds to the total asset value of the company, and asset value of each share. The objective of the research was to establish the effect of dividend policy on future financial performance of firms listed at the NSE. This study adopted a co-relational research design. After the screening process, the sample size was 43 and their financial statements for the period 2009-2013 were studied. A regression model was determined to establish the relationship between measures of earning distribution and its effect on future earnings of the firm. These correlations indicate that current operating accruals, non-current operating accruals and retained cash flows represent significant sources of variation in retained earnings. The findings support the position that the positive relationship between current dividend payout and future earnings growth is based on the free cash flow theory. The results also support the conventional wisdom that primary earning components are useful for determining association with future primary earnings, whereas other components are not as useful. The research is limited to the sample of Kenyan listed firms. Therefore the finding of this study could only be generalized to firms similar to those that included in this research. In addition, sample size is small. Consequently, managers should be aware of the intermediating impact of future performance of a firm and the future profitability of the firm could only be enhanced by improving earnings distribution in the first place.

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

One important financial decision firms are confronted with is the determination of the proportion of the earnings that should be retained by a firm and also determine the amount to be distributed to the shareholders due to its potential effect it has on the value of the firm. According to Weston and Bringham (2006), the earnings distribution strategy is the one that maximizes the market value of the firm's outstanding shares. Managers who are astute enough to identify and deploy the appropriate mix of retained earnings and dividend are amply rewarded in the market place, because, all things being equal, this appropriate dividend policy minimizes a firm's cost of financing. Given revenue and pre-financing profit streams that are generated through non-financial factors, minimizing cost of financing maximizes the net returns for the firm and thus improving its competitive advantage in the marketplace (Gleason et al., 2000).

Long term profitability is inevitable for the persistent payment to the supplier of funds as well as for the growth of business. Effort has been made to find out some correlation between various components of earnings. The earnings have been initially decomposed into retained earnings and distributed earnings. The two components have further been decomposed into their sub-components. The retained earnings are decomposed into retained cash flows, current operating accruals and noncurrent operating accruals whereas distributed earnings are decomposed into earnings distributed to debt holders (debt

repayment minus debt issues) and cash flows distributed to equity holders (dividends plus stock repurchases minus stock issues).

1.1.1 Dividend Policy

The issue of dividend policy is a very important one in the current business environment. Dividend policy remains one of the most important financial policies not only from the viewpoint of the company, but also from that of the shareholders, the consumers, employees, regulatory bodies and the Government. For a company, it is a pivotal policy around which other financial policies rotate (Alii et al., 1993). Dividend policy is the decision to pay out earnings versus retaining and reinvesting them. Dividend changes may be important signals if the market anticipates that the change will be maintained through time. If the market believes that the change is just a rearrangement of dividends through time, then the impact will be small. The reaction to the information contained in dividend changes is called the information content effect.

Dividend policy is considered to be one of the most important financial decisions that corporate managers encounter (Baker and Powell, 1999). It has potential implications for share prices and hence returns to investors, the financing of internal growth and the equity base through retentions together with its gearing and leverage (Omran and Pointon, 2004).

Mizuno (2007) agrees to the fact that a firm ought to distribute its earnings to shareholders if it cannot identify suitable investments which would bring higher returns than those expected by the shareholders. According to Miller and Modigliani (1961)

dividend irrelevance theorem a lower dividend payouts ratio was assumed to be associated with higher future growth and thus higher future equity returns.

While determining retention and distribution of earnings, a prudent manager strikes a balance between shareholder's expectations and firm's long-term interest. Such analysis is of great relevance to policy makers, because as the dividend literature suggest, if these decisions are handled efficiently, this is expected to be reflected in the firms' value. More prominently, such analysis is useful in enabling policy makers (CFOs and CEOs) to recognize the success or failure of policy initiatives or, alternatively, highlight different strategies undertaken by firms in services sector, which contribute to their success (Daniel and Titman, 2009). Enhancing shareholders' wealth and profit making are among the objectives of a firm (Pandey, 2005). Shareholder's wealth is mainly influenced by growth in sales, improvement in profit margin, capital investment decisions and capital structure decisions (Azhagaiah and Priya, 2008).

1.1.2 Future Financial Performance

Financial performance can be viewed as how well a firm enhances its shareholders' wealth and the capability of a firm to generate earnings from the capital invested by shareholders. Therefore, the dividend policy can affect the value of the firm as well as the wealth of shareholders (Baker et al., 2001). This position can explain the requirements by the Nairobi Securities Exchange for companies that want to be listed to have a clear future dividend policy. This makes the retention and the distribution of earnings policy of a firm to be worthy of serious management attention.

What a company does with its profits is important in assessing a business's potential to create wealth in the future. Re-investing profits wisely results in increased profitability of the company in the long run, which to the shareholders, is interest. Furthermore, the retained earnings on the company's books is not just earning higher returns, it also adds to the total asset value of the company, and of course the asset value of each share is a major element of the share price and this in turn will benefit the shareholders (Fairfield et al., 2003).

Financial measures are considered the most used parameter of business performance measurement, especially in the current economic climate. Most growing businesses ultimately target increased profits, so it is important to know how to measure profitability. The key standard measures are:-

Profitability measures the extent to which a business generates a profit from the factors of production: labor, management and capital. Profitability is the most important measure of success of the business. A business that is not profitable cannot survive, yet a highly profitable one has the ability to reward its owners with a large return on their investment. Profitability analysis focuses on the relationship between revenues and expenses and on the level of profits relative to the size of investment in the business (Mesquita and Lara, (2003). Four useful measures of firm profitability are the rate of return on firm assets (ROA), the rate of return on firm equity (ROE), operating profit margin and net firm income. The ROA measures the return to all firm assets and is often used as an overall index of profitability, and the higher the value, the more profitable the firm business. The ROE measures the rate of return on the owner's equity employed in the firm business. It

is useful to consider the ROE in relation to ROA to determine if the firm is making a profitable return on their borrowed money (Hadlock and James, 2002).

Net firm income comes directly off the income statement and is calculated by matching firm revenues with the expenses incurred to create those revenues, plus the gain or loss on the sale of firm capital assets. Net firm income represents the return to the owner for unpaid operator and family labor, management and owner's equity. Like working capital, net firm income is an absolute dollar amount and not a ratio, thus comparisons to other firms is difficult because of firm size differences (Deloof and Jegers, 1996).

On their part, Palepu et al (2000) asserted that "the starting point for a systematic analysis of a firm's performance is its return on equity (ROE) as well as return on assets (ROA)." Return on assets (ROA) is an important determinant of ROE because it shows how much profit a company is able to generate for each dollar of assets invested (Palepu et al., 2000). Although ROE and ROA are commonly used to assess the performance of large companies, research into SMEs performance has tended to focus on sales or profit, or growth in sales or profit (Fasci and Valdez, 1998). While there is no doubting the importance of sales and profit to a business, it is equally important to relate these output measures to measures of inputs (namely assets or equity) when making comparisons of business performance.

Liquidity measures the ability of the firm business to meet financial obligations as they become due, without disrupting the normal, ongoing operations of the business. Liquidity can be analyzed both structurally and operationally. Structural liquidity refers to the balance sheet (assets and liabilities) and operational liquidity refers to cash flow measures

(Du Rietz and Henrekson, 2000). Two recommended measures of liquidity are the current ratio and working capital. The current ratio measures the relationship between total current firm assets and total current firm liabilities and is a relative measure rather than an absolute dollar measure. The higher the ratio, the more liquid the firm is considered to be. Working capital is a measure of the amount of funds available to purchase inputs and inventory items after the sale of current firm assets and payment of all current firm liabilities. Working capital is expressed in absolute dollars; therefore, determining adequate working capital is related to the size of the firm operation (Du Rietz and Henrekson, 2000).

Solvency measures the amount of borrowed capital used by the business relative to the amount of owner's equity capital invested in the business. In other words, solvency measures provide an indication of the business' ability to repay all indebtedness if all of the assets were sold. Solvency measures also provide an indication of the business' ability to withstand risks by providing information about the firm's ability to continue operating after a major financial adversity (Hammes, 2003). Unlike liquidity, solvency is concerned with long-term as well as short-term assets and liabilities. Three widely used financial ratios to measure solvency are the debt-to-asset ratio, the equity-to-asset ratio and the debt-to-equity ratio. These three solvency ratios provide equivalent information, so the best choice is strictly a matter of personal preference. The debt-to-asset ratio expresses total firm liabilities as a proportion of total firm assets and the higher the ratio, the greater the risk exposure of the firm. The equity-to-asset ratio expresses the proportion of total assets financed by the owner's equity. The debt-to-equity ratio reflects the capital structure of the firm and the extent to which firm debt capital is being

combined with firm equity capital. It is a measure of the degree to which a firm is leveraging its equity.

Non-financial measures has also come out as a major factor to be considered especially in today's competitive environment where companies are competing in terms of product, quality, delivery, reliability, after-sales service and customer satisfaction. None of these services is measured by the traditional responsibility accounting system, despite the fact that they represent the major goals of world-class manufacturing companies. Many companies are using both qualitative and quantitative non-financial indicators such as; quality, lead time, number of customer complaints and warranty claims, delivery time, non-product hours, and system down time. Unlike traditional variance reports, measures such as these can be provided quickly for managers, per shift, daily or even hourly. They are easy to calculate and also easier for non-financial managers to understand (Bozec, 2005).

1.1.3 Dividend Policy and Future Financial Performance

Firm performance can be measured by the earnings generated by the company in terms of profitability. There is substantial literature on the relationship between dividend policy and profitability. Dividends are important to shareholders and potential investors in showing the earnings that a company is generating. Healthy dividends payouts thus indicate that companies are generating real earnings rather than cooking books (Barron, 2002). A study by Zhou and Ruland (2006) revealed that high dividend payout firms tend to experience strong future earnings but relatively low past earnings growth despite market observers having a contradicting view. The findings of another study done by

Arnott and Asness (2003) also revealed that future earnings growth is associated with high rather than low dividend payout. They concluded that historical evidence strongly suggests that expected future earnings growth is fastest when current payout ratios are high and slowest when payout ratios are low. Their evidence contradicted the view that substantial reinvestment of retained earnings would fuel faster future earnings growth. Their study was done to investigate whether dividend policy of the U.S. equity market portfolio, forecasts future earnings growth.

Arnott and Asness (2003) suggested that the positive relationship between current dividend payout and future earnings growth is based on the free cash flow theory. Low dividend resulting in low growth may be as a result of suboptimal investment and less than ideal projects by managers with excess free cash flows at their disposal. This is prominent for firms with limited growth opportunities or a tendency towards over-investment. Paying substantial dividends which in turn would require managers to raise funds from issuance of shares, may subject management to more scrutiny, reduce conflicts of interest and thus curtail suboptimal investment (Arnott and Asness, 2003). This is based on the assumption that suboptimal investments lays the foundation for poor earnings growth in the future whereas discipline and a minimization of conflicts will enhance growth of future earnings through carefully chosen projects. Therefore, paying dividends to reduce the free cash flows enhances the performance of a company since managers will have less cashflows thus avoiding suboptimal investments. This is also consistent with the agency cost theory.

However, Farsio et al. (2004) argue that no significant relationship between dividends and earnings hold in the long run and studies that support this relationship are based on short periods and therefore misleading to investors. They proposed three scenarios that would render the long-term relationship of dividends and future earnings insignificant. Lastly, an increase in dividends may be the result of good performance in previous periods which may continue into the future (Farsio et al., 2004). This supports the view of a positive causal relationship between current dividends and future earnings. From these scenarios, they argue that the overall long-term relationship is insignificant since there is a positive relationship between dividends and future earnings in some periods and a negative relationship in other periods.

Lie (2005) argues that firms that increase payouts have excess financial flexibility and exhibit positive concurrent income shocks and decreases in income volatility, but there is limited evidence of subsequent performance improvements. His study revealed that firms that increase payouts have lower past volatility of operating income than other firms. The volatility decreases even further. This can be explained by the fact that managers increase the firm's payout when they believe that the probability of sustaining the current level of income is high. Firms that decrease dividends on the other hand, have higher past volatility than other firms, and this volatility is on the rise.

1.1.4 Firms Listed at the NSE

The origin of Nairobi Stock Exchange (NSE) can be traced back to 1954, when it was constituted as a voluntary association of stockbrokers registered under the Societies Act. Africans and Asians were not permitted to trade securities at the NSE during this time. Business was conducted by resident Europeans only until 1963 when Kenya attained independence from Britain. The NSE was established to meet a number of objectives among them: to provide an alternative method of raising capital to small, medium sized and young companies that find it difficult to meet the more stringent listing requirements of the Main Investment Segment Market (MIMS), facilitate the liquidity of companies with a large shareholder base through ‘introduction’, that is, listing of existing shares for marketability and not for raising capital and also offer investment opportunities to institutional investors and individuals who want to diversify their portfolios and to have access to sectors of the economy that are experiencing growth.

A number of major steps can be identified to have been undertaken by the institution to modernize its operations to measure to other developed stock exchanges in Africa and the Europe. In 1966, the NSE began measuring daily trading activity by computing the NSE Index. The index measured daily average price changes in 17 companies that were considered the most active stocks in the market. This was computed as a weighted average of price changes in the selected stocks and 1966 was used as the base year and set at 100 points (Kimura and Amoro, 2004). The 1970s saw about 20 more companies listed on the NSE. This was the largest number of companies listed in a span of about a decade. In 1984, the Government of Kenya through the Central Bank of Kenya in

conjunction with the International Finance Corporation (IFC) conducted a study dubbed “Development of Money and Capital Markets in Kenya”. This study became a blue print for structural reforms in Kenya’s financial markets and culminated in the establishment of the Capital Markets Authority (CMA) in 1989 as a regulatory body that would enable the development of Kenya’s capital markets and the creation of a conducive environment for economic growth.

In 1991 NSE was registered under the Companies Act and also adopted a 20-share index and changed the computational method of the index to a geometric mean. In 2000, Kenya, Uganda and Tanzania signed the Joint Stock Exchange Taskforce report on cross border listing. Subsequently, the East African Breweries Ltd. and the Kenya Airways proceeded to cross list at the Kampala and Dar-as-Salaam Stock Exchanges. In 2001, NSE was categorized into three market segments namely, the Main Investment Market Segment (MIMS), Alternative Investment Market Segment (AIMS) and Fixed Income Securities Market Segment (FISMS). The first rights issue under the AIMS was implemented in February 2001. In 2002, an agreement was reached for the establishment of the Central Depository and Settlement Corporation (CDSC). The CDSC is the legal entity that owns the automated clearing, settlement, depository and registry system (CDS). All these changes in the management and operation of the NSE have been geared towards adapting the institution to meeting the changing demands of the financial market.

1.2 Research Problem

Distribution and retention of earnings is considered to be one of the most important financial decisions that corporate managers encounter. This is because a firm's policy on the same has potential implications for share prices which will eventually affect returns to investors, the financing of internal growth and the equity base through retentions together with its gearing and leverage (Omran and Pointon, 2006). This position had earlier been amplified by Frankfurtet and McGoun (2002) when they concluded that the dividend puzzle, both as a share value-enhancing feature and as a matter of policy is one of the most challenging topics of modern financial economics. Earnings are important to stockholders because earnings provide the cash flow necessary for paying dividends since dividends are what stockholders actually receive from the firm. While determining dividend payment a prudent management needs to strike a balance shareholders expectation and the firm's long term interest. This is because if the issue is handled efficiently, then it is going to positively affect the firm's value.

Researchers have different views about whether earnings distribution and retention materially affects the long term share prices and performance of a firm. Dhanani, (2005) who used a survey approach to capture managerial views and attitudes of corporate managers regarding distribution and retention of earnings, found that dividend policy serves to enhance corporate market value.

However, Farsio et al., (2004) argues that empirical studies that conclude a causal relationship exists between earnings and dividends are based on short periods of time and are therefore misleading to potential investors. Therefore, they found that, distributed earnings have no explanatory power to predict future earnings. On the one hand, high retained cash flows may have low persistence if they are derived by opportunistic earnings management (accounts receivables securitizations, transfers in and out of trading securities, delay of payments to suppliers) (Richardson, 2006). He further points out that high retained cash flows may also have a negative impact on future profitability since they could be associated with future overinvestment. Aivasian et al., (2008) argue that in the emerging markets, firms have high financial constraints and hence are highly sensitive to some determinants of dividends policy that are suggested by research in the developed countries. Consequently, it is necessary to investigate the effect of distribution of earnings on future performance of firms in developing country such as Kenya.

In Kenya, few empirical studies have been done to establish the relationship between distributed earnings and firm's future performance. Murekefu and Ouma (2013) studied on a survey of the relationship between dividend payout and firm performance in listed companies in Kenya and concluded that dividend payout affects firm performance and that this relationship is strong and positive. It therefore shows that dividend policy is relevant and affects the performance of a firm.

Muriuki (2012) carried out a research on the relationship between dividend policies and share prices for companies quoted at the NSE. His findings was that there was a statically significance positive relationship between the dividend payout of a firm and the

share price of the firms in the NSE. This study therefore differs with the reviewed studies and comes in to fill the void by establishing whether there is a relationship between retained and distributed earnings and firm's future performance among listed companies in Kenya.

1.3 Objectives of the Study

To establish the extent of the relationship between dividend policy and distributed earnings on future performance among companies listed at the Nairobi Securities Exchange.

1.4 Value of the Study

This study can be justified since retained and distributed earnings of a firm, has implication for investors, managers and lenders and other stakeholders (more specifically the claimholders). For investors, earnings whether distributed today or accumulated and provided at a later date are not only a means of regular income, but also an important input in valuation of a firm. Similarly, managers' flexibility to invest in projects is also dependent on the amount of earnings that they distribute to shareholders as more dividends may mean fewer funds available for investment. Lenders will also benefit from this study since they may also have interest in the amount of dividend a firm declares, as more the dividend paid less would be the amount available for servicing and redemption of their claims.

In any company, shareholders as rational investors usually expect to receive some income as return on their investments. The ability of a company to pay dividends will depend to a large extent on its financial performance. Lasher (2000) was right when he noted that a decrease in dividend is taken as terrible news. It generally comes after a sustained reduction in earnings and hence the importance of this study

The results of the research will provide invaluable information to companies listed in the NSE as well as other stakeholders within the corporate industry in the country. This is because the findings of the study will highlight to these parties the benefits of retained earnings as well as distributed earnings in the future growth and performance of the companies. Companies will find the findings of the research invaluable as to the reasons why there is need to have an optimal mix of retained earnings against distributed earnings thus help in the formulation of dividend policies in the industry. The findings of the present study will also be invaluable to academia in Kenya.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter reviews literature relating to dividend policy and future financial performance. It focuses on previous studies done by various authors in relation to dividend policy and firm performance. The literature review has been organized in the following sections. First section covers the review of theories guiding my work and the theoretical framework underpinning the subject area. The second section covers empirical reviews on the subject matter while retained earnings, distributed earnings and firm's future performance are covered in the third section. The last section is a summary of the chapter.

2.2 Theoretical Framework of Dividend Policy

2.2.1 Residual Theory of Dividend

The essence of the residual theory of dividend policy is that the firm will only pay dividends from residual earnings, that is, from earnings left over after all suitable (positive NPV) investment opportunities have been financed. Retained earnings are the most important source for financing for most companies. A residual approach to the dividend policy, as the first claim on retained earnings will be the financing of the investment projects. With the residual dividend policy, the primary focus of the firm's management is indeed on investment, not dividends. Dividend policy becomes irrelevant,

it is treated as a passive rather than an active, decision variables. The view of management in this case is that the value of firm and the wealth of its shareholders will be maximized by investing the earnings in the appropriate investment projects, rather than paying them out as dividends to shareholders. Thus managers will actively seek out, and invest the firm's earnings in, all acceptable (in terms of risk and return) investment projects, which are expected to increase the value of the firm. Dividends will only be paid when retained earnings exceed the funds required to finance the suitable investment projects. Conversely when the total investment funds required exceed retained earnings, no dividend will be paid. The motives for a residual policy, or high retentions, dividend policy commonly include: A high retention policy reduces the need to raise fresh capital, (debt or equity), thus saving on associated issues and floatation costs. A fresh equity issue may dilute existing ownership control. This may be avoided, if retentions are consistently high. A high retention policy may enable a company to finance a more rapid and higher rate of growth. When the effective rate of tax on dividend income is higher than the tax on capital gains, some shareholders, because of their personal tax positions, may prefer a high retention/low payout policy.

2.2.2 Bird in Hand Theory

Bird in hand theory proposes that a relationship exists between firm value and dividend payout. It states that dividends are less risky than capital gains since they are more certain. Investors would therefore prefer dividends to capital gains (Amidu, 2007). Because dividends are supposedly less risky than capital gains, firms should set a high dividend payout ratio and offer a high dividend yield to maximize stock price. The

essence of the bird-in-the-hand theory of dividend policy (John Litner in 1962 and Myron Gordon in 1963) argues that outside shareholders prefer a higher dividend policy. Investors think dividends are less risky than potential future capital gains, hence they like dividends. If so, investors would value high payout firms more highly.

Hence, the bird-in-the-hand theorem suggests that the relationship between dividend policy and the firm's value can be explained by investors' preference for dividend payments rather than the expected capital gains from stocks. This preference exists because dividends represent a sure thing, being less risky than the expected capital gains. However, MM argue that the riskiness of the firm depends on the riskiness of the operating cash flows and not on its dividend payout policy. In addition, tax preference theory comes from the favourable tax treatment of capital gains relative to dividend payments. This leads investors to prefer firms with lower payout ratios rather than firms with relatively high dividend payout ratios.

2.2.3 Agency Theory

The agency theory is based on the assumption that conflicts of interest arise between corporate insiders, and outsiders and hence managers may conduct actions according to their own self-interest, which may not always be beneficial for shareholders; such conflicts lead to agency costs (Ho, 2003). Agency cost models predict that dividends' payment can be used to reduce the problems related to information asymmetry. Further, a similar theory to the agency theory is the free cash flow hypothesis which is rooted in conflicts of interest between managers and stockholders in the presence of informational and self-seeking behaviour. In this context, firms prefer to increase their dividends and

distribute the excess free cash flow in order to reduce agency costs. Consequently, markets react positively to this type of information.

2.2.4 Signalling Theory

Modigliani and Miller (1961) argued that dividend may have a signalling effect. The top management of a firm has more information about the strategy of the firm and can also forecast future earnings of the company. Therefore, people working in the firm have more information as the other investors and the market in general. Thus this leads to the problem of information asymmetry. Hence, firms can use dividends as a signaling mechanism which sends information to investors in the market or to its shareholders. The information may reflect the strategies that the firm is employing in the short run or long run. Managers of the firm can change the expectations of people with regards to its future earnings through dividends. A firm has several ways is sending information to the market. This can include costly methods which will prevent smaller firms from imitating the signal. The methods refer to increasing the price of dividend; that is increasing dividend payout. However, the firm must also be able to sustain the costs of conveying the information. Miller and Rock (1985) discussed that dividends indeed have a signaling role but there are 'dissipative' costs that are involved and these are the firms' investment decisions. As mentioned previously, a firm who must pay a level of dividend which is high enough to avoid smaller firms to imitate the same strategy. The increase in dividend should eventually lead a share price increase and similarly, a decrease in the dividend should cause the price of the share to fall. Due to the subjective nature of dividend payout, some studies have actually found out that the relationship between dividend and

share price provides support to the hypothesis that dividends do carry information to the market about future expected profits (Griffin, 1976). However, though managers use dividend to convey information, dividend changes may not be the perfect signal. According to Easterbrook (1994), dividend increase may be an ambiguous signal unless the market can distinguish between growing firms and disinvesting firms.

2.3 Determinants of Future Financial Performance.

2.3.1 Investment Opportunities

One of the most important elements of market value is the investment opportunities available to the firm. The common assumption of investment opportunity set is making a capital expenditure to produce a new product or expand an existing production line (Kallapur and Trombley, 2001). The discretionary expenditures of managers depend on the internal funds of the firm and also the corporate capacity to issue low risk debt (Triantis, 2000). A firm with financial slack has cash or quick assets or extra debt capacity available so that it can use the investment opportunities as they come across, in fact firms with financial slack have the opportunity to invest in positive net present value projects without issuing risky securities (Smith and Kim, 1994). Kallapur and Trombley (2001) mention that investment opportunity impacts remarkably on the perspective of managers, owners, investors and creditors about the firm's value. The firms with potential profitable expansion opportunities have higher share prices although they might currently have low earnings (Aretz and Bartram, 2010). Investment opportunity set has a clear effect on the financial performance of firms. The increases in investment

opportunity set of a firm result in rise of dividend payout ratio and also increase of their dividend yield (Abbott, 2001).

2.3.2 Financial Leverage

Leverage refers to the proportion of debt to equity in the capital structure of a firm. The financing or leverage decision is a significant managerial decision because it influences the shareholder's return and risk and the market value of the firm. The ratio of debt-equity has implications for the shareholders' dividends and risk, this affect the cost of capital and the market value of the firm (Pandey, 2007). Gupta *et al* (2010) cited some studies showing contradictory results about the relationship between increased uses of debt in capital structure and financial performance. Ghosh, Nag and Sirmans (2000), Berger and Bonaccorsi di Patti (2006) reported a positive relationship between leverage and financial performance, while Gleason *et al* (2000), Simerly and Li (2000) showed negative relationship between financial performance and leverage level. Similarly, Zeitun and Tian (2007) found that debt level is negatively related with financial performance. Several researchers have studied firms' debt use and suggested the determinants of financial leverage by reporting that firm's debt-equity decision is generally based on a trade-off between interest tax shields and the costs of financial stress (Upneja and Dalbor, 2001). According to the trade-off theory of capital structure, optimal debt level balances the benefits of debt against the costs of debt (Gu, 1993) hence, use of debt to a certain debt ratio results in higher return on equity, however, the benefit of debt would be lower than the cost after this level of capital structure. In other words, the more a company uses debt, the less income tax the company pays, but the greater its financial risk. Based on the

trade-off theory for capital structure, firms can take advantage of debt to make a better return on equity.

2.3.3 Liquidity

The International Financial Reporting Standards (2006) define liquidity as the available cash for the near future, after taking into account the financial obligations corresponding to that period. Liargovas and Skandalis, (2008) argues that firm can use liquid assets to finance its activities and investments when external finance are not available. On the other hand, higher liquidity can allow a firm to deal with unexpected contingencies and to cope with its obligations during periods of low earnings. Almajali et al (2012) found that firm liquidity had significant effect on Financial Performance of firms. The result suggested that the companies should increase the current assets and decrease current liabilities because the positive relationship between the liquidity and financial performance. In contrast to the above reasoning, based on a theoretical model by Jovanovic (1982) suggested that a moderate amount of liquidity may propel entrepreneurial performance, but that an abundance of liquidity may do more harm than good. Therefore, they concluded that the effect of liquidity on firms' financial performance is ambiguous.

2.3.4 Firm Size

Previous studies in finance have shown that company size can predict the future stock price (Simerly and Li, 2000). For instance, Hvide and These (2007) in their study concluded that larger firms have better performance. Flamini et.al (2009) suggested that

bigger firms are more competitive than smaller firms in harnessing economies of scale in transactions and enjoy a higher level of profits. Athanasoglou et al., (2005) assert that increase in company size increases the performance of the bank. Almajali et al (2012) argued that the size of the firm can affect its financial performance. However, for firms that become exceptionally large, the effect of size could be negative due to bureaucratic and other reasons (Yuqi 2007).

2.4 Review of Empirical Evidence

Since Miller and Modigliani (1961) in their dividend irrelevance theory argue that dividend policy does not affect the value of the firm, different empirical works have been conducted to investigate the dividend puzzle. Ho (2003) presents a comparative study of dividend policies in Australia and Japan over a ten-year panel dataset for 332 firms in the Australian and Japanese markets from 1992 to 2001. The evidence that Australia has a significantly higher dividend payout than Japan provides support for the influence of environment on dividend policy. He finds the following relationships: dividend policy is positively affected by size in Australia and by liquidity in Japan, and negatively by risk only in Japan. These findings support the agency, the signalling, and the transaction cost theories of dividend policy. The industry effect is found to be significant in both Australia and Japan indicating the importance of the industry in which a company competes.

Mahalang'ang'a et al., (2012) established that there is a relationship between dividend payout and firm performance among listed firms in the Nairobi Securities Exchange. Regression analysis was carried out to establish the relationship. This study made use of

both primary and secondary data. Secondary data was obtained from the firm's annual reports, from the year 2002 to 2010. The population for this study consisted of the firms listed on the Nairobi Securities Exchange. The NSE classified these companies into ten sectors. The findings indicated that dividend payout was a major factor affecting firm performance. Their relationship was also strong and positive. Based on the findings of this research that dividend policy is relevant, managers should devote adequate time in designing a dividend policy that will enhance firm performance and therefore shareholder value.

Uwalomwa et al., (2012) investigated the relationship between the financial performance and dividend payout among listed firms' in Nigeria. Variables are ownership structure, size of firms and the dividend payouts. The period 2006-2010 was utilized as the main source of data collection for the 50 sampled firms. Found out that there is a significant positive association between the performances of firms and the dividend payout of the sampled firms in Nigeria. Additionally revealed that ownership structure and firm's size has a significant impact of the dividend payout of firms too.

Aivazian et al (2003), considered to be the leading scholars in investigating the dividend policy in developing markets, found that emerging market companies exhibit dividend behaviour njsimilar to US companies, in the sense that dividends are explained by profitability, debt and the market-to-book (MB) ratio. In addition, emerging market companies seem to be more affected by asset mix, which is related to their greater reliance on bank debt. Their empirical results (using pooled data) reveal that for both US companies and emerging market companies, profitability affects dividend payments; high

return on equity (ROE) leads to high dividend payments. Similarly, higher debt ratios correspond to lower dividend payments, suggesting that financial constraints affect dividend policy. In addition, the MB ratio has a positive effect on dividend payments. Aivazian et al (2003) find little evidence that BR or size affects dividend policy in a significant or consistent way. Finally, for emerging market companies, they find that dividends are negatively related to the assets tangibility.

Agyei and Yiadom (2011) examined the relationship between dividend policy and performance of banks in Ghana. The study used panel data constructed from the financial statements of 16 commercial banks in Ghana for a period of 5 years, from 1999-2003. These financial statements were obtained from the Banking Supervision department of Bank of Ghana. STATA was used for the data analysis. Indicate that banks pay dividend increase their performance. Generally, the result is shown that dividend policy has an effect on firm value.

Both Zhou and Ruland (2006) and Gwilym et al. (2006) supported the findings of Arnot and Asness. Zhou and Ruland examined the possible impact of dividend payouts on future earnings growth. Their study used a sample of active and inactive stocks listed on NYSE and NASDAQ with positive, non-zero payout ratio companies covering the period from 1950-2003. Their regression results depicted a strong positive relation between payout ratio and future earnings growth. Mancinelli and Ozkan (2006) undertook an empirical investigation of the relationship between the ownership structure of companies and dividend policy using 139 firms listed in Italian exchange. Their results

suggested that the dividend payout ratio is negatively associated with the voting rights of the largest shareholders.

In a study that examines whether dividend policy influences firm performance in the Ghana Stock Exchange, Amidu (2007) found that dividend policy affects firm performance especially the profitability measured by the return on assets. The results showed a positive and significant relationship between return on assets, return on equity, growth in sales and dividend policy. This showed that when a firm has a policy to pay dividends, its profitability is influenced. The results also showed a statistically significant relationship between profitability and dividend payout ratio. A study by Howatt et al., (2009) also concluded that positive changes in dividends are associated with positive future changes in mean real earnings per share.

Furthermore, Omran and Pointon (2004) investigate the role of dividend policy in determining share prices, the determinants of payout ratios, and the factors that affect the stability of dividends for a sample of 94 Egyptian firms. The study findings were that retentions are more important than dividends in firms with actively traded shares, but that accounting book value is more important than dividends and earnings for non-actively traded firms. However, after they combine both the actively traded and non-traded firms, they argue that dividends are more important than earnings. In the determinants of payout ratios, they find that the leverage ratio and MB ratio are negatively related to the payout ratios in actively traded firms. Leverage, tangibility ratios and firm size (measured by the market capitalization) are negatively related to payout ratios. BR, MB and firm size (measured by total assets) are positively related to payout ratios in non-actively traded

firms. However, for the whole sample, leverage has a positive relationship with payout ratios, while firm size (measured by market capitalization) is negatively related with payout ratios. Finally, the stepwise logistic regression analyses show that decreasing dividends is associated with lack of liquidity and overall profitability.

From the above studies, several points according to Al Najjar (2009) can be made. First, some of the empirical studies exclude some significant variables that may affect the dividend policy decision, such as Ho (2003) and Aivazian et al., (2003) models which exclude ownership structure variables. This may give evidence that dividend policy models have not yet reached to a specific set of factors that may affect the firms' dividend policy. Second, there is no precise relationship between the investigated variables and firms' dividend policy. For example, firm size is positively related to dividend policy in Holder et al.,(1998) and Ho (2003) and negatively related in Aivazian et al., (2003). BR is positively related in Holder et al (1998) and Ho (2003) and negatively related in Aivazian et al (2003). This conflict is due to the different interpretations of the variables. In addition, the different statistical methods that are used by the studies make the comparison between their results difficult. However, the empirical work in dividend policy field shows strong evidence that the agreed factors are important determinants of the dividend policy in both developed and emerging markets, as well as the theories of dividend policy which serve in both markets. In addition, different statistical approaches are used to investigate the dividend policy decisions (dynamic models and static models) and this validates and strengthens the dividend policy debate.

2.5 Summary of Literature Review

The importance of a firms' earnings distribution and its effect on various financial factors of a firm has been expounded in detail both in the literature as well as from the empirical studies done on the subject area. Firms generally adopt distribution of earnings policies that suit the life cycle that they are in. For example high growth rate companies with large cashflows and fewer projects tend to pay more of their earnings out as dividends. The literature reviewed also show that dividend payments tend to follow several patterns which tend to add to the existing puzzle. For example, dividends tend to lag behind the earnings in the sense that the dividends growth tends to be lower than the earnings growth. In addition, dividends are "sticky", because firms are reluctant to change dividends; in particular that firms are reluctant to reduce the level of dividend payment even in situations where their earnings drop. Another conclusion that can be deduced from the study is that dividends tend to follow a smoother path than earnings and this could be attributed to the "stickiness" of the dividends.

The previous empirical studies that have been looked at have concentrated mainly in developed countries. In developing countries, such as Kenya, few studies have analyzed the dividend behaviour of corporate firms and more so how the earnings distribution behaviour influences future performance of the firms. This research looks at the issue from a developing economy point of view.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter sets to explain the research design, the population of interest, the basis of sample selection, the type of secondary data used, the sources of data, the techniques of analysis used and the data analysis.

3.2 Research Design

This study employed correlation research design. According to Albright et al (2011) a correlation research is a procedure in which subjects' score on two variables are simply measured, without manipulation of any variable, to determine whether there is a relationship. A cross sectional study was also be used to determine the interrelationship between the variables under consideration among the different firms in the study and this allowed the researcher to make statistical inference on the broader population, to include non-listed firms, and generalize the findings to real life situations and thereby increase the external validity of the study.

3.3 Population of the Study

The population of interest in this study was all the firms listed in the Nairobi Securities Exchange between 2009 and 2013. As at 31st Dec 2013, there were 61 firms listed at the NSE (Appendix I). The reason as to why these firms are chosen is because of the availability and the reliability of the financial statements in that they are subject to the

mandatory audit by internationally recognized audit firms as well as regulators. In addition, all the firms have their headquarters in Nairobi and its environs and this made it convenient in terms of time and accessibility to the researcher. Since the number of the respondents is limited, then the study was a census survey.

3.4 Data Collection

Data was collected from annual reports submitted to the NSE and Capital Markets Authority. All the firms that had continually operated between 2009 and 2013 were included to ensure that the sampling frame is current and complete. From the financial statements, the researcher collected information on the net income levels for each of the firms level of customer deposits, cash level non-performing net current operating assets, cash and cash equivalents, total accruals, net non-current operating assets, free cash flow levels and the distributed earnings made in the years. In addition, only firms that had continuously operated over the period 2009 to 2013 were considered in the study.

3.5 Data Analysis

Multiple regression analysis was applied to the data to examine the effect of the various aspects of retained and distributed earnings on future performance of the firm. The statement of financial position as well as the statement of financial performance and their notes will be studied to get the data for the variables mentioned in the model

The regression is adapted from the one used by Papanastasopoulos et al (2012) when they did a similar research on US firms and took the form;

Profitability = f (Operating assets, Change in cash equivalents, Total accruals, Free cash flows, Distributed earnings, α)

3.5.1 Analytical Model

The model will specifically take the form;

$$NI_t = \beta_0 + \beta_1 CACC_t + \beta_2 NCACC_t + \beta_4 \Delta C_t + \beta_5 DIST_D_t + \beta_6 DIST_E_t + \epsilon$$

Where;

NI_t - One year- ahead annual net income/Net Income at time t

β_0 - Constant value

$CACC_t$ - Current operating accruals at time t

$NCACC_t$ - Net non-current operating assets at time t

ΔC_t - Change in cash and cash equivalents at time t

$DIST_D_t$ - Cash flows distributed to debt holders at time t.

$DIST_E_t$ - Cash flows distributed to Equity holders at time t.

ϵ .Random error term

The F- test was used to determine the significance of the regression while the coefficient of determination, R^2 , was used to determine how much variation in the net income is explained by the independent variable. This was done at 95% confidence level and correlation analysis was carried out to find the direction of the relationship between NI

and the independent variables. The Statistical Package for Social Sciences (SPSS) was used to analyze the data.

CHAPTER FOUR

DATA ANALYSIS, RESULTS AND DISCUSSION

4.1 Introduction

This chapter presents the results and findings of the study based on the research objectives. The results are presented in the form of summary tables. In addition a regression analysis is used to analyse the data to answer the research objective and to establish the strength of the relationship between the variables under consideration, correlation analysis is performed.

4.2 Results

The regression analysis was conducted with the control variables. Test of significance was carried out for all variables studied using t-test at the 95% level of significance.

From the observation;

Any p-value that is greater than 0.05 is deemed to have a significant relationship with the dependent variable else the relationship is considered insignificant.

The standardized coefficient and the t-statistic indicate the strength of the relationship between the dependent and the independent variables.

The adjusted R-square measures the degree of variability of the independent variable due to the change in the independent variable.

The results are as indicated below while the source data is presented in a tabular format in the appendix II.

4.3 Descriptive Statistics

Table 4.1 below summarizes the descriptive statistics of the variables included in the regression models as presented. It represents the variables of the 38 firms operating in Kenya in the financial years 2009-2013.

Table 4.1: Descriptive statistics of independent and Dependent variables

		NI ('000')	CACC	NCACC	ΔC_t	RE	Distr- E_t
N	Valid	168	166	166	166	165	166
	Missing	0	0	0	0	1	0
Minimum		23890.25	108410.60	200703.52	23200.43	327604.91	92350.75
Mean		559503.97	156149.33	373119.14	167965.95	761644.23	189377.06
Maximum		12267902.40	325790.25	628490.65	945900	1250528.90	1450360.6
Std. Deviation		178027.333	79262.175	188819.00	366433.192	656157.204	1324631.6
Skewness		2.5430	4.2105	3.2062	4.2370	5.2014	4.2004

Source: Calculations based on Annual reports of firms from 2009-2013

Notes: SD – standard deviation; NI –Net Income; CACC – Current operating accruals; NCACC – Change in Net Non-current operating Assets; ΔC_t – Change in cash and cash equivalent; RE –Retained Earnings; Distr- E_t – Distributed earnings to Equity holders.

The profitability of the firms sampled is 799,503.97 which is significantly positive, an indication that over the period under review, the firms registered positive profits and this could be attributed to positive economic growth that was experienced in most sector. However, the high standard deviation (SD = 778027.333) shows that the variation of the firms was high and this could be explained by the different sizes of firms and sectors under consideration. Some sectors such as banking and insurance firms registered impressive growth in profits over the period while other sectors such agriculture returns

was much lower and this could explain the variance. This difference is also evident in the retained earnings that the firms made. The standard deviation is almost equivalent to the mean, suggesting a wide variation as well. The other finding from the results is that the mean returns are almost equal to the retained earnings for the respective years. This findings show that the firms managers were of the view to have high retention ration and low dividend payout – meaning that they preferred internal financing than going to the financial market to source for funding. This might be due to the high cost of raising funds. This findings is consistent to one made by Chang and Rhee (1990) that the cost of capital is an hindrance to the firms managers sourcing for external funds and suggest that firms with higher assets tangibility are considered to gain better tax benefits without considering debt finances. On the contrary, it is argued that asset tangibility has an inverse relationship with dividend policy, especially in developing markets. Aivazian et al. (2003) argue that the more collateralized assets, the less the availability of current assets for lenders to lend against. Therefore, more financial restrictions are imposed on firms operating in financial environments where the main source of debt is short-term financing. Ho (2003) has also supported this result.

The high retained earnings cash flows experienced, may have a negative impact on future profitability of the firms since they could be associated with future overinvestment, a position that was supported by Richardson (2006). This is because, with a high retention level, the firms will have surplus cash flows which according to the agency theory might lead to wastefulness by the managers. This position contradicts that posited by the capital rationing theory which argues that high cash holdings enable managers to make optimal investment with less cost and obtain better future profitability (Myers and Majluf, 1984).

Thus, the implications of retained cash flows for future profitability will seem to be unclear. In addition, the normality of the data is within acceptable ranges as Skewness is not high enough to affect the normality of the data and kurtosis value for all the variables is positive. Moreover, the probability is less than 0.001.

4.4 Inferential Statistics

For quantitative analysis the study used correlation analysis and regressions model. This model was used to identify the effects of various independent variables on the future profitability of the firm. The determinants of corporate governance were estimated using pooled least squares and general least squares method with cross section weights. The determinants of firms dividend policy was estimated using pooled least squares and general least squares method with cross section weights. As pointed out by Raheman and Nasr (2007), when using pooled data and cross sections there may be a problem of hetroskedasticity (changing variation after short period of time) and to counter this problem, the general least square with cross section weights approach was adopted. In the regression, the common intercept was calculated for all variables and assigned a weight.

4.4.1 Correlation Coefficient

Table 4.2 below shows the Pearson and Spearman's correlation coefficient generated from the data. Consistent with Shin and Soenen (1998), the spearman's rank correlation coefficients are on the upper right triangle while the Pearson product moment correlation coefficients are on the lower left triangle. Pearson's Correlation analysis is used for data to see the relationship between variables such as those between the firm's profitability

and the effect of dividend policy on the future profitability. I expect to find a positive relationship between retained earnings level and firm performance/market value consistent with La Porta et al (2002) and Black et al. (2003). The results are presented in Table 4.2 below.

Table 4.2: Correlation Matrix Table (2 tailed Pearson correlations)

Parameter	NI	CACC	NCACC	ΔC_t	RE	Distr- E_t
NI	1					
CACC	0.295	1				
NCACC	0.323	0.107	1			
ΔC_t	0.317	-0.104	-0.024	1		
RE	0.504	-0.092	0.437	-0.059	1	
Distr- E_t	0.044	0.482	-0.316	0.718	-0.346	1

Notes: The table presents pair-wise (Pearson) correlations for earnings and its components; the sample consists of 166 firm-year observations covering firms (except financial firms) with available data on SPSS for the period 2009-2013; all variables are significance at less than 5 percent level

Table 4.2 above presents pair-wise (Pearson) correlations for net income and its components. There is a negative correlation between retained and distributed earnings (-

0.346). In the case of retained earnings, the negative correlation of non-current operating accruals with distributed earnings is much stronger than that of current operating accruals and retained cash flows. This result implies that the strong negative correlation between retained and distributed earnings is mainly due to non-current operating accruals. In addition, retained earnings are more highly correlated with non-current operating accruals and retained cash flows, than with current operating accruals. These correlations indicate that current operating accruals, non-current operating accruals and retained cash flows represent significant sources of variation in retained earnings.

The findings support the position that the positive relationship between current dividend payout and future earnings growth is based on the free cash flow theory. As Arnott and Asness (2003) suggested low dividend resulting in low growth may be as a result of suboptimal investment and less than ideal projects by managers with excess free cash flows at their disposal. This will be prominent for firms with limited growth opportunities or a tendency towards over-investment. Paying substantial dividends which in turn would require managers to raise funds from issuance of shares, may subject management to more scrutiny, reduce conflicts of interest and thus curtail suboptimal investment.

4.4.2 Regression Analysis

The estimates of the regression coefficients, t-statistics, standard errors of the estimates and p-values are shown in 4.3 below. The coefficient column gives estimated regression coefficients. It can be estimated that there would be 25.3 per cent positive change in the future profitability of the firms as a result of a unit change in retained earnings made by the firms. The t-statistic for this coefficient is 2.404, i.e. significant. From the findings it

can be deduced that as the firms retained earnings is increased, it is going to invest the earnings in more income generating activities which will the firms future profitability, a finding that is similar to the finding of Diamond and Rajan, (2001) as well as Kumar (2008).

Table 4.3: Results of General Least Square

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	520045.977	155290.402		3.349	.001
CACC	.020	.046	.022	.437	.663
NCACC	.001	.007	.004	.073	.942
ΔC_t	-.059	.045	-.072	-1.333	.186
RE	.253	.105	.150	2.404	.018
Distr- E_t	1.685	.149	.804	11.319	.000

a. Dependent Variable: Net_Income_ ('000')

The resultant regression will be as follows:

$$NI = 520045.977 + 0.020CACC + 0.001NCACC + - 0.059\Delta C + 0.253RE + 1.685 \text{ Distr- } E_t$$

The above results suggest the market overestimates the effect of current operating accruals, non-current operating accruals and retained cash flows as the determinant of the future earnings of the firm. This could be due to the fact that investors overestimate the sustainability of current earnings performance due to the fact that they do not distinguish and similarly price the differential elements of retained earnings. They consider both elements of retained earnings as if both components of distributed earnings have similar levels of effect on earnings.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

This chapter presents a summary of the key findings of the study as well as the conclusions, limitations of the study, and recommendations for further research

5.2 Summary of Findings

The secondary data in this analysis covered a period of 5 years from 2009 to 2013. The population of study was firms listed at the NSE that were in operation during the study period. After the screening process firms whose accounts were not available in all the years of study were eliminated and from this screening process 43 firms were considered in the research.

The research findings shows that some sectors such as banking and insurance firms registered impressive growth in profits over the period while other sectors such agriculture returns was much lower and this could explain the high variance in the results. This difference is also evident in the retained earnings that the firms made. The standard deviation is almost equivalent to the mean, suggesting a wide variation as well. The other finding from the results is that the mean returns are almost equal to the retained earnings for the respective years. This findings show that the firms managers were of the view to have high retention ration and low dividend payout – meaning that they preferred internal financing than going to the financial market to source for funding.

The main contribution of this paper is the fact that the factors affecting the dividend policy are similar to those affecting the likelihood of paying dividends in the Kenyan firms. There is strong significant positive relationship between profitability and dividend payments. This means that the profitable Kenyan firms are more likely to pay dividends to their shareholders. In addition, the high retained earnings cash flows experienced by a firm, may have a negative impact on future profitability of the firms since they could be associated with future overinvestment. This is because, with a high retention level, the firms will have surplus cash flows which according to the agency theory might lead to wastefulness by the managers. In the case of retained earnings, the negative correlation of non-current operating accruals with distributed earnings is much stronger than that of current operating accruals and retained cash flows. This result implies that the strong negative correlation between retained and distributed earnings is mainly due to non-current operating accruals.

In addition, retained earnings are more highly correlated with non-current operating accruals and retained cash flows, than with current operating accruals. These correlations indicate that current operating accruals, non-current operating accruals and retained cash flows represent significant sources of variation in retained earnings. The findings support the position that the positive relationship between current dividend payout and future earnings growth is based on the free cash flow theory. The regression results support, to some extent, the argument that growth opportunities play a key role in the dividend policy decision. There is evidence of strong significant positive relationship between firm size and dividend payment, indicating that large Kenyan firms tend to be more diversified

and hence less likely to be at financial distress risk. Therefore, are more able to pay dividends to the shareholders.

5.3 Conclusion

The results indicate that there are systematic differences in the persistence among the components of retained earnings and between the components of distributed earnings. However, investors act as if the components of retained earnings have similar implications for future profitability, leading to an overvaluation of their different firm value. The results also support the conventional wisdom that primary earning components are useful for determining association with future primary earnings, whereas other components are not as useful. The results support prior research regarding the importance of specifically identifying returns provision as a significant explanatory variable in explaining subsequent period earnings.

It is contended that dividend policy affects the agency costs as regular dividend payout leads to increased monitoring by capital markets by reducing the funds available for perquisite consumption and investment opportunities and require managers to seek financing in capital markets. It is imperative for the firm's management to be aware of its effect of dividend policy on the future performance of the firm. This will help them in enhancing their investment portfolio and providing a competitive edge in the market in the future. It is the utmost priority of a firm's management to pay the required attention to the dividend policy. Any factors affecting the affecting the firms dividend policy should be promptly addressed, and immediate remedial measures should be taken to avoid the

consequences of the firms not addressing its dividend policy and its effect on future earnings.

5.4 Recommendations

Managers should be aware of the intermediating impact of future performance of a firm and the future profitability of the firm could only be enhanced by improving earnings distribution in the first place. Finally, the firm managers should be aware that the imminent competitive pressures affecting a firm can be appeased through improving both dividend policy of the firm and future profitability and this depends on the recognition of the effect of present earning distribution on the future earnings of the firm.

The scope of further research may be extended to other components determining future earnings as well as incorporation of more control variables. In addition to relying on theories alternative to agency theory, future research should adopt various methodologies in order to explore different measures of dividend policy, such as stock ownership by executives and board members and examine the interactions connecting its several dimensions and the firm performance.

5.5 Limitation of the Study

One of the limitations of the study is that, there might exist potential interrelations between dividend policy and contextual variables which were not taken into account. This is because some studies such as Boujenoui and Zeghal (2006) have shown that certain divided policies are interconnected and that a variable such as ownership structure, might possibly affect the divided policy put in place by the companies.

Secondly, the research is limited to the sample of Kenyan listed firms. Therefore the finding of this study could only be generalized to firms similar to those that included in this research. In addition, sample size is small.

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 5 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.

5.6 Suggestions for Further Research

This study focused on the relationship between prior period dividends and the future 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 smaller 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.

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APPENDIX 1

COMPANIES LISTED ON THE NAIROBI SECURITIES EXCHANGE

AGRICULTURAL

- 1 Eaagads Ltd
- 2 Kakuzi Ltd
- 3 Kapchorua Tea Co Ltd
- 4 The Limuru Tea Co Ltd
- 5 Rea Vipingo Plantations Ltd
- 6 Sasini Ltd
- 7 Williamson Tea Kenya Ltd

AUTOMOBILES & ACCESSORIES

- 8 Car & General (K) Ltd
- 9 CMC Holdings Ltd
- 10 Marshalls (E.A.) Ltd
- 11 Sameer Africa Ltd

- 12 **BANKING**

Barclays Bank of Kenya Ltd

13 CFC Stanbic of Kenya Holdings Ltd

14 Diamond Trust Bank Kenya Ltd

15 Equity Bank Ltd

16 Housing Finance Co.Kenya Ltd

17 I&M Holdings Ltd

18 Kenya Commercial Bank Ltd

19 National Bank of Kenya Ltd

20 NIC Bank Ltd

21 Standard Chartered Bank Kenya Ltd

22 The Co-operative Bank of Kenya Ltd

COMMERCIAL AND SERVICES

23 Express Kenya Ltd

24 Hutchings Biemer Ltd

25 Kenya Airways Ltd

26 Longhorn Kenya Ltd

27 Nation Media Group Ltd

28 Scangroup Ltd

29 Standard Group Ltd

30 TPS Eastern Africa Ltd

31 Uchumi Supermarket Ltd

CONSTRUCTION & ALLIED

32 ARM Cement Ltd

33 Bamburi Cement Ltd

34 Crown Paints Kenya Ltd

35 E.A.Cables Ltd

36 E.A.Portland Cement Co. Ltd

ENERGY & PETROLEUM

37 KenGen Co. Ltd

38 KenolKobil Ltd

39 Kenya Power & Lighting Co Ltd

40 Kenya Power & Lighting Ltd 4% Pref 20.00

41 Kenya Power & Lighting Ltd 7% Pref 20.00

42 Total Kenya Ltd

43 Umeme Ltd

INSURANCE

44 British-American Investments Co.(Kenya) Ltd

45 CIC Insurance Group Ltd

46 Jubilee Holdings Ltd

47 Kenya Re Insurance Corporation Ltd

48 Liberty Kenya Holdings Ltd

49 Pan Africa Insurance Holdings Ltd

INVESTMENT

50 Centum Investment Co Ltd

51 Olympia Capital Holdings Ltd

52 Trans-Century Ltd

MANUFACTURING & ALLIED

53 A.Baumann & Co Ltd

- 54 B.O.C Kenya Ltd
- 55 British American Tobacco Kenya Ltd
- 56 Carbacid Investments Ltd
- 57 East African Breweries Ltd
- 58 Eveready East Africa Ltd
- 59 Kenya Orchards Ltd
- 60 Mumias Sugar Co. Ltd
- 61 Unga Group Ltd

TELECOMMUNICATION & TECHNOLOGY

- 62 Safaricom Ltd

GROWTH ENTERPRISE MARKET SEGMENT

- 63 Home Afrika Ltd

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