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CITATION: Wasike. w.T., A. & Ambrose, J . (2015). Determinants of Dividend Policy in Kenya.

International Journal of Arts and Entrepreneurship 4 (11), 71-80.

Abstract

Successful companies earn income. This income can be invested in operating assets, used to acquire securities, used to retire debt, or distributed to shareholders. The income distributed to shareholders is the dividend. Issues that arise if a company decides to distribute its income to shareholders include the proportion to which such income would be distributed to shareholders; whether the distribution should be as cash dividends, or the cash be passed on to shareholders by buying back some shares; and how stable the distribution should be. Much controversy surrounds dividends policy as there seems understand it. Since then, the amount of theoretical and empirical research on dividend policy has increased dramatically. This paper sought to address this problem by investigating the determinants of dividend policy in Kenya. It's used panel regressions techniques to analyse the data of all listed 60 (sixty) companies at Nairobi Securities Exchange (NSE) for the period 2004-2014. The results show positive relationships between dividend policy and profitability, cash flow, and tax. The results also show negative associations between dividend policy and risk, institutional holding, growth and market-to-book value. However, the significant variables in the results are profitability, cash flow, sale growth and market-to-book value.

Key words: Determinants, dividend policy, cash flow, corporate tax rate and institutional holdings

INTRODUCTION

1.1 Background of the Study

The dividend policy of a company determines what proportion of earnings is distributed to the shareholders by way of dividends, and what proportion is ploughed back for reinvestment purposes. Dividend policy question has been a controversial issue since the introduction of irrelevance of dividend policy theory by Modigliani and Miller (MM) in the 1960's when they believed in the world of efficient market where dividend policy does not affect the shareholder's wealth. Pandey (2001) defines dividend as that portion of a company's net earnings which the directors recommend to be distributed to shareholders in proportion to their shareholdings in the company. When a company makes a profit, they must decide on what to do with those profits. They could continue to retain the profits within the company, or they could pay out the profits to the owners of the firm in the form of dividends. Once the company decides on whether to pay dividends, they may establish a dividend structure, which may in turn impact on investors and perceptions of the company in the financial markets which bring impact on the firm's value. Basically, the principal hypotheses of dividend policy can be classified into signalling models, clientele effects, agency models, tax effects and free cash flow hypothesis (Frankfurter, Kosedag, Chiang, Collison, Power, Schmidt, So, and Topalov, 2004; Brav, Graham, Harvey and Michaely, 2005).

Dividend policy has been an issue of interest in financial literature since Joint Stock Companies came into existence. Dividend policy suggests a positive attitude for it is a deliberate policy to maintain or increase dividend at a certain level with the ultimate aim of sustaining the price of the ordinary shares on the stock exchange. This is because capital markets are not perfect, although shareholders are indifferent between dividend and retained earnings due to market imperfections and uncertainty, but they give a higher value to the current year dividend than the future dividend and capital gains. Dividend policy can be of two types: managed and residual. In residual dividend policy the amount of dividend is simply the cash left after the firm makes desirable investments using NPV rule.

1.1.1 Determinant of Dividend policy

Amidu and Abor (2006) on their study on determinants of dividend pay-out ratio in Kenya documented that, the results show positive relationships between dividend pay-out and profitability, cash flow, and tax. The results suggest that, profitable firms tend to pay high dividend. A good liquidity position increases a firm's ability to pay dividend. The results also show negative associations between dividend pay-out and risk, institutional shareholding, growth and market-to-book value. Firms experiencing earning volatility find it difficult to pay dividend, such firms would therefore pay less or no dividend. The higher the institutional holding the lower the dividend pay-out ratio, meaning firms pay dividends in order to reduce the cost associated with agency problems. The results again suggest that, growing firms require more funds in order to finance their growth and therefore would typically retain greater proportion of their earnings by paying low dividend. Also, firms with higher market-to-book value tend to have good investment opportunities and would therefore pay lower dividends. The results of this study generally support previous empirical studies. The implication of this article is that dividend pay-out policy decision of Kenyan listed firms is influenced by the profitability, cash-flow position, growth prospects, and investment opportunities of the firms.

1.2 Problem Statement

The issue of dividend policy is a very important one in the current business environment. Dividend policy is the regulations and guidelines that a company uses to decide to make dividend payments to shareholders (Nissim & Ziv, 2001). The area of corporate dividend policy has attracted attention of management scholars and economists culminating into theoretical modelling and empirical examination. Thus, dividend policy is one of the most complex aspects in finance. The behaviour of dividend policy is one most debatable issue in the corporate finance literature and still keeps its prominent place both in developed and emerging markets (Hafeez & Attiya, 2009). Many researchers have tried to uncover issues regarding the dividend dynamics and determinants of dividend policy but we still don't have an acceptable explanation for the observed dividend behaviour of firms (Black, 1976; Brealey & Myers 2005).

According to Miller and Modigliani (1961), the effect of a firm's dividend policy on the current price of its shares is a matter of considerable importance, not only to management who must set the policy, but also to investors planning portfolios and to economists seeking to understand and appraise the functioning of the capital market. Dividend policy has been analyzed for many decades, but no universally accepted explanation for companies' observed dividend behaviour has been established (Samuel & Edward, 2011). It has long been a puzzle in corporate finance. Therefore this study seeks to address this puzzle.

1.3 Purpose of the study

The main objective of this paper is establish the determinants of dividend policies in Kenya

1.4 Significance of the Study

This study aims to contribute to the finance literature, by looking at determinants of dividend policy. However, an attempt is made to make a valuable contribution by innovating on the rich existing literature in three major ways. The findings of this study will help policy makers to come up with factors to consider regarding the dividend policy

LITERATURE REVIEW

2.1 Theoretical Review

The theoretical principles underlying the dividend policy of firms can be described either in terms of information asymmetries, the tax-adjusted theory, or behavioral factors. The information asymmetries encompass several aspects, including the signaling models, agency cost, and the free cash flow hypothesis. Akerlof (1970) defines signaling effect as a unique and specific signaling equilibrium in which a job seeker signals his/her quality to a prospective employer. Though the scenario developed is used in labor market, researchers have used it in financial decisions. The signaling theories suggest that corporate dividend policy used as a means of putting quality message across has a lower cost than other alternatives. This means that the use of dividends as signals implies that alternatives methods of signaling are not perfect substitutes

Agency theory seeks to explain corporate capital structure as a result of attempts to minimize the cost associated with the separation of ownership and control. Agency costs are lower in firms with high managerial ownership stakes because of better alignment of shareholder and

managerial control (Jensen and Meckling, 1976) and also in firms with large block shareholders that are better able to monitor managerial activities. A potential wealth transfer from bondholders to stockholders is another agency issue associated with information asymmetries. The potential shareholders and bondholders conflict can be mitigated by covenants governing claim priority. The conflict can be circumvented by large dividend payment to stockholders. Debt covenants to minimize dividend payments are necessary to prevent bondholder wealth transfers to shareholders. With free cash flow hypothesis, Jensen (1986) asserts that funds remaining after financing all positive net present value projects cause conflicts of interest between managers and shareholders. Dividends and debt interest payment decrease the free cash flow available to managers to invest in marginal net present value projects and manager perquisite consumption. Tax-adjusted models presume that investors require and secure higher expected returns on shares of dividend-paying stocks. The consequence of tax-adjusted theory is the division of investors into dividend tax clientele. Modigliani (1982) argues that the clientele effect is responsible for the alterations in portfolio composition.

2.2 Empirical Review

Miller and Modigliani (1961) argued that the firm's value is determined only by its basic earning power and its business risk. A number of factors have been identified in previous empirical studies to influence the dividend policy of firms including profitability, risk, cash flow, agency cost, and growth. Profits have long been regarded as the primary indicator of a firm's capacity to pay dividends. Pruitt and Gitman (1991), in their study report that, current and past years' profits are important factors in influencing dividend payments find that a major determinant of dividend payment was the anticipated level of future earnings.

Pruitt and Gitman (1991) find that risk (year-to-year variability of earnings) also determines firms' dividend policy. A firm that has relatively stable earnings is often able to predict approximately what its future earnings will be. Such a firm is therefore more likely to pay out a higher percentage of its earnings than a firm with fluctuating earnings. They found statistically significant and negative relationship between beta and the dividend policy. Their findings suggest that firms having a higher level of market risk will pay out dividends at lower rate. D'Souza (1999) also finds statistically significant and negative relationship between beta and dividend policy. The liquidity or cash-flow position is also an important determinant of dividend policies. A poor liquidity position means less generous dividend due to shortage of cash. Alli et al. (1993) reveal that dividend payments depend more on cash flows, which reflect the company's ability to pay dividends, than on current earnings, which are less heavily influenced by accounting practices. They claim current earnings do not really reflect the firm's ability to pay dividends. The liquidity or cash-flow position is also an important determinant of dividend policies. A poor liquidity position means less generous dividend due to shortage of cash.

Alli et al. (1993) reveal that dividend payments depend more on cash flows, which reflect the company's ability to pay dividends, than on current earnings, which are less heavily influenced by accounting practices. They claim current earnings do not really reflect the firm's ability to pay dividends. Easterbrook (1984) argues that increasing dividends raises the probability that additional capital will have to be raised externally on a periodic basis and consequently, the firm will be subject to constant monitoring by experts and outside suppliers in the capital market. Monitoring by outside suppliers of capital also helps to ensure that managers act in the best

interest of outside shareholders. Thus dividend payments may serve as a means of monitoring or bonding management performance. Rozeff (1982) presents evidence that dividend policy level is negatively related to its level of insider holdings. Jensen et al. (1992) and Collins et al. (1996) confirm that the relationship between dividend policy and insider holding is negatively related. D'Souza (1999) however found statistically significant and negative relationship between institutional shareholding and dividend policy.

2.3 Empirical Gap

Dividend policy has been analyzed for many decades, but no universally accepted explanation for companies' observed dividend behaviour has been established (Samuel & Edward, 2011). It has long been a puzzle in corporate finance. Therefore this study seeks to address this puzzle. Green et al. (1993) questioned the irrelevance argument and investigated the relationship between the dividends and investment and financing decisions. Their study showed that dividend policy levels are not totally decided after a firm's investment and financing decisions have been made. Dividend decision is taken along investment and financing decisions. Their results however, do not support the views of Miller and Modigliani (1961). Partington (1983) revealed that firms' use of target policy, firms motives for paying dividends, and extent to which dividends are determined are independent of investment policy. Higgins (1981) indicates a direct link between growth and financing needs: rapidly growing firms have external financing needs because working capital needs normally exceed the incremental cash flows from new sales.

METHODOLOGY AND FINDINGS

3.1 Data and Procedures

This study examines the determinants of dividend policy of listed firms in Kenya. A sample of firms that have been listed on the NSE during the recent 10-year period 2004-2014 was considered. In all, 60 firms qualified for this study. This number represents 93.75 percent of listed firms in Kenya. We limited the sample to the sixty firms because they have been listed during the period under investigation and also have financial information for that period. Data was derived from the annual reports of the selected listed firms and the NSE Fact Books during the six-year period, 2004-2014. The dividend policy ratio, which is the dependent variable, is defined as the dividend per share. The explanatory variables include profitability (PROF), risk (RISK), cash flow (CASH), corporate tax (TAX), institutional holdings (INSH), sales growth (GROW). The panel character of the data allows for the use of panel data methodology. Panel data involves the pooling of observations on a cross-section of units over several time periods and provides results that are simply not detectable in pure cross-sections or pure time-series studies. The panel regression equation differs from a regular time-series or cross section regression by the double subscript attached to each variable. The general form of the panel data model can be specified more compactly as:

$$\text{Dividend Policy } i,t = B_0 + B_1 \text{Prof } i,t + B_2 \text{Risk } i,t + B_3 \text{Cash } i,t + B_4 \text{Tax } i,t + B_5 \text{Growth } i,t + B_6 \text{Inst. } + e_{i,t} \quad 1.$$

Where:

Dividend policy i,t = dividend per share for firm i in period t ,

PROF i,t = earnings before interest and taxes/total assets for firm i in period t ,

RISK_{i;t} = variability in profit for firm *i* in period *t*,
CASH_{i;t} = log of net cash flow for firm *i* in period *t*,
TAX_{i;t} = corporate tax divided by net profit before tax for firm *i* in period *t*,
INST_{i;t} = percentage of institutional holdings of equity stock for firm *i* in period *t*,
GROW_{i;t} = growth in sales for firm *i* in period *t*, and
E'_{i;t} = the error term for firm *i* in period *t*.

The model for this study follows the one used by D'Souza (1999) to explain the relationships between dividend policies and the determinants.

FINDINGS

4.1 Findings

The descriptive statistics for all the regression variables shows the average indicators of variables computed from the financial statements. The average (median) dividend policies (measured as dividend per share/ earnings per share) is 30.16 percent (32.92 percent) and the average (median) profitability is 11.54 percent (10.01 percent). This means, on the average, firms pay about 30 percent of their profits as dividends and the average return on assets stands at 11.54 percent. Average (median) risk is 0.9750 (0.6934). Cash flow, determined as the natural logarithm of cash balance has a mean (median) of 22.1322 (22.12). Corporate tax rate on average is 21.9 percent (22.93 percent). Average (median) percentage of institutional holdings is 71.8 percent (81.89 percent), suggesting that 71.8 percent of the companies' shares are owned by institutional shareholders and the average (median) growth rate in sales is 35.15 percent (25.61 percent).

The regression results from the run in panel manner were done. Various options of panel data regression were run, fixed effects, random effects and OLS panel. The most robust of all was the OLS panel, thus we report results of the OLS panel regression. The dividend policies are regressed against the seven explanatory variables. These variables include profitability, risk, cash flow, tax, institutional ownership and growth. The results indicate a statistically significant and positive relationship between profitability and the dividend policies. This is explained by the fact that, highly profitable firms tend to declare and pay high dividend. Thus, they would have exhibited high policies. A firm's profitability is considered an important factor in influencing dividend payment. This result clearly supports our hypothesis of a positive relationship. The results also appear to be consistent with the findings of other empirical studies (Baker et al., 1985; Pruitt and Gitman, 1991). The results of this study show a negative but insignificant association between risk and dividend policies, suggesting that, high-risk firms pay lower dividends to their shareholders. Firms experiencing earning volatility find it difficult to pay dividend, such firms would therefore pay less or no dividend. On the other hand, firms with relatively stable earnings are often able to predict approximately what its future earnings will be and therefore are more likely to pay out a higher percentage of its earnings as dividend.

As expected, the results indicate a significantly positive relationship between cash flow and dividend policies. The liquidity or cash-flow position is an important determinant of the dividend policies. The results of this study suggest that, a good liquidity position increases a firm's ability

to pay dividend. Generally, firms with good and stable cash flows are able to pay dividend easily compared with firms with unstable cash-flow position. Contrary to my hypothesis, the results of this study surprisingly show a positive relationship between corporate tax and dividend policies, indicating that, increasing tax is associated with increase in dividend policies. This position seems to also contradict existing literature. The results also reveal a negative but insignificant association between institutional shareholding and dividend policies. This means the higher the percentage of institutional holding the lower the dividend policies. A possible explanation is that firms pay dividend in order to avoid the cost associated with agency relationship.

Growth in sales and market-to-book values are used as proxies for the firm's future prospects and investment opportunities. Both variables were found to have statistically significant and negative associations with dividend policies. This is indicative of the fact that, growing firms require more funds in order to finance their growth and therefore would typically retain greater proportion of their earnings by paying low dividend. These results are also consistent with the results of previous studies (Rozeff, 1982; Lloyd et al., 1985; Collins et al., 1996) and also support the hypotheses of negative associations for both sales growth and market value.

4.2 Conclusions

This study examines the determinants of dividend policies of listed companies in Kenya. The analyses are performed using data derived from the financial statements of firms listed on the NSE during a ten-year period. Ordinary Least Squares model is used to estimate the regression equation. The results show positive relationships between dividend policies and profitability, cash flow, and tax. The results suggest that, profitable firms tend to pay high dividend. A good liquidity position increases a firm's ability to pay dividend. The results also show negative associations between dividend policies and risk, institutional shareholding, growth and market-to-book value.

4.3 Policy Recommendation

The implication of this article is that dividend policies policy decision of Kenyan listed firms is influenced by the profitability, cash-flow position, growth prospects, and investment opportunities of the firms. Firms experiencing earning volatility find it difficult to pay dividend, such firms would therefore pay less or no dividend. The higher the institutional holding the lower the dividend policies, meaning firms pay dividends in order to reduce the cost associated with agency problems. The results again suggest that, growing firms require more funds in order to finance their growth and therefore would typically retain greater proportion of their earnings by paying low dividend. Also, firms with higher market-to-book value tend to have good investment opportunities and would therefore pay lower dividends. The results of this study generally support previous empirical studies.

4.4 Future Study

Following from these findings, it would be useful to also consider the following directions for future research: What determines the decision to pay or not to pay dividends in listed firms? What determines dividend policies of unquoted firms in Kenya? What determines dividend policy decisions of unquoted companies in Kenya?

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