APPLICABILITY OF LINTNER'S DIVIDEND POLICY TO COMPANIES QUOTED ON THE NAIROBI STOCK EXCHANGE

By

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DECLARATION

This thesis is my original work and has not been presented for a degree in any other University or for any other award.

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DEDICATION

To wife Agnes, daughter Elizabeth and son Elvis. I thank them for their invaluable care, love, support and patience. They mean every thing to me.

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ABSTRACT

Distribution of profit through dividends is a problem unique to companies due to segregation of management from the ownership. In 1956, John Lintner laid the foundation for modern understanding of dividend policy a model that has been used over the years to explain companies' dividend policies. Researches done in the developed world provide insights into the dividend policy of companies based on Lintner's earlier findings. In the developing world however, few studies on the dividend policies of companies exist. More research is therefore required to understand the dividend policy of companies in the developing world and in particular, Kenya. This study examined whether companies quoted on the Nairobi Stock Exchange follow Lintner's model in their dividend policies and planning as is the case in the developed world. In which data from the 48 Nairobi Stock Exchange (NSE) quoted companies for the period 1998 to 2004 was used giving a 336 firm–year data. The data was analyzed to ascertain applicability of the model. The research indicated that on average, NSE companies paid 59.4 percent of their net earnings as dividends and had a dividend yield of 6.1 percent. Also, it emerged that the NSE companies while declaring dividends to be paid in any particular period did not apply the Lintner's dividend model.

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OPERATIONAL DEFINITION OF TERMS

Budget	Estimates of source and use of resources in the future, based on past experiences, to achieve set objectives.
Capital budgeting	A plan to finance long-term outlays, assets, other facilities, equipment and investment projects for a certain period of time.
Cum dividend	Purchase of shares in which the buyer is entitled to forthcoming dividend.
Common stock	Security representing ownership of a corporation
Correlation Coefficient	Measure of closeness of the relationship between two variables
Dividend	Payment of returns on investment by a company to its stockholders.
Dividend Policy	General plan of action to pay dividends to owners.
Ex-dividend	Purchase of shares in which the buyer is not entitled to the forthcoming dividend.
Market capitalization	It is the total market value of a security.
Market segment	It is a separate segment of the Official List established by a securities exchange, with the approval of the Authority, with respect to listings of securities for which specific eligibility and disclosure requirements are prescribed.
Par value	Face value shown on the security certificate.
Regular dividend	Dividend that the company expects to maintain in the future

Retained earnings	Earnings not paid out as dividends.
Stock dividend	Dividend in the form of stock rather than cash.
Symmetric information	Same set of information available to managers and investors.

LIST OF ABBREVIATIONS AND ACRONYMS

AGM	– Annual General Meeting
AIMS	– The Alternative Investment Market Segment
BAT	– British American Tobacco
CAPM	– Capital Asset Pricing Model
CMA	– Capital Markets Authority
CFC	– Credit Finance Corporation
CFO	– Chief Finance Officer
CEO	– Chief Executive Officer
CIC	– Capital Issue Commission
DIV	– Dividend
DPS	– Dividend Per Share
EABL	– East African Breweries Limited
EPS	– Earnings per Share
IAS	–International Accounting Standard
ICPAK	– Institute of Certified Public Accountants of Kenya
IPAR	– Institute of Policy Analysis and Research
KENGEN	– Kenya Electricity Generating Company
MMIS	– The Main Investment Market Segment
NASDAQ	– National Security Dealers Automated Quotations System
NSE	– Nairobi Stock Exchange
NYSE	– New York Stock Exchange
OLS	–Ordinary Least Squares

ROA	– Return on Assets
SAP	– Structural Adjustment Program
SPSS	– Statistical Package for Social Sciences
SSA	– Sub Saharan Africa
USIU	– United States International University
UK	– United Kingdom
US	– United States

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND

Most large and medium-sized businesses are organised as companies for example, Kenya Power and Lighting Company Limited, Cooper Motors Corporation (CMC) Holdings Ltd, Barclays Bank of Kenya, East African Cables Ltd, British American Tobacco (BAT) Kenya Ltd, Limuru Tea Kenya Ltd and Kenya Airways Ltd. When a company is first established, its shares may all be held by a small group of investors. Eventually, the firm may issue new shares like has been the case in the recent past with Kenya Electricity Generating Company (KENGEN), ScanGroup Ltd and Eveready Company to raise additional capital. The company on issuing shares to the public becomes a public company and is quoted on the stock exchange. This way, the company is able to attract a wide variety of investors raging from small time individual investors holding shares worth a few hundred shillings to giant pension funds and insurance companies whose investment may run into millions of shillings. All these investors are entitled to a share of the company's profits and dividends in proportion to their ownership of the company.

The stockholders however, do not manage these corporations on a day-to-day basis. Instead they vote to elect a board of directors to represent them who in turn appoints top management, among them the finance manager, and ensure that the managers act in the shareholders' best interest. The main objective of

companies is to create value for its shareholders. Finance managers work to maximize the wealth of firms' existing stockholders by making three major decisions that relate to investment, financing and dividend payment (Van Horne, 2002). A firm's decisions about dividends are therefore made alongside other financing and investment decisions (Brealey and Myers 2000).

Investment decisions are concerned with the efficient deployment of capital funds to investment proposals whose benefits are to be realised in future. As future benefits are not known with certainty, investment proposals involve risk. Also these decisions involve reallocation of capital when an asset no longer economically justifies the capital committed to it. Through investment decisions, finance managers determine the total amount of assets held by a firm, their composition and the business-risk complexion of the firm as perceived by suppliers of capital.

Finance managers also determine the best financing mix or capital structure. They do this through financing decisions, which require an appropriate selection and combination of capital from available resources whereby a company's total valuation is continually altered by varying the capital structure until an optimal financing mix is achieved. This optimal financing mix exists when market price per share is maximised.

The other important decision that finance managers make is on the amount of cash to distribute to stockholders. This is done through payment of cash

dividends or through share repurchase. Dividends and share repurchase reduce the amount of earnings retained in a company and affect the total amount of internal financing. Dividend policy includes the percentage of earnings paid to stockholders in cash dividends, the stability of absolute dividends in relation to trend, stock dividends and stock splits. Dividend decisions involve the periodic determination of a proportion of a firm's total distributable earnings that are payable to its ordinary shareholders. According to Allen and Michaely (2002), dividend decision is important not only because of the amount of money involved, or the repeated nature of the decision, but also because it is closely related to, and interacts with most of the financial and investment decisions firms make.

Dividends are usually increased gradually and are rarely reduced. Share repurchase allows the distribution of a large amount of cash without tax consequence to those who continue to hold their shares. Both dividends and share repurchases are important financial signals to the market. Dividend decisions have therefore attracted the interest of financial economists such as Lintner (1956), Moddigliani and Miller (1961), Fama and Babiak (1968) and Al-Malkawi (2005) leading to intensive theoretical modelling and empirical examination. Firm dividend policy, especially understanding how managers set and change dividends, is therefore a central issue in financial economics.

There is no simple economic rationale for payment of dividends or the adoption of a particular dividend policy, for example a residual versus a dividend smoothing policy.

1.1.1 Importance of dividends

In the early stages of corporate history, managers realised the importance of high and stable dividend payments. In some ways, this was due to the analogy investors made with the other form of financial security then traded, namely government bonds (Al-Malkawi 2005). Bonds paid a regular and stable interest payment, and corporate managers found that investors preferred shares that performed like bonds, that is, paid a regular and stable dividend. For example, Bank of North America in 1781 paid dividends after only six months of operation, and the bank charter entitled the board of directors to distribute dividends regularly out of profits. Paying consistent dividends remained of paramount importance to managers during the first half of the 19th century (Frankfurter and Wood 1997).

In addition to the importance placed by investors on dividend stability, another issue of modern corporate dividend policy to emerge early in the nineteenth century was that dividends became an important form of information. The scarcity and unreliability of financial data often resulted in investors making their assessments of corporations through their dividend payments rather than reported earnings. Investors were often faced with inaccurate information about the performance of a firm, and used dividend policy as a way of gauging

what management's views about future performance might be (Al-Malkawi 2005). Consequently, an increase in dividend payments tended to be reflected in rising stock prices. As corporations became aware of this phenomenon, it raised the possibility that managers of companies could use dividends to signal strong earnings prospects and/or to support a company's share price because investors read dividend announcements as a proxy for earnings growth.

1.1.2 History and evolution of dividends

Corporate dividends date back at least to the early sixteenth century in Holland and Great Britain when the captains of sixteenth century sailing ships started selling financial claims to investors, which entitled them to share in the proceeds, if any, of the voyages. Kimura and Amoro (2000) observed that the Dutch were the first people to trade in stocks as far back as 1585.

At the end of each voyage, the profits and the capital were distributed to investors, liquidating and ending the venture's life. By the end of the sixteenth century, these financial claims began to be traded on open markets in Amsterdam and were gradually replaced by shares of ownership. Many investors would buy shares from more than one captain to diversify the risk associated with this type of business. At the end of each voyage, the enterprise liquidation of the venture ensured a distribution of the profits to owners and

helped to reduce the possibilities of fraudulent practice by captains (Baskin, 1988). However, as the profitability of these ventures was established and became more regular, the process of liquidation of the assets at the conclusion of each voyage became increasingly inconvenient and costly.

The successes of the ventures increased their credibility and shareholders became more confident in their management (captains), and this was accomplished by, among other things, the payment of generous dividends (Baskin 1988). As a result, these companies began trading as going concern entities, and distributing only the profits rather than the entire invested capital. The emergence of firms as going concerns initiated the fundamental practice of firms to decide what proportion of the firms' income (rather than assets) to return to investors and produced the first dividend payment regulations (Frankfurter and Wood 1997). Gradually, corporate charters began to restrict the payments of dividends to the profits only.

The ownership structure of shipping firms gradually evolved into joint stock company form. But it was chartered trading firms that generally adopted the joint stock form which was most common. In 1613, the British East India Company issued its first joint stock shares with a nominal value. No distinction was made, however, between capital and profit (Walker 1931). In the seventeenth century, the success of this type of trading company seemed poised to allow the spread of this form of business organisation to include other activities such as mining, banking, clothing, and utilities. Indeed, in the

early 1700's, excitement about the possibilities of expanded trade and the corporate form saw a speculative bubble form, which collapsed spectacularly when the South Sea Company went into bankruptcy. The Bubble Act of 1711 effectively slowed, but did not stop the development of the corporate form in Britain (Walker 1931).

The development of dividend payments to shareholders has been tied up with the development of the corporate form itself. Corporate managers realised the importance of dividend payments in satisfying shareholders expectations. They often smoothed dividends over time believing that dividend reductions might have unfavourable effects on share price and therefore, used dividends as a device to signal information to the market. Moreover, dividend policy is believed to have an impact on share price. Since the 1950's, the effect of dividend policy on firm value and other issues of corporate dividend policy have been subjected to great debate among finance scholars such as Lintner (1956), Fama and Babiak (1968), Karak (1993) and Al-Malkawi (2005) among many others.

1.1.3 Dividend policy

Dividend policy involves the decision to pay out earnings or to retain and reinvest them in the business. It represents a plan of action followed whenever the dividend decision is made. The dividend decision should consider the two basic objectives, one being to maximize the wealth of shareholders and the other retaining enough earnings to facilitate continued growth of the firm.

The payment of dividends depends on the policy in place, and this implies that there is consistency over time as payouts and dividends in particular, do not simply evolve in an arbitrary and random manner (Allen and Michaely 2002). Dividend policy has two key elements, one of which is the target payout policy decision, which involve determination of the fraction of earnings that should be paid out on average over time. The second is the dividend stability policy decision in which the management decides whether dividend to be paid should be stable and predictable or should vary from year to year, depending on the company's internal needs and cash flows (Fama and Louis 1996).

1.1.4 Dividend policy in developed countries

Research into dividend policy has shown that corporate dividend practice varies over time, between firms and across countries. In developed countries, the decision between paying dividends and retaining earnings is taken seriously by both investors and the management and this explains why it has been of considerable interest to researchers among them Lintner (1956), Modigiliani and Miller (1961), Brittain (1964), Pettit (1972), Black and Scholes (1974), Michaely, Thaler and Womack (1995), Dhillion and Johnson (1994), Amibud and Murgia (1997), Charitou and Vafeas (1998) and Benzinho (2004).

These researchers were all in agreement that the after-tax earnings of any business firm are an important internal source of investment funds and a basis for dividend payment to shareholders. The research and theory of the dividend

puzzle (Black 1976) was influenced by the empirical observations of the market, corporate and investor attitude towards the dividend policy. Lintner (1956) observed that corporations trading in developed markets follow stable dividend policy and pay out a substantial part of their earnings as dividends.

Fama and French (2001) documented a sharp decline in cash dividends paid by publicly traded firms in the United States (US) over the last 25 years. In 1973 and 1978, the proportion of firms that paid dividends was 52.8 percent and 66.5 percent, respectively, whereas in 1999, only 20.8 percent of firms paid dividends. This significant decrease in dividend paying firm was due to the growth in firms that had never paid dividends and a decline in propensity to pay dividends regardless of firm characteristics. However, De Angelo *et al.* (2004) found that although the number of dividend-paying firms decreased over the period 1978 to 2000, the magnitude of dividends paid by US firms had actually increased. They found that this was largely due to the concentration of dividends and earnings. For instance, in the year 2000, the 25 top dividend-paying firms accounted for about 55 percent of aggregate industrial dividends paid and about 51 percent of aggregate earnings.

In real terms, De Angelo *et al.* (2004) reported that the level of dividends paid by these 25 firms in 2000 exceeded their 1978 level by $9.2 billion. This was attributed to the fact that ownership of companies in the developed markets was dispersed and lay predominantly in the hands of financial institutions. In the United Kingdom (UK) for example, the proportion of company profits

paid out in the form of dividends tended to be higher with the aggregate ownership of the companies being by institutional investors which was frequently in excess of 50 percent for the larger part of the 1980s and 1990s (Tehmina Khan 2006). Khan found that an increase in the shareholding of financial institutions led to an increase in dividends in large firms. In general, there was also a strong negative relationship between shareholdings by individual investors and dividends, and positive relationship between equity holding by insurance companies and dividends.

1.1.5 Dividend policy in developing countries

Glen *et al.* (1995) found that dividend policies in developing countries differed from those in developed countries. They reported that dividend payout ratios in developing countries were only about two thirds that of developed countries. Wagacha (2000) observed that capital markets development in Africa lag behind the rest of the world. The Sub Saharan Africa (SSA) region has the least developed capital market. Only a few countries have established stock exchanges, and in the countries where the stock exchanges have been established, the number and size of participation is very low.

Wagacha (2000) argued that capital markets were an essential part of the financial sectors of modern economies and that well-developed capital markets promoted economic growth through increased savings mobilization, access to foreign savings and spreading of financial risks in enterprises. They also helped governments to finance their deficits while reducing the fiscal

pressures of debt redemption if the maturity of the security issued was lengthened. The market plays a facilitating role in translating savings to investment. The East Asian experience suggests that savings cannot only be enhanced through good policies that meet shareholder expectations, but also the activities in the capital markets can strengthen the savings and investments link.

Ramcharran (2001) also observed low dividend yields for developing countries. This was because firms in developing markets faced more financial constraints and limited resources to finance their investment opportunities, which resulted in reliance on retained earnings and accordingly resulted in lower payout ratios. The markets in developing countries are also small, with low levels of activity and concentration. The poor functioning of Africa's stock exchanges is explained by several factors including: interest rate policy, taxation system, legal and regulatory framework within which the stock exchanges operate lack of expertise and poor methods in the stock exchange system and lack of technological progress (Kimura and Amoro 2000). However these assertions are largely speculative, since very little research has been done on dividend policy in developing markets.

1.1.6 Profile of Nairobi Stock Exchange

In Kenya, dealing in shares and stocks started in the 1920's when the country was still a British colony. There was however no formal market, no rules and no regulations to govern stock broking activities. In 1954 Nairobi Stock

Exchange (NSE) was constituted as a voluntary association of stockbrokers registered under the Societies Act. After independence in 1963, the NSE handled a number of highly over-subscribed public issues and the market grew rapidly with the buoyant economic performance of the time. By 1966, the NSE had started measuring daily trading activity by computing the NSE index, which measured daily price changes. However, the oil crisis of 1973, the imposition of a capital gains tax at 35 per cent in 1975 (suspended in 1985), and a loss of a regional outreach due to nationalization in Tanzania and Uganda, inflicted losses on market growth. The NSE adopted a 20-share index in 1991 and changed the computational method of the index to a geometric mean. NSE was also registered under the Companies Act and introduced the floor based open outcry system in the place of 'call over' trading system.

Kibua and Masinde (2004) observed that the stock market experienced significant gains in early 1990's when the number of listed companies increased from 54 to 58 in 1996. However, the number decreased to 48 in 2004 with eight companies getting de-listed as a result of poor performance and non-compliance with listing requirements; among them Pearl Dry Cleaners, Lonrho Motors, Theta and Regent Undervalued Assets. Fixed income securities were also de-listed during the period for non-compliance with minimum listing requirements including Kenya Hotels, Chancery Investments, Marshalls, Standard Newspapers and Hutchings Biemer. The largest share issue in the history of NSE was the 1996 privatisation of Kenya Airways, where more than 110,000 shareholders acquired a stake in the

airline. In 2001 Mumias Sugar Company became the first firm on the NSE's official list, following its privatisation that culminated in its admission on 14th November 2001. Eight million additional Industrial and Commercial Development Corporation (ICDC) shares were admitted to official NSE list on 20th November 2001.

NSE has been actively working towards a customer focus. In this regard, NSE has stepped up the efforts to create and transfer knowledge to all NSE public through a number of initiatives such as education forums including workshops and seminars to various target audiences, the redesign and re-engineering of the NSE website and the production of industry relevant publications such as the monthly bulletin and the handbook. NSE today is poised to play an increasingly important role in Kenyan economy especially in the privatisation of state owned enterprises. NSE could further expect to reap some profits from the integration of East African Market covering Tanzania, Uganda, Rwanda, Burundi and Kenya.

1.2 THE STATEMENT OF THE PROBLEM

Most businesses in Kenya are organised as sole proprietorships and partnerships. The earnings of these companies are prorated among the owners. The main factor that determines the amount of cash dividend paid by these companies is the earnings. The companies therefore follow unstable cash dividend policies as earnings for each period change with changing circumstances. Dividends are paid out of what remains of earnings after other

investment proposals have been effected. The fluctuation of dividends created by the residual policy contrasts greatly with the certainty of the dividend stability policy practiced (Adaoglu 2000).

The instability of dividends paid by companies in Kenya, and the NSE companies in particular, creates uncertainty in the decisions made by investors due to lack of proper and accurate prediction leading to poor decisions by these companies. This scenario is also due to the fact that NSE companies eke out profit while serving customers with low disposable incomes. Managers have therefore to innovate on a shoe string budget because of scarcity and the high cost of capital.

Soyode (1975), Oyejide (1976) and Ariyo (1983) stated that the decision to retain, invest or payout after tax earnings in form of cash or stock dividend, was important for the maximization of the value of a firm. The firm's board of directors sets the dividends to be paid for a certain period. However, managers are not free to declare whatever dividend they choose. Lenders, who are concerned that excessive dividend payments would not leave enough in the kitty to pay the company's debts, may impose some restrictions. Statutes also help to protect the company's creditors against excessive dividend payments, an example of which is the restriction imposed on companies to pay dividends out of paid up capital. Shareholders can also reduce or reject but not increase the dividends proposed by directors. Hence dividend declaration is a controversial issue. Dividend payment by companies depend on various

factors among them past performance, dividends paid in the past, future prospects, level of borrowing, global economic conditions and the stability of the Kenya shilling against the major hard currencies (Mungai, 2000). All these factors vary from one period to the next as a result of which dividends paid fluctuate period after period hence are unpredictable and unstable which is not good for investors especially for planning purposes.

Lintner (1956) asserts that a firm that is currently paying dividends at a certain rate and time will adjust its dividend rate, but less than fully, as its earnings per share changes. Investors prefer stable and dependable dividend payments and yet without the application of Lintner's dividend policy model that emphasise on stability of dividends, NSE companies will not be efficient and effective in the decision making process particularly on payment of dividends. Poor decisions have been the cause of NSE companies failing to maximize shareholders' wealth because companies set less than optimal dividend policies.

Few empirical works have be en carried out to test whether the Lintner's dividend policy model is applied by managers in Kenya while declaring dividends. This study therefore focused on Lintner's dividend policy model applicability to NSE companies.

1.3 THE OBJECTIVES OF THE STUDY

The objective of the study was to determine whether companies quoted on the NSE apply Linter's dividend policy model that emphasises the stability of dividends paid by companies. Specifically the study aimed at achieving the following: -

i. Analysing trends in dividend patterns in various companies from various segments of the economy.

ii. Finding out whether dividends paid in the current year depend on the firm's current earnings per share.

iii. Finding out whether dividend paid in the current year depend on the dividend paid during the previous year.

1.4 RESEARCH QUESTIONS

The following were the research questions:

i. Do dividends paid indicate any trend or pattern in various companies from various segments of the economy?

ii. Do dividends paid in the current year depend on the firm's current earnings per share?

iii. Do dividends paid in the current year depend on the dividend paid in the previous year?

1.5 SIGNIFICANCE OF THE STUDY

This study provides an insight on how companies' set dividend policy, which is critical for financial management functions such as capital restructure, asset pricing, mergers and acquisitions among others. Furthermore, cash dividends paid have a direct impact on the amount of retained earnings available for firms to undertake new investments in future therefore its management is critical for sound financial planning.

The study provides a benchmark against which recommendations have been derived on ways by which companies should formulate dividend policy so as to maximize shareholders wealth. The government and the Capital Markets Authority (CMA) will find the information of interest in their efforts to formulate policies that ensure efficient functioning of the Nairobi Stock Exchange. Further, the study is important to researchers as it details literature on firms' dividend policy hence encourage more research on optimal capital structure for corporations.

The study also provides that when change in dividend policy occurs, it is essential that the company fully informs stockholders of the rationale for the change. Good communication between the company and the investors can mitigate the potential negative consequences of such change. Finally, there is richness of information on the applicability of Lintner's dividend model in the

developed world, but there is scarcity of evidence about its applicability in the developing world. This study attempts to fill gaps on this issue, especially with respect to Kenyan firms.

1.6 THE SCOPE AND ORGANISATION OF THE STUDY

The study covered 48 companies quoted on the NSE for the entire period from January 1998 to December 2004. This was due to the fact that the earnings and dividends paid each year can be traced for the seven years up to December 2004. Firms listed on the NSE were chosen for the study because they operate under minimum level standards set by both the Companies Act (Cap 486) and the stringent guidelines set by the Capital Markets Authority. These measures are meant to ensure corporate stewardship and are generally aimed at investor protection. These rules ensure among other issues that firms supply timely and accurate information to investors concerning their operations.

This thesis is presented in five chapters. The current chapter has provided background information on the decisions managers make on a daily basis, description of what dividend policy involve, importance of dividends, dividend policies in the developed and developing countries, history of the Nairobi Stock Exchange, statement of the problem, objectives and significance of the study. Chapter two is on the review of literature in which the various theories on dividend policy have been discussed and Lintner's model which formed the core of this study outlined.

Research methodology used in this study has been described in chapter three whereby the research design, target population, data collection and procedures including data refinement, analysis and presentation have been discussed in detail. Chapter four outlines the empirical findings on the research variables and finally chapter five provide the summary and conclusions derived from the study and outline the policy implications and areas of further research.

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION

This chapter presents theoretical considerations and relevant prior work on dividend policy. It begins by presenting a general introduction on the topic, and theoretical literature on dividends reviewing the historical background of dividends and corporate dividend policy. The chapter then presents the main modern theories of dividend policy. Several theories of dividend policy and the empirical evidence on them have been presented. The chapter also presents some empirical studies based on developing markets in general and the available research findings for Kenya. Finally in this chapter, Lintner's (1956) model is discussed.

2.2 THEORETICAL LITERATURE

According to Van Horne (2002), the rigidity of dividend payout in as far as reduction is concerned, is explained by the various factors that come into play when a company is trying to determine the appropriate amount of cash to distribute to stockholders and whether it should be dividends or share repurchase. The following are various factors that financial managers analyse.

(a) Ability to borrow

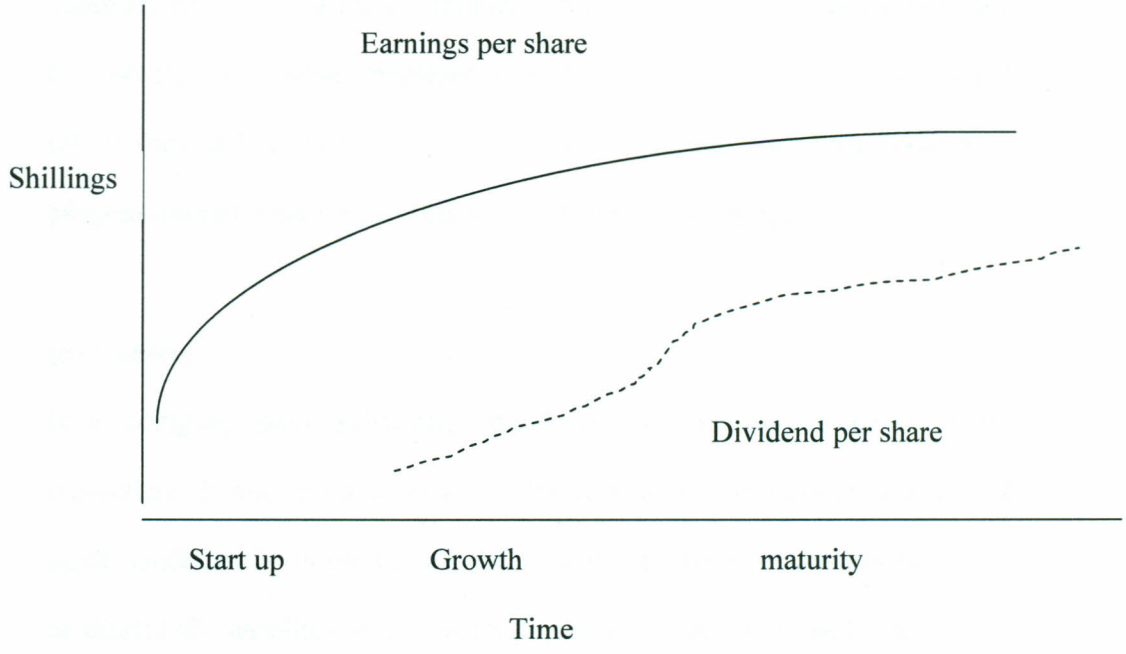
A liquid position is not the only way to provide for flexibility and thereby protect against uncertainty (Van Horne 2002). If a firm has the ability to borrow on comparatively short notice, it may be relatively flexible. This

ability to borrow can be in the form of a line of credit or a revolving credit from a bank or simply the informal willingness of a financial institution to extend credit. Flexibility can also come from the ability of a company to go to the capital markets with a bonds issue. The larger and the more established a company is, the better its access to capital markets (Van Horne 2002). The greater the ability of the firm to borrow, the greater its flexibility and the greater its ability to pay a cash dividend or engage in stock repurchase.

(b) Financial needs of the firm

The management and board of directors need to determine the likely cash flows and cash position of the company in the absence of a change in dividends or share repurchase. The firm wishes to determine if anything is left over after servicing its funds needs, including profitable investment projects. In this regard, a company should look at its situation over a reasonable number of future years to iron out fluctuations. On the basis of this analysis, a company can determine its likely future residual funds that are available for distribution to stockholders with respect to dividends.

Figure 2.1 Dividends and the company life cycle



As illustrated in Fig 2.1, no dividends are paid in the early life of a company. As it matures and begins to generate excess cash, dividends may be paid - a token at first, but bigger ones as relatively fewer productive investment opportunities are found. The dividends may be supplemented or supplanted by share repurchase. In the late stages of a company's life cycle, "harvesting" may occur (Van Horne 2002). Here a company self-liquidates by paying substantial dividends to its stockholders or more usually, engaging in substantial stock repurchase.

(c) Assessment of any valuation information

A company will look at the dividend payout ratios of other companies in the industry, particularly those having about the same growth. It may not matter that a company is out of line with similar companies, but it will be

conspicuous; and usually a company will want to justify its position. Also, a company should judge the information effect of dividends or share repurchase by looking into what investors expect. The company asks itself what information it is conveying with its present dividend and share repurchase programme and what it would convey with a possible change.

(d) Control

If a company pays substantial dividends or engages substantial share repurchase, it may need to raise capital at a later time through the sale of stock. Under such circumstances, the controlling interest of the company may be diluted if controlling stockholders do not or cannot subscribe for additional shares.

These stockholders may prefer a low dividend pay out or share repurchase programme and the financing of investment needs with retained earnings. Control can work two ways however. When a company is being bought by another or by individuals, a low dividend payout may work to the advantage of the "outsiders' seeking control. The outsiders may be able to convince stockholders that the company is not maximizing shareholders wealth and that they (the outsiders) can do a better job. Consequently, companies in danger of being acquired may establish a high dividend pay out in order to please stockholders.

(e) Nature of stockholders

When a company is closely held, management usually knows the dividend desires of its stockholders in relation to their share repurchase desires and act accordingly. If most stockholders are in high tax brackets and prefer capital gains to current income, the firm can establish a low, or even zero, dividend payout and use share repurchase as a way to distribute excess cash. The corporation with a large number of stockholders can judge their desires for dividends only in a market context.

(f) Liquidity

The liquidity of a company is a consideration in many dividends or share repurchases decisions. As they represent a cash outflow, the greater the cash position and overall liquidity of a company, the greater its ability to pay a cash dividend or engage in a share repurchase programme. A company that is growing and profitable may not be liquid, for its funds may go into fixed assets and permanent additions to current assets. Because the management of such a company usually desires to maintain some liquidity cushion, it may be reluctant to jeopardise this position in order to pay a large dividend or engage in a substantial share buyback.

(g) Restrictions in bond indenture or loan agreement

The protective covenants in a bond indenture or loan agreement often include a restriction on payment of dividends and share repurchase. The restriction is employed by lenders to preserve the company's ability to service debt.

Usually, it is expressed as a maximum percentage of cumulative earnings. When such a restriction is in force, it ordinarily influences dividends and share repurchases.

(h) Dividend stability

The financial manager should be concerned with the stability of dividends to investors. Stability means maintaining a position in relation to a dividend trend line, preferably one that is upward sloping. Investors value stability since dividends serve to resolve uncertainty. When earnings drop and a company does not cut its dividend, the market may have more confidence in the stock than it would have if dividends were cut. The stable dividends may convey management's view that the future of the company is better than the drop in earnings suggested. Thus management may be able to influence the expectations of investors through the informational content of dividends. Management will not be able to fool the market permanently. If there is a downward trend in earning, a stable dividend will not convey forever an impression of a rosy future.

Investors who desire a specific periodic income will prefer a company with stable dividends to one with unstable dividends even though both companies may have the same pattern of earnings and long-run dividend payout. Although investors can always sell portions of their stock for income when the dividend is not sufficient to meet their current needs, investors have an aversion to dipping into principal and to transaction and inconvenience costs.

Dividend stability may be important from the stand point of permitting certain institutional investors to buy the stock. Various governmental bodies prepare lists of securities in which pension funds, trustees, insurance companies and other institutions invest. A company must have an uninterrupted pattern of dividends to attract institutional investors. A cut in dividends or their omission may result in putting off these investors.

(i) Target – payout ratios

A number of companies appear to follow a target dividend pay out ratio over the long run (Van Horne 2002). Lintner (1956) contended that dividends are adjusted to change in earnings, but with a lag. When earnings increase to a new level, a company increases dividends only when it feels it can maintain the increase in earnings. Companies are also reluctant to cut the absolute amount of their cash dividend. Both these factors explain the lag in dividend changes behind changes in earnings. In an economic upturn, the lag relationship becomes visible when retained earnings increase in relation to dividends. In a contraction, retained earnings grow at a slower rate than dividends.

However, a company cannot pay dividends indefinitely unless there is profitability (Van Horne 2002). According to De Angelo *et al.* (1992) loss is a necessary condition for dividend reductions but not a sufficient reason. Income adjusted for unusual items is a critical determinant of dividend changes. Rather than omit dividends in the face of financial distress, the

majority of companies reduce them indicating managerial reluctance to do away with a dividend. De Angelo *et al.* (1992) viewed the evidence as supporting Lintner's target pay out notion.

2.3 DIVIDEND POLICY THEORIES

The previous section established that dividend policy was bound up with the development of the corporate form itself. It was seen that the emergence of dividend policy was important to investors. However, as financial markets developed and became more efficient, it was thought by some researchers that dividend policy would become increasingly irrelevant to investors. Why dividend policy should remain so evidently important has been theoretically controversial.

Three other main contradictory theories of dividends can be identified (Fama and Louis 1996). Some argue that increasing dividend payments increases a firm's value. Another view claims that high dividend payouts have the opposite effect on a firm's value; that is, it reduces firm value. The third theoretical approach asserts that dividends should be irrelevant and all effort spent on the dividend decision is wasted. These views are embodied in three theories of dividend policy: high dividends increase share value theory (or the so-called 'bird-in-the- hand' argument), low dividends increase share value theory (the tax-preference argument), and the dividend irrelevance hypothesis.

Dividend debate is however not limited to these three approaches. Several other theories of dividend policy have been presented, which further increases the complexity of the dividend puzzle. Some of the more popular of these arguments include the information content of dividends (signalling), the clientele effects, and the agency cost hypotheses. These are discussed in turn in the ensuing sections with dividend irrelevance hypothesis.

2.3.1 Dividend irrelevance: Modigliani and Miller (1961)

Before 1961, there was a common belief that higher dividends increase a firm's value. This belief was mainly based on the so-called "bird-in-the-hand" argument, which is discussed in detail in the ensuing paragraph. Graham and Dodd (1934), for instance, argued that the sole purpose for the existence of the corporation is to pay dividends, and firms that pay higher dividends must sell their shares at higher prices (Frankfurter et al. 2002). However, Modigliani and Miller (1961) d emonstrated that under certain assumptions of perfect capital markets, dividend policy would be irrelevant.

The assumptions of a perfect capital market necessary for the dividend irrelevancy hypothesis according to Modigliani and Miller (1961), can be summarised as follows: (1) no differences between taxes on dividends and capital gains; (2) no transaction and flotation costs incurred when securities are traded; (3) all market participants have free and equal access to the same

information (symmetrical and costless information); (4) no conflicts of interests between managers and security holders that is, no agency problem; and (5) all participants in the market are price takers.

Modigliani and Miller (1961) stated that the underlying source of value for a share is earnings. They concluded that the dividend decision is relatively unimportant as far as price of a stock or its cost of capital is concerned. Modigliani and Miller (1961) stated that with no transaction costs, investors could adjust a portfolio to get any dividend desired by selling stocks. They reasoned that the value of a firm is determined by its basic earning power and its risk class, and therefore, that a firm's value depends on its asset investment policy rather than on how earnings are split between dividends and retained earnings. Therefore, in Modigliani and Miller's world, dividends are irrelevant. Modigliani and Miller (1961) argued that regardless of how the firm distributes its income, its value is determined by its basic earning power and its investment decisions. They stated that given a firm's investment policy, the dividend payout policy it chooses to follow will affect neither the current price of its shares, nor the total returns to shareholders.

2.3.2 Empirical literature

In perfect capital markets, Modigliani and Miller (1961) asserted that the value of a firm is independent of its dividend policy. However, various market imperfections exist including taxes, transaction costs, and information asymmetry and agency problems. These market imperfections have provided

the basis for the development of various theories of dividend policy including tax-preference, clientele effects, signalling, and agency costs. Modigliani and Miller (1961) proved that their proposition holds in theory but only under some specific assumptions: there are no personal or corporate income taxes, there are no stock flotation or transaction costs, investors are indifferent between a dollar of dividends and a dollar of capital gains, the firms capital investment policy is independent of its dividend policy and that investors and managers have symmetric information regarding future investment opportunities. These assumptions are however unrealistic and cannot hold. Firms and investors pay income taxes, firms incur flotation costs, and investors incur transaction costs. Again, managers often have better information than outside investors and as a result the Modigliani and Miller's theoretical conclusions on dividend irrelevance are not valid under real world conditions.

The Modigliani and Miller (1961) dividend irrelevance proposition however, provided the foundation for much subsequent research on dividend policy. However, according to Ball et al. (1979), empirical tests of Modigliani and Miller's (1961) dividend irrelevance theorem has proven difficult to design and to conduct. Black and Scholes (1974) examined the relationship between dividend yield and stock returns in order to identify the effect of dividend policy on stock prices by constructing 25 portfolios of common stocks listed on the New York Stock Exchange (NYSE) and extended the capital asset

pricing model (CAPM) to test the long run estimate of dividend yield effects. Black and Scholes (1974) used a long-term definition of dividend yield (previous year's dividends divided by the year-end share price). Their results showed that the dividend yield coefficient is not significantly different from zero either for the entire period (1936-1966) or for any of shorter sub-periods an indication that the expected return either on high or low yield stocks was the same. Black and Scholes (1974) concluded that neither high-yield nor low-yield payout policy of firms seemed to influence stock prices. Black and Scholes's (1974) conclusion lent important empirical support to Modigliani and Miller's dividend irrelevance argument. Other studies by financial economic researchers such as Miller and Scholes (1978, 1982), Hess (1981) Miller (1986), and Bernstein (1996) provided evidence in support of the dividend irrelevance hypothesis.

While some empirical research supported the dividend irrelevance hypothesis, other research did not provide evidence directly challenging the irrelevance hypothesis. Ball et al. (1979) examined the effect of dividends on firm value using Australian data over the period 1960 to 1969. Ball et al. however, failed to find conclusive evidence to support Modigliani and Miller's irrelevance proposition. Baker, Farrelly and Edelman (1985) surveyed the chief financial officers (CFOs) of 562 firms listed on the New York Stock Exchange (NYSE) from three industry groups (150 utilities, 309 manufacturing, and 103 wholesale and retail) and found from the 318 respondents who strongly agreed that dividend policy affected common stock prices. Partington (1985) found

that Australian senior managers viewed dividend payments as a way to satisfy shareholders and support the share price and, Baker and Powell (1999) in a survey of 603 CFOs of US firms listed on the NYSE observed that 90 percent of respondents believed that dividend policy affected a firm's value as well as its cost of capital. Siddiqi (1995) and Casey and Dickens (2000) in their research have provided evidence inconsistent with dividend irrelevance hypothesis. Baker, Powell and Veit (2002) surveyed managers of National Association of Security Dealers Automated Quotations Systems (NASDAQ) firms to assess their view about dividend policy issues including the "bird-in-the hand" hypothesis and stated that investors generally preferred cash dividends than to uncertain future price appreciation. Based on 186 responses, only 17.2 percent agreed with the statement, 28 percent were indifferent, and 54.9 percent disagreed and therefore, they concluded, that the finding did not provide support for the bird-in-the-hand explanation for why companies pay dividends.

Little evidence on the Modigliani and Miller's dividend irrelevance hypothesis exists for emerging markets. Ben Naceur and Goaied (2002) examined 28 companies listed on the Tunisian Stock Exchange for the period 1990 to 1997. Using unbalanced panel data, they estimated a random effects Probit model to test whether the probability of creating future value of the Tunisian companies related to dividend policy, financial policy, and profitability. Dividend (measured by payout ratio) and financial (measured by debt to total assets) policies were found to be insignificant. Ben Naceur and Goaied (2002)

concluded that their evidence supported the Modigliani and Miller (1961) irrelevance propositions of dividend and capital structure for Tunisian firms. In contrast, Omet and Abu-Ruman (2003) provided evidence inconsistent with the dividend irrelevance hypothesis. Omet and Abu-Ruman (2003) surveyed the CFOs of 47 manufacturing companies listed on the Jordanian capital market to identify their views about policy. Based on 33 responses, the researchers observed that most of the CFOs questioned strongly agreed that dividend policy affects share prices. This evidence suggests that dividend policy matters in Jordan. However, the sample size in both the Omet and Abu-Ruman (2003), and the Ben Naceur and Goaied (2002) studies, were small for their results to be fully relied on.

Despite all the empirical work testing the dividend irrelevance hypothesis, the impact of dividend policy on the value of a firm remains unresolved. At the beginning of this section, it was noted that the proposition of dividend irrelevancy was based on several binding assumptions about the nature of perfect capital markets. Once the Modigliani and Miller's world of prefect capital market is modified by relaxing one or more of the assumptions of perfect capital markets and market imperfections are introduced, the issue of dividend policy becomes more complicated. Dividend policy may also interact with other decisions made by the firm about investment and financing making it relevant.

2.3.3 "Bird-in-the- hand" theory: Gordon (1963) and Lintner (1962)

An older view about the effect of dividend policy on a firm's value is that dividends increase firm value (Al-Malkawi 2005). In a world of uncertainty and imperfect information, dividends are valued differently to retained earnings (or capital gains). Investors prefer the "bird in the hand" of cash dividends rather than the "two in the bush" of future capital gains. Increasing dividend payments, *ceteris paribus*, may then be associated with increases in firm value. As a higher current dividend reduces uncertainty about future cash flows, a high payout ratio will reduce the cost of capital, and hence increase share value. That is, according to the so-called "bird-in-the hand" hypothesis, high dividend payout ratios maximize a firm's value.

Gordon (1979) suggested that there were three possible hypotheses for why investors would buy a certain stock. First is to obtain both dividends and earnings, secondly to obtain dividends, and finally to get the earnings. Gordon examined these hypotheses by estimating different regression models using cross-section sample data of four industries (chemicals, foods, steels, and machine tools) for two years 1951 and 1954. The dividend hypothesis was tested using a linear regression. According to Gordon, dividends have greater influence on share price than retained earnings. Again Gordon argued that the required rate of return on a share increases with the fraction of retained earnings because of the uncertainty associated with future earnings and that higher dividend payouts decrease the cost of equity or the required rate of

return on equity. Fisher (1961), using British data for the period between 1949 and 1957, also found that dividends have greater impact on share prices than retained earnings.

Gordon (1963, 1979) and Lintner (1962) found out that the rate of discount (K_s), increases as the dividend payout is reduced because investors are certain of receiving dividends than the capital gains which result from retained earnings. Gordon and Lintner argued that investors value a dollar of expected dividends more highly than a dollar of expected capital gains because the dividend yield component, D_1/P_0, is less risky than the growth rate, g, component in the total expected return equation, $Ks = D_1/P_0 + g$ where K_s is the appropriate rate of discount, D_1 is the dividend per share expected to be paid at the end of period 1, P_0 is the value of share of stock at time 0 and g is the growth rate.

2.3.4 Empirical literature

Empirical support for the "bird-in-the hand" hypothesis as an explanation for paying dividends is generally very limited, and the argument was challenged especially by Modigliani and Miller (1961) who argued that the required rate of return (or the cost of capital) is independent of dividend policy, suggesting that investors are indifferent between dividends and capital gains. Litzenberger and Ramaswamy (1979), among other researchers, developed an explanation of dividend policy that reached the opposite result. That is, investors are disadvantaged in receiving cash dividends.

Modigliani and Miller (1961) criticised the bird in hand hypothesis and argued that the firm's risk is determined by the risk of its operating cash flows, not by the way it distributes its earnings. Consequently, Modigliani and Miller (1961) called this argument the bird-in-the-hand fallacy. The notion that firms facing greater uncertainty of future cash flow (risk) tend to adopt lower payout ratios seems to be theoretically plausible (Friend and Puckett 1964). Further, Bhattacharya (1979) suggested that the reasoning underlying the bird in hand hypothesis is fallacious. Moreover, he suggested that the firm's risk affects the level of dividend not the other way round. That is, the risk of a firm's cash flow influences its dividend payments, but increases in dividends will not reduce the risk of the firm. Empirically, Rozeff (1982) found a negative relationship between dividends and firm risk. That is, as the risk of a firm's operations increases, the dividend payments decrease (Jensen, Solberg and Zorn 1992).

Gordon's linear regression however did not take into account the risk variation among firms drawn from different industries, which could lead to an upward bias in the coefficient on dividends. That is, high risk associated with a stock may result in low price and low payout, while low risk associated with a stock may result in high payout and low price. Secondly, the equation accounted only for the growth coming from investments that were financed with retained earnings, while it ignored the growth that would have come from the use of external financing. This would have bias on the coefficient of retained earnings. Thirdly, since dividends are more stable than reported earnings, the

short-run fluctuations in income were mainly reflected in change in retained earnings. If share prices and dividends were related to normal rather than reported income, the equation was biased in favour of dividends. Finally, dividends are measured more precisely than retained earnings because the estimated retained earnings depend on the accounting procedure followed to measure total earnings, which placed an additional downward bias on the retention coefficient (Friend and Puckett 1964; and Diamond 1967).

Diamond (1967) introduced into the regression equation the average three-year earning-price ratio. He examined the impact of dividends and retained earnings on share prices for a sample of 255 US firms from eight industries for 1961 and 1962. Diamond found only weak support for the notion that investors have preference for dividends over retained earnings and that in industries where rates of growth were relatively high, retained earnings were preferred marginally more than dividends, whereas in mature industries with low growth rate, a dollar of dividends was slightly preferred to a dollar of retained earnings. This suggested a negative relationship between a firm's growth and dividend payout. The results obtained by Diamond (1967) are consistent with earlier findings of Friend and Puckett (1964).

2.3.5 Tax preference theory: Litzenberger and Ramaswamy (1979)

The Modigliani and Miller's assumptions of a perfect capital market exclude any possible tax effect. Litzenberger and Ramaswamy (1979) propagated the third theory, which was based on tax effects and stated that investors prefer

retained earnings to dividends because of the tax preference given to capital gains. The theory suggests that the companies should hold dividend payments to low levels if they intend to maximize stock prices. It has been assumed that there is no difference in tax treatment between dividends and capital gains. However, in the real world taxes exist and may have significant influence on dividend policy and the value of the firm. In general, there is often a differential in tax treatment between dividends and capital gains, and, because most investors are interested in after-tax return, the influence of taxes might affect their demand for dividends (Al-Malkawi 2005). Taxes may also affect the supply of dividends, when managers respond to this tax preference in seeking to maximize shareholder wealth (firm value) by increasing the retention ratio of earnings.

2.3.6 Empirical literature

According to Al-Malakawi (2005), a large body of empirical research is devoted to testing Brennan's model and to understanding the relationship between dividend yields and stock returns. For example, Black and Scholes (1974) tested Brennan's model and found no evidence of a tax effect. The coefficient of dividend impact in Black and Scholes's (1974) model was found to be insignificant. Therefore, they concluded that low or high-dividend yield stocks do not affect the returns of stocks either before or after taxes. However, Litzenberger and Ramaswamy (1979) strongly challenged the results of Black and Scholes and criticised their methods, especially their definition of dividend yield. Litzenberger and Ramaswamy (1979) extended Brennan's

(1970) model and used a monthly dividend yield definition in classifying stock into yield classes, a positive dividend-yield class and zero dividend-yield class. The results of Litzenberger and Ramaswamy (1979) showed that the coefficient on dividend yield variable was positive and highly significant. Therefore, they provided empirical support for Brennan's (1970) model. Litzenberger and Ramaswamy (1979) concluded that, for every dollar increase in return in the form of dividends, investors require an additional 23 cents in before tax returns.

Of interest, the dividend coefficient obtained by Litzenberger and Ramaswamy (1979) was consistent in magnitude with that reported by Black and Scholes (1974). The implication of Litzenberger and Ramaswamy's (1979) findings is that firms could increase their share prices by reducing dividends. However, if this prediction holds, one may raise a question about why corporations pay dividends at all. Miller and Scholes (1982) challenged Litzenberger and Ramaswamy's (1979) conclusion, and critiqued their short-term (monthly) definition of dividend yield. They suggested that tests employing a short-term dividend yield definition are inappropriate for detecting the impact of differential tax treatment of dividends and capital gains on stock returns.

Furthermore, Miller and Scholes (1982) argued that the positive yield-return relation was caused by information bias. The reason for this argument is that Litzenberger and Ramaswamy (1979) ignored the information effect of

dividend omissions. An announcement of dividend omissions (perceived as bad news) may result in an upward bias in the dividend yield coefficient, since it reduces the return of the zero yield-dividend class. Miller and Scholes (1982) attempted to correct the information bias and then re-ran Litzenberger and Ramaswamy (1979) tests. They found that the dividend yield coefficient was not statistically different from zero. Hess (1981) found similar results to Miller and Scholes (1982). In his study, Hess tested the relation between the monthly stock returns and dividend yield over the period of 1926 to 1980. He found mixed results and concluded that the findings of Miller-Scholes (1982) study lend further empirical support to the original Modigliani and Miller (1961) proposition.

Litzenberger and Ramaswamy (1982) re-examined the relationship between dividend yield and stock returns after adjusting the dividend yield coefficient for any potential information effects. Their results, consistent with their previous findings, were that the yield coefficient is positive and statistically significant. Kalay and Michaely (2000) re-examined the Litzenberger and Ramaswamy (1979) experiment using weekly data. They attempted to find whether the positive dividend yield obtained by Litzenberger and Ramaswamy (1982) was due to tax effects or to the information effects as conjectured by Miller and Scholes (1982). Kalay and Michaely (2000) excluded all weeks containing dividend omissions. They found a positive and significant dividend yield coefficient, inconsistent with Miller and Scholes's (1982) conjecture that

the positive yield coefficient was driven by information biases. Furthermore, using daily and monthly British data, Poterba and Summers (1984) provided evidence that strongly supported the tax-effect hypothesis.

Along the lines of Litzenberger and Ramaswamy (1979) and Blume (1980), Keim (1985) used the Sharpe-Lintner CAPM to estimate the relation between long-run dividend yields and stock returns. He used a sample of 429 firms in January 1931 and 1289 firms in December 1978. In his study, Keim constructed six dividend-yield portfolios. The first portfolio contained all zero-dividend firms, and the other five ranked from lowest to highest positive dividend-yield firms. Consistent with Blume (1980), he documented a non-linear relation between dividend yields and stock returns, and his results rejected the hypothesis that average returns are equal across portfolios. Moreover, Keim tested the impact of firm size and stock return seasonality on the relationship between stock returns and dividend yields. He found a positive and significant yield coefficient. However, much of the non-linear relation was concentrated in the month of January for small firms. Nonetheless, Keim obtained the same results even after controlling for firm size. In addition, Keim reported an inverse relationship between positive yield and firm size as measured by market capitalization.

Taken together, Keim concluded that at a minimum, the results suggested that the observed relation between long-run dividend yields and stock returns was not solely attributable to difference in marginal tax rates for dividends and

capital gains. Keim's results suggested a yield-related tax effect. However, because of the significant effect of the month of January (seasonality) on the relation between dividend yields and stock returns these findings were not totally consistent with the after-tax CAPM. This conclusion deepens the puzzle surrounding the issue of a yield-related tax effect.

Using UK data, Morgan and Thomas (1998) examined the relationship between dividend yields and stock returns over the period 1975 to 1993. Drawing on Keim's (1985) methodology, Morgan and Thomas tested the tax-based hypothesis in which dividend yields and stock returns were positively related. However, they pointed out that under the 1973 imputation tax system, capital gains received a disadvantaged tax treatment when compared to dividend income; consequently the tax-based hypothesis, in the case of the UK, would predict a negative relation between dividend yields and risk-adjusted stock returns. Stocks with low yields therefore should produce higher returns to compensate stockholders for the increased tax burden associated with capital gains, and vice versa. Contrary to prediction, Morgan and Thomas (1998) found a positive relationship between dividend yields and stock returns. Their results suggested a non-linear relation between risk-adjusted returns and dividend yield, which was inconsistent with Brennan's model. Also, firm size and seasonality seemed to influence the relationship between dividend yield and stock returns. Morgan and Thomas (1998) were therefore

unable to provide support for the tax-effect hypothesis. Also, Baker et al. (2002) surveyed the managers of 630 NASDAQ firms and found weak or no support for the tax-preference theory.

The tax-effect hypothesis is therefore based on a simple proposition. Many investors are faced with dividends being taxed at a higher rate than capital gains. In addition, dividends are taxed immediately, while taxes on capital gains are deferred until the gains are actually realized. Therefore, the tax-effect hypothesis suggests that taxable investors will demand superior pre-tax returns from stocks that pay a large proportion of their income in the form of highly taxed dividends. In other words, investors will value the dollar of capital gains greater than a dollar of dividends, resulting in lower dividend-stocks selling at a relative premium to their higher-dividend counterparts.

From the foregoing empirical studies, the evidence with respect to the tax-effect hypothesis appears to be inconclusive. There is lack of evidence in relation to the tax-effect hypothesis in emerging markets, since most of the prior research focused on developed capital markets. From the aforementioned studies the tax-effect hypothesis has been addressed from one perspective: the relationship between dividend yields and the stock returns (CAPM-based studies). The literature, however, has also provided a vast amount of empirical research on the tax-effect hypothesis by examining the behaviour of stock

prices around the ex-dividend day (ex-dividend day studies). Other dividend policy issues worth mentioning are the clientele effect, signalling effect of dividends and the effect of agency costs on dividend policy.

2.3.7 Clientele effect

Modigliani and Miller (1961) noted that the pre-existing dividend clientele effect hypothesis might play a role in dividend policy under certain conditions. They pointed out that the portfolio choices of individual investors might be influenced by certain market imperfections such as transaction costs and differential tax rates to prefer different mixes of capital gains and dividends. Modigliani and Miller argued that these imperfections might cause investors to choose securities that reduce these costs and termed the tendency of investors to be attracted to a certain type of dividend-paying stocks a "dividend clientele effect".

Different groups, or clienteles, of stockholders prefer different dividend payout policies. Retired individuals generally prefer current income and therefore would want a firm that pays out a high percentage of its earnings. Stockholders in their peak earning years however prefer reinvestment, because they have no need for current investment income and would simply reinvest any dividends received. These clienteles will be attracted to firms that follow dividend policies that best suit their particular situations. Similarly, firms may tend to attract different clienteles by their dividend policies. For example, firms operating in high growth industries that usually pay low (or no)

dividends attract a clientele that prefers price appreciation (in the form of capital gains) to dividends. On the other hand, firms that pay a large amount of their earnings as dividends attract a clientele that prefers high dividends.

Allen, Bernardo and Welch (2000) suggest that clienteles such as institutional investors tend to be attracted to invest in dividend-paying stocks because they have relative tax advantages over individual investors. These institutions are also often subject to restrictions in institutional charters (such as the "prudent man rule"), which, to some extent, prevent them from investing in non-paying or low-dividend stocks. Similarly, good quality firms prefer to attract institutional clienteles (by paying dividends) because institutions are better informed than retail investors and have more ability to monitor or detect firm quality. Allen *et al.* (2000) in their study concluded that, these clientele effects are the very reason for the presence of dividends.

2.3.8 Empirical literature

The empirical studies that examined the clientele effect hypothesis have taken different paths. Pettit (1977) provided empirical evidence for the existence of a clientele effect by examining the portfolio positions of 914 individual investors. He found a significant positive relationship between investors' ages and their portfolios' dividend yield, and a negative relationship between investors' incomes and dividend yield. Pettit suggested that elderly low-income investors tend to rely more on their portfolios to finance their current consumption, and avoid the transaction costs associated with selling stocks.

Consequently, they have more of a tendency to invest in high-dividend stocks. Pettit also showed that investors whose portfolios have low systematic risk prefer high-payout stocks, and he found evidence for tax-induced clientele effect. However, using a sample constructed from the same database used in Pettit's (1977) study, Lewellen et al. (1978) found only very weak supportive evidence of the clientele effect hypothesis. Scholz (1992) developed an empirical model to test the dividend clientele hypothesis directly by examining individual investor portfolio data. He found that differential tax treatment of dividends and capital gains influences investors' decisions in choosing between higher-or-lower-dividend yield portfolios, consistent with dividend-/tax–clientele hypothesis.

Richardson, Sefcik and Thompson (1986) tested a sample of 192 US firms that initiated dividends for the first time during the period of 1969 through 1982. They attempted to investigate whether the observed (post-dividend-initiations) increase in firms' stocks trading volume was due to the signalling effect or was a product of investors in various tax clienteles adjusting their portfolios. They found that the increased trading volume associated with dividend policy changes was mainly related to the information contained in the dividend announcement, and only a small part was related to clientele adjustment. Richardson *et al.* (1986) concluded that the evidence supporting the existence of clientele trading is somewhat weak and Asquith and Krasker (1985) in their study reached a similar conclusion.

Dhaliwal, Erickson and Trezevant (1999) examined institutional shareholding changes following dividend initiations. Based on the theory of tax-induced clienteles, Dhaliwal et al. expected an increase in institutional ownership subsequent to dividend initiations. Using a sample of 133 dividend initiators from the 1982 to 1995 period, the results obtained are consistent with their prediction. They reported that 80 percent of their sample firms experience an increase in institutional shareholders following dividend initiation. Dhaliwal *et al.* found that this increase was statistically and economically significant. They concluded that the dividend/tax-clientele effect is "strong enough" to influence investors' decisions. Seida (2002) provided evidence consistent with Dhaliwal *et al.'s* (1999) findings and the dividend clientele hypothesis. Earlier research by Bajaj and Vijh (1990), Ang, Blackwell and Megginson (1991), and Denis, Denis and Sarin (1994) provided empirical support for the existence of the dividend clientele hypothesis.

2.3.9 Dividends as a signal

Another hypothesis for why Modigliani and Miller's (1961) dividend irrelevance hypothesis is inadequate as an explanation of financial market practice is the existence of asymmetric information between insiders (managers and directors) and outsiders (shareholders). Modigliani and Miller assumed that managers and outside investors have free, equal and instantaneous access to the same information regarding a firm's prospects and

performance. But managers who look after the firm usually possess information about its current and future prospects that is not available to outsiders.

This informational gap between insiders and outsiders may cause the true intrinsic value of the firm to be unavailable to the market. If so, share price may not always be an accurate measure of the firm's value. In an attempt to close this gap, managers may need to share their knowledge with outsiders so they can more accurately understand the real value of the firm. Historically, due to a lack of complete and accurate information available to shareholders, the cash flow provided by a security to an investor often formed the basis for its market valuation (Baskin and Miranti 1997). Dividends therefore serve as a signal to the market concerning future prospects where there is information asymmetry. An increase in the dividend is often accompanied by an increase in the price of stock while a reduction in dividend generally leads to a stock price decline.

Modigliani and Miller argued that a higher-than-expected dividend increase is a signal to investors that the firm's management forecasts good future earnings. Conversely, a dividend reduction, or a smaller-than-expected increase, is a signal that management is forecasting poor earnings in the future. In other words, dividend announcements may be seen to convey implicit information about the firm's future earnings potential.

This proposition has since become known as the "information content of dividends" or signalling hypothesis. According to the signalling hypothesis, investors can infer information about a firm's future earnings through the signal coming from dividend announcements, both in terms of the stability of, and changes in, dividends.

As managers are likely to have more information about the firm's future prospects than outside investors, they may be able to use changes in dividends as a vehicle to communicate information to the financial market about a firm's future earnings and growth. Outside investors may perceive dividend announcements as a reflection of the managers' assessment of a firm's performance and prospects. An increase in dividend payout may be interpreted as the firm having good future profitability (good news), and therefore its share price will react positively. Similarly, dividend cuts may be considered as a signal that the firm has poor future prospects (bad news), and the share price may then react unfavourably. Accordingly, it would not be surprising to find that managers are reluctant to announce a reduction in dividends.

Lintner (1956) argued that firms tend to increase dividends when managers believe that earnings have permanently increased. This suggests that dividend increases imply long-run sustainable earnings. This prediction is also consistent with what is known as the "dividend-smoothing hypothesis". That is, managers will endeavour to smooth dividends over time and not make substantial increases in dividends unless they can maintain the increased

dividends in the foreseeable future. Lipson, Maquieira and Megginson (1998) observed that, "managers do not initiate dividends until they believe those dividends can be sustained by future earnings".

2.3.10 Empirical Literature

In the preceding section, the theory of dividend signalling was developed around the proposition that corporate insiders are more informed about the firm's current performance and future prospects than outsiders. This suggests that the market perceives dividends (and repurchases) as signals of a management's view about the firm's fortunes, and therefore share prices react to that signal. The empirical work on dividend signalling has examined two main issues. First was whether share prices move in the same direction with dividend change announcements. The second was whether dividend changes enable the market to predict future earnings. Finance scholars have addressed these issues extensively, but once again the results have been mixed and inconclusive. The first question has received much attention in the literature, because if the announcement of dividend changes does not have the predicted impact on share prices this will cast doubt on the validity of the information content of dividend hypothesis.

Pettit (1972) observed that dividend announcements do communicate valuable information, and showed that the market reacts positively to the announcement of dividend increases (significant increase in stock prices), and negatively to the announcement of dividend decreases (significant drop in stock prices).

Pettit also added that dividend announcement, when forthcoming, may convey significantly more information than the information implicit in an earnings announcement. Aharony and Swary (1980) suggest that dividend and earning announcements are not perfect substitutes and a proper test for the signalling hypothesis needs to take into account the effect of earnings announcements. Aharony and Swary (1980) found support for the results obtained by Pettit (1972) even after controlling for contemporaneous earnings announcements. Woolridge (1983) also found significant increase (decrease) in common stock returns following the unexpected dividend increase (decrease) announcements.

Asquith and Mullins (1983) examined the market's reaction to dividend announcements for a sample of 168 firms that initiated dividends either for the first time in their corporate history or resumed paying dividends after at least a ten-year hiatus. Asquith and Mullins tested the average daily excess stock returns ten days before and ten days after the announcement of dividend initiation. For the two-day announcement period their result showed that there was an excess return of about 3.7 percent. Using cross-sectional regression Asquith and Mullins (1983) found a positive and significant relationship between the magnitude of initial dividends and the abnormal returns on the announcement day. This suggests that the size of dividend changes may also matter. In another empirical study, Asquith and Mullins (1986) reinforce their earlier findings and offer more support to the information content of dividend hypothesis.

Michaely, Thaler and Womack (1995) went further by examining the impact of both initiations and omissions of cash dividends on share prices reaction. They observed 561 dividend initiation events and 887 dividend omission events over the period of 1964 to 1988. Michaely *et al.* documented that, during three days surrounding the announcements, the average excess return was about –7.0 percent for omissions and 3.4 percent for dividend initiations. The market reactions to dividend omissions were therefore greater than for dividend initiations implying that the market reacts optimistically to dividend initiations (or increases); however, the market is more pessimistic in response to the announcements of dividend omissions (or decreases). Michaely *et al.* also found significant long-run drifts in stock prices in response to dividend initiations and omissions. They reported 7.5 percent excess returns after one year of initiation announcements and 24.8 percent after three years. For dividend omissions they reported abnormal returns of –11.0 percent in the first year and –15.3 percent after three years.

Bali (2003) presented evidence consistent with the preceding results. He reported an average 1.17 percent abnormal return for dividend increases and -5.87 percent for decreases. In addition, Bali examined the long run drifts of stock prices reaction to dividend increases and decreases and reinforced Michaely *et al.'s* (1995) findings. In these studies there seems to be general agreement that share prices follow the same direction as the dividend change announcements. Dividend increases and dividend initiations (decreases and

omissions) are associated with subsequent significant increases (decreases) in share prices. Moreover, the reaction of share prices in the event of dividend decreases and dividend omissions was found to be more severe.

The signalling power of dividends, however, may not be the same in markets other than US markets. For example, in a comparative study of dividend policies for Japanese and US firms, Dewenter and Warther (1998) revealed that the influence of dividends as a signalling mechanism in Japan is significantly lower as compared to the US. They studied 420 US firms and 194 Japanese firms. The results indicated that the impact of dividend omission and initiation announcements on US stock prices was significantly larger than on Japanese stock prices. Dewenter and Warther (1998) concluded that Japanese firms were subject to less information asymmetry especially among keiretsu (industrial groups) member firms. These differences in the findings were attributable to the differences in corporate governance structures between Japan and the US, and to the nature of corporate ownership in Japan. Conroy, Eades and Harris (2000) provided evidence consistent with Dewenter and Warther's (1998) study for Japanese firms.

Using a sample of 200 German firms listed on Frankfurt Stock Exchange, Amihud and Murgia (1997) found support for the notion that dividend changes convey information about firms' values. They examined the stock price reaction to dividend announcements using 255 events of dividend increase and 51 events of dividend decrease for the period of 1988 to 1992, and compared

the results with findings of studies based on US data. Amihud and Murgia (1997) reported that the average excess return (AER) of stock prices is 0.965 percent for dividend increase and –1.73 percent for dividend decrease. In addition, Amihud and Murgia (1997) also observed that though the earnings news preceded dividend change announcements, dividends still had significant information. However, the findings of this study were inconsistent with tax-based signalling models (i.e., John and William 1985; Bernheim, 1991) because dividends in Germany were not tax-disadvantaged. According to these models, if dividends do not suffer from a tax penalty (as in the case Germany) share prices should not react to dividend changes.

Travlos, Trigeorgis and Vafeas (2001) provided evidence from an emerging market in favour of the dividend-signalling hypothesis. They used a sample of 41 announcements of cash dividend increase and 39 announcements of stock dividends for firms listed on the Cyprus Stock Exchange for the period of 1985 to 1995, and examined market reaction to the announcement of cash dividend increases and stock dividends. Travlos et al. found positive and significant abnormal returns for both cash dividend increases and stock dividend announcements and interpreted their results as consistent with the signalling hypothesis.

El-Khouri and Almwalla (1997) provided evidence from the Jordanian Capital Market. They examined the impact of dividend changes on share prices for a sample consisting of 20 manufacturing companies listed on the Amman

Financial Market (AFM) covering a period between 1989 and 1993. In order to test only the effect of dividend changes on stock prices, all stocks subjected to announcements other than dividends were excluded from the sample. The researchers constructed portfolios of all common stocks and calculated the daily stock returns 10 days before and after the dividend announcement date. Although the effect of dividend announcements seemed to be insignificant, stock prices moved in the same direction as dividend increases or decreases. Overall, announcements of dividend changes did not seem to have a significant impact on stock prices for companies listed on the AFM. However, these results may not be plausible due to the sample selection bias since only 20 companies were included in the study and only manufacturing firms.

In contrast to El-Khouri and Almwalla (1997), Omet and Abu-Ruman (2003) found evidence consistent with the signalling hypothesis. Omet and Abu-Ruman (2003) conducted a survey of the CFOs of 47 Jordanian manufacturing companies and also used the Lintner model to examine the stability of the corporate dividend policy of these firms. Their results revealed that Jordanian companies, to some extent, follow stable dividend policies, consistent with the signalling hypothesis. The survey results also produced similar evidence where 76 percent of the respondents agreed that firms use dividends to convey information about their prospects, and 67 percent of the respondents considered that announcements of dividend changes affected share prices.

Further, Nissim and Ziv (2001) found that dividend changes and earnings changes were positively correlated, and provide support for the signalling hypothesis. However, their results were not the same for dividend increases and decreases. Nissim and Ziv did not find an association between dividend decreases and future profitability after controlling for current and expected profitability, and they assumed that this result was possibly due to the accounting conservatism. Mixed support exists about issues relating to the information content of dividends hypothesis, a common concept in the dividend literature. Firms use dividend policy to communicate information about their future prospects to the market, and this provides another possible explanation of why firms pay dividends. Signalling could play a pivotal role in determining firms' dividend policies and their values. Most of the studies mentioned earlier (among many others) are built on firms operating in developed markets, especially in US markets. However, there is a lack of empirical evidence regarding firms' performance in emerging markets particularly in Kenya.

The signalling hypothesis makes an important assumption that managers want to signal the proper value of the firm via dividends. However, a separate thesis has been developed on the basis that managers may have incentives not to pay dividends and will therefore need to be forced (or given incentives) to pay dividends. Ambarish, John and Williams (1987) examined the signalling equilibrium with dividend and new stock issues. A major conclusion of their research was that the tax on dividends is not significant; the dividend itself

may not be an economical signal. By combining the dividend signal with other signals such as debt or investment changes, the firm may be able to retain a less-costly signalling mix. Sharma and Rao (1992) studied the signalling aspects of corporate dividend policy. They concluded that the dividends are used as signals from management on the performance of the company in the market. The empirical results indirectly support the semi strong form of efficient market hypothesis. Constas (1994) examined the relationship between earnings, dividend declarations and investor returns. The empirical results reported suggest that most of the information contained in dividends that is useful to financial markets, is also contained in accounting earnings. There does appear to be some useful information in dividends that is not contained in accounting earnings.

2.3.11 Dividend policy and agency costs

One of the assumptions of Modigliani and Miller's perfect capital market is that there are no conflicts of interests between managers and shareholders. In practice, however an agency conflict exists between stockholders (owners) and managers. This is because as owners of the firm are interested in maximizing their wealth by high values of stocks they own, managers are motivated to act in their own best interests. As a result of this potential agency conflict, stockholders are willing to incur agency costs to monitor managerial actions. Most of the times, some other party, and similar to a trustee is contracted to monitor managerial actions, on behalf of the stockholders. The board of directors normally performs this role. The investment bankers and other rating

agencies substantially reduce the monitoring problem when firms must frequently raise external capital as a result of which its operating and financial decisions are scrutinized. For any given level of investment, the higher the dividend payout, the more frequently the firm must issue new securities mitigating the agency problem.

Some firms pay low dividends because management is optimistic about the firm's future and wishes to retain earnings for expansion. The dividend in such a firm is a by-product of the firm's capital budgeting decision. Another firm might finance capital expenditures largely by borrowing. This releases cash for dividends and the firm's dividend is a by-product of the borrowing decision. Dividend decisions are different from other decisions that financial managers have to make and the question that begs to be answered is the effect that a change in cash dividends paid has, given the firm's capital budgeting and borrowing decisions. Cash used to finance a dividend has to come from somewhere. Firms, however, do not schedule a stock issue with every dividend but many of them pay dividends and also issue stock from time to time. Companies can hand back cash to their shareholders either by paying a dividend or by buying back their stock. Dividend payments therefore, increase management scrutiny by outsiders and reduce the chances for managers to act in their own self-interest.

Kee (1987) studied the influence of transaction costs and agency costs on dividend payout of companies. The cross sectional test of the models performed on a sample of 357 industrial companies in 1979-1981 related dividend payout ratios to exploratory variables which included the fraction of equity held by insiders, past and expected future growth of the firm, the firm's beta, the total risk of the firm, the number of shareholders of the firm and the research and development expenditure of the firm. The results of the study indicated that transaction costs and agency costs influence company's divided policy.

This chapter began with an overview of the evolution of corporate dividend policy. It was noted that dividend policy has been bound up with the development and history of the corporation itself. In order to provide an understanding of dividend policy theories, the chapter attempted to explain the basic argument for each theory followed by the most important empirical evidence on testing of these theories. Although numerous studies have examined various issues of dividend policy, they have produced mixed and inconclusive results. It is observed that most of the studies conducted on dividend policy used data from developed markets. The evidence in relation to emerging markets is limited.

Uzoaga and Alozienwa (1974) found little evidence to support classical influences that determine dividend policies in Nigeria during the period of their study but instead found that fear and resentment had taken over from the

classical forces. Uzoaga and Alozienwa's work did not exhaustively cover the determinants of optimal dividend policy. Oyejide's (1976) study failed to adjust for stock dividend. Karak (1993) examined the policy decision regarding divisible profit and dividend decision. The study concluded that management in India, as a rule, followed conservative policies with regard to dividends. There is an increasing tendency on their part to finance the expansion out of internal resources as far as possible. In the case of Kenya, the evidence is even more scant, and provides a further justification for the current research.

The theoretical and empirical research discussed in this chapter has established that a range of possible factors can influence dividend policy. The previous studies have failed to consider several factors that affect dividend policy. Managers appear to believe strongly that the market puts a premium on firms with a stable dividend policy. Mungai (2000) used a sample size of twenty-eight companies where random sampling was used to pick on the companies that were included in the study. In Kenya, more empirical studies on dividend pay out of companies need to be under taken to be able to come up with a position on the factors that managers consider when declaring dividends.

2.4 LINTNER'S DIVIDEND SMOOTHING MODEL

Lintner's (1956) model suggested that dividend depends partly on the firm's current earnings and partly on the dividend for the previous year, which in turn depend on that year's earnings and the dividend in the year before.

Lintner (1956) conducted a series of interviews with corporate managers about their dividend polices. Lintner was the first to observe that firms tended to follow a slow adaptive process in setting their dividend per share. According to Brealey and Myers (2000), Lintner's description of how dividends are determined can be summarized using four points.

First, firms have long run target divided pay out ratios. Mature companies with stable earnings generally payout a high proportion of earnings whereas growth companies have low payouts. Secondly managers focus more on dividend changes than on absolute levels. Thus, paying a Ksh. 2.00 dividend is an important financial decision if last year's divided was Ksh. 1.00 but no big deal if last year's dividend was Ksh. 2.00. The third conclusion was that divided changes follow steps in long run sustainable earnings. Managers 'smooth' dividends. Transitory earnings changes are unlikely to affect dividends payouts. Finally, Lintner concluded that managers were reluctant to make changes that might have to be reversed. They are particularly worried about having to rescind a dividend increase. From the foregoing, Lintner's model of dividend smoothing, with a slow adjustment to an equilibrium rate is regarded as the standard model of dividend policy and is viewed as a solution to the agency and signalling problems. A pattern of consistent and increasing dividends convinces the external shareholders that excess cash will be disgorged, thus mitigating the agency costs of equity, while signalling the consistent quality of the firm's earnings.

2.4.1 Empirical literature

Lintner (1956) made the earliest attempt to explain dividend behaviour of a company. Lintner selected 28 companies from over 600 listed for the survey. Lintner made a number of important observations concerning the dividends policies of these firms. The first was that firm's were primarily concerned with stability of dividends. They did not set dividends each quarter; instead they first considered whether any change from the existing rate was necessary. Only when they had decided a change was necessary did they consider how large it was to be. Second, Lintner observed that earnings were the most important determinant of any changes in dividends with a reported a median target pay out of 50 percent.

Lintner's third finding was that dividend policy was set first. Other policies were then adjusted, taking dividend policy as given. The fourth observation by Lintner (1956) was that on average the market reacted positively to announcements of increases in payouts and negatively to announcements of dividends decreases. The classic study of 28 American Companies for the period of 1947 to 1953 showed that dividend smoothing behaviour was fairly widespread. The study concluded that a major portion of dividends of a firm would be expressed in terms of the firm's dividend payment and target payout ratio. Since then, the debate on dividend policy in developed markets has been mixed, controversial and inconclusive.

Fama and Babiak (1968) undertook a more comprehensive study of the Lintner models' performance, using data for 392 major industrial firms over the period 1946 through 1964. The study used ordinary least squares method of regression analysis, simulations and prediction tests and concluded that net income seemed to provide a better measure of dividend than either cash flow or net income and depreciation included as a separate variable in the model. Fama and Babiak (1968) study concurred with the findings of Lintner (1956) and Benartzi, Michaely and Thaler (1997), among others, concluded "Lintner's model of dividends remains the best description of the dividend setting process available." Uzoaga and Alozienwa (1974) attempted to highlight the pattern of dividend policy pursued by Nigerian firms during the period of indigenisation and participation programme defined in the decree in which they covered 52 company years of dividend (13 companies for 4 years). They found little evidence to support classical influences that determine dividend policies in Nigeria during the period.

Oyejide (1976) empirically tested for company dividend policy in Nigeria using Lintner's model as modified by Brittain (1964) and disagreed with previous studies and concluded that the available evidence provides a strong and unequivocal support for the conventional devices for explaining the dividend behaviour of Nigerian limited liability business organizations. Inanga (1978) and Soyonde (1975) reviewed the work of Uzoaga and Alozienwa, where Inanga concluded that the problem arising from the change in dividend policy could be attributed to the share pricing policy of the Capital Issue

Commission (CIC). Murray (1981) used non-capital market data to test theoretical implication that dividend payout is negatively connected with earning uncertainty. The study concluded that earnings uncertainty is a determinant of the corporate dividend decision.

Mungai (2000) researched on the dividend policy and value of publicly quoted companies on the NSE over the 1988 to 1997 period. He found that various firms, depending on the sectors they are grouped, followed different dividend policies where some adopted a regular dividend policy, others a combination of different dividend policies and still others had an amorphous dividend policy.

The literature on dividend policy has produced a large body of theoretical and empirical research, especially following the publication of the Lintner's (1956) dividend policy model. The 28 companies that Lintner selected out of the over 600 listed formed a very small sample. The companies were chosen to encompass a wide range of different situations. The study was conducted half a century ago. It is therefore difficult to conclude whether the findings are still as relevant in this age of information technology as they were then. No general consensus has yet emerged after several decades of investigation, and scholars can often disagree even about the same empirical evidence.

2.4.2 Theoretical model

Lintner (1956) presented a model of dividend behaviour suggesting that a firm's dividend or change in dividends is a function of current earnings and the dividend in the previous year (lagged dividend). The Lintner model is introduced here to examine the behaviour of corporate dividend policy in Kenya, mainly to test whether Kenyan companies follow a stable dividend policy. If the model works well, and dividends appear to be stable in Kenya, one can interpret this as consistent with the signalling hypothesis. Since many companies in Kenya do not pay dividends, the censoring problem has to be taken into account. As stated earlier, the exclusion of non-dividend-paying firms may result in a selection bias problem as Anderson (1986) and Kim and Maddala (1992) found out in their studies. According Lintner's (1956) model, if a firm always stuck to its target payout ratio, the dividend payment in the coming year (DIV_1) would equal a constant proportion of earnings per share (EPS_1)

DIV_1 = target dividend

= target ratio * EPS_1

The change in dividend ($DIV_1 - DIV_0$) would therefore be as follows: -

$DIV_1 - DIV_0$ = target change

= (target ratio * EPS_1) – DIV_0.....2.1

Where DIV_0 is dividend payment in the preceding year.

2.4.3 Model specification

A firm that had a target payout ratio would have to change its dividend whenever earnings changed to be able to have a constant dividend payment. However, Lintner found out that managers were reluctant to do this. They believed that shareholders prefer a steady progression of dividends. Therefore even if circumstances appeared to warrant a large increase in their company's dividends, they would move towards their target payment. Their dividend changes would conform to the following model: -

$DIV_1 - DIV_0$ = Adjustment rate * target change

=Adjustment rate * [target ratio * $(EPS_1 - DIV_0)$].....2.2

The more conservative the company, the more slowly it would move towards its target and therefore, the lower would be its adjustment rate. Lintner's model suggests that the dividend depends in part on the firm's current earnings and in part on the dividend for the previous year, which in turn depends on that year's earnings and the dividend in the year before. Dividend payment is therefore a function of current year earnings (EPS_t) and immediate past dividends (DIV_{t-1}) as indicated below: -

$DIV_t = f(EPS_t, DIV_{t-1})$.....2.3

Where,

DIV_t – divided paid in year t

EPS_t – earning per share in year t

DIV_{t-1} – dividends paid in the previous year.

This study was based on this model and the dividends were described in terms of a weighted average of current and past earnings given as follows: -

Dividends per share in time t are:

$DIV_t = \propto + \propto T\ (EPS_t) + (1-\propto)\ DIV_{t-1}$ 2.4

Where,

DIV_t is the dividend per share in time t,

$\propto$ is the adjustment rate and

T is the target payment ratio.

The probability of an increase in the dividend rate will be greatest when current earnings have increased; it will be less when only the earnings from the previous year have increased. This process continues from year to year. This implies that current dividend is a function of current earnings and immediate past dividends. Lintner's model provides a good explanation of how companies decide on the dividend rate. While good fortune will always play some part in managing common stock portfolios, sustained success requires skill and consistent application of sound policies.

2.4.4 Definition and measurement of variables

Dividend is payment by a company to its stockholders and is represented in the equations as DIV. Dividend paid in the current year is indicated in the equation as DIV_1 and is a dependent variable whereas dividend paid in previous year is given as DIV_0 in the equation and is an independent variable measured in units of currency.

Earnings Per Share is calculated by dividing the net profit after tax of a company (less any dividends on preference shares that the company may have paid) for a given year or period by the number of equity shares outstanding at the end of the year and is represented in the model as EPS. EPS in the model is an independent variable measured as a ratio.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 INTRODUCTION

This chapter describes the data used in this study, and how the data was compiled. The chapter is organised under research design, target population, data collection and procedures and finally refinement, analysis and presentation.

3.2 RESEARCH DESIGN

The study involved both qualitative and quantitative data based on primary and secondary sources. The study also adopted an explanatory approach to assess how companies listed on the stock exchange determine dividends. Moreover, this approach was considered to be valuable in assessing key factors that managers take into consideration while declaring dividends to be paid to shareholders. The study was carried out on firms listed on NSE.

3.3 TARGET POPULATION

Data was collected from 48 firms listed on the NSE. Quoted corporations are companies whose shares are freely transferable from one holder to another. The Kenya Companies Act (Chapter 486, laws of Kenya) sets the general framework for financial accounting and reporting by all registered companies in Kenya, and stipulates the basic minimum requirements with regard to financial reporting. Financial reporting and regulation are supplemented by pronouncements of the institute of certified public accountants of Kenya

(ICPAK). In 2002, through a gazette notice, the capital markets authority (CMA) issued the guidelines on corporate governance practices by public listed companies in Kenya. All companies are required to comply with the guidelines, effectively from 2003.

The stock market provides an avenue for pricing and transfer mechanism of such stocks. All the 48 listed firms were used in the study and are set in two main categories. The first category was the Main Investment Market Segment (MIMS), which is the main quotation market with more stringent listing requirements. This category includes firms that are in agricultural sector, commercial and services, finance and investment and finally industrial and allied sectors. Other firms that were studied were those that do not satisfy the requirement of the MIMS. These firms were listed on the Alternative Investments Market Segment (AIMS).

This segment provides access to the capital market for small and medium sized companies with high growth potential. This provides an alternative method of raising capital for those companies that find it difficult to meet the more stringent listing requirement of the MIMS. These companies are relatively new compared to companies listed in the MIMS and have high growth potential. The companies have a large shareholder base. The period of the study was 1998 to 2004. The time period was chosen as it explains well the current situation as the economic realities and knowledge of this period is not significantly different from what it is today.

Firms quoted on the NSE were chosen for this study, as they have to maintain a certain level of standard and must comply with the requirements of the Companies Act amongst other strict guidelines enforced by the NSE which provide adequate, accurate, transparent, timely and accessible information to investors as part of measures aimed at investor protection. These requirements ensure orderly development of the market and investor confidence. These minimum requirements include the fact that a company to be listed must be limited by shares and registered under the Companies Act, have a minimum authorized, issued and fully paid up share capital of Ksh 50 million and net assets of Ksh 100 million, free transferability of shares, published audited financial statements in line with International Accounting Standards (IAS) at least 3 months earlier, must not be in breach of any of its loan covenants, its directors should be free from bankruptcy or criminal record, must have declared positive profits after tax for at least three of the last five years, among other requirements.

Once on the official list, a company has a responsibility to make timely and adequate public disclosure of material developments. Particular emphasis is placed on developments that are price sensitive. When a listing is granted, the company is required to maintain a standard of continuing disclosure sufficient to enable investors and their advisers to assess performance and to estimate its prospects. To this end, the prospectus on flotation must include, *inter alia*, particulars of the company, its origins and history and its financial performance over time. A reasoned forecast of current and future earnings and

prospective dividends is also required. Such disclosure is essential to correct investment analysis and decision; it is the great safeguard that governs the conduct of corporate managements in many of their activities; and it is the best bulwark against reckless and irresponsible recommendations and sale of securities.

The public disclosure of the fullest possible information about company's activities is in the best interests of investors in general, of the shareholders and of the company itself. It is imperative for management to recognize and follow the worldwide trend towards fuller and more frequent disclosure to shareholders. Disclosure (initially and on a continuing basis) is fundamental to the whole system of a free and unfettered market in securities, and it is the basic principle underlying the listing requirements of the Nairobi Stock Exchange. Once on the official list, a company has a responsibility to make timely and adequate public disclosure of developments especially those that are price sensitive. This made comparison of the information provided by these companies possible. These research hypotheses formed the empirical model to examine whether dividend decisions are made in line with Lintner's model, which tests dividend smoothing of Kenyan companies.

3.4 DATA COLLECTION AND PROCEDURE

Both primary and secondary data were collected. Secondary data was extracted from annual reports of the companies listed on the NSE whereas primary data was from the answers received through the questionnaires sent

out and filled by chairmen and CEOs of companies quoted on the NSE. The firm's dividend payout is measured by the ratio of dividend in a year to its net income.

3.5 DATA REFINEMENT, ANALYSIS AND PRESENTATION

The company's dividend pay out was measured by the ratio of dividend in a year to its net income. Results on earnings and dividend history were coded and analyzed using descriptive statistics and regression analysis statistics. The Statistical Package for Social Sciences (SPSS) was used to help analyze relationship between current dividends and current earnings, and current dividends and previous year's dividends. Results were interpreted and inferences made and presented using charts, frequency distribution tables and percentages to explain the outcomes.

CHAPTER FOUR

EMPIRICAL FINDINGS

4.1 INTRODUCTION

This chapter presents and discusses the results of the empirical testing. The chapter provides descriptive statistics of all variables used in the study along with some statistical tests. This analysis covers both the statistical and the economic significance of coefficients of the variables and also provides the results of the Lintner model. The chapter then presents detailed analysis of the research findings.

4.2 DESCRIPTIVE STATISTICS

The NSE was divided into two major segments; the Main Investment Market Segment (MIMS) and the Alternative Investment Market Segment (AIMS). The MIMS had 39 firms listed throughout the period of study while AIMS had 9 listed firms by 2003 as indicated by Table A1 in appendix I. A trend analysis of dividend payments during the period was carried out and compared with trend in earnings growth for the companies.

NSE companies studied had an average payout ratio of 49.97 percent over the 1998 to 2004 period of study with an average standard deviation of 67.19 percent indicating that the dividend policies of the NSE companies were very unstable during the period.

From Table A2 in appendix I, it can be seen that companies listed under AIMS have the highest mean value of cash dividends at an average of ksh.7.103 a relatively stable dividend as indicated by the average standard deviation of 13.4 percent, while in terms of the payout ratios they come third with average payout ratio of 51.5 percent and an average standard deviation of 80.2 percent, after companies listed under the industrial and allied, and agricultural sectors respectively, which had average payout ratios of 63.6 and 57 percent respectively but average standard deviations of 71.2 and 104.8 percent respectively. These measures indicate that dividends paid out and the dividend policies of NSE companies were very unstable during the period. When the dividend yield is considered, companies under AIMS have the lowest ratios after those listed under the industrial and allied, financial and investment, commercial and services, and agricultural sectors respectively. The commercial and services sector companies have the lowest mean payout ratios. The mean payout and dividend yield ratios for the overall sample are 49.968 and 6.116, respectively.

4.2.1 Dividend payments and earnings.

A trend analysis of dividend payments during the period was carried out and compared with trend in earnings growth for the companies. The comparison of the dividend per share paid and earnings per share during the period of study are as indicated in Table A3 in appendix I. As shown in the table, dividend patterns of fourteen companies among them Car and General, Marshalls, Housing Finance, Kakuzi Ltd, East African Portland Cement and Kenya

Orchards do not reveal any relationship between dividends paid in a certain year and earnings realised during the year. The dividends paid during the period did not depict any pattern as a result of which dividends paid were unstable. In some instances companies made losses but still paid dividends and also at other times they made profit but paid no dividends. This was the case with East African Cables in 2002 when the company paid a dividend of Ksh.0.50 per share, yet the company realised loss of Ksh. 0.29 per share. The chairman attributed the loss to high material costs, depressed margins, low interest income, competition, quality standards certification and the setting up of a branch in Mombasa and a subsidiary in South Africa.

Again, the future was predicted to be brighter with expected upturn in the economy. East African Portland Cement also made a loss of Ksh. 2.99 per share in 2004 but still paid dividend of Ksh. 1.75 per share. This was due to the stiff competition in the cement industry and harsh economic conditions during 2004. Kenya Power and Lighting Company made a loss of Ksh.40.33 per share but still paid a dividend of Ksh. 2 per share in 2000. This was due to the turn around the company was experiencing as a result of the strategic recovery measures that were being implemented then which included re-negotiation and rationalization of bulk power tariffs, reduction of system losses, network reinforcement and improvement of quality supply which were expected to secure adequate power capacity to meet demand and cost containment. Again, Unga limited in 1988 when they made a loss of Ksh. 13.84 per share and still paid a dividend per share of Ksh. 1.20. Also A.

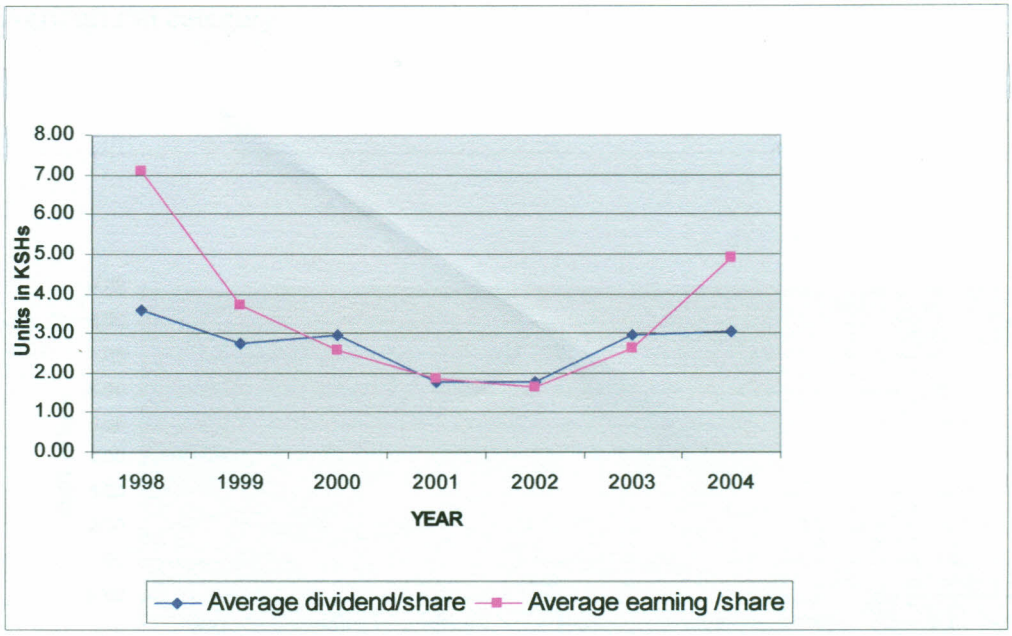
Baumann paid a dividend of Ksh. 1 per share in 2001 against a loss of Ksh.0.67 per share just like Kenya Orchards in 1998 when the company paid a dividend of Ksh. 0.28 against a loss of of Ksh. 17.69 per share realised then. This therefore indicates that managers were reluctant to reduce the dividend levels when the losses were attributed to temporary conditions in line with Lintner's model.

TPS Serena paid a constant dividend of Ksh.1.00 in 1998 and 1999 and increased the dividends to Ksh.1.10 in 2000 with the same Ksh.1.10 being paid for the remainder of the period up to 2004 irrespective of the earnings per share realised during the period. CFC also had a constant dividend payment of Ksh.0.67 for 1998 to 2002 and then increased it to Ksh. 0.87 in 2003 and 2004, which did not have any relationship with the earnings. Diamond Trust's dividend payment for the first two years was Ksh.0.80 per share, which was reduced to Ksh.0.60 in 2000 and then to Ksh.0.40 in 2001. The dividend was then increased to Ksh.0.60 in 2002 and Ksh.0.70 was paid for 2003 and 2004 as dividends.

Jubilee Insurance Company had a constant dividend payout of Ksh.1.75 from 1998 to 2002, which was adjusted, to Ksh.2.25 in 2003 and then Ksh.2.50 for 2004 indicating preference by managers of stable dividends in line with Lintner's model. Other NSE companies including Rea Vipingo, Sasini Tea & Coffee, Uchumi, Total Kenya, Eaagads, Express Kenya and Limuru Tea, paid dividends only when there were profit realised with no dividends paid during

years when losses were realised while still other companies among them CMC, Nation Media, Barclays, ICDC, NIC BOC, Carbacid, EABL Sameer Africa Ltd and City Trust paid dividends throughout the period but the dividend depended on the earnings per share realised. Table 4 in appendix II and Figure 4.1 indicates the relationship between the dividends paid by all the NSE companies and the earnings per share during the period of study.

Figure 4.1: Dividends and earnings per share for all NSE companies



From Figure 4.1, average dividends paid by all the NSE companies during the period of study do not indicate any particular pattern. The dividend policy for these companies was also unstable. In 1998, the dividend paid of Ksh.3.60 was 51.7 per cent of the EPS of 7.10, which reduced in 1999 to an average dividend of Ksh.2.75 being 74.1 per cent of the Ksh.3.71 realised during the

year. In years 2000, 2002 and 2003, the average dividends paid were more than average EPS an indication that overall, NSE companies did not follow any particular pattern. This pattern is also clearly indicated by Table A4 in appendix I. Figures 4.2, 4.3 and 4.4 indicate the dividends paid in relation to the earnings of each of the years for all the NSE companies categorised under MIMS.

Figure 4.2: Dividends and earnings per Share for all NSE companies under Agricultural category

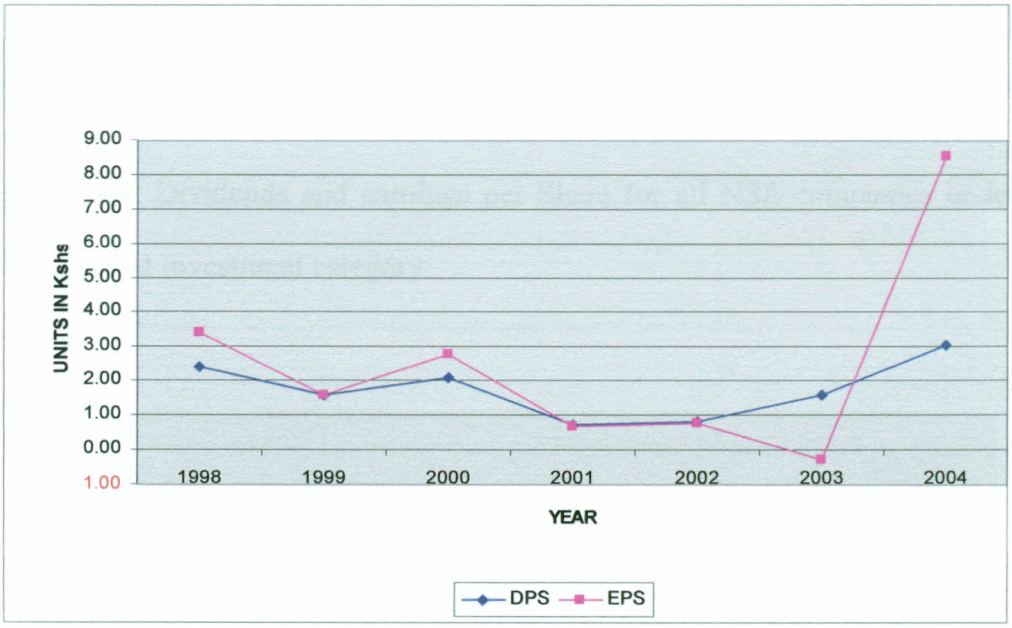


Figure 4.3: Dividends and earnings per Share for all NSE companies under commercial and allied category

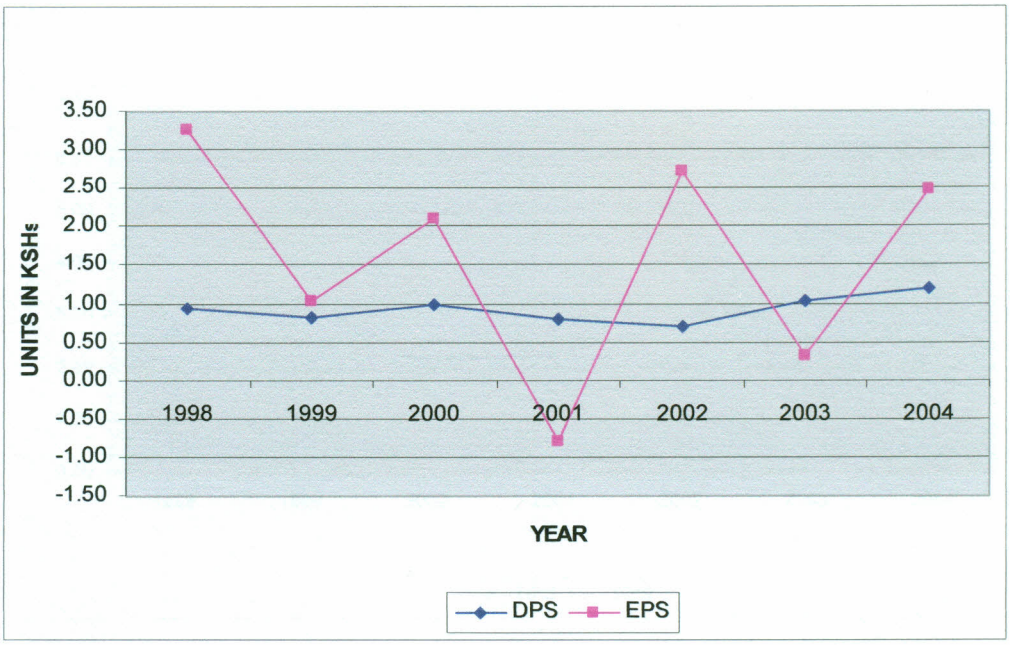


Figure 4.4: Dividends and earnings per Share for all NSE companies under Finance and Investment category

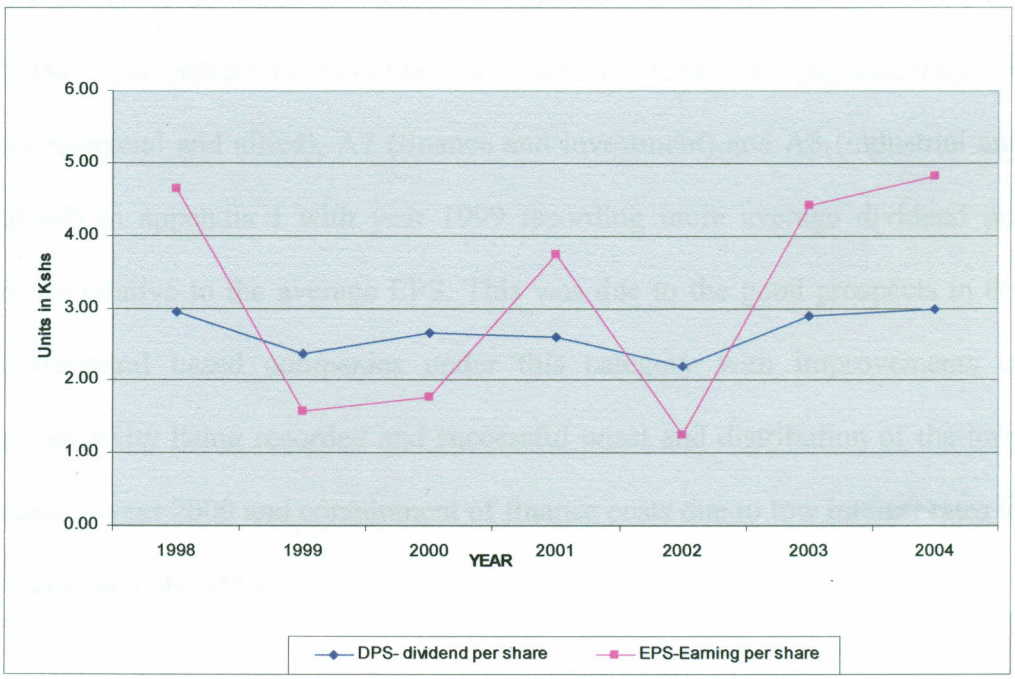
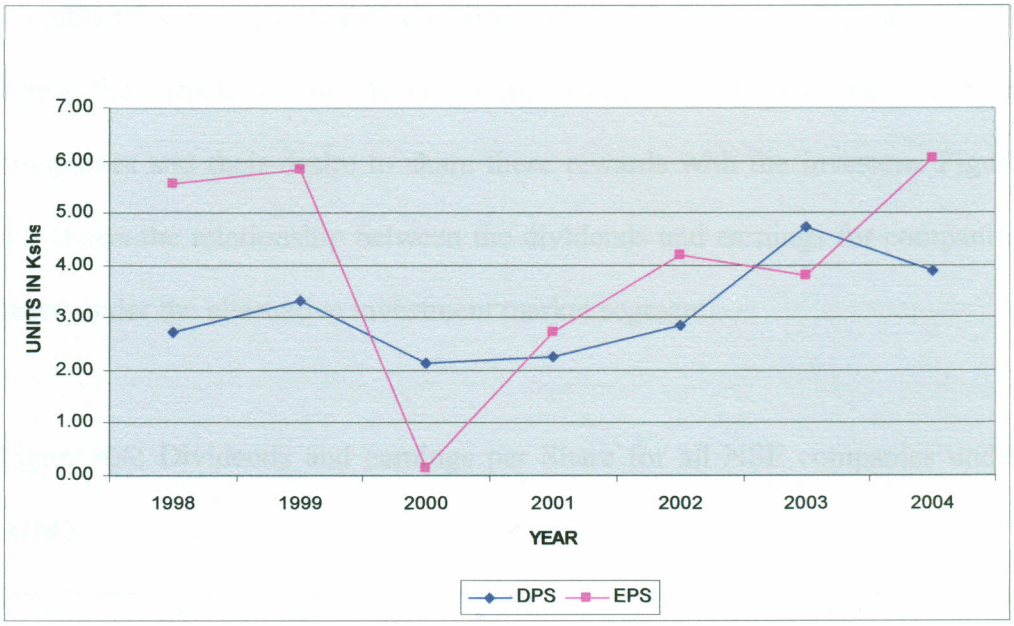


Figure 4.5: Dividends and earnings per Share for all NSE companies under Industrial and Allied category



The Figures 4.2 (agricultural), 4.3 (commercial and allied), 4.4 (finance and investment) and 4.5 (industrial and allied) indicate a pattern of fluctuating dividends all of which are companies grouped in sectors that fall under the MIMS. The pattern is also clearly indicated by Tables A5 (agricultural), A6 (commercial and allied), A7 (finance and investment) and A8 (industrial and allied) in appendix I with year 1999 recording more average dividend per share relative to the average EPS. This was due to the good prospects in the agricultural based companies under this category with improvements in productivity being recorded and successful onset and distribution of the long rains in year 2000 and containment of finance costs due to low interest rates in years 2003 and 2004.

Under the commercial and allied sectors companies realised increased rage of products and growth of market share in core product lines. Finance and investment sector companies also had successful years in 2002 up to 2004 hence the directors' confidence in the future earning potential for these companies and their desire to share these rewards with the investors. Figure 4.6 shows the relationship between the dividends and earnings for companies listed under the alternative investment market segment.

Figure 4.6: Dividends and earnings per Share for all NSE companies under AIMS

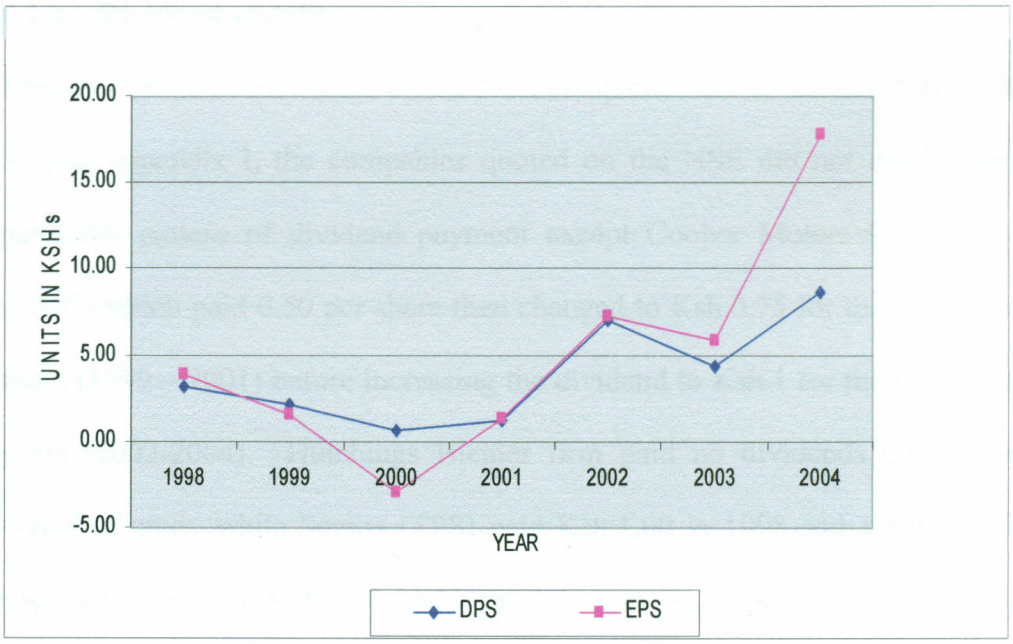


Figure 4.6 and Table A9 in the appendix I, indicate a similar pattern of fluctuating dividends similar to patterns of companies categorised under MIMS with year 2000 where a dividend of Ksh.0.722 was paid even when an average loss of Ksh.2.946 was realised per share. This was attributed to increased investment income especially in City Trust Limited and the expected improvement in the economy as a result of expected change in the political leadership in the country. The weaker shilling against the sterling pound coupled with tight cost control at Williamsons Tea Kenya Limited resulted in the improved showing.

4.2.2 Dividend stability

From the research conducted on the NSE companies and as indicated in Table A10 in appendix I, the companies quoted on the NSE did not display any particular pattern of dividend payment except Cooper Motors Corporation (CMC) which paid 0.50 per share then changed to Ksh.0.75 for the next three years (1999 – 2001) before increasing the dividend to Ksh.1 for the next three years (2002-2004). Hutchings Biemer firm paid no dividends during the period of study while Serena (TPS) paid Ksh.1.00 in 1998 and 1999, which was increased, to Ksh.1.10 paid in the next 5 years. Credit Finance Corporation (CFC) paid Ksh.0.67 for the first 5 years and increased the dividend by 25 per cent to stand at Ksh.0.84 for the next 2 years. Housing Finance Company paid a dividend of Ksh.1.50 in 1998 reduced it to Ksh.0.50 and then 0.38 in 1999 and 2000 respectively and then paid no dividend thereafter for four years (2001-2004). National Bank of Kenya has also not

paid any dividends during the period, as was the case with Dunlop (K) Ltd, Express (K) Ltd and the Standard Media Group even during years that these companies realised profits.

Unilever paid a dividend of Ksh.4.00 in 1998 and 1999 then increased the amount paid to Ksh.6.00 in 2000. However, a 66.7 per cent decrease was realised when dividend paid was reduced to Ksh.2.00 after which an increased dividend of 2.50 was paid in 2002, a 25 per cent increase, which was eventually increased to Ksh.8.00 in 2004, a 33 per cent increase, from the Ksh.6.00 paid in 2003. Rea Vipingo paid dividend for 3 years during the period starting with Ksh.0.25 in 2002, increasing to Ksh.0.40 in 2003 and finally paying Ksh.0.80 in 2004 an increase of 1.00 per cent from the Ksh.0.40 paid in 2003. This was also the case with the Nation Media Group whose dividend payout consistently increased from Ksh.1.65 in 1998 with Ksh.6.00 per share being paid in 2004. Barclays Bank paid a dividend of Ksh.11.00 in 1998 then reduced to Ksh.10.00 in the next two years before increasing the dividend payment to Ksh.14.00 in 2001. The payment was reduced to Ksh.9.00 in 2002 and then increased to Ksh.14.00 paid in each of the next two years.

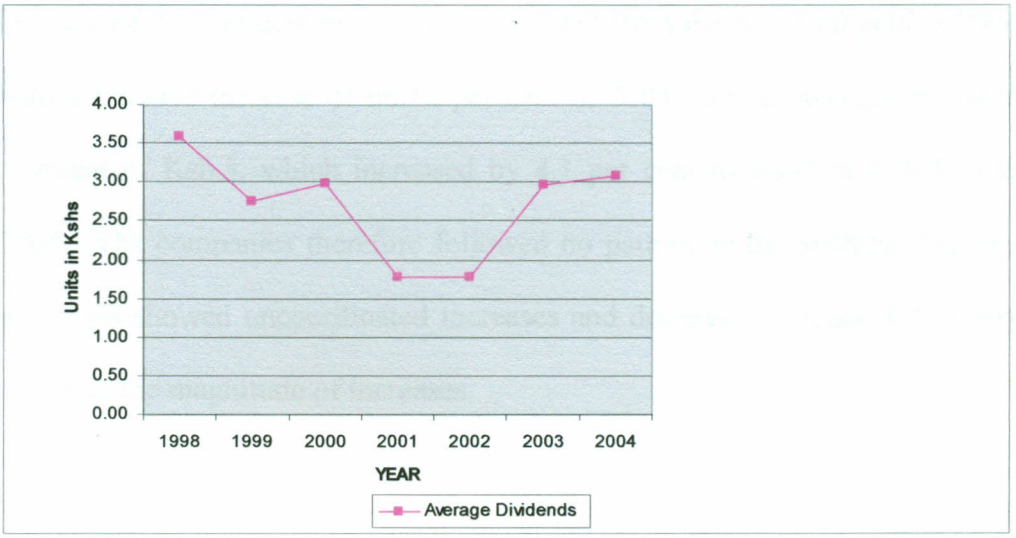
From the analysis 45.83 per cent or 22 companies out of the total 48 companies paid dividends in all the years but the companies did not follow any particular pattern. The companies spread equally in the MIMS

categorised under agricultural, commercial and allied, finance and investment and under industrial and allied categories with the rest being in the Alternative Investment Market Segment.

Seven companies, which constitute 14.6 per cent of the NSE companies, paid dividend for 3 years during the period. A further five companies which form 10.4 per cent of the companies quoted on the NSE did not pay any dividends during the period and another five companies or 10.4 paid dividend only once. Three companies (6.3 per cent) of the total NSE companies paid dividends for 4 years, three others for 5 years and the other three paid dividends for 6 years during the period of study.

Average dividends paid during the period of study by the 48 companies listed on the NSE do not indicate any constant pattern as indicated in Figure 4.7.

Figure 4.7: Average dividends paid for all NSE Companies

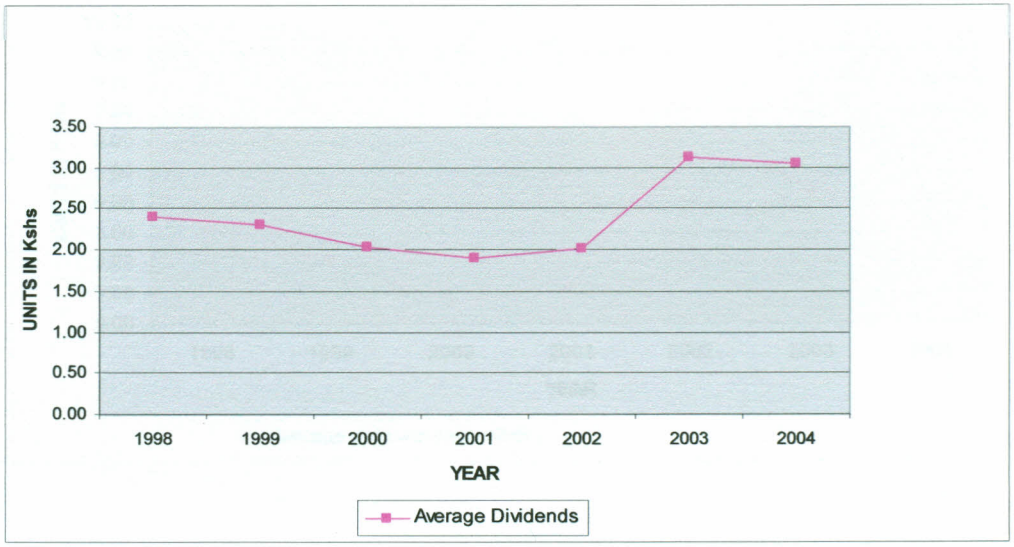


This was attributed to the fact that the period 2001 to 2002 was a very challenging period for agricultural sector especially because of low price levels for agricultural products and insufficient rainfall realised during the early part of 2002. Again the challenges that resulted from the September 11, 2001 terrorist attacks in the United States affecting the performance of commercial and services sector and especially Kenya Airways. The economic performance of 2002 was also poor affecting all the sectors of the economy with a gross domestic growth of 0.8 percent, which was lower than the 1.8 percent expected.

In 1998 the NSE companies paid an average of Ksh.3.60 per share. However, in 1999 an average dividend of Ksh.2.8 was paid a reduction of 23.41 percent, which then increased to Ksh.3.00 in 2000 an 8.17 per cent of increase on average. In 2001 an average dividend of Ksh.1.75 per share was paid which is a 40.35 per cent decrease from the Ksh.3.00 paid in 2000. A marginal increase of 0.03 percent was recorded in 2002 from the Ksh.1.80 paid in 2001 with a massive increase of 66.12 per cent in 2003 with an average dividend payment of Ksh.3, which increased by 4.1 per cent to stand at Ksh.3.10 in 2004. The companies therefore followed no pattern as the average dividend payments showed uncoordinated increases and decreases. Figure 4.7 clearly indicates the magnitude of increases.

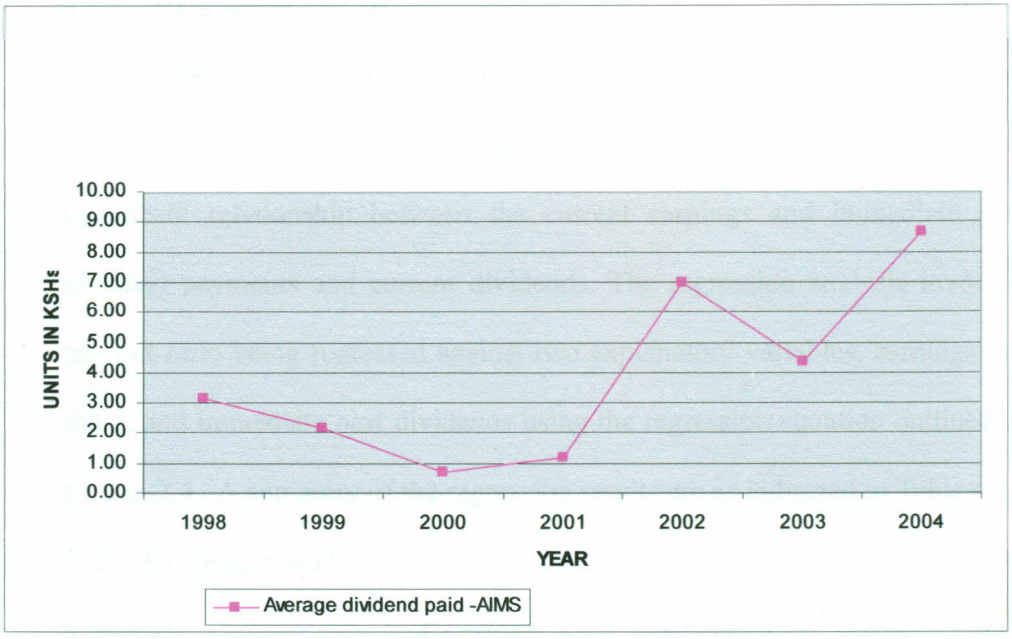
Figure 4.8 also indicates that companies quoted on the MIMS also had a similar trend to that of the total population of 48 companies.

Figure 4.8: Average dividends for firms categorised under MIMS



In this category, 39 companies were listed which are further categorised under agricultural, commercial and allied, finance and investment and industrial and allied sectors. In 1998, an average dividend of Ksh.2.42 was paid which decreased to Ksh.2.38 in 1999, a reduction of 1.65 percent, which further reduced by 13.9 per cent to Ksh.2.05 in 2000 and a further reduction of 6.83 per cent was realised when an average dividend per share of Ksh.1.91 was paid in 2001. However, an increase of 6.3 per cent was recorded in 2002 with an average dividend payment of Ksh.2.03 and a further significant increase of 54.7 per cent in 2003 at an average dividend payment of Ksh.3.14 but a reduction of 2.5 per cent was eventually realised in 2004 at an average payment per share of Ksh.3.06. Figure 4.9 relates to average dividend payment for NSE included under the AIMS category

Figure 4.9: Average dividends for firms listed under AIMS



Companies listed under this category also reflect a similar pattern to the whole population whereby an initial average dividend payment of Ksh.3.194 was realised in 1998 which reduced by 31.31 per cent with the average dividend payment of Ksh.2.194 paid in 1999 and a further massive reduction of 67.92 per cent to stand at Ksh.0.722 in 2000. The payout however increased by 69.25 per cent in 2001 before a more massive increase in 2002 was recorded of 472.83 per cent with the payment of Ksh.7.00 per share. The Ksh.4.389 paid in 2003 was a reduction of 37.3 per cent but this trend again reversed in 2004 with a 98.04 per cent increase in dividend payment.

4.3 REGRESSION RESULTS AND DISCUSSION

4.3.1 Regression results

A regression analysis was done for the 48 companies which had full information for the period of study, to establish whether or not there was a significant relationship between the current earnings and immediate past dividend payments and current dividends. The regression analysis involved pay out ratio being regressed against two explanatory variables, earnings per share, and immediate past dividends using the regression equation outlined in section 2.4. A summary of the regression results are as indicated in Table 4.1.

Table 4.1: Regression Results

Segment	**Constant**	**Coefficient**		**Adj. R^2**	**F stat.**
		EPS_t	**DIV_{1-t}**		
Agricultural	0.959 (3.50)*	0.99 (4.12)*	0.47 (6.51)*	0.76	17.0
Commercial and services	2.260 (5.81)*	0.09 (0.18)	0.26 (5.38)*	0.24	0.032
Financial and investment	0.972 (16.77)*	0.90 (4.72)*	0.42 (5.81)*	0.78	22.25
Industrial and allied	2.125 (2.93)*	0.50 (1.27)	0.07 (2.90)*	0.27	1.62
AIMS	1.710 (2.20)*	0.92 (4.72)*	0.01 (0.18)	0.81	22.24
All NSE Companies	1.708 (4.77)*	0.81 (3.11)*	0.17 (2.20)*	0.59	9.70

Source: table is derived from the population data compiled for the study

Where DIV_{t-1} is the previous level dividends; EPS is the earnings per share; AIMS is alternative investment market segment. Adj. R^2 is adjusted R squared; F stat. stands for F statistics. t- Statistics are in parenthesis and * indicate that the t- statistics is significant at 5 percent level of significance.

4.3.2 Dividends and earnings per share.

The results indicated that there is a significant relationship between earnings per share and dividends paid out during the period, for all the 48 quoted companies. The coefficient is 0.81 and is statistically significant. This means that when earnings per share change by one shilling, dividends paid change by 81 cents and that the earnings per share explain about 59 percent of the changes in dividends paid out as evidenced by the value of adjusted R squared of 0.59.

The agricultural sector recorded a significant relationship between earnings per share and dividend paid out of 0.99 during the period. This means that for any one shilling change in earnings, dividends paid out will change by 99 cents and that the earnings per share explain about 76 percent of the changes in dividends paid out as indicated by the adjusted R squared of 0.76.

Companies listed under the financial and investment sector had a positive significant relationship between earnings per share and dividends paid out of 0.90, indicating that dividends change by 90 cents for any one shilling change in earnings per share. Adjusted R squared of 0.78 indicates that earnings per share in this sector explain about 78 percent of all changes in dividends paid out.

Industrial and allied sector companies had a 0.50 coefficient indicating that for any one shilling change in earnings per share, dividends paid out changed by 50 cents. Earnings per share in this sector explain only 27 percent of all changes in dividend paid out as indicated by the adjusted R squared of 0.27. Companies under the commercial and services sector had a coefficient of 0.09 indicating that for any one shilling change in earnings per share, dividends change by only 9 cents. Earnings per share explain 24 percent of all changes in dividends paid out in the commercial and services sector as indicated by the adjusted R squared of 0.24.

Companies categorised under AIMS had a coefficient of 0.92 indicating that when earnings per share change by one shilling, dividends paid change by 92 cents. Earnings per share explain 81 percent of the changes in dividends paid out during the period by all companies under the AIMS as indicated by adjusted R squared of 0.81. This confirms that earnings are a critical determinant of the level of dividends paid by Kenyan firms. The positive relationship between earnings and dividends is well documented in the literature for example, Jensen *et al.* (1992), Han *et al.* (1999), and Fama and French (2001, 2002) which have been reviewed in this study.

These results are consistent with the key finding of the pioneering study of Lintner (1956), who stated that net earnings were the predominant element which determined current changes in dividends. In addition, the results are consistent with the work of Aivazian *et al.* (2003) who concluded that

profitability affects dividend payments in emerging markets. Similarly, the significant positive relationship between earnings and dividends is generally consistent with the pecking order theory as espoused by Fama and French (2001, 2002).

4.3.3 Dividend stability

The regression results between current dividends and previous year's dividends are reported in Table 4.1 column of DIV_{t-1}. The results indicate that there is a significant positive relationship between dividends paid in the current year and those paid in the previous year. Dividends paid in the Agricultural sector had a significant positive relationship with a coefficient of 0.47. Results for companies listed under the Industrial and Allied sector indicate a positive relationship with a coefficient of 0.26. The results for companies listed under Commercial and Services sector indicate a significant positive relationship with a coefficient of 0.42 with companies listed under Financial and Investment sector reflecting a significant positive relationship with a coefficient of 0.07. The lowest significant relationship is recorded in the Alternative Investment Market Segment with a coefficient of 0.01. Over all, the regression results of all NSE companies indicate a significant positive relationship with a coefficient of 0.17. This indicates that dividends paid during the period were very unstable and fall below Lintner's target rate of 0.50.

The F-statistics show that the statistically significant explanatory variables were the earnings per share and the previous level dividends. All the NSE companies had a coefficient for the constant term of about 1.00 and above with companies under the industrial and allied sector having the highest at constant coefficient of 2.30 and companies in the agricultural and commercial and services sectors recording on average a coefficient for the constant of 1.00. The results from the regression results reveal a higher coefficient for the constant than the maximum those companies in Lintner's study revealed of 1.00 meaning that NSE companies did not smooth the dividends at all during the period of study. These coefficients for the constants indicate that if the earnings per share for the period and dividends paid in the previous period are equal to zero, the dividends paid out during the period of study will be equal to the value of the respective constant as indicated in Table 4.1 column 2.

In the presence of information asymmetry between a firm's managers and outside investors, the signalling hypothesis predicts that dividends can be used as a mechanism to convey information to the market about the true value of the firm, and only good-quality firms can use such a device. The evidence here, therefore, does provide support for the signalling hypothesis.

From the regression results, it is clear that overall, NSE companies follow the residual dividend policy in which the dividend paid is set equal to the actual earnings minus the amount of retained earnings necessary to finance the company's optimal capital budget as opposed to Lintner's dividend policy

model. This finding is affirmed even when companies are categorised under the various NSE categories of MIMS and also under AIMS. The choice of these companies was based on full availability of information for the period of study for which the applicability of Lintner's model to dividend payment was carried out. The implication of the results is that higher earnings mean higher dividends for NSE companies. Dividends were however found to be less sticky for NSE companies compared to Lintner's assertions that managers in developed countries only change dividends paid if the change was likely to be sustained in the future otherwise they would stick to current dividends.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND POLICY IMPLICATIONS

5.1 SUMMARY

This chapter summarises the main findings of the study, highlights the implications for dividend policy research and identifies areas for further research. This study sought to contribute to the current literature on dividend policy of Kenyan companies by making an analysis of dividend policy in Kenya, an emerging market using the Lintner's dividend policy model. Chapter one provided a general introduction on dividend policy and the motivation for the thesis. It established that the thesis was motivated by the importance of, and the ongoing debate about, dividend policy within corporate finance research, lack of detailed evidence about, and analysis of, the determinants of corporate dividend policy in emerging markets, and the particular scarcity of studies on the Kenyan capital market. The chapter also discussed the objectives and significance of the study.

Chapter two provided an overview and analysis of the evolution of corporate dividend policy. It established that the development of dividend policy has been tied up with the long evolution of the corporate form itself, and the way the corporation has mediated relations with shareholders and capital markets more generally over that time. In its modern form, however, dividend policy theory is closely tied to the work of John Lintner (1956) whose theory was the earliest attempt at explaining dividend theory of firms. In this chapter, it was concluded that, to date, the controversy surrounding the issue of dividend

policy remains unresolved. Despite extensive research on these theories, consensus is still lacking about which theory best explains dividend policy. The chapter also noted the lack of empirical work on emerging stock markets as the motivating factor for this research. In the chapter it was noted that a range of possible factors have been proposed as playing a role in determining dividend policy. Because of this, and as a way of informing the empirical testing to be conducted, the chapter concluded that some understanding of the nature of the Kenyan capital market was important.

Chapter three provided a description of the data used in the study. The sample comprises 48 firms across all sectors of the NSE covering the period from 1998 to 2004. Unlike most dividend studies, especially those that have used Kenyan data, this study included all firms listed during the period of study and tested the applicability of Lintner's dividend policy model. An explanation of the SPSS method used to analyse data collected was also done.

Chapter four presented the results of the empirical testing of the determinants of corporate dividend policy in Kenya. The chapter began by providing some important descriptive statistics on dividend policy and the variables used in the study.

5.2 CONCLUSIONS

The main factor that determines the amount of cash dividends distributed is the earnings of the company in that year as earnings were found to be

positively and significantly related to dividend paid out by the companies quoted on the NSE. Dividend stability was also found to be important. Earnings and cash flows vary over time in line with variations in investment opportunities. Companies should therefore vary their dividends over time, increase them when cash flows are large and need for internal funds is low, and lower them when cash is in short supply relative to investment opportunities. In other words, earnings instability results in instability in dividends. However, many investors rely on dividends to meet their expenses and they would be seriously inconvenienced if the dividend stream were unstable. Furthermore, reducing dividends to make funds available for capital investment could send the incorrect signals to investors who might then push down the stock price since they interpret the dividend reduction to mean that the company's future earning prospects had diminished. Thus maximising its stock price requires a company to balance its internal needs for funds against the needs and desires of the investors.

Investors therefore prefer stocks that pay more predictable dividends to stocks that pay the same average amount of dividends over the long run but in a more erratic manner. This means that the cost of equity will be minimised and the stock price maximised if a company stabilises its dividends as much as possible. In light of these findings, it is clear that there are significant differences between NSE companies and the developed market corporations' dividend policies especially for companies that are wholly locally owned. This

view is likely to be true for other emerging markets (Glen *et al.* 1995) and international investors should be aware of these differences when making their investment decisions.

5.3 POLICY IMPLICATIONS

Based on the analysis of the theoretical discourse and findings presented in this study, several implications can be drawn about dividend policy research. First, the study demonstrated that much of the existing theoretical literature on dividend policy could be applied to an emerging capital market such as Kenya. The evidence derived from the literature suggests that dividend policy matters in developed markets, such as the UK and US. Managers of companies in emerging markets need to explore ways of applying Lintner's model and other dividend policies in their planning to ensure shareholders wealth is maximised.

For NSE companies, dividend policy was found to be important. This intuition is to some extent, consistent with Lintner's model and also Miller and Modigiliani, including many of the theories on dividend policy. The findings of this study are broadly consistent with other studies of dividend policy in emerging markets. While it is understood that firms in such markets are generally more credit constrained, the finding that dividend policy in emerging capital markets may be less important than in developed markets is a paradox that deserves further research. The results from the replies received from the chairmen and CEOs of fourteen companies interviewed, indicate that other

factors that NSE firms consider include, cash liquidity, market signals/state of the economy, investment, opportunities/capital expenditure commitments, target earnings, majority shareholder decisions (perception) at AGM, nature of dividend (cash or script) and anticipated challenges in years ahead.

5.4 LIMITATIONS OF THE STUDY

Like all other studies on dividend policy, this study has some limitations. The main limitations to be addressed here are related to the case study approach in general and to the data set in particular.

While financial economists agreed that in perfect capital markets, dividend policy should be irrelevant, they conceded that some market imperfections might make dividend policy matter. For example, market imperfections may create clienteles, taxes may make dividend policy matter and there may be information content in dividends. It should be reiterated that Kenya is not considered to be the basis of a general model of an emerging market dividend policy. The results of this thesis are specific to NSE companies and may not apply in all emerging markets, but they do shed light on the generality of the other models of dividend policy.

The reliability and accuracy of data affects the robustness of the results of the present study. All efforts have been made to ensure the accuracy of the data, but this potential data problem was reduced to a minimum. The problem is, however, not limited to Kenya, or even to developing capital markets. It

should be borne in mind however that various companies have different year-ends, which range from March, June, September and December each year. This made comparisons of the different dividends difficult.

Again the ratios were derived from balance sheets and income and expenditure statements. However, some of the ratios included information which differs from company to company based on the items included or excluded from the calculation an example of which is earnings per share; the ratio between profit attributable to shareholders and shares in issue. Profits attributed to shareholders in some cases included extraordinary items and general provisions while in others it did not. Some companies used the weighted average number of shares issued during the year as opposed to shares in issue at one point in time. Taxation was sometimes treated as a charge (which is the norm) or a credit.

5.5 AREAS FOR FURTHER RESEARCH

The present study has examined the applicability of Lintner's dividend policy model by NSE companies. The incentives for further research on other emerging markets come from the contradictory results and the limitations of those studies that currently exist. In the Kenyan context, further research could be conducted to examine whether dividend policy has an influence on firm value. This aspect of dividend policy research has been very important in the theoretical and empirical literature, but was not the focus of the present study.

Also, research needs to be done to test share price reaction around ex-dividend days to make inferences about investor preferences for dividends and capital gains. Furthermore, the signalling hypothesis could be examined by observing the share price reaction to dividend change announcements. Finally, a potential research area in Kenya is to study how investors view dividend policy, and to examine various investors' portfolios and their demographic attributes.

The current study was the first attempt to examine empirically the determinants of dividend policy in Kenya taking into account all companies listed on the NSE. It has also provided the basis for testing the explanatory power of various theories on dividend policy determination for which there was lack of consensus in the theoretical discourse in general leading to mixed results. It has, however, provided a number of insights, which could form the basis of both further researches in Kenya, and comparative research in emerging equity markets.

It is obvious, therefore that apart from the two factors which were chosen by Lintner for study due to the availability of data and computational purposes the other factors listed above should be looked at in detail to help in understating the extent to which they are applicable. The right hand side variables could also be extended to incorporate more of these explanatory variables.

The literature on dividend policy is voluminous, and it remains a core issue of modern corporate finance. In examining this issue therefore, the thesis has helped to reveal much about the nature of corporate finance in Kenya, and potentially opened up wider issues of the role of dividend policy in emerging capital markets like Kenya.

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APPENDICES

APPENDIX I: LIST OF TABLES

Table A 1 Listed companies at the Nairobi stock exchange on 21st February 2003

MAIN INVESTMENT MARKET SEGMENT (MIMS)					
No.	**Company**	**EPS**	**DPS**	**Mkt Cap Sh. (M)**	**% of Total Cap.**
Agricultural					
1.	Unilever Tea	2.83	2.5	3,274.63	2.64
2.	Kakuzi Limited	-1.19	0.00	319.48	0.26
3.	Rea Vipingo	0.41	0.25	300.00	0.24
4.	Sasini Tea & Coffee Ltd	-0.18	0.50	651.86	0.52
Commercial and Allied					
5.	Car & Gen Limited	-0.26	0.00	193.83	0.16
6.	CMC Holdings	6.29	1.00	594.85	0.48
7.	Hutchings Biemer	-18.34	0.00	7.29	O.006
8.	Kenya Airways Limited	1.88	0.60	2,769.69	2.23
9.	Marshalls E.A. Limited	2.03	0.00	73.40	0.06
10.	Nation Media Group Limited	7.20	2.35	4,545.71	3.66
11.	TPS Eastern Africa (Serena) Ltd.	2.15	1.10	850.94	0.68
12.	Uchumi Supermarkets	1.49	1.60	1,740.00	1.40
Finance & Investment					
13.	Barclays Bank Limited	9.63	12.00	20,368.26	16.39
14.	CFC Bank	1.18	0.67	1,500.00	1.21
15.	Diamond Trust	0.51	0.40	993.75	0.80
16.	Housing Finance Company of Kenya	0.19	0.00	782.00	0.63
17.	ICDC Investment Company Ltd.	4.83	2.00	2,089.35	1.68
18.	Jubilee Holdings Limited	2.82	1.75	756.00	0.61
19.	K.C.B. Limited	-9.31	0.00	3,590.40	2.89
20.	National Bank of Kenya Ltd.	1.49	0.00	1,140.00	0.92
21.	National Industrial Credit Ltd.	3.04	1.60	1,998.55	1.61
22.	Pan Africa Holdings Ltd.	-3.17	0.00	612.00	0.49
23.	Standard Chartered Bank Ltd.	8.92	8.25	17,307.04	13.93
Industrial & Allied					
24.	Athi River Mining Limited	0.41	0.30	651.00	0.52
25.	Bamburi Cement Ltd.	1.65	1.00	16,333.20	13.15
26.	British American Tobacco Ltd.	4.67	4.00	6500.00	5.23
27.	BOC (K)	5.40	4.35	956.75	0.77
28.	Carbacid Investments Ltd.	4.93	23.10	438.91	0.35
29.	Crown Berger (K) Ltd.	1.23	0.50	161.78	0.13
30.	Olympia Capital Holdings Ltd.	0.32	0.40	50.00	0.04
31.	E.A. Cables	0.24	0.00	183.26	0.15
32.	E.A. Portland Ltd.	1.37	1.50	1,462.50	1.18
33.	E.A. Breweries Ltd.	21.16	11.50	15,264.27	12.29

34.	Sameer Africa Ltd.	1.04	0.50	2,797.34	2.25
35.	Kenya Oil Ltd.	43.80	9.50	1,310.35	1.05
36.	Mumias Sugar Company	0.13	0.10	2,116.50	1.70
37.	Kenya Power & Lighting Co. Ltd.	-23.75	0.00	1,899.07	1.53
38.	Total Kenya Ltd.	-2.23	0.00	4982.18	4.01
39.	Unga Group Ltd.	-1.07	0.00	4,982.18	4.01
ALTERNATIVE INVESTMENT MARKET SEGMENT (AIMS)					
40.	A. Baumann	-12.52	0.00	21.12	0.02
41.	City Trust Ltd.	1.28	2.00	74.99	0.06
42.	Eaagads Ltd.	0.48	0.50	128.23	0.10
43.	Express Kenya Ltd.	-6.55	0.00	34.08	0.03
44.	Kapchorua Tea Company	-4.08	0.50	535.94	0.43
45.	Kenya Orchads	-19.20	0.00	41.34	0.03
46.	Limuru Tea Company	3.46	3.00	236.40	0.19
47.	Standard Group Limited	4.90	0.00	586.20	0.47
48.	Williamson Tea	-3.93	0.50	551.65	0.44
TOTAL				124,249.26	

Source: Nairobi Stock Exchange. NB. .EPS- Earnings per Share, DPS- Dividend per Share, Mkt – Market and Cap.- Capitalization.

Table A 2: Descriptive Statistics on Dividend Policy By Sector (1998-2004)

Sector	Cash dividends	Payout ratio	Dividend yield
Agricultural			
Mean	1.771	57.009	4.308
Standard Deviation	2.149	104.761	3.816
No. Of Observations	28	28	28
Commercial and services			
Mean	1.262	33.450	4.988
Standard Deviation	1.275	32.071	4.264
No. Of Observations	56	56	56
Financial and investment			
Mean	2.616	40.722	5.739
Standard Deviation	3.547	32.818	4.657
No. Of Observations	77	77	77
Industrial and allied			
Mean	3.592	63.595	8.028
Standard Deviation	4.374	71.171	8.533
No. Of Observations	112	112	112
AIMS			
Mean	7.103	51.518	4.202
Standard Deviation	13.443	80.192	4.761
No. Of Observations	63	63	63
All			

Mean	2.663	49.968	6.116
Standard Deviation	6.033	67.193	6.340
No. Of Observations	336	336	336

Source: (NSE 2005)

Table A 3: Dividend and Earnings compared

	2004		2003		2002		2001		2000		1999		1998	
	D/S	E/S	D/S	E/S	D/S	E/S	D/S	E/S	D/S	E/S	D/S	E/S	D/S	E/S
1	8.00	7.39	6.00	1.27	2.50	2.54	2.00	4.57	6.00	9.19	4.00	4.40	4.00	4.70
2	1.00	4.27	0.00	-0.60	0.00	0.39	0.00	-2.31	0.40	-1.44	2.00	1.87	2.75	5.11
3	0.80	2.14	0.40	0.05	0.25	0.41	0.00	0.07	0.00	-0.57	0	-0.11	0	0.73
4	2.50	20.29	0.00	-1.77	0.50	-0.18	1.00	0.40	2.00	2.91	0.5	0.32	3.00	3.20
5	0.67	1.64	0.67	2.72	0	0.33	0	-0.26	0	-0.19	0	0.66	0	-1.52
6	1.00	5.42	1.00	7.29	1.00	6.29	0.75	3.58	0.75	5.05	0.75	6.61	0.50	6.39
7	-	4.66	-	-18.53										
8	0.75	2.82	0.50	0.87	0.60	1.88	1.25	2.94	1.25	6.03	-	2.61	1	2.85
9	0	1.55	0	1.53	-	2.03	-	-21.45	-	-7.24	-	-14.67	1	2.61
10	6.00	11.99	5.00	11.27	2.50	7.55	1.60	4.80	1.75	5.70	1.75	7.01	1.65	9.16
11	1.10	3.37	1.10	0.65	1.10	2.74	1.10	2.50	1.10	2.15	1.00	2.05	1.00	1.48
12	0.00	-11.65	0.00	-3.28	0.50	0.83	1.60	1.49	3.00	5.33	3.05	4.07	3.35	5.21
13	14.00	18.1	14.00	16.5	9.00	9.6	14.00	16.00	10.00	11.2	10.00	14.6	11.00	19.4
14	0.84	3.01	0.84	2.49	0.67	1.45	0.67	1.18	0.67	1.61	0.67	1.58	0.67	2.39
15	0.70	1.65	0.70	1.40	0.60	0.95	0.40	0.51	0.60	2.06	0.80	1.31	0.80	2.60
16	0	0.52	0	0.45	0	0.49	0	-1.62	0.38	0.45	0.5	0.61	1.5	2.48
17	3.00	4.39	2.20	2.89	2.00	4.48	2.00	3.35	3.00	5.92	2.5	7.17	3	5.30
18	2.50	7.68	2.25	5.91	1.75	4.57	1.75	3.37	1.75	2.17	1.75	2.62	1.75	4
19	2.00	3.94	1.00	3.25	0.00	-20.06	0.00	1.31	0.00	-4.14	0	-13.86	6.0	10.04
20	0.00	1.91	0.00	2.02	-	0.99	-	1.49	-	-11.03	-	-12.14	-	-14
21	2.40	3.17	2.25	2.94	2.00	2.78	1.60	3.12	1.80	3.79	1.80	3.65	1.00	4.71
22	1.00	1.95	0	-0.49	-	-0.33	-	3.41	-	-1.36	0.75	1.28	1.75	5.65
23	6.50	6.74	8.50	11.28	8.25	8.92	8.25	9.07	11.00	8.80	7.40	10.54	5.00	8.67
24	0	1.26	0.50	1.04	0.40	0.62	0.20	0.40	0	0.40	0	0.27	0	0.10
25	6.12	4.73	2.80	2.94	3.50	3.38	1.12	2.01	0.75	0.80	1.00	1.74	0.75	1.57
26	16.50	12.10	12.50	11.40	9.00	8.23	7.90	6.04	7.90	5.83	10.50	16.50	7.50	14.98
27	4.50	8.20	4.35	7.82	4.35	5.40	3.55	3.84	3.55	3.83	3.55	5.75	3.49	7.81
28	4.00	7.99	23.10	7.81	2.30	4.93	2.75	3.97	2.75	9.77	5.00	11.50	2.20	8.57
29	1.50	2.74	1.50	2.57	0.50	1.08	0.50	0.90	2.00	2.13	2.00	2.13	1.00	1.05
30	-	-	-	-	-	-	-	-	-	-	-	-	-	-
31	3.50	6.11	1.00	0.46	0.50	-0.29	1.10	0.79	1.10	1.50	4.50	1.08	2.00	3.14
32	1.75	-2.99	1.75	2.51	1.50	1.37	1.00	8.18	0.00	-4.66	-	-9.76	1	4.17
33	18.00	35.05	15.00	13.76	11.50	21.28	9.00	14.88	7.50	12.91	7.00	11.49	6.00	2.27
34	1.00	0.99	0.50	0.56	1.00	0.83	1.00	1.20	1.00	1.05	1.00	1.40	1.50	2.20
35	2.00	8.32	10.50	46.50	9.50	43.80	7.50	37.21	6.00	15.15	7.50	29.32	6.00	23.67
36	1.10	1.55	0.00	-0.42	0.10	0.13	0.71	0.95	-	-	-	-	-	-
37	0	5.79	0	-38.56	0	-23.75	0	-36.36	2	-40.33	8.00	16.52	8.00	27.76

38	2.50	3.34	2.50	3.10	1.70	2.31	0.00	-2.23	0.00	3.69	3.40	9.85	3.00	5.73
39	0.00	-1.62	0.00	-0.43	0.00	-1.07	0.00	-2.20	0.00	-9.81	0.00	-4.45	1.20	-13.84
40	-	-.2.75	-	-0.63	-	-12.52	1.00	-0.67	1.00	1.12	1.25	3.3	0.50	0.97
41	6.25	2.64	2.25	1.66	2.00	1.28	2.00	2.23	2.00	2.68	2.00	3.44	2.00	11.81
42	0.00	-0.18	0.00	-0.53	0.50	0.48	0.50	0.12	-	-1.33	1.25	1.14	4.75	7.58
43	0	0.14	0	-14.20	-	-11.67	-	-6.55	-	-1.24	-	-2.79	1.70	2.77
44	3.75	9.98	3.75	8.90	0.50	-3.54	2.50	1.60	2.50	3.80	2.50	3.94	7.5	19.06
45	0	-1.24	0	-0.89	-	0.07	-	0.00	-	-0.02	0.03	-0.23	0.28	-17.69
45	15.00	16.10	10.00	13.41	3.00	3.40	0.00	-4.97	55.00	59.12	30.00	46.51	60.00	103.81
47	0	1.19	0	-0.76	0	-0.94	0	4.90	0	-7.33	-	-9.41	-	0.43
48	3.75	9.18	3.75	7.35	0.5	-3.07	5.00	15.56	2.5	8.93	2.50	6.70	1.50	31.79
	145.98	**235.57**	**142.16**	**125.48**	**85.57**	**80.39**	**85.30**	**89.32**	**143.00**	**124.19**	**132.20**	**178.12**	**172.59**	**340.87**

Table A 4: Dividends and Earnings per Share for all NSE companies

Year	Average dividends per share Ksh.	Average earnings per share Ksh.	% of DPS over EPS
1998	3.60	7.10	51.7
1999	2.75	3.71	74.1
2000	2.98	2.58	115.5
2001	1.78	1.86	95.7
2002	1.78	1.67	106.60
2003	2.96	2.61	113.40
2004	3.04	4.91	61.90

Table A 5: Dividends and Earnings per Share for all NSE companies under Agricultural category

Year	Average dividends per share Ksh.	Average earnings per share Ksh.	% of DPS over EPS
1998	2.4375	3.435	70.96
1999	1.625	1.62	100.31
2000	2.1	2.8075	74.80
2001	0.75	0.6825	109.9
2002	0.8125	0.79	102.85
2003	1.600	(0.263)	(608.37)
2004	3.075	8.523	36.08

Table A 6: Dividends and Earnings per Share for all NSE companies under Commercial and Allied category

Year	Average dividends per share Ksh.	Average earnings per share Ksh.	% of DPS over EPS
1998	0.9375	3.2725	28.65
1999	0.81875	1.0425	78.54
2000	0.98125	2.10375	46.64
2001	0.7875	(0.8)	(98.44)
2002	0.7125	2.70625	26.33

2003	1.03375	0.315	328.17
2004	1.19	2.475	48.08

Table A 7: Dividends and Earnings per Share for all NSE companies under Finance and Investment category

Year	Average dividends per share Ksh.	Average earnings per share Ksh.	% of DPS over EPS
1998	2.952	4.658	63.375
1999	2.379	1.578	150.76
2000	2.655	1.77	150
2001	2.606	3.745	69.59
2002	2.206	1.258	175.36
2003	2.885	4.422	65.24
2004	2.995	4.824	62.09

Table A 8: Dividends and Earnings per Share for all NSE companies under Industrial and Allied category

Year	Average dividends per share Ksh.	Average earnings per share Ksh.	% of DPS over EPS
1998	2.7275	5.574	48.93
1999	3.3406	5.834	57.26
2000	2.1594	0.14125	1528.78
2001	2.271	2.74875	82.62
2002	2.866	4.2094	68.09
2003	4.75	3.8163	124.47
2004	3.904	6.05	64.53

Table A 9: Dividends and Earnings per Share for all NSE companies under Alternative Investment Market Segment

Year	Average dividends per share Ksh.	Average earnings per share Ksh.	% of DPS over EPS
1998	3.194	3.896	81.98
1999	2.194	1.590	137.99
2000	0.722	(2.946)	(24.51)
2001	1.222	1.358	89.99
2002	7.000	7.3033	95.85
2003	4.392	5.844	75.15
2004	8.692	17.837	48.73

Table A 10: NSE Companies' Dividend patterns for 1998 to 2004

	2004		2003		2002		2001		2000		1999		1998	
	D	%Δ	D	%Δ	D	%Δ	D	%Δ	D	%Δ	D	%Δ	D	%Δ
1.	8.00	33.3	6.00	140	2.50	25	2.00	-66.67	6.00	50	4.00	-	4.00	-
2.	1.00	1.00	0.00	0	0.00	0	0.00	-100	0.40	-80	2.00	-27.3	2.75	-
3.	0.80	100	0.40	60	0.25		0.00	-	0.00	-	0	-	0	-
4.	2.50	0.00	0.00	1.00	-50	-50	1.00	-50	2.00	300	0.50	-83.3	3.00	-
5.	0.67	-	0.67		0	-	0	-	0	-	0	-	0	-
6.	1.00	-	1.00	-	1.00	33.3	0.75	-	0.75	-	0.75	50	0.50	-
7.	-	-	-	-	-	-	-	-	-	-	-	-	-	-
8.	0.75	25	0.50	-16.67	0.60	-52	1.25	-	1.25		-	-100	1	-
9.	0	-	-	-	-	-	-	-	-	-	-	-100	1	-
10.	6.00	20	5.00	100	2.50	56.25	1.60	-8.57	1.75	-	1.75	10	1.65	-
11.	1.10	-	1.10	-	1.10	-	1.10	-	1.10	10	1.00	-	1.00	-
12.	0.00		0.00		0.50	-68.75	1.60	-46.67	3.00	-1.64	3.05	-8.96	3.35	-
13.	14.00	-	14.00	55.6	9.00	-35.71	14.00	40	10.00	-	10.00	-9.1	11.00	-
14.	0.84	-	0.84	25.4	0.67	-	0.67	-	0.67	-	0.67	-	0.67	-
15.	0.70	-	0.70	16.67	0.60	50	0.40	-33.3	0.60	-25	0.80	-	0.8	-
16.	0	0	0	0	0	0	0	-100	0.38	-24	0.5	-66.67	1.5	-
17.	3.00	36.36	2.20	10	2.00	-	2.00	-33.3	3.00	20	2.5	-16.67	3.0	-
18.	2.50	11.1	2.25	28.57	1.75	-	1.75	-	1.75	-	1.75	-	1.75	-
19.	2.00	100	1.00	-	0.00	-	0.00	-	0.00	-	0		6.0	-

20.	0.00	-	0.00	-	-	-	-	-	-	-	-	-	-	-
21.	2.40	6.67	2.25	12.5	2.00	25	1.60	-11.11	1.80	-	1.80	80	1.00	-
22.	1.00		0	-	-	-	-	-	-		0.75	-57.14	1.75	-
23.	6.50	-23.53	8.50	-	8.25	-	8.25	-25	11.00	48.65	7.4	48	5.00	-
24.	0	-100	0.50	25	0.40	100	0.20		0	-	0	-	0	-
25.	6.12	118.57	2.80	-20	3.50	212.5	1.12	49.33	0.75	-25	1.00	33.3	0.75	-
26.	16.50	32	12.50	38.89	9.00	13.92	7.90	-	7.90	-24.76	10.50	40	7.50	-
27.	4.50	3.45	4.35	-	4.35	22.53	3.55	-	3.55	-	3.55	-1.72	3.49	-
28.	4.00	-82.68	23.10	904.3	2.30	-16.4	2.75	-	2.75	-45	5.00	127.3	2.20	-
29.	1.50	-	1.50	200	0.50	-	0.50	-75	2.00	-	2.00	100	1.00	-
30.	-	-	-	-	-	-	-	-	-	-	-	-	-	-
31.	3.5	250	1.00	100	0.50	-54.5	1.10	-	1.10	-75.56	4.50	125	2.00	-
32.	3.75	114.29	1.75	16.67	1.50	50	1.00		0.00	-	-	-100	1.00	-
33.	18.00	20	15.00	30.43	11.50	27.78	9.00	20	7.50	7.14	7.00	16.67	6.00	-
34.	1.00	100	0.50	-50	1.00	-	1.00	-	1.00	-	1.00	-33.3	1.50	-
35.	2.00	-80.95	10.50	10.50	9.50	26.67	7.50	25	6.00	-20	7.50	25	6.00	-
36.	1.10		0.00	100	0.10	-85.92	0.71		-	-	-	-	-	-
37.	0	-	0.00	-	0.00	-	0	100	2	-75	8.00	-	8.00	-
38.	2.50	-	2.50	47.06	1.70		0.00	-	0.00	-100	3.40	13.33	3.00	-
39.	0.00	-	0.00	-	0.00	-	0.00	-	0.00	-	0.00	100	1.20	-
40.	-	-	-	-	-	-	1.00	-	1.00	-20	1.25	150	0.50	-
41.	6.25	177.78	2.25	12.5	2.00	-	2.00	-	2.00	-	2.00	-	2.00	-
42.	0.00	-	0.00	100	0.50	-	0.50		-	-100	1.25	-73.68	4.75	-

43.	0.00	-	0.00	-	-	-	-	-	-	-	-	100	1.70	-
44.	3.75	-	3.75	650	0.50	-80	2.50	-	2.50	-	2.50	-66.67	7.50	-
45.	0	-	0	-	-	-	-	-	-	-	-	100	0.28	-
46.	15.00	50	10.00	233.3	3.00		0	-100	55.00	83.3	30.00	50	60.00	-
47.	0.00	-	0	-	0	-	0	-	0	-	-	-	-	-
48.	3.75	-	3.75	650	0.5	-90	5.00	100	2.50	-	2.50	66.67	1.50	-
	147.98		**142.16**		**85.57**		**85.3**		**143**		**132.17**		**172.59**	

Where D represents dividend paid during the year per share and %Δ being the percentage change in dividends paid in subsequent year

Table A 11: Average dividends over the period of study for all NSE Companies

Year	Average dividends paid (ksh)	% Change
1998	3.596	-
1999	2.754	(23.41)
2000	2.979	8.17
2001	1.777	(40.35)
2002	1.783	0.03
2003	2.962	66.12
2004	3.083	4.1

Table A 12: Average dividends over the period of study for MIMS

Year	Average dividends paid (ksh)	% Change
1998	2.42	-
1999	2.38	1.65
2000	2.05	(13.87)
2001	1.91	(6.83)
2002	2.03	6.3
2003	3.14	54.7
2004	3.06	(2.5)

Table A 13: Average dividends over the period of study for AIMS

Year	Average dividends paid (ksh)	% Change
1998	3.194	-
1999	2.194	(31.31)
2000	0.722	(67.92)
2001	1.222	69.25
2002	7.000	472.83
2003	4.389	(37.3)
2004	8.692	98.04

APPENDIX II: QUESTIONNAIRE

RESPONDENT.....

I am a Master of Science (Finance) student at Kenyatta University carrying out research on *"Applicability of Lintner's Dividend Policy by Companies quoted on the Kenya's Nairobi Stock Exchange".*

This is to request you to kindly fill this questionnaire, I wish to assure you that information gathered shall be confidential and shall not be used anywhere but for this research only

1. Is your company's dividend declaration made in line with the Lintner's Dividend Policy Model?

   Yes..... No.....

2. List the factors that you take into account when setting the dividend levels?

   (i).....

   (ii).....

   (iii).....

   (iv).....

   (v).....

3. Does the level of current year's dividend depend on the firm's current year's earnings?

   Yes..... No.....

4. Does the current year's dividend level depend on the dividend level of the previous year?

Yes..... No.....

5. Do you consider stability of dividends as a factor when declaring dividends?

Yes..... No.....

6. Do dividends in the previous year depend on that year's earnings and the dividend in the year before?

Yes..... No.....

7. Are the company's earnings the most important determinant of any dividend change?

Yes..... No.....

Thank you for your co-operation

Sign.....Date.....

Raphael Muigai Ikame