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Determinants of Dividend Policy Decisions of the Listed Banks in Kenya

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Abstract

The primary objective of a firm is to maximize shareholders wealth by making proper financial management decisions among them; financing, investment and distribution of earnings (dividend policy decision). Dividend policy decision includes making decision on the target pay out, dividend growth rate, amount to be paid out from the current earnings and the form of dividends paid out. Corporate managers have to make decisions on the way profits are utilized as this can influence the future performance of the firm as well as its current value. This paper sought to establish the relationship between dividend policy decision (Dependent Variable) and profitability, cash flows and bank size (independent variables) for the 11 listed commercial banks on the Nairobi Securities Exchange (NSE) in Kenya over the period 2011-2015. Audited published annual financial statements were used as the source of secondary data that was collected by averaging out the variables over the 5 years. The data was analyzed using descriptive statistics as well as inferential statistics. Correlation and regression analyses were used to find the degree of relationship between the dependent variable and the independent variables. Using correlation research design, the study established that profitability and cash flows have a positive and significant relationship with the dividend policy decision among the 11 commercial banks listed in NSE while bank size has insignificant effect on the dividend policy among the banks studied.

Keywords

Dividend Policy Decision, Dividend Puzzle, Profitability, Cash Flows, Bank Size

I. Introduction

Dividend policies are designed to suit each firm's requirements necessary to achieve firm specific goals. Dividend policies guide a firm to vary dividend payment from period to period and from year to year depending on the cash flows and the financing requirements [1]. Dividend policies are the regulations and guidelines that firms develop and implement as means of splitting their earnings between distributions to their shareholders and the retained earnings. Dividend policy may affect such aspects as the finance structure, the flow of liquid funds, corporate liquidity, stock prices and investor satisfaction and for this reason it is clearly an important decision in financial management. According to [2], dividend policy has remained a great puzzle that many scholars have tried to solve. In coming up with a dividend policy a firm has to decide what share of their earnings is going to be distributed to its shareholders since shareholders are interested in maximization of their wealth which they receive as dividends. Dividend policy involves the decision to pay out earnings versus retaining them for reinvestment in the firm, [3]. Dividend policy is an important aspect of corporate finance and dividends are major cash outlays for many corporations. In establishing the dividend policies employed by the listed commercial banks in Nairobi Securities Exchange, three questions arise: First, does profitability influence what is to be paid out as dividends or the target pay out? Secondly, do the cash flows determine the dividends payment from year to year? Thirdly, do the dividend pay outs depend on the size of the bank? [4] argue that financial managers cannot avoid taking a view on dividend payout question. If one is involved in the company's dividend decision, there is an interest on how this decision will affect the company's shareholders and if one is concerned with capital investment appraisal, there is need to know whether the firm's cost of capital depends on its dividend policy. For instance, if shareholders prefer companies with high dividend payouts, management would be more reluctant to take on investments financed by retained earnings.

A. Problem Statement

There has been a stream of studies on dividend policy puzzle that indicate that dividend policy is relevant in determining the value of a firm. Earlier studies by [5], [6], [7], [8], [9], [10], [11], [12], [13] and [14] indicate on balance that dividend policy is an active decision variable, and managers believe that dividend decision is important in maximizing shareholders' wealth. Dividend policy debate has remained unresolved for a long time. Scholars such as [15] and [16] argue that dividend policy decision is irrelevant in determining the valu e of a firm. Contemporary financial analysts also feel that consideration of a dividend policy is irrelevant because investors have the ability to create home-made dividends. They can do this by adjusting their personal portfolios to reflect their own preferences. Investors looking for a steady stream of income are more likely to invest in bonds (whose interest payments do not change over time), rather than a dividend paying stock whose value can fluctuate. Since their interest payments from bonds would not change, those who own bonds will not care about a particular company's dividend policy. [5] and [6], however, argue that dividend policy matters. Their studies on balance indicate that a high dividend payout is more important for investors because dividends provide certainty about the company's financial wellbeing and that dividends are also attractive for investors looking to secure current income.

Factors that management considers in arriving at dividend policy decision vary from company to company and from one economy to another, hence the need to find out the factors considered within commercial banks listed on the Nairobi Securities Exchange. Many scholars have come up with theories and models to explain corporate dividend behaviour. For instance, [2] pointed out that dividend policy is like a puzzle in that "the harder we look at the dividends picture, the more it seems like a puzzle, with pieces that just do not fit together." Much empirical research has been done to find the relationship between profitability, firm size, cash flows and dividend payout [17]. Most of these studies tend to focus on developed markets. However, little is known about how a firm's profitability, size and cash flows influence dividend payout policy in the emerging markets. Firms in emerging markets tend to exhibit different dividend behaviour from those of developed markets like the US. This may be a result of the differences in levels of efficiency and institutional arrangements between developed markets and emerging markets. It is, therefore, useful to enhance the level of knowledge on dividend policy decisions from an emerging market perspective [18].

Investor advisors among them brokers and market analysts need to continuously consider the trends of bank performance based on the determinants of dividend policy decision over the years in order to provide timely and quality advice to members of the public in so as to enable them make quality investment decisions. This will correct the existing challenges of share buying and selling by the public which heavily relies on a word of mouth often leading to financial losses among the local investors which sometimes is misleading in making key share trading decisions. Provision of investors' education by capital market regulators and securities exchange will also avail fundamental insights to both the existing and potential investors as well as investment advisors. According to [19] dividends have two important features. First, it is an effective element of corporations' investment. On the one hand, the higher the dividend paid out, the lower will be the corporations' internal resources for performing investment projects, while outsourcing requirement will increase which is an effective element of the stock price. On the other hand, many corporate shareholders demand cash dividends and with this, a manager will try to fulfill the different interests of shareholders so that they could utilize investment profitable opportunities and would pay required cash dividends for some shareholders. From earlier empirical studies a number of factors have been identified which influence the dividend payout ratios of firms and include the following: profitability, risk, cash flow, agency cost and growth. There is need for an in-depth research on determinants of dividend policy decisions. This study sought to fill this knowledge gap in trying to establish the influence profitability, cash flows and bank size have on dividend policy decisions among banks listed at the Nairobi Securities Exchange in Kenya.

B. Objectives of the study

The general objective of this study was to establish the determinants of dividend policy decisions among the listed banks in Kenya.
The specific objectives of the study were;

- To determine whether profitability influence dividend policy decision of the listed banks in Kenya.
- To find out whether cash flows influence dividend policy decision of the listed banks in Kenya.
- To establish whether a bank's size influence its dividend policy decision for the listed banks in Kenya.

C. Hypotheses

- Profitability has no influence on dividend policy decision of the listed banks in Kenya.
- Cash flows have no influence on dividend policy decision of the listed banks in Kenya.
- Bank size has no influence on dividend policy decision of the listed banks in Kenya.

D. Justification of the Study

Dividend policy decision is of interest to bankmanagers given that deciding on the amount of earnings to pay out as dividends is one of the major financial decisions that a firm's managers have to make as they pursue wealth maximization for the shareholders. Managers have to decide whether to pay dividend or not and if they decide to pay dividend for a particular year, they are further faced with the question of how much they should pay for that year. The study will also educate investors and management on useful considerations underpinning the dividend policy decisions framework in Kenya and the factors considered while making dividend policy decisions. As owners of a firm, shareholders would benefit from the study as it would help them understand the dividend payout decisions adopted by their respective banks. The study contributes to the existing knowledge and would act as a reference point for future research.

E. Scope of the Study

The study focused on banks listed on the Nairobi Securities Exchange and operating in Kenya over the five year period 2011-2015 with emphasis on factors determining their dividend policy decisions specifically; profitability, cash flows and bank size. The population of the study was more restrictive as it comprised of only banks listed on the Nairobi Securities Exchange which were eleven (11) in total. The banks are also highly regulated and the study may have yielded different results if the population contained both regulated and unregulated study units.

II. Literature Review

Dividend policy debate has remained unresolved for a long time. Scholars such as [15] and [16] argue that dividend policy is irrelevant in determining the value of a firm. Other scholars for example; [5] and [6] aver that dividend policy matters. In an attempt to resolve this dividend puzzle, various theories have been advanced. The theories view dividend policy as either relevant or irrelevant in determining the value of a firm. This paper reviews four theories that are relevant to the study.

In their Dividend Irrelevance theory, Miller and Modigliani [15] argue that if a firm's investment policy (and hence its cash flows) does not change, the value of the firm will not change with dividend policy decision. If personal taxes are ignored or in situations where personal taxes are equal to capital gain taxes, investors would be indifferent to receive either dividends or capital gains. Given that a firm's investment policy is fixed, [15] show that dividend policy is irrelevant. However, if capital market imperfections for instance taxes are introduced or if dividend announcements signal new information, then dividend policy will be relevant. There are important factors in dividend policy decision that are against high dividend payout and factors that are in favour of high dividend payout and those that may affect dividend payout either way. One of the insights from the Miller-Modigliani analysis concerns the firm's dividend policy, which involves setting the level of dividends for each period. Given that investment is chosen to maximize firm value, the firm's payout in each period must be equal to the difference between earnings and investment. The level of dividend in each period can take any value. It follows from this argument that dividend policy does not affect a firm's value at all. It is only investment policy that matters. However, [15] theory has heavily been criticized for being unrealistic in the real world where there are a lot of imperfections. [20] observes that in real life, financial markets do not satisfy the strict conditions of perfect capital markets and when market imperfections come into play dividend irrelevancy theory cannot hold.

The bird in the hand theory by [21] holds that dividends now are more certain than capital gains later. The theory proposes that a relationship exists between firm value and dividend payout. It states that dividends are more valuable than capital gains given that dividends are less risky than capital gains since they are more

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certain. [22] suggests that there are three possible reasons as to why investors would buy a certain stock. First, to get dividends and earnings, secondly; to get dividends only and lastly to get earnings only. [22] finds that payment of cash now is preferred. Investors run less risk if the firm pays them cash now rather than reinvesting it in the hope of paying higher dividends in the future. [23] argues that investors prefer to receive dividends today than in future because current dividends are more certain than future capital gains that might be realized from investing retained earnings in growth opportunities. According to the bird in the hand theory high dividend payout ratios lead to maximization of value of the firm as higher current dividend lead to a reduction in uncertainty about firm's future cash flows, reduced cost of capital due to a high payout ratio, and therefore an increase in share value.

The free cash flow theory of [24] point to a positive relationship between current dividend payout and future earnings growth. That is, low dividends due to low growth could be as a result of lower quality investments and also less ideal proposals even though there is some excess free cash to use particularly for firms with limited growth opportunities. By paying dividends, managers will have to raise more funds from the market to finance investments and this may put them under more scrutiny and thus reduce conflicts of interest. [25] argue that investments of lower quality lead to low future earnings growth but due to diminished conflicts of interest this may result into better future earnings growth and better quality projects for investing. This therefore means that paying dividends reduces free cash flow which in turn improves firm's performance [24].

Constant growth dividend model by [22] assumes that investors are rational and risk averse and that they prefer certain return to uncertain returns. They therefore put a premium to the certain returns and discount uncertain returns. Investors would prefer higher price for the stocks which earn them current dividend income and would discount those stocks which either postpone dividend or reduce the current income. In the real world, however, dividend growth often changes from year to year for a variety of reasons; companies may choose to conserve cash during industry downturn or spent cash to make an acquisition. In either case, the dividend growth rate would likely be at least temporarily affected. According to this model, firms are expected to pay out a gradually growing dividend stream since in many cases firms will not increase their dividends in the short run for fear of not being able to maintain the new level of payouts into the future. [26] argues that dividends will be expected to grow at some rates into the indefinite future and thus, investors would prefer current dividends and avoid risks. Retained earnings involve risks and so the investor discounts the future dividends. This risk will also affect the stock value of the firm, [1]. [22] avers that investors believe that future capital gains are more uncertain than dividends, thus having low present value than dividends. However, the limitation of such a dividend policy is that investors do not like reductions in dividends payments; companies need enough cash to pay out dividends and good investment opportunities reduce possibilities to pay out dividend. Constant growth dividend policy has the following implications; first; it creates certainty and it is therefore preferable to the low income shareholders who have high preference for dividend instead of capital gains and the certainty reduces the shareholders' required rate of return. Secondly; when the firm has high earnings, more income will be retained for future financing needs and lastly, the model presupposes that investors prefer current certain dividends to future uncertain dividends.

A. Empirical Review

When bank managers make dividend decisions they face constraints such as liquidity problems, tax considerations and profitability. Dividends do provide a stable income for shareholders who are able to plan their daily expenses on it, and on the other hand investors and stock buyers will pay attention to corporations' annual stock dividend news and reports. Investors will give due attention to the fact that dividend represents corporation's power, while profit payment will cause shareholders to have confidence in their yield on capital. [27] studies 84 listed companies in Australia and finds that the main factors that determine dividend payout decision are profitability, liquidity and stability of earnings. [28] support these findings. In their recent study, [25] find a positive and significant relationship between dividend payout and the performance of listed firms in Kenya. [29] study financial factors influencing cash dividend policy for a sample of U.S. manufacturing companies. Some of the factors considered in their study include; profitability ratios, liquidity ratios, expansion and investment, investors perceptions, companies risk, and companies' size. Using a regression model their findings confirm that profitability, liquidity, risks and company size on average are critical determinants of cash dividend decision.

B. Banks Size

[29] study the financial factors influencing cash dividend policy for U.S. manufacturing companies and consider factors including profitability ratios, liquidity ratios, expansion and investment, investors' perceptions, companies risk, and companies' size. Their study uses regression model. The research findings confirm that profitability, liquidity, risk and company size on average, are important determinants of cash dividend decision. [30] investigates the dividend payment behaviour in Malaysia for 248 listed corporations in the period from 1993 to 2000. These corporations include; building industries, consumer products, industrial products, agricultural products, real estate and service enterprises. The results show that dividend payment ratios among different industries are different in Malaysia. Agricultural and consumer product corporations had the highest level of dividend payment, because they had limited investment opportunities and more working capital.

The study also finds that profitability; firms' size and investment opportunities affect dividend payments and suggest that larger and more profitable companies pay higher dividends. However, firms with profitable opportunities pay fewer dividends. Thus one of the basic characteristic of dividend payers is the firm's size – firms that pay dividends tend to be larger than firms that do not.

[31] surveys dividend payout ratio of Indian companies and reports that firms maintain a constant dividend per share and have fluctuating payout ratio depending on their profits and conclude that expected future earnings growth is fastest when current payout ratios are high and slowest when payout ratios are low. [32] studies determinants of dividend payout policy in Bangladesh. The study finds negative relationship between earnings per share and dividend payout, a positive effect of net income on dividend payout and revenue (sales) to have no effect on dividend payout. The study concludes that dividend payout of commercial banks in Bangladesh is dependent more on net income than on any other variable. [33] analyzes selected factors affecting dividend

policy of listed firms at the Nairobi Securities Exchange. The study examines if and how current earnings, dividend yield, and firm size affect dividend payout of firms listed at the Nairobi Securities Exchange (NSE). The study reports that only earnings have a significant influence on dividend payout for the listed firms at the NSE. Firm size and previous dividend paid are insignificant variables.

According to [34], dividends are usually paid out of earnings, but a firm requires cash to pay out dividends. Profits made may not necessarily be available in cash as the cash flow generated may have been used to finance increased stocks, debtors or fixed assets, or may be required to meet maturing debt obligations. [35] find that firms generally adopt a residual dividend payment policy where dividends are paid only if more cash is available than is needed to support the optimal capital budget. [36] finds that dividend payment policy is positively correlated with cash flows. [37], studies the level of corporate dividend payout to stockholders to find out if optimal dividend policy exists for firms quoted at the Nairobi Securities Exchange (NSE). The research findings suggest that the average corporate dividend payout to stockholders for 40% of the firms is low and stable and that 28% of the firms quoted pay out high and stable dividends.

The study further identifies factors that determine dividend policy to be: tax, growth potential of firms, earnings and liquidity. [38] examines the effect of liquidity on dividend payment for UAE firms. The study finds liquidity to have an insignificant influence on the dividend payout decision.

III. Research Methodology

The study used correlational research design which involves assessment of relationships among variables. Correlation is a measure that indicates how one variable, factor or attribute varies in relation to another. The variation could be negative or positive. This design built a profile about the factors that influence dividend policy decisions of the listed banks listed in Kenya. The target population for this study was all the 11 commercial banks quoted on the Nairobi Securities Exchange. All the 11 banks fitted within the parameters of the study as the banks had been in operations throughout the period of study 2011 to 2015. The study used secondary data collected from annual financial returns of the 11 commercial banks quoted in the Nairobi Securities Exchange as filed with the Central Bank of Kenya over the period 2011 to 2015. The data collected was quantitative in nature and related to the factors considered in arriving at dividend policy, particularly; profitability, cash flows and bank size. Variable averages were calculated over this five year period. Averaging over the five years reduced the measurement error due to random year-to-year fluctuations in the variables.

The study used inferential statistics to carry out the analysis. Correlation analysis was also used for purposes of measuring the degree and direction of the relationship between the variables. Data was analyzed using Statistical Package for Social Sciences (SPSS) version 21. A simple linear regression model was used to determine the relative importance of each explanatory variable in influencing the dividend policy as represented by dividend pay-out ratio. Inferential statistics were used for purposes of coming up with the various analysis that were relevant for interpretation of the results for purposes of fulfilling the objectives of the study. The study documented a number of determinants and their indicators that may in theory affect a firm's dividend policy. The theories do not however specify the functional forms describing how the attributes relate to the indicators and the dividend payout ratios. The model requires that these relations be linear. In the measurement model, unobservable firmspecific attributes were measured by relating them to observable variables, e.g., accounting data. The measurement model was specified as follows;

Dividend Payout = $\beta 0$+ $\beta 1$Profitability + $\beta 2$Cashflows + $\beta 3$Bank Size + error term

The above equation states that, although the firm- specific attributes that supposedly determine dividend policy decision cannot be observed, a number of other variables denoted as indicators, are observable. The dividend payout (dependent variable representing dividend policy decision) can then be expressed as a linear function of one or more of the unobservable attributes and a random measurement error. The independent variables will be measured using the following indicators as proxies; profit before tax was aken as measure for level of profitability (PBT), Total cash held as at the balance sheet date was taken as indicator for measure of available cash (TCH), and Total fixed assets as at the balance sheet date is an indicator for measuring size of the bank (TFA).

IV. Data Analysis and Findings

To arrive at the findings in this study, inferential statistics among them R square, r values and p values were generated as presented in the tables 1, 2 and 3 below. R Values equal to 0.769 and 0.831 for profitability and cash flows implies that the two variables have strong and positive correlation with dividend policy decisions. Given bank size has a p value > 0.000, the study concludes there is no significant relationship between bank size and dividend policy decision among listed commercial banks in Kenya.

A further review of the R Square values indicates that profitability and cash flows explain the variations of the dividend policy decision among the listed commercial banks. Profitability explains up to 59.1% of the variations in dividend policy decision in commercial banks listed at the NSE with cash flows explaining 69.1% of the variations. From the research findings, cash flows explain the variations in dividend policy decision (10% more) implying that even when firms may be reporting growing profits, free cash flows remain a fundamental determinant. of dividends payout.

Table 1: Model Fitness Test

Inferential Statistic Measure	Variable		
	Profitability	Cash Flows	Bank Size
R Value	0.769	0.831	0.568
R Square	0.591	0.691	0.322
R Square Adj.	0.589	0.657	0.318
P Value	0.000	0.000	0.520

A review of the regression coefficients in Table 2 reveals that from Table 1, cash flows and profitability have positive and significant correlation with the dividend policy decision. Profitability, cash flow and dividend policy decision move in the same direction implying that an increase in profitability and cash flow leads to a growth in dividend payout. For every 1 unit increase in profitability, dividend policy decision grows by 1.029 units while a 1 unit increase in cash flows leads to a 1.861 units increase in

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dividend policy decision. Given the p values are less than zero i.e. (P Value <0), we conclude that the relationship is significant. Reviewing the bank size, given the p value equal to 0.210 > 0.05 significance level, the study concluded that bank size has no significant influence on the dividend policy decision among the listed commercial banks in Kenya. Overall model is significant given p value is equal to zero as shown in Table 2.

Table 2: Anova Test

	Sum of Squares	Deg.	Mean Squares	F	Sig.
Regression	56568.74	1	56568.74	5.065	0.000
Residual	10862.73	3	3620.91		
Total	67431.479	4			

On the overall model, Table 3 reveals that the variables profitability, cash flow and bank size have positive and strong 0.876 correlation with bank dividend policy decision that is significant (P value<0.000). R square equal to 0.767 indicates that the variables when combined together explains up to 76.7% of the variations in bank dividend policy decision.

Table 3: Model Fitness Test

Indicator	Inferential Statistic Measure
R Value	0.876
R Square	0.767
R Square Adj.	0.766
P Value	0.000

Table 4: Regression Coefficients

Inferential Statistic Measure	Variable		
	Profitability	Cash Flows	Bank Size
Beta	1.029	1.861	0.865
Std. Errors	0.336	0.531	0.486
t	3.0625	3.504	1.779
Sig.	0.000	0.000	0.210

Given the significant findings from the regression model analysis in table 1.4, the model of the study therefore becomes;
Dividend Payout = 1.029 Profitability + 1.861 Cash flows

V. Conclusions and Recommendations

From the study results, profitability and cash flows were reported to have positive and significant influence on the dividend policy decisions while bank size doesn't influence the dividend policy decisions among the listed commercial banks in Kenya. Investor advisors among them brokers and market analysts need to continuously consider the trends of bank performance based on the cash flow and profitability over the years to establish the performance trends of the banks in order to provide timely and quality advice to customers given profitability and cash flows to a great extent have statistical significant influence on the banks' dividend policy decisions. It is also recommended to the management of listed commercial banks to ensure that financial disclosures are timely and accurately available to the public to make quality investment decisions. This will correct the existing challenges of share buying and selling by the public which heavily relies on a word of mouth often leading to financial losses among the local investors which sometimes is misleading in making key share trading decisions. Provision of investors' education by capital market regulators and securities exchange will also provide fundamental insights to both the existing and potential investors as well as investment advisors.

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