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# Relationship Between Dividend Payouts and Firm's value in Kenya

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**Abstract**— the main purpose of this research is to verify the relationship between dividend payout and the firm's value in Kenya.

The literature on dividend policy has produced a large body of theoretical and empirical research, especially following the publication of the dividend irrelevance hypothesis of Miller and Modigliani (1961). No general consensus has yet emerged after several decades of investigation and scholars can often disagree even about the same empirical evidence.

This paper aims at providing the reader with a comprehensive understanding of dividends Policy and dividend payouts; perceived effects on firm's value, by reviewing the main theories and explanations of dividend policy including dividend irrelevance hypothesis of Miller and Modigliani, bird-in-the-hand, tax-preference, clientele effects, signaling, and agency costs hypotheses. The paper also attempts to present the main empirical studies on corporate Dividend policy in Kenyan perspective.

**Index Terms contents:** Dividends, Dividend Policy, and Dividend Policy Theories

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## 1.0 INTRODUCTION

### 1.1 Background of the study

In corporate finance, the finance manager is generally thought to face two operational decisions: the investment (or capital budgeting) and the financing decisions. The capital budgeting decision is concerned with what real assets the firm should acquire while the financing decision is concerned with how these assets should be financed.

A third decision may arise, however, when the firm begins to generate profits. Should the firm distribute all or proportion of earned profits in the form of dividends to the shareholders, or should it be ploughed back into the business? Presumably, in taking any course of action, managers should concentrate on how to maximize the wealth of shareholders for whom the firm is being managed. Managers must not only consider the question of how much of the company's earnings are needed for investment, but also take into consideration the possible effect of their decisions on share prices (Bishop et al., 2000).

The term 'dividend policy' refers to "the practice that management follows in making dividend

Payout decisions or, in other words, the size and pattern of cash distributions over time to Shareholders" (Lease et al., 2000, p.29). This issue of dividend policy is one that has engaged managers since the birth of the modern commercial corporation. Surprisingly then dividend policy remains one of the most contested issues in finance.

The study of dividend policy has captured the attention of finance scholars since the middle of the last century. They have attempted to solve several issues pertaining to dividends and formulate theories and models to explain corporate dividend behaviour. The dividend enigma has not only been an enduring issue in finance, it also remains unresolved.

Almost three decades ago Black (1976) described it as a "puzzle", and since then an enormous amount of research has occurred trying to solve the dividend puzzle.

Allen, Bernardo and Welch (2000, p.2499) summarised the current consensus view when they concluded "Although a number of theories have been put forward in the literature to explain their pervasive presence, dividends remain one of the thorniest puzzles in corporate finance".

The enduring nature and extensive range of the debate about dividend policy has spawned a vast amount of literature that grows by the day. For this reason, a full review of all debates is not feasible.

However, this paper endeavours to give justice to the importance of both the topic of dividend policy, as an area of financial economic research, and also to the literature that has been produced addressing that topic, by reviewing the most important and influential studies in this area and main empirical studies on corporate dividend policy.

## 1.2 Statement of the problem

Despite the numerous studies (Arnott & Asness 2003; Farsio et al 2004 and Nissim & Ziv 2001) that have been done, dividend policy remains an unresolved issue in corporate finance. Corporate management in making capital structure decision of paying out dividends to the shareholders has always faced the dilemma of whether; the payout criterion should be effect on the value of the firm. Several theories have been proposed to explain the reliance of dividend policy and whether it affects firm value, but there has not been a universal agreement, (Stulz, 2000, Pandey, 2003; and DeAngelo et al, 2006). Researchers: Amidu (2007), Lie (2005), Zhou & Ruland (2006) Howattetal. (2009) continue to come up with different findings about the relationship between dividend payout and firm performance as measured by its profitability. The results showed positive and significant relationship between return on assets, return on equity, growth in sales and dividend policy affects firm value. Howatt et al. (2009) al; so concluded that positive changes in dividends are associated with positive future changes in earnings per share. In contrast Lie (2005) argues that there is limited evidence that dividend paying –firms

experience subsequent performance improvements.

A number of studies (Arnott Asness 2003); Farsio et al 2004 and Nissim & Ziv 2001) have been done with regard to divided policy and firm performance and its growth in value especially in developed economies.

Can the findings of those studies (Aivazian et al., 2001 and Al-Haddad, et al 2011) be replicated in emerging economies or infant capital markets? In Kenya few empirical studies have been done to establish the relationship between dividend payout and firm's growth in value. This study therefore comes in to fill the void by establishing whether there is a relationship between dividend payout and growth in value among companies in Kenya.

## 1.3 Objectives of the study

### 1.3.1 General objective

To establish the relationship between dividend payout and firms value in Kenya.

### 1.3.2 Specific objective

1. To determine whether firm's riskiness exposure of its cash flows has bearing to its dividends payout and the firm's performance and its value.
2. To investigate the effect of unreliability of financial data and its relationship with the firm's dividend payout policy
3. To establish whether the macro economic factors play a role in payout of dividends
4. To establish the pattern of dividend payout and its relationship with the firm's value.

## 1.4 Research Hypotheses

This study sought to address the following pertinent research hypotheses;

**HI<sub>1</sub>.** Dividends payouts have a positive effect on total performance of the firm and its value.

**HI<sub>2</sub>.** Asymmetric information of financial data affects firm's value negatively.

**H1<sub>3</sub>**. Macro-economic factors affect the firm's dividend policy.

**H1<sub>4</sub>**. What is the extent of the relationship between dividend payout and firm's value?

### 1.5 Justification of the study

The purpose of this study was to study the relationship between payout of dividends and the firm's value. This study aimed to investigate how corporate financial managers payout dividends to enhance firms value. To clarify issues surrounding Dividend policies and the significance of dividend payout on corporate firm's value and reveal if there are any specific aspects of dividends that benefit firm.

### 1.6 Scope of the study

This study was library research in which in depth theoretical and empirical literature review was done to assess Dividend policies in firms. The analysis was based on previously conducted research from books, published scholarly works, relevant journal articles (Ball, Ray, Philip Brown, Frank J. Finn, and R. R. Officer, 1979, Dividend and the Value of the Firm: Evidence from the Australian Equity Market, *Australian Journal of Management* 4, Baker, H. Kent, E. Theodore Veit, and Gary E. Powell, 2001, Factors Influencing Dividend Policy 13-26.; Decisions of Nasdaq Firms, *The Financial Review* 38, 19-37.) and internet sources.

### 1.7 Limitation of the study

This study presented two major limitations: The data collected for this study was secondary data as documented in books, journals, academic papers, newspaper articles and the internet. Secondly, it is a content analysis and therefore an empirical study will be required to attest to the accuracy of the findings. Third, the empirical study were conducted in European countries thus there is need to

replicate the same in the African states to see if it can yield same results.

### 1.8 Significance of the study

The study provides potential information on understanding the effect of dividend policy payout and its effect on firm's value.

## 2.1 INTRODUCTION

Literature review is the revisiting of the other scholar's work related with the area of study in order to establish the benchmark and link to assist the current research in propelling his/her study to a successive conclusion.

Corporate managers realized early 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 a great debate among finance scholars.

The chapter is divided into three sections. The first section gives a definition for dividends and dividends policy. The second section discusses the key theoretical considerations from previous studies to inform the general and specific objectives developed for this study, that is, dividend policy and the firms' performance; extended of their relationship, factors that affect dividend policy and forms of dividend policy used by listed firms. The third section gives a brief description of research methodologies used by previous studies in attaining their objectives.

## 2.2 Dividend Policy Theories

The dividend policy was bound up with the development of the corporate form itself. In the early stages of corporate history, managers realized 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.

Bonds paid a regular and stable interest payment, and corporate managers found that investors preferred shares that performed like bonds (i.e. paid a regular and stable dividend). "Paying consistent dividends remained of paramount importance to managers during the first half of the 19th century" (Frankfurter and Wood, 1997, p.24)

It was seen that the emergence of dividend policy as important to investors was, to some extent, also seen that in the absence of regular and accurate corporate reporting, dividends were often preferred to reinvested earnings, and often even regarded as a better indication of corporate performance than published earnings accounts. However, as financial markets developed and became more efficient, it was thought by some that dividend policy would become increasingly irrelevant to investors.

Why dividend policy should remain so evidently important has been theoretically controversial.

Three main contradictory theories of dividends can be identified. 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 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.

## **2.3 Dividend Irrelevance Hypothesis**

### **2.3.1. The Basic Irrelevance Thesis**

Prior to the publication of Miller and Modigliani's (1961, hereafter M&M) seminal paper on dividend policy, a common belief was that higher dividends increase a firm's value.

This belief was mainly based on the so-called "bird-in-the-hand" argument, discussed in more detail shortly. 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 (cited in Frankfurter et al., 2002, p.202). However, as part of a new wave of finance in the 1960's, M&M demonstrated that under certain assumptions about perfect capital markets, dividend policy would be irrelevant.

Given that in a perfect market dividend policy has no effect on either the price of a firm's stock or its cost of capital, shareholders wealth is not affected by the dividend decision and therefore they would be indifferent between dividends and capital gains. The reason for their indifference is that shareholder wealth is affected by the income generated by the investment decisions a firm makes, not by how it distributes that income.

Therefore, in M&M's world, dividends are irrelevant. M&M 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” (p.414).

In other words, investors calculate the value of companies based on the capitalized value of their future earnings, and this is not affected by whether firms pay dividends or not and how firms set their dividend policies.

M&M go further and suggest that, to an investor, all dividend policies are effectively the same since investors can create “homemade” dividends by adjusting their portfolios in a way that matches their preferences.

M&M based their argument upon idealistic assumptions of a perfect capital market and rational

investors. The assumptions of a perfect capital market necessary for the dividend irrelevancy hypothesis can be summarized 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 (i.e. no agency problem); (and (5) all participants in the market are price takers.

The notion that in perfect capital markets dividend policy should be irrelevant is a logical extension of the neoclassical proposition of perfect competition into financial economics.

Its elegance and simplicity were recognized by M&M. For instance, they observed in their initial paper that, “Like many other propositions in economics, the irrelevance of dividend policy, given investment policy, is ‘obvious, once you think of it” (M&M, 1961, p.414).

The above discussion suggests that the firm’s investment policy is the key determinant of its value and dividend policy is the residual. Operating cash flows depend on investments.

In other words, the firm’s investments in positive net present value (NPV) projects will increase the cash flows from operation, which is the only way to

increase the value of the firm. In summary, given the assumptions of perfect capital markets, the firm’s future cash flow from investment activities is the sole determinant of the value of the firm.

The firm’s payout policy must therefore be independent of its value (Bishop et al., 2000).

## **2.4.0 High Dividends Increase Stock Value (Bird-In-The-Hand Hypothesis)**

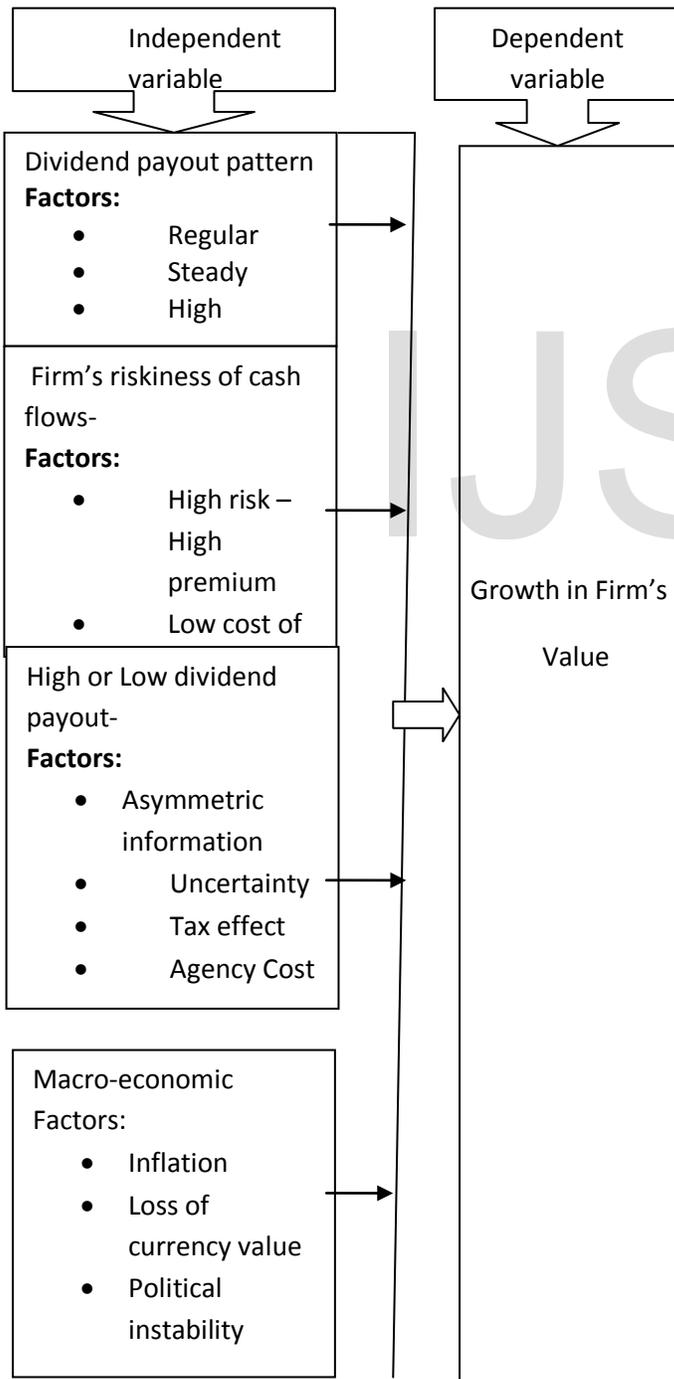
### **2.4.1. The Basic Argument**

One alternative and older view about the effect of dividend policy on a firm’s value is that dividends increase firm value. 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 henceforth BIHH) high dividend payout ratios maximize a firm’s value. Graham and(Dodd, for instance, argued that a dollar of dividends has, on average, four times the impact on stock prices as a dollar of retained earnings (see Diamond, 1967,p.16). Studies that provide support for the BIHH include Gordon and Shapiro (1956) Gordon (1959, 1963), Lintner (1962), and Walter M&M (1961) have criticized the BIHH and argued that the firm’s risk is determined by the riskiness of its operating cash flows, not by the way it distributes its earnings. Consequently, M&M called this argument the bird-in-the-hand fallacy. Further, Bhattacharya (1979) suggested that the reasoning underlying the BIHH is fallacious. Moreover, he suggested that the firm’s risk affects the level of dividend not the other way around. That is, the riskiness of a firm’s cash flow influences its dividend payments, but increases in dividends will not reduce the risk of the firm. The notion that firms facing greater uncertainty of future cash flow

(risk) tend to adopt lower payout ratios seems to be theoretically plausible (see, for example, Friend and Puckett, 1964). 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 (see also Jensen, Solberg, and Zorn, 1992).

### 2.5 Conceptual framework



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### 2.6.0 Low Dividends Increase Stock Value (Tax-Effect Hypothesis)

#### 2.6.1 The Basic Argument

The M&M assumptions of a perfect capital market exclude any possible tax effect. 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.

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.

The tax-effect hypothesis suggests that low dividend payout ratios lower the cost of capital and increase the stock price.

In other words low dividend payout ratios contribute to maximizing the firm's value.

This argument is based on the assumption that dividends are taxed at higher rates than capital gains. In addition, dividends are taxed immediately, while taxes on capital gains are deferred until the stock is actually sold.

These tax advantages of capital gains over dividends tend to predispose retain most of investors, who have favourable tax treatment on capital gains, to prefer companies that their earnings rather than pay them out as dividends,

and are willing to pay a premium for low-payout companies. Therefore, a low dividend payout ratio will lower the cost of equity and increases the stock price. Note that, this prediction is almost the exact opposite of the BIHH, and of course challenges the strict form of the DIH.

In many countries a higher tax rate is applied to dividends as compared to capital gains taxes. Therefore, investors in high tax brackets might require higher pre-tax risk-adjusted returns to hold stocks with higher dividend yield. This relationship between pre-tax returns on stocks and dividend yields is the basis of a posited tax-effect hypothesis.

Brennan (1970) developed an after-tax version of the capital asset pricing model (CAPM) to test the relationship between tax risk-adjusted returns and dividend yield. Brennan's model maintains that a stock's pre-tax returns should be positively and linearly related to its dividend yield and to its systematic risk.

Higher pre-tax risk adjusted returns are associated with higher dividend yield stocks to compensate investors for the tax disadvantages of these returns.

This suggests that, *ceteris paribus*, a stock with higher dividend yield will sell at lower prices because of the disadvantage of higher taxes associated with dividend income.

## **2.7.0 Clientele Effects of Dividends Hypothesis**

### **2.7.1 The Basic Argument**

In their seminal paper M&M (1961) noted that the pre-existing dividend clientele effect hypothesis (hereafter DCH) 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.

M&M argued that these imperfections might cause investors to choose securities that reduce these costs. M&M termed the tendency of investors to be attracted to a certain type of dividend-paying stocks a "dividend clientele effect"<sup>12</sup>. Nonetheless, M&M maintained that even though the clientele effect might change a firm's dividend policy to attract certain clienteles, in a perfect market each clientele is "as good as another"; hence the firm valuation is not affected; that is, dividend policy remains irrelevant.

In practice, investors often face different tax treatments for dividend income and capital gains, and incur costs when they trade securities in the form of transaction costs and

Inconvenience (changing portfolios). For these reasons and based on different investors' situations, taxes and may create investor clienteles, such as tax minimization induced clientele and transaction cost transaction costs minimization induced clientele respectively.

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<sup>14</sup>. Allen et al. conclude with the proposition that, "...these clientele effects are the very reason for the presence of dividends..."(2000, p. 2531).

### 2.7.2 Tax-Induced Clientele-Effects

Since most of the investors are interested in *after-tax* returns, the different tax treatment of dividends and capital gains might influence their preference for dividends versus capital gains. This is the essence of the tax-induced DCH. For example, *ceteris paribus*, investors in low tax brackets who rely on regular and steady income will tend to be attracted to firms that pay high and stable dividends.

In addition, some corporate or institutional investors tend to be attracted to high-dividend stocks (see, for example, Han, Lee and Suk, 1999, Dhaliwal, Erickson and Trezevant, 1999, and Short, Zhang and Keasey, 2002) On the other hand; investors in relatively high tax brackets might find it advantageous to being equal. Some clienteles, however, are indifferent between dividends and capital gains such as tax exempt and tax deferred entities (see Elton and Gruber, 1970, among others).

### 2.7.3 Transaction Cost-Induced Clientele

Another argument of the DCH is based on the proposition that dividend policy may influence different clienteles to shift their portfolio allocation, resulting in transaction costs. For example, (Such as retirees, income-oriented investors, and so on) who rely on dividend income for their small

investors consumption needs, might be attracted to (and even may pay a premium for) high and stable-dividend stocks, because the transaction costs associated with selling stocks might be significant for such investors.

On the other hand, some investors (e.g. wealthy investors), who do not rely on their share portfolios to satisfy their liquidity needs, prefer low payouts to avoid the transaction costs associated with reinvesting the proceeds of dividends, which they actually do not need for their current consumption (Bishop et al., 2000).

Note that for both groups of investors, transforming one financial asset to another, transaction costs need to be incurred. That is, M&M's notion of homemade dividends

is not costless and the existence of such costs may make dividend policy not irrelevant.

The other effect of transaction costs on dividend policy is related to the fact that firms may need to restore cash paid out as dividends with new equity issues (or debt financing) to *take advantage of new investment opportunities*.

If issuing costs are significant, then firms are most likely to rely on retained earnings rather than external financing.

This is reinforced by the empirical fact that retained earnings constitute the major source of firm finance not just in developing but also even in developed capital markets.

Fazzari, Hubbard and Petersen (1988) reported that, over the period of 1970 to 1984, the retained earnings amounted to 71.1 percent of the total source of funds of US manufacturing firms with an average retention ratio of 60 percent.

In these cases, there should be a negative relationship between transaction costs and dividend payments.

Firms can reduce or avoid such expenses by lowering dividend payments or not paying them at all. However, in practice, many firms continue to

pay cash dividends, while at the same time issuing new equity and debt, suggesting that other factors may also be at work in influencing dividend policy. An important implication of the DCH is that, by changing its dividend policy, a firm's ownership structure might also change.

Another implication of clientele theory is that firms should attempt to adopt a stable dividend policy to avoid inducing shareholders to modify their portfolios, entailing transaction costs (see for example Schulz, 1992).

The theoretical plausibility of dividend clientele hypothesis is relatively ambiguous. On the one hand, transaction costs and taxes may influence demands for dividends. But the mere existence of transaction costs or differential taxes is not on its own a rationale for a general of the determination of dividend policy.

Not surprisingly, therefore, most of the literature that has theoretical explanation tested the DCH has produced mixed results.

## **2.8.0. The Information Content of Dividends (Signalling) Hypothesis**

### **2.8.1. The Basic Argument**

Another hypothesis for why M&M's DIH is inadequate as an explanation of financial market practice is the existence of asymmetric information between insiders (managers and directors) and outsiders (shareholders). M&M 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).

In this way dividends came to provide a useful tool for managers in which to convey their private information to the market because investors used visible (or actual) cash flows to equity as a way of valuing a firm.

Many academics and financial practitioners also suggest that dividends might have implicit information about a firm's prospects. Even M&M (1961) suggest that when markets are imperfect share prices may respond to changes in dividends. 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.

However, M&M dismissed the possibility that this occurred by suggesting that the empirical evidence does not support the notion that investors prefer dividends to retained earnings.

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.

However, for this hypothesis to hold, managers should firstly possess private information about a firm's prospects, and have incentives to convey this information to the market.

Secondly, a signal should be true; that is, a firm with poor future prospects should not be able to mimic and send false signals to the market by

increasing dividend payments. Thus the market must be able to rely on the signal to differentiate among firms. If these conditions are fulfilled, the market should react favourable to the announcements of dividend increase and unfavourably otherwise (Ang, 1987, and Koch and Shenoy, 1999).

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, Maqueira and Megginson (1998, p.44) observed that, "managers do not initiate dividends until they believe those dividends can be sustained by future earnings".

It is worth noting that, although management can use changes in dividends as a signal to convey information to the market, in some cases dividend changes may be an ambiguous signal. This can be illustrated through the case of FPL Group, the parent company of Florida Power & Light

Company (see, Soter, Brigham and Evanson, 1996). On May 9, 1994 FPL announced a 32 percent cut in its quarterly dividends. The market responded negatively to the announcement and FPL's stock price dropped by about 20 percent, because the market perceived it as a signal of bad future prospects.

However, the FPL board had in fact decided to retain funds for new investments to improve the Company's future performance. After realizing the reason for the dividend reduction, financial analysts concluded that the action was not a signal of financial distress. Thereafter, FPL's stock price recovered.

The market was initially mistaken but the case is a good example of the possible (and sometimes contradictory) signalling effects of dividend announcements.

Although the information content of dividends (signalling) has been noted earlier, it was not modeled until the late 1970s and early 1980s.

The most cited dividend signalling models can be found in Bhattacharya (1979), John and Williams (1985), and Miller and Rock (1985) 22. In general, these models are based on several assumptions. There is asymmetric information between corporate insiders (managers) and outside investors (shareholders).

Dividends contain information about the firm's current and future cash flows, and managers have incentives to convey their private information to the market through dividend payments in order to close the information gap.

The announcement of a dividend increase will be taken as good news and the market will bid up share prices accordingly.

Similarly, an announcement that a dividend will be cut suggests unfavourable prospects and will tend to see the firm's share price fall<sup>23</sup>. Dividends are considered a credible signalling device because of the dissipative costs involved. For example, in Bhattacharya's (1979) model the cost of signalling is the transaction cost associated with

external financing. In Miller and Rock's (1985) model the dissipative cost is the distortion in the optimal investment decision, whereas in John and William's (1985) model the dissipative signalling cost is the tax penalty on dividends relative to capital gains. Therefore, only good-quality firms (undervalued) can use dividends to signal their prospects, and poor-quality firms cannot mimic by sending a false signal to the market because of the costs involved in that action.

A major criticism addressed to these models is why firms choose dividends to signal their prospects while other less costly means are available such as share repurchases (see, for example, Allen and Michaely, 2002).

## **2.9.0 Agency Costs and Free Cash Flow Hypothesis of Dividend Policy**

### **2.9.1 The Basic Argument**

One of the assumptions of M&M's perfect capital market is that there are no conflicts of interests between managers and shareholders. In practice, however, this assumption is questionable where the owners of the firm are distinct from its management. In these cases managers are always imperfect agents of shareholders (principals). This is because managers' interests are not necessarily the same as shareholders' interests, and they might conduct actions that are costly to shareholders, such as consuming excessive perquisites or over-investing in managerially rewarding but unprofitable activities.

Shareholders therefore incur (agency) costs associated with monitoring managers' behaviour, and these agency costs are an implicit cost resulting from the potential conflict of interest among shareholders and corporate managers.

The payment of dividends might serve to align the interests and mitigate the agency problems between managers and shareholders, by reducing the discretionary funds available to managers

(Rozeff, 1982, Easterbrook, 1984, Jensen, 1986, and Alli, Khan and Ramirez, 1993).

Another source of the agency costs problem that may be influenced by dividend policy is the potential conflict between shareholders and bondholders. Shareholders are considered as the agents of bondholders' funds. In this case, excess dividend payments to shareholders may be taken as shareholders expropriating wealth from bondholders (Jensen and Meckling, 1976).

Shareholders have limited liability and they can access the company's cash flow before bondholders; consequently, bondholders prefer to put constraints on dividend payments to secure their claims. Conversely, for the same reasons, shareholders prefer to have large dividend payments (Ang, 1987).

In an often-cited article, Easterbrook (1984) argued that dividends could be used to reduce the free cash flow in the hands of managers. In addition, Eastbrook hypothesised that dividend payments will oblige managers to approach the capital market to raise funds. In this case investment professionals such as bankers and financial analysts will also be able to monitor managers' behaviour.

Therefore, shareholders are able to monitor managers at lower cost (and minimize any collective action problems).

This suggests that dividend payments increase management scrutiny by outsiders and reduce the chances for managers to act in their own self-interest. However, Easterbrook suggested that increasing dividend payments might force managers to take undesirable actions like increasing firm leverage, which may sometimes increase the riskiness of the firm.

Healy and Palepu (1988) reported a positive association between unexpected dividend changes and subsequent unexpected earnings.

Along the lines of Easterbrook's argument, Jensen (1986) provided another explanation for paying dividends based on the agency costs hypothesis. Jensen contended that firms with excess (free) cash flow give managers more flexibility for using the funds in a way that benefit themselves but not shareholders' best interests.

He argued that managers have incentives to enlarge the size of their firms beyond the optimal size to amplify the resources under their control and moreover to increase their compensation, which is often related to firm size (see also Gaver and Gaver, 1993). Thus, if a firm has a substantial surplus of cash the overinvestment problem will be more pronounced, and managers may undertake negative NPV projects. Extracting the excess funds of free cash flow that management controls can reduce this overinvestment problem. Increasing dividend payouts may help to mitigate the free cash flow under managers' control, thereby preventing them from investing in negative NPV or poor projects.

As a result, paying more dividends will reduce the agency costs between managers and shareholders. Moreover, Jensen has pointed out that debt might play a similar role to dividends in reducing the agency costs of free cash flow by reducing the funds under management control.

As noted earlier, M&M suggested that a firm's dividend policy is independent of its investment Policy. By contrast, the free cash flow hypothesis implies that dividend policy and the investment decision are interrelated. It is argued that an increase in dividend payments will reduce the "overinvestment" problem, which will have a positive impact on the market value of the firm, ceteris paribus (Lang and Litzenberger, 1989).

However, accepting the notion that increasing dividends will reduce the funds available to managers and force them to be in the market to acquire funds means that shareholders should be

willing to tolerate the risk of the firm being more indebted and also accept paying higher Personal tax rates on dividends. In other words, shareholders have to trade off between the costs and benefits of acquiring more dividends.

### 3.1 INTRODUCTION

The chapter discusses the research methods adopted when conducting the study. Why the design was applicable.

### 3.2 Research design

The research design is correlation since it sought to establish the relationship between dividend payout and firms value. The data used in this research was obtained from the annual reports of companies listed in the Nairobi stock exchange for a nine year period that is, from 2002 to 2010. Dividend payout was measured by the actual dividends paid out and firm performance was measured by profit after tax. Regression analysis was carried out to establish the relationship between dividend payout and firm value.

### 3.2 Research Sample

The research team used purposive sampling where the aim was to find data whose experience and context enables them to give informative and knowledgeable insights on the topic of the research.

A few empirical studies on the related topic effects of dividend policy on Corporate Value by esta Black, Fischer, and Myron S. Scholes, 1974, The Effects of Dividend Yield and Dividend Policy on Common Stock Prices and Returns, *Journal of Financial Economics* 1, 1-22 and Bhattacharya, Sudipto, 1979, Imperfect Information, Dividend Policy, and "the Bird in the Hand" Fallacy, *Bell Journal of Economics* 10, 259-270. Bhattacharya, Sudipto, 1979, Imperfect Information, Dividend Policy, and "the Bird in the Hand" Fallacy, *Bell Journal of Economics* 10, 259-270.

**The Empirical Evidence**

The results of the study were presented in tables. Dividend payout was measured using the actual dividends paid out. The company performance was measured by the net profit after tax which indicates profitability. Regression analysis was used in this case to determine the relationship between dividend payout and firm performance. Dividends paid, total assets and revenue were the independent variables while the net profit margin was dependent variable. The following regression model was used to determine the relationship between dividend payout and firm performance; given as under:-

$$NPAT (000) = 24,824 + 0.00130 DIV + 0.00289 Tot Assets (Sh 000) + 0.0101 rev (sh000)$$

Where: NPAT = Net profit after tax in thousands; TotAssets=Total assets in thousands.

Div = Actual dividends paid; Rev =Revenue

**4.0 INTRODUCTION**

Chapter four is about the information collected from the study in various books, journals, news papers, articles, etc. it is the findings of the study, trying to answer questions that relates to the objectives raised in chapter one. From the findings of the empirical study with similar characteristics, [Financial statements (2002-2010 NSE) the following information was evident and supported by a number of other mentioned theories in the discussion and summarized below:

**Table of Regression Analysis Results.**

Predictor	Coef	Se Coef	T	P
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Constant	24828	47620	0.52	0.602
Div	0.00130047	0.00003983	32.65	0.00
Total Assets	0.0028858	0.0007793	3.7	0.000
Rev	0.010066	0.002596	3.88	0.000

S= 740966 R-sq=80.8% R-sq (adj) =80.7%

Source: Financial statements (2002-2010)

The results of the regression analysis showed that upto 80.7% (p value 0.00) of the Net profit after Tax was affected by dividends paid, total assets and revenue .An adjusted R squared of 80.7% from the model showed that the independent variables were strong predictors of the depended Variables. The model is therefore a significant predictor of how dividends paid; total assets and revenue affected the performance of some listed companies in Kenya. This is in conformity with similar studies carried out in developed economies, whose findings are given below:

**4.1 Relationship between Paying out dividend and Firm's Value**

Miller and Modigliani's (1961, hereafter M&M) seminal paper on dividend policy, a common belief was that higher dividends increase a firm's value. This belief was mainly based on the so-called "bird-in-the-hand". 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 (cited in Frankfurter et al., 2002, p.202).

However, as part of a new wave of finance in the 1960's, M&M demonstrated that under certain assumptions about perfect capital markets, dividend policy would be irrelevant.

Given that in a perfect market dividend policy has no effect on either the price of a firm's stock or its cost of capital, shareholders wealth is not affected by the dividend decision and therefore they would be indifferent between dividends and capital gains. M&M further and suggest that, to an investor, all

dividend policies are effectively the same since investors can create “homemade” dividends by adjusting their portfolios in a way that matches their preferences.

M&M based their argument upon idealistic assumptions of a perfect capital market and rational investors. The assumptions of a perfect capital market necessary for the dividend irrelevancy hypothesis can be summarized 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 (i.e. no agency problem); and (5) all participants in the market are price takers.

#### 4.2 Relationship between dividend irrelevance theorem and firms value

Ball et al. (1979, p.14), empirical tests of M&M’s “dividend irrelevance theorem” have proven difficult to design and to conduct”. Recall that M&M built their conclusions on a certain set of assumptions of perfect capital markets. Relaxing one or more of these assumptions has formed the basis for most of theoretical and empirical studies. Black and Scholes (1974) examined the relationship between dividend yield and stock returns in order to identify the effect of dividend policy.

They constructed 25 portfolios of common stocks listed on the New York Stock Exchange (NYSE), extending the capital asset pricing model (CAPM) to test the long run estimate of dividend yield effects. Black and Scholes 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 ( $\gamma_1$ ) is not significantly different from zero either for the entire period (1936-1966) or for any of shorter sub periods.

That is to say, the expected return either on high or low yield stocks is the same. Black and Scholes, therefore, concluded that, “we are unable to show that differences in yield lead to differences in stock prices” (p.18). Stated another way, in their study neither high-yield nor low-yield payout policy of firms seemed to influence stock prices.

Black and Scholes’s conclusion lent important empirical support to M&M’s dividend irrelevance argument. Other studies by leading financial economic researchers such as Miller and Scholes (1978, 1982), Hess (1981) Miller (1986), and more recently, Bernstein (1996) provided evidence in support of the dividend irrelevance hypothesis (hereafter DIH).

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 M&M’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/retail). Based on 318 responses, they found that respondents strongly agreed that dividend policy affects common stock prices. Partington (1985) found that Australian senior managers viewed dividend payments as a way to satisfy shareholders and support the share price.

In a more recent study, Baker and Powell (1999) surveyed 603 CFOs of US firms listed on the NYSE, and observed that 90 percent of respondents believed that dividend policy affects a firm’s value as well as its cost of capital.

Siddiqi (1995) and Casey and Dickens (2000) have provided evidence inconsistent with DIH.

Despite all the empirical work testing the DIH, the impact of dividend policy on the value of a firm remains unresolved.

### **4.3 Bird-In-The-Hand Hypothesis and The Firm's Value**

From the empirical literature study, Graham and Dodd, for instance, argued that a dollar of dividends has, on average, four times the impact on stock prices as a dollar of retained earnings (see Diamond, 1967, p.16). Studies that provide support for the BIHH, include Gordon and Shapiro (1956) Gordon (1959, 1963), Lintner (1962), and Walter (1963).

M&M (1961) have criticized the BIHH and argued that the firm's risk is determined by the riskiness of its operating cash flows, not by the way it distributes its earnings.

Consequently, M&M called this argument the bird-in-the-hand fallacy.

Further, Bhattacharya (1979) suggested that the reasoning underlying the BIHH is fallacious. Moreover, he suggested that the firm's risk affects the level of dividend not the other way around. Dividend payments, but increases in dividends will not reduce the risk of the firm.

That is, the riskiness of a firm's cash flow influences its dividend payments, but increases in dividends will not reduce the risk of the firm.

### **4.4 Relationship between Dividend payout and Firm's Value**

From the empirical evidence, Gordon (1956) found that dividends have greater influence on share price than retained earnings. In addition, he 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. Similarly, Gordon (1963) argued that higher dividend payouts decrease the cost of equity or the required rate of return on equity. Using British data for the period between 1949 and 1957, Fisher (1961) reached a similar finding that dividends have greater impact on share prices than retained earnings.

### **4.5 Relationship between Dividend payout and Firm's Value**

More recently, Baker, Powell and Veit (2002a) surveyed managers of NASDAQ firms to assess their view about dividend policy issues including the BIHH. Their questionnaire contains one statement about the BIHH, stating "investors generally prefer cash dividends today to uncertain future price appreciation". Based on 186 responses, only 17.2 percent agree with the statement, 28 percent no opinion, and 54.9 percent disagree. Therefore, they conclude, "...this finding does not provide support for the bird-in-the-hand explanation for why companies pay dividends" (p.278).

Empirical support for the BIHH as an explanation for paying dividends is generally very limited, and the argument has been challenged especially by M&M (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.

### **4.6 Relationship between Low Dividends Increase Stock Value (Tax-Effect Hypothesis)**

From the empirical review, Black and Scholes (1974) tested Brennan's model and found no evidence of a tax effect.

Recall from Section 0 that the coefficient of dividend impact in Black and Scholes's model was found to be insignificant. Therefore, the concluded that low or high-dividend yield stocks do not affect the returns of stocks either before or after taxes.

Litzenberger and Ramaswamy (1979) strongly challenged the results of Black and Scholes and criticized their methods; especially their definition of dividend yield Litzenberger and Ramaswamy 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 show that the coefficient on dividend yield variable ( $\gamma_2$ ) is positive and highly significant, under OLS, GLS, and MLE10.

Therefore, they provided empirical support for Brennan's (1970) model. Litzenberger and Ramaswamy (1979, p.190) 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  $\gamma_2$  (0.236) obtained by Litzenberger and Ramaswamy is consistent in magnitude with that reported by Black and Scholes (1974). The implication of Litzenberger and Ramaswamy's findings is that firms could increase their share prices by reducing dividends.

Miller and Scholes (1982) challenged Litzenberger and Ramaswamy's conclusion, and criticized 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. Miller and Scholes argued that the positive yield-return relation was caused by information bias.

The reason for this argument is that Litzenberger and Ramaswamy 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.

#### 4.7 Relationship between Agency Costs and Free Cash Flow Hypothesis of Dividend Policy

From the empirical review, Rozeff *et al.* (1982) studied the issue of agency costs hypothesis as an explanation of corporate dividend policy and was

one of the first to formally model agency costs using a large sample of US firms.

Rozeff suggested that the benefits of dividends in reducing agency costs are smaller for companies with lower dispersion of ownership and/or higher insider ownership. He found the agency costs variables significant and consistent with their hypothesised sign. Rozeff's (1982) results provide empirical support for the agency costs hypothesis.

Dempsey and Laber (1992) updated the work of Rozeff using an extended period over the years 1981-1987 and strongly supported Rozeff's findings (see also Lloyd, Jahera and Page, 1985).

Jensen, Solberg and Zorn (1992) applied three-stage least squares to examine the determinants of cross-sectional differences in insider ownership, debt, and dividend policy. They used a sample of 565 firms for the year 1982 and 632 firms for the year 1987. From the dividend equation, the insider ownership variable was found statistically significant with a negative sign.

This implies that there is a negative relationship between insider holdings and dividend payments. The result of Jensen *et al.* is consistent with Rozeff (1982) and therefore with the agency costs hypothesis.

#### 4.8 Conclusion

The literature on dividend policy has produced a large body of theoretical and empirical research, especially following the publication of the dividend irrelevance hypothesis of M&M (1961). No general consensus has yet emerged after several decades of investigation, and scholars can often disagree even about the same empirical evidence. In perfect capital markets, M&M asserted that the value of a firm is independent of its dividend policy. However, various market imperfections exist (taxes, transaction costs, information asymmetry, agency problems, etc) and 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.

#### 4.9 Recommendations

Although numerous studies have examined various issues of dividend policy, they have produced mixed and inconclusive results. Perhaps the famous statement of Fisher Black about dividend policy "the harder we look at the dividends picture, the more it seems like a puzzle, with pieces that just do not fit together" (Black, 1976, p. 5) is still valid.

There is a need therefore further academic research to shed more light on this concept of Dividend policy and its relationship on firm's value.

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