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THE RELATIONSHIP BETWEEN PROFITABILITY AND DIVIDEND PAYOUT: A STUDY OF LISTED COMPANIES IN KENYA

Teresiah Muthoni Chumari

Department of Finance & Accounting, School of Business, University of Nairobi [UoN], Kenya

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ABSTRACT

The objective of this study was to examine the relationship between profitability and dividend payout. The research study adopted a descriptive research design. To achieve the objective thirty financial statements of listed companies was analyzed. The research also advanced the work of previous scholars and academicians. Based on this research the results showed that there was a positive relationship between dividend payout and profitability. The study recommended that firm managers should plan on the proportion of profits that should be retained.

Key Words: *Divided Payout, Profitability*

INTRODUCTION

Successful companies earn income. According to Welch (2009) this income can be kept in the company (spent or re-invested), pay off liabilities, pay dividends or used to repurchase shares. Issues that arise if a company decides to distribute its income to shareholders include the proportion to which such income would be distributed to shareholders; whether the distribution should be as cash dividends or cash buying back some shares and how stable the distribution should be. Much controversy surrounds dividend policy. Black (1976) observed that the harder they look at the dividends picture the more it seems like a puzzle with pieces that just do not fit together. Since then the amount of theoretical and empirical research on dividend policy has increased dramatically.

Ross, Westerfield & Jaffe (1999) defined dividend payout as amount of cash paid to shareholders expressed as a percentage of earnings per share. Welch (2009) defined dividend payout ratio as the ratio of dividends to net income. The dividend payout ratio measures what percent of earnings is paid out as dividends. Holding everything

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else equal, the same firm that pays out more of its earnings today would pay out less in the future. If it had retained earnings, it would have earned more cash for payout later.

Amidu & Abor (2006) summarized significant variables measuring firm's financial performance such as profitability and cash flow. Brealy, Myers & Marcus (2007) defines profit as sales less all expenses that are associated with the sales. Ross, Westerfield & Jaffe (1999) defines cash flow as cash generated by the firm and paid to creditors and shareholders. It can be classified as from operations, cash flow from investments and financing activities. Sale growth is a measure of increase in sales volume over a period time.

Research Problem

A positively significant relationship is expected to exist between dividend payout and profitability. The above relationship between dividend payout and profitability has been studied empirically in Kenya. Njuguna (2006) conducted a study on determinants of dividend payout. He found out that successful companies accorded key importance to profitability and cash flow. The nature of the industry, the size of the company and the number of years the company had been in operation were found not to significantly affect company dividend policy in relation to payout. The theoretically expected relationship between dividend payout and profitability measuring firm performance are very clear but the empirical findings showed mixed results. The study sought to test the relationship between dividend payout and financial performance of firms listed on the Nairobi Securities Exchange as at 31st December 2013. This study tested the relationship between dividend payout profitability.

Research Objective

To test the relationship between profitability and dividend payout of stocks listed in the Nairobi Securities Exchange.

LITERATURE REVIEW

Dividend Irrelevance Theory of Modigliani and Miller

Modigliani and Miller (MM) in 1961 founded the dividend irrelevance theory. This is the theory that a firm's dividend policy has no effect in either its value or its cost of capital. MM argued that a firm's value is determined only by its basic earning power and its business risk. They argued that the value of the firm depends only on the income produced by its assets, not how this income is split between dividends and retained earnings.

MM noted that any shareholder can in theory construct his/her own dividend policy that is if a firm does not pay dividends, shareholder who wants a 5% dividend can 'create' it by selling 5% of his/her own stock. Conversely if a company pays higher dividend than the investor desires, the investor can use the unwanted dividends to buy additional shares of the company's stock. If investors could buy and sell shares and thus create their own dividend policy without incurring cost, then the firm's dividend policy would be truly irrelevant.

Factors Influencing Financial Performance

According to Bashir, Abbas, Manzoor&Akram (2013), there are eight factors affecting firm's financial performance namely leverage, size, growth, risk, tax, tangibility, liquidity and non-debt tax shield. According to Jensen (1986) debt financing raises the pressure on managers to perform, because it reduces the moral hazard behavior by reducing free cash-flow at the disposal of managers. Consequently, the firms with the higher leverage should be the most incited to improve their performance. However, according to Jensen &Meckling (1976) on the other side, a higher leverage means higher agency costs because of the diverging interests between shareholders and debt holders: this moral hazard problem suggests that leverage may be negatively linked to performance.

According to Grossman & Hart (1982), the leverage can work as disciplinary device that controls the management from wasting their firm's resources. William (1987) found that decision for high leverage by the management decreases the conflict between management and shareholders. The study conducted by Krishnan & Moyer (1997) found a negative and significant relationship between leverage and firm's performance while other factors affecting firm's performance positively includes size, growth, tax and risk.

Empirical Review

Nissim & Ziv (2001) investigated the relationship between dividend changes and future profitability, measured in terms of either future earnings or future abnormal earnings. They sourced data from the Centre for Research in Security Prices (CRSP) between the start of the second quarter of fiscal 1963 and the end of first quarter of fiscal 1998. They used regression analysis with earnings being the dependent variable and dividend being the independent variable. They found out that dividend changes provided information about the level of profitability in subsequent years, incremental to market and accounting data. They also found out that dividend changes were positively related to earnings changes in each of the two years after the dividend change.

Njuguna (2006) conducted a study on determinants of dividend payout on listed companies in Kenya over seven year period (1999 to 2005). Primary data was collected by administering questionnaires and the response was presented by use of tables, graphs and charts. Descriptive statistics in form of means and standard deviation were further used to discuss the findings. He found out that successful companies accorded key importance to four factors namely profitability, cash flow, financing requirements and availability of profitable investments. The nature of the industry, the size of the company and the number of years the company had been in operation were found not to significantly affect company dividend policy in relation to payout. However, companies in the finance and investment industry rated certain factors such as inflation and the economic growth rate higher as determinants of payout policy, as compared to companies in other industries.

Yegon, Cheruiyot, J., Sang & Cheruiyot, P.(2014) studied the effects of dividend policy on firm's financial performance of listed manufacturing firms in Kenya. Their objective was to ascertain the relationship between dividend policy and firm's profitability, investment and earnings per share. Data for the study was extracted from the annual reports and accounts of nine quoted manufacturing companies in Kenya for a ten year period that is 2003 to 2013.The data was subjected to regression analysis where dividend policy was the dependent variable and the independent variables included profitability, investment and earnings per share. They used e-view software for analysis. They found a significant positive relationship between dividend policies of organizations and firm's profitability, a significant positive relationship between dividend policy and investments and a significant positive relationship between dividend policy and earnings per share. They recommended that organizations should have a good and robust dividend policy in place because it will enhance their profitability and attract investments to the organizations.

METHODOLOGY

The proposed study used descriptive research design. The population of the proposed study consisted of the thirty stocks listed in the NSE as at 31st December 2013. Financial statements were analyzed for a period of five years that is from year 2008 to year 2012 for thirty listed companies (Excluding banks and insurance companies). Variables were calculated as follows;

Profitability (PROF) = Earnings before interest and taxes divided by total assets for firm I.

$$\textbf{PROF} = \frac{\text{Earnings before interest and taxes}}{\text{Total assets}}$$

RESULTS

Linear regression was done to try and bring out clearly the relationship between dividend payout and the following financial performance variable of profitability, that is, whether it has a positive or negative relationship to the dividend payout.

The standard co-efficient for profitability performance variable for the 5 years showed that it was significantly related to the dependent variable, that is, dividend payout.

From the regression analysis results, it was revealed that a unit increase in profitability would lead to an increase in the dividend payout of the company while a unit decrease in profitability would lead to an decrease in the dividend payout of the company, This showed that dividend payout has a positive relationship with profitability.

CONCLUSION AND RECOMMENDATIONS

The study revealed that the financial performance variable namely profitability was positively and statistically significant in influencing the dividend payout ratio. The study found that there is a positive relationship between dividend payout and profitability. This can be explained by the fact that a good liquidity position increases a firm's ability to pay dividend. Generally firms with good and stable profits are able to pay dividend easily compared with firms with unstable profitable position.

Basing on the results from the study, the study recommended that all financial Institutions should plan on setting a corporate dividend policy in place that is efficient and reliable since this will affect their financial performance either positively or negatively. The study further recommended that cash flow/ liquidity ratios remain manageable under the financial period to boost their gains for positive financial performance outcomes.

Managers should take keen interest on profitability since it has a significant effect/impact on dividend payout.

This study can be repeated with a wider population of study by including the Banks and Insurance Companies across all countries in East Africa, African and European Continents. This study further recommended that the study can be done on different economies to make the findings relevant to all various countries with different economic levels.

Suggestions for Further Study

There is need for further studies to carry out similar study for a longer time period. This study only took into consideration of five years from 2008 – 2012. A study of 10 – 15 years would be recommended.

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