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ABSTRACT

This study examined the relationship that exists between profitability, cash flow and dividend payout. The research study adopted a descriptive research design. To achieve these 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 results also showed a positive relationship between dividend payout and cash flow. The study recommended that firm managers should plan on the proportion of profits that should be retained versus the portion that should be distributed as dividends to stockholders. Managers are also rated on financial performance hence the findings of this study would be of great benefit to them and would also act as a guide to setting reliable corporate dividend policies.

Key Words: *Divided Payout, Firms Profitability*

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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 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.

According to Amidu&Abor (2006) a positive relationship is expected to exist between profitability, cash flow and dividend payout. This is explained by the fact that highly profitable firms tend to declare and pay high dividend. Thus they would have exhibited high payout ratios. A firm's profitability is considered an important factor in influencing dividend payment. The liquidity or cash flow position is an important determinant of the dividend payout ratio. A good liquidity position increases a firm's ability to pay dividend. Generally firms with good and stable cash flows are able to pay dividend easily compared with firms with unstable cash flow position.

In Kenya, dealing in shares and stocks started in the 1920's when the country was still a British colony. The market was not formal as there was no existence of any rules and regulations to govern stock broking activities. Trading took place on a 'gentleman's agreement.' Standard commissions were charged, with clients being obligated to honor their contractual commitments of making good delivery, and settling relevant costs. At that time, stock broking was a sideline business conducted by accountants, auctioneers, estate agents and lawyers who met to exchange prices over a cup of coffee. Because these firms were engaged in other areas of specialization, the need for association did not arise.

In 1954 the Nairobi Stock Exchange was then constituted as a voluntary association of stockbrokers registered under the Societies Act. Since Africans and Asians were not permitted to trade in a security, until after the attainment of independence in 1963, the business of dealing in shares was confined to the resident of European community.

Research Problem

A positively significant relationship is expected to exist between dividend payout and profitability and cash flow.

The above relationship between dividend payout and its determinants 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.

Bitok, Tenai, Cheruiyot, Maru&Kipsat (2010) conducted a study in order to determine the level of corporate payout to stockholders and to establish if the optimal dividend policy. They found out that the aggregate dividend payout ratio for the Kenyan market was 44.14%. Mbuki (2010) studied factors that determine dividend payout ratio among Savings and Credit Cooperative Societies (SACCO) in Kenya. The study established that SACCO's profitability, growth opportunity, cash flow and size variables positively influenced dividend payout ratio, while risk variable negatively influenced dividend payout ratio.

Kibet (2012) conducted a study on the effect of liquidity on dividend payout. He found a positive relationship between dividend payout and leverage, profitability, corporate tax, sales growth, industry and earnings per share. He also found a negative association between dividends pay out and cash flow.

Yegon, Cheruiyot,J., Sang &Cheruiyot, P. (2014) studied the effects of dividend policy on firm's financial performance. 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.

The theoretically expected relationship between dividend payout and variables measuring firm performance are very clear but the empirical finds 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. The proposed study tested the relationship between dividend payout and two variables measuring financial performance namely profitability and cash flow.

Research Objective

To test the relationship between profitability, cash flow 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.

Information Content/ Signaling Theory

Bhattacharya (1979), John and Williams (1985) and Miller and Rock (1985) developed this theory. It states that investors regard dividend changes as signals of management's earnings forecast. It states that payment of dividends convey information to the market with respect to the management expectations of future earnings. A change in dividend up or down is viewed as a signal that management expects future earnings to change in the same direction thus an increase in dividends is a positive signal that should lead to a rise in share prices and vice versa.

However, MM argued differently. They noted the fact that companies are reluctant to reduce dividends and hence do not raise dividends unless they anticipate higher earnings in the future. They argued that a higher than expected dividend increase is a signal that the firm's management is forecasting poor earnings in the future. Therefore, investor's reactions to changes in dividend policy do not necessarily mean that investors prefer dividend to retained earnings. Rather, they argued the price changes following dividend actions simply indicate that there is important information or signaling content in dividend announcements.

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.

The findings of Zeitun&Tian (2007) indicated that leverage has a significant and negative relationship with firm's performance. They used leverage, growth, size, tax, risk and tangibility as independent variable to see their effect on firm's performance. They concluded that firm's size and tax have positive and significant relationship with firm's performance while risk and tangibility have negative and significant relationship with firm's performance.

Nosa&Ose (2010) found that effective funding required for the growth and development of the corporations in Nigeria. They suggested enhancing the regulatory framework for increasing the firm's performance by focusing on risk management and corporate governance. Onaolapo&Kajola (2010) found a significant and negative relationship between debt ratio and firm's financial performance.

Empirical Review

Adedeji (1998) tested whether the pecking order hypothesis explained the dividend payout ratios of firms in the United Kingdom (UK). Data of 224 firms over the period 1993-1996 inclusive was analyzed. He used cross section regressions and found out that there was a negative relationship between the long term value of dividend payout ratio and investment. The evidence also indicated that financial leverage had a positive interaction with dividend payout ratio but no significant interaction with investment. He also observed that irrecoverable advance tax had a positive, albeit weak influence on dividend payout ratio and overseas profit had a negative influence on the ratio.

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.

Arnott&Asness (2003) investigated the relationship between payout and future earnings growth in the United States (US) market by focusing on the market portfolio proxied by the S & P 500 index. They analyzed 130 years (1871 to 2001) of data. They used regression analysis where earnings growth was the dependent variable and preceding payout ratio was the independent variable. They found out that the historical evidence strongly suggested that expected future earnings growth was fastest when current payout ratios were high and slowest when payout ratios were low.

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.

Bitok, Tenai, Cheruiyot, Maru, Kipsat (2010) conducted a study in order to determine the level of corporate payout to stockholders and to establish if the optimal dividend policy existed for firms quoted at Nairobi Stock Exchange. The study analyzed a sample of 43 firms that were quoted and which were the firms trading in the Main Investment Market for a period of thirteen years that is 1991-2003. They used the dividend model. Companies whose dividend payout was less 50% were considered to be low payout, whereas those companies whose dividend payout was greater or equal to 50% were considered high payout. On the other hand, those firms whose standard deviation of dividend payout was greater than 35% were regarded unstable, whereas those whose standard deviation of payout was less than that were regarded stable.

They found out that the aggregate dividend payout ratio for the Kenyan market was 44.14%. The finding suggested that the average corporate dividend payout to stockholders for 40% of the firms was low and stable and that 28% of the firms quoted paid out high and stable dividends. It was also observed that most of the firms that paid high and stable dividends were blue chip firms.

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. Cooper & Schindler (2011) defines descriptive research design as a research design concerned with finding out who, what, where, or how of the research. 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). All variables were calculated as follows;

Dividend Payout Ratio (PAYOUT) **=** Yearly dividends divided by net income after tax for firm I.

$$\textbf{PAYOUT} = \frac{\text{Dividends (common \& preferred dividends)}}{\text{Net Income after tax}}$$

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

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

Cash Flow (**CASH)** = Log of net cash flows from operating activities for firm I.

RESULTS

Linear regression was done to try and bring out clearly the relationship between dividend payout and the following financial performance variables of profitability and cash flow, that is, whether they have a positive or negative relationship to the dividend payout.

The standard co-efficient for profitability and cash flow financial performance variables for the 5 years were above 0.10 and hence this showed that they were significantly related to the dependent variable, that is, dividend ayout.

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

CONCLUSION

The study revealed that the financial performance variables namely profitability and cash flow were positively and statistically significant in influencing the dividend payout ratio. The study found that there was a positive relationship between dividend payout and cash flow. There was 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 cash flows are able to pay dividend easily compared with firms with unstable cash flow position.

From regression equations it was revealed that there was positive dividend payout ratio to financial performance variable namely cashflow and profitability. From the findings on the correlation co-efficient, it was also revealed that there was a positive relationship between dividend payout of the firms and the following financial performance variable cashflow, and profitability.

RECOMMENDATIONS

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 variables 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 financial performance variables namely, cash flow and profitability since they have 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.

We recommend that this study can be done by testing the relationship of the financial performance variables in the Banking and Insurance sector for further decision making.

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.

A similar study to be done in other firms not listed in NSE. The same study can be done on Banking and Insurance Companies. It can also be done in other Companies with different economies level. The study can be done in other countries.

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