IOSR Journal of Business and Management (IOSR-JBM)
e-ISSN: 2278-487X, p-ISSN: 2319-7668. Volume 20, Issue 4. Ver. VIII (April. 2018), PP 69-75
www.iosrjournals.org

Corporate Earnings and Dividend Payout Ratio of Commercial Banks in Kenya

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Abstract: *This study sought to determine the effect of corporate earnings on dividend payout ratio of commercial banks listed at the Nairobi Stock Exchange (NSE). Secondary data was collected for a period of 10 years (January 2007 to December 2016) on an annual basis. The study employed a descriptive cross-sectional research design and a multiple linear regression model was used to analyze the relationship between the variables. The results of the study indicated that corporate earnings were significantly related to dividend payout ratio and that liquidity was a determinant of the payout ratio.The results further revealed that only profitability and liquidity produced positive and statistically significant highlight of the payout ratio. Bank size and debt ratio were found to be statistically insignificant determinants of dividend payout ratio of commercial banks. This study recommends that adequate measures should be put in place to improve and grow earnings of commercial banks.*
Keywords*: Corporate Earnings, Dividend Payout Ratio*

Date of Submission: 16-04-2018 Date of acceptance: 04-05-2018

I. Introduction

As companyowners, shareholders are entitled to servings of the profits or earnings. The servings are received in form of dividends. Ranti (2013) observed significant positive link between financial performance and dividend payouts in Nigerian firms. Baker and Powell (2000) opine that good financial performance translates to high dividend payout to shareholders. Indeed, earnings of a firm portray its financial performance. Baker and Gandi (2007) assert that the anticipated level of future earnings greatly determines the capacity of a firm to pay dividends. As such, a variety of theories have been formulated by scholars on the subject of dividend policy. This study is based on three theories: (i) *dividends irrelevance theory*(Miller and Modigliani, 1961), argues that value of the firm is not determined by the dividend policy and that the level of business risk and earnings power of the firm determine the value of the firm; (ii)*bird in hand theory* (Gordon, 1963), argues that dividend policy is relevant to value of the firm but dividend payments reduce uncertainty thus increasing value of the share. Certain currentdividend is appropriate than an anticipated dividend in future (capital gain) despite the possibility of higher future returns; (iii) *transaction cost theory* (Bhattacharya, 1979), argues that dividend policy is influenced by extant transaction costs associated with payment or non-payment of dividend.

Kenya banking industry is administered by the Companies Act, the Banking Act and the Central Bank of Kenya (CBK) Act and guidelines. In 1995, the banking sector was liberalized leading to lifting of exchange controls. The CBK is responsible for monetary policies formulation and implementation and the liquidity fostering, solvency and proper functioning of the financial system (CBK, 2013). Its reports show that corporate earnings for most commercial bank in Kenya have been on the rise in the last 10 years. Whereas some of the banks have a consistent year to year dividend payout others do not. It is therefore not clear whether Kenyan commercial banks' dividend payouts depict any pattern.The term corporate earnings refers to the net revenue of a company in the particular financial year being reviewed (Pandey, 2010). The share price of a firm is mainly determined by its earnings since earnings and their subsequent circumstances dictate the success and profitability of the business in the long run (Teoh, Welch &Wong, 2008). Lumby and Chris (2003) indicated that earnings are the single most significant factor in the financial reports hence can be said to be the "bottom line" indicator of financial performance. High earnings per share (EPS) attract more investors whilst a relatively low figure may scare away potential investors. The quarterly and annual earnings of a business portray the analyst estimates and guidance of the actual business. The stock price of a firm however always drops when earnings do not meet the estimates. The share price will also surge when the when actual earnings exceed the estimates by a large amount.

Corporate earnings are determined by deducting the operating expenses, taxes and cost of sales from revenues over a certain timeframe. In most studies net income is used as a measure of earnings (Manduku, 2010). EPS are the earnings of the firm divided by the sum ordinary shares issued by a firm, that is, it's the net income of a firm per unit of issued ordinary shares. The firm's earnings are also used for valuation of a company. The value of equity of a firm is thereby determined by multiplying the current earnings after interest and tax (EAIT) by an efficient multiple. The EAIT in place could be adjusted so as to represent factors such as the owner manager policies and annual events. The suitable multiple is usually the price-earnings ratio of a quoted firm (Grinblatt& Titman, 2006).

Dividend payout ratio is the form of dividends paid to shareholders as a percentage of profits. It is the ratio of annual dividend per share to profits per share of the firm (Brockington, 2013). The returns of the shareholder is made of two components which are capital or dividend gain. Both of these factors are influenced by the dividend payout ratio. A higher share price is brought about by a low payout policy since it accelerates earnings growth rate. Less retained earnings and more dividend payouts are brought about by a high payout policy, this reduces the market price per share and thus leading to slower growth. Firms basically adopt dividend policies based on their business life cycle stage. According to Kapoor (2009) firms with higher growth for instance have fewer projects and large cash flows which enable them to pay their earnings in dividends.

Ross, Westerfield and Jaffe (2002) assert that dividend decisions are vital since they describe the type of funds that circulates to investors and those that the firm retain for investment purposes. The essential information is also provided to stakeholders regarding the company performance. (Foong, Zakaria& Tan, 2007) argue that the future potential of dividends and earnings are determined by firm investments and affect the firms' cost of capital. A firm's dividend policy is among the most vital concepts in finance from the perspective of the shareholders, employees, the consumers, government and the regulatory bodies. It can be viewed as a pivotal policy upon which other financial policies rely on (Sujata, 2009).

The dividend policy guides the finance manager in deciding on how much will be paid out in form of dividends to shareholders for their share capital holding in the firm. The main types of dividend policies include; Constant payout ratio under which a firm agrees upon a constant percentage of the profits as dividends. It maintains this amount regardless of whether the firm makes more profits or not. Residual dividend policy payout; where a firm issue out dividends from the amount that remains after all investments have been undertaken. If all profits are used for investment then no dividends are paid out during that period. Stable dividend policy; where a constant amount of money is to be distributed to every shareholder in the firm. Occasionally firms use the stable plus extra policy where a constant amount of money is maintained as dividend to be issued to every shareholding but an extra amount can be paid when the firm makes huge profits in a particular trading period (Pandey, 2010).

Dividends are issued out from the firm's retained earnings. The shareholders are issued with more shareholders' dividends. The distribution in the earnings proportion is determined by the payout ratio based on cash dividend divided by earnings per share. However a firm may not always declare higher dividend when it reports higher earnings. This is so because the management has to be sure of favorable earnings in future since a future decrease in dividends may send a negative signal to both the shareholders and future prospective investors. To avoid this scenario, the management may declare lower dividends even when earnings are favorable (Brockington, 2013).

A study done by Asness and Arnott (2003) revealed that growth in earnings is associated with higher rather than low payouts of dividends. The study concluded the rate of anticipated earnings in future is faster during high current payout ratios and slowest during low seasons of low payout ratios. A high payout ratio therefore indicates the confidence of the management in regarding future earnings' stability and growth. They further assert that managers are reluctant to cut dividends and therefore, reduce dividend fallouts by paying low dividends when earnings falls since this can send to investors the unintended signals.

In his study on the distribution of incomes of corporations, Lintner (1956) found out that dividends of the previous years and earnings influence the firms' dividend payments in the developed markets. He argued that stable dividend policies are highly preferred by firms since higher dividend levels are unsustainable. The assertion means that firms pay dividends to the extent that they are sustainable.

II. Research Problem

The dividend decision of a firm has for long been a subject of corporate finance and has always been studied with regard to the financing and investment decisions of the firm. The dividend irrelevant theory by Modigliani and Miller (1961) postulates that the dividend distributions does not affect the worth of the firm by but is depended on the firm's level of risk. Gordon (1959) and Lintner (1956) in their Dividend Preference Theory suggested that current dividends were more preferred by the shareholders compared to capital gains. They further suggested that with more earnings, more dividends should be paid out. This would safeguard the shareholders dividend preference. Therefore, a positive link exists between earnings and dividends contrary to the findings by Modigliani and Miller (1961).The theory by Ross (1977) the Information Content Theory, suggested that investors can acquire information about a firms future profit position from the implications of the announcements from dividends. This implies that a positive association exists between profits and dividend payouts which contradict the findings by Modigliani and Miller (1961).

According to CBK annual report (2016), commercial banks' core earnings have been on a steady rise with the latest being a 2.8% growth from 2015 to 2016. This indicates that banks earnings were not significantly affected by the interest rate cap in 2016 with the full effects of the cap expected to show in 2017 performance. Despite the growth in earnings, dividend payout ratio among commercial banks have been fluctuating overtime with an all time-low dividend payout ratio of 31.7% being recorded in the year 2014 (CBK, 2016). New Central Bank of Kenya (CBK) guidelines require lenders to maintain a core capital that is minimum to total risk weighted assets ratio of 10.5% up from 8.5%.The new regulations have forced banks which previously had high payouts to cut dividends and reap cash in order to raise capital through retained earnings. Most of the banks are pursuing progressive conservative dividend payout arrangement to build strong core capital base by retaining a big portion of their profits(Cytonn Investments, 2017).

From past studies, differences in findings in the earnings-dividend relationship still exist where some studies find a positive significant relationship while others show no statistically significant relationship. Holder, Langrehr and Hexter (2012) examined how dividend policy is influenced by earnings of Pakistani listed companies. It was concluded from the study that a link exists between the two variables but co-efficient indicates a weak link. The studies by Gupta and Banga (2010) exploring the corporate dividend policy determinants in India found that earnings were of no consequence on the dividend rate. Hanif (2013) examined the association between dividends, earning and investment for firms listed on the NSE .The results disclosed positive relationship among earning, investment and dividends. Perretti, Allen and Shelton (2013) examined the determinants of dividend policy for American depository receipts. They concluded that earning is among the main dividend payment determinants where a rise in corporate earnings leads to a rise in dividend payout ratio.

In Kenya, Kinyua (2013) sought to assess the type of associations between earnings volatility and dividend payout of the firms in the NSE listing. The research found that no significant association was found to exist between earnings volatility and dividend payouts. Bulla (2013) did an analysis of the factors which had an influence on dividend policy of companies listed at the NSE and found out that earnings had a significant positive link with dividend payout for companies being studied. Mbuki (2010) found out that the dividends payout ratio was determined by various factors including availability of investments opportunities, availability of cash to pay the dividend and future sustainability of dividends. However, the study did not mention any association between dividend payout and earnings but only examined the different factors affecting the dividend payout.

The lack of consensus among the various scholars on how corporate earnings affects dividend payout ratio is reason enough to conduct further examination on this area of study. Holder, Langrehr and Hexter(2012), Gupta and Banga (2010) and Kinyua 2013 found no significant relationship while Hanif (2013), Perretti, Allen and Shelton (2013), Bulla (2013) and Kibet (2012) found a constructive substantial relationship between earnings and dividend payout ratio. Despite the fact of earnings determining if dividends are paid or not, the study of the relationship has not been extensive in Kenya and the few available studies arrive at conflicting conclusions. This forms the foundation for this research. This paper seeks to identify how corporate earnings affect dividend payout ratio of commercial banks in Kenya. It attempted to give an explanation to the research question; what is the effect of corporate earnings on dividend payout ratio of commercial banks in Kenya?

III. Methodology

Descriptive cross-sectional design was used for the study. This enabled comparison of relationship between corporate earnings and dividend payout ratio for commercial banks in Kenya.The population of study comprised of the 42 commercial banks operating in Kenya as at end of the year 2016. The sample for the study was the 11 commercial banks listed at the NSE.Secondary data was obtained solely from the published annual reports of the listed commercial banks at the NSE for the last 10 years. The reports were obtained from the Capital Markets Authority website and the bank's annual reports. The end result was information detailing the independent variables and dependent variable for the 11 commercial banks listed at the NSE. The researcher used descriptive statistics to capture the features of data collected whilst a multiple regression model used to draw performance comparisons while dealing with time series factors. The regression model below was used:

$Y= \alpha+ \beta_1X_1+\beta_2X_2+\beta_3X_3+ \beta_4X_4+\varepsilon.$

Where: Y = Bank's dividend payout ratio as measured by dividend per share/earnings per share

α =y intercept of the regression equation.

$\beta_1, \beta_2, \beta_3, \beta_4$, =are the slope of the regression

X_1 =Banks earnings, as given by, return on equity, ROE

X_2 =Bank's liquidity, as given by current assets divided by current liabilities

X_3 =Bank's size, as given by; natural logarithm of total assets
X_4 = Bank's debt ratio given as long term debt / (shareholders equity + long term debt)
ε =error term
To test the statistical significance the F- test and the t – test were used at 95% confidence level. The F statistic was utilized to establish a statistical significance of regression equation while the t statistic was used to test statistical significance of study's coefficients.

IV. Results and Discussion

Coefficients of determination were used as indicators of the relationship direction between the independent variables and dividend pay-out ratio of commercial banks. The p-value under sig. column was used as an indicator of the relationship significance between the dependent and the independent variables. At 95% confidence level, a p-value of less than 0.05 was interpreted as a measure of statistical significance. As such, a p-value above 0.05 indicates a statistically insignificant association between the variables which are dependent and the independent variables. The results are as shown in table 1.

Table 1: ANOVA

Model		Sum of Squares	Df	Mean Square	F	Sig.
	Regression	1.695	4	.424	13.269	$.000^b$
1	Residual	3.353	105	.032		
	Total	5.047	109			

a. Dependent Variable: DividendPayoutRatio
b. Predictors: (Constant), Debtratio, Profitability, Size, Liquidity

Furthermore, as shown in table 2, profitability and liquidity showed positive statistically significant values for this study (high t-values (2.423 and 4.154), p <0.05). Bank size and debt ratio were found to be statistically insignificant for this study as evidenced by (t= -1.693, p= 0.093) and (t= .669, p= 0.505) respectively.
The following regression equation was estimated:
$Y = -0.20 + 1.610X_1 + 0.223X_2$
Where,
Y = Dividend payout ratio
X_1= Profitability
X_2 = Liquidity

On the estimated regression model above, the constant = -0.20 shows that if selected dependent variables (profitability, liquidity, bank size and debt ratio) were rated zero, the dividend payout ratio will be -0.20.An increase in profitability unit would cause raise in dividend payout ratio by 1.610. An increase in liquidity unit would lead to a dividend payout ratio increase in by 0.223.

Table 2: Model Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
	(Constant)	-.020	.077		-.255	.799
	Profitability	1.610	.665	.206	2.423	.017
1	Liquidity	.223	.054	.467	4.154	.000
	Size	-.011	.006	-.146	-1.693	.093
	Debt ratio	.082	.123	.073	.669	.505

a. Dependent Variable: Dividend Payout Ratio

The study findings are in line with Abu (2012) research based on the evidence from Bangladesh to explore the determinants of dividend payout policy. The results identified EPS to be negatively significant for dividend payout policy; net income positively influences dividend payout; revenue (sales) has no impact on the dividend payout; liquidity significantly influences dividend payout and price-earnings ratio has no impact on dividend payout policy. Hanif (2013) findings also revealed the existence of long term positive associations among earning, dividends and investments.This study agrees with Olang, Akenga and Mwangi (2015) who studied the effect of liquidity, profitability, working capital and cash flow on dividend payout. Their study concluded that profitability hadimpacted on the amount of dividends paid. They also found that liquidity influences dividend payout.

V. Conclusions and Recommendations

The study concludes that dividend payout ratios of commercial banks in Kenya are significantly affected by profitability and liquidity of the banks. The study concluded that profitability had a significant positive effect on dividend payout ratio. The study therefore concludes that higher profitability of commercial banks leads to dividend payout ratio increase. The study found that liquidity had a positive and significant effect on dividend payout ratio and therefore it is concluded that higher levels of liquidity leads to an increase in dividend payout ratio. Bank size and debt ratio were found to be statistically insignificant determinants of dividend payout ratio and therefore this study concludes that bank size and debt ratio do not significantly influence the dividend payout ratio among commercial banks in Kenya.

The study established that there was a positive influence of profitability on dividend payout ratio of commercial banks in Kenya. This study recommends adequate measures to be put into place to improve and grow the profitability of the banks. Commercial banks and other sectors should invest in profitable assets that will yield higher returns in the future to enhance their financial performance and increase dividend payout in future. The management of the banks should ensure a good proportion of deposits are converted into loans which will result to increased bank interest income hence leading to higher profits and better financial performance.

The study concluded existence of a positive relationship between dividend payout and liquidity position. This study recommends that a comprehensive assessment of a bank's immediate liquidity position should be undertaken before any dividend payout is declared to the shareholders. This is because the bank's liquidity position is of high importance since it influences the bank's current operations.Commercial banks should develop dividend policies to guide them in establishing and guiding them in surplus distributions. This will guide them on when to pay dividends, how to pay dividends and when to retain surpluses. It is also recommended that an investment policy should be developed and implemented. This will ensure that the management is not left to decide on how to use the little surplus left but would rather be guided by the investment policy.This study focused on corporate earnings and dividend payout of commercial banks listed at the NSE and relied on secondary data. A research study where data collection relies on primary data i.e. in depth questionnaires and interviews covering all the 42 commercial banks registered with the Central Bank of Kenya is recommended so as to compliment this research.The study was not exhaustive of the independent variables affecting dividend payout ratio of commercial banks in Kenya and this study recommends that further studies be conducted to incorporate other variables like growth opportunities, industry practices, a firm lifecycle stage, political stability and other macro-economic variables. Establishing the effect of each variable on dividend payout ratio will enable policy makers know what tool to use when controlling the dividend payout ratios.The study concentrated on the last ten years since it was the most recent data available. Future studies may use a range of many years e.g. from 1970 to date and this can be helpful to confirm or disapprove the findings of this study. The study limited itself by focusing on financial institutions. The recommendations of this study are that further studies be conducted on other non-financial institutions operating in Kenya. Finally, due to the shortcomings of regression models, other models such as the Vector Error Correction Model (VECM) can be used to explain the various relationships between the variables.

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IOSR Journal of Business and Management (IOSR-JBM) is UGC approved Journal with Sl. No. 4481, Journal no. 46879.

Mercy Mutindimuendo "Corporate Earnings and Dividend Payout Ratio of Commercial Banks in KenyaIOSR Journal of Business and Management (IOSR-JBM) 20.4 (2018): 69-75.