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Dividend Decisions and Economic Value-Added of Firms in Kenya

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Abstract:

Creating corporate value is one of the organization's primary priorities. As the value of the company increases, shareholders will receive additional benefits. The result of empirically based research is a substantial body of literature on dividend policy. There are two major schools of thought in the research: one argues that a company's dividend policy influences its value, while the other maintains that it has no effect on it. After many years of research, no agreement has been reached, and scholars cannot even agree on the same empirical evidence. Over the years, a variety of theories about the potential influence of dividend choices on a company's total wealth and performance have been developed, with varying degrees of success. Numerous financial ideas and models were put forth, and the business sector later used them. It is still unclear, despite several studies, how dividend decisions impact the share price of the firm and the overall wealth of shareholders. The purpose of this study was to investigate the relationship between business valuation and dividend policy choices. Several studies indicate a statistically significant positive correlation between the dividend policy and return on equity. As a result, raising dividend payments will help the business succeed. A substantial body of evidence, however, suggests a conflict between firm profitability and dividend payout. As a result, when companies pay dividends, their retained earnings are impacted, which affects their expected internal profitability.

Keywords:

Firm Value, Financial performance, Firm Size, Dividend Payout Ratio.

1. Introduction

Dividends are rewards paid to shareholders for their financial stakes and associated risk in an organization or business. According to well-known financial theory, managers have a duty to maximize shareholder value through efficient resource management (Anton, 2016). The company's dividend policy establishes the limitations, constraints, and rules necessary to allocate a company's net earnings between retained earnings and dividend payouts in order to maximize value.

There are a broad range of factors, including the firm's financial constraints (such as the credit crunch), investment options, funding opportunities, quantities of funds necessary, stakeholder needs, firm size, and legal provisions, that are taken into account when deciding on a dividend policy (Husna & Satria, 2019). Evidently, a financial and organizational strategy strand that successfully determines a firm's long-term viability as a going concern has a dividend policy at its foundation. The preservation of shareholder wealth, principally through the augmentation of a company's share price, is usually believed to be a firm's main goal. (Tamrin, Mus, & Arfah, 2018).

Three categories of decisions that have the ability to significantly affect a company's value have been identified: dividend, investment, and finance decisions. In terms of the capital structure, the weighted average cost of capital (WACC), liquidity, internal rate of return (IRR), and financial risk, the choice of the ratio to be used to split net earnings between dividend payout and retained earnings has a significant effect on the firm's financial position and, as a result, its ability to operate. Such is the significance of dividend policy that the cascading effects of all of these components literally reach the majority of an organization's operating centers (Anton, 2016). Executives, shareholders, and other concerned parties study these financial statements to assess present firm performance and prospective future business success (Hakeem & Bambale, 2016). The semi-strong variant of the efficient market hypothesis further assumes that the market can promptly assess the information present in these variables that is accessible to the general public and take it into account when determining future stock prices (Michael, 2019).

One of the primary aspects of managing a company's financial performance is whether or not to increase profitability, along with financial and investment choices. The value of the company could be severely affected. Making the choice to sustain income or pay dividends is frequently challenging due to the conflicting forces that must be balanced (Priya & Mohanasundari, 2016). Thus, when a company can increase its dividend payouts, investors generally view this as positive news, whereas when it decreases them, the market typically reacts negatively. Given that a company's principal goal is to increase shareholders' wealth, it stands to reason to assume that management would prefer a favorable business reaction than a negative one (Husain, Sarwani, Sunardi, & Lisdawati, 2020).

It is crucial to conduct a thorough investigation of the company-specific elements that affect the dividend policy in order to develop the most effective dividend policy. This is due to the importance of dividend decisions to both the broader business strategy and the process of generating new shareholder value. Business executives can assess their dividend policies,

compare them to those of their rivals, and make improvements to how they distribute profits in order to raise the firm's worth by recognizing these characteristics (Banerjee, 2018).

2. Relationship between Dividend and Financial performance

On the relationship between dividend payment and companies' financial performance across various jurisdictions, continents, and economies with various levels of development, numerous studies have been conducted (Yeo, 2018). Studies on this phenomenon have been substantially published in the scientific literature, which provides evidence of their importance and potential impacts on the long-term financial health of any firm entity. The dividend relevance hypothesis is constantly brought up by the disputed and ambiguous empirical information on the nature of the connection between a company's financial success and its dividend policy (Murage & Memba, 2019).

A study on the relationship between dividend payment and a firm's financial success by Murage and Memba (2019) established that actual dividend payments determined dividend payment, and net operating profit after taxes defined business financial performance. Firm size (determined by total assets) and revenue were also taken into account when developing the theoretical framework. According to the findings, net earnings (a measure of a company's financial performance) are positively correlated with dividend payout, firm size, and revenue. The dividend relevance hypothesis was confirmed, and managers were advised to put a lot of effort into developing a dividend policy that will boost businesses' performance in this situation. Some people have criticized the approach utilized in this research and other research like it. The criticism is based on the idea that these studies did not take future revenues into account; consequently, the signaling hypothesis ignores the possibility that dividends could be utilized as a costly tool to promote future profitability (Erin, Bamigboye, & Arumona, 2020).

A number of factors have been used to proxy financial performance (i.e., earnings, stock repurchases, revenue, and firm size) in establishing its link with dividend distribution. Systematic risk has not traditionally been considered a control variable in many earlier investigations (Rehman, 2019). Profitability, growth rate, business risk, debt policy, free cash flow, liquidity, asset tangibility, age, and size are some of a company's distinguishing characteristics. The corporation's status as a private or public company is another feature (Sukmawardini & Ardiansar, 2018).

Every financial management strategy must take into account the aforementioned factors, which are highly critical aspects, when establishing how dividends will be distributed. Given how challenging it is to create a set of universally accepted dividend policy principles, this is required. In light of the numerous elements that are specific to each business, each company is making a distinct decision on dividend payments (Sondakh, 2019). The following factors were taken into account: P/E ratio, dividend cover, dividend payment, and earnings per share. Meanwhile, in modern research, that is, in studies that demand estimates of earnings per share, corporate success is often expressed in terms of dividends per share (Munawar, 2018).

2.1 Dividend Decision

The term "dividend option" describes a company's dividend payout policy and the total amount of retained earnings that may be invested in new initiatives. This decision concerns the proportion of earnings that should be distributed to shareholders versus the proportion that should be invested in new opportunities. The decision to declare a dividend involves selecting the payment plan that management will employ to decide the timing and amount of future cash distributions to shareholders.

2.2 Types of Dividend Decision

According to Michael (2019), there are several dividend decisions which include:

***Pure Residual Dividend Decision*:** When the firm's return on equity capital exceeds the rate of return the investor could achieve by reinvesting those dividends in another investment of comparable risk, the investor would prefer the corporation act on his behalf and reinvest the earnings rather than issue a dividend. By first determining the firm's optimal capital budget and noting the level of risk involved, the company can then decide which alternative is more advantageous to the investor.

***Smoothed Residual Dividend Decision*:** This implies that payout variation is minimized. Since payouts are established at a level corresponding to the extended residual between expected profits and investment requirements, Shapiro claims that revisions to dividend policies frequently occur after adjustments to earnings. Due to this, dividend adjustments are only made when a change in the long-term residual is expected. Instead of profit fluctuations that are considered to be passing trends for deciding dividend payments, a constant but growing dividend per share is obviously wanted.

Constant or Fixed Decision: A specific portion of the company's profit after taxes is distributed as dividends. As a result, the corporation keeps its dividend payment ratio constant. A measure of payout is the dividend-to-profit ratio. A company may elect to hold onto the remaining 40% as a matter of policy and habitually distribute 60% of its post-tax profit as a dividend to its shareholders. With the help of this type of policy, shareholders are given the chance to determine the exact dividend amount they may be able to anticipate from their investments in the company.

***Progressive Decision*:** When inflation rises, dividend payments frequently do too. Financially, this can result in a higher dividend. As a lever for the business, the policy to keep marginal growth going, every effort is made. It is quite unlikely that the company will ever have to cut dividend payments. It can function better as a result of this. Even if it rarely occurs, this conduct deceives investors. Businesses employing this method will decide not to pay dividends for the duration of the period rather than continuously cutting the payout.

***Zero Dividend Decision*:** It's possible for certain companies to decide against paying dividends. This is especially characteristic of newly established businesses because they typically require funding to realize their objectives. As a result, the full earnings are retained to support business expansion (Husain, Sarwani, Sunardi, & Lisdawati, 2020). Such a policy will unavoidably attract investors who, due to taxation, prefer capital gains over dividends.

This kind of insurance is comparatively simple to use and eliminates any expenses related to dividend distribution (Anton, 2016).

***Alternative Dividend Policy*:** The company may opt to buy back shares to provide shareholders a choice between dividends and fresh shares. This involves buying stock or shares (Tamrin, Mus, & Arfah, 2018). In terms of tax advantages, this is especially beneficial for the shareholder. The stock repurchases or buybacks are not taxed until the shares are sold and the shareholder realizes a profit or capital gain, but the dividend is fully taxed just like ordinary income. The policy of stock dividends and splits is also covered. Owners of stock receive more shares than cash.

3. Economic Value-Added

Economic value-added has only recently been embraced as a measure of internal and external financial success, but its conceptual foundations are grounded in well-established microeconomic literature about the relationship between business revenues and wealth creation (Michael, 2019). Since Alfred Marshall's Principles of Economics, at least for a significant portion of this history, the focus of analysis has centered on accounting profit adjustments to reflect the opportunity cost of capital. This is mostly due to the fact that the unadjusted measure has the potential to be a misleading indication of success in both theory and practice. As shown by this, economic profit should be measured as a measure of wealth creation.

3.1 Firm Performance

The organization's performance can be defined as the organizational capacity of management to achieve a competitive edge over other organizations based on change sensitivity, in particular the competence to match customer expectations (Hakeem & Bambale, 2016). Businesses should be concerned about changes in the impact of internal and external globalization. Additionally, they cannot just watch events play out; rather, they must actively respond to changes in the environment. If this weren't the case, the business would not be able to function in the market today and successfully compete with its rivals (Olaniyan, Efuntade, & Efuntade, 2021).

The performance of a company is determined by its management policy, which is defined at the start of operations, targeted plans, and operational business strategies that consumers can monitor and evaluate based on satisfaction, sales, earnings, and other operational challenges (Sondakh, 2019). Some of the key variables affecting earnings are free cash flow, management compensation, dividend payments, and the amount of debt (Kamau, Banafa, & Kariuki , 2022). A company's ability to grow and compete more successfully against both established and up-and-coming rivals is influenced by the efficiency of its operations, which in turn strengthens the company's competitive edge. While some studies have demonstrated a negative link, previous studies on the relationship between environmental sustainability and corporate performance have found a significant correlation. The different metrics that were used to assess business and environmental performance are directly responsible for these diverse results (Yeo, 2018).

There may be a correlation between profitability and the decision to pay dividends because it is commonly understood that profitable companies will pay greater dividends (Michael, 2019). The majority of performance research studies that have been evaluated use performance metrics, which include return on assets (ROA), return on equity (ROE), return on investment (ROI), earnings per share (EPS), gross and net profit margins, economic profit, and Tobin's Q. Earnings per share (EPS) may be used as a tool for measuring profitability (Triani & Tarmidi, 2019).

The standard accounting ratios and financial measures that companies use to determine their level of profitability are gathered under the umbrella term "ROA." In many different ways, this principle has been interpreted and used. The return on assets, or ROA, of a company measures its success in relation to its total assets. It reveals how well management uses its resources to produce profits and exemplifies management's effectiveness (Olaniyan, Efuntade, & Efuntade, 2021).

Monitoring an organization's profit accumulation, share value, and growth index can be used to gauge its financial performance. Other financial analysts use indicators of financial performance include return on investment, net income as a percentage of sales, and costs of low-quality production as a percentage of sales. For the purposes of this study, we will evaluate an institution's financial performance using factors including its gross profit margin, return on investment, and earnings before interest and taxes (Kanyanga, 2022).

3.2 Financial Performance

The term "financial performance" refers to a technique for determining a company's success over a certain time frame. This evaluation takes the company's market share growth, return on equity, and liquidity into account. The income received and expenditures made by a corporation during a specific time period make up the financial performance of that company. Turnover is a measure of corporate expansion and a technique to evaluate a company's success over a certain time period (Erin, Bamigboye, & Arumona, 2020). The study's findings, however, focused on the companies' return on equity (ROE) and return on assets (ROA) (ROE). Businesses must perform financially in order to accomplish their goals for a specified period of time. Returns on investments serve as a measure of the financial performance of businesses based on their guiding principles and objectives (Okafor & Odoemelam, 2018).

In order to implement this objective, conventional accounting metrics like profits, earnings, and cash flows from businesses, as well as financial statement ratios like earnings per share and returns on assets, investments, and equity, are frequently used as proxies for shareholder wealth (Triani & Tarmidi, 2019). Because these decisions are directly related to the value of the company and the wealth of its shareholders, dividend policies are an extremely important and critical component of the business operation. Though some academics have viewed dividends as a source of revenue for shareholders, others have argued that, in line with the signaling hypothesis, payouts represent a complex part of the signaling information relating to the firm's future and current success (Rizqia & Sumiati, 2013). Some of the finance metrics used to measure firms' performance include:

Return on Assets (ROA): Return on Assets (ROA) is defined as the ratio of assets to turnover during a specific time period according to (Erin, Bamigboye, & Arumona, 2020). On the other side, dividing net income by total assets is how the return on assets is calculated.
Retained Earnings (RER): Profitability and the total number of shares that were issued throughout the year may be used to evaluate a company's financial success (Solomon, 2020). However, earnings per share can be calculated by dividing the net profit after taxes of a company by the total number of shares that were issued during the year.
Rate of Return on Equity (ROE): Because of this, return on equity, often known as ROE, is a metric for evaluating a company's success that is based on the equity that is held by its shareholders. To calculate a company's return on equity, just divide its net income by the total number of shares owned by its shareholders.

4. Conclusion

In conclusion, the literature has pointed out that firm value is impacted by return on asset, firm size, and payout ratio, although not by return on asset. There is a beneficial relationship between organizational value and return on assets (ROA), retained earnings, and return on equity. Dividend policies can boost firm value, and the outcomes of this research can help corporate management maximize the value of the company. Management must exercise greater caution when paying dividends to shareholders. Additionally, by examining funding decisions taken in light of the present debt and dividend policy, the findings of this study can be used as information by investors to select market shares whose firm value is anticipated to rise in the future.
Companies should pay closer attention to the aspects that affect company value and, per the study, exert appropriate caution when implementing regulations to avoid lowering firm value. It is advised to increase the model's dimensionality by including more factors, such as the risk-taking policy variable that is determined by standard deviations from returns or alternative potential variables. Future studies are expected to include longer time periods and more samples in order to improve test results.
Scholars should investigate managerial opportunism in order to increase dividend payouts. Examine the corporate strategy's phases with a focus on profit margin, return on assets, and return on equity (ROA and ROE) indicators to make sure the business is as profitable and liquid as possible and to maximize the wealth of shareholders, who are the principal owners.

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