

**THE IMPACT OF DIVIDEND PAYMENT POLICY ON THE
FINANCIAL PERFORMANCE OF PRIVATE COMMERCIAL
BANKS IN ETHIOPIA**

**A RESEARCH PAPER SUBMITTED TO DEPARTMENT OF
ACCOUNTING AND FINANCE FOR PARTIAL FULFILMENT OF
BACHELOR OF ART (BA) DEGREE IN ACCOUNTING AND FINANCE**

By: Getahun Dachew

Advisor: Mrs. Sitina A. (Asst. Prof.)



COLLEGE OF BUSINESS AND ECONOMICS

DEPARTMENT OF ACCOUNTING AND FINANCE

WOLKITE, ETHIOPIA

JANUARY, 2021

STATEMENT OF DECLARATION

I declare that the thesis entitled: *the impact of dividend payment policy on the financial performance of Ethiopian private commercial banks*, hereby submitted by me in partial fulfilment of the requirements for the BA Degree in Accounting and Finance at the Wolkite University, is my original work and has not been submitted for any degree in any other university. I have undertaken it independently with the advice of my advisor, Mrs. Sitina Akmel (Asst. Proof), n performing the thesis, I have used different sources and material which have been acknowledged.

Name: Getahun Dachew Negash

Signature: _____

Date: _____

WOLKITE UNIVERSITY
COLLEGE OF BUSINESS AND ECONOMICS
DEPARTMENT OF ACCOUNTING AND FINANCE

This is to certify that the thesis prepared by Getahun Dachew, entitled: *the impact of dividend payment policy on the financial performance of Ethiopian private commercial banks*, and submitted in partial fulfilment of the requirements for the BA degree in Accounting and Finance complies with the regulations of the University and meets the accepted standards with respect to originality and quality.

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Internal examiner: Mr. _____ Signature _____ Date _____

External examiner: Mr. _____ Signature _____ Date _____

Advisor: Mrs. Sitina Akmel (Asst. Proof), _____ Signature _____ Date _____

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Abstract

The dividend pay-out policy is one of the most debatable topics within corporate finance and some academics have called the company's dividend policy unsolved puzzle. The main objective of this study was to examine the impact of dividend pay-out policy on the financial performance of Ethiopian private commercial banks. To answer the objective of the study, explanatory and quantitative type study was used & the data covered the period from 2010-2018 for the sample of twelve Ethiopian private commercial banks and used secondary data. Bank specific variables were analysed by employing the balanced panel fixed effect regression model and the study used two models for two dependent variables those are net interest margin and return on asset and one independent variable which is dividend pay-out ratio. In addition, the study was used three control variables; they are: liquidity, leverage, and firm size. The result of the study showed that, dividend pay-out ratio has positive and statistically significant impacts on return on asset of Ethiopian private commercial banks whereas dividend pay-out ratio found to be positive and statistically insignificant impact on net interest margin of Ethiopian commercial private banks during the year between 2010 and 2018.

Key words: dividend policy; financial performance; dividend pay-out ratio

Acknowledgement

First and for most, I will like to express my heartfelt thanks to my God for my life and abilities he put in me to successfully complete this research paper. My limitless thanks go to my advisor, Mrs. Sitina Akmel (Asst. Prof.), Department of Accounting and Finance, wolkite university for painstakingly seeing me through the arduous task of BA studies, and also for her unflinching support and relentless advice to ensure the completion of my studies. All my family and friends for their moral and financial support throughout this study deserves thanks.

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ACRONYMS

MM: Modigliani and Miller

DPR: dividend pay-out ratio

ROA: return on asset

NIM: net interest margin

CHAPTER ONE

1 INTRODUCTION

1.1 BACKGROUND OF THE STUDY

The most commonly accepted aim of a firm is to maximize the value of the firm and the wealth of its stock holders (Ali and Chowdhury, 2010). In general, there are three types of financial decisions that could have an impact on the value of the firm. These are investment decisions, financing decisions and dividend decisions (Uddin and Chowdhury, 2005).

These three decisions are linked to each other in series. Investments made by a firm determine the future gains and potential dividend amount of the firm. The policy of dividend distribution determines the equity capital rate within the capital structure of the firms; therefore, capital cost is being influenced as well. The aim of these interrelated decisions is maximizing the wealth of the stock holders (Fong et al., 2007).

Profits made by corporation can either be re-invested or be distributed as dividend to stock holders. Every investor expects return on investment which is in the form of capital gains and or dividend. Dividend is a share of the after-tax profit of a company, distributed to its shareholders according to the number and class of shares held by them. A dividend is the money that a company pays out to its shareholders from the profits it has made, either in the form of cash or by issuing of additional shares as in script dividend.

Dividend can also be said to be distributable earnings of a company. The earnings, which are not distributed, constitute retained earnings. It is the board of directors of a company that decide whether or not to declare dividend. The decision on dividend pay-out and retained earnings constitute the dividend policy. Dividend pay-outs is one of the most debatable issues in modern corporate finance and still a puzzle (Dakito 2015). A famous quotation by (Fisher, 1976) states. The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just do not fit together (Gustav & Gairatjon 2012)

Researchers have provided considerable attention and thought towards solving the dividend puzzle resulting in number of contradictory hypothesis theories and explanations (Alkuwari

2009). Dividend pay-out policy, according to Lease et al. (2000), refers to the practice that management follows in making dividend pay-out decision or, in other words, the size and pattern of cash distributions over time to shareholders (Sunday 2015). Making a decision regarding the portion of the profit to be distributed to the suppliers of funds (equity shareholders) as dividend and the portion to be retained for future re-investment is a significant managerial decision.

Dhanani (2005) contend that it is possible for a firm to develop a dividend pay-out policy that takes into consideration the different conditions of its shareholders. Certain shareholders may have a preference for cash dividends, others for dividend stability while others would prefer capital gains earned through reinvestment of dividends and thus no cash dividends. earned through reinvestment of dividends and thus no cash dividends.

Depending on the various shareholders 'preferences, a company should therefore, formulate a dividend pay-out policy that meets the needs of its shareholders. Financial managers are generally supposed to take different important decisions like investment portfolios, product development, and financing with the objective to increase market value of the firm (Afza & Mirza 2011). The dividend is not just a source of income for shareholders, but act as an indicator to judge the performance of the firm (Al-Malkawi et al., 2010). Dividend pay-out indicates the level of earnings paid to shareholders on their investment. It is a critical decision because it relates with other financial and investment decision (Abor & Bokpin 2010). Malcolm and Wurgler (2004) agree with this and have demonstrated that firms design dividend policy in response to shareholders 'preference for dividends. This is consistent with the clientele effect theory (Ongeri 2014).

Musiega et al. (2013) argued that dividend policy has not attained a universal acceptance despite its analysis by many researchers over several decades. In their study, Chay and Suh (2008) concluded that different countries exist among unique regulatory environment and dividend policy regulations. Their findings may not apply across all markets. There have been differences in opinion among researchers on what exactly impact of dividend policy.

Since Banking industry is very important sector for economic development of the country and Ethiopian banking sector is on growing stage, examining the dividend pay-out policy of private banks in Ethiopia could appropriate decision for the researcher. This study will contribute to

Ethiopian private bank officials in making dividend pay-out decisions and it highlights the different variables that might affect dividend pay-out between the established facts and practice. A study about dividend pay-out is also important for investors, managers, lenders and others to make financial decision. Investors consider dividends not only the source of income but also a way to assess the firms from investment points of view and assessing whether the company could generate cash or not. Thus, this paper contributes for stockholders who make such kinds of financial decisions.

Studies on dividend policy in Ethiopia are mostly inclined to its determinants in service industry such as financial and nonfinancial institutions, and manufacturing sector chekole, Dagne (2009), Twedros (2011) & Simegn (2013). Furthermore, conducted the impact of profitability on dividend policy. The previous studies conduct by using different variable both dependent and independent but they did not consider the impact of dividend policy on the financial performance. Eventually, the researcher study was conducted to fill this gap by examining the impact of dividend policy on the financial performance private commercial banks in Ethiopia.

1.2. STATEMENT OF THE PROBLEM

The issue of dividend policy is a very important one in the current business environment. Dividend policy is the regulations and guidelines that a company uses to decide to make dividend payments to shareholders (Nissim & Ziv, 2014). Many researchers in corporate finance have developed several theories and modes to explain the dividend policy of firms and their determinants however there is a disagreement regarding to the findings.

The impacts of Dividend policy on shareholder's wealth is an unresolved issue and has been discussed in many empirical discussions within finance literatures (Rafique, 2012). Three decades ago, Black (1976) in his study on dividend wrote, "*The harder we look at the dividend picture the more it seems like a puzzle, with pieces that just don't fit together*". Why shareholders like dividends and why they reward managers who pay regular increasing dividends is still unanswered. According to Brealey and Myers (2002) dividend policy has been kept as the top ten puzzles in finance. So, the problem is that how much company should spend on Dividend pay-out and what they should keep as retained earnings (Periyathamby and Navaratnaseelan, 2012).

On a global perspective, Musiega et al. (2013) argued that dividend policy has not attained a universal acceptance despite its analysis by many researchers over several decades. In their study, Chay and Suh (2008) concluded that different countries exist amidst unique regulatory environment and dividend policy regulations. Their findings may not apply across all markets. There have been differences in opinion among researchers on what exactly determines dividend policy.

Studies on dividend policy in Ethiopia are mostly inclined to its determinants in service industry such as financial and nonfinancial institutions, and manufacturing sector, chekole, Dagneu (2009), Twedros (2011) & Simegn (2013).

To the best of researcher knowledge, no prior study has focused on the impact of dividend pay-out policy on financial performance by using dividend pay-out ratio as independent variable and ROA and NIM as dependent variable. In addition, this study was employed three control variable namely firm size, liquidity and leverage. More so, the continuous debated on dividend policy decisions as well as conflicting findings on the subject matter has necessitated the need to carry out a research on the subject matter. Hence, this study was attempt to fill this gap by empirically investigating the impact of dividend policy on the performance of private commercial banks in Ethiopia.

1.4 OBJECTIVE OF THE STUDY:

1.4.1 GENERAL OBJECTIVE

The main objective of this study was to examine the impact of dividend pay-out policy on financial performance of private commercial banks in Ethiopia.

1.4.2 SPECIFIC OBJECTIVE

- To investigate the impact of dividend pay-out ratio on ROA
- To find out the impact of dividend pay-out ratio on NIM.

1.5. RESEARCH HYPOTESIS

H1: dividend pay-out ratio has positive significant influence on ROA.

H2: dividend pay-out ratio has positive significant influence on NIM

1.6. SIGNIFICANCE OF THE STUDY

This study was designed to investigate the impact of dividend pay-out policy on financial performance of private commercial banks in Ethiopia; it is important to both internal and external stakeholders of the banks.

The study will help for the management of Ethiopian commercial banks in their dividend decision through identifying significant impact of dividend payment policy on the banks profitability.

The study will have a great importance for external stakeholders such as investors in their investment decision on the banks, the community for which the financial service is provided. The government which regulates the sector for the sake of the safety of the public resource and sustainable economic development. In addition, other interested researchers on this area may use as a source for detailed and further studies.

1.7. SCOPE OF THE STUDY

This study was focused on private commercial banks that are currently operated in the banking sector in Ethiopia. Even though there are many variables identified from previous literatures, this study is limited to examine only the impact of dividend pay-out policy on the financial performance private commercial banks in Ethiopia by using one independent variable which is dividend pay-out policy with three control variable and two dependent variables namely return on asset and net interest margin. Furthermore, this study was covered from 2010 to 2018-time period operation of banks that affect the dividend policy decisions. Therefore, the study was covered all banks that are under operation during the period and have audited financial statement for the period.

1.7.1 LIMITATION OF THE STUDY

A study of the impact of dividend pay-out policy in Ethiopia commercial banks needs wider coverage in terms of countrywide examination of all factors deemed necessary. The study uses quantitative approach and secondary data. Consequently, the study lacks rich qualitative data that triangulate and further explain the quantitative findings. Furthermore, the sample includes only a private bank only in Ethiopia and covered by firm specific factor. It would be difficult, therefore, to generalize unless this kind of study is undertaken in some more developing countries like Ethiopia. Despite the limitations, compressive study was conducted to the achievement of the research objectives.

1.8 ORGANIZATION OF THE PAPER

The paper is organized in five chapters. Chapter one is the introduction part that addresses; background of the study, statement of the problem, objective of the study, hypothesis of the research, scope of the study, significant of the study, Chapter two presents theoretical and empirical review of the literature related. Chapter three provides research design and methodology employed for the research, the fourth chapter is about data presentation and analysis and the final chapter is all about conclusion and recommendation.

CHAPTER TWO

2. RELATED LITERATURE REVIEW

2.1 INTRODUCTION

This chapter focuses on the meaning of dividend pay-out, different theories on dividend pay-out, dividend policies as well as detailed review of empirical studies on impact of dividend policy on private bank financial performance and previous research knowledge gap. It was provided the reader relevant theories and previous studies related the impact of dividend, on financial performance.

2.1.1 DIVIDEND PAY-OUT

Dividend represents the distribution of the company's after tax earnings to shareholders with the residual being retained earnings. (Pandy, 1979) defines dividend as that portion of a company's net earnings which the directors recommend to be distributed to shareholders in proportion to their shareholdings in the company. It is usually expressed as a percentage of nominal value of the company's ordinary share capital or as a fixed amount per share. When a company makes a profit there are mainly two alternatives in which the company can make use of the profit. The first alternative is to retain the earnings within the company in order to improve or develop something internally. The second alternative is to pay out the profit to the shareholders, if the company chooses the latter approach there are two alternatives in which the company can distribute the profits to the shareholders. The company can either pay dividends or they can buy back their outstanding stocks (Brealey et.al., 2008).

To determine the proportion of net earnings to appropriate to shareholders as dividend is a major challenge faced by firms because of the alternative uses of such earnings. Nuredin (2012) stated that firms are faced with dilemma of sharing dividend to stockholders and retaining their earnings with a view to reinvesting it into the business so as to promote further growth. Retaining such earnings and reinvesting it for growth and expansion may seem to be a better option. However, dividend could be a means of financial performance red flag especially to investors who need to be assured that the future of the firm is bright and promises enhanced return on investment.

Dividend is usually decided upon by the board of directors at the declaration date (Brealey et.al 2008). The onerous task on the side of the directors as shareholders 'fund managers is to be able to strike a balance between the proportion of net earnings to retain for investment purposes and the amount of earnings to appropriate as dividend to shareholders. The dividend policy is set to encourage retention for investment and at the same time, it canvasses for dividend pay-out.

This is because, it is widely believed, against the position of (Miller & Modigliani, 1961), that payment of dividend to shareholders has a signalling and multiplier effect of pushing up the share price; though reducing available cash for investment. There are other reasons as suggested by (Gill, Biger and Tibrewala, 2010) why dividend should be paid such as: dividends provide certainty about the company's financial wellbeing, Dividends are attractive for investors looking to secure current income, and Dividends help maintain market price of the share.

This scenario might have informed Finnerty (1986) advice that firms should establish its dividend policy with a view to capitalize shareholders wealth, set its pay-out policy to keep with its investment opportunities and internal funds need, taking knowledge of the relative preferences of its shareholders for capital gains and dividends; liquidity preferences and the relative costs to the firm and to shareholders of selling shares to meet socio-economic needs when there is no dividend; and legal or policy restrictions on substantial shareholders that may create a preference for dividend income.

The conventional wisdom is that a properly managed dividend pay-out policy had an impact on share prices and shareholders 'wealth (Gill, Biger and Tibrewala, 2010). (Nwidobie, 2013) is of the opinion that the higher these dividends, the satisfied are these owners who see such financial investments as rewarding, and thus attractive to non-owners to invest in; as payment of the reward, dividend, signals good prospects for firms. He stated, while citing (Park, 2009) that dividend payments are associated with firms with good corporate governance, concluding that firms in —legal regimes that focus on protecting investors are more likely to pay even —higher dividends than firms in legal regimes with less investor protection as cited by (InyamaOkwo&Oliver, 2015)

Dividends are not always in the form of cash. Frequently companies also declare stock dividends. That means it sends each shareholder some extra shares for every shares currently

owned. A stock dividend is very much like a stock split (Ehrhardt & Brigham, 2002). Both stock dividends and splits increase the number of shares, but the company's assets, profits, and total value are unaffected. Eventually both reduce value per share. The distinction between the two is technical. A stock dividend is shown in the accounts as a transfer from retained earnings to equity capital, whereas a split is shown as a reduction in the par value of each share.

2.1.2. THEORIES OF DIVIDEND POLICY

The finance literature contains standard explanations for paying dividends: Dividend pay-out policy has an enlarged theoretical underpinning such as the bird-in-hand theory by (Gordon 1959), dividend irrelevancy theory by (Miller and Modigliani, 1961), life cycle theory of dividends by (Mueller, 1972), agency theory by Jensen and (Meckling, 1976) and the signalling theory by (Ross, 1977), tax preference and clientele effect. (Brealey & Meyers, 2003) argued that dividend increase indicates management's optimism about earnings and thus affects the stock price. But the jump in stock price that accompanies an unexpected dividend increase would happen eventually anyway as information about future earnings comes out through other channels.

A question arises whether the dividend decision changes the value of the stock, rather than simply providing a signal of stock value. One endearing feature of economics is that it can always accommodate not just two but three opposing points of view. Additionally, it is with the controversy about dividend policy which paved the road to emerge of different school of thoughts pertaining dividend. On the right there is a conservative group which believes that an increase in dividend pay-out increases firm value. On the left, there is a radical group which believes that an increase in pay-out reduces value.

The middle-of-the-road party was founded in 1961 by Miller and Modigliani (MM); when they published a theoretical paper showing the irrelevance of dividend policy in a world without taxes, transaction costs, or other market imperfections. By the standards of 1961 MM were leftist radicals, because at that time most people believed that even under idealized assumptions increased dividends made shareholders better off. But now MM's proof is generally accepted as correct, and the argument has shifted to whether taxes or other market imperfections alter the situation. In process, M & M have been pushed toward the center by New Leftist party which argues for low dividends. The leftists' position is based on MM's argument modified to take

account of taxes and costs of issuing securities. The studies carried out by (Black & Scholes, 1974), (Miller & Scholes, 1982) are in line with the propositions of the MM theorem. Those opposing the propositions can be classified into two groups. For instance, one group would be those who argue that a high dividend payment increases share price which in turn increases firm value and therefore decreases the cost of equity (Graham & Dodd, 1951). The other group gave evidence that higher dividend pay-out led to higher required rate of returns which adversely impacts on share price (Thwodos, 2011)

2.1.2.1 DIVIDEND IRRELEVANCE THEORY

Franco Modigliani and Merton Miller (1961) presented one of the most influential dividend theories and even though it was generated for more than 50 years ago it is still seen as one of the most respected theories. When the theory was presented in the article Dividend policy, growth and the valuation of shares it provided a new benchmark and changed the view that both practitioners and academics had towards dividends (Gustav & Gairatjon, 2012).

Modigliani & Miller (1961) put forward the irrelevance theorems, more commonly known as the MM theorems and argued that dividend policy has no effect on either the price of a firm's stock or its cost of capital; if dividend policy has no significant effects, then it would be irrelevant. They argued that the firm's value is determined only by its basic earning power and its business risk. In other words, MM argued that the value of the firm depends only on the income produced by its assets, not on how this income is split between dividends and retained earnings.

MM's argument that dividend policy is irrelevant based on that any shareholder can in theory construct his or her own home-made dividend policy. If a firm does not pay dividends, a shareholder who wants dividend can create it by selling of his or her stock. Conversely, if a company pays a higher dividend than an 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 costs, then the firm's dividend policy would truly be irrelevant. Note, though, that investors who want additional dividends must incur brokerage costs to sell shares, and investors who do not want dividends must first pay taxes on the unwanted dividends and then incur brokerage costs to purchase shares with the after-tax dividends. Because taxes and brokerage costs certainly exist, dividend policy may well be relevant.

In many cases, the MM theorems have been argued to be irrelevant mainly because of the assumptions based on a perfect world without taxes and no market imperfections; they assumed that everyone; investors and managers alike has identical information regarding the firm's future earnings and dividends. In reality, however, different investors have different views on both the level of future dividend payments and the uncertainty inherent in those payments, and managers have better information about future prospects than public stockholders. Hence, in the real world, these assumptions do not hold. For example, companies pay corporate taxes and there are many imperfections which provides arbitrage opportunities. Various theories have been developed with the relaxation of MM assumptions.

The theories had with main objective to explain why companies pay dividends. Black (1976) argued that there may be infinite reasons of paying dividends and posed the question, if dividends are irrelevant, why do corporations pay dividends 'and why investors 'pay attention to dividends'. According to this researcher, dividends may simply represent the return to the investor who faces a particular level of risk when investing in the company. He mentioned, also, that companies pay dividends as a means of rewarding existing shareholders but the main argument was that dividends were paid so that the company is seen as a worthwhile investment as cited by (Theodros, 2011).

2.1.2.2 BIRDS-IN-HAND THEORY

The opposing view towards Modigliani and Miller's dividend irrelevance theory is that dividends affect the company's value and this assumption is represented by the so-called bird in hand theory. The theory was first mentioned by Lintner in 1956 and it has been supported by various researchers including (Gordon, 1959&1962). The name bird in hand is the umbrella term for all studies that argues that dividends are positively correlated to the company's value. It is based on the expression that a bird in the hand is worth more than two in the bush.

Expressed in financial terms the theory says that investors are more willing to invest in stocks that pay current dividend rather than to invest in stocks that retain earnings and pay dividends in the future. This is due to the high degree of uncertainty related to capital gains and dividends paid in the future. Current dividends are more predictable than capital gains, since the stock price is determined by market forces and not by the managers it has a higher degree of uncertainty (Keown et.al, 2007).

The bird-in-hand theory argues that cash dividend received now, reduces the risk associated with the uncertainty surrounding deferred income; in form of capital gain. Hence, investors may prefer to purchase shares of companies with track record of dividend pay-out than companies that retain heavily for growth and expansion. The dividend irrelevancy theory opines that in a perfect market with independence of investment and dividend policies, perfect capital market information, no taxes, no agency, contracting, transaction or flotation costs, and complete market, dividend pay-outs may not influence firm value. In this scenario, investors create dividend by disposing their shares and usually at a minimal or no costs; thereby making dividend pay-out policy very irrelevant and unattractive (Inyiama Okwo & Oliver, 2015)

The underlying assumptions of Gordon's model is based on the idea of what is available today compared to what may be available in the future (Khan & Jain, 2008). It is based on the logic that the more distant the future is, the higher the uncertainty regarding capital gains and future dividends. Even though the capital gains in the future may provide a higher return than the current dividends, there is no guarantee that the investor will accumulate a higher return due to the high degree of uncertainty (Gordon, 1962). Since the length of the time and the level of risk are correlated, investors are unwilling to invest in companies where the time until the dividend payments are far away.

An investor would therefore be willing to pay a higher price for firms that pay current dividends. For companies who do not pay current dividends, the investor would use a higher discount rate in order to discount the earnings and the value of these companies should therefore be lower than the companies who pay current dividends (Khan & Jain, 2008) companies who pay current dividends have a lower level of retained earnings which contributes to lower discount rate which in turn contributes to a higher value of the firm.

Lintner's (1956) main arguments towards the bird in hand theory is based on that most companies are conservative in their financing policy and the dividend payments are therefore based on an optimal pay-out ratio. The principal factor that contributes to deviations from the optimal pay-out ratio is due changes in the company's profit, and if the profit increases the dividend pay-out should increase in the same proportions (Myers & Bacon, 2004). But uncertainty regarding future profits also has an impact on the company's dividends. If the

estimated risk in the future is higher than the current risk, the company may decrease the dividend pay-out ratio in order to hedge to decreasing future profits (Friend & Puckett, 1964).

The bird in hand theory has been subject to a large amount of criticism and opponents to the theory states that it excludes important factors. Keown et.al (2007) argues against the theory and says that increases in current dividends do not decrease the riskiness of the company; it does in fact work in the opposite direction. Because if an increase in dividend payments are made the managers have to issue new stocks in order to raise the needed capital. Therefore, a dividend payment just transfers the risk from the old to the new shareholders. But even though the theory contains some limitation (Keown et.al, 2007) argues that there are still many individual investors and financial institutions who consider that dividends are important and it is therefore of importance to include the theory even though it has some limitations (Gustav & Gairatjon, 2012).

The principal conclusion of MM's dividend irrelevance theory is that dividend policy does not affect the required rate of return on equity. As stated in the above, the bird in hand theory is the opposing view towards Modigliani and Miller's dividend irrelevance theory and it says among other things that companies with higher profits pay higher dividends to its shareholders (Gustav & Gairatjon, 2012).

2.1.2.3. TAX PREFERENCE THEORY

Taxation is one the critical factors that affect firm value and future expected profits. For example, discounted expected after-tax cash flows can be used as a determinant for the market value of a firm. In this respect, differential tax treatment of capital gains relative to the dividends can influence the after-tax returns of investors and in turn affect the willingness of investors to receive dividends (demand for dividends). (Brennan, 1970) was the one of the first who investigated the relationship between dividend yields and risk adjusted returns in the context of taxation. He proved that using the Capital Asset Pricing Model (CAPM), the pre-tax excess return on a security is positively and linearly related with the dividend returns and systematic risk of the security. In other words, the tax disadvantages of dividends faced by investors in general is compensated by higher pre-tax returns. These findings were further supported by (Litzenberger & Ramaswamy, 1979).

Brigham & Houston (2004) pointed out three tax-related reasons for thinking that investors might prefer a low dividend pay-out to a high pay-out: for example, in case of USA the long-term capital gains are taxed at a maximum rate of 20 percent, whereas dividends are taxed at effective rates that go up to 39.1 percent. Therefore, wealthy investors (who own most of the stock and receive most of the dividends) might prefer to have companies retain and low earnings back into the business. Earnings growth would presumably lead to stock price increases, and thus lower-taxed capital gains would be substituted for higher-taxed dividends. In addition, taxes are not paid on the gain until a stock is sold. Due to time value effects, a dollar of taxes paid in the future has a lower effective cost than a dollar paid today. Furthermore, if a stock is held by someone until he or she dies, no capital gains tax is due at all the beneficiaries who receive the stock can use the stock's value on the death day as their cost basis and thus completely escape the capital gains tax.

Because of these tax advantages, investors may prefer to have companies retain most of their earnings. If so, investors would be willing to pay more for low-pay-out companies than for otherwise similar high-pay-out companies.

As a whole, some empirical evidences in this section reveal that there exists a positive relationship between dividend yields and stock returns while other literature oppose this argument. However, the findings remain subjective to one's own understanding. It can be said that capital gains face a lower tax rate as compared to dividend yields. Moreover, capital gains are only taxed when they are realized. In Ethiopian law every person deriving income from dividends from a share company or withdrawals of profits from a private limited company shall be subject to tax at the rate of ten percent and this tax is exempted if the investor invests his dividend income back to the business (FDRE Income Tax Proclamation no.286/2002).

2.1.2.4 AGENCY THEORY

The agency theory is one of the most respected dividend theories and it has been extensively debated among various scholars. One of the most influential studies regarding agency costs was presented by (Jensen & Meckling, 1976). The study provided a new view of the agency problem and most studies concerning agency costs use Jensen and Meckling's (1976) research as a benchmark. They define the agency cost as a cost that arises between the principals (stockholders) and the agents (management). Principals hire and delegate the agents with a

certain power to maximize the wealth of the principals. They further state that only stocks and bonds can be used as claims towards the company. Hence, only shareholders and creditors can be seen as principals. Jensen and Meckling presented a prominent research regarding agency costs and they provided a clear definition of what the agency cost is. But they did not provide a thorough corroboration regarding the effect of agency cost on dividend policies and many scholars have been trying to develop the theory.

Easterbrook (1984) presented another study regarding agency costs and his result supports the findings made by (Rozeff, 1982) & (Jensen, 1976). Easterbrook conducted an investigation of whether dividend payments can be used in order to minimize the agency costs between managers and investors. Easterbrook states that two factors affect the agency costs in a company, monitoring costs and the risk aversion preferences of managers. The monitoring cost refers to the costs incurred by the shareholders in order to supervise the managers and prevent them from following their own personal agendas instead of maximizing the value of the shareholder's equity. The second source of agency costs is the risk aversion preferences of managers.

The problem arises because most shareholders have diversified portfolios and they are therefore only interested in systematic risk which cannot be eliminated through diversification. In contrast to shareholders, managers usually have a large amount of their personal wealth connected to the company. Therefore, if the company is unprofitable or even goes bankrupt, the managers' personal wealth becomes heavily affected. The managers will as a result be more risk averse compared to the shareholders and they may reject potential high value project due to their risk aversion preferences (Gustav & Gairatjon, 2012)

As stated before, agency problem refers simply the principal-agent problem where the principle is the holder of the stocks or shareholders and the agent is the manager dividends can be used as a tool to reduce agency costs. The main duties of the manager would be to run the firm effectively and efficiently so as to maximize firm value and also maximize returns to the shareholders. However, agency problem arises when managers' and shareholders' interests are not in line with each other. This may arise since the manager is not acting in the interest of the shareholders, for example, the manager is not investing in projects that the shareholders consider to be worth investing.

In addition to cost of monitoring the managers another problem that exists in this case is that the managers are involve in the daily running of the business and they are more aware about which investment should bring higher positive returns. However, past studies show, it has been observed that if managers are not monitored properly, they tend to surround themselves with luxury products and also tend to pursue their personal interests which in most cases would be to maximize their wages instead of returns to shareholder (Jensen, et al., 1992).

According to Easterbrook (1984) these two sources of agency cost can be reduced by paying dividends to shareholders. However, Easterbrook further states that dividends are worthless in themselves and companies should therefore only pay dividends in order to reduce agency conflicts.

Another theory that explains the agency cost is the free cash flow theory by (Jensen, 1986). Jensen argues that the agency costs arise as the free cash flow increases. Because the shareholders have to increase the supervision in order to prevent the managers from engaging in excessive spending or unprofitable investments, such as empire building. This can be explained by the positive correlation between the size of the company and the enumeration plan of management (Murphy, 1985). In order to prevent these kinds of conflicts between managers and shareholders, Jensen argues that the companies should pay excessive free cash flow as dividends to shareholders. Otherwise, the managers may follow their own personal agenda instead of maximizing the wealth of the shareholders (Gustav & Gairatjon, 2012).

2.1.2.5 SIGNALLING THEORY

The signalling theory of dividends has its origins in Lintner's (1956) studies who revealed that the price of a company's stocks usually changes when the dividend payments changes. Even though (Modigliani and Miller, 1961) argued in favour of the dividend irrelevance they also stated that in the real world disregarding the perfect capital markets, dividend provides an information contentll which may affect the market price of the stock. Many researchers have thereafter been developing the signalling theory and today it is seen as one of the most influential dividend theories.

The signalling theory by Ross (1977), who created a theoretical model, had its root from the information asymmetry existing between managers as fund users and shareholders as fund

providers. The theory assumes that managers have access to more information relating to the value of the firm's assets than other outside agents and investors. Therefore, managers seek to use dividend pay-out policies to signal to the shareholders about the financial performance of their firms. In addition, the firms could also reveal the strategies adopted in pursuing their vision and attaining their mission (Inyiama Okwo & Oliver, 2015).

Bhattacharya (1979) presented one of the most acknowledged studies regarding signalling theories which states that dividends may function as a signal of expected future cash flows. An increase in the dividends indicates that the managers expect higher cash flows in the future. The research is based on the assumptions that outside investors have imperfect information regarding the company's future cash flows and capital gains. Another important assumption is that dividends are taxed at a higher rate compared to capital gains. Bhattacharya (1979) argues that under these circumstances even though there is a tax disadvantage for dividends, companies would choose to pay dividends in order to send positive signals to shareholders and outside investors.

Baker (2009) states that a company's source of information such as accounting data and future prospect reports is not completely reliable. These kinds of information do not fully represent a company's profitable business opportunities in the future. Given that outside investors have imperfect information regarding the firm's profit opportunities, the company has to find other ways in order to convince outside investors about future cash flows and profits. Therefore, favourable signals such as increasing dividends provide a positive sign to outside investors.

The signalling hypothesis was further developed by (Miller & Rock, 1985) who stated that there is a high degree of information asymmetry between managers and outside investors. They further state that almost any company is able to pay small dividends to its shareholders regardless of whether its future outlooks are positive or negative. Consequently, if the dividend payments should be seen as a signal for profitable future business opportunities the dividend has to be large enough so that only companies with profitable future prospects can afford to pay it. Otherwise, companies with poor future prospects would just copy the signals and pay the same number of dividends in order to send false signals to investors.

A lot of research has been conducted in order to test if the signalling theory applies in the real world and there exist different opinions regarding the applicability of the signalling theory. (Asquith & Mullins, 1983) provided empirical evidence in favour of the signalling theory. They argue that an increase of dividend payments tends to increase the shareholders wealth. Asquith and Mullins also state that dividends contain information which is not available in other sources of information such as accounting data. But the signalling theory cannot be seen as applicable in all situations and a lot of researchers have found various drawbacks with the theory. For example, (Pettit, 1972) and (Black, 1976) states that the informational role of dividends are exaggerated and there exist less expensive way to signal the same information to shareholders (Gustav & Gairatjon, 2012)

The top management of a firm has more information about the strategy of the firm and can also forecast future earnings of the company. Therefore, people working in the firm have more information as the other investors and the market in general. Thus, this leads to the problem of information asymmetry. Hence, firms can use dividends as a signalling mechanism which sends information to investors in the market or to its shareholders. The information may reflect the strategies that the firm is employing in the short run or long run. Managers of the firm can change the expectations of people with regards to its future earnings through dividends. A firm has several ways is sending information to the market. This can include costly methods which will prevent smaller firms from imitating the signal. The methods refer to increasing the price of dividend; that is increasing dividend pay-out.

2.1.2.6 CLIENTELE EFFECT THEORY

The theory states that different shareholders of a firm prefer different dividend pay-out policies. Taxes and transaction cost influence a shareholder's preference for either capital gains or dividends. Different shareholders have different income levels. Retired individuals or those with no regular source of income or low-income earners prefer firms that pay a high dividend pay-out. Such investors are usually in zero or low tax bracket hence taxes are of no concern to them. They also view such regular dividend pay-out as a source of regular income to take care of their immediate consumption/needs (Petit, 1977).

Investors with a regular source of income have no urgent need for dividends issued by the firm. They prefer the firm to pay less or no dividends at all but instead offer capital gains which

attracts a low tax payment as compared to dividends. Even if they are paid any dividends, they would simply reinvest them after first paying income taxes on the dividend income. Pettit (1977), argued that stocks with low dividend yields will be preferred by investors with high income; by younger investors; by investors' whose ordinary and capital gains tax rates differ substantially; and investors whose portfolios have high systematic risk.

MM (1961) argued that one client is as good as the other and so the existence of clientele effect does not necessarily imply that one dividend policy is better than the other. He may be wrong, though, no one has offered proof that the aggregate makeup of investors, permits firms to disregard clientele effects as this issue, like most others in the dividend arena, is still up in the air (Brigham and Gapenski, 2002).

Hence the clientele effect refers to firms making their dividend policy decision based the customers they would like to attach to themselves (Litzenberger and Ramasawmy, 1979). Brigham and Houston (2004) avowed as stockholders can switch firms based on their specific dividend preference a firm can change from one dividend pay-out policy to another and then let stockholders who do not like the new policy sell to other investors who do. However, frequent switching would be inefficient due to some constraints brokerage costs, the likelihood that stockholders who are selling will have to pay capital gains taxes, and a possible shortage of investors who like the firm's newly adopted dividend policy. Thus, management should be hesitant to change its dividend policy, because a change might cause current shareholders to sell their stock, forcing the stock price down. Such a price decline might be temporary, but it might also be permanent if few new investors are attracted by the new dividend policy, then the stock price would remain depressed. Of course, the new policy might attract an even larger clientele than the firm had before, in which case the stock price would rise in this case, the company will be fully financed through debt. This will dramatically increase the leverage thereby increasing the risk of going bankrupt (Jensen, et al., 1992).

The life cycle theory of dividends by (Mueller, 1972) argued that a firm has a relatively well-defined life cycle, which is fundamental to the firm life cycle theory of dividends. However, as firms develop and age through its 'life cycle, they tend to alter the dividend policy depending on the financial demands of a particular stage. By implication, firms at their early stages of growth are likely to retain more earnings for expansion, thereby paying lesser dividend than older firms.

More matured and older firms are likely to pay more dividends as growth opportunities would have dwindled. Agency relationship is defined by Jensen and (Meckling, 1976) a contract under which one or more persons the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent. The theory stated that dividends act as a protection for investors because dividends reduce the excess cash available to managers after investment and operational activities (Inyiama Okwo & Oliver, 2015).

2.1.4 DIVIDEND POLICIES

A dividend policy is an action plan adopted by a firm's directors whenever dividend pay-out decisions are to be made. It determines the division of earnings between shareholders (dividend payment) and the company (reinvestment).

Dividend pay-out policies in practice are designed to suit each firm's requirements necessary to achieve firm specific goals. The main approaches include: residual, stable predictable, constant pay-out or low regular plus extra policy. Dividend pay-out policies assist a firm to vary dividend payment from period to period and from year to year depending on the cash flows and the financing requirements (Pander, 2005)

Dividend policy, in practice, primarily concerned with the decisions regarding dividend pay-out and pattern of payment and retention. It is a decision that considers the number of profits to be retained by the company and that to be distributed to the shareholders of the company (Watson & Head, 2004). Investors may or may not prefer dividends to capital gains, but that they do prefer predictable to unpredictable dividends.

Given this situation, determining firm's specific percentage of earnings that it will pay out as dividends remains as important task of managers. (Bringham & Houston, 2004) argued when deciding how much cash to distribute to stockholders, two points should be kept in mind: The overriding objective is to maximize shareholder value, and the firm's cash flows really belong to its shareholders, so management should refrain from retaining income unless they can reinvest it to produce returns higher than shareholders could themselves earn by investing the cash in investments of equal risk.

Theoretically, there are different types of dividend policies establishing target pay-out ratio. These include constant pay-out, progressive policy, residual policy, and zero policy and noncash dividend policy. Investors are seen to belong to a particular group or clientele. This is because they tend to pitch their tent with a particular policy that might suite them. This is the clientele effect of dividend policy (Hutchinson, 1995, Kolb; Rodriguez, 1996).

Under this policy, the dividend payment is set equal to the actual earnings available less the amount of retained earnings necessary to finance the firm's optimal capital budget. (Myers, 1984) argued that firms will only pay dividends from residual or leftover equity after all project capital requirements are met. This implies that companies using this policy tend to finance new projects through internally generated funds and thus the decision to pay dividends is only made if there is enough money left over after all operating and expansion expenses. According to this policy, dividends would thus fluctuate from period to period. This would create uncertainty to investors and as a result the cost of capital may increase. The policy best suits growth companies with large growth prospects (Ongeri, 2014)

I. Pure residual dividend policy

When the corporation return on equity capital is greater than the rate of return the investor could obtain by reinvesting those dividends in another investment of equivalent risk, the investor would rather the corporation act on his behalf and reinvest the earnings rather than issue a dividend; the firm can determine which option is better suitable to benefiting the investor by first identifying the firm's optimal capital budget, thereby noting the level of equity capital required, and then maintaining the amount of earnings required to finance the equity capital in the capital budget and allowing residual funds (earnings not utilized in internal investment) after the mandated reinvestment to be issued as a dividend (Droms, 1990).

Therefore, dividends are a function of earnings fluctuations, and this method allows for significant fluctuations in dividends with changes in earnings and corporate investment opportunities. In effect, all residual earnings are paid out which causes the dividend pay-out ratio to fluctuate. This policy also results in a dividend that varies from year to year, and when equity investment is greater than earnings, equity financing must be initiated to create a residual (Droms, 1990).

II. Smoothed residual dividend policy

Based on this policy dividend fluctuation are kept to a minimum. The policy changes tend to lag behind earnings fluctuations according to Shapiro, as dividends are set equal to the long run residual between forecasted earnings and investment requirements. Dividend changes, in turn, are made only when this long run residual is expected to change; earnings fluctuations believed to be temporary are ignored in setting dividend payments.

The clear preference is for a stable, but increasing, dividend per share (Shapiro, 1990). As such, the dividend pay-out ratio fluctuates significantly with this payment method, and dividends have the potential to exceed the residual if earnings are unexpectedly low.

III. Constant or fixed policy

This policy entails payment of a certain constant percentage of earnings to the shareholders for each dividend period hence since earnings fluctuate from period to period, likewise, dividend per share will also fluctuate. However, a problem comes in when earnings drop or worse still when the company makes losses in which case dividends may be low or non-existent. This would cause uncertainty to the investors. In addition, as noted by (Watson &Head, 2004), the policy could be traumatic to companies experiencing a volatile or fluctuating profit earning. This is because of the uncertainty of its profit. If capital projects are to viable capital projects, the policy can be chaotic.

IV. Progressive policy

Payments on dividend are on a steady increase usually in line with inflation. This could result in increasing dividend in money terms. The firm uses the policy as a ratchet. Every effort is made to sustain the increase even though marginal. Seldom, the company may be constrained to cut down on dividend pay-out. This is to enable it sustain its operations. This though not a frequent action as it sends a wrong signal to investors. Firms operating this policy will opt to avoid paying dividends during the period rather than consistently cut down on the dividend (Kolb & Rodriguez, 1996).

V. Zero dividend policy

Some firms may decide not to pay dividend. This is especially common in newly formed companies that rather require capital to execute its projects. All the profit is thus retained for expansion of the business as cited by (Theodros, 2011).

Investors who prefer capital gains to dividends because of taxation will naturally be lured by this kind of policy. This type of policy is quite easy to operate and avoids all the costs associated with payment of dividends (Watson and Head, 2004). There are also alternative policies in order to give shareholders a choice between dividends or new shares, the company might choose to buy back shares. This is share or stock repurchase. This has a significant advantage in terms of tax to the shareholder.

While the dividend is fully taxed just as ordinary income, the stock repurchases or buyback is not taxed until the shares are sold and the shareholder makes a profit or capital gain (Jordan, et al., 2001). There is also the policy of stock dividends and split. Shareholders are given additional shares in lieu of cash to the shareholders (Brealey & Myers, 2003).

VI. Stable or Predictable Policy

This policy involves payment of a specific amount of dividend per share in each dividend period or periodically increasing the dividends at a constant rate. This reduces uncertainty on future dividends since dividends become more predictable. If, however, management is convinced that the new higher level of earnings is permanent, then an increase in the number of dividends can be made (Lintner, 1956). Most firms prefer reasonably stable dividends policies.

Dividend stability: According to (Brigham & Houston, 2004) the stability of dividends is important. Profits and cash flows vary over time, as do investment opportunities. Taken alone, this suggests that corporations should vary their dividends over time, increasing them when cash flows are large and the need for funds to invest is low and lowering them when cash is in short supply relative to investment opportunities. However, many stockholders rely on dividends to meet expenses, and they would be seriously inconvenienced if the dividend stream were unstable. Further, reducing dividends to make funds available for capital investment could send incorrect signals to investors, who might push down the stock price because they might interpret the dividend cut to mean that the company's future earnings prospects have been diminished.

Thus, maximizing its stock price requires a firm to balance its internal needs for funds against the needs and desires of its stockholders.

Dividend stability has two components: How dependable is the growth rate, and can we count on at least receiving the current dividend in the future? The most stable policy, from an investor's standpoint, is that of a firm whose dividend growth rate is predictable such a company's total return (dividend yield plus capital gains yield) would be relatively stable over the long run, and its stock would be a good hedge against inflation. The second most stable policy is where stockholders can be reasonably sure that the current dividend will not be reduced, it may not grow at a steady rate, but management will probably be able to avoid cutting the dividend. The least stable situation is where earnings and cash flows are so volatile that investors cannot count on the current dividend in the future (Theodros, 2011).

According to Stable Dividend hypothesis, a firm's value is influenced by the regularity of its dividend pay-out. Firms with stable dividend policies enjoy better valuation in the capital markets than those with variable dividend policy. It therefore follows that the investors of firms following stable dividend policy will enjoy better opportunity for wealth creation. Stable dividend policy results in more predictable cash flows in the hands of the shareholders; this reduces uncertainty and consequently the required rate of return whereas variable dividend policy makes the cash flow in the hands of shareholder more variable and hence increases their risk and subsequently, the required rate of return. Managers may then have to satisfy the shareholder's preference for increases in rate of return; else the value of the firm will be subsequently affected (manoj and manasvi, 2012)

2.2 FIRM FINANCIAL PERFORMANCE (PROFITABILITY)

Profit is the major intention of a business. An enterprise should make profits to continue and grow over a long period of time. It provides evidence concerning the earnings potential of a company and how effectively a firm is being managed. If the enterprise fails to make profit, capital invested is eroded and if this situation extends the enterprise ultimately ceases to exist.

A profitable financial sector is better able to withstand negative shocks and contribute to the stability of the financial system. Important changes in the operating environment particularly credit risk is likely to affect banks profitability. Empirical analysis finds that both banks specific as well as macroeconomic factors are important determinants in the profitability of microfinance institutions, (Westerfield, 2008). Brealey and Myers (2003) argue that there are numerous important measures in determining profitability of an organization. These include; Return on Assets (ROA) and Return on Equity (ROE).

Profitability measures, such as return on equity and return on assets, incline to summarize performance in all areas of the company. If portfolio quality is poor or efficiency is low, this will be reflected in profitability (Micro Rate & Inter-American Development Bank, 2003).

But in the same guide they also point out that all performance indicators tend to be of limited use (in fact, they can be outright misleading) if looked at in isolation and this is particularly the case for profitability indicators.

To measure the profitability of banks we can use Return on Equity, Return on Assets and Portfolio Yield as indicators (Micro Rate & Inter-American Development Bank, 2003).

2.3 PROFITABILITY MEASURES

The two major methods of measurements of profitability are: the traditional accounting-based measurements and economic measurements of profitability. In economic measurements of profitability, the two common methods are: Risk-Adjusted Return on Capital (RAROC) and economic value added (EVA), which are the economic based metrics of economic profits. Following Kimball study as cited in (Ommeren, 2011) these metrics are taken into account risks and opportunity costs of equity when measuring the profitability.

But related to Ommeren (2011) study, although, numerous banks disclose RAROC and EVA economic profit metrics, academic literature does not use these measures to analyze banks' and other financial institution's profitability, because the disclosed parameters are subject to internal policies and assessments which cannot be generalized or validated. So, the researcher attempts to discuss more on accounting measurements of profitability.

The traditional accounting-based measures are easy proxy of banks profitability, obtainable from public disclosed information. As concluded by extensive Prior academic researches there are different accounting-based measures for financial institutions' profitability. For instance, return on Equity (ROE) used by Goddard et al, (2004), Return on Assets (ROA) used by (Flamini et al., 2009, return on equity (ROE) and Return on Assets (ROA) used by Athanasoglou et.al. (2006), Ommeren (2011) and Demirguc-Kunt and Huizinga (1999) uses as proxy for profitability.

2.3.1. RETURN ON ASSET

The return on assets ratio measures how effectively a company can earn a return on its investment in assets. In other words, ROA shows how efficiently a company can convert the money used to purchase assets into net income or profits.

Since all assets are either funded by equity or debt, some investors try to disregard the costs of acquiring the assets in the return calculation by adding back interest expense in the formula.

It only makes sense that a higher ratio is more favorable to investors because it shows that the company is more effectively managing its assets to produce greater amounts of net income. A positive ROA ratio usually indicates an upward profit trend as well. ROA is most useful for comparing companies in the same industry as different industries use assets differently. For instance, construction companies use large, expensive equipment while software companies use computers and servers.

2.3.2 NET INTEREST MARGIN

Net interest margin is a ratio that measures how successful a firm is at investing its funds in comparison to its expenses on the same investments. A negative value denotes that the firm has not made an optimal investment decision because interest expense exceed the amount of returns generated by investments. Net interest margin is expressed a percentage. It is one of the profitability indicators of an organization, showing how much it earns on interest from its credit products—loans, mortgages compared to the interest it pays out on things like savings accounts and certificates of deposit (Robert A. Goddard, 1992).

Net Interest Margin Works

Net interest margin is typically used for a bank or investment firm that invests depositors' money, allowing for an interest margin between what is paid to the bank's client and what is made from the borrower of the funds. A positive net interest margin indicates an entity invests its funds efficiently, while a negative return implies the bank or investment firm doesn't invest efficiently. In a negative net interest margin scenario, the company is better served by applying the investment funds toward outstanding debt or utilizing the funds for more profitable revenue streams.

Net interest margin is a profitability indicator investor really needs to understand before they make certain investments. Here's a way to simplify the concept of net interest margin. Banks lend money to customers. That capital comes from money from people making deposits, other lenders, and shareholders. They earn money from the interest on those loans, which is offset by the interest they pay to consumers with savings accounts. If a bank consistently has a negative net interest margin, investors may want to steer clear because it lends more than it makes in interest. All the figures needed to calculate an institution's net interest margin can be found in its financial statement

$$\text{Net interest margin} = \frac{\text{investment return} - \text{interest paid}}{\text{Average asset}}$$

2.4. PROFITABILITY AND DIVIDEND POLICY

According to McCabe (2011), the profitability of a company is the most essential and reliable indicator of financial performance. Profitability provides a broad indication that a firm has the ability to raise its income level. Companies with consistent high profit levels tend to pay high dividends to the shareholders. This can explain why higher profitability persistence is witnessed in larger companies because they are more flexible to changes than the small sized firms in similar markets. Friend and Puckett (2004) purported that high dividend ratios are not always a good strategy to adopt by firms. They recommend reinvestment of the earnings not paid as dividends for it helps the company to grow its future earnings. High ratios may also imply that the company lacks enough funds to make new projects investments which affect the future profitability of the firms. The use of dividend policy ratios should seek to strike a balance between short term cash flow and growth in the firm's future earnings. The theoretical

expectation of a firm's profitability is that it is supposed to have an impact to the firm's dividend policy in place.

2.5. EMPIRICAL REVIEW

Muchira (2013) examined the relationship between dividend pay-out and financial performance of manufacturing firms listed in the Nairobi Securities

The target population was the listed manufacturing firms in Kenya as at December, 2015. All the ten listed firms at the period were used in the study. The study used secondary data. Annual financial reports for the period 2002-2015 were utilized as the main source of data collection for the 10 firms. Ordinary Least Squares (OLS) was used to estimate the coefficients of explanatory and control variables. Return on Assets (ROA) serves as the dependent variable, profitability, while Dividend Pay-out ratio proxy for dividend policy was the explanatory variable. Control variables include firm size and leverage. Correlational coefficient findings indicated that the independent variables that is; dividend pay-out, Firm Size, and Leverage, and the dependent variable -Return on Assets, all had a positive relationship. From the results, there is a clear positive and significant relationship between return on assets and dividend pay-out. The significance and the positive coefficient of the variable dividend pay-out indicate that when a listed firm has a policy to pay dividend it influences its level of future financial performance as measured by ROA.

Kolawole et al. (2018) investigated the effect of dividend policy on the performance of listed oil and gas firms in Nigeria spanning from, 2007-2016. Secondary data were sourced from 9 listed firms which formed the sample size of this study. The collected data were analysed using descriptive statistics, correlations matrix and pooled regression analysis. Also, residuals of result were subjected to various diagnostic tests such as Variance Inflation Factor and Heteroscedasticity. Findings from the analysis revealed that dividend pay-out ratio and retained earnings positively affects earnings per share of listed oil and gas firms in Nigeria while dividend yield had a significant but negative effect on earnings per share.

Hafeez et al. (2018) investigated the relationship between dividend policy and firm performance. The samples of 15 manufacturing companies in the year of 2014 to 2017 were used. Time series

data were calculated from the financial statement of the selected manufacturing firms. Return on asset (ROA) and return on equity (ROE) were used as dependent variables while dividend pay-out ratio (DPOR), earning per share (EPS) and price earnings ratio (PER) was modelled as independent variables. Multiple regressions like correlation, descriptive were used as data analysis techniques. Findings reveal that all the independent variable have a positive relationship with dependent variables. Dividend pay-out ratio, earning per share, price earnings ratio positively influence return on investment. Limitation of our study is that we examine only 15 manufacturing firm's other researcher uses large size sample and other sector firms expect manufacture.

Innocent et al. (2015) investigated the effect of dividend pay-out on performance evaluation of quoted cement companies in Nigeria over the past twelve years' period from 2003 to 2014. The researcher employed four variables for the analyses such as: Dividend Pay-out Ratio (DPR); Return on Capital Employed (ROCE); Return on Assets (ROA) and Return on Equity (ROE). Performance evaluation as dependent variable was represented by Return on Capital Employed (ROCE); Return on Assets (ROA) and Return on Equity (ROE) while Dividend Pay-out stands as Dividend Pay-out Ratio (DPR) for independent variable. Secondary data were obtained from the financial statements (Statement of Comprehensive income and Statement of Financial Position) of the selected quoted cement companies in Nigeria on Nigerian Stock Exchange. The model specification for the analysis of data is ordinary least squares techniques applied as panel estimation. The researchers' empirical results suggest that dividend pay-out ratio (DPR) has positive relationship with all the dependent variables (ROCE, ROA and ROE) used for this study; that dividend pay-out ratio (DPR) has statistically significant with Return on Capital Employed (ROCE) and Return on Asset (ROA) while DPR has statistically insignificant with Return on Equity (ROE) of quoted cement companies in Nigeria and that of all the dependent variables (Return on Capital Employed; Return on Assets and Return on Equity) used for the study were affected by other variables outside the model. It further revealed that dividend pay-out ratio (DPR) has statistically significant effect on Return on Capital Employed (ROCE) and Return on Assets (ROA) of quoted cement companies in Nigeria while DPR has no statistically significant effect on Return on Equity (ROE) of quoted cement companies in Nigeria.

Thafani and Abdullah (2015) examined the impact of dividend pay-out on corporate profitability in the Manufacturing Companies listed on Colombo Stock Exchange in Sri Lanka. For this purpose, the data were extracted from the annual reports of the selected companies during the period from 2007 – 2011. Regression model was used to study and estimate the relationship between dividend pay-out and corporate profitability. The study also employed a subsample in order to arrive at a profound conclusion with regard to the impact of dividend policy on corporate profitability. The results of the study revealed that there was a significant relationship between dividend pay-out and corporate profitability in terms of return on assets, return on equity and earnings per share. A positive significant relation was found between dividend pay-out and return on assets and return on equity for the whole sample while significant negative relationship was found between dividend pay-out and earnings per share as far as the dividend paying sample was concerned.

2.5.1. SUMMARY AND KNOWLEDGE GAP

In this chapter the discussion was about the essential theories namely: dividend irrelevance, birds in_ hand, agency, signaling, theory, types of dividend, types of dividend payment policy and other related empirical studies on the impact of dividend policy on firm financial performance. From the theoretical and empirical studies point view, there are contradicting conclusions existed between empirical studies about the effect of dividend policy on financial performance of companies. In line with this theories and empirical studies, the researcher observed that, dividend policy affects the financial performance of firms in to positively or negatively.

Therefore, evaluating the impact of dividend policy on the profitability of all business firms is important, especially for financial industry like banks. The performance of banks can be affected by different factors such as company specific, macroeconomic and regulatory factors. From those factors the firm dividend decision is the most crucial parts in these business activities.

According to the empirical studies, there is no direct empirical literature which is related with impact of dividend policy on profitability of private banks in Ethiopia. So far, as to the knowledge of the researcher, there is no study directly linked with it. Even the existing studies were concentrated on determinates of dividend policy and effect of profitability on dividend policy on manufacturing companies, insurance companies, and other listed firms by using

different variable but they not include net interest margin. To this end, the researcher was conduct fill these gaps.

CHAPTER THREE

RESEARCH METHODOLOGY

INTRODUCTION

This chapter presents research design and methodology for the study. The first section of this chapter presented a research approach (the quantitative, qualitative and mixed method), following the research approach model specifications offered. Finally, the research method, which included data source, collection and analysis methods are presented

3.1 RESEARCH DESIGN

Research design is a master plan specifying the methods and procedures frame work for collecting and analysing the required data (Bryman& Bell, 2007). Or it is the plan and structure of investigation so conceived as to obtain answers to research questions (Cooper& Emory, 1995). This means it gives the procedure necessary for obtaining the information needed to solve the research problems. Many research designs could be used to study business problems Hair et al. (2011). The choice of research design depends on objectives that the researchers want to achieve (John, 2007). Depending on the way in which researchers ask their research questions and present their purpose, the research design could be classified into three groups, namely exploratory, descriptive and explanatory studies (Saunders et al., 2009).

Exploratory study is performed when the researcher has little information (Hair et al., 2011) or when the research problem is badly understood (Ghauri and Grønhaug, 2005). It is particularly useful to clarify the understanding of a problem, such as if you are unsure of the precise nature of the problem (Saunders et al., 2009).

As to the **descriptive studies**, they are designed to obtain data that describe the characteristics of the topic of interest in the research (Hair et al., 2011). In descriptive research, the research problem is structured and well understood (Ghauri and Grønhaug, 2005). Compared with exploratory study, descriptive study would give the readers a comforter answer addressed to the research question. In other words, it is used for testing hypothesis Hair et al. (2011).

The last category is **explanatory study** Saunders et al., (2009) or in some book scaled “causal research design” (Hair et al., 2011). In this research, the problems are well structured as in descriptive studies. In contrast to descriptive studies, the researcher is facing with “causes-and-

effects” problems. The main task is to separate such causes and to say to what extent they lead to such effects (Ghauri and Grønhaug, 2005). In other words, it is to explain the causal relationship between variables (Saunders et al., 2009). Explanatory research design examines the cause-and-effect relationships between dependent and independent variables (Kothari, 2004).

Therefore, based on the above discussion the research design of this study was an explanatory to achieve the intend objective of this study. Since this study was design to examine the cause-and-effect relationships between dividend policy and its impact on financial performance of private commercial banks.

3.1.1 RESEARCH APPROACH

The researchers have three alternatives of research approach to conduct a specific research, the qualitative, quantitative and mixed method. From these approaches the base for selecting one to conduct a research is research problem. If the research problem is to identifying the factors that influence an outcome then the quantitative approach is best (Creswell, 2002). Since the main objective of this study was to identify the impact of dividend pay-out on the financial performance of private banks in Ethiopia so researcher was applied quantitative research method. From the alternatives under quantitative research causal comparative research design because the causal comparative research designs provide an opportunity to the researcher to examine the interaction between independent variables (DPR) and their influence on dependent variables (ROA and NIM).

3.2 SAMPLE AND SAMPLING PROCEDURE

All private banks in Ethiopia are considered as the population of the study. Currently, in Ethiopia there are eighteen commercial banks out of these sixteen of them are private owned the remaining are owned by Government. For the purpose of this study, the researcher was collected nine years (2010-2018) secondary data from annual reports of selected private banks and national bank of Ethiopia. Banks was selected based on their establishment year

3.2.1 SAMPLING TECHNIQUE

Purposive sampling technique was used in case of availability of nine years’ data from selected private banks. Banks was selected according to their life existing in business. Relatively banks

which have short period in operation are not included due to in availability of the required data from them. Based on these eight senior private commercial banks in Ethiopia are taken as a sample for the study.

Annex 1 List of Commercial Bank Operating In Ethiopia

No	Bank Name	year of establishment
1	Development Bank of Ethiopia	1909
2	Commercial Bank Of Ethiopia	1963
3	Awash International Bank	1994
4	Dashen Bank	1995
5	Bank of Abyssinia	1996
6	Wegagen Bank	1997
7	United Bank	1998
8	Nib International Bank	1999
9	Cooperative Bank of Oromia	2004
10	Lion International Bank	2006
11	Oromia International Bank	2008
12	Zemen Bank	2008
13	Bunna International Bank	2009
14	Birhan International Bank	2009
15	Abay Bank	2010
16	Addis International Bank	2011
17	Dehub Global Bank	2012
18	Enat Bank	2012

3.3 DATA SOURCE AND COLLECTION

This study was used secondary data based on financial statements therefore the main sources of data was annual reports of the selected banks. Banks financial report, such as income statements, balance sheets and cash flow statement of concerned banks for the period from 2010 to 2018 was used.

3.4. DATA ANALYSIS METHOD

In this study to analysis the data, descriptive statistics and inferential statistics analysis is used. Descriptive statistics is used to measure the central value of the observations, Maximum and minimum to indicate the highest and lowest values respectively. The standard deviation also is used to measure the dispersion the values of all the dependent and independent variables.

Inferential statistics is used to measure the degree of association between the dependent and independent variable since it indicates the direction and the strength of association between independent and dependent variables and infer about the population (Kothari, 2004). To estimate the causal relationship between dependent and independent variables, the Ordinary Least Square (OLS) Regression analysis method is used by statistical software E-views 8.

3.5 VARIABLE DESCRIPTION

This study was conducted to examine the relationship between the dependent and independent variables through testing the hypotheses, regarding to the relationships between dividend policy and financial performance of private commercial banks in Ethiopia.

This study was selects dividend pay-out ratio as independent variable. The dependent variables are ROA, NIM and two additional control variable namely firm size and leverage. The computations for all of the variables (dependent and explanatory) are based on the review of literature and are discuss below.

3.5.1 INDEPENDENT VARIABLE

Dividend pay-out ratio

According to Lease et al. (2000), dividend Pay-out Ratio is the number of dividends paid to stockholders relative to the amount of total net income of a firm. Investors usually seek a consistent and/or improved dividends pay-out ratio. DPR is measured as:

$$\text{DPR} = \text{Total dividends} / \text{Total net earnings} \times 100\%$$

3.5.2 DEPENDENT VARIABLE

Return on asset

The return on assets ratio measures how effectively a company can earn a return on its investment in assets. In other words, ROA shows how efficiently a company can convert the money used to purchase assets into net income or profits (Mutie, 2011).

$$\text{Return on asset} = \text{total net income over total asset}$$

Net interest margin

Net interest margin is a ratio that measures how successful a firm is at investing its funds in comparison to its expenses on the same investments

$$\text{Net interest margin} = \frac{\text{investment return} - \text{interest paid}}{\text{Average asset}}$$

3.6 CONTROL VARIABLES

In order to test the relative impact of independent variables, control variables are included in the model to regulate for the flow of control. Among some of the control variables included but not of major study are firm size and leverage

3.6.1 SIZE

As firm grow, they mature, have easy access to financial market and become less dependent on internally generated funds which allow them to pay higher dividends. Larger firms pay lower transaction cost as compared to smaller ones due to the economies of scale or scale they may enjoy in operations. It therefore expected that size of a bank has positive influence on its performance (Talat Afaz, 2011).

Firm size =the logarithm of total assets to control for size differences across the sample firms.

3.6.2 LEVERAGE

High debt means that firms have high interest expense, which will lead to a low net income and thus less earning will be available for shareholders. Dividend payments to shareholders may suffer the financing and investment plans especially in case of high leveraged firms. Highly leveraged firms tend to pay low dividends in order to reduce transaction cost of external capital. It is therefore expected that an inverse association be seen in leverage and banks ROE (Waswa, 2013).

$$\text{Leverage} = \frac{\text{debt}}{\text{total asset}}$$

3.6.3 LIQUIDITY

3.7 MODEL SPECIFICATION

The following regression model has been formulated to guide the researcher in this study

$$\text{Model I; ROA} = \beta_0 + \beta_1 \text{DPR} + \beta_2 \text{FS} + \beta_3 \text{LVRG} + \text{LIQDT} + \epsilon_i$$

$$\text{Model II; NIM} = \beta_0 + \beta_1 \text{DPR} + \beta_2 \text{FS} + \beta_3 \text{LVRG} + \text{LIQDT} + \epsilon_i$$

Where,

ROA =return on asset

NIM= net interest margin

DPR=dividend pay-out ratio

FS = firm size

LVRG= leverage

LQDT =liquidity

β_0 = constant term

ϵ_i =error term

CHAPTER FOUR

4. DATA PRESENTATION AND ANALYSIS

4.1 INTRODUCTION

In the preceding chapters important literatures which give understanding about the topic and used to identify knowledge gap on the area were reviewed. The research objectives, research questions, research hypotheses & the research design used for this study were also discussed.

The next chapter deals with the descriptive statistics of the dependent and independent variables, correlation analysis also presented.

4.2 DESCRIPTIVE STATISTICS

Table 4.1 shows a summary of the descriptive statistics of all variables for 12 Ethiopian commercial banks during the period of nine years from year 2010–2018 with a total of 108 observations. The table reports the mean, standard deviation, number of observations, minimum and maximum of all variables to give an overall description of data used.

	NIM	ROA	DPR	FSZ	LIQUIDITY	LVRG
Mean	0.054320	0.032105	0.858884	3.895449	0.308696	0.840003
Median	0.050849	0.030889	0.877223	3.988752	0.278946	0.853397
Maximum	0.144286	0.067172	2.014519	4.742475	0.578940	0.920513
Minimum	0.012255	0.018090	0.175536	2.579229	0.135807	0.063040
Std. Dev.	0.024753	0.008840	0.277000	0.445629	0.125551	0.087982
Observations	108	108	108	108	108	108

Table 4.1 Descriptive statistics (*Source: Output of Eviews 8*)

Net interest margin was the dependent variable. Net interest margin is a ratio that measures how successful a firm is at investing its funds in comparison to its expenses on the same investments which having a mean, maximum, minimum and standard deviation of 0.0544, 0.14428, 0.01225 and 0.02475 respectively. As shown from the result, all variables comprised 108 observations and the net interest margin measure used in this study was indicates that the profitability of Ethiopian commercial banks in the previous nine years is nearly 0.0544 with a maximum of 0.014428, minimum 0.01225 and standard deviation of 0.02475 which was relatively high variation compared with return on asset.

The second dependent variable is return on asset. The return on assets ratio measures how effectively a company can earn a return on its investment in assets. In other words, ROA shows how efficiently a company can convert the money used to purchase assets into net income or profits (Mutie, 2011). Return on asset=total net income over total asset the result show that ROA have mean of 0.0321 with a minimum of 0.01809, maximum 0.0680 and standard deviation of 0.0089 which was relatively low variation compared with NIM. The independent variable of the study was Dividend Pay-out Ratio is the number of dividends paid to stockholders relative to the amount of total net income of a firm. The above result implies that DPR have a of mean 0.8598 with a maximum of 2.0145 and a minimum of 0.1755

	NIM	ROA	DPR	FSZ	LIQ	LVRG
NIM	1.000000					
ROA	-0.345623	1.000000				
DPR	-0.017628	0.275011	1.000000			
FSZ	0.36939	-0.140814	0.121571	1.000000		
LQD	-0.377024	0.298900	-0.026824	-0.696393	1.000000	
LVRG	0.220265	-0.070201	-0.023399	0.131825	-0.070201	1.000000

Table 4.2 Correlation Matrix of Dependent and Independent Variables (source E-views output)

As it can be seen from the table, the result of correlation between dividend pay-out ratio and profitability (ROA) showed a positive coefficient 27.5011%. It indicates that if the DPR increases by one birr it will increase by 0.275011 cents. whereas, the correlation between dividend pay-out ratio and profitability (NIM) shows that negative coefficient of 0.017628 or 17.628%. it indicates that if the DPR increase by one birr it will decrease 0.017628 cents.

4.3 TESTS FOR THE CLASSICAL LINEAR REGRESSION MODEL (CLRM) ASSUMPTIONS

In this study as mentioned in chapter three diagnostic tests were carried out to ensure that the data fits the basic assumptions of classical linear regression model. Consequently, the results for the model assumption tests are presented as follows:

4.3.1 TESTS FOR CLASSICAL LINEAR REGRESSION ASSUMPTIONS

In order to use the regression models that developed earlier in the methodology section, the basic Ordinary least square assumptions should be valid. The following tests: Homoscedasticity Test, Test for autocorrelation, Multicollinearity and Normality test were conducted in order to check whether these assumptions are violated or not.

4.3.2 ASSUMPTION ONE: THE ERRORS HAVE ZERO MEAN ($\epsilon = 0$)

According to Brooks (2008), if a constant term is included in the regression equation, this assumption will never be violated. Thus, since the regression model used in this study included a constant term, this assumption is not violated

4.3.3 TEST FOR NORMALITY

Normality is a condition in which the variables to be used in the model follow the standard normal distribution. The Jarque-Bera statistics was used to test the normality of the variable under different conditions and under the hypotheses;

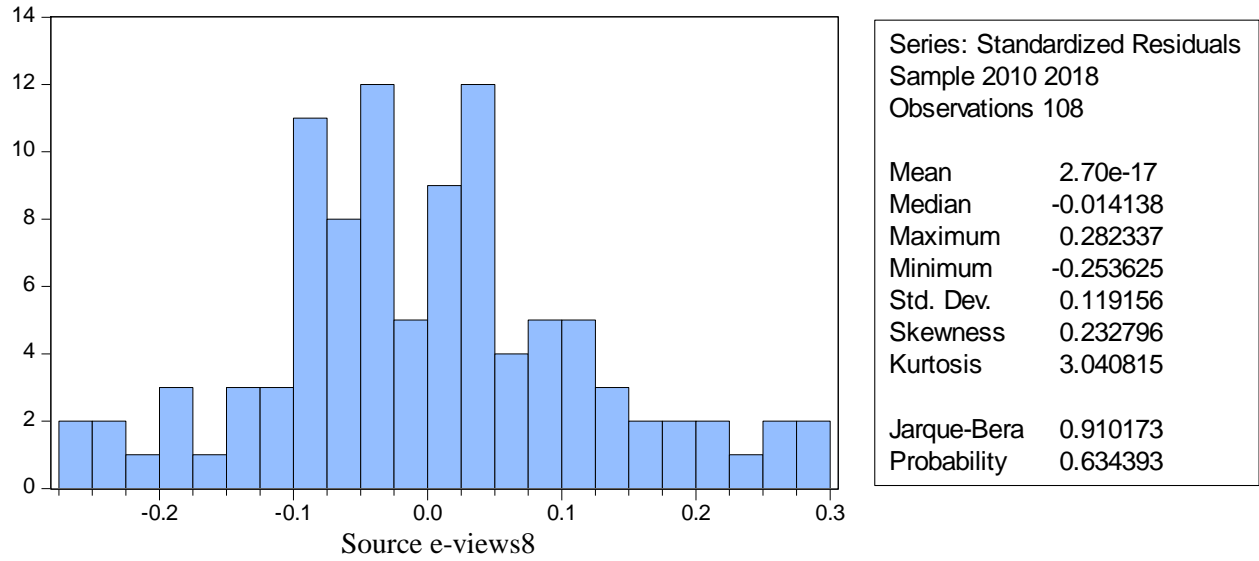
Ho: The series is normally distributed

H1: The series is not normally distributed

If the series are normally distributed, the histogram should be bell shaped and the Jarque-Bera statistic insignificant.

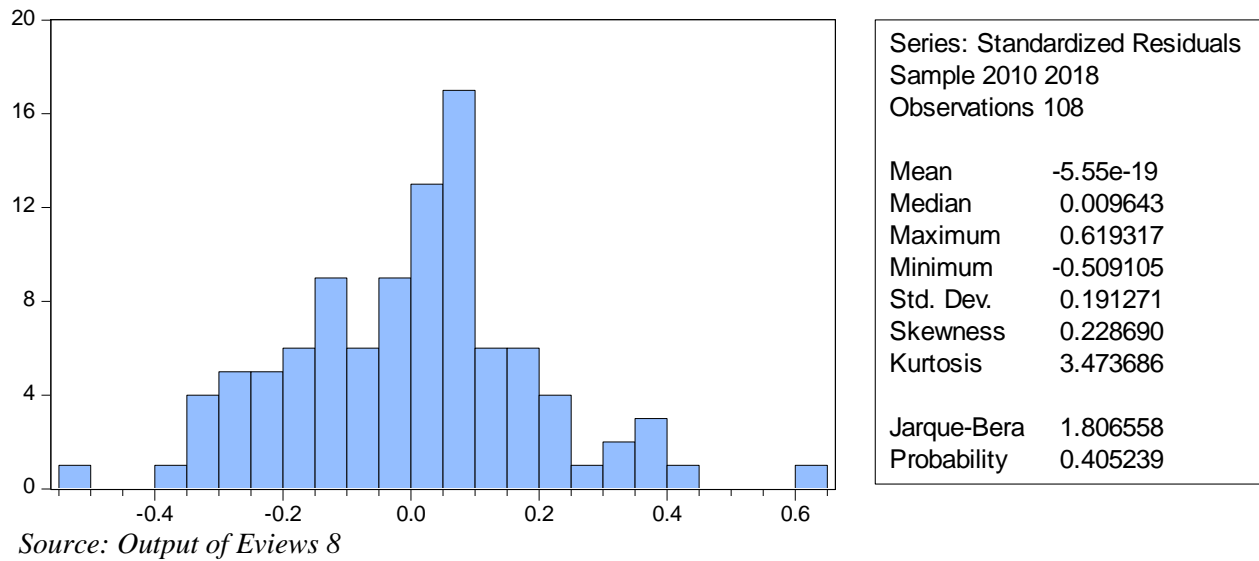
figure 4.1 shows histogram test

NIM model result



As shown in the above Histogram, kurtosis approaches to 3 (i., 3.040815), skewness approaches to 0 (0.232796) and the Jarque-Berastatistics was not significant even at 5% level of significance as per the P-values shown in the histogram more than 5% (i.e 0.634393). Hence, the null hypothesis that the error term is normally distributed should be accepted

ROA model result



As shown in the above Histogram, kurtosis approaches to 3 (i.e 3.473686), skewness approaches to 0 (0.228690) and the Jarque-Bera statistics was not significant even at 5% level of significance as per the P-values shown in the histogram more than 5% (i.e. 0.405239). Hence, the null hypothesis that the error term is normally distributed should be accepted

4.3.4 TEST FOR MULTICOLLINEARITY

Multicollinearity is an assumption of a linear relationship between explanatory variables that creates biased regression model. This problem occurs when the explanatory variables are Very highly correlated with each other (Brook, 2008). According to (Hair et al., 2006) multicollinearity problem exists when the correlation coefficient among the variables are greater than 0.90. On the other hand, according to Gujarati (2004), if the correlation coefficient is higher than 0.8, it is considered as the model consists of serious multicollinearity problem. If multicollinearity problem is too serious in a model, either additional important variable should be added or unimportant independent variable should be dropped. This study uses high pair-wise correlation coefficients method to detect the existence of multicollinearity. As it appears in the correlation matrix in the below tables all the modes are less than the stated value.

	NIM	ROA	DPR	FSZ	LIQDT	LVRG
NIM	1.000000					
ROA	-0.345623	1.000000				
DPR	-0.01762	0.275011	1.000000			
FSZ	0.36939	-0.14081	0.121571	1.000000		
LIQDT	-0.37703	0.298900	-0.02683	-0.69639	1.000000	
LVRG	0.220265	-0.07020	-0.02339	0.131825	-0.07020	1.000000

Table 3.5 test for Multicollinearity (Source: Output of Eviews 8)

The result correlation matrix implies that the highest correlation is 0.131825, i.e., between leverage and firm size. Since there is no correlation above 0.75 according to Malhotra (2007), it is possible to conclude in this study that there is no problem of Multicollinearity.

4.3.5 TEST FOR SERIAL CORRELATION LM TEST

As shown in the below table 4.3, the F test and the P value of F-statistic result of the model was 0.0000, which is less than the significance level of 5%. As a result, the null hypothesis which states residuals are serially correlated is rejected at 5 percent of significant level. This implies that there is significant evidence for the presence of serial correlation in these models. In addition, the Chi-Square P-value of the models also supports the presence of serial correlation in the model. Therefore, there is serial correlation among residuals.

Breusch-Godfrey Serial Correlation LM Test:

F-statistic	20.68916	Prob. F(10,93)	0.0000
Obs*R-squared	74.50790	Prob. Chi-Square(10)	0.0000

Table 4.3.6 test for serial correlation SLM test (Source: Output of Eviews 8)

4.3.6 HETEROSCEDASTICITY TEST

The Heteroscedasticity problems present when the variance of the error term is not constant. As noted in Brooks, (2008, p.182) the variance of the errors is constant, this is known as the assumption of homoscedasticity. If the errors do not have a constant variance, they are said to be heteroscedastic. The study would be employed the popular white test to detect heteroscedasticity. This test involves testing the null hypothesis that the variance of the errors is constant (homoscedasticity) or no heteroscedasticity against the alternative that the errors do not have a constant variance.

In this study, as shown below, both the F-statistic and Chi-Square versions of the test statistic draw the same conclusion that there is evidence for the presence of heteroscedasticity, since the p-values were less than 0.05. This indicates that, there is evidence that we reject the null hypothesis implying that the residuals are not homoscedastic, since the p-value was considerably less than 0.05.

Heteroskedasticity Test: White

F-statistic	1.595923	Prob. F(14,93)	0.0948
Obs*R-squared	20.92053	Prob. Chi-Square(14)	0.1037
Scaled explained SS	36.98085	Prob. Chi-Square(14)	0.0007

Table 4.4 hetroskedasticity test (Source: Output of Eviews 8)

4.4 CHOOSING OF REGRESSION RESULT

4.4.1 CHOOSING RANDOM EFFECT (RE) VERSUS FIXED EFFECT (FE) MODELS

In order to achieve the objective of the study the researcher employed panel data model. As far as the data is concerned, comprising both time series and cross section elements panel model is appropriate. The choice of this methods are, comprising time series and cross-section units and by using Hausman specification test. As noted by Gujarati (2004) if T (the number of time series data) is large and N (the number of cross –sectional unit) is small there is likely to little difference in the values of parameters estimated by fixed effect model and random effect model. Hence the choice of here is based on computational convenience. On this score random effect model should have used.

Running a Hausman specification test five percent level enables the researcher to choose between fixed effect and random effect models (Hausman, 1978). The hypothesis for Hausman specification test is;

Null hypothesis: random effect model is more appropriate

Alternative hypothesis: Fixed-effect model is more appropriate

Decision rule: if the P-value from the Hausman test is statistically significant (less than five percent) the fixed-effect model is preferred in favour of random effect, otherwise the random effect model is selected.

The result from Hausman test in table allows as rejecting the null hypothesis for the first model that fixed model is better in this regression analysis. This implies that a fixed effect model is more appropriate than random effect model to undertake the panel regression estimation for this

study. And for the second model the result from Hausman test in table allows as to not reject the null hypothesis that random model is better in this regression analysis. This implies that a random effect model is more appropriate than fixed effect model to undertake the panel regression estimation for this study.

4.5 ANALYSIS AND INTERPRETATION OF REGRESSION RESULT

This section present regression result of fixed effect model to examine the impact of dividend payout policy on the performance of private commercial banks in Ethiopia

figure 4.2 Regression result- random effect model (REM)

Dependent Variable: NIM

Method: Panel EGLS (Cross-section random effects)

Sample: 2010 2018

Periods included: 9

Cross-sections included: 12

Total panel (balanced) observations: 108

Swamy and Arora estimator of component variances

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.009505	0.021576	0.440540	0.6605
DPR	0.000267	0.005134	0.051996	0.9586
FSZ	0.014515	0.004776	3.039397	0.0030
LIQUIDITY	-0.032193	0.012440	-2.587921	0.0110
LVRG	-0.002403	0.010991	-0.218596	0.8274
<hr/>				
R-squared	0.466389			
Adjusted R-squared	0.445666			
S.E. of regression	0.008983			
F-statistic	22.50613			
Prob(F-statistic)	0.000000			

(Source: Output of E-views 8)

Thus, based on the result figure 4.2 above, the following model was developed to examine the impact of dividend pay-out ratio on the financial performance of private commercial banks in Ethiopia.

$$NIM=0.95+0.026dpr+1.45fsz+3.219lqdt+0.24lvrg$$

According to Table 4.5 below shows regression results between the dependent variable (net interest margin) and the explanatory variables. The R-square value measures how well the regression model explains the actual variations in the dependent variable (Brooks, 2008). The random effect regression results, R2 has the value of 46.36%. The value (i.e. 46.63%) could be interpreted as; net interest margin of Ethiopian private commercial banks 46.631% were explained by DPR, , SIZE , LVRG, and LIQ, for the study period from year 2010 up to 2018 whereas the rest 53.37% variation of net interest margin of Ethiopian private banks were explained by other bank specific variables or macro variables. Also, the overall test of significant F statistics shows that the model was good enough fitted and statistically significant at 1% level (i.e. p-value = 0.000).

figure 4.3 Regression result- fixed effect model (FEM)

ROA model result

Dependent Variable: ROA

Method: Panel Least Squares

Sample: 2010 2018

Periods included: 9

Cross-sections included: 12

Total panel (balanced) observations: 108

Variable	Coefficient	Std. Error	t-Statistic	Prob.
----------	-------------	------------	-------------	-------

C	0.035612	0.014442	2.465865	0.0155
DPR	0.020744	0.003593	5.773450	0.0000
FSZ	-0.004248	0.003355	-1.266221	0.2086
LIQUIDITY	0.009601	0.008662	1.108487	0.2705
LVRG	-0.009215	0.007581	-1.215446	0.2273

Effects Specification

Cross-section fixed (dummy variables)

R-squared	0.582806
Adjusted R-squared	0.514785
S.E. of regression	0.006158
Sum squared resid	0.003489
Log likelihood	405.1350
F-statistic	8.568050
Prob(F-statistic)	0.000000

(Source: Output of E-views 8)

Thus, based on the result Table 4.3 above, the following model was developed to examine the impact of dividend pay-out ratio on the financial performance of private commercial banks in Ethiopia.

$$\text{ROA} = 3.56 + 2.07\text{dpr} + 0.424\text{fsz} + 0.96\text{lqdt} + 0.92\text{lvrgr}$$

According to figure 4.5 below shows regression results between the dependent variable (return on asset) and the explanatory variables. The R-square value measures how well the regression model explains the actual variations in the dependent variable (Brooks, 2008). The fixed effect regression results, R² has the value of 58.28% which reveals that the explanatory power of model is good. The value (i.e., 58.28%) could be interpreted as; return on asset of Ethiopian private commercial banks 58.28% were explained by DPR, SIZE, LVRG, and LIQ, for the study period from year 2010 up to 2018 whereas the rest 42.72% variation of return on asset of Ethiopian private banks were explained by other bank specific variables or macro variables. Also, the overall test of significant F statistics shows that the model was good enough fitted and statistically significant at 1% level (i.e., p-value = 0.000).

4.6 DISCUSSION OF THE REGRESSION RESULT

In this section the discussions of regression results were made on the basis of related literature provided in chapter two of this study. Accordingly, the relationship between dependent and independent variables were discussed on the basis of the findings of this study and then it was associated to the theoretical literature and the finding of other researchers provided in the empirical review under this study.

4.6.1 DIVIDEND PAYOUT RATIO AND NET INTEREST MARGIN

Dividend pay-out ratio is measured by dividend paid divided by net income of the year. The regression result shows dividend pay-out ratio and profitability have positive and statistically insignificant effect on net interest margin at 5 percent significance level with p-value is 0.9586 it's above 0.05. This implies that the increasing or decreasing in dividend pay-out has no statistically significant effect on profitability of private commercial banks which is measured by net interest margin for the study period (2010-2018). the result implies that one-unit change in dividend payment keeping other things remain unchanged will result 0.0026 changes the profitability (NIM) in similar direction but its insignificant effect This result is compatible with the hypothesis and existed theory. Thus, hypothesis which was DPR have positive significant effect should be rejected.

The result shows this finding is inclined to dividend irrelevance theory which was formulated by Franco Modigliani and Merton Miller in 1916. According to this theory dividend policy has no

effect on either the price of the firm's stock or its cost capital; if dividend policy has no significant effect then it would be irrelevant.

This finding is similar to the finding of fathima, 2011; momamed abullah,2014

4.6.2 DIVIDEND PAYOUT RATIO AND RETURN ON ASSET

The result of dividend pay-out policy measured by DPR shows in the table 4.5.1 is positive and statistically significant effect on the financial performance of private commercial banks measured by return on asset with a coefficient of 0.020744 and p- value 0.000 at 5% significance level. This implies that for one-unit change in DPR remaining other things constant will result change in performance of Ethiopian private commercial banks which measured by ROA by 0.020744 at the same direction. This means the Ethiopian private banks dividend payout policy will have significant impact on future profitability of the banks.

This result is consistent with birds in hand theory, this theory is the opposing view towards Modigliani and Miller's dividend irrelevance theory is that dividends affect the company's value and this assumption is represented by the so called bird in hand theory^l. The theory was first mentioned by Lintner in 1956 and it has been supported by various researchers including (Gordon, 1959 &1962). The name bird in hand^l is the umbrella term for all studies that argues that dividends are positively correlated to the company's value. It is based on the expression that a bird in the hand is worth more than two in the bush.

Expressed in financial terms the theory says that investors are more willing to invest in stocks that pay current dividend rather than to invest in stocks that retain earnings and pay dividends in the future. This is due to the high degree of uncertainty related to capital gains and dividends paid in the future. Current dividends are more predictable than capital gains, since the stock price is determined by market forces and not by the managers it has a higher degree of uncertainty (Keown et.al., 2007) cited by (Gustav and Gairatjon, 2012).

The bird-in-hand theory argues that cash dividend received now, reduces the risk associated with the uncertainty surrounding deferred income; in form of capital gain. Hence, investors may prefer to purchase shares of companies with track record of dividend pay-out than companies that retain heavily for growth and expansion. The dividend irrelevancy theory opines that in a perfect market with independence of investment and dividend policies, perfect capital market

information, no taxes, no agency, contracting, transaction or flotation costs, and complete market, dividend pay-outs may not influence firm value. In this scenario, investors create dividend by disposing their shares and usually at a minimal or no costs; thereby making dividend pay-out policy very irrelevant and unattractive (Okwo & Oliver, 2015)

The underlying assumptions of Gordon’s model is based on the idea of what is available today compared to what may be available in the future (Khan & Jain, 2008). It is based on the logic that the more distant the future is, the higher the uncertainty regarding capital gains and future dividends. Even though the capital gains in the future may provide a higher return than the current dividends, there is no guarantee that the investor will accumulate a higher return due to the high degree of uncertainty (Gordon, 1962). Since the length of the time and the level of risk are correlated, investors are unwilling to invest in companies where the time until the dividend payments are far away.

This result is similar with previous research conducted by (muchira, 2013; kolawole et al, 2018; Hafeez et al, 2018; innocent et al, 2015; Thafi and Abdullah, 2015) the result of those researcher shows dividend pay-out policy have positive and statistically significant effect on profitability this implies the dividend policy can affect the performance of private commercial banks which means an increasing or decreasing payment of dividend will result change the profitability at the same time and direction.

4.7 SUMMARRY OF THE ANALAYSIS

Hypothesis	Independent variable	Expected outcome	Actual result	Decision
H1	DPR	significant	insignificant	Reject
H2	DPR	significant	Significant	accept

CHAPTER FIVE

CONCLUSION AND RECOMMENDATION

5.1 CONCLUSION

The main trust of this research is to find out the relationship between dividend pay-out policy and financial performance or profitability of Ethiopian private commercial banks from the period of 2010-2018. In order to meet the objective of the study a nine-year financial statement data was used from audited financial statement of banks and national bank of Ethiopia report from 2010-2018 for twelve selected private commercial banks. The collected data was analysed by using both fixed and random effect panel regression model. The result shows that dividend pay-out policy which is measured by dividend pay-out ratio have positive but insignificant effect on the performance of private commercial banks which was measured by net interest margin for the period covered by the study. The relationship between dividend pay-out ratio and return on asset was positive and significant which implies an increasing or decreasing dividend payment policy resulted change in the performance of Ethiopian private commercial banks which is expressed by return on asset. This implies that an increasing one-unit may increase the future financial performance of private commercial banks at the same direction significantly. Additionally, the positive result shows payment of dividend will increase the performance of private commercial banks by attracting investors whose need payment of dividend this will result increasing the firm stock value and increase the profitability. This positive result is consistent with bird-in-hand theory.

5.2 RECOMMENDATION

Based on the findings and conclusions of the study, the following recommendations are forwarded to managers, investors, government and banks.

The Result indicates there is positive relationship between dividend pay-out and banks profitability to increase the profitability of private commercial banks the managers should give attention when they make dividend policy payment because the payment of dividend affects the return on asset of the companies significantly and positively. This result opposes the previews

theories, reinvestment of the earnings not paid as for it help the company to grow its future earnings. High ratios may also imply that the company lacks enough funds to make new projects investments which affect the future profitability of the firms. The use of dividend policy ratios should seek to strike a balance between short term cash flow and growth in the firm's future earnings. The theoretical expectation of a firm's profitability is that it is supposed to have an impact to the firm's dividend

The investors should make rational analysis when they want to invest their capital in private commercial banks regarding with the dividend payment policy of the company because investors are advantageous when the company get high profit

The government should facilitate the establishment of stock market in the country so that shares can be traded freely in the market. This will help Ethiopian private commercial banks not to be depend on internally generated funds so as to make proper decision on dividend policy which will affect future performance the private banks. The positive result shows dividend has impact on the value of the company because divided lover's investors are attracted by payment of dividend and if there is stock market the company can easily sell his share and it result increase the company profitability

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APPENDIX

Annex 1 List of Commercial Bank Operating In Ethiopia

No	Bank Name	year of establishment
1	Development Bank of Ethiopia	1909
2	Commercial Bank Of Ethiopia	1963
3	Awash International Bank	1994
4	Dashen Bank	1995
5	Bank of Abyssinia	1996
6	Wegagen Bank	1997
7	United Bank	1998
8	Nib International Bank	1999
9	Cooperative Bank of Oromia	2004
10	Lion International Bank	2006
11	Oromia International Bank	2008
12	Zemen Bank	2008
13	Bunna International Bank	2009
14	Birhan International Bank	2009
15	Abay Bank	2010
16	Addis International Bank	2011
17	Dehub Global Bank	2012
18	Enat Bank	2012

Descriptive statistics

	NIM	ROA	DPR	FSZ	LIQUDITY	LVRG
Mean	0.054320	0.032105	0.858884	3.895449	0.308696	0.840003
Median	0.050849	0.030889	0.877223	3.988752	0.278946	0.853397
Maximum	0.144286	0.067172	2.014519	4.742475	0.578940	0.920513

Minimum	0.012255	0.018090	0.175536	2.579229	0.135807	0.063040
Std. Dev.	0.024753	0.008840	0.277000	0.445629	0.125551	0.087982
Skewness	1.401328	1.183401	0.287781	-0.695320	0.598372	-6.862905
Kurtosis	5.545501	5.300936	6.289282	3.107449	2.116680	59.03482
Jarque-Bera	64.50505	49.03228	50.17790	8.754407	9.956027	14977.35
Probability	0.000000	0.000000	0.000000	0.012560	0.006888	0.000000
Sum	5.866575	3.467340	92.75952	420.7085	33.33922	90.72028
Sum Sq. Dev.	0.065559	0.008362	8.210015	21.24858	1.686660	0.828276
Observations	108	108	108	108	108	108

correlation

	NIM	ROA	DPR	FSZ	LIQUIDITY	LVRG
NIM	1.000000	-0.345623	-0.017628	0.369395	-0.377024	0.220265
ROA	-0.345623	1.000000	0.275011	-0.140814	0.298900	-0.254533
DPR	-0.017628	0.275011	1.000000	0.121571	-0.026824	-0.023399
FSZ	0.369395	-0.140814	0.121571	1.000000	-0.696393	0.131825
LIQUIDITY	-0.377024	0.298900	-0.026824	-0.696393	1.000000	-0.070201
LVRG	0.220265	-0.254533	-0.023399	0.131825	-0.070201	1.000000

Correlated Random Effects - Hausman Test (NIM)

Equation: Untitled

Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	4.618223	4	0.3288

Correlated Random Effects - Hausman Test (ROA)

Equation: Untitled

Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	37.344413	4	0.0000

NIM model result

Dependent Variable: NIM

Method: Panel EGLS (Cross-section random effects)

Date: 12/07/20 Time: 02:32

Sample: 2010 2018

Periods included: 9

Cross-sections included: 12

Total panel (balanced) observations: 108

Swamy and Arora estimator of component variances

Variable	Coefficient	Std. Error	t-Statistic	Prob.
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C	0.009505	0.021576	0.440540	0.6605
DPR	0.000267	0.005134	0.051996	0.9586
FSZ	0.014515	0.004776	3.039397	0.0030
LIQUIDITY	-0.032193	0.012440	-2.587921	0.0110
LVRG	-0.002403	0.010991	-0.218596	0.8274

Effects Specification		S.D.	Rho
Cross-section random		0.021187	0.8484
Idiosyncratic random		0.008956	0.1516

Weighted Statistics			
R-squared	0.466389	Mean dependent var	0.007579
Adjusted R-squared	0.445666	S.D. dependent var	0.012065
S.E. of regression	0.008983	Sum squared resid	0.008312
F-statistic	22.50613	Durbin-Watson stat	1.594767
Prob(F-statistic)	0.000000		

Unweighted Statistics			
R-squared	0.158424	Mean dependent var	0.054320
Sum squared resid	0.055173	Durbin-Watson stat	1.438034

ROA model result

Dependent Variable: ROA
Method: Panel Least Squares
Date: 12/07/20 Time: 02:48
Sample: 2010 2018
Periods included: 9
Cross-sections included: 12
Total panel (balanced) observations: 108

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.035612	0.014442	2.465865	0.0155
DPR	0.020744	0.003593	5.773450	0.0000
FSZ	-0.004248	0.003355	-1.266221	0.2086
LIQUIDITY	0.009601	0.008662	1.108487	0.2705
LVRG	-0.009215	0.007581	-1.215446	0.2273

Effects Specification			
Cross-section fixed (dummy variables)			
R-squared	0.582806	Mean dependent var	0.032105
Adjusted R-squared	0.514785	S.D. dependent var	0.008840
S.E. of regression	0.006158	Akaike info criterion	-7.206205
Sum squared resid	0.003489	Schwarz criterion	-6.808852
Log likelihood	405.1350	Hannan-Quinn criter.	-7.045092
F-statistic	8.568050	Durbin-Watson stat	1.686207
Prob(F-statistic)	0.000000		

