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IMPACT OF DIVIDEND POLICY ON PERFORMANCE OF FIRMS HAVING STOCKS LISTED IN AN EMERGING STOCK MARKET

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ABSTRACT

In this research paper we have discussed various theories regarding the impact of dividend policy on the performance of the firms. We have also analyzed these theories in the light of the companies that are practically undergoing through the debate of determining the key factors, which play a crucial role in measuring the performance of the companies. There can not only be a single determinant having impact on the overall financial performance of the firm rather there can be number of dividends that can have a combined effect of the overall performance. In this paper we have tried to find out the key indicators that do impact the performance of the firm and are also incorporated in the dividend policy of the firm. The impact can either be positive or negative depending upon the nature of variable. In this paper we have taken sample of 475 companies and the data is the secondary one. Ratios have been computed of all the companies that basically determine the dividend policy and then the correlation tests have been run to see the whether the results are significant or not. In the conclusion we have mentioned the variables that play a key role in determining the performance of the firms.

Key Words: Stock Market

INTRODUCTION

There are many discussions and theories in the past about the relationship between dividend policies and performances of the firms. Also there are numerous papers that discussed about the impact of dividend policies on the performance whereas other discussed about the impact of performance of firms on the dividend policy. Both the theories have different implications and justifications that have been shortly discussed in the literature review section. Dividend policy no

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doubt mainly depends on the management decision of any company but no doubt, the preference of the external investors, i.e. the share holders do have an impact in molding the behavior of the management about the dividend policy. Regarding the capital structure many companies prefer internal source of financing for the new or upcoming projects rather than going for external financing, i.e. the debt or investors. So, retained earnings may provide for internal financing but only on the expense of share holder's dividends or else in case of high dividends payouts, level of retained earnings might not serve the purpose. On the contrary, there is also a negative picture regarding the retained earnings theory, that the management when sufficiently has the retained earnings, sometimes engage in the unnecessary extra managerial perquisites. This also includes sometimes, investing in projects having negative net present values just because the company has sufficient cash inflows and is in a position to take the risks that it would, otherwise might not have taken in case of high dividend payout ratio. This paper will try to focus on the effects that the dividend policies have on the performance of the firms and vice versa. We shall try to reach at a consensus between different theories and researchers arguments about the cause and effect relationships between dividend policies and the firm performances. We shall also try to find out the major factors that influence and are being influenced by the dividend policies declared by the management of any firm. No doubt there may be many factors that are collectively part of the firm performance in terms of both the financial performance and the creation of market value of the firm, but we will try to tap the variables that will play a major role in tapping the performance of the firm and has the maximum relation with the dividend policy of the said firm.

LITERATURE REVIEW

Dividend policy can not only signal current performance and future prospects of the firm but also addresses the agency problems between the managers and the outside investors. Both of the above factors support much of the empirical fact that the increase in the dividends is a kind of good news resulting increase in stock prices (Fairchild, 2010). There has been found a negative relationship between investment opportunities and the dividend payout policy. Also the relation of external financing, the use of financial leverage and debt maturity on dividend policy is found insignificant. Profitability and stock market capitalization have found to influence the dividend payout ratio in a very positive way. Firms with profitability trend tend to support their share holder's with high dividends whereas well developed markets tend to support low dividend payout policy (Abort and Bopping, 2010)

Dividends can either be in the form of cash flows or resulting in capital gains depending on the investors view point. Now the decision lies with the management of any corporation whether to declare dividends in the form of cash outlays or in capital gains but, it is the preference of the investors that really matters to the management which has a strong market reputation in investors view point. In view point of the management, more dividend payout means less retained earnings that is, the lowest cost source of capital. Thus declaring high dividends payout can cost the firm

higher cost capital as they have lowest retained earnings after dividend payout and thus, bearing higher cost of capital acquisition in the form of higher interest rates through debt financing or higher required rate of return through equity financing (Ramachandran and Packkirisamy, 2010). The main motive of any corporate firm is to maximize its value, whether through the dividend payout policy to increase the payout ratio or to retain the after tax earnings as it mainly depends on the corporate strategy that has to be formulated by the management. But still if the management policy is to maximize the share holder's wealth through the distribution of dividends, this decision also depends on various factors like the past performances, the growth and the future profit paying capacity of the firm to maintain the increasing share holder's wealth image in the market and the cash inflows of various projects because we are talking of cash dividends that requires enough cash instead of stock dividends (Adelegan, 2009). There are numerous cases in which the return on assets have increased before the announcement of dividends and declined after the announcement for several years. This fact declines the beliefs that positive dividends are associated are associated only with higher future profitability. It is also find that majority of the firms pay cash dividends just to eject the excess cash to the shareholders, disregarding of whether there is a significant profitability of the firm (Farther and Weygand, 2009). The profitability of the firm if related to the dividend policy also depends on the factors that determine the formulation of such policy and there are number of determinants that influence the dividend policy. These factors mainly include the cash inflows, investment opportunities and the consistency in the profits of the last years (Pourheydari, 2009)

The firms with a higher return on equity declares greater amount of dividends and also positive association has been found between dividend decision and the payout ratio. But it is also important that no significant association was found between dividend policy and the composition of the board of the firm (Abdelsalam et al. 2008). Dividends are not solely associated with net earnings but with the past dividends paid, in fact the strongest determinant of the dividends payout ratio is its past ratios. There is no significant association of the dividends payout ratio with the past, present or future net earnings and also the correlation between dividend payout ratio and future earnings growth is negative and insignificant. Also to note that the company's financial leverage level has a negative relationship with the dividend payout ratio (Twaijry, 2007). Dividend policy is like a puzzle that is still unsolved and search for the explanation for this still continues. There is an inverse relationship between dividend signaling model and managerial type, i.e. manager with a lower productivity declares higher dividends and the one with lower productivity declares higher dividends, showing that difference in productivity and incorporation of costly efforts modifies the results. Whereas the implications of empirical model suggest that the higher dividend value is an indication of the lower agent type and should result in lower return and also lower firm value. Both the above approaches are a contradiction to the dividends signaling theory that higher firm value is signaled by higher dividends having arguments in support that declaration of dividends leave managers with less cash flow to waste in projects with negative net present value or extra manager's perquisite (Bhattacharyya, 2007). There have been contradicting results about whether

there is a relationship between dividends or earnings of a company to the long term financial performance or profitability of the company. In most of the cases, the dividend /earnings ratio does not have to do anything with the long term profitability of the company. There have also been some cases in which the companies that reported lowest earnings and cut in the dividends revealed the largest excess returns over the next five years (Gunasekarage and Power, 2006)

Profitability of the firm is not the only factor that assures the flow of free dividends to the share holder's. Dividends are distributed from the net profit but dividends are not the only option, there may be conflicts among the managers that profit may be used to either pay dividends, keep retained earnings or to invest in marginal net present value projects and in the consumption of the manager perquisite as dividend payments and debt interest payments decrease the availability of free cash flows to managers (Amidu and Abort, 2006). It is absolutely not obvious that the firm giving no dividends to its share holder's is not in a profit and some prediction about its non performance can be predicted in future years. Many firms despite of going into profits does not declare profits because they have many projects of positive net present values and dislike them, other does not declare because they don't have sufficient inflows to accommodate their share holders. In many cases the cessation of dividends is an indication of the financial distress of the firm but it can also result in the increased share price in the following years due to the investment made by the particular company in some project having positive net present value (McManus *et al*, 2006). There is no one single theory or factor about the explanation of dividends in corporate finance. There are various roles whose influence in many cases has a combined effect on the dividend policy for example signaling models, agency models, stake holder's models and managerial models. There is no single reason to believe that the dividend policy of any corporate entity is driven by that particular single factor. The important discussion would be to investigate that factor that has the major contribution in influencing the dividend policy for example the signaling model is known as the factor that drives the dividend policy but in one research it was founded that its impact was present but to very little extent (Eagan *et al*. 1999)

Dividend policy declared by the management of any company is irrelevant of the stock prices in case of the perfect markets they are efficient too and so in this setup investors are not much concerned of the choice between capital gains and dividends along with the arbitrage ensures that the dividend policy is irrelevant under the efficient markets (Modigliani and Miller, 1961). There is a theory that relaxes the assumption of the efficient capital markets and the arbitrage theory. The main parts are that there are some investors who have uninformed, time varying demands for the dividends and at times the arbitrage fails to prevent this demand of investors that drives away the prices of stocks that pay and does not pay dividends and finally managers does bother about the demand of investors if they put the higher prices on the shares of payers and put the lower prices for non payers (Baker and Wurgle, 2002). Profitability is no doubt, an important determinant in the divided policy to be determined for payout but the strong block holders also play as an obstacle between the two above mentioned variables. These block holders believe that the high payout to the

share holders may render the company to be in strong liquidity position resulting in suboptimal investment policy. Thus the impact of these share holders coalitions always has a negative magnitude towards the payouts (Renneboog and Trojanowski, 2007)

The decision of retention or non-retention is chosen by managers, if retention decision is made by the managers, then the decision of determining the NPV is made by managers and if extra distribution to share holders decision is taken by managers, then the NPV is determined by the expectations of the new share holders. So concluding that the share holder's wealth is controlled only by the managers if the decision of retention is made by the managers, despite the fact that the managers are very much interested in retained earnings because that gives them much control on the share holders and also gives them the option to invest in the projects having negative NPV sometimes either (Magni, 2006). The announcement about the dividends does have an effect on the share prices in the market and there have been many investigations about the behavior of price fluctuations in the market price of shares relating to the news regarding the disbursement if favorable, unfavorable or nonexistent (McCluskey et al. 2007)

METHODOLOGY

We have analyzed 475 companies and the data has been mainly gathered from the Karachi stock exchange website. All the data is based on the secondary sources. We have calculated the ratios of the factors that are basically incorporated in the dividend policy of any company and the data is for the past five years. The companies includes main sectors like cement sector, pharmaceutical sector, banking sector and a vast collection of the major sectors that are basically playing a strong role in the economy of the country. The ratios have been computed and the statistical tests have been applied to observe the correlation between these determinants of the dividend policy. We have included five ratios that mainly determine the dividend policy of the companies and which we have included. These ratios are dividend payout ratio, size of the company, return on asset ratio, return on equity and finally market to book value of the company.

Data and Analysis

By analyzing the table it is obvious that dividend payout ratio has a significant relationship with the return on equity ratio whereas the size of the firm does have significant relationship with the return on asset ratio. Return on asset factor does have a significant relationship with the dividend payout, size and book to market value ratio. Return on equity has also a significant relationship with the dividend payout ratio. The last ratio that is book to market value has a significant correlation with the size of the firm and also with the return on asset ratio. So by analyzing the above statistics it is obvious that all the four ratios that are mainly incorporated in the dividend policy of the firms does have a significant correlation among them and in considering all the above mentioned factors that are mainly included in the dividend policy of the companies, the return on asset does have a significant correlation with three of the four factors that determine the dividend policy of the firm.

We have formulated the relationship between these determinants of the dividend policy areas under following equations:

$$DPO_{it} = \beta_{0it} + \beta_1 ROA_{it} + \beta_2 ROE_{it} + \beta_3 BM_{it} + \beta_4 S_{it} + \varepsilon_{it} \quad (1)$$

$$ROA_{it} = \beta_{0it} + \beta_1 DPO_{it} + \beta_2 ROE_{it} + \beta_3 BM_{it} + \beta_4 S_{it} + \varepsilon_{it} \quad (2)$$

$$ROE_{it} = \beta_{0it} + \beta_1 DPO_{it} + \beta_2 ROA_{it} + \beta_3 BM_{it} + \beta_4 S_{it} + \varepsilon_{it} \quad (3)$$

$$BM_{it} = \beta_{0it} + \beta_1 DPO_{it} + \beta_2 ROA_{it} + \beta_3 ROE_{it} + \beta_4 S_{it} + \varepsilon_{it} \quad (4)$$

In the analysis of the above mentioned equations, the second equation does have a significant correlation with most of the ratios as mentioned in the above paragraph, so for our paper and the data that we have included, this equation basically depicts the factors that are included in the dividend policy that have a significant impact on the performance of the firms.

CONCLUSION

By analyzing the above data and the statistical tests that have been applied, the determinants have been tested to see the correlation between these main factors that basically determine the dividend policy of any firms that have an impact on the overall performance of the firm. There are five main factors that have been set as the determinants of the dividend policy and we have analyzed their significance level with each other. The return on asset does have a significant correlation with three of the four factors that determine the dividend policy of the firm. So, in our tests this particular variable does have a most significant impact among all the variables and thus in our tests the equation that we have formulated including the return on asset factor does show the most significant results. The impact on the return on asset ratio is largely determined by the three factors that are dividend payout ratio, return on equity ratio and finally the book to market value ratio. The return on asset does have a significant correlation with all of these factors and does show a linear relationship with all of the above mentioned factors. Thus, the return on asset if considered in the dividend policy is strongly influenced by these three ratios that have been included in the principle ration of our study. Besides, this ratio, the other three equations that we have formulated does also show a significant linear relationship among the ratios, but return on asset has the most significant relationship among all of these factors and therefore will play a main role in formulating the overall dividend policy of the firm.

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Table-1: Pearson Correlation

		Dpo	Size	Roa	Roe	Bm
dpo	Pearson Correlation	1	.047	.096(*)	.322(**)	-.019
	Sig. (2-tailed)		.304	.036	.000	.681
	N	475	475	475	475	475
size	Pearson Correlation	.047	1	.331(**)	-.059	.129(**)
	Sig. (2-tailed)	.304		.000	.202	.005
	N	475	475	475	475	475
roa	Pearson Correlation	.096(*)	.331(**)	1	.038	.619(**)
	Sig. (2-tailed)	.036	.000		.407	.000
	N	475	475	475	475	475
roe	Pearson Correlation	.322(**)	-.059	.038	1	-.014
	Sig. (2-tailed)	.000	.202	.407		.763
	N	475	475	475	475	475
bm	Pearson Correlation	-.019	.129(**)	.619(**)	-.014	1
	Sig. (2-tailed)	.681	.005	.000	.763	
	N	475	475	475	475	475

*Correlation is significant at the 0.05 level (2-tailed).

** Correlation is significant at the 0.01 level (2-tailed).

Table-2: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
DPO	475	-.07	2.36	.0855	.16594
SIZE	475	3.52	22.93	10.4891	4.41683
ROA	475	-11.98	86.69	3.0186	6.29309
ROE	475	-2.10	3.87	.1672	.31717
BM	475	-1.10	676.90	1.6816	31.05148
VALID N(LISTWISE)	475				

Table-3: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.345(a)	.119	.111	.15643

a Predictors: (Constant), bm, roe, size, roa

Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.034	.019		1.783	.075
	size	.001	.002	.034	.732	.464
	roa	.004	.002	.137	2.351	.019
	roe	.166	.023	.317	7.284	.000
	bm	-.001	.000	-.104	-1.871	.062

a. Dependent Variable: dpo

Table-4: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.629(a)	.395	.390	24.24691

a Predictors: (Constant), dpo, size, roe, roa

Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-.292	3.002		-.097	.923
	size	-.600	.268	-.085	-2.237	.026
	roa	3.229	.188	.654	17.145	.000
	roe	-2.045	3.722	-.021	-.549	.583
	dpo	-13.329	7.123	-.071	-1.871	.062

a. Dependent Variable: bm

Table-5: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.333(a)	.111	.103	.30038

a Predictors: (Constant), bm, dpo, size, roa

Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.173	.036		4.776	.000
	size	-.006	.003	-.088	-1.903	.058
	roa	.003	.003	.055	.940	.348
	dpo	.612	.084	.320	7.284	.000
	bm	.000	.001	-.031	-.549	.583

a. Dependent Variable: roe

Table-6: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.676(a)	.457	.452	4.65804

a Predictors: (Constant), roe, bm, size, dpo

Coefficients^a

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-1.347	.573		-2.350	.019
	size	.360	.049	.253	7.344	.000
	dpo	3.210	1.365	.085	2.351	.019
	bm	.119	.007	.588	17.145	.000
	roe	.672	.715	.034	.940	.348

a. Dependent Variable: roa