

Impact of Dividend Policy on Shareholders' Wealth: A Study of Selected Manufacturing Industries of Pakistan

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ABSTRACT: This study examines the impact of dividend policy on shareholders' wealth in context of Pakistan. Thirty five companies randomly from three sectors; Textile, Sugar and Chemical are observed in the study. The annual data for these companies from 2006 to 2011 is used in the study. Simple OLS technique for analysis is used to derive the results of the study. The findings showed that dividend policy of the firm has significant positive impact on shareholders wealth. Similarly firm growth rate also has significant positive impact on shareholders' wealth. Firm size has significant positive impact on shareholders wealth; indicating that large domain of operations of a business make it more capable to exploit maximum opportunities and in position to earn greater amount of return due to greater growth prospects so it ultimately place greater value to shares of large size companies. The results of study help the corporate management to better decide the level of dividend to be distributed so that shareholders wealth could be maximized.

KEYWORDS: Dividend, Shareholders' wealth, Relevance theory.

INTRODUCTION

Dividend policy has the significant importance in the financial decisions of the corporation. Dividend policy is cause to increase the wealth of shareholders, finance manager make different financial decisions and dividend policy decision is one of them (Baker & Powell 1999). . Dividend decision has great impact on firm financial decision and stock price. The stock price increases when there is smooth payment of dividend exist. Investors do not prefer to purchase the shares of such type of companies which cannot make payment regularly and of which the dividend decisions have variability because of the risk of loss associated with these variations. Simians (1995) argue that shareholders' wealth is largely influenced by the organization's dividend policy. It is an approach which is used to distribute the profit back to its shareholders. If a company is in a growing stage, it may decide it will be reinvested in company's future projects rather than distributing the profit to shareholders .If a company decides to pay dividend, it must decide how much and at what rate dividend should be paid. Dividend policy plays a vital role at company in financial markets and it directly affects the stock price of the company. If a company pays handsome return to its shareholders it will attract to the new investors to invest their money in the company and vice versa. So we can say dividend policy have a strong impact on its share price. Dividend policy is guidelines for financial managers, how to pay dividend to the shareholders either through cash dividend or through fixed percentage dividend.

The primary objective of any organization is to maximize the wealth of shareholders. Financial manager's aim is to take a decision in such a way that shareholders receive the high contribution of dividend which leads to increase the price of share. Because market price is indicator of profitability, progress and productivity, however, it is an unresolved issue whether the dividend policy has impact on its shareholders wealth.

The literature describes that dividend policy has been a topic of discussion for many researchers and academia. Therefore, the present research study intended to analyze the impact of dividend policy on the wealth of shareholders.

THEORETICAL BACKGROUND

Dividend distribution is considered one of the strategic corporate decisions. The sudden increase or decrease in the dividend payout can affect stock price both positively and negatively (Fama et al. 1996). Further, Petit (1972) holds the similar view about the company's dividend policy and stock price reaction. In the same vein, Asquith and Mullins (1983) find that, like dividend increases, dividend initiations have a significant positive impact on shareholder wealth. Much subsequent research has focused on explaining the dividend increase induced positive stock market reaction. The predominant explanation, by far, has been the information signaling hypothesis significant impact on their wealth.

RELEVANCE THEORY

Relevance theory explains that dividend policy has significant effect on shareholders wealth as well as firms' values. If the dividend is paid on regular basis, there must be an optimum payout ratio, that ratio increase the market value of per share, Walter's model is supportive for relevant theory. Gordon & Lintner (1956-62) argue that, firstly distribution of current dividend reduce the level of uncertainty among shareholder as a result they discount the share price by lower rate thereby placing the higher value on share. Secondly the theoretical underpinning of dividend distribution impact on shareholder wealth is linked with the signaling theory.

SIGNALING THEORY

According theory of Jenson and Mekling (1976) whenever companies attempt to distribute the earnings among shareholder, information is disseminated in the market. Market price this information as good news as a result the share prices of the company climbs up.

LIFE CYCLE THEORY

The life cycle theory is also quoted as one of the clarifications for dividend payments. Mueller (1972) suggested a proper theory that a firm has a comparatively well-defined life cycle, which is important to the firm life cycle theory of dividends. The main theme of the theory is that the firms face different stages in their lives; they change their dividend policy according to the need of every stage. This theory explained that firms pay fewer dividends in growth stage as compared to their maturity stage; firms pay more dividends when there are no growth opportunities in future.

RESIDUAL THEORY

Residual theory of dividend given by Miller & Modigliani (1961) explained that if external financing for reinvestment is either not available or the external financing too costly in any profitability opportunity. If firm has better investment opportunity available for investment, so firm make investment and reduce dividend or pay no dividend at all. There is no investment opportunity for firm, so firm pays more dividends to shareholders.

PROBLEM STATEMENT

The impact of dividend policy on shareholders wealth remains controversial issue. The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just don't fit together. Previous research in context of Pakistan has been incapable to provide clear direction about dividend policy, a shift in importance is proposed. Despite the healthy body research exists, there is a lack of clarity that either dividend policy has significant impact on shareholders wealth or not.

RESEARCH QUESTION

The present study focuses on dividend policies and shareholder wealth. To achieve the objectives of the study, the researcher has adopted the following question:

Does dividend policy have an impact on shareholders wealth?

OBJECTIVES OF THE STUDY

The objectives of the study are as follow:

- To describe the concept of the dividend and its policy.
- To identify the effect of dividend policy on the shareholders wealth.

SIGNIFICANCE OF THE STUDY

This research have importance for both academicians and practitioners, dividend is the key decision at the corporate sector because this decision directly affects the business and the market value of the shares and the value creation process of the firm.

LIMITATIONS OF THE STUDY

As all research works have some limitation in one way or the other, therefore, the fundamental limitation of this research is that the study is based on secondary data. Further due to cost and time constraints the researcher limits the study to dividend policy and selected sample also.

LITERATURE REVIEW

Dividend payment policy is one of the most discussed topics and an essential theory of corporate finance which still has its significance. Many researchers presented numerous theories and pragmatic evidences, however the problem is quiet unsettled and open for further debate. It is among the top ten unsettled issues in economic literature and one that does not have satisfactory clarification for the observed dividend behavior of the firms (Allen and Michaely, 2003; Black, 1976; Brealey and Myers, 2005). In advanced economies the stakeholders and management of the firms decides very deviously whether to pay dividends to shareholders or to retain in the business (Glen et al., 1995).

The first model about dividend adjustment was presented by Lintner in 1956. He suggests in his model that the changes in dividend are because of the dividend payout ratio of current and last year. He found that the shareholders wish to continue and return on their investment so managers tend to make partial adjustment in payment ratio instead of changes in payment.

However, the impact of dividend policy on a corporation's market value is a subject of long standing controversy. Black (1974) exemplifies the lack of consensus by stating "The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just don't fit together."

Because the academic community has been unable to provide clear guidance about dividend policy, a shift in emphasis is proposed. In the spirit of Lintner's seminal work, we asked a sample of corporate financial managers what factors they considered most important in determining their firm's dividend policy.

The academicians also engaged in finding out the facts and issues relating to dividend policy and they made different theories on this topic. There are various models presented by these researchers (Joos and Plesko 2004). They used the survey method for finding the issues and factors that have impact on such policy. On the basis of this survey they had found different views on such policy. The views of different researchers are as follows.

According to Hayn (1995), dividend payments reduce the earning of any corporation if there are low earnings are realized ,it make the decision uneven which enables managers to take strong decision for dividend and earning in future. Whereas, DeAngeb et al,1992& Charitou,2000) describe the changing in dividend policy make the managers informative about the cost of dividend payment. Spencer (1973) argues that dividends payout increases the investors' confidence in the company. Thus, the company can make future decisions of dividends payout on the basis of the past dividends policies. The study conducted by Farley and Baker (1989) suggests that dividends policy has a significant impact on stock prices. Dividend payout ratio is based on current and last year earnings, the changes in year wise earning and increasing rate of earnings. The past year dividend payments have great influence on current policy (Pruitt and Gitman 1991).

Manager tends to maintain the smoothness in such payment and they make the decisions for dividends independently from other financial decisions (Edelman 1986). The dividend payment decrease the company cash flows therefore, Easterbrook (1984) believes that due to reduction of free cash flows companies go to stock market for raising more funds.

A significant stream of prior research in the United States has empirically documented that unexpected increases (decreases) in regular cash dividends generally elicit a significantly positive (negative) stock market reaction (Fama et al; 1969 & Petit; 1972). Moreover, this finding persists even after controlling for contemporaneous earnings announcements (Aharony and Sway (1980). In the same vein, Asquith and Mullins (1983) find that, like dividend increases, dividend initiations have a significant positive impact on shareholder wealth. Much subsequent research has focused on explaining the dividend increase induced positive stock market reaction. The predominant explanation, by far, has been the information signaling hypothesis. According to Rozeff (1982) there is a negative relationship between dividend policy and stock price. Previous studies have identified major contributing factors in shareholder's wealth such as: current and past year profit, current and past year profit, year wise changing in earnings and earnings growth rate and dividend policy.

Black and Scholes (1974) state that if investors required higher returns for holding higher yield stocks, corporations would regulate their dividend policy to contain the amount of dividends payment, lower their cost of capital, and increase their share price. Similarly, if investors required a lower return on high-yield stocks, value maximizing firms would increase their dividend payouts to increase their share price. However, Black and Scholes (1974) found no statistically steady fast link between a portfolio's monthly stock return and its long-run dividend yield.

Zero yield stocks holds maximum return than paying out dividends to shareholders, however, higher yield stock realizing greater risks have lower return on investment (Blume 1980; and Keim, 1985)

Chen et al. (1990) show that tests relating returns to dividend yields are sensitive to the method of risk return adjustment. Gordon (1959, 1962) and Lintner (1962) prerogative that dividend policy does affect the shareholders wealth, and they provide some early evidence to support the view that a higher dividend payout reduces the cost of capital (i.e., investors prefer dividends). Others claim that personal and corporate taxes cause dividend policy to affect the firm's cost of capital, but the high payment of dividend raise the shareholders wealth and cost of capital (i.e., investors prefer capital gains).

Since managers have information that outside investors do not have, dividend policy is a costly to-replicate vehicle for conveying positive private information to market participants. Also, businesses consider the dividend policy obvious (Easterbrook 1984). In line with these arguments, signaling models by Bhattacharya (1979) and Miller and Rock (1985), among others, find that dividend increases convey information about the firm's current and future cash flows. In addition to supportive event study results, empirical studies by Offer and Siegel (1987) and Healy and Palepu (1988) examine changes in dividend policy in relation to future earnings and related analysts forecasts, also consistent with the information-signaling hypothesis. Bernartzi and Thaler(1997) find that earnings are less likely to drop after a dividend increase; however, they do not find that dividend increases are followed by unexpected earnings increases. Their evidence is only weakly consistent with an information-signaling hypothesis. DeAngelo and Skinner (1992) find that a loss is a necessary but not a sufficient condition for a dividend cut, and that dividend cuts improve the ability of current earnings to predict future earnings. Moreover, DeAngelo, and Skinner (1992), Bernartzi, Michaely, and Thaler(1997), and Jensen and Johnson (1995) document that dividend cuts are followed by earnings increases, consistent with dividend cuts marking the end of a firm's financial decline and the beginning of its restructuring. In sum, the empirical evidence by prior research on the signaling value of dividend changes has been mixed. An alternative explanation for changes in corporate dividend policy stems from agency theory. Jensen (1986) suggests that managers, motivated by compensation and human capital considerations, have incentives to over invest free cash flows even in the absence of profitable growth opportunities (the free cash flow hypothesis). Dividend payout policy in this case becomes a vehicle for monitoring the managers' potential to misuse excess funds. Thus, the observed positive stock market reaction following dividend increase is consistent, in addition to information-signaling, with a reduction in agency costs. Lang and Lichtenberger (1989) attempt to disentangle between signaling and agency explanations by separating firms that are presumably over investing from all other value-maximizing firms. They find higher abnormal returns for over investing firms for which the agency-related benefits of a dividend payout increase are higher compared to value-maximizing firms.

Over and above, dividends policy implications on shareholders wealth carry diverse arguments from the previous researchers. One school of thought hold the notion that dividend policy does help maximizing the shareholders' wealth, however, the other argues that there is no such impact can be arguably supported. Therefore, the present research would identify the relationship between dividend policy and shareholder wealth in light of the previous literary studies on the basis of secondary data in non-financial organizations of Pakistan.

DATA DESCRIPTION AND METHODOLOGY

The study focuses the manufacturing sector. 35 companies randomly from three sectors namely Textile, Sugar and Chemical are observed in the study. These companies are selected on the basis of regular dividend payment pattern. Data from 2006 to 2011 for these companies is collected from balance sheet analysis of State Bank of Pakistan. Market capitalization data is collected from Business Recorder. Multiple Regressions is used to analyze the data and to get answer to the queries of the study. Following quantitative model is used for multiple regression analysis.

$$SHRW = \beta_1 + \beta_2DPS + \beta_3GRW + \beta_4Size + U_t$$

Where market capitalization is used as proxy for shareholders wealth (**SHRW**), **DPS** is Dividend per Share, **Size** is measured in term of total assets and sale growth is used as proxy for measuring the growth (**GRW**). U_t is there error term.

RESULTS AND DISCUSSIONS

The results of the study are arranged as follows: first tables show the descriptive statistics the second one exhibit the correlation matrix. Then the results of multivariate regression are presented.

DESCRIPTIVE STATISTICS

	DPS	GRW	SHRW	SIZE
Mean	3.287	0.315	6.839	9.577
Median	2.001	0.178	1.580	3.512
Std. Dev.	3.800	1.057	11.498	20.735
Maximum	30.000	14.803	63.519	183.004
Minimum	0.000	-0.364	0.159	0.337

Descriptive statistics during period from 2006 to 2011 of the variable used in the study are shown in above table. On average the companies under consideration of the study pay 3.287 rupees dividend per share (**DPS**). The possible deviation from average is 3.800. Companies paid 30 rupees dividend on maximum and rupees zero on minimum. The minimum figure zero basically shows the absence of dividend payment in any time period. Average market capitalization (**SHRW**) level of companies is 6.839 billion rupees and dispersion is 11.498. Average growth rate (**GRW**) of companies is 31.5 percent while dispersion from average growth rate is 105.7 percent; this is indication of high volatility of sale level in manufacturing companies under consideration. On average the level of firm **Size** is 9.557 billion rupees.

The results of correlation matrix show that level of correlation between shareholders wealth (**SHRW**) and **DPS**; between **EPS** and **GRW** and between **EPS** and size is not much significant. However positive correlation exists among variables.

CORRELATION MATRIX

	DPS	GRW	SIZE	SHRW
DPS	1			
GRW	0.066	1		
SIZE	0.076	0.104	1	
SHRW	0.188	0.094	0.381	1.000

The results of multivariate regression analysis show that (DPS) dividend payment has significant positive impact on shareholders wealth as p-value of DPS is significant as it is observed at 0.002. The coefficient of DPS shows that one percent change in dividend payment will lead to 47.6 percent change in shareholders wealth. Similarly the coefficient of growth (GRW) is also significant as p-value is 0.022; showing that growth level of company has significant positive impact on shareholders' wealth; that one percent change in growth level will result in 49.9 percent change in shareholders wealth. The size of firm has significant positive impact on shareholders' wealth as p-value is 0.001 and coefficient of size is positive indicating that size of firm has significant positive impact on shareholders' wealth. Coefficient of size (0.202) shows that one percent change in size will lead to 20.2 percent change in shareholders wealth in positive way.

MULTIVARIATE REGRESSION

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	3.181	0.929	3.425	0.001
DPS	0.476	0.154	3.102	0.002
GRW	0.499	0.217	2.300	0.022
SIZE	0.202	0.057	3.550	0.001
R-squared	0.173			
Adjusted R-squared	0.161			
F-statistic	14.351	Durbin-Watson stat		0.651
Prob(F-statistic)	0.000			

Explanatory power of model as depicted through R-Square (0.173); map that the studied independent variable explain almost 17 percent dynamics of shareholders' wealth. Model is good fit as p-value of F-Stat is significant.

CONCLUSION

This study provided orientation towards impact of dividend policy on shareholder wealth in scenario of Pakistan. The results of the study reveal that dividend policy of the firm has significant positive impact on shareholders wealth in context of Pakistan. So our hypothesis is accepted. Dividend payment effect is relevant to influence the shareholders wealth; current payment of dividend reduces the uncertainty of investors and they place high value on share price of the company. Similarly firm growth rate has significant positive impact on shareholders' wealth. This result also in line with the general argument and theories propositions that level of firms' growth and shareholders' wealth always move in same direction. Firm size has significant positive impact on shareholders wealth; this too is in discipline with theoretical argument as well as empirical realities. As large domain of operations of a business is in position to exploit maximum opportunities and in position to earn greater amount of return due to greater growth prospects so it ultimately place greater value to shares of large size companies.

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