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A Descriptive Study of Dividend Policies with Reference to Indian Firms

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Abstract: *Present study examined the factors which are considered vital for a firm while deciding about the distribution of dividend of the companies. The study is beneficial for the potential investors in the equity market as they can compare the performance of firms paying with that of companies not paying dividend. With this study investors also understand about the pattern of dividend payment of the Indian listed companies belonging to various sectors. The research can provide a better understanding of the factors that contribute in determining the dividend payout and would give an insight into what kind of ownership structure is beneficial for the wealth of shareholders.*

Keywords: Dividend policy, capital structure, value of firm

I. INTRODUCTION

Dividend policy means the practice that company follows in making dividend payout choices or the size and frequency with which the dividends are paid out. In other words, Dividend policy means policy or guideline followed by the management in declaring of dividends. It is the plan of action to be followed in deciding whether there is need for plugging back of earnings and retaining the profits for future projects or to distribute the earnings among its holders to satisfy them. It is the decision about the ratio between paying out as cash dividends and retaining back the earned income for reinvesting in the firm.

Dividend is the amount of current distribution of profits whereas Dividend policy determines whether such distribution be regular and involves the allocation of between retention and cash dividend. Retained earnings are the amount of undistributed dividends, which constitutes the internal source of finance for the firm. Since they are the reserved profits, its cost is exactly equal to the cost of equity capital. It is always advisable for firms to reinvest the profits retained in case of investment project whose returns exceed its cost of capital. There is a reciprocal relationship between retained earnings and dividend i.e. larger the retained earnings, lesser the dividend and smaller the retained earnings, larger the dividend.

II. LITERATURE REVIEW

2.1 Agency Theory

The major contributors of the agency theory include Jensen and Meckling, 1976, Roseff, 1982 and Easterbrook; 1984.Agency cost theory explains the relationship between principals, for example shareholders and agents, such as a firm's executives. Agency cost is an economic concept concerning the cost to a principal, when the principal chooses or hires an agent to act on its behalf. Due to the separation between ownership and control, managers (agents) may not always act in the best interest of the firm's owner. This encourages shareholders to incur agency costs to monitor managers' behavior. Dividend payments may help in reducing agency costs between managers and shareholders. As the two parties have different interests and the agent has more information, the principal cannot directly ensure that its agent is always acting in its best interests. Employing leverage in the company is one of the effective methods against manager's behavior. In order to overcome agency problems the employment of debt and dividends payments is recommended through agency models of leverage and dividend policy. According to Rozeff (1982), Easterbrook (1984) and Bhaduri (2002), both dividend payments and ability to issue debt can help to bring down the cash flows that are under the control of management. From the point of view of agency theory, factors that largely influence leverage and dividend policy decisions are institutional ownership, asset tangibility and liquidity.

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2.2 Pecking Order

Myers and Majluf (1984) and Myers (1984) presented another capital structure theory named Pecking Order Hypothesis. The pecking order ranks internal equity at the top of the order, followed by debt and then hybrid securities, with external finance in the form of equity capital at the bottom of the pecking order. This order is followed as it reduces the chances of taking up profitable opportunities. Initially Donaldson developed the theory, which in 1984, Myers and Majluf modified further. According to this theory, managers follow a hierarchy of financing. They use internally generated funds as principal source of long-term financing. If internal financing is not enough, it resorts to debt financing and finally to equity and prefer to raise equity as a last option. Higher dividend payout means greater need of funds, which suggests positive relationship between dividend payout and leverage. Dividends are declared only after meeting all its investment opportunities. Profitability and liquidity of a firm have a significant role in deciding for leverage and dividend policy.

2.3 Signaling Theory

Signaling theory focuses upon the asymmetric information between insiders, as managers; and outsiders, as shareholders and banks. Dividend and issuance of debt capital both has signaling effect and provides information about the future growth of the firm to the market. Bhattacharya (1980) explains that the firms use dividend payment as a positive signal of its financial health to investors. Ross (1977) contributed to the concept that when a firm issues debt it is also an important source of information about its performance by the investors. Issue of debt capital helps to build confidence among the investors as they think that the firms are earning profits after meeting interest. Managers have more information about the company than the investors do which leads to information asymmetry. Majority of the investors prefer regular income through cash dividends. Thus, payment of higher dividend is a positive signal, which increases the share prices while the decrease in dividend or no dividend is a negative signal, which leads to fall in the share prices. This theory proves the relevancy of dividend and has informational content. From the signaling theory point, institutional ownership and profitability of the firm have a significant effect on both leverage and dividend policy decisions.

2.4 Trade off Theory

Miller and Modigliani (1961) proposed that in a perfect market the dividend policy shows no impact on firm's value. In perfect competitive market, MM Theory is based on the assumptions that investors behave rationally as information is freely shared, there is no transaction and flotation costs taxes are absent. However, in the real world bankruptcy cost and market imperfections are present. Kraus & Litzenberger (1973) theory is resulted from the debate on the Modigliani and Miller propositions. As per this theory, a company uses debt instead of equity to a certain extent to maximize its enterprise value. Highly profitable firms have high debt ratios thus the chances of bankruptcy are less. Thus, trade-off theory suggests a positive relationship between profitability and leverage. An optimal Capital Structure can be achieved by establishing equilibrium between the tax saving benefits of debt and distress costs of bankruptcy due to debt. Bankruptcy costs arise when there is a high probability that a company will default in paying off its financial obligations. These costs are high in case when a company decides to raise more of its debt financing rather than use equity. According to the study of Haugen and Senbet (1978), the size of a firm influences how a firm overcomes its bankruptcy costs. Large capital firms are financial strong to repay its liabilities are less prone to experience financial distress as compared to smaller ones. Thus, leverage and dividend policy decisions are majorly influenced by size of the firm.

2.5 Relationship between Dividend Payout Policy and Ownership Structures

Short et al. (2002) examine the potential association between ownership structures and dividend policy using three alternative dividends models for the UK companies. They present the first results for the UK, and concluded that ownership structures are different from those of the US. The results consistently showed positive association between dividend payout policy and institutional ownership. The results found that a negative association exists between dividend payout policy and managerial ownership.

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Kumar (2003) examines the possible association between ownership structure, corporate governance and firm's dividend payout policy of all manufacturing firms over the period 1994-2000. He examines the payout behavior of dividends and the association of ownership structure for Indian corporate firms. Kumar finds positive association between ownership structure and dividend payout policy and that dividend payout are not influenced by the ownership structure of the firms. The results reveal that Debt and equity are negatively related whereas past investment opportunities have positive relationship with dividends.

Julie, Elston, & Junsoo Lee, (2004) in their study on dividend policy and Institutional ownership investigated the relationship between the two of sample firms in Germany. The researchers used the propensity scoring method estimator to control endogenously problem. They find evidence that neither institutional ownership nor bank control is statistically significant in determining dividend payout. These finding were found to be consistent with stylized facts regarding the nature of the German institutional environment. The German companies rely majorly on internal finances and retain a significant percentage of the net profit of the firm and lack tax incentives, focus to reduce agency costs associated with conflict between management and shareholders' interests regarding use of the firm free cash flow.

Wei et al. (2003) investigate the relation between dividend payout policy and ownership structure for a sample of 3994 observations of Chinese listed firms for the period from 1995 to 2001. In this study they found that there is a significant positive correlation between the state ownership and cash dividends, but public ownership and stock dividends are negatively correlated. They also concluded that larger firms pay more cash dividend over stock dividends.

Mancinelli et al. (2006) investigated the relationship between dividend policy and ownership structure using a sample of 139 listed Italian companies. The results of the empirical analysis reveal that firms make lower dividend payouts as the voting rights of the largest shareholder increase since the ownership is largely concentrated. Additionally, the results also suggest that the presence of agreements among large shareholders might explain the limited monitoring power of other `strong' non-controlling shareholders.

Khan (2006) investigated the relationship between dividends and ownership structure for a panel of 330 large quoted UK firms or the period 1985-1997. The results indicate that dividends and ownership have a negative relationship during the study period. The ownership composition of insurance companies showcases a positive relationship whereas companies having individual ownership have a negative relationship.

Gustav & Gairatjon (2012) conducted a study to determine whether there is a relationship between the companies selected factors and the dividend payout ratio. The sample for the study was collected from 87 financial and non-financial Swedish large and mid-cap companies during 2006- 2010. For this purpose the researcher, identified six key variables i.e. free cash flow, growth, leverage, profit, risk and size. The analysis was carried using Ordinary least square (OLS) and Tobit regression. The findings indicate that some of the company-selected factors have a positive impact on the companies' dividend payout ratios. The results also showed evidence that these factors are different for large and medium capital companies. The dividend payout ratios of large caps have a significant relationship to free cash flow, growth and risk. Whereas payout ratios of medium cap companies show a significant relationship to free cash flow, leverage, risk and size of the firms.

Literature also covered studies assuming asymmetric adjustment toward the target dividend payout. Zurigat and Gharaibeh (2011) in their study of 35 Jordanian firms investigated the effect of ownership structure on corporation dividend policy. They found that institutional ownership provides return to shareholders to use their influence for maximizing the value of firms by reducing the use of funds in investments with low return, and cash flows can be distributed as dividends. They conclude that Jordanian firms do not depend on dividends as a technique to minimize the agency problem between directors and shareholders.

Douglas, Cook, & Jeon, (2006) investigated Korean firms in order to provide new evidence on the relationship between the ownership structure and payout policy in an emerging market. Authors found that foreign investors were more attracted to dividend-paying firms.

Neo & Rebello (1996) theorized the relationship between institutional ownership, insider holding, debt, and dividend policy. The researchers showed that dividend policy and the desire to seek external financing varies across firms, based on whether a firm is managerially controlled or shareholder controlled. As managers are self-seeking opportunities, they will finance growth with internally generated funds, to avoid submitting themselves to the evaluation of the capital market. This implies firms with higher insider holding will have lower levels of debt, as well as lower levels of dividend

payout ratio. Shareholder-controlled firm will prefer higher levels of debt and dividend, so that managers have to subject themselves to market discipline and /or commit themselves to payout operating cash flow{Jensen, 1986}.
Zuraidah Ahmad, N.M.H.A. investigated the relationship between ownership structure and dividend policy based on Linters model by analyzing the cross sectional data of 100 Malaysian listed firms for the year 2010. Most importantly their study revealed that high dividend payments could be used as a substitute for shareholders monitoring for mitigating agency conflict. Their findings revealed negative relation of managerial ownership, institutional ownership and dispersed ownership with dividend policy and only high concentrated ownership found to be significant and positively related with dividend policy.

III. FINDINGS

After considering the theories of capital structure and dividend policies, the study concludes that dividend policies must always consider two basic objectives:

1. Maximizing owners' wealth
2. Providing sufficient financing

While determining a firm's dividend policy, management must focus to find a balance between current income for stockholders and future growth prospects of the company. A firm must consider the cash available after paying all expenses and debt holders' interest and also the requirement and availability of working capital.
Choice of dividend policy almost affects the value of all enterprises. Dividend policy must be designed in light of achieving the objective of the firm namely; a policy that will maximize the value of the firm should be chosen (James E. Walter, 1963). As in corporation, owners are shareholders but management of the business decisions are carried by the Board of directors. The Board of Directors decides whether to pay dividend or retain it for expansion projects. This gives rise to conflict between shareholders and directors as the former supports dividends and the latter may agree for retaining the earnings. Shareholders expect a quick return on their capital. On the other hand, directors have to consider a number of factors in determining divided policy.
For investors who are seeking stock that will advance on their performance and earnings and earnings per share, lower dividend may mean high returns. The dividend policy of a company reflects how prudent its financial management is(Thornton O. Glove 1987). The future prospects, expansion, diversification mergers are effected by dividing policies and for a healthy and buoyant capital market, both dividends and retained earnings are important factors. The usual policy of a company is to retain a position of net earnings and distribute the remaining amount to the shareholders.

IV. CONCLUSION

Financial leverage influences the policy of distributing dividends, because they are effective in changing Company's dividends. Also, terms that lenders exercise on dividend, are effective on distributing dividends. In current study long term debt was used to total assets ratio as a representative of leverage. Companies with higher financial leverage pay less dividends and more interest. As Jensen (1986) mentioned conflict matter among share-holders and managers is how one use internal funds. The current theories cannot justify whether distribution of dividend and its non distribution affects the companies. HarFord & et al (2008) also described that during the economic boom, firms have increase cash reserves and managers should make decisions strategically whether they distribute cash between share-holders or spend it in companies.

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