A Study on Impact of Dividend Policy on shareholder's Value

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INTRODUCTION

Dividend policy has been an issue of interest in financial literature since Joint Stock Companies came into existence. Dividends are commonly defined as the distribution of earnings (past or present) in real assets among the shareholders of the firm in proportion to their ownership. Dividend policy connotes to the payout policy, which managers pursue in deciding the size and pattern of cash distribution to shareholders over time. Managements' primary goal is shareholders' wealth maximization, which translates into maximizing the value of the company as measured by the price of the company's common stock. This goal can be achieved by giving the shareholders a "fair" payment on their investments. However, the impact of firm's dividend policy on shareholders wealth is still unresolved.

The area of corporate dividend policy has attracted attention of management scholars and economists culminating into theoretical modelling and empirical examination. Thus, dividend policy is one of the most complex aspects in finance. 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. The most pertinent question to be answered here is that how much cash should firms give back to their shareholders? Should corporations pay their shareholders through dividends or by repurchasing their shares, which is the least costly form of payout from tax perspective? Firms must take these important decisions period after period (some must be repeated and some need to be revaluated each period on regular basis.)

Dividend policy can be of two types: managed and residual. In residual dividend policy the amount of dividend is simply the cash left after the firm makes desirable investments using NPV rule. In this case the amount of dividend is going to be highly variable and often zero. If

the manager believes dividend policy is important to their investors and it positively influences share price valuation, they will adopt managed dividend policy. The optimal dividend policy is the one that maximizes the company's stock price, which leads to maximization of shareholders' wealth. Whether or not dividend decisions can contribute to the value of firm is a debatable issue.

Firms generally adopt dividend policies that suit the stage of life cycle they are in. For instance, high- growth firms with larger cash flows and fewer projects tend to pay more of their earnings out as dividends. The dividend policies of firms may follow several interesting patterns adding further to the complexity of such decisions. First, dividends tend to lag behind earnings, that is, increases in earnings are followed by increases dividends and decreases in earnings sometimes by dividend cuts. Second, dividends are "sticky" because firms are typically reluctant to change dividends; in particular, firms avoid cutting dividends even when earnings drop. Third, dividends tend to follow a much smoother path than do earnings. Finally, there are distinct differences in dividend policy over the life cycle of a firm, resulting from changes in growth rates, cash flows, and project investments in hand. Especially the companies that are vulnerable to macroeconomic vicissitudes, such as those in cyclical industries, are less likely to be tempted to set a relatively low maintainable regular dividend so as to avoid the dreaded consequences of a reduced dividend in a particularly bad year.

Shareholders wealth is represented in the market price of the company's common stock, which, in turn, is the function of the company's investment, financing and dividend decisions. Among the most crucial decisions to be taken for efficient performance and attainment of objectives in any organization are the decisions relating to dividend. Dividend decisions are recognised as centrally important because of increasingly significant role of the finances in the firm's overall growth strategy.

The objective of the finance manager should be to find out an optimal dividend policy that will enhance value of the firm. It is often argued that the share prices of a firm tend to be reduced whenever there is a reduction in the dividend payments. Announcements of dividend

increases generate abnormal positive security returns, and announcements of dividend decreases generate abnormal negative security returns.A drop in share prices occur because dividends have a signalling effect. According to the signalling effect mangers have private and superior information about future prospects and choose a dividend level to signal that private information. Such a calculation, on the part of the management of the firm may lead to a stable dividend payout ratio.

Dividend policy[1] of a firm has implication for investors, mangers and lenders and other stakeholders (more specifically the claimholders). For investors, dividends – whether declared today or accumulated and provided at a later date are not only a means of regular income[2], but also an important input in valuation of a firm[3]. Similarly, managers' flexibility to invest in projects is also dependent on the amount of dividend that they can offer to shareholders as more dividends may mean fewer funds available for investment. Lenders may also have interest in the amount of dividend a firm declares, as more the dividend paid less would be the amount available for servicing and redemption of their claims. The dividend payments present an example of the classic agency situation as its impact is borne by various claimholders. Accordingly dividend policy can be used as a mechanism to reduce agency costs. The payment of dividends reduces the discretionary funds available to managers for perquisite consumption and investment opportunities and requires managers to seek financing in capital markets. This monitoring by the external

Brealey (1992) poses that dividend policy decisions as "what is the effect of a change in cash dividends, given the firm's capital budgeting and borrowing decisions?" In other words, he looks at the dividend policy in isolation and not as by products of other corporate financial decisions.

Linter (1956) finds that firms pay regular and predictable dividends to investors where as the earnings of corporate firms could be erratic. This implies that shareholders prefer smoothened dividend income.

Bernstein (1976) observes that given the 'concocted' earnings estimate provides by firms, the low dividend payout induces reinvestment risk and earnings risk for the investors capital markets may encourage the mangers to be more disciplined and act in owners' best interest.

Companies generally prefer a stable dividend payout ratio because the shareholders expect it and reveal a preference for it. Shareholders may want a stable rate of dividend payment for a

variety of reasons. Risk average shareholders would be willing to invest only in those companies which pay high current returns on shares. The class of investors, which includes pensioners and other small savers, are partly or fully dependent on dividend to meet their day-to -day needs. Similarly, educational institutions and charity firms prefer stable dividends, because they will not be able to carry on their current operations otherwise. Such investors would therefore, prefer companies, which pay a regular dividend every year. This clustering of stockholders in companies with dividend policies that match their preference is called clientele effect.

RELEVANCE OF THE STUDY

Previous empirical studies have focused mainly on developed economies The study undertaken looks at the issue from emerging markets perspective by focusing exclusively on Indian Information Technology, FMCG and Service sector respectively. The present research work also seeks to examine and identify the relative importance of some of known determinants of dividend policy in Indian context. The research work also has made an endeavor to bring to light the influence of ownership groups of a company on dividend payout behavior of a firm. This research tries to unfold the relationship between the shareholders wealth and the dividend payout and analyse whether the dividend payout announcements affects the wealth of the shareholders.

Given the diversity in corporate objectives and environments, it is conceivable to have divergent dividend policies that are specific to firms, Industries, markets or regions. Through the research an attempt has been made to suggest how dividend policy can be set at micro level.

Finance mangers would be able to examine how the various market frictions such as asymmetric information, agency costs, taxes, and transaction costs affect their firms, as well as their current claimholders, to arrive at reasonable dividend policies.

Previous research studies have focused on dividend payment pattern and policies of developed markets, which may not hold true for emerging markets like India. In Indian Context, few studies have analysed the dividend behavior of corporate firms and focused on Indian cotton textile Industry and Manufacturing sector. However, it is still not apparent what

the dividend payment pattern of firms in India is. Very few studies have analyzed the dividend behavior of corporate firms in the Indian context. To date, most studies have paid attention on influence of cash flows or earnings on the dividend payment of a firm.
It also gives insight into what kind of ownership structure is beneficial for the shareholders.

SHAREHOLDERS' VALUE CREATION AND ITS LINKAGE WITH DIVIDEND POLICY DECISIONS

It has been recognized by various research studies that a dividend policy could make significant impact on corporate future value when established and carefully followed. The goal of wealth maximisation is widely accepted goal of the business as it reconciles the varied, often conflicting, interest of the stakeholders.
The interest in shareholders' value is gaining momentum as a result of several recent developments:
The threat of corporate takeovers by those seeking undervalued, under managed assets
Impressive endorsements by corporate leaders who have adopted the approach
The growing recognition that traditional accounting measures such as EPS and ROI are not reliably linked to the value of the company's shares
Reporting of returns to shareholders along with other measures of performance in business press.
A growing recognition that executives' long-term compensation needs to be more closely tied to returns to shareholders.
The "shareholders value approach" estimates the economic value of an investment (e.g shares of a company, strategies, mergers and acquisitions, capital expenditure) by discounting forecasted cash flows by the cost of capital. These cash flows, in turn, serve as the foundation for shareholder returns from dividends and share price appreciation.

A going concern must strive to enhance its cash generating ability. The ability of a company to distribute cash to its various constituencies depends on its ability to generate cash from operating its business and on its ability to obtain any additional funds needed from external sources. Debt and equity financing are two basic external sources. Borrowing power and the market value of the shares both depend on a company's cash generating ability. The market

value of the shares directly impacts the second source of financing, that is, equity financing. For a given level of funds required, the higher the share price, the less dilution will be borne by current shareholders. Therefore, management's financial power to deal effectively with corporate claimants also comes from increasing the value of the shares. This increase in value of shares can be brought about by rewarding shareholder with returns from dividends and capital gains.

The most famous statement about the relationship between dividend policy and corporate value claimed that, in the presence of perfect markets, "given a firm's investment policy, the dividend payout policy it chooses to follow will affect neither the current price of its shares nor the total return to its shareholders" However, "market imperfections as differential tax rates, information asymmetries between insiders and outsiders, conflicts of interest between managers and shareholders, transaction costs, flotation costs, and irrational investor behavior might make the dividend decision relevant".

The relevance of dividend policy to corporate value is due to market imperfections. Shareholders can receive the return on their investment either in the form of dividends or in the form of capital gains. Dividends constitute an almost immediate cash payment without requiring any selling of shares. On the contrary, capital gains or losses are defined as the difference between the sell and buy price of shares. Friction costs are one of the market imperfections and are further distinguished in transaction costs, floatation costs and taxes. Another market imperfection is that of information asymmetries between the insiders (e.g. managers) and the outsiders (e.g. investors). Agency conflicts, stemming from the different objectives of company's stakeholders, form the third market imperfection. Finally, there are some other issues that are related to dividend policy and cannot be placed among the previously mentioned imperfections.

REVIEW OF THE LITERATURE

The research aims at analysing information asymmetry, agent conflicts, signalling effect and corporate dividend policy determinants. This section on literature review is focussed on various models and theories that are relevant to our study.

The review of the literature is organised into various schools of thoughts on dividend policy

which are discussed as follows:

DIVIDEND IRRELEVANCE PROPOSITION: MODIGLIANI &MILLER APPROACH (1961)

In 1961, two noble laureates, Merton Miller and Franco Modigiliani (M&M) showed that under certain simplifying assumptions, a firms' dividend policy does not affect its value. The basic premise of their argument is that firm value is determined by choosing optimal investments. The net payout is the difference between earnings and investments, and simply a residual. Because the net payout comprises dividends and share repurchases, a firm can adjust its dividends to any level with an offsetting change in share outstanding. From the perspective of investors, dividends policy is irrelevant, because any desired stream of payments can be replicated by appropriate purchases and sales of equity. Thus, investors will not pay a premium for any particular dividend policy.

M&M concluded that given firms optimal investment policy, the firm's choice of dividend policy has no impact on shareholders wealth. In other words, all dividend policies are equivalent. The most important insight of Miller and Modigliani's analysis is that it identifies the situations in which dividend policy can affect the firm value. It could matter, not because dividends are "safer" than capital gains, as was traditionally argued, but because one of the assumptions underlying the result is violated. The propositions rest on the following four assumptions:

1. Information is costless and available to everyone equally.
2. No distorting taxes exist
3. Flotation and transportation costs are non- existent
4. Non contracting or agency cost exists

DIVIDEND POLICY AND AGENCY PROBLEMS

The level of dividend payments is in part determined by shareholders preference as implemented by their management representatives. However, the impact of dividend payments is borne by a variety of claim holders, including debt holders, managers, and supplier. The agency relationship exists between

The shareholders versus debt holders conflict, and

The shareholder versus management conflict

Shareholders are the sole receipts of dividends, prefer to have large dividend payments, all else being equal; conversely, creditors prefer to restrict dividend payments to maximize the firm's resources that are available to repay their claims. The empirical evidence discussed is consistent with the view that dividends transfer assets from the corporate pool to the exclusive ownership of the shareholders, which negatively affects the safety of claims of debt holders.

n terms of shareholder- manger relationships, all else being equal, managers, whose compensation (pecuniary and otherwise) is tied to firm profitability and size, are interested in low dividend payout levels. A low dividend payout maximizes the size of the assets under management control, maximizes management flexibility in choosing investments, and reduces the need to turn to capital markets to finance investments.Shareholders, desiring managerial the need to turn to capital markets to finance investments. Shareholders, desiring managerial efficiency in investment decisions, prefer to leave little discretionary cash in management's hands and to force mangers to turn to capital markets to fund investments. These markets provide monitoring services that discipline managers. Accordingly, shareholders can use dividend policy to encourage managers to look after their owners' best interests; higher payouts provide more monitoring by the capital markets and more managerial discipline.

La Porta, Lopez- de – Silannes, Shleifer, and Vishny (2000), have argued that a legal environment provides strong protection to shareholders enables them to force companies to disgorge cash. The implication is that effective monitoring by shareholders in UK, where legal protection is strong, should be associated with higher dividend payments. Studies for the UK where empirical evidence on the relationship between dividends and ownership structures is rather limited show that there is a negative relationship between 'inside' ownership and dividends (Short ,Zhang and Keasey,2002, Renneboog and Trojanowski,2005, Farinha, 2003).However , evidence regarding financial institutions is not only limited but also contradictory: Short ,Zhang and Keasey report a positive relationship between dividends and shareholding by financial institutions while Renneboog and Trojanowski find a negative.

Some of the important Research studies on agency conflicts are Berle and Means (1932), Easterbrook analysis (1984), the Jensen & Meckling (1986) □18□, Lang and Linzenberger (1989), Jensen, Solberg and Zorn (1992) Agrawal and Jayaraman (1994) , Yoon and Starks (1995), Denis, Denis, and Sarin (1997) Heaton (2002)

DIVIDEND POLICY AND ASYMMETRIC INFORMATION

In a symmetrically informed market, all interested participants have the same information about a firm, including mangers, bankers, shareholders, and others. However, if one group has superior information about the firm's current situation and future prospects, an informational asymmetry exists. Most academics and financial practitioners believe that managers possess superior information about their firms relative to other interested parties.

Dividend changes (increases and decreases), dividend initiations (first time dividends or resumption of dividends after lengthy hiatus), and elimination of dividend payments are announced regularly in the financial media. In response to such announcements, share prices usually increase following dividend increases and dividend initiations, and share prices usually decline following dividend cuts and dividend eliminations. The idea that dividend payouts can signal a firm's prospects seems to be well accepted among the chief financial officers (CFOs) of large US corporations. In a survey of these executives conducted by Abrutyn and Turner (1990), 63% of the respondents ranked signaling explanation as the first reason for dividend payouts.

Information about the prospects of a firm may include the firm's current projects and its future investment opportunities. The firm's dividend policy, either exclusively or in combination with other signals, such as capital expenditure announcements or trading by insiders, may communicate this information to a less informed market. Empirical studies in this area include Akerlof's (1970) Bhattacharya model (1979), John and Williams model (1985) Miller and Rock model (1985) Constantinides and Grundy (1989) John and Nachman (1986) Kale and Noe (1990), Allen . Bernado , and Welch (2000)

Pettit (1972) documented that announcements of dividend increases are followed by significant price increases and that announcements of dividend decreases are followed by significant price drops. Three studies of large changes in dividend policy—Asquith and Mullins (1983) (dividend initiations), Healy and Palepu (1988), and Michaely, Thaler, and

Womack (1995) (dividend omissions)—showed that the market reacts dramatically to such announcements. Other research studies which tested the dividend announcement effects include Aharony and Swary (1980) Ofer and Siegel (1987) 25, Dyl and Weigand (1998)
Empirical studies however showed mixed evidence, using the data from US, Japan and Singapore markets. A number of studies found that stock price has a significant positive relationship with dividend payments (Gordon (1959) ,Oggden (1994) ,Stevents and Jose(1989),Kato and Loewenstein (1995) ,Ariff and Finn(1986),and Lee(1985)),while others found a negative relationship like Loughlin(1989) and Easton and Sinclair(1989) Dividends are meant convey private information to the market, predictions about the future earnings of a firm based on dividend information should be superior to forecasts made without dividend information.A number of studies have tested these implications of the information content of dividends which includes studies by Watts (1973) Gonedes (1978)
Charest (1978) Michaely , Thaler and Womack (1995) Benartzi, Michaely, and Thaler (1997) Grullon, Michaely and Swaminathan (2002Lipson, Maquieira, and Megginson (1998) Brook, Charlton, and Hendershott (1998) Nissim and Ziv (2001)

RESEARCH ON CORPORATE DIVIDEND POLICY DETERMINANTS

Black (1976) in his study concluded with the following question: “What should the corporation do about dividend policy? We don’t know” .A numbers of factors have been identified in previous empirical studies to influence the dividend policy decisions of the firm. Profits have long been regarded as the primary indicator of the firm’s capacity to pay dividends. Lintner (1956) conducted a classic study on how U.S. managers make dividend decisions. He developed a compact mathematical model based on survey of 28 well-established industrial U.S. firms which is considered to be a finance classic. According to him the current year earnings and previous year dividends influence the dividend payment pattern of a firm22. Fama and Babiak (1968) studied the determinants of dividend payments by individual firms during 1946-64. The study concluded that net income seems to provide a better measure of dividend than either cash flows or net income and depreciation included as separate variables in the model. Baker, Farrelly and Edelman (1986) surveyed 318 New York stock exchange firms and concluded that the major determinants of dividend payments are anticipated level of future earnings and pattern of past dividends. Pruitt and

Gitman (1991) asked financial managers of the 1000 largest U.S. and reported that, current and past year' profits are important factors influencing dividend payments and found that risk (year to year variability of earnings) also determine the firms' dividend policy. Baker and Powell (2000) concluded from their survey of NYSE-listed firms that dividend determinants are industry specific and anticipated level of future earnings is the major determinant.

In other studies, Rozeff (1982), Lloyd *et.al.* (1985), and Colins *et. al.* (1996) used beta value of a firm as an indicator of its market risk. They found statistically significant and negative relationship between beta and dividend payout. D'Souza (1999) also found statistically significant and negative relationship between beta and dividend payout[30]. D,Souza (1999) however showed a positive but insignificant relationship in the case of growth and negative but insignificant relationship in case of market to book value[12]. Alli *et.al* (1993) reveal that dividend payments depend more on cash flows, which reflect the company's ability to pay dividends, than on current earnings, which are less heavily influenced by accounting practices. Green *et. al.* (1993) questioned the irrelevance argument and investigated the relationship between the dividends and investment and financing decisions .Their study showed that Dividend decision is taken along with investment and financing decisions. The results however do not support the views of Miller and Modigliani (1961). Dhrymes and Kurz (1967) and McCabe (1979) found that the firm's investment decision is linked to its financing decision. Higgins (1972), Fama (1974), and Smirlock and Marshall (1983) documented no interdependence between investments and dividends.

Higgins (1981) indicated a direct link between growth and financing needs: rapidly growing firms have external financing needs because working capital needs normally exceed the incremental cash flows from new sales. Rozeff (1982), Lloyd *et al.*(1985) and Collins *et al* .(1996) all show significantly negative relationship between historical sales growth and dividend payout.

Arnott and Asness (2003) based their study on American stock markets (S&P500) and found that higher aggregate dividend payout ratios were associated with higher future earnings growth.

Both Zhou and Ruland (2006) and Gwilym *et.al.* (2006) supported the findings of Arnot and Asness. Zhou and Ruland examined the possible impact of dividend payouts on future earnings growth. Their study used a sample of active and inactive stocks listed on NYSE and

NASDAQ with positive, non- zero payout ratio companies covering the period from 1950-2003.Their regression results showed a strong positive relation between payout ratio and future earnings growth. Mancinelli and Ozkan (2006) undertook an empirical investigation of the relationship between the ownership structure of companies and dividend policy using 139 firms listed in Italian exchange. Their results suggested that the dividend payout ratio is negatively associated with the voting rights of the largest shareholders. Mohammed Amidu and Joshua Abor (2006) examined the factors affecting dividend payout ratios of listed companies in Ghana. The results of their study showed that payout ratios were positively related to profitability, cash flow and tax but are negatively related risk and growth.

INDIAN SCENARIO

In Indian Context, a few studies have analyzed the dividend behavior of corporate firms. Krishnamurty and Sastry (1971) analyzed dividend behaviour of Indian chemical industry for the period 1962-67 and undertook cross sectional data of 40 Public Limited companies. The results revealed that Lintner model provides good explanation of dividend behavior. Dhameja (1978) in his study tested the dividend behaviour of Indian companies by classifying them into size group, industry group, growth group and control group.

The study found there was no statistically significant relationship between dividend payout, on the one hand and industry and size on the other. Growth was inversely related to dividend payout and was found to be significant .The main conclusion were that dividend decisions are better explained by Lintner's model with current profit and lagged dividend as explanatory variable. Mahapatra and Sahu (1993) found cash flows as a major determinant of dividend followed by net earnings. Bhat and Pandey (1994) undertook a survey of managers' perceptions of dividend decisions and found that mangers perceive current earnings as the most significant factor. Narsimhan and Asha(1997) observed that a the uniform tax rate of 10 % on dividend as proposed by Union Budget 1997-98 , alters the demand of investors in favor of high payouts. Mohanty (1999) found that firms, which issued bonus shares, have either maintained the payout at the pre bonus level or only decreased it marginally thereby increasing the payout to shareholders. Narsimhan and Vijay Lakshmi (2002) analysed the influence of ownership structure on dividend payout of 186 manufacturing firms.

Regression analysis shows that promoters holding as of September 2001 have no influence on average dividend payout for the period 1997-2000.

Anand Manoj (2002) analyzed the results of 2001 survey of 81 CFOs of Business today-500 companies in India to find out the determinants of the dividend policy decisions of the corporate India. He used factor analytic framework on the CFOs' responses to capture the determinants of the dividend policy of corporate India. The findings revealed that most of the firms have target dividend payout ratio and were in agreement with Lintner's study on dividend policy. CFO's use dividend policy as a signaling mechanism to convey information on the present and future prospects of the firm and thus affects its market value. The managers design dividend policy after taking into consideration the investors' preference for dividends and clientele effect. Reddy Y.Subba and Rath Subhrendu (2005) examined Dividend trends for large sample of stocks traded on Indian markets indicated that the percentage of companies paying dividend declined from over 57% in 1991 to 32% in 2001, and that only a few firms paid regular dividends.

Dividend – paying companies were less likely to be larger and more profitable than non-paying companies, though growth opportunities do not seem to have significantly influenced the dividend policies of Indian firms. The rise of the number of firms not paying dividends is not supported by the requirements of cash for investments Sharma Dhiraj (2007) empirically examined the dividend behavior of select Indian firms listed on BSE from 1990 to 2005.The study analyzed whether or not the dividends are still vogue in India and tried to judge the applicability of one of the two extremely opposite schools of thoughts-relevance and irrelevance of dividend decision. The study also analyzed the applicability of tax theory in the Indian context. The findings offered mixed and inconclusive results about tax theory indicating that the change in the tax structure does not have a substantial effect on dividend behavior of firms.

CONCLUSION

A number of conflicting theoretical models, all lacking strong empirical support, define recent attempts by researchers in finance to explain the dividend phenomenon. But to come with concrete conclusions an intensive study of all theoretical models together with empirical proof is needed. The extensive literature on dividend policy in the last five decades have been unable to reach a consensus on research on a general dividend theory that can either explain the process of dividend decision making or predict an optimal dividend policy. Therefore it becomes important to study dividend behavior of Indian companies using the framework of empirical models.

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