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IMPACT OF DIVIDEND POLICY ON FIRM PERFORMANCE EVIDENCE FROM LISTED COMPANIES IN COLOMBO STOCK EXCHANGE

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ABSTRACT

The aim of this study is to examine the impact of dividend policy on firm performance of listed companies in Colombo Stock Exchange (CSE) for 5 year period from 2013-2017. This study pays the attention on the impact of three aspects of listed companies which can cause economic decline or success. According to the market capitalization, highest 30% of market capitalization 82 listed companies in CSE are selected based on data availability for 5 years. The performance measurements are return on equity and return on assets and dividend policy is measured by dividend pay-out ratio and earning per share. Panel data regression model is used as it has cross sections and time series nature of data. The study finds that the dividend policy variables are enough to describe the firm performance. The findings will guide decision makers, future and potential investors, econometricians, academics and other stakeholders for making their strategic planning, cost controlling, profit allocation, related academic studies, taking decisions on managerial implications of economy and corporate sector.

1.0 Introduction and Background of the Study

A company can do two things when they have earned profit. The surplus can pay back to its investors as dividends and/or firm can retain profits within the business as an addition to shareholders' equity as retained earnings. It may however decide to apportion the surplus to both. Earnings are the free cash flows allocate to investors after all expenses and taxes have been paid. If the firm decides to redistribute the earnings to the investors, then the investors can decide whether reinvest it themselves or spend it.

Priya & Nimalathasan (2013) propose that the divided policy is more ordinarily tool of wealth distribution to its shareholders than it is a tool of wealth formation to stakeholders. When a company is defining the value of the firm, the dividend policy is one of the irrelevant things (Modgliani & Miller (1961). The agency cost concept proposes that, dividend policy is governed by agency costs which arise from the disagreement of ownership and control and ownership. Managers cannot always implement a dividend policy which is value-maximizing for its shareholders. But it should select a dividend policy which maximizes their private benefits. Creation of dividend payouts that decreases the free cash flows which is available to the managers, should confirm that managers maximize shareholders' wealth other than consuming the funds for their own personal benefits (De Angelo, De Angelo & Stulz, 2006).

Investors always prefer higher current income and try to find limited capital progress prefer companies with a high dividend payout. However, investors looking for higher capital growth may prefer a lower payout as capital gains are taxed at a lower rate. Barron, (2002) defines dividends as one of the most important things to its investors since; it gives the signs that a company is creating profits. Firm's policies vary from company to company. Among those policies dividend policy is one of the most significant news. Cash divided plays a vital role among the shareholders as well as dividend policy effect on the firms' valuation. However, implementing a policy of divided is a crucial problem face by companies. One of the main factors which determine the dividend policy is corporate governance (Mehrani, Moradi & Eskandar, 2011).

The dividend policy remains as an unresolved problem in corporate finance and many scholars have carried out researches on this topic by Farsio, Geary & Moser (2004), Arnott & Asness (2003) and Nissim & Ziv (2001). Some theories were tested by some researchers to clarify the relevance and significance of dividend policy and whether it affects firm value, but still there is no any universal agreement (Stulz, 2000, De Angelo et al., 2006,

Pandey, 2005). Researchers namely Amidu (2007), Zhou & Ruland (2006), Lie (2005), Howatt (2002), came up with different judgements about the relationship between dividend policy and firm performance.

Numerous studies (Arnott et al., 2003; Nissim et al., 2001; Farsio, Geary et al., 2004) have been focused on dividend policy and firm performance, but especially in developed economies. But these conclusions and findings of those studies directly cannot be replicated in developing countries. It is found that in Sri Lanka there is lack of such studies to establish the relationship between dividend policy and firm profitability. The extant literature reveals that empirical studies have been conducted in different countries under various economic and social conditions. Sri Lanka is under different economic, social and technological conditions and it is immensely important to carry out this type of study in Sri Lanka. Thus, this study therefore comes into fill the gap by investigating "what is the impact of dividend policy on firm performance of listed manufacturing companies in Sri Lanka?"

1.2 Purpose of the Study

The main objective of the study is to investigate the impact of dividend policy on firm's performance of listed companies in the CSE.

1.3 Resecrch Hypothesis

H_1: There is a significant impact of dividend payout on firm performance for listed companies in CSE.

H_2: There is a significant impact of Earning per share on firm performance for listed companies in CSE.

2.0 Literature Review

2.1 Theoretical Review

Dividend Relevant Theory

According to Pandey (2005) Proponents Gordon and Walter said that the dividend policy closely affects the firm's value. Therefore, if there is a change will occur in dividend payout it will affect to a change in market value of a firm. Therefore, an optimum payout ratio is required to gives maximum market price.

Dividend Irrelevant Policy

The first theoretical explanation of dividend was established by Lintner (1956); Miller & Modigliani in 1961 introduced a model by their study which is considered as the classical research which the dividend irrelevance theory was proposed. They argued that dividend policy is an irrelevant thing to determine the firms' value. Therefore, there has no influence on the firm's stock price from the dividend policy or its cost of capital. The Miller & Modigliani model effects are depended on specific considerations, where taxes or transaction cost won't be paid by investors, they can borrow at the interest rate and lend also done at the equal interest rate, and there is the access to all information of the future growth of the firm, and where high dividends will be paid to the shareholders, and by issuing new shares the firm can recover any paid out earnings (Arnold, 2008). Pruitt and Gutman (1991) established that some factors have vital influences to the amount of dividends paid by the firm, past and current years' profits, variability of earnings, earnings growth and previous years' dividends. Fama & French (2001) discussed in their study that the percentage of dividends payment by firms reduced after 1978. Firms which pay dividends regularly can loose their competitive advantages as they have to bare high cost of equity when it is compared to companies which do not pay dividends regularly.

Furthermore, another study by Al Shabibi and Ramesh (2011) disclosed dividend policy is one of the vital decision can be affects to the company performance and growth in long term. Not only that but also it is affected to the profitability, industry, cash flow stability of the firm, the firm size and so on.

Agency Theory

According to D'Souza and Saxena (1999) investigated whether there is a relationship between dividend policy and the agency cost. According to the findings of the study there is a statistical significant negative relation between dividend policy and the agency cost, and they expressed that dividends should be paid in a regular basis to decrease the agency cost.

Managers' opinion is dividends can be used as a tool which helps to reduce agency costs. Ross et al.,(2008) said that managers can remove the conflict between bondholders and shareholders by paying dividend in stocks instead of regular cash payment which will keep the excess cash in the firm. Al-Malkawi (2007) and Arnold (2008) agreed with D'Souza and Saxena results and found that dividend is the best solution to reduce agency cost. Al-Najjar and Hussainey (2009) in their study on UK firms proposed that dividend payment is a substitute for companies which have weak corporate governance. According to Al-Kuwari (2009) shareholder is the principal in agency problem while the manager acts as the agent whose responsible to maximize value of

the firm and returns to the firm's shareholders. The agency problem is born when interest of shareholders' and managers' are not the same one. It can be born due to various roles of the manager which influence to the interest of shareholders. As an example, sometimes the manager may their perk attentions which the shareholders do not consider them as investing in some projects which does not help to increase shareholders value. However, the cost which uses to monitor the managers is identified as the agency costs.

Puzzle Theory

However, Black (1976) had moved toward with the puzzle theory, but no one had argued it because it mentioned the real points as transaction cost and taxes are exist in our world, and number of factors such as sensitivity of earnings, government regulation, cliental effect, firm size, debt level, and so on affect to the dividend policy of the firm. (Al-Shabibi & Ramesh, 2011).

Bird in hand Theory

Gordon (1962) argues that the "Bird in Hand" theory defined that shareholders always prefer higher dividend policy. Bird in hand theory suggests there is a relationship occurs between dividend payout and firm value. Amidu, (2007) stated that dividends do not have more risk than capital gains meanwhile they are more certain. Hence, investors would always have a preference with dividends to capital gains. For the reason that hypothetically dividends have less risk than capital gains. So that firms have a duty to fix a good dividend payout ratio and give a high dividend return to maximize the company stock price. Many studies prove that this mode can fail if it is proposed in a perfect market with investors who perform according to thinking of rational behavior (Miller and Modigliani, 1961, Bhattacharya, 1979).

Many different strategies are used by the investors to analyze the available information, and then based on the results their reactions are created in many different ways according to the level of risk. This theory asset that investors always prefer with high dividend payment stocks which influence to reduce the risk, "A bird in hand (dividend) is worth more than two in the bush (capital gains)" (Al-Malkawi, 2007). Investors are divided based on the level of risk they are willing to take to risk adverse, risk neutral, and risk takers. On the other hand Easterbrook (1984) was against the bird in the hand theory. Because in his argument it is totally based on the selling ability of the share of the investors' at any time without waiting for dividend pay outs and that will cause to decrease the volume of tax paid as well.

Signalling Theory

Changes in cash dividends are used by managers to distribute rates to convey information to the firm's investors about the company. This theory is based on the information irregularity between managers and investors who are in outside, where managers have own and private information about future and current wealth of the firm and it is not available to outsiders of the organization. Bhattacharya (1979), William and John (1985), and Miller and Rock (1985) said that information asymmetries within firms and outside shareholders have a possibility to bring a kind of signaling role for dividends. The vital element in this theory is the firms should pay funds regularly.

Signaling theory was an outcome of the asymmetric information between the investors and the management (Fairchild, 2010). And also according Fairchild (2010) signaling model used the dividend as a sign of the firm yearly income, and it affected the management decisions in taking new projects. Dividend policy sends mixed and complicated signals to investors. If the management decided to increase their dividend pay-out, investors might analyse that as a bad sign for future growth, although the reason might be the lack of opportunities to grow or an increase in last year earnings. If the management decided to decrease their dividends pay-out to invest in a positive net present value projects, investors might respond negatively, and question the management decision if it is based on a personal profit, or for the sack of the firm (Arnold, 2008).

2.3 Empirical Review

As Hafeez & Attiya, (2009) defined the dividend policy behavior is one of the most debatable issue in the corporate finance literature and both in developed and emerging markets still retains it in a prominent place. Dividend policy and the firm performance have been analyzing for many decades, but up to now there is no universally standard justification for companies' observed dividend payout (Samuel & Edward, 2011). Many researchers have given an effort to find issues regarding the dividend dynamics and determining factor of dividend policy. But still there is no standard justification for the dividend behavior of firms (Brealey & Myers, 2005).

Al-Malkawi (2007) took 15 years data with 1137 observations of Jordanian public listed companies and it said that companies which have a growth of the profitability motivate to pay more dividends than others. The finding of the study made an argument with the study of Aivazian, Booth & Clearly (2003) which described the signaling theory and companies with higher profits allure to pay more dividends to the shareholders by sending a message of good financial performance of the companies.

Gupta and Banga (2010) used the sample for seven years data from 150 listed Indian companies on Bombay Stock Exchange. The end results of the investigation showed that company performance and dividend policy had a significantly negative relationship. The same relationship is shown in other studies such as Aurangzeb & Dilawer (2012), Bacon & Kania (2005). This implies that the companies with more profits have a preference to pay less dividends to the shareholders. According to Rozeff (1982) explained that if there are more growth opportunities companies which generate higher profits like to reinvest in future projects to develop the business. Therefore, this study shows a positive relationship between company's profitability and its dividend policy.

Another study of Maldajian and El Khoury (2014) studied Lebanese banks listed on Beirut Stock Exchange from the period of 2005 to 2011 and finds that there is a negative relationship between company profitability and dividend payout policy because of the same reason as above, sometimes profitable companies allure to pay less dividends to shareholders and invest the earnings in business.

3.0 Methodology

3.1 Population and sample of the study

The population of the study is all the companies listed in CSE, in Sri Lanka. The study focuses on dividend policy impacts on firm performance of listed companies in CSE in Sri Lanka. So that this study uses the population as the 296 listed companies in CSE to evaluate the impact of dividend policy on firm performance. This study selects its sample as first 30% of the company in CSE according to the market capitalization. This study considers the annual reports during the period of 2013 -2017.

3.2 Definition of variables

Concept	Variable	Indicator	Measurement
Dividend policy	Dividend Payout	Dividend Payout ratio	$\frac{Total\ dividends}{Total\ Net\ Earnings}$
	Earning per share	Earning per share Ratio	$\frac{Net\ Income - Dividends\ on\ Preferred\ Stock}{Average\ Outstanding\ shares}$
Firm Performance	Profitability	Return on assets	$\frac{Net\ income}{Total\ Assets}$

		Return on Equity	$\frac{Net\ Income}{Shareholders\ Equity}$

3.3 Research model

Panel data regression procedure is used to investigate dividend policy and firm performance. It examines individual firm effect, time effect, or both and these effects are either fixed or random. The pooled OLS model is run by neglecting the cross sections and time series nature of data assuming that all companies are same at all the time. Heterogeneity or individuality does not exist in pool OLS model while it allows for fixed effect model. A fixed effects model is one of the statistical models which the parameters of the model are fixed. They have their own intercept values, but intercepts do not vary over the time. Random effect model has a common mean value for the intercept.

Both time effect and group effect are put through dummy variables into the model in the fixed effect model. For example, if only the group effect is entered in the model then it should be included through the dummy variables d1, d2, …., dn-1 if there are n number of groups. F test is used to check the appropriateness of the fixed effect model. If the p value of F test gives under significant level fixed effect model is appropriate. The model is given below.

$$Y_{it} = \alpha + \mu_i + T_t + \cdots \ldots \ldots + x_{it}^{T}\beta + \epsilon_{it}$$

However, due to time effect, group effect and error, the variability is separated in the random effect model. So that it estimates variance components for groups, time or error. Therefore, differences are shown in error variances. Breush Pagan Lagrange Multiplier (LM) test is used to check whether the random effect model is appropriate or not. If the p value of LM test gives under significant level random effect model is appropriate. The model is as follows.

$$Y_{it} = \propto + X_{it}^{T}\beta + u_i + \epsilon_{it}$$

The Durbin–Wu–Hausman test, also called as Hausman test is the specification test which is used to estimate the appropriate model among random effect model and fixed effect model. If the hausman test reject null hypothesis it implies that the fitted model is fixed effect model otherwise random effect model.

4.0 Results and Discussions

The data were analyzed using STATA. This part provides descriptive statistics, correlation analysis, regression analysis and Diagnostic Tests which includes the results of Fisher (F)-test, VIF test, Unit root tests, Lagrange Multiplier (LM)-test and Hausman Specification test.

4.1 Correlation Analysis

Table 1: Correlation Analysis

Variable	ROE		ROA	
	Pearson Correlation	Sig. (2-tailed)	Pearson Correlation	Sig. (2-tailed)
Dividend payout	0.700***	0.004	0.608**	0.016
EPS	0.873***	0.000	0.805***	0.000

Note: ***, ** and * indicate significance at 1%, 5% and 10% respectively
Source: (Surveyed Data, 2018)

As per the correlation analysis of Table 1, the dividend payout and earning per share have significant positive relationship with ROE. According to Pearson correlation values the dividend payout had a significant positive relationship with ROA while earning per share denotes a significant positive relationship with ROA.

4.2 Diagnostic Tests

The study applied three regression techniques such as pooled OLS, fixed effect and random effect. According to Harris Tzavalis and Breitung unit-root tests results show that the dividend policy and firm performance were stationary at the level. Hence, it can be concluded that the data of the study do not have a unit root hence, they are stationary. Breitung unit-root test also produces enough evidence to reject null hypothesis (H0) while accepting alternative hypothesis (H1) as the p-value of the test 0.0646 (0.0646 < 0.1) and the data are stationary and the results show that the data are stationary.

Table 2: Unit Root Test

Variable	Harris-Tzavalis unit root test	Level of significant
ROE	0.0219	0.05
ROA	0.0000	0.01
Dividend Payout	0.0000	0.01
EPS	0.0000	0.01

Source: (Surveyed Data, 2018)

The multicollinearity issue was tested using VIF and all the VIF values of independent variables are less than 10 (Table 4) which shows that there does not exist any multicollinearity issue.

The study contains small number of periods of 5 years which is treated as a micro panel. When apply the serial correlation test to a micro panel it is not performed well as they put on to macro panels with long time series such as 20-30 period of years (Baltagi, 2012). Robust standard error correcting is the answer to correct this issue in micro panels for the possible presence of Heteroscedasticity proposed by Baltagi (2012). Heteroscedasticity is existing in samples that random variables show differing variabilities than other subsets of the variables. Therefore, in both regression models, both fixed and random effects are performed by using robust standard errors to do the estimation of the efficient regression coefficients.

4.3 Fishaer (F)- Test Results

The existence of the fixed effects in residuals is tested through *F* statistic (Panel A and B of Table 4). The F- tests of all the two regressions performed reject the null hypothesis that all dummy parameters are jointly equal to zero and it may be concluded that the fixed firm effect model is better than the pooled OLS model. Hence, the fixed effect model is the better choice than the pooled OLS regression model. In the one- way fixed time effect models and the two-way models, no significant time impacts were found, and the analysis was conducted only on the one- way fixed firm and random effects models and the results are presented in Table 5.

Table 4: Specification Tests

Model	Panel A-ROE				Panel B-ROA			
Specification Test	Statistic	P-value	Tested	Selection	Statistic	P-value	Tested	Selection
Hausman	183.550	0.0000***	Random/Fixed	Fixed	11.0300	0.0873*	Fixed/Random	Fixed
Breusch-Pagen	66.3400	0.0000***	OLS/Random	Random	50.6900	0.0000***	OLS/Random	Random
F-test	7.8400	0.0000***	OLS/Fixed	Fixed	4.9800	0.0000***	OLS/Fixed	Fixed

Note: ***, ** and * indicate significance at 1%, 5% and 10% respectively.

Source: (Surveyed Data, 2018)

Table 5 : Results of the One Way: Fixed firm Effect Model for ROE and ROA

Model	Panel A -ROE					Panel B – ROA				
Variable	Coefficient	Robst Standard Error	T-statistic	P-value	Variance Inflation Factor	Coefficient	Robst Standard Error	T-statistic	P-value	Variance Inflation Factor
Constant	-0.1786	0.1080	-1.65	0.108		-0.1075	0.0946	-1.24	0.222	
Payout	0.1006	0.0424	2.37	0.024**	0.9600	0.0634	0.0309	2.05	0.049**	0.9599
EPS	0.0022	0.0008	2.67	0.012**	0.8667	0.0017	0.0012	1.35	0.100*	0.8667
sigma_u	0.1281					0.1989				
Rho	0.6939					0.5461				
sigma_e	0.0851					0.1813				
R^2	0.3189					0.0490				

Note: ***, ** and * indicate significance at 1%, 5% and 10% respectively.
Source: (Surveyed Data, 2018)

4.5 Results and Discussion

As per Table 5 the dividend payout and earning per share have a positive significant impact on both ROA and ROE hence, accept H_1 and H_2.

According to the specification tests the fixed firm effect model is the best model for panel A and panel B. The dividend payout ratio is the most influential variable in determining dividend policy and firm performance which had a strong positive significant impact. The "Bird in Hand" theory defines that the shareholders always prefer higher dividend policy and signaling model proposes that the dividend as a sign of the firm's yearly income, and it affects the management decisions in taking new projects. When dividend payout ratio increases it signals to the shareholders and investors that the company is performing well.

This study proves that earning per share has a significant positive effect on firm performance which proves that if the firm financial performance is high, shareholders' earning per share also goes high. Further, it signals to future and potential investors that an increase of profits of the firms will have a tendency of a positive impact on the dividend policy of firms.

5. Conclusion

The aim of the study is to investigate the impact of dividend policy on firm performance in listed companies in Colombo Stock Exchange (CSE) over the period from 2013 to 2017. Panel data approach was applied, and series of tests were conducted namely, diagnostics test of f-test, breusch-pagen test, hausman test and correlation analysis and panel data analysis.

The correlation analysis reveals that the dividend payout ratio and earning per share have significant positive relationships with ROE and dividend payout ratio has a significant positive relationship with ROA whereas earning per share reveals a negative relationship with ROA.

The fixed firm effect model shows that the dividend payout ratio and earning per share have significant impact on ROE and ROA.

The study finds that dividend payout ratio and earning per share imply a positive significant impact on ROA. The results are useful for managers, employees, shareholders, potential and existing investors and academics.

The future and potential investors who prefer to invest in CSE can use this as governance whether this sector matches with investors' preferences or not regarding dividend policy. Further, it can be a vital study for econometricians, policy makers, academics and other stakeholders for their policy making, decision making, related academic studies and so on. Also, this study is being veil for many parties for

strategic planning, to take decisions on managerial implications.

Future researchers can incorporate more variables on risk levels, economic conditions of firms and can consider other measures of firm performance such as both net profit and profit before income tax and interest.

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