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Dividend Policy and Firm Performance: Evidence from the Manufacturing Companies Listed on the Colombo Stock Exchange

By T. Velnampy, P. Nimalthasan & K. Kalaiarasi
University of Jaffna, Sri Lanka

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Design: A set of listed manufacturing companies have been investigated to using the data representing the periods of 2008 – 2012.Returns on equity and return on assets were used as the determinants of firm performance whereas dividend payout and earnings per share were used as the measures of dividend policy. The statistical tests were used includes: descriptive statistics, correlation and regression analyses.

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T. Velnampy [α], P. Nimalthasan [σ] & K. Kalaiarasi [ρ]

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Findings: The study found that determinants of dividend policy are not correlated to the firm performance measures of the organization. Regression model showed that dividend policy don't affect companies' ROE and ROA. Further recommendations are also put forwarded in the research.

Research Limitations: The study only used data from the 2008-2012 annual reports. However, the findings have highlighted the effects of the firm performance and dividend policy.

Originality: The study contributes to literature in Sri Lanka. Furthermore, the finding of the paper can be considered as helpful for managers and users that are anxious to develop financial description quality and practices of dividend policy.

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I. Introduction

Dividend Policy has attracted great interest over the past decade. The widely held view that dividend policy has an impact on the firm performance has led to increasing global attention. Sri Lanka a developing economy is not immune to these developments. Investment activity is an activity faced with various risks and uncertainty condition which is mostly difficult to predict by investors. There is much information, not only achieved from the performance of the company, but also other relevant information, such as economic condition and the political situation in a country which are needed by investors to reduce the risks rate and any uncertainty that possibly appears. Information which is achieved from a company is commonly based on the company's performance, reflected from the financial report. Based on the report, investors could understand the company's performance and its capability to raise profits.

Dividend represents a distribution of earnings to the shareholders of a company that are usually declared at Annual General Meetings and paid to shareholders of record. Dividend or profit allocation decision is one of the four decision areas in finance. The other three are financing, investment, and working capital management decisions. As noted by Ross, Westerfield and Jaffe (2002) companies view the dividend decision as quite important because it determines what funds flow to investors and what funds are retained by the firm for investment. Dividend policy can also provide information to stakeholders concerning the company's performance.

Generally, the main purpose of investors when investing their assets is to search for income or the rate of return. Dividend is one of the sources of income in such circumstances; each company is forced to operate with high efficiency in order to maintain the quality and capability of competing to raise a net income with the best result. Therefore, a company determines dividends policy to look forward the profit gained that will be allocated into two components: dividends and retained earnings.

II. Review of Literature

The dividend policy and firm performance theories mentioned in section, dividend policy has been analyzed for many decades, but no universally accepted explanation for companies' observed dividend behavior has been established (Samuel & Edward,2011).The behavior of dividend policy is one most debatable issue in the corporate finance literature and still keeps its prominent place both in developed and emerging markets (Hafeez & Attiya, 2009).Pruitt and Gutman (1991) found that the following factors are important influences in the amount of dividends paid, current and past years' profits, the year to year variability of earnings, the growth of earnings and prior years' dividends.

Foong, *et al* (2007) observed that although firms do not have obligations to declare dividends on common stock, they are normally reluctant to change their dividend rate policy every year as the firms strive to meet stockholders' expectation, build a good image

Author α σ ρ : Faculty of Management Studies & Commerce, University of Jaffna, Sri Lanka. e-mails: tvnampy@yahoo.co.in, pnthasan@gmail.com, kkarasi4@gmail.com

among investors and to signal that the firm has stable earnings to the public. Many researchers have tried to uncover issues regarding the dividend dynamics and determinants of dividend policy but we still don't have an acceptable explanation for the observed dividend behavior of firms (Black, 1976; Brealey & Myers 2005).

Rozeff (1982) is one of the first to propose a role for dividends in reducing agency-related losses, substituting for other bonding and auditing costs incurred by the firm. He finds that ownership concentration is negatively related to payout, which is consistent with the argument that greater insider concentration results in better monitoring thus reducing the need to pay dividends.

Kale and Noe (1990) in a related study opined that a firm's dividend basically indicates the stability of the firm's future cash flows. A review of related prior studies shows further that the main factors that influence a firm's dividend decisions include cash flow considerations, investment returns, after tax earnings, liquidity, future earnings, past dividend practices, inflation, interest, legal requirements and the future growth projection.

Dividends are compensatory distribution to equity shareholders for both time and investment risks undertaken. Such distributions are usually net of tax and obligatory payments under debt capital and they represent a depletion of cash assets of the company (Lipson *et al*., 1998). Amidu (2007) Investigated that dividend policy affects firm performance as measured by its profitability. The results showed a positive and significant relationship between return on assets, return on equity, growth in sales and dividend policy.

Oskar, Ivan, Oleksandr, Diw (2007) pointed that two perspectives. First, explore the determinants of the dividend policy in Poland. Second, test whether corporate governance practices determine the dividend policy in the non-financial companies listed on Warsaw Stock Exchange. The findings are based on the period 1998-2004. Quantitative measures on the quality of the corporate governance for 110 non-financial listed companies. These results suggest that dividends may signal the severity of conflicts between controlling owners and minority shareholders. Those dividends in Poland have less of a signaling role than in the developed capital markets.

Zeckhauser & Pound (1990) revealed that found out that there is no significant difference among dividend payouts with or without large block shareholders. Dividend policy is the regulations and guidelines that a company uses to decide to make dividend payments to shareholders (Nissim & Ziv, 2001).Miller and Modighani (1961) were the first to demonstrate that under certain assumptions (perfect market conditions, rational behavior and perfect certainty), the value of the firm is independent of the way the firm chooses to finance its investments and that all that matters is the firm's investment opportunities.

III. Objectives of the Study

The following objectives are taken for the study.

1. To determine the relationship between firm performance and dividend policy for manufacturing companies listed on CSE.
2. To determine the impact of firm performance on dividend policy of manufacturing companies listed on CSE.

IV. Research Question

- ✓ Is there any relationship between firm performance and dividend policy of manufacturing companies listed on CSE?
- ✓ Does firm performance of manufacturing companies listed on CSE have an impact dividend policy?

V. Data Collection

Data on dividend policy and firm performances were collected from secondary sources as Annual reports of the manufacturing companies, Colombo stock exchange publications and URL of the Colombo stock exchange for the period of 2008 to 2012.

VI. Sampling

The Colombo Stock Exchange (CSE) has 287 companies representing 20 business sectors as at 31st January 2013. Out of 37 Manufacturing companies 25 companies were selected for the present study.

VII. Methodology

The following dividend policy and firm performance are taken into accounts which are given below.

Table 1 : Calculations of Dividend Policy Ratios and Firm Performance Ratios

Dividend Policy	
Dividend Payout	Dividend Per Share (DPS) / Earning Per Share (EPS)*100
Earnings per Share	Net Income-Dividends on Preferred Stock/Average Outstanding Shares
Firm Performance	
Return on Equity	Net Income /Shareholders fund * 100
Return on Assets	Net Income /Total Assets*100

The purpose is to describe the research methodology of this study. Since the aim of the study was to test the effect of dividend payout on firm performance, the design of the methodology was based on prior research into these relationships. This section describes the method of data collection, the variables used to test the hypothesis and statistical techniques employed to report the results. The regression models utilized to test the relationship between the determines dividend policy such as dividend payout (DIP) and earnings per share (EPS)and firm performance such as return on equity (ROE), and return on assets (ROA) are as follows.

$$ROE = \alpha_o + \alpha_{1DIP} + \alpha_{2\,EPS} + \epsilon$$

$$ROA = \alpha_o + \alpha_{1\,DIP} + \alpha_{2\,EPS} + \epsilon$$

VIII. Conceptual Frame Work

The following conceptual model was formulated through the extensive literature.

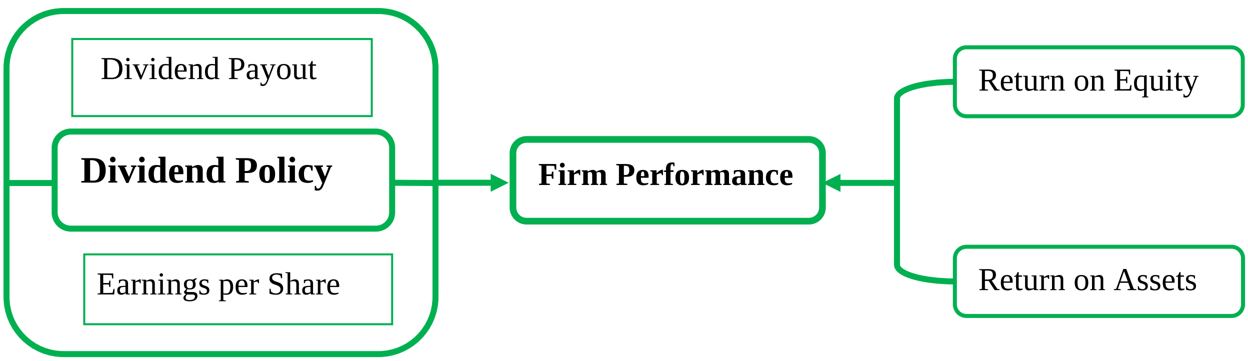

Figure 1 : Conceptualization Model

The above model shows the relationship between the determinants of the dividend policy and firm performance.

IX. Hypotheses

The following are the hypotheses formulated;

H_1: There is a significant relationship between firm performance and dividend policy.

H_2: There is a significant impact of dividend policy on firm's performance.

X. Analysis and Interpretation

Descriptive statistics were carried out to obtain sample characteristics. Output of the descriptive statistics is presented in table 02.

Table 2 : Descriptive Analysis

	N	Range	Minimum	Maximum	Mean	Std. Deviation
Return on Equity	25	106.65	-47.25	59.40	8.9894	18.55674
Return on Assets	25	97.01	-8.25	88.76	14.3020	18.58527
Dividend Payout	25	663.29	-144.47	518.82	38.1600	108.26356
Earnings per Share	25	81.91	-3.71	78.20	7.7017	15.53814

According to the descriptive statistics in table 02 for the independent variables indicate that average debt equity ratio and debt assets ratio. The descriptive statistics, data are well set, further return on equity, return on assets, dividend payout and earnings per shareare in the same level approximately among all the listed manufacturing companies in Sri Lanka.

Correlation analysis was carried out to find out the relationship between determinants of dividend policy and the measures of firm performance.

Table 3 : Correlation Matrix for manufacturing companies

	Return on Equity	Return on Assets	Dividend Payout	Earnings per Share
Return on Equity	1	.480*	-.069	.235
		(.015)	(.744)	(.259)
Return on Assets		1	-.200	.220
			(.337)	(.291)

Dividend Payout			1	-.115 (.584)
Earnings per Share				1

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

According to the correlation in table 03 shows that the determinants of firm performance such as return on equity, return on assets, are not significantly correlated with dividend payout and earnings per share as the measures of capital structure it means companies are still not properly practiced dividend policy guidelines.

The regression analysis was performed to recognize the impact of firm performanceon dividend policy. The results of the analysis are given in Table 04 & 05.

XI. Regression Analysis

a) Impact of dividend policyon firm performance

Table 4 : Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.238[a]	.057	-.029	18.82370
2	.282[b]	.079	-.004	18.62582

a. Predictors: (Constant), Earnings per Share, Dividend Payout

a. *Dependent Variable: Return on Equity*

b. *Dependent Variable: Return on Assets*

The specification of the two variables is earnings per share and dividend payout in the model revealed the ability to predict firm performance and dividend policy. R2 Value of 0.057, and 0.079 which are in the models denote that 5.7%and7.9% of the observed variability in firm performance and dividend policy can be explained by the differences in both the independent variables namely earnings per share and dividend payout.

Remaining 94.3% and 92.1% of the variance in firm performance and dividend policy is related to other variable which is not explained, because they are not depicted in the model. R2 values of 5.7% and 7.9% indicate that there may be number of variables which can have an impact on firm performance and dividend policy that need to be studied. Hence this area is indicated as a scope for future research.

Table 5 : Coefficients for predictors of dividend policy

Model	Unstandardized Coefficients				Standardized Coefficients					
	B		Std. Error		Beta		t		Sig.	
DV	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE	ROA
(Constant)	7.154	13.628	4.506	4.459			1.588	3.056	.127	.006
Dividend Payout	-.007	-.030	.036	.035	-.042	-.177	-.203	-.861	.841	.398
Earnings per Share	.274	.238	.249	.246	.230	.199	1.102	.968	.282	.344

a. Dependent Variable: ROE, ROA

The results of the regression analysis in table 05 show that the coefficient for all two variables such as earnings per share and dividend payout is not significant. Further t values for all two variables of dividend policy are insignificant event at 5% level. It means that these variables are not contributing to the firm performanceof return on equity and return on assets.

XII. Conclusion and Recommendation

The research aims to explore the relationship between dividend policy and firm performance of manufacturing companies listed on Colombo Stock Exchange. Out of 37 Manufacturing companies 25 companies were used for the period 2008-2012. The statistical tests were used includes: descriptive statistics, correlation and regression analyses.

To conclude, listed companies under the Colombo stock exchange (CSE) are practicing dividend policy system. The results of the study provide evidence that the dividend policy measures are not significantly correlated with earnings per share and dividend payout as dividend policy, return on equity and return on assets as firm performancemeasures. So that hypotheses are rejected. R2 Value of liquidity and corporate governance 0.057, and 0.079 which are in the models denote that

5.7% and 7.9% of the observed variability in liquidity can be explained by the differences in both the independent variables namely earnings per share and dividend payout. Further dividend policy did not contribute tofirm performanceof earnings per share and dividend payout.

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