Macrothink Institute™

Research in Business and Management
ISSN 2330-8362
2017, Vol. 4, No. 1

The Relationship between Dividend Payout and Firm Financial Performance

Munaza Kanwal (Corresponding author)
Department of management sciences Islamia university, Bahawalpur
E-mail: Munaza9225@yhaoo.com

Shahid Hameed
Department of management sciences Islamia university, Bahawalpur
E-mail: Shahid_pk88@yahoo.com

Received: January 22, 2017 Accepted: February 8, 2017 Published: February 20, 2017

doi:10.5296/rbm.v4i1.10784 URL: http://dx.doi.org/10.5296/rbm.v4i1.10784

Abstract

This article examines the association between the dividend payout ratio and financial performance of the firm. Basically the dividend payout is the ratio of dividend payment to shareholder by the organization from its net earning while the financial performance include the net profit after tax, return on equity, return on asset etc. To locate the association between dividend payout and FP, the five year data (2008 to 2012) of 20 Pakistani companies listed in Karachi stock exchange has been collected. The correlation analysis and liner regression analysis method is use to find out the relationship between them. The result of this study shows that there dividend payout positively influenced on financial performance of firm.

Keyword: Dividend payout ratio, financial performance, Pakistan, ROA, ROE, Total net profit

1. Introduction

In corporate finance the dividend policy remains a controversial problem. In today environment the dividend policy remains a very important issue. The dividend policy remains like a financial policy not only from the company point of view but also from that the shareholder, government, employees, consumer and other dictatorial bodies. The corporate dividend policy is evaluates or modeling by the financial economist for more than half century. This issue has not been resolve even by the forty year research. The pattern of corporate dividend policy is different from country to country in developing, developed and rising capital market.

The dividend policy is more important for the companies because it decide that how much funds retained by the firm for investment and how much fund give to the shareholder as a dividend (Ross, Westerfield, & Jaffe, 2002). More over the dividend policy tells about the firm performance to the shareholder. The cost of capital is influenced by the future cash flows and future potential dividends determined by the firm investment (Foong, Zakaria, & Tan, 2007).

The dividend policy of developed market is different from the dividend policy of emerging market. In developing countries the dividend payouts ratio were only two third of that developed countries (Glen, Karmokolias, Miller, & Shah, 1995). The share holder wealth and firm value can be influenced by the dividend policy (Baker, Veit, & Powell, 2001).

The agency cost theory determines the dividend policy arising from the control and deviation of possession. The manager of the firm can choose dividend policies that enhance their own private benefit rather than to choose a dividend policy which enhance the value of shareholder (DeAngelo & DeAngelo, 2006).

Signaling theory explains that the dividend policy work as a source of communication that provide the information to the investor about the firm performance. It also provides valuable information to the shareholder about the management assessment for the firm future performance or profitability. The firm share price can be assessed by the investor by using this information. So according to this theory the dividend policy is relevant (Al-Kuwari, 2009).

Problem statement:

In spite of many studies the dividend policy remain an uncertain issue in cooperate finance. Many studies try to explain the association of dividend payout ratio with financial performance of firm, but there is no universal agreement. Many researchers found that the firm financial performance is highly influenced by dividend payout ratio. While other found that there is no significant relationship present between them. Few empirical studies have been done to uncover the affiliation between the financial performance and dividend payout ratio of the firm in Pakistan. So to fill the negated by establishing weather there is an association between the firm financial performance and dividend payout in Pakistani Karachi stock listed companies.

1.1 Variables

Dependant variable:

1). Financial performance of the firm,

2). Return on asset.

3).Return on equity

4). Net profit.

1.2 Independent variable:

1). Dividend payout ratio

2. Literature Review

The dividend policy pays a vital role in today business. Basically the dividend policy is one of the important financial policies not accordingly of the shareholder, employees, consumer and government but also firm point of view (Alii, Khan, & Ramirez, 1993).

Basically the Financial performance is measuring the domino effect of a firm's policies and operations in financial expressions. These outcomes are reflected in the firm's value added, return on investment, and return on assets (Farlex Inc., 2012).

To find out the firm market value by the coprate dividend policy is a very important topic to attract the interest of many researchers. The researchers explain that dividend policy influence the stock price of the company and enhance the shareholder wealth and firm value as well (Salih, 2010). Dividend decision are important because it explain that how much fund retained by the company for the investment purpose and how much flows towards investor

(Ross, Westerfield, & Jaffe, 2002).The investment of firm explains about the influence of cost of capital, future earning and potential dividend (Foong, Zakaria, & Tan, 2007). In cop rate finance the behavior of dividend policy remain the debatable issue and also still have a outstanding place both in emerging and developed markets (Hafeez & Attiya, 2009).

Under the certain simplifying assumptions the dividend decisions are not important and also have no affect on firm value, but in traditional way it advocates that the dividend policy have vital affect on the share price and shareholder wealth when it is properly managed by the firm. So this argument based upon two assumption in which first explain that those investor who receive dividend have no tax disadvantage and the second explain that for investment purpose, without bearing significant issuance costs the firm can raise funds in capital markets (Miller & Modigliani, 1966).

The primary factor of the cooperate policy is the dividend policy decision of the firm. Basically the dividend is the return against the risky investment of the investor and determined by the different factors in the company, financing limitation, investment chance, firm size and investment choices are included in these factor (Lintner, 1956).

The dividend payout explain or provide information about the firm correct and future performance of the firm but also act as a source of cash flow to shareholder. The design of dividend policy explains about the earning prospects of investor (Lintner, 1956).

The firm dividend policy explains about the stability of future cash flows of the firm. Prior studies shows that the cash flow consideration, investment return, after tax earning, liquidity, future earning, inflation , interest, legal requirements are the main factor that influence the dividend decision making of the firm (Uwuigbe, Jafaru, & Ajayi, 2012).

The profits or earning which is generated by the company tells about the financial performance of the firm. The dividend pay a vital role to show the earning which is generated by the company to the shareholder and potential investor. Healthy dividend payout to the investor or shareholder shows the company actual earning rather than cooking books (Murekefu & Ouma, 2012).

One study find out that high dividend become the base of the high future earnings rather than low dividend payout. The expected future cash flows are high if dividend payout ratio high while the growth of future earning is low when dividend payout ratio is low is suggested by the historical evidence. The free cash flow theory explains that the association between the future earnings growth and dividend payout ratio is positive (Arnott & Asness, 2003).

Other study explain that in long run there is inconsequential impact of dividend on future earnings, while those studies which explain the relationship between them are based on short term period and misleading to investor. There are three scenarios which explain that there is no considerable relationship between dividend and future earnings. The first one tells about that high dividend payout lead to decrease in reinvested funds .Secondly the high dividend may prevent investor from sealing the stock when losses occur continually and future earnings are expected to decline. Finally the increase in dividend leads to high performance of the firm in past year and may continue in future. This show that the dividend highly influenced the future earning, the argue is that the positive relationship in one period but negative relationship in other period (Farsio, Geary, & Moser, 2004).

The dividend policy have impact on firm performance and the profitability of the firm can be measured by the return on asset, return on equity, and growth in sales. So the result shows that the firm financial performance is highly influenced by dividend payout ratio (Amidu, 2007).

Those firm which increase dividend payout have flexible return and future earning while decrease in income volatility than other firm which have low dividend payout ratio. The manager of the firm may increase the payout ratio when they want to keep high level of current income (Lie, 2005).

One study shows that the shareholder wealth can be enhance by the effective dividend policy. The taxes and transaction cost, the agency problem between the manger and shareholder and information asymmetry between the manager and shareholder are those imperfections which are influenced by the dividend policy of the firm (Dhanani, 2005). A dividend policy have influence the financial performance of firm, capital structure, investor decision making and also boost the firm value for shareholder (Baker, Veit, & Powell, 2001).

The bird in hand theory explains about the association between the firm value and dividend payout. It describe that the dividend are less risky than capital gain because the capital gain are more risky. So the investor prefers more to dividend due to its less riskiness rather than capital gain. To maximize the stock price, companies should set more dividend payout and offer a high dividend yield (Amidu, 2007).

The primary objective of the company management is to enhance the shareholder wealth which means to increase the company value as evaluate by the price of the firm common stock. So to achieve this objective the firm gives the fair payment to shareholder on their investment (Frankfurter, Wood, & Wansley, 2003).

Basically there are two types of dividend policy, managed dividend policy and residual dividend policy. After the firm makes investment on the base of NPV rule which amount of dividend remaining in the form of cash include in residual dividend policy. In residual dividend policy the amount of dividend is approximately equal to zero or highly variable. The manager of the firm uses the managed dividend policy when they believe that it is necessary for the investor and also positively influence on the share price valuation (Kapoor, 2009).

The relationship between the dividend and earning has an unresolved issue to the investor and analyst. Some studies show considerable affiliation between the dividend and future earnings while other studies show no significant relationship between them. So the studies shows that the dividend have a positively impact on future earning for a short time period. But in the long run there is no considerable affiliation between the dividend and future earning (Farsio, Geary, & Moser, 2004).

There are three factors that affect the dividend policy decision making: firm size, investment opportunity and yield. The large firm has the better opportunity to increase their funds at the low cost because these firms are more diversified and bear low risk. So mostly the large companies not totally depending on internal funding and that's why they pay high dividend to their shareholder (Fama & French, 2001).

In other study shows that the Canadian large firm have high dividend payout ratio with a large profit, positive future cash flow and big opportunities in future (Baker, Veit, & Powell, 2001). One school of thought explains Dividend irrelevance theory, that the dividend has no relation with the value of the firm and the firm valuation. This theory shows that the firm value is not enhancing by the dividend or retained earning but it depend on its earning power (Miller & Modigliani, 1966).

Second school of thought explains Dividend relevance theory, that the association between the firm value and dividend policy is positive. So this theory shows that as evaluate by the market price of share the dividend is relevant to the firm value (Lintner, 1956). The dividend payout ratio has a strong impact on the firm value. The result shows that those firms which pay more dividends get higher value (Kostyuk, 2006).

The cooperate dividend policy has been classified into three main points. 1) Dividend policy enhance the firm value, 2) dividend policy reduce firm value, 3) dividend policy not influenced on the firm value. The first group of researchers explains about the first point that the firms can enhance the shareholder wealth, stock prices by the dividend payment to the shareholder. So by doing this they can increase the value of firm (Manos, 2001).

Second group of researchers explain that the payment of dividend to the shareholder reduce the stock price and also the wealth of shareholder decrease as well. So in this way the value of firm also decrease. The third group of researchers believes on irrelevance dividend policy and explains that the dividend payout ratio has no effect on firm value and stock price (Manos, 2001). The change in cash dividend payout has a positive impact on the stock price of the firm (Huang, Liu, & Chen, 2009).

Those firm which have stable earning they predict the stable future cash flows. So with the stable earning the firm pay more dividends to shareholder rather than that firm has fluctuated earnings. The stable earning is a main factor for the decision making of dividend payment (Brav, Graham, Harvey, & Michaely, 2005). Most of the firm follow the modified residual policy practice, where firm managed there dividend stream and payout ratio I a better way after making the investment decision (Baker, & Smith, 2006).

Towards the growth opportunity the agency cost theory and the residual theory has different explanation, the residual theory explains that the firms pay low dividend with a high growth opportunity because they invest the available funds with a positive NPV. This implies that the firm pay high dividend and have higher cash flow with a given investment opportunities (Deshmukh, 2005).

3. Study Objective

The main idea of this study is to find the relationship between the dividend payout ratio and financial performance of the firm.

To find the relationship between return on equity and payout ratio.

To find the relationship between return on asset and payout ratio.

To find the relationship between net profit and payout ratio.

4. Hypotheses

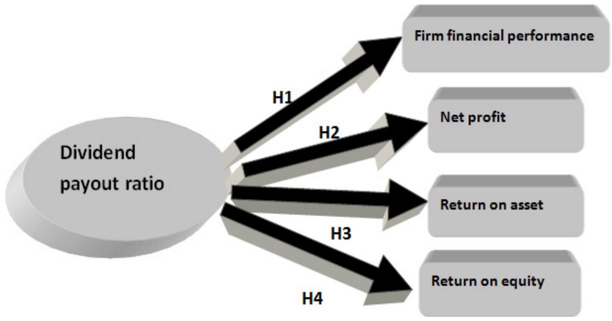
H1: There is a significant relationship between the dividend payout ratio and firm's financial performance.

H2: There is a significant relationship between the dividend payout ratio and net profits.

H3: There is a significant relationship between the dividend payout ratio and ROA.

H4: There is a significant relationship between the dividend payout ratio and ROE.

Research model



5. Research Methodology

5.1 Sample

In this research, the sample consist five year data (2008 to 2012) of 20 Pakistani companies listed in KSE. Data is collected from the annual report of the companies listed in KSE. The financial data of annual report include dividend payment, ROE, ROA, net profits, total assets, are used to find out the association between the firm financial performance and dividend payout ratio.

5.2 Research Instrument

The regression and correlation method is used to find out the association between the firm financial performance and dividend payout. Basically the regression analysis tells about the strength and causal effect between the dependent and independent variable. While the correlation analysis is used measure the strength and direction of the variables ranges from +1 to -1. The regression and correlation analysis is very simple statistical technique to find the association between firm financial performance dividend payout. Many researchers are used this method in different articles as shown in citation analysis (Table 1).

5.3 Citation Analysis

The citation analysis shows that how much papers used which methodology to find out the impact of dividend on firm financial performance. Here the table shows that there are 13 papers used regression analysis while 8 papers used correlation & regression analysis to find out the association between them.

Table 1. Citation Analysis

Methods	No	
Correlation and regression models	A	8
Regression and analysis	B	13
Correlation analysis	C	1
Panel data approach	D	1
Survey	E	1
Tobit models	F	1
Stata analysis	G	1

6. Results & Discussion

Table 2 Correlation & Regression Analysis:

Correlation Analysis			
	Dividend payout & NPAT	Dividend payout & ROE	Dividend payout & ROA
correlation	0.701	0.709	0.285
Regression analysis			
F value	2.912	3.049	0.266
Dividend p value	0.186	0.179	0.641
R square	0.492	0.503	0.081
coefficient	909.66	0.308	0.011

The result shows that there is a strong positive association between the payout ratio and net profit after tax and also strong correlation between the dividend payout and ROE. While the association between the payout and ROA is positive but weak association as (shown in 1.3).The result of the regression analysis shows that R square value is approximately up to 50% of NPAT and ROE while 8% of return on asset which is very low. The intercept p value of NPAT, ROE and ROA is 0.8, 0.2, and 0.12 respectively which shows that there is a high impact of dividend payout on firm financial performance. The value of coefficient shows that dividend paid increase by 1 unit, enhance the ROA by 0.011 units and by increasing 1 unit of dividend paid, increase the ROE by 0.308 units. There is a strong positive association between the payouts and firm financial performance. The fewer amounts of p value and positive coefficient show that the dividend payout ratio highly influenced on firm financial performance.

7. Conclusion

The main object of this study was to find out the association between the payout ratio of dividend and firm financial performance of the companies listed in Karachi stock exchange. To find the association between payout ratio and firm financial performance the correlation and regression analysis was used. Based on the above result and discussion the following conclusion can be drawn that there dividend payout have a positive impact on firm financial performance as shown (table 1.3). It is shows that the firm financial performance is influenced by the dividend policy. Consequently the results suggest that the dividend payout ratio highly influenced the firm financial performance. So by this result, the hypotheses H1, H2, H3 and H4 are accepted which shows that the association between the dividend payout and FP, dividend payout and net profit after tax, dividend payout and ROA, dividend payout and ROE respectively are positive. Overall study shows that the firm financial performance influenced by the dividend payout.

Reference

Alii, K. L., Khan, A. Q., & Ramirez, G. G. (1993). Determinants of corporate dividend policy: A factorial analysis. *Financial Review,* 28, 523-47.

Al-Kuwari, D. (2009). Determinants of the dividend policy in emerging stock exchanges. *Global Economy & Finance Journal, 2*(2), 38-63.

Amidu, M. (2007). How does dividend policy affect performance of the firm on Ghana stock

Exchange. *Investment Management and Financial Innovations, 4*(2), 104-112.

Arnott, D. R., & Asness, S. C. (2003). Surprise higher dividends is higher earnings growth. *Financial Analyst Journal,* 70-87.

Baker, H. K., & Smith, D. M. (2006). In search of a residual dividend policy. *Review of Financial Economics, 15*(1), 1-18.

Baker, H. K., Veit, E. T., & Powell, G. E. (2001). Factors influencing dividend policy decisions of Nasdaq firms *The Financial Review, 36*(3), 19-37.

Baker, H. K., Veit, E. T., & Powell, G. E. (2001). Factors influencing dividend policy decisions of Nasdaq firms. *Financial Review, 36*(3), 19-38.

Brav, A., Graham, J. R., Harvey, C. R., & Michaely, R. (2005). Payout policy in the 21st century. *Journal of Financial Economics, 77*, 483-527.

DeAngelo, H., & DeAngelo, L. (2006). Payout policy pedagogy: What matters and why. Working paper. University of Southern California.

Deshmukh, S. (2005). The effect of Asymmetric Information on dividend policy. *Quarterly Journal of Business and Economics, 44*(1/2), 107-127.

Dhanani, A. (2005). Corporate dividend policy: The views of British financial managers. *Journal of Business Finance & Accounting, 37*(7) & (8), 1625-1672.

Fama, E. F., & French, K. R. (2001). Disappearing dividends: Changing firm characteristics or lower propensity to pay. *Journal of Financial Economics, 60*, 3-43.

Farlex Inc. (2012). *Defination of financial performance.* Retrieved July 24, 2013, from http://financial-dictionary.thefreedictionary.com/Financial+Performance

Farsio, F., Geary, A., & Moser, J. (2004). The relationship between dividends and earnings. *Journal for Economic Educators, 4*(4), 1-5.

Foong, S. S., Zakaria, N. B., & Tan, H. B. (2007). Firm Performance and Dividend-Related Factors: The Case of Malaysia. *Labuan Bulletin of International Business & Finance, 5*, 97-111.

Frankfurter, G., Wood, B. G., & Wansley, J. (2003). *Dividend policy: Theory and practice*. Academic Press.

Glen, J. D., Karmokolias, Y., Miller, R. R., & Shah, S. (1995). Dividend policy and behavior in Emerging markets. International Financial Corporation, Discussion pp No. 26.

Hafeez, A., & Attiya, Y. J. (2009). The Determinants of Dividend Policy in Pakistan',*International Research Journal of Finance Economics, 25*, 148-171.

Huang, C., Liu, H., & Chen, D. (2009). The announcement effect of cash dividend changes on share prices: An empirical analysis of China. *Chinese Economy, 42*(1), 62-85.

Kapoor, S. (2009). *Impact of Dividend Policy on Shareholders' Value: A Study of Indian Firms* (Doctoral dissertation, Jaypee Institute of Information Technology, Noida).

Kostyuk, D. (2006). D*ividend Payout its Impact on Firm Value.*

Lie, E. (2005). Financial flexibility, performance, and the corporate payout choice. *The Journal of Business, 78*(6), 2179-2202.

Lintner, J. (1956). Distribution of income of corporations among dividends, retained earnings and taxes', *American Economic Review, 60*, 1-40.

Manos, R. (2001). Capital structure and dividend policy: Evidence from emerging markets. PhD thesis', The University of Birmingham, Birmingham, UK.

Miller & Modigliani. (1966). *Dividend Policy and Growth and the Valuation of Share. Journal of Business, 34*, 411-433.

Murekefu, T. M., & Ouma, O. P (2012). The Relationship Between Dividend Payout and Firm Performance. *European Scientific Journal, 8*(9), 199-215.

Ross, S. A., Westerfield, R. W., & Jaffe, J. (2002). *Corporate Finance* (6th ed.). McGraw-Hill Companies.

Salih, A. A. (2010). the effect of dividend policy on market value: UK empirical study. Doctoral thesis Durham University. Retrieved from http:// etheses.dur.ac.uk/556/

Uwuigbe, U., Jafaru, J., & Ajayi, A. (2012). Dividend Policy and Firm Performance. *Accounting and Management Information Systems, 11*(3), 442-454.