



Dividend Policy Ratios and Firm Performance: a case study of Selected Hotels & Restaurants in Sri Lanka

Priya, K^a & Nimalathasan, B^b

^aDemonstrator, Department of Commerce, University of Jaffna.

^bSenior Lecturer, Dept of Accounting, University of Jaffna, Sri Lanka.

Abstract

Dividend policy is one of the most complex aspects in finance. The reality is that dividend policy is more commonly an instrument of wealth distribution than it is an instrument of wealth creation. The study of firm performance determinants is a central question for strategic management. In this study, an attempt has been made to analyze the Dividend policy Ratios and Firm Performance during 2008 to 2012 (05 years) financial year of Selected Hotels & Restaurants in Sri Lanka. For the purpose of this study, the data was extracted from the annual reports of sample companies. Correlation and multiple regression analysis are used for analysis. The results revealed that dividend policy ratios has a great impact on all firm performance ratios except return on investment (ROI) and return on equity (ROE). Further EPS, P/E and PB are significantly correlated with ROA 5 percent level of significance. At the same time P/E is significantly correlated with ROE at 5 percent level of significance. Finally EPS and PB are significantly correlated with ROE at 1 percent level of significance.

Key Words: Dividend Policy; Firm Performance; and Dividend Policy Ratios

Introduction

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.

The issue of dividend policy is a very important one in the current business environment. Dividend policy remains one of the most important financial policies not only from the viewpoint of the company, but also from that of the shareholders, the consumers, employees, regulatory bodies and the Government. For a company, it is a pivotal policy around which other financial policies rotate (Alii et al., 1993).

Dividend policy define, it's the decision to pay out earnings versus retaining and reinvesting them. Dividend changes may be important signals if the market anticipates that the change will be maintained through time. If the market believes that the change is just a rearrangement of dividends through time, then the impact will be small. The reaction to the information contained in dividend changes is called the information content effect.

This is particularly critical in the case of firm performance, one of the most relevant constructs in the field. Firm performance is a relevant construct in strategic management research and frequently used as a dependent variable. The concept of firm performance needs to be distinguished from the broader construct of organizational effectiveness. Venkatraman and Ramanujan (1986) offered an enlightening figure of three overlapping concentric circles with the largest representing organizational effectiveness. This broadest domain of organizational effectiveness includes the medium circle representing business performance, which includes the inner circle representing financial performance.

Significance of the Study

Dividend policy is one of the significant components of firm policies and has been viewed as an interesting issue present. Dividend payout decisions effect on the firms' valuation. Moreover, cash dividend has a special position among the shareholders. However, the main problem is the reasons for adopting a policy of divided payout. Dividend policies depend on several factors. One of these factors is corporate governance (Mehrani Sasan, Moradi Mohamad & Eskandar Hoda, 2010).

Dividend policy is the regulations and guidelines that a company uses to decide to make dividend payments to shareholders (Nissim & Ziv, 2001). The dividend policy decisions of firms are the primary element of corporate policy. Dividend, which is basically the benefit of shareholders in return for their risk and investment, is determined by different factors in an organization. Basically, these factors include financing limitations, investment chances and choices, firm size, pressure from shareholders and regulatory regimes. However, the dividend payout of firm's is not only the source of cash flow to the shareholders but it also offers information relating to firm's current and future performance. (Lintner, J.1956).

Dividend Policy in Practice will be residual dividend policy. Constant growth dividend policy refers dividends increased at a constant rate each year. Constant payout ratio, pay a constant percent of earnings each year. Dividends matter the value of the stock is based on the present value of expected future dividends. Dividend policy is the decision to

pay dividends versus retaining funds to reinvest in the firm. In theory, if the firm reinvests capital now, it will grow and can pay higher dividends in the future.

Objectives

The main objective of the study is to find out the impact of Dividend Policy Ratios and Firm Performance of Selected Hotels & Restaurants in Sri Lanka.

Sub objectives are as follows:

- To identify the factors which are significantly contribute to the Dividend Policy Ratios and Firm Performance
- To find out the relationship between Dividend Policy Ratios and Firm Performance.
- To suggest appropriate measures to improve the firm performance of Selected Hotels & Restaurants in Sri Lanka.

Literature review and Hypothesis Development

Theoretical Framework

Agency theory

The agency cost theory suggests that, dividend policy is determined by agency costs arising from the divergence of ownership and control. Managers may not always adopt a dividend policy that is value-maximizing for shareholders but would choose a dividend policy that maximizes their own private benefits. Making dividend payouts which reduces the free cash flows available to the managers would thus ensure that managers maximize shareholders' wealth rather than using the funds for their private benefits (DeAngelo, H., & DeAngelo, L., 2006). In the process of attracting new equity, firms subject to the monitoring and disciplining of these markets.

Signaling Theory

The signaling theory proposes that dividend policy can be used as a device to communicate information about a firm's future prospects to investors. Cash dividend announcements convey valuable information, which shareholders do not have, about management's assessment of a firm's future profitability thus reducing information irregularity. Investors may therefore use this information in assessing a firm's share price. The intuition underlying this argument is based on the information irregularity between managers and outside investors, where managers have private information about the current and future fortunes of the firm that is not available to outsiders. Dividend policy under this model is therefore relevant (Al-Kuwari, 2009).

Bird in hand theory

Bird in hand theory proposes that a relationship exists between firm value and dividend payout. It states that dividends are less risky than capital gains since they are more certain. Investors would therefore prefer dividends to capital gains (Amidu, 2007). Because dividends are supposedly less risky than capital gains, firms should set a high dividend payout ratio and offer a high dividend yield to maximize stock price. The essence of the bird-in-the-hand theory of dividend policy (John Litner in 1962 and Myron Gordon in 1963) argues that outside shareholders prefer a higher dividend policy. Investors think dividends are less risky than potential future capital gains, hence they like dividends. If so, investors would value high payout firms more highly.

Dividend Irrelevance Theory

Investors are indifferent between dividends and retention-generated capital gains. If they want cash, they can sell stock. If they don't want cash, they can use dividends to buy stock. Modigliani-Miller support irrelevance. Theory is based on unrealistic assumptions (no taxes or brokerage costs), hence may not be true.

Empirical Review

Recent literature has shown that the patterns of corporate dividend payout policies vary tremendously between developed and transition equity markets. Glen Karmokolias, Miller, Shah, (1995) find that payout ratios in developing countries are only about two thirds that of developed countries.

Alii, Khan, and Ramirez, (1993) Examined that the relationship between expected price-to-book ratio, dividend per share, dividend payout ratio, systematic and unsystematic risks. The sample includes the non-financial firms in the DJIA, the period 1997-2006. The result show, the variations in price-to-book ratios, systematic and unsystematic risks are not due to dividends per share. Then, the relationships between expected price-to-book ratio and dividend payout ratios are intrinsically nonlinear. Finally, the expected dividend payout ratios can be used efficiently for signaling purposes as well as a proxy for measuring the agency problem.

Uwalomwa, Jimoh and Anijesushola (2012) investigated the relationship between the financial performance and dividend payout among listed firms' in Nigeria. Variables are ownership structure, size of firms and the dividend payouts. The period 2006-2010 was utilized as the main source of data collection for the 50 sampled firms. Find out that there is a significant positive association between the performances of firms and the dividend payout of the sampled firms in Nigeria. Additionally revealed that ownership structure and firm's size has a significant impact of the dividend payout of firms too.

Kale and Noe (1990) 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.

Zeckhauser & Pound (1990) revealed that found out that there is no significant difference among dividend payouts with or without large block shareholders. In addition, Kouki and Guizani (2009), and Kumar (2006) also observed in their study that managerial ownership appears to have a visible and significant effect on dividend payout.

Mehdi, Hassan and Abouzar () pointed the impact of corporate governance on dividend policy within the context of Iran. A sample of 85 firms has been selected from all Iranian firms listed on the Tehran Stock Exchange during is significant and positive but the relationship between ownership concentration and dividend payout did not find.

Oskar, Ivan, Oleksandr, Diw (2007) Investigated 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.

Luis Correia da Silva, Marc Goergen, and Luc Renneboog (2004) pointed that Dividend policy and other corporate governance mechanisms are interacted. First, the conventional wisdom, which states that German dividends are lower than UK or US dividends, is not necessarily upheld as on a published profits basis; the exact converse is true. Second, dividends in the UK and US are relatively smooth as they are characterized by frequent, but small changes, whereas dividends in Germany show less frequent, but larger changes. Third, link between corporate control and dividend payouts. Fourth, evidence existence of a loss is an additional determinant of dividend changes. Finally, results have important implications for the current debate on the best corporate governance system.

Samuel Kwaku Agyei, Edward Marfo-Yiadom (2011) examined the relationship between dividend policy and performance of banks in Ghana. The study used panel data constructed from the financial statements of 16 commercial banks in Ghana for a period of 5 years, from 1999-2003. These financial statements were obtained from the Banking Supervision department of Bank of Ghana. STATA was used for the data analysis. Indicate that banks pay dividend increase their performance. Generally, the result is shown that dividend policy has an effect on firm value.

Timothy Mahalang'ang'a Murekefu Ochuodho Peter Ouma () revealed that establish the relationship between dividend payout and firm performance among listed firms in the Nairobi Securities Exchange. Regression analysis was carried out to establish the relationship there. This study made use of both primary and secondary data. Secondary data was obtained from the firm's annual reports, from the year 2002 to 2010. The population for this study consisted of the firms listed on the Nairobi Securities Exchange. The NSE classified these companies into ten sectors. The findings indicated that dividend payout was a major factor affecting firm performance. Their relationship was also strong and positive. Based on the findings of this research that dividend policy is relevant and that managers should devote adequate time in designing a dividend policy that will enhance firm performance and therefore shareholder value.

A study by Amidu (2007) revealed 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.

Arnott & Asness (2003) pointed the positive relationship between dividend payout and growth in future earnings is that managers are reluctant to cut dividends. A high payout ratio indicates management's confidence in the stability and growth of future earnings and a low payout ratio suggests that management is not confident of the stability of earnings or sustainability of earnings growth (Arnott & Asness, 2003). Managers therefore pay low dividends to avoid dividend cuts when earnings drop.

In a study that examines whether dividend policy influences firm performance in the Ghana Stock Exchange, Amidu (2007) found that dividend policy affects firm performance especially the profitability measured by the return on assets. The results showed a positive and significant relationship between return on assets, return on equity, growth in sales and dividend policy. This showed that when a firm has a policy to pay dividends, its profitability is influenced. The results also showed a statistically significant relationship between profitability and dividend payout ratio.

From the literature review the following hypotheses are developed for the study purpose.

H₁: Dividend Policy Ratios has an impact on Financial Performance.

H₂: Dividend Policy Ratios and Financial Performance are significantly correlated.

H₃: All factors determine the Dividend Policy Ratios is significant.

Conceptual frame work

Based on the literatures, the following conceptual frame work is formulated.

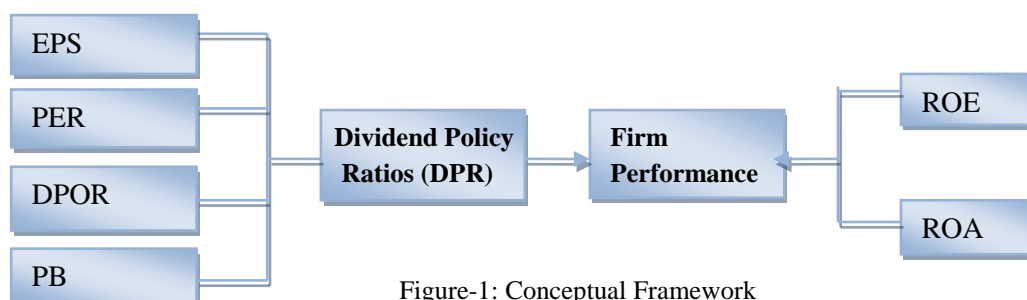


Figure-1: Conceptual Framework

EPS	: Earning Per Share	DPOR	: Dividend payout Ratio
P/E	: Price Earnings Ratio	PB	: Price to Book Value
		ROA	: Return on Asset
		ROE	: Return on Equity

Methodology

A discussed by mouton (2001) research methodology focuses on the research process a kind of tools and procedures to be used. It describes research design, research approach, sampling procedure, data sources, instrumentation, reliability, validity and mode of analysis.

Research Design

This research will be an explanatory studies. The emphasis here is on studying a situation or a problem in order to explain the relationship between variables (i.e., Dividend Payout Ratios and Firm Performance).

Sampling design

The sample of this study composed of listed Hotels and Restaurants in Sri Lanka for the period of 2008-2012. To evaluate this topic, researchers have used different methods of Statically Package for Social Science (SPSS) for analyzing the data. Here Correlation and Multiple Regression are used to analysis the data.

Reliability and Validity of the Data

Reliability will be established with an overall Cronbach’s alpha and other techniques. It will be compared our reliability value with the standard value alpha of 0.7 advocated by Cronbach (1951), a more accurate recommendation (Nunnally & Bernstein’s, 1994) or with the standard value of 0.6 as recommended by Bagozzi & Yi’s (1988). Secondary data for the study were drawn from audit accounts (i.e., income statement and balance sheet) of the concerned companies; therefore, these data may be considered reliable for the purpose of the study. Necessary checking and cross checking were done while scanning information and data from the secondary sources. All these efforts were made in order to generate validity data for the present study. Hence researcher satisfied content validity.

Mode of Analysis

The following Dividend Payout Ratios and firm performance ratios are taken into accounts which are given below.

Dividend Policy Ratios	
Earnings Per Share	Net Income / Total Number of Capital
Price to Earnings Ratio	Market Price per Share / Earnings per Share
Dividend Payout Ratio	Total Dividends / Total Net Earnings x 100%
Price / Book Value Ratio	Stock Price Per Share / Shareholders’ Equity Per Share
Firm Performance Ratios	
Return on Asset	Return / Total Asset X 100
Return on Equity	Profit after interest & tax / Equity capital X 100

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

Multiple regression analysis was performed to investigate the impact of Dividend Policy Ratios on Firm Performance which the model used for the study is given below. Firm Performance = f (ROA; and ROE) It is important to note that the firm performance depend upon Earnings Per Share (EPS), Price to Earnings Ratio(P/E), Dividend Payout Ratio (DPOR), Price / Book Value Ratio (PB). Since two Firm Performance Ratios Return on Asset (ROA) and Return on Equity (ROE). The following two models are formulated to measure the impact of Dividend Policy Ratios on firm performance is as follows.

$$ROA= \alpha + \beta_1 EPS+ \beta_2 P/E + \beta_3 DPOR + \beta_4 PB + \varepsilon \dots\dots\dots (1)$$

$$ROE = \alpha + \beta_1 EPS+ \beta_2 P/E + \beta_3 DPOR + \beta_4 PB+ \varepsilon \dots\dots\dots (2)$$

Where, α , is constant, $\beta_1, \beta_2, \beta_3$ & β_4 are coefficients of variables, ε , is error term.

Data Analysis and Discussion

Multi-Co linearity

Two major methods were used in order to determine the presence of multi-co linearity among independent variables in this study. These methodologies involved calculation of a Tolerance test and variance inflation factor (VIF) (Ahsan, Abdullah, Gunfie, & Alam, 2009). The results of theses analysis are presented in table 2. Test of Co linearity.

Table-2: Test of Co linearity

Variables	Tolerance	VIF
EPS	.091	8.982
P/E	.193	5.177
DPOR	.694	1.442
PB	.094	9.682

According to the table-2, Test of Co linearity, none of the tolerance level is < or equal to 1; and also VIF values are perfectly below 10. Thus the measures selected for assessing independent variable in this study do not reach levels indicate of multi-co linearity.

Correlation

Table -3: Correlation Matrix

Variables	ROA	ROE	EPS	P/E	DPOR	PB
EPS	.525* (.045)	.677** (.006)	1			
P/E	.616* (.014)	.578* (.024)	.841** (.000)	1		
DPOR	-.035 (.902)	-.241 (.388)	-.103 (.715)	.199 (.477)	1	
PB	.551* (.033)	.713** (.003)	.948** (.000)	.839** (.000)	-.097 (.731)	1

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

** Correlation is significant at the 0.01 level (2-tailed)

It is found that from table-3; describes the correlation between dividend policy ratios and firm performance. That indicates that EPS, P/E and PB are significantly correlated with ROA 5 percent level of significance.

EPS and PB are significantly correlated with ROE at 1 percent level of significance. At the same time P/E is significantly correlated with ROE at 5 percent level of significance. Finally the rest of other variables are not correlated. Then a multiple regression analysis was performed to identify the predictors of firm performance variables as conceptualized in the models. A step wise variable selection was used in the regression analysis and Table-4 provides the summary measure of the models.

Table-4: Predictor of Firm Performance – Model summary

Details	ROA	ROE
EPS	-.424 (.680)	-.108 (.916)
P/E	1.386 (.196)	.302 (.769)
DPOR	-.692 (.505)	-.838 (.422)
PB	.272 (.791)	.917 (.381)
Constant	6.546 t=-.655; p=.656	.506 t=.961 p=.359
R	0.645	.736
R ²	0.416	.542
Adjusted R ²	0.183	.359
Standard Error	3.70548	.19554
F Value	1.784 (.209)	2.958 (.055)

From the table-4; it is seen that the specification of the four predictor variables (EPS, P/E, DPOR, PB) in the above model reveals that the ability to predict the firm performance. (R² =0.416 and .542 respectively).

In R^2 value of 0.416 which is in the model 1 denotes that 41.6 % of observed variability in ROA can be explained by the differences in the independent variables. Remaining 58.4 % variance in the return on asset is attributed to other variables.

In this model 2, R^2 value of 0.542 which denotes 54.2 % of observed variability in ROE can be explained by the differences in the independent variables. Remaining 45.8 % variance in the return on equity is attributed to other variables.

In this models summary, that the value of an adjusted R^2 0.183 and 0.359, slightly less than the value of adjusted R^2 . An examination of the model summary in conjunction with ANOVA (F-value) indicates that the model explains the most possible combination of predictor variables that could contribute to the relationship with the dependent variables.

Hypothesis Testing

Serial No	Hypothesis	Tools	Accepted/Rejected
H ₁	Dividend Policy Ratios has an impact on Financial Performance.	Regression	Partially Accepted
H ₂	Dividend Policy Ratios and Financial Performance are significantly correlated.	Correlation	Partially Accepted
H ₃	All factors determine the Dividend Policy Ratios is significant.	Correlation	Partially Accepted

Conclusion

This study basically looked at dividend policy ratios and firm performance in Sri Lanka. The study came up with findings that are of most important investigating dividend issues in the Sri Lankan selected hotels and restaurants. Based on the first hypotheses, the study observed that that firm performance has a significant impact on the dividend policy ratios of selected hotels and restaurants in Sri Lanka. That is, an increase in the financial well being of a firm tends to positively affect the dividend policy of firms. Also, findings from the second hypothesis assert that there is a significant positive relationship between dividend policy ratios and firm performance.

In addition, large firms tends to pay more dividend to reduce agency costs since they tend to face high agency costs as a result of ownership dispersion, increased complexity and the inability of shareholders to monitor firm activity closely. More so, due to the weak control in monitoring management in large firms, a large dividend payout increases the need for external financing, which, in turn, leads to the increased monitoring of large firms by creditors. This may be a quality that is attractive to the shareholders.

Explaining dividend policy has been one of the most difficult challenges facing financial economists. For long time this topic has been studied without being understood completely, there is still the unsolved question which factors influence the dividend policy and how are those factors interacting.

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