IMPACT OF DIVIDEND POLICY ON FIRM PERFORMANCE EVIDENCE FROM SRI LANKAN LISTED COMPANIES

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Abstract

One of the most controversial issues in the field of finance is the behavior of the dividend policy, which is still given considerable attention in developing economies. There are limited research studies investigating the associations between dividend policies and financial performance, particularly in developing nations. Thus, the purpose of this paper is to investigate the impact of dividend policy on the firm performance of Sri Lankan publicly listed companies. The population of interest for this study consists of 289 companies registered on the Colombo Stock Exchange, and 100 companies were selected at random. The dependent variable is firm performance, which is measured by return on assets and return on equity, and the independent variable is dividend policy, which is measured by dividend payout ratio and dividend yield. The data are collected from the annual reports of selected companies for the period from 2017 to 2022, which are available on the Colombo Stock Exchange and the company website. The results of Hausman's model specification test concluded that the fixed effects model is most appropriate for testing the formulated hypothesis. The regression outcomes indicate a positive relationship between dividend policy and firm performance, but dividend yield has an insignificant impact on return on assets. The conclusion of the study is that dividend policy explains a significant portion of a company's performance, indicating that dividend policy has a statistically significant effect on a company's performance. The results of this research will assist decision-makers, prospective investors, academics, econometricians, and other interested parties in making decisions regarding the managerial implications of the economy and corporate sector.

Keywords: Dividend policy, firm performance, Hausman's model specification test.

1. Introduction

The dividend is a form of compensation shareholders receive for bearing a certain level of risk (Lipson et al., 1998). Therefore, the dividend decision is the most challenging and critical element of a company's long-term financial strategy over the past few decades to preserve shareholder wealth (Chauhan et al., 2019). In addition, the dividend policy of a company might provide insight into the company's success and growth prospects (Ali, 2022; Shehata, 2022).

There are several theoretical and empirical pillars advancing the link between dividend policy and corporate performance (Chauhan et al., 2019). In the "perfect world" scenario proposed by Miller and Modigliani (1961), dividend policy is assumed to have an indirect effect on a company's value. That research study shows that the value of businesses is affected by growth prospects (future earnings) and investment risk. However, Miller and Modigliani's "perfect world" scenario has been disputed by Black (1976).

Black's claim has been supported by several research studies (Hasan et al., 2023; Hauser & Thornton, 2017; Ofori-Sasu et al., 2017; Tran, 2021) that have relaxed the perfect market assumptions made by Miller and Modigliani. The interactions in the modern world do not represent a perfect system (Hauser & Thornton Jr, 2017). Black argues that dividends are tax disadvantageous compared to stock repurchases and, therefore, should not have a direct impact on firm value. Thus, Black (1976) presents a "puzzle" of dividend policy among companies and argues that the pervasiveness or prevalence of dividend-paying firms embodies the conundrum. The dividend decision remains one of the most pressing unanswered questions in finance even though dividend theories have progressed over several decades.

Sondakh (2019) discovered a negative relationship between dividend policy and firm performance after examining the impact of dividend policy on the value of firms in the financial services industry. However, Hauser and Thornton Jr. (2017) revealed a positive correlation between dividend policy and corporate valuation. On the other hand, using data from the Ghana Stock Exchange, Ofori-Sasu et al. (2017) found an adverse relationship between dividend yield and the wealth of shareholders in Ghana. These findings contradicted the results reported by Oppong Fosu (2015), who analyzed the dividend policy along with the performance of listed Ghanaian banks. Thus, it is important to note that previous studies have consistently produced contradictory outcomes regarding the association between dividend policy and firm performance.

Many research studies (Arnott & Asness, 2003; Farsio et al., 2004; Nissim & Ziv, 2001) have been conducted on dividend policy and firm performance, particularly in wealthy nations. However, these studies' conclusions and findings cannot be matched in developing nations. It is crucial to examine the

dividend policy dilemma in developing nations and to compare them to established markets to see if there are any differences in the dividend policy situation. In addition, there is a dearth of research into the link between dividend policy and company profitability in Sri Lanka (Wijekoon & Senevirathna, 2019). According to the existing literature, empirical research has been carried out in a wide range of nations with varying economic and social settings. Since Sri Lanka's economic, social, and technological factors are unique, it is crucial to conduct research of this nature in Sri Lanka. This research inquires, "What is the impact of dividend policy on the firm performance of listed companies in Sri Lanka?"

2. Literature Review

In the field of corporate finance, dividend payout policy has always been a contentious topic and unsolved conundrum (Baker & Kapoor, 2015; Raza et al., 2018; Wadhwa & Sharma, 2014). Some research on dividend policy has already been undertaken, making it an ongoing subject of debate in the economics and finance communities (Raza et al., 2018). The finance literature contains numerous underlying theories, including the Modigliani-Miller, bird-in-hand theory, and agency theory.

Miller and Modigliani (1961) developed one of the most well-known and influential dividend theories. Despite being presented over 50 years ago, it is still regarded as one of the greatest credible theories. The Modigliani-Miller (1961) theory, commonly known as the irrelevance theory, is a cornerstone of corporate finance that contends that a company's dividend policy has no bearing on its overall value or performance. According to this idea, a company's value is purely based on its cash flows and the risk attached to those cash flows in a perfect capital market with no taxes or transaction expenses. This theory implies that the dividend payout ratio, i.e., the proportion of profits distributed as dividends, should not significantly affect a firm's performance in terms of its overall value or profitability.

Contrary to Modigliani-Miller's irrelevance theory, the "bird-in-hand theory" posits that dividends can influence a company's value. Lintner (1956) first proposed this theory, which has since become a generic term for all studies claiming that dividend payments are positively correlated with a company's value. This theory is based on the proverb, " Better a bird in the hand than two in the bush." This theory posits that investors prefer to have "one bird in hand" in the form of a dividend payment from a stock than "two birds in the bush" in the form of a potential capital gain that is larger and more uncertain. From a financial standpoint, investors tend to be more excited to purchase stocks that pay a current dividend than those that will pay dividends in the future and retain earnings. This notion was supported by Gordon (1962) and Gordon (1959). The bird-in-the-hand theory disputes that investor favor cash dividends over

retained earnings due to the unpredictability of future cash flows. As a result, a higher dividend payout ratio reduces the required rate of return and increases the value of the firm (Lintner, 1956).

In accordance with agency theory, a principal employs an agent to perform services on his behalf (Jensen & Meckling, 2019). Managers have the fiduciary duty to maximize shareholder value on behalf of the shareholders (Windsor & Boatright, 2010). However, the relationship between the principal and the agent is complicated by a number of circumstances. First, there is a conflict of interest between the principals, information asymmetry between the principal and agent, and the proprietor's inability to ensure that the agent acts in accordance with his/her wealth maximization objective. Consequently, agency costs result from the agent's divergent behavior (Jensen & Meckling, 2019). Dividend policy aims to reduce agency costs because through dividend payout, enterprises are strictly tracked by capital markets authorities, and managers are kept on their toes to act in the best interests of shareholders (Hamdan, 2018; Schooley & Barney Jr, 1994). Dividend policy helps to solve the agency problem, and as a result, increased financial performance increases shareholder value (La Porta et al., 2000).

One of the most essential aspects of evaluating a company's success is its dividend policy (Kanakriyah, 2020; Olaoye & Olaniyan, 2022). The dividend policy's behavior is one of the most debated topics in financial literature and still holds a prominent position in emerging markets. Only a few studies have explored the relationship between dividend policy and financial performance, particularly in developing nations. Enekwe et al. (2015) discovered a significant relationship between dividend payout ratio and return on capital employed (ROCE), return on assets (ROA), and return on equity (ROE) of cement-related businesses in Nigeria over a 12-year period. Similarly, Hafeez et al. (2018) used a regression model based on panel data to analyze ROA and ROE as performance indicators and the dividend payout ratio and EPS as indicators of dividend policy and concluded that dividend policy influences firm performance. In addition, Farrukh et al. (2017) conclude that dividend policy, which is measured by two variables, dividends per share and dividend yield, has a substantial impact on ROE-based firm performance.

Velnampy et al. (2014) endeavored to determine the link between dividend policy and firm performance for listed Sri Lankan manufacturing firms. Returns on equity and return on assets were used to determine the performance of a company, while dividend payout and earnings per share were used to evaluate dividend policy. According to the findings of the study, there is no correlation between dividend policy determinants and firm performance indicators.

Consequently, a number of research studies conclude that dividend policy positively influences firm performance (Aman-Ullah et al., 2020; Emeka-

Nwokeji et al., 2022; Jatoi & Rasheed, 2023; Mopho et al., 2022). Few studies, however, have concluded that dividends have a negative impact on firm performance, and some researchers have discovered an insignificant correlation between dividends and performance (Kanakriyah, 2020). following hypotheses are developed based on the above discussion:

H_1: - Dividend payout ratio has a positive impact on return on equity.

H_2: - Dividend yield has a positive impact on return on equity.

H_3: - Dividend payout ratio has a positive impact on return on assets.

H_4: - Dividend yield has a positive impact on return on assets.

3. Methodology

This study used quantitative techniques to assess the relationship between corporate governance and dividend policy of Sri Lankan listed companies from 2016/17 to 2021/22. This study's population of interest consists of 289 listed companies on the Colombo Stock Exchange (CSE) as of May 31, 2023. The research sample is comprised of 100 listed companies chosen at random.

Two distinct measures, dividend yield and dividend payout, are used as proxies for the independent variable of this study. According to the literature, dividend yield is determined as the dividend per share divided by the market price per share at the end of the year (Al-Najjar & Kilincarslan, 2016; Rajput & Jhunjhunwala, 2019) and the dividend payout ratio is measured by the ratio of dividend per share to earnings per share (Al-Najjar & Kilincarslan, 2016; Yanti & Dwirandra, 2019). Both of these variables have a positive value when the company paid dividends and a value of zero when the company did not pay dividends. Firm performance is measured by Return on Assets (ROA) and Return on Equity (ROE) as a dependent variable. In accordance with previous research, ROA is calculated as the ratio of earnings before interest and taxes to total assets, whereas ROE is calculated by dividing the profit after taxes and dividends of preference of a given year by the book value of equity (Moore & Simpson, 2023; Tran & Vo, 2022). The data for the empirical analysis is gathered from the selected company's annual reports, which are available on the Colombo Stock Exchange (CSE) and the company website. EViews 12 is used to generate Spearman rank correlation and Ordinary Least Squares for the quantitative data (OLS). Two model specifications are used to investigate the link between dividend policy and firm performance.

$ROA_{it} = \alpha + \beta 1 DPO_{it} + \beta 2 DY_{it} + e_{it}$ ……Model (1)

$ROE_{it} = \alpha + \beta 1 DPO_{it} + \beta 2 DY_{it} + e_{it}$ ……Model (1)

Where ROA= Return on Assets. ROE = Return on Equity, α = regression constant, DPO = dividend payout ratio, DY = dividend yield, and e=error term

4. Data Analysis and Discussion

4.1. Correlation Analysis

Table 1: Results of the Spearman Rank Correlation Analysis

	DPO	DY	ROE	ROA
DPO	1			
DY	0.67***	1		
ROE	0.21***	0.41***	1	
ROA	0.15***	0.06	0.11***	1

Source: Output of Data Analysis

Table 1 displays the results of the Spearman rank correlation analysis on the selected variables to check multicollinearity issues. ROE has a positive correlation with DPO (r = 0.21, p 0.00) and DY (r = 0.41, p 0.00), but ROA only has a positive correlation with DPO (r = 0.15, p 0.001). When an independent variable is highly correlated with one or more of the other independent variables in the research model, this is referred to as multicollinearity (Allen, 1997). According to Akoglu (2018), Spearman's correlation coefficient value is greater than 0.80, indicating a very strong correlation between the variables. None of the independent variables are highly correlated with each other (r<0.8). Therefore, this result concludes that there are no multicollinearity issues. Additionally, the presence of multi-collinearity among independent variables can be detected using the tolerance test and the Variance Inflation Factor (VIF) (O'Brien, 2007; Schroeder et al., 1990). The results of the tolerance test and VIF test are presented in Table 2. A VIF greater than ten is considered to indicate significant collinearity (Midi et al., 2010), a tolerance of less than 0.20 is considered to be concerning, and a tolerance of less than 0.10 is considered to indicate severe collinearity (Chen et al., 2008; Menard, 2002). Table 2 shows that the VIF is less than ten and the tolerance value is more than 0.10, demonstrating that no multicollinearity exists among the independent variables.

Table 2: Test of Colinearity

	Tolerance	VIF
DPO	0.555	1.801
DY	0.555	1.801

Source: Output of Data Analysis

4.2. Regression Analysis

The results of Hausman's (1978) model specification test are used to choose between the fixed-effect and random-effect models, as shown in Table 3. In the

Hausman Test, the null hypothesis is that the preferred model has random effects, whereas the alternative hypothesis is that the preferred model has fixed effects (Dieleman & Templin, 2014). The fixed effects model is preferred for both models based on the probability of the Hausman test presented in Table 3, which is less than 0.05. This indicates that the research rejects the null hypothesis of the Hausman test, which holds that random effects are preferred, and accepts the alternative hypothesis that the fixed effects model is favored.

Table 3: Results of Hausman's test

	Statistic	p-value	Selection
Model 01	33.10772	0.00	Fixed
Model 02	31.8	0.00	Fixed

Source: Output of Data Analysis

The regression results for the two models are presented in Table 04. Interestingly, DPO appeared to positively influence ROE (R=0.10, p=0.01). This result is consistent with the findings of Uwuigbe et al. (2012), which indicate a positive correlation between dividend payout ratio and ROE in Nigerian listed firms. Similarly, there is a positive correlation between DPO and ROA (R=0.01, p=0.04). This result indicates that a higher dividend payout contributes to a higher ROA, but the effect is minimal. When the dividend payout rate increases by one percentage point, the return on assets increases by only 0.01 percentage points. This result is consistent with the findings of Amidu (2007) and Nguyen et al. (2021), but it contradicts the findings of (Khan et al., 2016). DY has no significant impact on ROA (R=0.17, p>.01) but a significantly positive relationship with ROE (R=1.29, p=0.00).

Table 4: Result of OLS regressions

	Model 01 (ROE)			Model 02 (ROA)		
	Coeffici-ents	t Stat	P-value	Coeffici-ents	t Stat	P-value
Constant	0.14	21.98	0.00	0.05	11.04	0.00
DPO	0.10	2.57	0.01	0.01	2.61	0.04
DY	1.29	0.25	0.00	0.17	0.09	0.93
R Square			0.64			0.51
Adjusted R Square			55			0.39
F-statistic			7.1			4.16
Prob(F-statistic)			0.00			0.00

Source: Output of Data Analysis

The regression model 01 results showed that the two dividend policies explained 64 percent of the variance in ROE (R^2=0.64, F=7.1, p0.00) and 51 percent of the variance in ROA (R^2=0.51, F=4.16, p 0.00) of listed companies in Sri Lanka. Because other internal and external factors such as corporate governance, firm characteristics, political, legal, economic, and so on may impact on firm performance.

5. Conclusions

Furthermore, there is a lack of empirical support for dividend policy's impact on firm performance in developed and developing countries, particularly in Sri Lanka. As a result, this study examines the association between board characteristics and firm performance in 100 listed companies in Sri Lanka for the financial year from 2017/18 to 2021/22.

This study concludes that the dividend policy has a significant impact on firm performance, particularly DPO and DY. However, DY has a negligible relationship with ROA.

This study only considers DPO and DY, which are utilized to gauge dividend policy, as well as ROA and ROE, which are utilized to measure performance. Thus, future studies can include the dividend per share and earnings per share, firm characteristics, and governance characteristics such as board characteristics, audit committee, and ownership structure; they can also use the ROI and Tobin Q ratio to measure the performance. This study is conducted in the Sri Lankan context, so future studies might be needed in both developed and developing countries or conduct a cross-country study. This study uses the OLS techniques. Thus, future research works can use other statistical techniques, such as partial least squares structural equation modelling.

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