

# [Determinants of the dividend policy](https://assignbuster.com/determinants-of-the-dividend-policy/)

[](https://assignbuster.com/)[Finance](https://assignbuster.com/essay-subjects/finance/)

## Introduction

The literature about the determinants of dividend policy discussed in the previous section is collected from various empirical researches based on different conditions. Some of the results are gleaned from surveys by directly asking the managers‘ view towards dividend policy; some are gleaned from statistical analysis by observing the companies‘ financial data; others are just a theoretically deductive process conducted by academicians. Therefore, it is necessary to find out that whether those determinants gained from the empirical literature can work properly in Financial Service industry in UK market. Thus, 9 hypotheses withrespectto each of the determinants have been raised. H1: All else equal, dividend policy relies upon firm’s earnings power. This paper expects that more profitable firms should pay more dividends in UK stock market. Firms with high profitability have the capacity to provide large cash flow. Therefore, there is no need to worry whether the firms have enough cash flow to payout dividends even if a lot of cash flow is used tofinancenew investments. Thus, it can be hypothesized that profitability has a positive relationship with dividend payouts. As a proxy, the level of firms‘ profitability can be measured by the return on assets (ROA). H2: All else equal, dividends signals future earnings growth. This paper expects that low dividend payments will predict a high earning growth in UK market.

Dividends act as a signaling mechanism under the imperfect market situation, where information asymmetry exists between managers and investors. Managers often process and trade on information about firm‘ s future earning fluctuation through dividend payments. Therefore, any change in dividend policy will be interpreted as a change in management‘ s expectation of future earnings. Under the circumstance oflimited cash flow, more investment opportunities actually mean high future earnings growth, but in the same time, will reduce the free internal cash flow available for dividend payments. Therefore, it can be hypothesized a negative relationship between dividend payouts and future earnings growth. Annual rate of growth of earnings per share (GROWTH) is commonly used as a proxy for firms‘ earning growth. H3: All else equal, dividend and debt are direct substitutes. This paper expects that the level of risk will be negatively related to dividend payments in UK market. Firms with high debt ratios are more likely to pay a lower level of dividends, because they have already pre-committed their cash flows to make debt payments and to avoid borrowing more capital. Thus, high leveraged firms do not have sufficient cash flow to afford high dividend payment, and reflect a negative relationship. Firms‘ leverage ratio (LEV) is used to represent risk in statistical analysis. H4: All else equal, past dividend have influence on current dividend policy. This paper expects a positive relationship between past dividend and dividend payouts in UK market. The signaling function of dividend payments suggests that any change in dividend policy reflects changes in the managers‘ prediction of firms‘ prospects. In addition, both the market and the firms prefer certain degree of continuity in dividend payments. Therefore, past dividend payments is essential in the decision making of future dividends. Lintner‘ s partial adjustment model and target payout ratio present a positive relationship between the two variables. As a proxy for continuity of dividends, past dividend (PD) can be used and a positive relationship can be expected from the result.

H5: All else equal, liquidity/ cash flow is the fundamental element in dividend paying. This paper expect dividend payments positively correlated with firms’ cash flow in UKmarket. Sometimes, the concepts of cash flow and profit is two different things. The former is the free cash flow in the companies available for companies operating and investing activities, the later means the current earnings of the firm. The empirical experience tell us that even companies with negative earnings pay dividend to shareholders to maintain a stable dividend payments, and transfer the information of temporary losses to the public. In that case, only the free cash flow of the companies matters when dividends are distributed to shareholders. A poor liquidity position means less generous dividends due to shortage of cash. Therefore, it can be hypothesized that firms with high cash flows have the tendency to allocate more to paying dividends. The variable used is the cash flow per share (CFPS) and it should have a positive impact on dividend payout ratios. H6: All else equal, larger firms distribute larger dividends. This paper expects that dividend payments will be positively associated with size of the firm in UK market. In the imperfect capital market, where the investors and firms cannot borrow at the same cost, larger firms should have easier access to external funds and can borrow at a cheaper rate than small firms can. In addition, being more competitive than smaller firms are, larger firms should have more investment opportunities, and therefore high future earnings growth can be expected. In that case, managers of large firms are more likely to distribute high dividend payments, and convey their positive expectations of the firms‘ prospect. As a common surrogate for size is logarithm of the firms‘ total market value (MV) and it is expected to be positively correlated to dividend payouts. H7: All else equal, dividend payments operates as an information signal. This paper expects that firms with greater investment opportunities will pay lesser dividend in UK market. Asymmetry information provides a new insight into the explanation of dividend puzzle. The unequal information barrier of the insiders and outsiders inevitably highlight the importance of dividend payments acting as a medium to convey information for the two parties. Meanwhile, because of the general tendency for stable dividend payouts, any change in dividend policy is recognized as an information exposure of firms‘ prospects. Therefore, rather than distributing more to shareholders, managers are likely to retain more to satisfy the financial needs required by future investment opportunities. Thus, a common proxy for investment opportunities is the market-to-book ratio (MBV) and it is expected to be negatively associated with dividend payouts. H8: Financial crisis has jeopardized the economy on a worldwide basis. This paper expects that financial distress will influence dividend policy in service industry in UK market. Happened in the middle of 2007, financial crisis lasted for almost two years, and has brought great damage to global economy. The major victim of financial crisis is global banks and financial institutions. Other industries will be more or less affected by the influence of financial pressure. In the three years of financial crisis, almost all the industries are confronting the increasing requirements of free cash flow. However, during this period, both banks and financial institutions are extremely lack of funds, and therefore, cannot satisfy the financial requirements of the market. As a response to this serious situation, tougher capital constrains resulted in high costs for borrowing from external sources. Therefore, for companies, financial crisis raised the pre-determined cost of debt, and in turn reduce the amount of cash flow for dividend payments.

H9: Different industries have different regulations and laws. This paper expects that different industrial classification will result in different dividend policies in UK market. It is generally accepted that firms adjust their dividend policies to suit the particular circumstances facing the industry in which they operate. Like for instance, firms in high growth industries will enjoy many financing discounts from the regulations, therefore, facing more advantages in investing and financing activities. Thus, it is necessary for them to modify their dividend-based strategies in an attempt to maintain more retained earnings for more new investment opportunities. Nevertheless, firms in mature and saturated industries ought to maintain stable dividend payouts rather than to reserve more retained earnings when investment opportunities are limited in their industrial sector. The expectations of this paper and the previous researchers’ attitudes towards the relationship between dividend policy and its determinants can be summarized in the table 1.

Conclusion

Proxies Variables Expected Literature indicated relationship PR dividend payout policy ROA profitability Positive Positive GROWTH earnings growth Negative Positive or Negative LEV level of risk Negative Negative PD past dividens Positive Positive CFPS liquidity Positive Positive MV firms’ size Positive Positive MTBV investment opportunities Negative Negative or no relationship.