

Impact of Dividend Policy on Share Prices of Listed Companies in Sri Lanka: Evidence from Bank Finance and Insurance Sector in Colombo Stock Exchange (CSE)

W.K.P.S. Wimalaratna and Y.M.C. Gunaratne
Uva Wellassa University, Badulla, Sri Lanka

Introduction

Share market is a vital part in any economy as it helps investors to sell their securities in a secondary market at an efficient price. Further, it helps favorably to the initial public offering since most of the people invest in shares with the intention of selling those at a higher price in the future. Stock market gives a great opportunity to investors to buy and sell their shares at a satisfactory price in a well functioning secondary market. Recently, there is a significant development in Colombo Stock Exchange (CSE). At present, 241 companies have been listed in CSE representing 20 business sectors.

Investor seeks to earn the maximum return from their investment. As far as the return of the share market is concerned, total expected return includes two components namely, capital gains and dividends. Shareholders make investment in equity capital with the expectation of earning dividends or capital gains. Thus, shareholders can increase their wealth either from dividends or capital gains. Once the company earns a profit, Board of directors need to decide to retain the profit within the company or to pay it out as dividends to the owners of the company. Dividend policy determines the amount of earnings to be distributed to shareholders and the amount to be retained or reinvest in the firm. The objective of a dividend policy should be to maximize shareholder's wealth.

Retained earnings are used to contribute investment opportunities which lead to increase the growth rate of the firm in the long run and the shareholders can obtain benefits of the retain earning in the long run. How much is needed to pay as a dividend is always a controversial topic for the business. Therefore management has to carefully design the dividend policy of the company in order to satisfy all the shareholders while achieving the company's objectives satisfactorily. Company's profit after tax can either be divided among shareholders as dividend or can retain in the company or combination of these two. However, this may determine after comparing the costs of paying dividends with the cost of retain earnings. None of the companies has an obligation to declare dividends on common stock. However, director board can decide whether to pay or not dividend in the year.

By maintaining a proper dividend policy a company can build a good image among the investors. Many theoretical models describe the factors that managers should consider when making dividend policy decisions. Miller and Modigliani (1961) states that in a given perfect capital market, the dividend decision does not affect firm's value and is, therefore, irrelevant. They offered many theories about how dividends affect value of a share and how managers should design their dividend policy.

Stock Prices are changing according to the behavior of various factors. Some information regarding the stock prices such as earning per share, net assets per share highly affected the changes of stock prices because they reflect the strength of the company. Basically, investors consider companies' profitability, liquidity, leverage, asset utilization and future strategies when making the investment decisions.

Accordingly, earning per share and net assets per share are the major information to the investors in their investment decision making. Thus, the second objective is how do earning per share and net assets per share impact on the market prices and how important those factors in investment decisions.

Methodology

Overall population is the companies that are listed in the Colombo stock exchange. In the Colombo Stock Exchange (CSE) 243 Companies are listed representing 20 business sectors. Selection of the sample is mainly based on the dividend announcements and capitalization. Banks, Finance and Insurance sector was the sector that has more dividend announcements and the number of companies is 37. Therefore, the Banks Finance and Insurance sector was selected to the study and 28 listed companies of the sector were used while other Companies were ignored due to unavailability of data. Annual Reports of the selected companies were used and the required data was collected from the consolidated income statements and balance sheets of each individual company. Using the secondary data collected, the Dividend Payout ratio and Plowback ratio was calculated.

Researcher involved to data evaluation process using the Bi-Variant Analysis and multi variant Analysis and the strength of relationship between Independent and dependent variables were determined by Karl Pearson product movement correlation coefficient while the relative contributions of independent variables towards dependent variable were determined by multiple regression analysis. And also three hypotheses are tested to identify the relation between variables.

Results and discussion

When the relationship between the dividend payout ratio and share market prices examined, it can be identified a negative correlation between these two variables. As the correlation has become negative, it has depicted that there is a negative relationship among the market price of share and dividend payout ratio. By the correlation value of - 0.321, it also suggests that there is a low negative linear relationship between the variable concerned and also relationship between dividend plowback ratio and share market prices. It is a positive relationship. By having the correlation of + 0.321, it can be suggested that there is a low positive linear relationship between the variable concerned. There is a high positive correlation with earning per share and share market prices. The relationship between NAPS and MPS has been examined and it can be identified a positive correlation between these two variables. As the correlation has become positive, it has depicted that there is a positive relationship among NAPS and MPS. By existing correlation of 0.784, it has also suggested that there is a high relationship between the variables concerned. Multiple regression analytical tools are used to interpret the dependent and independent variables and regression model is built. After applying research finding data to regression model, the results are $MPS = 26.312 + 2.764 \text{ EPS} + .199 \text{ NAPS}$.

Conclusions

The relationship between dividend payout ratio and share prices was measured and it is concluded that it's having a low negative relationship between dividend policy and share prices. The results of Karl Pearson product moment correlation coefficient,

reveals a low positive relationship between dividend plowback ratio and share market price. It means that when company takes a decision to increase the dividend plowback ratio, they can invest retained earnings in the profitable investment opportunities. It will help to the growth of the firm. Then it will be a reason for the increase of the share market price. When plowback ratio is decreased it will affect the above explanation vice versa. Thus investors need to invest the companies which are having higher plowback ratio than the payout ratio.

In accordance with this research, researcher found the impact of earning per share and net assets per share towards the share market prices and its importance in investment decisions. According to the results of multiple regression models, it has implied that earning per share is more significant than the Net Assets per Share. And also earning per share has more relative contribution than the net assets per share towards share prices. Earning per share represents the profitability of the companies and also Net assets per share represent the financial strength of the companies. It can be generalized that, investors consider the level of profitability of the companies and financial strength of the companies.

References

- Abdulla, 1993. The relationship between EPS and share prices in the Saudi Arabia Stock Market. *Journal of Economic and Administrative Sciences*, 9:1-21.
- Allen, F. and R. Michaely 2002. Payout Policy Working Paper, The Wharton Financial Institution Center.01-21.
- Bajaj, M., and A.M.Vijh,1990. Dividend Clienteles and the Information Content of Dividend Change. *Financial Economics Journal*.26:193-219.
- Bahadur Malla , B. 2009. Dividend policy and its impact on share price Apex College Kathmandu 2-71.
- Bista, S. 2008. Dividend Policy and Practices in Nepal: A Comparative Study of Listed Joint Venture Commercial Banks and Manufacturing Companies. Shanker Dev Campus, Kathmandu.
- Hijazi, A.1998.The relationship between stock prices and listed companies dividends and earnings in Kuwait *Finance and Industry journal*. 9:53-60.
- Miller, M.H.and F. Modigliani.1961 Dividend Policy: Growth and the Valuation of Share. *Journal of Business* 34:411-433.
- Mohammed, B.U. 2009.Determinants of market price of stock: study of Bank Finance and insurance companies of Bangladesh *Modern Accounting and Auditing journal* 15:1-7.
- Talla, M. and Al-Deehani. 2003. Determinants of Dividend Policy *Economic & Administrative Sciences Journal*.19:59-70.
- Weston, F.J. and T.E. Copeland 2001. *Managerial Finance*.The Dryden Press, New York.657.