CHAPTER- I
INTRODUCTION

1.1. Background of the Study

The topic of dividend policy remains one of the most controversial issues incorporate finance. For more than half a century financial economists have engaged in modeling and examining corporate dividend policy. Research into dividend policy has shown not only that a general theory of dividend policy remains elusive, but also that corporate dividend practice varies over time, between firms and across countries. (Fama and French, 2001:3.43), for instance, document a sharp decline in cash dividends paid by publicly traded (non-financial and non-utility) firms in the US over the last 25 years. In 1973 and 1978, the proportion of firms that paid dividends was 52.8 percent and 66.5 percent, respectively, whereas in 1999, only 20.8 percent of firms paid dividends. This significant decrease in dividend paying firms is partly due to the growth in firms that have never paid dividends (small size, less profitable, and more growth options) and to a decline in propensity to pay dividends regardless of firms' characteristics. Nevertheless, in a recent study, DeAngelo and Skinner (2004) found that although the number of dividend-paying firms decreased over the period 1978-2000, the magnitude of dividends paid by US firms has actually increased. They show that this is largely due to the concentration of dividends and earnings. For instance, in 2000 the 25 top dividend-paying firms accounted for about 55 percent of aggregate industrial dividends paid and about 51 percent of aggregate earnings. In real terms, DeAngelo et al report that the level of dividends paid by these 25 firms in 2000 exceeds their 1978 level by $9.2 billion. This example highlights another enduring feature of the dividend policy debate. Researchers often disagree about the interpretation of the same empirical data.

The patterns of corporate payout policies not only vary over time but also across countries, especially between developed and emerging capital markets. (Glen et al., 1995:26) found that dividend policies in emerging markets differed from those in developed markets. They reported that. Dividend payout ratios in developing countries were only about two thirds that of developed countries. More recently, Ramcharran (2001) also observed low dividend yields for emerging markets. Generally speaking, firms in emerging capital markets face more financial constraints and limited resources to finance their investment opportunities, which may result in more reliance on retained earnings and accordingly result in lower payout ratios. But this explanation is largely speculative, since so little research has been done on dividend policy in emerging equity markets.

La Porta et al. (2000a) suggested that dividend policy variations across countries can be explained by differences in their legal systems. They found that firms in countries governed by common law (better shareholder protection) made higher dividend payouts than those in civil law countries. For example, La Porta et al. reported a median payout ratio (dividends/earnings) of 37.42 percent for the common law countries sample and only 25.11 percent for the civil law countries sample. Aivazian, Booth and Cleary (2003a) compared a sample of firms operating in eight emerging markets with a sample of 99 US firms. They concluded "... results suggest that the dividend policies of firms in emerging markets react to variables similar to those in the United States; however, their sensitivity to these variables varies across countries" . In contrast to Glen et al. (1995) and Ramcharran (2001), they observed that, in general, payout ratios for emerging market firms were comparable to their US counterparts. It is worth pointing out that Aivazian et al. used the International Finance Corporation's (IFC) database, similar to that used by Glen et al. (1995), where only the largest firms were included from each emerging market. This may bias their results but underscores the controversial nature of dividend policy.

Financial and business historians have shown that dividend policy has been bound up with the historical development of the corporation. In its modern form, however, dividend policy theory really only began in 1961 with the publication of the pioneering paper of Miller and Modigliani demonstrating that under certain assumptions including rational investors and a perfect capital market, the market value of a firm is independent of its dividend policy. The value of the firm is determined solely by its earning power and investment decisions, which are independent of dividend policy. The dividend irrelevance hypothesis has been central to the development of financial economics as a scientific discourse. In particular, it helped to integrate dividend policy into the wider theoretical discipline of financial economics by giving it similar theoretical underpinnings. However, the dividend irrelevance hypothesis is quite controversial, and empirical support for it is limited. In an attempt to develop more empirically supported models of dividend policy, financial economists have proposed a number of competing theories. These have attempted to explain the actual patterns of corporate dividend behavior and why dividend policy seems to be relevant in the real world, where hypothesized perfect markets do not exist. Identifying which market imperfection matters. In determining dividend policy has formed the basis for almost all subsequent theories of dividend policy.

The bird-in-hand theory (a pre-Miller-Modigliani theory) asserts that in a world of uncertainty and information asymmetry dividends are valued differently to retained earnings (capital gains). Because of uncertainty of future cash flow, investors will often tend to prefer dividends to retained earnings. As a result, a higher payout ratio will reduce the required rate of return (cost of capital), and hence increase the value of the firm. This argument has been widely criticized and has not received strong empirical support.

The tax-preference theory posits that low dividend payout ratios lower the required rate of return and increase the market valuation of a firm's stocks.

Because of the relative tax disadvantage of dividends compared to capital gains investors require a higher before-tax risk adjusted return on stocks with higher dividend yields (Brennan, 1970:96). The thesis reviews several studies that present empirical evidence in support of the tax effect argument. It also considers other research that has produced opposing findings or provided different explanations.

Another closely related theory is the clientele effects hypothesis. According to this argument, investors may be attracted to the types of stocks that match their consumption/savings preferences. That is, if dividend income is taxed at a higher rate than capital gains, investors (or clienteles) in high tax brackets may prefer non-dividend or low-dividend paying stocks, and vice versa. Also, the presence of transaction costs may create certain clienteles. For example, to avoid the transaction costs associated with selling stocks, small investors (e.g. income-oriented) who rely on dividend income to satisfy their liquidity needs may prefer to invest in steady and high-dividend paying stocks. For the same reason, wealthy investors who are not relying on dividend income may be attracted to low-payout stocks. There are numerous empirical studies on the clientele effects hypothesis but the findings are mixed.

Despite the tax penalty on dividends relative to capital gains, firms may pay dividends to signal their future prospects. This explanation is known as the information content of dividends or signaling hypothesis. The intuition underlying this argument is based on the information asymmetry between managers (insiders) and outside investors, where managers have private information about the current performance and future fortunes of the firm that is not available to outsiders. Here, managers are thought to have the incentive to communicate this information to the market. According to signaling models (Bhattacharya, 1979, John and Williams, 1985, and Miller and Rock, 1985) dividends contain this private information and therefore can be used as a signaling device to influence share price. An announcement of dividend

increase is taken as good news and accordingly the share price reacts favorably, and vice versa. Only good-quality firms can send signals to the market through dividends and poor-quality firms cannot mimic these because of the dissipative signaling costs (for example, transaction costs of external financing, or tax penalties on dividends, or distortion of investment decisions). Moreover, as suggested by Lintner (1956), firms do not increase dividends unless the new level of dividends can be sustained at least in the near future. They are also reluctant to cut dividends because managers believe that it hurts a firm's reputation.

The information asymmetry between managers and shareholders, along with the separation of ownership and control, formed the base for another explanation for why dividend policy may matter; that is, the agency costs thesis. This argument is based on the assumption that managers may conduct actions in accordance with their own self-interest which may not always beneficial for shareholders. For example, they may spend lavishly on perquisites or overinvest to enlarge the size of their firms beyond the optimal size since executives' compensation is often related to firm size.(see Jensen, 1986, Gaver and Gaver, 1993). The agency costs thesis predicts that dividend payments can reduce the problems associated with information asymmetry. Dividends may also serve as a mechanism to reduce cash flow under management control, and thus help to mitigate the agency problems. Reducing funds under management discretion may result in forcing them into the capital markets more frequently, thus putting them under the scrutiny of capital suppliers (Rozeff, 1982, and Easterbrook, 1984). An important implication for this argument is that paying dividends may have a positive impact on firm value because it reduces the overinvestment problem.

1.2 Statement of Problems

Dividend policy has been a controversial subject for a long time. Although Dividend policy is not a new area of research, it is still attracting the attention

of financial economists and for many researchers it remains one of the most interesting and puzzling topics in modern corporate finance. The theories and explanations that have emerged have resulted in an enormous theoretical and empirical body of research with several hundred monographs, working papers, and journal articles. This controversy therefore motivates the conduct of research on dividend policy where answer too many questions are still not clearly developed.

An examination of what determines corporate dividend policy in emerging equity markets is currently not well established in the literature. Moreover, the existing work on emerging markets has also produced conflicting results. Emerging markets differ from those in developed countries in many aspects. They are often of more recent origins, have less information efficiency, more volatility, and are smaller in size (Kumar and Tsetsekos, 1999: 323). Emerging markets also differ from those developed markets in other characteristics such as corporate governance, taxation on dividends and capital gains, and ownership structure. Moreover, emerging markets including Nepal are usually characterized by concentrated ownership, and financial systems that are bank rather than market-based. In this case, corporations can play an important role in closing the information gap between firm management and the market, rendering the role of dividends as a device for signaling or reducing agency costs less important. In addition, firms in emerging markets are subject to more financial constraints than their counterparts in developed markets, which may have some influence on their dividend policy. These differences, and the peculiarities of the particular markets themselves, raise the question about the extent to which competing dividend policy theories can apply to such markets, in particular to Nepal. In some respects, Nepal provides an ideal ground for examining such theories and their implications for developed countries. It is a market that has been guided by international institutions, it has adopted an advanced trading pattern, and it seeks to model itself as a regional stock market. Finally, evidence is currently very limited with regard to dividend

policy in Nepal. It has been observed that the extant studies in this area have not focused on what determines dividend policy of Nepalese publicly quoted companies.

Moreover, the existing studies that have used Nepalese data have been based on small and in some respects biased samples, which make their findings unreliable although some of them have applied sound econometric methods. The studies on dividend policy previously done in emerging equity markets and in the Nepalese context are particular and the shortcomings of those that do exist provide strong justification for the current study.

The study took divergent paths in identifying factors that influence dividend policy decisions. As previously indicated some took a normative approach and developed theories about how companies should make dividend policy decisions. Others, who took a behavioral approach, went directly to managers and asked them what they actually consider when making such decisions. Comparing the responses from various surveys to the theoretical models provided a way of determining whether managers make dividend decisions in a manner consistent with academic theory.

The following are the major issues that have been identified for the purpose of this study in the context on Nepal:

- What are the processes of managerial decision to administer dividend policy?
- What are the factors influencing in making the dividend policy decision?
- What is the relation of change in dividend and change in earnings?
- Do dividend changes convey new information about future profits?
- What is the relationship of earning with lag book value, dividend, earning and price?
- How does dividend increase and dividend decrease influence the future earning?

1.3 Objectives of the Study

The specific objectives of the study are:

- To analyze the factors influencing in making the dividend policy decision.
- To study the issues involving corporate dividend policy in Nepalese corporations.
- To examine the relationship between dividend change and earning change.
- To analyze the change in future profits due to change in dividend.
- To find the role of dividend policy measures i.e. dividend yield and on share price change in the long run.

1.4 Limitations of Study

As with any research, this study has several potential limitations which have been enumerated below:

- The sample selected for secondary data analyses does not include non-dividend paying firms and only cash dividends paying firms are taken into consideration and excludes the bonus share.
- The study period covers 16 fiscal years beginning from 1993 to 2008 but for some corporation only 3 fiscal years will be taken due to unavailability of data. And out of 135 listed companies, 29 listed companies are taken as sample for study.
- The study addresses only some of the interesting dividend policy issues. In general, this research study will provide information about how dividend policymakers view certain determinants and issues involving dividend policy, but it does not provide information about why the respondents hold these views.
- The probability of getting responses to each question will depend on the question's location in the survey. For example, respondents may be less

likely to answer questions at the end of a section or in sections at the end of the survey.

1.5 Organization of the Study

This study will be organized into five chapters. Chapter first will deal with the subject matter of the study consisting introduction, significance of the study, statement of the problem, objective of the study, limitation of the study and chapter plan. Second chapter will deal with review of literature. It will include a discussion on the conceptual framework on dividend, also include major studies relating with dividend decision. Third chapter will explain research methodology use to evaluate dividend policy. It will contain research design, source of data, population and sample, statistical and financial tools. Fourth chapter will deal with analysis and presentation of data and information through a define course of research methodology. Fifth chapter will deal main finding, issues and gaps and suggestive framework of the study.

CHAPTER -II
LITERATURE REVIEW

2.1 Conceptual Framework

Dividend is that portion of the net earning divided by the company among the Shareholders as returned for the money invented. or in other word dividend is a periodic payment made to the shareholders to compensate them for the use of and risk to their investment. Dividend is a return form of shareholders property made by a corporation to its shareholders out of its net earning or profit for the year. The term 'dividend policy' refers to the practice that management follows in making dividend payout decisions or, in other words, the size and pattern of cash distributions over time to shareholders (Lease et aI., 2000:29).

The dividend policy adopted by the firm should be such that it strikes a proper balance between the financing and investment decisions. There is a reciprocal relation between retained earning and cash dividend. If retained earning is kept more by the company, less will be dividend and vice versa. It is in the sense that the firm has to choose between the distributions of profits to shareholders and plugging them back into the business. The decision depends upon the ability to achieve the objectives of wealth maximization. The firm will use the net profit for reinvestment if reinvestment leads to the maximization of wealth of the shareholders, if not, it is better to distribute them to the shareholders.

How much it is desirable to pay dividend is always a controversial topic because owners expect higher dividend from the company but company ensures toward setting aside funds for maximizing the overall shareholders wealth. Financial management is, therefore, concerned with the activities of corporation that affect the well being of stockholders. That well-being can be partially measured is the market value of stock.

The shareholders expect, at some point, a distribution of the firm's earning in the form of dividend. This expectation takes priority over the desire to retain earnings to finance expansion and growth. Thus, shareholders expectation can be fulfilled through either capital gain or dividends. Since dividend would be more attractive to shareholder, one might think that there would be a tendency for corporations to increase distribution of dividend. But one might equally pressure that gross dividends would be reduced some what, with an increase in net after tax dividends still available to stockholders, and increase in retained earnings for the corporation. (Throp, 1977:141) So the firm should maintain a policy between the distribution of dividends and retained earnings.

Dividends are generally paid in cash; therefore, it reduces the cash balances of the company. The dividend policy must be formulated with the basic objective of maximizing the wealth of the firm's owners and providing for the sufficient financing. These objectives are not mutually exclusive but rather interrelated.

The issue of corporate dividends has a long history and, as Frankfurter and Wood (1997) observed, is bound up with the development of the corporate form itself. Corporate dividends date back at least to the early sixteenth century in Holland and Great Britain when the captains of sixteenth century sailing ships started selling financial claims to investors, which entitled them to share in the proceeds, if any, of the voyages. At the end of each voyage, the profits and the capital were distributed to investors, liquidating and ending the venture's life. By the end of the sixteenth century, these financial claims began to be traded on open markets in Amsterdam and were gradually replaced by shares of ownership. It is worth mentioning that even then many investors would buy shares from more than one captain to diversify the risk associated with this type of business.

At the end of each voyage, the enterprise liquidation of the venture ensured a distribution of the profits to owners and helped to reduce the possibilities of

fraudulent practice by captains (Baskin, 1988:29). However, as the profitability of these ventures was established and became more regular, the process of liquidation of the assets at the conclusion of each voyage became increasingly inconvenient and costly. The successes of the ventures increased their credibility and shareholders became more confident in their management (captains), and this was accomplished by, among other things, the payment of "generous dividends" (Baskin, 1988:283). As a result, these companies began trading as going concern entities, and distributing only the profits rather than the entire invested capital. The emergence of firms as a "going concern" initiated the fundamental practice of firms to decide what proportion of the firms' income (rather than assets) to return to investors and produced the first dividend payment regulations (Frankfurter and Wood, 1997:202). Gradually, corporate charters began to restrict the payments of dividends to the profits only.

The ownership structure of shipping firms gradually evolved into joint stock company form. But it was chartered trading firms more generally that adopted the joint stock form most commonly. In 1613, the British East India Company issued its first joint stock shares with a nominal value. "No distinction was made, however, between capital and profit" (Walker, 1931:102). In the seventeenth century, the success of this type of trading company seemed poised to allow the spread of this form of business organization to include other activities such as mining, banking, clothing, and utilities. Indeed, in the early 1700's, excitement about the possibilities of expanded trade and the corporate form saw a speculative bubble form, which collapsed spectacularly when the South Sea Company went into bankruptcy. The Bubble Act of 1711 effectively slowed, but did not stop, the development of the corporate form in Britain for almost a century (Walker, 1931:123).

In the early stages of corporate history, managers realized the importance of high and stable dividend payments. In some ways, this was due to the analogy

investors made with the other form of financial security then traded, namely government bonds. Bonds paid a regular and stable interest payment, and corporate managers found that investors preferred shares that performed like bonds (Le. paid a regular and stable dividend). For example, Bank of North America in 1781 paid dividends after only six months of operation, and the bank charter entitled the board of directors to distribute dividends regularly out of profits. "Paying consistent dividends remained of paramount importance to managers during the first half of the 19th century" (Frankfurter and Wood, 1997:24)

In addition to the importance placed by investors on dividend stability, another issue of modern corporate dividend policy to emerge early in the nineteenth century was that dividends came to be seen as an important form of information. The scarcity and unreliability of financial data often resulted in investors making their assessments of corporations through their dividend payments rather than reported earnings. In short, investors were often faced with inaccurate information about the performance of a firm, and used dividend policy as a way of gauging what management's views about future performance might be. Consequently, an increase in divided payments tended to be reflected in rising stock prices. As corporations became aware of this phenomenon, it raised the possibility that managers of companies could use dividends to signal strong earnings prospects and/or to support a company's share price because investors may read dividend announcements as a proxy for earnings growth.

To summarize, the development of dividend payments to shareholders has been tied up with the development of the corporate form itself. Corporate managers realized early the importance of dividend payments in satisfying shareholders expectations. They often smoothed dividends over time believing that dividend reductions might have unfavorable effects on share price and therefore, used dividends as a device to signal information to the market.

Moreover, dividend policy is believed to have an impact on share price. Since the 1950's, the effect of dividend policy on firm value and other issues of corporate dividend policy have been subjected to a great debate among finance scholars.

2.1.1 Forms of Dividend

A firm can use its profit in several ways. Profits are normally either distributed as cash form or retain in business. Some time firm can utilize its profit to repurchase the outstanding stock. However, in order to maximize the value of firm, it may decide to distribute stock dividend instead of cash. When business is in the need of money, but at the same time, the management feels the necessary of maintaining dividend distribution, than they can distribute stock dividend. According to changing. needs of corporation, objectives and policy of corporation, legal restriction, and liquidity position of corporation, financial condition and capability of firm, out side investment opportunity and so on, influence the decision of dividend and its types.

The type of dividend that corporation follow is partly of a matter of attitude of directors and partly a matter of the various circumstances and financial constraints that bound corporate plan and policies (Shrestha 1980:85). The usual forms of dividend are cash dividend, stock or bonus dividend, script dividend. In Nepal, cash dividend and stock dividend are quite famous and used.

Cash dividend is more popular than stock dividend. Most of the shareholder desire to have cash dividend out of the earnings. To declare cash dividend, the company's liquidity position must be strong. In the case of shortage, the company can manage fund to pay cash dividend through borrowing. Stock dividends are used as a substitute or a supplement to cash dividend. The shares are issued proportionately, leads to increase the number of outstanding shares of the company. Declaration of the stock dividend will increase the paid up

capital and reduced the reserve and surplus of the company, but total net worth is not affected by this action. The shareholders' proportional ownership also remains unaffected.

Bond dividend is an alternate decision of stock dividend. Bond dividend is distributed to shareholders in form of a bond. Bond dividend helps to postpone the payment of cash. In other words, company declares dividends in the form of its own bond with a view to avoid cash outflow. Dividend is declared in the form of scripts, when the earning of the company justifies dividends but the company's liquidity position is temporarily weak and does not permit cash dividend. In this method of dividend, company issue and distributed to shareholders transferable promissory notes which may be interest bearing or not. Script dividends are appropriate only when the company has earned profit but it has to wait for conversion of other current assets into cash.

2.1.2 Stability of Dividend

Most companies are considering stability or regularity of dividend as a desirable policy. Shareholders also favor the stable dividend rather than fluctuation ones. At the same time stable dividend has favorable and positive impact on market price of share. "The term dividend stability refers to the consistency or lack of variability in the stream of dividends. In more precise terms it means that a certain minimum amount of dividend is paid out regularly." (Khan, et.al, 1992:98).

Stability of dividend payment is an attractive feature to any investors. It is believed that stable dividend leads to higher stock prices because investors are generally sure of receiving the return on there investment and fluctuating dividend are riskier than stable ones as well. Another reason for investor preferring stable dividend is that many investors live on income received in the form of dividends. These stockholders are greatly inconvenienced by

fluctuating dividends, and they will pay a premium for a stock with a relatively assured minimum rupees dividend.

There are three distinct forms of such stability of dividend payments. They are constant dividend per share, Constant payout ratio and Stable rupee dividend plus extra dividend.

The policy of constant dividend per share follows a policy of paying a certain fixed amount per share as dividend. the stable dollar amount implies a steady change in dividend amount which increases at a certain constant growth rate to compensate for inflationary effect (or remains constant or decrease at a stable fluctuations rate depending on the trend of earnings) irrespective of short term fluctuation in earning. (Pradhan-1992:365)

Another form of stable dividend policy is constant/ target payout ratio. The ratio of dividend to earning is known as payout ratio. With this policy of constant payout ratio, the amount of dividend will fluctuate in direct proportion to earnings. If the bank incurs loss in some year, dividend will not be paid to shareholder. When the earning of company increases than dividend amount as well as retain earning also increases, where as when earning decreases than dividend and retain earning decreases.

According to this policy, the company pays fixed amount of stable dividend to the shareholder to reduce the possibility of ever missing a dividend payment and in years of market prosperity, additional dividend is paid over and above the regular dividend. When normal condition returned, the company cuts the extra dividend and returned in its normal dividend payment.

2.1.3 Factor Influencing Dividend Policy

Some of the shareholders are interested in the capital gains but most of the shareholders have a desire to receive dividends. The dividend decision

followed by each company may be differed due to implication of rationality of executive decision maker and other number of other factors, which influence the managerial decision. "The decisions whether or not to pay a cash dividend-and if so, how much are matters for the board's discretion" (Hunt, 1971:68). Some of the corporation implies that nonpayment of dividend so their long term policy and at the same times other corporations is known to pay a large proportion of profit as dividend. The factors, which restrict the firm's ability to declare and pay dividend, are legal restriction, liquidity, financial condition, access to the capital market, investment opportunity, inflation and some other factors.

The dividend policy of the corporation is greatly influenced by legal framework and restriction. The legal rules act as a boundary and it guide the dividend policy within which a company can operate in term of paying dividend. This implies that the corporation must follow to the legal restrictions like insolvency rule, capital impairment rule and surplus rule and so on. The decision of dividend declaration should consider the liquidity position of the corporation. The dividend payment indicates cash out flow from the company. Although the company may have adequate earning but that doesn't mean that its liquidity position is strong and it may not have sufficient cash to pay dividends. The greater the cash position, and overall liquidity position of the company, the grater its ability to pay dividend. So liquidity influences the dividend policy of company.

A liquidity position is not the only way to provide for flexibility but the ability to borrow on comparatively short term represents its flexibility and protection against uncertainty. The financial condition and capability of a company depends on its borrowing power and interest charges payable capacity. The greater the ability of the firm to raise funds in the capital markets, the grater will be its ability to pay dividends even if it is not liquid.

Easy accessibility to the markets provides flexibility to the management in paying dividends as well as in meeting the corporate obligations. Thus, fast growing firms never face problem of paying dividend if it has access to the capital market. When the company pays dividend, the cash from company outflows and later on in future it may need large amount of cash than it has to issue new stock to raise fund to finance its investment programmes. In this condition the control of the existing stockholder will be diluted it they do not want or cannot buy additional share. Under this circumstance, the payment of dividends may be withheld and earning may be retained to finance the firm's investment opportunity.

When many investment opportunities exist in the environment, then the company wishes to retain its earning to grab the opportunity. However, the investment opportunity is infrequent the company distribute its earning in the form of dividend rather than retention. If the company retains earning at the time of infrequent investment opportunity, the retained fund would be reinvested either in short term securities yielding nominal returns or remain idle. This will have and negative impact on shareholders' wealth. Inflation influences dividend-paying decision indirectly. Our accounting system is based on historical cost basis, which does not consider the inflationary pressure on value of assets. To replace existing assets, depreciation has been charged which would be insufficient to replace the existing assets so extra earning should be retained for replacement, which influence the dividend decision.

Other factors that influence dividend decision are:

- The need to repay debt and redemption of preference share increase the cash out flow.
- A high rate of asset expansion creates a need to retain funds
- The tax position of stockholders also affects dividend policy.

2.2 Theories of Dividend

2.2.1 The Basic Irrelevance Thesis

Prior to the publication of Miller and Modigliani's (1961, hereafter M&M) seminal paper on dividend policy, a common belief was that higher dividends increase a firm's value. This belief was mainly based on the so-called "bird-in-the-hand" argument, discussed in more detail shortly. Graham and Dodd (1934), for instance, argued that "the sole purpose for the existence of the corporation is to pay dividends", and firms that pay higher dividends must sell their shares at higher prices (cited in Frankfurter et aI., 2002:202). However, as part of a new wave of finance in the 1960's, M&M demonstrated that under certain assumptions about perfect capital markets, dividend policy would be irrelevant.

Given that in a perfect market dividend policy has no effect on either the price of a firm's stock or its cost of capital, shareholders wealth is not affected by the dividend decision and therefore they would be indifferent between dividends and capital gains. The reason for their indifference is that shareholder wealth is affected by the income generated by the investment decisions a firm makes, not by how it distributes that income. Therefore, in M&M's world, dividends are irrelevant. M&M argued that regardless of how the firm distributes its income, its value is determined by its basic earning power and its investment decisions. They stated that "...given a firm's investment policy, the dividend payout policy it chooses to follow will affect neither the current price of its shares nor the total returns to shareholders" (p.414). In other words, investors calculate the value of companies based on the capitalized value of their future earnings, and this is not affected by whether firms pay dividends or not and how firms set their dividend policies.

M&M go further and suggest that, to an investor, all dividend policies are effectively the same since investors can create "homemade" dividends by adjusting their portfolios in a way that matches their preferences. M&M based

their argument upon idealistic assumptions of a perfect capital market and rational investors. The assumptions of a perfect capital market necessary for the dividend irrelevancy hypothesis can be summarized as follows: (1) no differences between taxes on dividends and capital gains; (2) no transaction and flotation costs incurred when securities are traded; (3) all market participants have free and equal access to the same information (symmetrical and costless information); (4) no conflicts of interests between managers and security holders (Le. no agency problem); and (5) all participants in the market are price takers. Given the importance of M&M's argument in the dividend policy debate, the following section provides their proof of irrelevancy.

2.2.2 High Dividends Increase Stock Value (Bird-In-The-Hand Hypothesis)

One alternative and older view about the effect of dividend policy on a firm's value is that dividends' increase firm value. In a world of uncertainty and imperfect information, dividends are valued differently to retained earnings (or capital gains). Investors prefer the "bird in the hand" of cash dividends rather than the "two in the bush" of future capital gains. Increasing dividend payments, ceteris paribus, may then be associated with increases in firm value. As a higher current dividend reduces uncertainty about future cash flows, a high payout ratio will reduce the cost of capital, and hence increase share value. That is, according to the so-called "bird-in-the hand" hypothesis (henceforth BIHH) high dividend payout ratios maximize a firm's value. Graham and Dodd, for instance, argued that a dollar of dividends has, on average, four times the impact on stock prices as a dollar of retained earnings (see Diamond, 1967, p.16). Studies that provide support for the BIHH include Gordon and Shapiro (1956) Gordon (1959, 1963), Linter (1962), and Walter (1963).

M&M (1961) have criticized the BIHH and argued that the firm's risk is determined by the riskiness of its operating cash flows, not by the way it

distributes its earnings. Consequently, M&M called this argument the bird-in-the-hand fallacy. Further, Bhattacharya (1979) suggested that the reasoning underlying the BIHH is fallacious. Moreover, he suggested that the firm's risk affects the level of dividend not the other way around. That is, the riskiness of a firm's cash flow influences its dividend payments, but increases in dividends will not reduce the risk of the firm. The notion that firms facing greater uncertainty of future cash flow (risk) tend to adopt lower payout ratios seems to be theoretically plausible (see, for example, Friend and Puckett, 1964). Empirically, Rozeff (1982) found a negative relationship between dividends and firm risk. That is, as the risk of a firm's operations increases, the dividend payments decrease.

2.2.3 Low Dividends Increase Stock Value (Tax-Effect Hypothesis)

The M&M assumptions of a perfect capital market exclude any possible tax effect. It has been assumed that there is no difference in tax treatment between dividends and capital gains. However, in the real world taxes exist and may have significant influence on dividend policy and the value of the firm. In general, there is often a differential in tax treatment between dividends and capital gains, and, because most investors are interested in after-tax return, the influence of taxes might affect their demand for dividends. Taxes may also affect the supply of dividends, when managers respond to this tax preference in seeking to maximize shareholder wealth (firm value) by increasing the retention ratio of earnings.

The, M&M assumptions of a perfect capital market exclude any possible tax effect. It has been assumed that there is no difference in tax treatment between dividends and capital gains. However, in the real world taxes exist and may have significant influence on dividend policy and the value of the firm. In general, there is often a differential in tax treatment between dividends and capital gains, and, because most investors are interested in after-tax return, the influence of taxes might affect their demand for dividends. Taxes may also

affect the supply of dividends, when managers respond to this tax preference in seeking to maximize shareholder wealth (firm value) by increasing the retention ratio of earnings.

The tax-effect hypothesis suggests that low dividend payout ratios lower the cost of capital and increase the stock price. In other words low dividend payout ratios contribute to maximizing the firm's value. This argument is based on the assumption that dividends are taxed at higher rates than capital gains. In addition, dividends are taxed immediately, while' taxes on capital gains are deferred until the stock is actually sold. These tax advantages of capital gains over dividends tend to predispose investors, who have favorable tax treatment on capital gains, to prefer companies that retain most of their earnings rather than pay them out as dividends, and are willing to pay a premium for low-payout companies. Therefore, a low dividend payout ratio will lower the cost of equity and increases the stock price. Note that, this prediction is almost the exact opposite of the BIHH, and of course challenges the strict form of the DIH.

In many countries such as the UK, US and Jordan a higher tax rate is applied to dividends as compared to capital gains taxes. Therefore, investors in high tax brackets might require higher pre-tax risk-adjus.ted returns to hold stocks with higher dividend yield. This relationship between pre-tax returns on stocks and dividend yields is the basis of a posited tax-effect hypothesis.

2.2.4 Clientele Effects of Dividends Hypothesis

In their seminal paper M&M (1961) noted that the pre-existing dividend clientele effect hypothesis (hereafter DCH) might play a role in dividend policy under certain conditions. They pointed out that the portfolio choices of individual investors might be influenced by certain market imperfections such as transaction costs and differential tax rates to prefer different mixes of capital gains and dividends. M&M argued that these imperfections might cause

investors to choose securities that reduce these costs. M&M termed the tendency of investors to be attracted to a certain type of dividend-paying stocks a "dividend clientele effect". Nonetheless, M&M maintained that even though the clientele effect might change a firm's dividend policy to attract certain clienteles, in a perfect market each clientele is "as good as another"; hence the firm valuation is not affected; that is, dividend policy remains irrelevant.

In practice, investors often face different tax treatments for dividend income and capital gains, and incur costs when they trade securities in the form of transaction costs and inconvenience (changing portfolios). For these reasons and based on different investors' situations, taxes and transaction costs may create investor clienteles, such as tax minimization induced clientele and transaction cost minimization induced clientele respectively. These clienteles will be attracted to firms that follow dividend policies that best suit their particular situations. Similarly, firms may tend to attract different clienteles by their dividend policies. For example, firms operating in high growth industries that usually pay low (or no) dividends attract a clientele that prefers price appreciation (in the form of capital gains) to dividends. On the other hand, firms that pay a large amount of their earnings as dividends attract a clientele that prefers high dividends.

2.2.5 Tax-Induced Clientele-Effects

Since most of the investors are interested in after-tax returns, the different tax treatment of dividends and capital gains might influence their preference for dividends versus capital gains. This is the essence of the tax- induced DCH. For example, ceteris paribus, investors in low tax brackets who rely on regular and steady income will tend to be attracted to firms that pay high and stable dividends. In addition, some corporate or institutional investors tend to be attracted to high-dividend stocks (Han, Lee and Suk, 1999, Dhaliwal, Erickson and Trezevant, 1999, and Short. Zhang and Keasey, 2002). On the other hand, investors in relatively high tax brackets might find it advantageous to invest in

companies that retain most of their income to obtain potential capital gains, all else being equal. Some clienteles, however, are indifferent between dividends and capital gains such as tax exempt and tax deferred entities (see Elton and Gruber, 1970, among others).

2.2.6 Transaction Cost-Induced Clientele

Another argument of the DCH is based on the proposition that dividend policy may influence different clienteles to shift their portfolio allocation, resulting in transaction costs. For example, small investors (such as retirees. Income-oriented investors, and so on) that rely on dividend income for their consumption needs, might be attracted to (and even may pay a premium for) high and stable-dividend stocks, because the transaction costs associated with selling stocks might be significant for such investors. On the other hand some investors (e.g. wealthy investors), who do not rely on their share portfolios to satisfy their liquidity needs, prefer low payouts to avoid the transaction costs associated with reinvesting the proceeds of dividends, which they actually do not need for their current consumption (Bishop et aI., 2000:365). Note that for both groups of investors, transforming one financial asset to another, transaction costs need to be incurred. That is, M&M's notion of homemade dividends is not costless and the existence of such costs may make dividend policy not irrelevant.

The other effect of transaction costs on dividend policy is related to the fact that firms may need to restore cash paid out as dividends with new equity issues (or debt financing) to take advantage of new investment opportunities. If issuing costs are significant, then firms are most likely to rely on retained earnings rather than external financing. This is reinforced by the empirical fact that retained earnings constitute the major source of firm finance not just in developing but also even in developed capital markets. Fazzari, Hubbard and Petersen (1988) reported that, over the period of 1970 to 1984, the retained earnings amounted to 71.1 percent of the total source of funds of US

manufacturing firms with an average retention ratio of 60 percent. In these cases, there should be a negative relationship between transaction costs and dividend payments. Firms can reduce or avoid such expenses by lowering dividend payments or not paying them at all. However, in practice, many firms continue to pay cash dividends, while at the same time issuing new equity and debt, suggesting that other factors may also be at work in influencing dividend policy.

2.2.7 The Information Content of Dividends (Signaling) Hypothesis

Another hypothesis for why M&M's DIH is inadequate as an explanation of financial market practice is the existence of asymmetric information between insiders (managers and directors) and outsiders (shareholders). M&M assumed that managers and outside investors have free, equal and instantaneous access to the same information regarding a firm's prospects and performance. But managers who look after the firm usually possess information about its current and future prospects that is not available to outsiders. This informational gap between insiders and outsiders may cause the true intrinsic value of the firm to be unavailable to the market. If so, share price may not always be an accurate measure of the firm's value. In an attempt to close this gap, managers may need to share their knowledge with outsiders so they can more accurately understand the real value of the firm.

Historically, due to a lack of complete and accurate information available to shareholders, the cash flow provided by a security to an investor often formed the basis for its market valuation (Baskin and Miranti, 1997:231). In this way dividends came to provide a useful tool for managers in which to convey their private information to the market because investors used visible (or actual) cash flows to equity as a way of valuing a firm. Many academics and financial practitioners also suggest that dividends might have implicit information about a firm's prospects. Even M&M (1961) suggest that when markets are imperfect share prices may respond to changes in dividends. In other words, dividend

announcements may be seen to convey implicit information about the firm's future earnings potential. This proposition has since become known as the "information content of dividends" or signaling hypothesis. However, M&M dismissed the possibility that this occurred by suggesting that the empirical evidence does not support the notion that investors prefer dividends to retained earnings.

According to the signaling hypothesis, investors can infer information about a firm's future earnings through the signal coming from dividend announcements, both in terms of the stability of, and changes in, dividends. However, for this hypothesis to hold, managers should firstly possess private information about a firm's prospects, and have incentives to convey this information to the market. Secondly, a signal should be true; that is, a firm with poor future prospects should not be able to mimic and send false signals to the market by increasing dividend payments. Thus the market must be able to rely on the signal to differentiate among firms. If these conditions are fulfilled, the market should react favorably to the announcements of dividend increase and unfavorably otherwise (Ang, 1987:62, and Koch and Shenoy, 1999:194).

As managers are likely to have more information about the firm's future prospects than outside investors, they may be able to use changes in dividends as a vehicle to communicate information to the financial market about a firm's future earnings and growth. Outside investors may perceive dividend announcements as a reflection of the managers' assessment of a firm's performance and prospects. An increase in dividend payout may be interpreted as the firm having good future profitability (good news), and therefore its share price will react positively. Similarly, dividend cuts may be considered as a signal that the firm has poor future prospects (bad news), and the share price may then react unfavorably. Accordingly, it would not be surprising to find that managers are reluctant to announce a reduction in dividends. Lintner (1956)

argued that firms tend to increase dividends when managers believe that earnings have permanently increased.

2.2.8 Agency Costs and Free Cash Flow Hypothesis of Dividend Policy

One of the assumptions of M&M's perfect capital market is that there are no conflicts of interests between managers and shareholders. In practice, however, this assumption is questionable where the owners of the firm are distinct from its management. In these cases managers are always imperfect agents of shareholders (principals). This is because managers' interests are not necessarily the same as shareholders' interests, and they might conduct actions that are costly to shareholders, such as consuming excessive perquisites or over-investing in managerially rewarding but unprofitable activities. Shareholders therefore incur (agency) costs associated with monitoring managers' behavior, and these agency costs are an implicit cost resulting from the potential conflict of interest among shareholders and corporate managers. The payment of dividends might serve to align the interests and mitigate the agency problems between managers and shareholders, by reducing the discretionary funds available to managers (Rozeff, 1982:94, Easterbrook, 1984:112, Jensen, 1986:435, and Alii, Khan and Ramirez, 1993:87).

Another source of the agency costs problem that may be influenced by dividend policy is the potential conflict between shareholders and bondholders. Shareholders are considered as the agents of bondholders' funds. In this case, excess dividend payments to shareholders may be taken as shareholders expropriating wealth from bondholders (Jensen and Meckling, 1976:446). Shareholders have limited liability and they can access the company's cash flow before bondholders; consequently, bondholders prefer to put constraints on dividend payments to secure their claims. Conversely, for the same reasons, shareholders prefer to have large dividend payments (Ang, 1987:354).

In an often-cited article, Easterbrook (1984) argued that dividends could be used to reduce the free cash flow in the hands of managers. In addition, Eastbrook hypothesized that dividend payments will oblige managers to approach the capital market to raise funds. In this case investment professionals such as bankers, and financial analysts will also be able to monitor managers' behavior. Therefore, shareholders are able to monitor managers at lower cost (and minimize any collective action problems). This suggests that dividend payments increase management scrutiny by outsiders and reduce the chances for managers to act in their own self-interest. However, Easterbrook suggested that increasing dividend payments might force managers to take undesirable actions like increasing firm leverage, which may sometimes increase the riskiness of the firm.

2.3 Review of Related Studies

It was seen that the emergence of dividend policy as important to investor was, to some extent, driven by the evolving state of financial markets. Investing in shares was initially seen as analogous to bonds, so regularity of payments was important. It was also seen that in the absence of regular and accurate corporate reporting, dividends were often preferred to reinvested earnings, and often even regarded as a better indication of corporate performance than published earnings accounts. However, as financial markets developed and became more efficient, it was thought by some that dividend policy would become increasingly irrelevant to investors. Why dividend policy should remain so evidently important has been theoretically controversial.

Three main contradictory theories of dividends can be identified. Some argue that increasing dividend payments increases a firm's value. Another view claims that high dividend payouts have the opposite effect on a firm's value; that is, it reduces firm value. The third theoretical approach asserts that dividends should be irrelevant and all effort spent on the dividend decision is wasted. These views are embodied in three theories of dividend policy: high

dividends increase share value theory (or the so-called 'bird-in-the- hand' argument), low dividends increase share value theory (the tax-preference argument), and the dividend irrelevance hypothesis. Dividend debate is not limited to these three approaches. Several other theories of dividend policy have been presented, which further increases the complexity of the dividend puzzle. Some of the more popular of these arguments include the information content of dividends (signalling), the clientele effects, and the agency cost hypotheses. These are discussed in turn below beginning with dividend irrelevance hypothesis.

Prior to the publication of Miller and Modigliani's (1961, hereafter M&M) seminal paper on dividend policy, a common belief was that higher dividends increase a firm's value. This belief was mainly based on the so-called "bird-in-the-hand" argument, discussed in more detail shortly. Graham and Dodd (1934), for instance, argued that "the sole purpose for the existence of the corporation is to pay dividends", and firms that pay higher dividends must sell their shares at higher prices (cited in Frankfurter et aI., 2002, 202). However, as part of a new wave of finance in the 1960's, M&M demonstrated that under certain assumptions about perfect capital markets, dividend policy would be irrelevant.

Given that in a perfect market dividend policy has no effect on either the price of a firm's stock or its cost of capital, shareholders wealth is not affected by the dividend decision and therefore they would be indifferent between dividends and capital gains. The reason for their indifference is that shareholder wealth is affected by the income generated by the investment decisions a firm makes, not by how it distributes that.

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and capital gains. The reason for their indifference is that shareholder wealth is affected by the income generated by the investment decisions a firm makes, not by how it distributes that income. Therefore, in M&M's world, dividends are irrelevant. M&M argued that regardless of how the firm distributes its income, its value is determined by its basic earning power and its investment decisions. In other words, investors calculate the value of companies based on the capitalized value of their future earnings, and this is not affected by whether firms pay dividends or not and how firms set their dividend policies. M&M go further and suggest that, to an investor, all dividend policies are effectively the same since investors can create "homemade" dividends by adjusting their portfolios in a way that matches their preferences.

M&M based their argument upon idealistic assumptions of a perfect capital market and rational investors. The assumptions of a perfect capital market necessary for the dividend irrelevancy hypothesis can be summarized as follows: (1) no differences between taxes on dividends and capital gains; (2) no transaction and flotation costs incurred when securities are traded; (3) all market participants have free and equal access to the same information (symmetrical and cost less information); (4) no conflicts of interests between managers and security holders (Le. no agency problem); and (5) all participants in the market are price takers. Given the importance of M&M's argument in the dividend policy debate, the following section provides their proof of irrelevancy.

2.3.1 Review of Empirical Works Prior to 1980

This section is carried out to review the major studies concerning dividend prior to 1980.

Table 2.1
Review of Empirical Workers Prior to 1980

Research	Conclusion
Linter (1956)	• Firms generally prefer desired proportion of earning to be paid as dividend. • Investment opportunities are not considered for modifying the pattern of dividend behavior. • Firm generally have target payout ratios in view while determining change in dividend per share.
Walter (1957)	The dividend policy of the firm depends on the availability of investment opportunities and the relationship between the firms internal rate of return, r, and its cost of capital, k.
Modigliani and Miller's (1961)	That dividend policy doesn't affect the wealth of the share holders, imply that when firm pays dividend, external financing offsets its advantage. Thus, the wealth of shareholders dividend plus terminal price-remains unchanged. As a result, the present value per share after dividends and external financing is equal to the present value per share before the payment of dividend. Thus the shareholders are indifferent between payments of dividend and retention of earnings.
Gordon (1962)	The higher payout increases the dividend yield and hence increases the value of stock. But the assumption of this model is also far from the reality.

Linter (1956) conducted a study, which is focused in the behavioral aspect of dividend policy. He investigated dividend pattern of 28 different companies of America and found that, firm generally predetermines the desired payout and tries to achieve it and rarely considers other factors. The model developed firm in his research is as follows

$DIV^*_t = pEPS_t$ ... ... (i)

& DIV_t - $a+b(DIV^*_t - DIV_{t-1}) + e_1$ …….... (iii)

or, $DIV_t = a+b\ DIV^*_t + (a+b)\ DIV_{t-1} + e_1$ ……... (iii)

Where,

DIV^*_t= Firm's desired payment

EPS= Earning per share

p= Targeted pay-out ratio

A= Constant relating to dividend growth

B= Adjustment factor relating to the previous period's dividend & new desired level or dividend where b<1.

He had more emphasize on target dividend payout ratio of the firm. The firm does not consider the investment opportunity and prefer to declare desire proportion of earning to pay dividend to its shareholder.

Walter (1957) argued that the choice of dividend policies almost always affect the value of enterprises. His model, one of the earlier theoretical works shows clearly the importance of the relationship between the firm's internal rate of return, r, and its cost of capital, k, in determining the dividend policy that will maximize the wealth of shareholders. Walters's model is based on the following assumptions (Pandey, 1975: 741).

- The firm finances all investment through retain earnings, that is debt or new equity is not issued.
- The firm's internal rate of return, r, and its cost of capital, k is constant.
- All earnings are distributed as dividend or reinvested internally immediately.
- Beginning earnings and dividends never change. The value of the for share, EPS, and the dividend per share DPS may be changed in the model to determine results, but any given value of EPS/DPS are assumed to remain constant for ever in determining the given value.
- The firm has a very long infinite life.

Walter's formula to determine the market price per share is as follows.

$$\boldsymbol{P = \frac{DPS}{K} + \frac{r(EPS - DPS)/k}{K} = \frac{DPS + r(EPS - DPS).k}{K}}$$

Where,

P	=	market price per share
DPS	=	Dividend per share.
EPS	=	Earning per share.
r	=	internal rate of return. (Average).
K	=	Cost of capital! Capitalization rate.

In Walter's model the optimum dividend policy depends on the relationship between the firm's internal rate of return, r, and its cost of capital, k. Walter's view of the optimum dividend payout ratio can be summarize as follows:

Growth Finn r>k

Firm having r>k may he referred as growth firm. The optimum payout ratio for a growth firm is O. The market values per share p increases as payout ratio declines when r>k.

Normal Firm r=k

Firm having r=k may be referred as normal firm. There is no unique optimum payout ration for a normal firm. One dividend policy is a good as the other. The market values per share is not affected by the payout ratio when r=k.

Declining Firm r<k

Firm having r<k may be referred as declining firm. The optimum payout ratio for a declining firm is 100%. The market values per share p increases as payout ratio increases when r<k.

The firm should use earning to finance investment if r>k, should distribute all earnings when r<k and would remain indifferent when r=k. Thus dividend policy is the financing decision. When dividend policy is treated as a financing

decision, the payment of cash dividend is a passive residual (Solomon, 1963:139-140).

Modigliani and Miller's (1961) model (M-M) dividend policy of the firm is irrelevant. According to the Modigliani and Miller's, "There is no effect on the share prices by causing the change on dividend policy." In other word, the dividend policy of the firm does not affect the value of the firm because according to them, the value of the firm depends on the firm's earnings which depend on its investment policy. So they concluded that a firm's value is independent from dividend policy which is based on the following assumptions:

- The firm operates in perfect capital markets where investors behave rationally, information is freely available to all transactions and flotation costs do not exist.
- Taxes do not exist
- The firm has a fixed investment policy.
- Risk of uncertainty does not exist.

Modigliani and Miller provided the proof in support of their argument in the following manner:

Step 1:

The market price of a share in the beginning of the period is equal to the present value of dividend paid at the end of the period plus the market price of the share at the end of the period.

Symbolically,

$$\boldsymbol{Po = \frac{D1 + P1}{1 + Ke}}$$

Where,

Po = market price at the beginning or at the zero period.

Ke= cost of equity capital (assume constant)

D_1= dividend per share to be received at the end of the period

P_1 = market price of the share at the end of the period

Step 2:

Assuming that the firm does not resort to any external financing the market value of the firm can be computed as follows:

$$\boldsymbol{nPo} = \frac{\boldsymbol{nD1 + P1}}{\boldsymbol{1 + Ke}}$$

Where,

N = number of equity share at zero period.

Step 3:

If the firm's internal sources of financing its investment opportunities fall short of the funds required, and Δn is the number of new shares issued at the end of the year 1 at price P_1 than,

$$\boldsymbol{nPo} = \frac{\boldsymbol{nD1 + P1(n + \Delta n) - \Delta nP1}}{\boldsymbol{1 + K}}$$

N = no of share at the beginning

Δn = no of equity shares issued at the end of the period.

Step 4:

If the firm were to finance all investment proposals, the total amount of new shares issued would be given by the following equation.

$$\boldsymbol{\Delta nP_1 = I - (E - nD_1)}$$

$$\boldsymbol{\Delta nP_1 = I - E + nD_1}$$

Where,

ΔnP_1= the amount obtained from the sale of new shares to finance capital budget.

I= the total amount requirement of capital budget.

E = earning. of the firm during the period

E- nD_1= retained earning

Step 5:

By substitution the value of dnP1 from equation of step 4 to equation of step 3, we find,

$$\boldsymbol{nPo} = \frac{\mathbf{1}}{\mathbf{1}+\boldsymbol{K}}[\boldsymbol{nD1} + (\boldsymbol{n}+\Delta\boldsymbol{n})\boldsymbol{P_1} - (\boldsymbol{I}-\boldsymbol{E}+\boldsymbol{nD_1}]$$

$$\boldsymbol{Or}, \quad \boldsymbol{nPo} = [(\boldsymbol{n}+\Delta\boldsymbol{n})\boldsymbol{P_1} - \boldsymbol{I} + \boldsymbol{E}]/(\mathbf{1}+\boldsymbol{Ke})$$

Step 6: Conclusion

Since dividend is not found in step 6, MM conclude that dividends do not count and that dividend policy has no effect on the share price.

It doesn't affect the wealth of the shareholder. They argue that the value of the firm depends on the firms earning, which result from its investment policy. Thus, when investment decision of the firm is given the dividend decision- the split of earnings between dividends and retains earnings is of no significance in determining the variable of the firm. Modigliani and Miller's model hypothesis of irrelevance is based ion the following assumptions (Pandey, 1995:751-752).

- The firm operates in profit capital markets where investors behave rationally, information freely available to all and transaction and floatation cost do not exist. Perfect capital markets also imply that no investor is large enough to affect the market price of share.
- Taxes do not exist or there is no difference in the tax rate applicable to the capital gains and dividends. This means that investors value a rupee of dividend as much as a rupee of capital gains.
- The firm has a fixed investment policy.
- Risk of uncertainty does not exist .i.e. investors are able to forecast future prices and dividend with certainty and one discount rate is appropriate for all securities and all time periods. Thus, r=k=kt for all t.

Modigliani and Miller asserts that there hypothesis of dividend irrelevance is not affected if the firm raises external funds by issuing debts instead of shares. When external financing involves debts Modigliani and Miller invoke their indifference hypothesis with respect to leverage (Pandey, 1995: 753-754).

Gordon (1962) developed own very popular model explicitly relating the market values of the firm to dividend policy. Gordon made a study on the dividend policy and market price of the stock and concluded that the dividend policy of a firm influences the market value of stock. He explained, 'The investor's preferred present dividend rather that future capital gains. He further explained that the dividend policy has direct relation with the value of stock even if the internal rate of return is equal to the required rate of return.

Gordon's model is based on the following assumptions:

- The firm is an all equity firm.
- No external financing is available. Consequently retain earning would be used to financial expansion.
- The internal rate of return, r, of the firm is constant. This ignores the diminishing marginal efficiency of the investment.
- The appropriate discount rate, k, for the firm remains constant. Thus, Gordon's models also ignore the effect of a change in the firms risk class and its effect of k.
- The firm and its stream of earning are perpetual.
- The corporate taxes do not exist.
- The relation ratio b, ones decide upon, is constant. Thus the growth rate g=br, each constant forever.
- K>br =g. if this condition is not fulfilled we can't get a meaningful value
- For the share.

Gordon's relevant theory is a popular theory of dividend as investor's prefer current dividends earnings rather than expected higher future income so as to eliminate the risk associated with future capital gain.

2.3.2 Review of Empirical Works During 1985 to 1999

This section is carried out to review the major studies concerning dividend during 1985 to 1999 period of time.

Table 2.2
Review of empirical works during 1985 to 1999

Researcher	Conclusion
H. K. Baker, G. E. Farrelly, and Richard B. Edelman (1985)	• The first highly ranked determinants are the anticipated level of a firm's future earnings and the second factor is the pattern of the past dividends. • The second factor is the pattern of past dividends. They found the high ranking of first and second factors is consistent with Linter's findings. • A third factor cited as important in determining dividend policy is the availability of cash. • A fourth determinant is concern about maintaining or increasing stock price. They found this factor is particularly strong among utilities that ranked this factor second importance.
H.K. Baker And Aaron L. Phillips (1992)	• The dominant motive for paying stock dividends is to maintain the firm's historical practice. • Management views on issues and motives about stock dividends differ little based on the firm's trading location or the size of the stock dividends. • Managers believe that stock dividends enable them to express their confidence in the firm's future prospects, suggesting that stock dividends may have some information content. • Mangers strongly agree that stock dividends have a positive psychological impact on investors receiving them.

H. K. Baker, G. E. Farrelly, and Richard B. Edelman's Study (1985) surveyed management views on dividend policy. According to them "The corporate financial manager what they considered is the most important things in determining their firm's dividend policy". The main management views of this study's objects are as follows:

- To determine whether managers in different industries share similar views about the determinants of dividend policy.
- To examine management's perception of signaling and clientele effects;

- To compare the determinants of dividend policy today with Linter's behavioral model of corporate dividend policy and to assess management's agreement with Linter's findings;

The firms they surveyed were listed on the New York Stock Exchange (NYSE) and classified four-digit Standard Industrial Classification (SIC) codes. A total of 562 NYSE firms were selected from three industrial groups: Utility (150), manufacturing (309), and wholesale/retail (103). They mailed questionnaire to obtain information about corporate dividend policy. The questionnaire consisted of three parts. First part consists of 15 closed-end statements about the importance of various factors that each firm used in determining its dividend policy. Second part consist of 18 closed-end statements about theoretical issues involving corporate dividend policy, and last part consist of a respondent's profile including such items as the firm's dividends and earnings per share.

They sent the final survey instrument to the chief financial officers (CFOs) of the 562 firms, followed by a second complete mailing to improve the response rate and reduce potential non-response bias. Their survey yielded 318 usable responses (a 56.6% response rate), which were divided among the three industry groups as follows: 114 utilities (76%), 147 manufacturing firms (47.6%), and 57 and wholesale/retail (5.3%). Based on dividend and earning per share data provided by the respondents, the 1981 average dividend payout ratio were computed. They found that payout ratio of the responding utilities (70.3%) were considerably higher than for manufacturing (36.6%) and wholesale/ retail (36.1 %).

They come to the conclusion that respondents from all three industries groups thought that investors have different perceptions of the relative friskiness of dividends and retained earnings and hence are not indifferent between dividend and capital gain returns. The respondents also demonstrated a high level of

agreement that the reasons for dividend policy changes should be adequately disclosed to investors. The respondents from all three industry groups agreed, on average, that dividend payouts provide a "signaling device" of future company prospects and that the market uses dividend announcements as information for assessing security value. Respondents from all three industry groups agreed relatively strongly that dividend payout affects common stock prices.

H.K. Baker and Aaron L. Phillips (1992) surveyed management views on stock dividend. They describe about the dividend policy in their published book in 1992 "Management's view on Stock Dividend". They address two major research questions in this survey.

- Firstly, why do some managers continue to support stock dividends given the apparently limited benefits of these distributions to shareholder?
- Second, do management views about the issues and motives for stock dividends differ based on the firm's trading location, the size of the stock dividend, or the frequency of issuing stock dividends?

Their sample contained all firms that paid at least one stock dividend between 1988 and 1990-100 NYSE/Amex firms and 26 Nasdaq firms. The source of their stock dividend firms was the CRSP Nasdaq and combined NYSE/Amex master files. They chose the 1980-90 periods for two reasons. First, they wanted the study period to span several years to avoid any potential bias of using a single year. Second, they wanted to period, long enough to provide a large sample size, but short enough to ensure getting someone knowledgeable about the firm's most recent stock dividend to answer the questionnaire. The questionnaire used by them had two parts. First part contained 15 closed-end questions on issues drawn from the finance literature about stock dividends. Second and last part contained seven questions about stock dividend decision and four questions about the respondent's profile.

They sent a survey questionnaire and a cover letter to the highest-ranking financial officer of each firm in early November 1991. Non-respondents received a follow-up survey and another cover letter one month later. Of the initial 312 questionnaires mailed, only 299 questionnaires were delivered. Of these 299 questionnaires, 136 firms completed and returned them, giving a response rate of 45.6%.

2.3.3 Review of Empirical Works During 2000 to 2008

This section is carried out to review the major studies concerning dividend during 2000 to 2008 period of time.

Table 2.3
Review of empirical works during 2000 to 2008

Doron Nissim and Amir Ziv (2001)	Dividend changes provide information about the level of profitability in subsequent years, incremental to market and accounting data. They also document that dividend changes are positively related to earnings changes in each of the two ears after the dividend change.
Claudio F. Lodere And David C. Mauer (2002)	Stock-offering announcement effects do not worsen if firms do not announce immediately after dividend declaration. Dividend-paying firms have significantly larger stock-offering in formativeness and elicit more negative issue announcement effects than non-dividend-paying firms. The only exception is the few firms who announce a dividend decrease prior to the equity issue.
H.K. Baker, Tarun K. Mukherjee, and Ohannes George Paskelian's Study (2008)	The most important factors influencing dividend decision are the level of current and expected future earnings as well the stability of earnings. They show that a firm should devise its dividend policy to produce maximum value for its shareholders. And they added that the firms express stronger support for a signaling explanation for paying dividends than they do for a tax-preference exclamation.

Doron Nissim and Amir Ziv (2001) have investigated the relation between dividend change and future profitability, measured in terms of either future earnings or future abnormal earnings. Supporting "the information content of dividends hypothesis,' researchers found that dividend changes provide information about the level of profitability in subsequent years, incremental to market and accounting data. They also document that dividend changes are positively related to earnings changes in each of the two years after the dividend change.

The findings are not symmetric for associated dividend increases and decreases. For the research full sample, dividend increases are associated with future profitability for at least four years after the dividend change, whereas dividend decreases are not related to future profitability after controlling for current and expected profitability. They conjectured that the lack of association between dividend decreases and future profitability is due to accounting conservatism.

Claudio F. Loderer and David C. Mauer (2002) have investigated on whether managers rely on dividends to obtain a higher price in a stock offering and whether the stock price reaction to dividend and offering announcements justifies such coordination. The sample of their research consists of all primary offerings of seasoned common stock reported by the investment dealers digest's directory of corporate financing for the years 1973-1984. The final sample consists of 450 offerings by industrial firms listed on either the New York or the American Stock Exchange. The following conclusions are derived from their study:

- There are no significant differences between the dividend policy decisions of sample of issuing firms and control samples of non issuing firms;
- Firms appear to time equity issue announcements after rather than before dividend declarations. However, the median time between the issue announcement and the immediately preceding dividend declaration is 24 trading days;
- There is no relation between stock-offering in formativeness or announcement effects and preceding dividend announcement effects; . Joint dividend and stock-offering announcement effects are not less negative than the simple offering announcement effects experienced by non-dividend-paying firms, and they are inconsistent with the predictions of the John and Williams (1985) signaling model

H. K. Baker, Tarun K. Mukherjee, and Ohannes George Paskelian's Study (2008) was conducted on "How Norwegian Managers View Dividend Policy". The main management views of this study's objects are as follows:

- To investigate the views of corporate managers of Norwegian dividend-paying firms listed on the Oslo Stock ,Exchange about (1) the determinants influencing the dividend policies of their firms and (2) theoretical and empirical issues about dividend policy in general.
- To compare the importance that Norwegian and U.S. managers attached to the factors influencing dividend policy.

The firms they surveyed were listed on the Oslo Stock Exchange and classified according to the Global Industry Classification Standard developed by Morgan Stanley Capital International, Inc. A total of 121firms were selected from three industrial scale groups: Mix of Small, Medium, and Large-sized firms with the four most common industry classifications- manufacturing, financial services, information technology and consulting services- represent about 66% of the population.

They mailed questionnaire to obtain information about corporate dividend policy. The questionnaire consisted of three parts. First part consists of 22 closed-end statements about the importance of various factors that each firm used in determining its dividend policy. Second part consists of 26 closed-end statements about theoretical issues involving corporate dividend policy, and last part consists of 6 closed-end statements about the background of respondents and their firms.

They sent the final survey instrument to the chief financial officers (CFOs) of the 121 firms. Their survey yielded 33 usable responses (27.3% response rate). The responding firms represent various industries of which the most common industry type is manufacturing (33.3%) followed by financial services (15.2%). No other industry group amounts to as much as 10% of the responding firms.

The results of their survey on the aspect of "How Norwegian Managers View Dividend Policy" were as follows:

- First, the most important factors influencing the dividend policy of Norwegian firms relate to earnings, specifi9ally the level of current and expected future earnings as well the stability of earnings.
- Second, the relative importance that managers of Norwegian firms attach to earnings in influencing dividend policy is similar to that previously reported by managers of U.S. firms.
- Third, Norwegian managers generally support some statements related to the concept that a firm's dividend policy matters. They show a high level of agreement that a firm should devise its dividend policy to produce maximum value for its shareholders.
- Finally, managers of Norwegian firms express stronger support for a signaling explanation for paying dividends than they do for a tax-preference explanation.

2.4 Concluding Remark

The review of above-mentioned studies carried out in western countries reveals many interesting findings on dividends. However, pertinent question arises as to what extent these findings are relevant for pertinent question arises as to what extent these findings are relevant for Nepal. They all may not be applicable for Nepal where the capital market is small and is emerging one. In fact, it is not the studies conducted in western countries that are more relevant for Nepal.

The literature on dividend policy has produced a large body of theoretical and empirical research, especially following the publication of the dividend irrelevance hypothesis of M&M (1961). No general consensus has yet emerged after several decades of investigation, and scholars can often disagree even about the same empirical evidence. In perfect capital markets, M&M asserted that the value of a firm is independent of its dividend policy. However, various

market imperfections exist (taxes, transaction costs, information asymmetry, agency problems, etc) and these market imperfections have provided the basis for the development of various theories of dividend policy including tax preference, clientele effects, signaling, and agency costs.

Although numerous studies have examined various issues of dividend policy, they have produced mixed and inconclusive results. We also observed that most of the studies conducted on dividend policy used data from developed markets. The evidence in relation to emerging markets is often very limited. However, recently, there has been a growing interest among academics and financial practitioners to examine corporate dividend policy in these emerging markets. In the case of Nepal, the evidence is even more scant, and provides further justification for the current research.

CHAPTER THREE
RESEARCH METHODOLOGY

Research methodology refers to the various sequential steps to adopt by a researcher in studying a problem with certain objectives in view. (Kothari, 1989) Research methodology describes the methods and process, which has been applied in the entire aspect of the study. In this study Research Methodology has been paid due attention to achieve the objectives of the study.

3.1 Research Design

Research design is a series of stages or tasks in planning or conducting a study. It is a consideration, which enter into making decisions regarding what, where, when, how much, by what means constitute a plan of study design. The research design of this study will be descriptive, correlation as well as analytical using the various phenomena related and influencing the dividend decision and future profitability. For this purpose secondary data and information are obtained from different reliable sources and primary data are obtained through questionnaire survey.

3.2 Population and Sample

For primary data and information, the survey of financial executives is based on a structured questionnaire. Dividend distributing financial and non financial sectors were selected from this purpose. The dividend decision of respondents of financial sectors may differ from the respondents of non financial sectors so the sample includes from both the sectors randomly. The sample selected for this section of the study is drawn from the groups of executives dealing directly or indirectly on dividend practice. The sample comprises 60 respondents.

Table 3.1
Sample Company for Secondary Data

Name of Organization	Sample Years	No of year observation	Percentage
ACE Development Bank	2000-2008	9	5.0
Bishal Bazar company	1997-2008	12	6.7
Bank of Kathmandu	2002-2008	7	3.9
Central Finance	2007-2008	2	1.1
Development and credit	2004-2008	5	2.8
Everest Bank Limited	2002-2008	7	3.9
Everest In	1999-2002	4	2.2
Himalayan Bank Limited	1997-2007	11	6.1
Maha laxmi Bank	2000-2002	3	1.7
NABlL Bank	1995-2008	14	7.8
Narayani Finance	2000-2002	3	1.7
National Finance	1995-1995	6	3.3
National Life & General In.	1995-1997	3	1.7
Nepal Aawash	1994-2002	5	2.8
Nepal Bank Limited	2000-2002	3	1.7
Nepal lever	2000-2008	3	1.7
Nepal Share market complex	2006-2008	3	1.7
Nepal lubricate	1998-2008	4	2.2
Nepal Investment Bank	1995-2008	14	7.8
NIC Bank	2007-2008	2	1.1
Nepal Insurance	1995-2002	8	4.4
Nepal Battery	1994-1999	6	3.3
Premier Insurance	1999-2002	4	2.2
Salt Trading	1995-2002	8	4.4
SBI Bank	1999-2007	9	5.0
Standard Charter Bank	1995-2008	14	7.8
Soltee Hotel	1997-2002	6	3.3
United Insurance	1999-2002	4	2.2
Yeti Finance	1999-2002	4	2.2
Total		183	100.0

To analyze secondary data, it was not appropriate to consider all the business sectors that are not paying dividend. Out of all listed business sector, only dividend distributing firms that are listed in Nepal Stock Exchange Ltd, were taken as sample. The sample was taken based on judgment of researcher. It

includes sample from 29 listed banking and non banking sectors of 183 observations from the year 1994 to 2008

3.3 Source of Data

This study is based on both primary and secondary data. To analyze the impact of dividend on future profitability, secondary data are taken into consideration. For the analytical purpose, the annual reports published by the relative business sectors and financial statements of the business sectors published by Nepal Stock Exchange Ltd. Were collected from the fiscal year 1997/98 to 2007/08.

To examine the dividend practices of financial and non financial sectors of Nepal, primary data and information are collected.' For this regard structured questionnaire survey is conducted from executive and manager of different sectors and their opinion regarding dividend practices are examined. The primary data is therefore based on visits to the business sectors of these respondents located in Katmandu Valley.

3.4 The Model

Multiple regression analysis, two or more independent variables are used to estimate the values of a dependent variables where as in simple or linear regression analysis a single independent variable is used to estimate the values of a dependent variable. (Shrestha, et.al, 2050) Multiple Regression analysis helps us to know the relative movement in the variables.

To examine the relationship between dividends change and future earning change, the theoretical statement of the model is that the future earning change deflated by Price on dividend change. The underlying assumption is that earnings follow a random walk, so the change in earnings measures unexpected profitability. The theoretical statements framed above may be stated as,

$$\frac{(\boldsymbol{E_r - E_{r-1}})}{\boldsymbol{P_{-1}}} = \boldsymbol{\alpha_0 + \alpha_1 R\Delta DIV_0 + \varepsilon_r}$$

Where,

r = year

E_r =earning in year r

P_{-1} = Price of stock at the beginning of the dividend year

R∆DIV = Rate in change of dividend

When earnings information is only considered then the expected change in earnings may be zero (or constant, if there is a drift). However, in the presence of additional information, this property may not hold. Since dividend changes are positively correlated with current ROE, the expected change in earnings is likely to be negative correlated with the dividend change. Hence, a lack of correlation between earnings changes and dividend changes would actually indicate that dividend changes are informative about future earnings. To address this issues following regression model has been suggested:

$$\frac{(\boldsymbol{E_r - E_{r-1}})}{\boldsymbol{B_{-1}}} = \boldsymbol{\alpha_0 + \alpha_1 R\Delta DIV_0 + \alpha_2 ROE_{r-1} + \varepsilon_r}$$

Where,

B = Book value of common equity

ROE = Ratio of earning to book value of equity

Dividend changes are highly correlated with contemporaneous earnings changes. Therefore, the positive relation between dividend changes and earnings changes in the two subsequent years may be due to autocorrelation in the earnings change series. To examine whether dividend changes contain information on future earnings changes, incremental to the earnings changes in the dividend change year, the model include $(E_O\text{-}E_{-1})/B_{-1}$ as an additional control variable. The following model is regressed:

$$\frac{(\boldsymbol{E_r - E_{r-1}})}{\boldsymbol{B_{-1}}} = \boldsymbol{\alpha_0 + \alpha_1 DPC_0 \times \alpha_1 R\Delta DIV_0 + \alpha_2 DNC_0 \times \alpha_2 R\Delta DIV_0} + \boldsymbol{\alpha_3 ROE_{r-1}} + \frac{\boldsymbol{\alpha_4(E_0 - E_{-1})}}{\boldsymbol{B_{-1}}} + \boldsymbol{\varepsilon_r}$$

Where,

E_r = earnings in year t relative to the dividend event year.

RΔDlV = the change in dividends.

DPC (DNC) = a dummy variable that equation for dividend increase (decrease).

P_{-1} = the market value of equity at the beginning of the dividend event year.

DIV_{-1} = total common dividend in the year before the dividend change.

According to the information content of dividend hypothesis, dividend changes trigger stock return because they convey new information about the firm's future profitability, which in turns determines equity price. Future earnings are affected by value- creating activities, but they are also affected by actions that are not directly relevant for current price, such as future retained earnings, stock issues and stock repurchase. Earnings in year r relative to the dividend change year are considered as dependent variable in the estimated model:

$$\boldsymbol{E_r = \alpha_0 + \alpha_1 DPC_0 \times R\Delta DIV_0 + \alpha_2 DNC_0 \times R\Delta DIV_0 + \alpha_3 E_{-1} + \alpha_4 B_{-1} + \alpha_5 P_{-1} + \alpha_6 DIV_{-1} + \alpha_7 E_0 + \varepsilon_r}$$

Where,

Er = earnings in year t relative to the dividend event year.

RΔDIV = the change in dividends.

DPC (DNC) = a dummy variable that equation for dividend increase (decrease).

P_{-1} = the market value of equity at the beginning of the dividend event year.

DIV_{-1} = total common dividend in the year before the dividend change.

The most basic test involved regressing the dependent variable PV against the three independent variables DA, PE Ratio and ASg. This provides a crude test of the relationship between common stock volatility and dividend policy. The following regression is adopted

$$PV=\alpha_0 + \alpha_1 DA + \alpha_2 PE\ Ratio + \alpha_3 ASg + \varepsilon_r$$

Where,

PV= Price Volatility

ASg= Growth in Assets

PE Ratio= Price Earning ratio

DA= Debt to Assets ratio

The difficulty with the specification above is that the three dividend policy variables are likely to be related plus a number of other factors are likely to influence both dividend policy and price volatility. In an attempt to limit these problems the regression is modified to include the control variables as shown below:

$$PV=\alpha_0 + \alpha_1 DA + \alpha_2 PE\ Ratio + \alpha_3 ASg + \alpha_4 DY + \varepsilon_r$$

Where,

DY= Dividend yield

The result of these regression models are analyzed in data presented and analysis chapter.

3.5 Variables Definition

Some financial indicators and variables used in this study are defined as follows:

RΔDIV

Rate of change in dividend per share is denoted as RΔDIV. this variable is calculated by taking difference between dividend per share of event year and lag dividend per share divided by lag dividend per share. This variable shows increase or decrease in dividend comparing to last year's dividend.

ROE

ROE is denoted for the variable return on equity calculated as Earning per share divided by book value per share. This variable explains annual return on book value of share.

DPC (DNC)

DPC is a dummy variable that equals one for dividend increase and zero for dividend decrease. At the same time another dummy variable is also used DNC that equals one for dividend decrease and zero for dividend increase.

Price Volatility

The dependent variable in the regression is derived by estimating variance of the rate of return. In this case, for each year, the annual range of stock price will be divided by the average of the closing and opening stock prices and then raised to the second power.

Dividend yield (DY)

The variable was calculated by dividing annual cash dividend paid to common stockholders by the closing market value of the stock in the year.

Payout Ratio (POR)

This ratio indicates the ratio of Dividend per share paid out to shareholder with comparison to earning per share. The use of this procedure controls the problem of extreme values in individual years attributable to low or possibly negative net income.

Size (SZ)

The variable size was constricted in a form that reflects the order of magnitude in real terms. The variable was constructed by taking the average market value of common socks.

Debt to total assts ratio (DA)

The ratio of the sum of all the total debt to total assets is taken.

Growth in Assets (ASg)

The yearly growth rate was calculated by taking the ratio of the change in total assets in a year.

PE Ratio

The variable is calculated by dividing closing market price per share of the year by earning per share on common stock.

CHAPTER -IV
PRESENTATION AND ANALYSIS OF DATA

Though the argument of the irrelevance of corporate dividend policy in perfect capital markets has been very important in financial theory, there is also much controversy about dividend policy in the real world where market perfections exist. The presence of information asymmetry, agency problems, taxes, and transaction costs all seem to make dividend policy matter. Literature review established that a large body of theoretical and empirical research has attempted to identify the determinants of corporate dividend policy. To date, however, there is no consensus about what factors affect corporate payout policy. The issue gets even more complicated when it comes to emerging markets. This study attempts to provide an insight into dividend policy in one emerging market where there is a lack of evidence about the determinants of corporate dividend decisions.

4.1 Dividend Change and Future Earning Changes

In this section, secondary data has been used to explain the current earning and its influence on future profitability. For this purpose different statistical tool like average, standard deviation, correlation and multiple regression analysis is used to analyze relationship among different key variable. Table 4.1 presents descriptive statistics for the sample. The total no. of sample consist of 183 observations: 95 dividend increase, 49 dividend decrease and 39 no change observation. Observation of Dividend increase is more frequent then dividend decrease. Average rate of change in dividend is 16.79% with standard deviation of 68.92. Average rate of decrease in dividend is -57.77% with standard deviation of 36.48 and average rate of increase in dividend is 62.14% with standard deviation 58.52. (See Panel A).

Table 4.1

Description of Sample

RL\DIV is the rate of change in dividend per share. Average and standard deviation is calculated out of 180 sample observation for Dividend. DPS is the Dividend per share, EPS is earning per share, and ROE is return on equity calculated as Earning per share divided by book value per share.

Panel A: Sample				
	Dividend increase	Dividend decrease	No change	Total
No of observation	95	49	39	183
Average RL\DIV	62.14%	-57.77%	0	16.79%
SD on RL\DIV	58.52	36.48	0	68.92

Panel B: Descriptive Statistics		
	Mean (Rs)	Std. Deviation
DPS	27.14	28.10
EPS	57.33	58.83
Market Price	769.62	702.18
Book Value	234.86	200.72
ROE	22.90	11.61

Panel B reflects the average and standard deviation of key variables like dividend per share, earning per share, market price per share, book value per share and return on equity for 183 observations of 30 listed companies.

Correlation Matrix

Correlation analysis is used to describe the degree to which one variable is linearly related to other variables. The coefficient of correlation measures the degree of relationship between two sets of figures. When the one variable increases leads in increase in other variable or both the variables are changing in the same direction, than correlation is said to be positive but when one variable increase cause decrease in other variables or two variables take place in opposite direction, the correlation is termed as negative. Correlation

coefficient helps to identify and predicts the relationship between two variables at a time.

Table 4.2

Correlations Matrix

RDIV is the rate of change in dividend per share. DPS is the Dividend per share, EPS is earning per share, and ROE is return on equity calculated as Earning per share divided by book value per share.

	Dividend Per share	Earning Per Share	Market Price	Book Value	ROE	RΔDIV
Dividend Per share	1	.547(**)	.544(**)	.283(**)	.673(**)	.249(**)
Earning Per Share	.547(**)	1	.489(**)	.869(**)	.551 (**)	.051
Market Price	.544(**)	.489(**)	1	.331 (**)	.473(**)	-.119
Book Value	.283(**)	.869(**)	.331 (**)	1	.152(*)	-.054
ROE	.673(**)	.551 (**)	.473(**)	.152(*)	1	.181 (*)
RΔDIV	.249(**)	.051	-.119	-.054	.181 (*)	1

** Correlation is significant at the 0.01 level (2-tailed).
* Correlation is significant at the 0.05 level (2-tailed).

Table 4.2, represent the correlation between different key variable. The lowest significant coefficient of correlation exists between rate of change in dividend and return on equity, which indicate there is weak relation between that two variable. Return on equity may not influence the decision of dividend because the distribution of dividend decision is taken by manager for signaling effect of dividend. Highest correlation can be observed between variable earning per share and book value per share. Higher earning increases the book value of share. Hence they are highly positively correlated. Highest correlated variable causes multi co-linearity in the result of multiple regressions.

A. Initial Analysis

In this section, the relation between dividend change and future earning change is investigated. For this purpose the following regression equation has been run:

$$\frac{(E_r - E_{r-1})}{P_{-1}} = \alpha_0 + \alpha_1 R\Delta DIV_0 + \varepsilon_r$$

For r = 0, 1, and 2, where E_r denotes earnings in year r, P-1 is market value of equity at the beginning of the dividend event year and $R\Delta DIV_o$ is the rate of change in dividend per share. The table 4.3 provides pooled OLS estimate results. The findings shows a1 positive and significant for r = 0 but it is insignificant for r = 1 and r = 2.

Table 4.3

Summary Statistic from Regression of Future Earnings Change, Deflated by Price on the Dividend Change

E_r denotes earnings in year r relative to the dividend event year (year 0). P_{-1} is Market value of equity at the beginning of the dividend event year. RΔDIVo is the rate of change in dividend per share. For each regression, the first row reports the coefficient and the second row reports t-statistics.

$\frac{(E_r - E_{r-1})}{P_{-1}} = \alpha_0 + \alpha_1 R\Delta DIV_0 + \varepsilon_r$			
r	α_0	α_1	R^2
0	1.078	0.020	0.047
	2.243*	2.997**	
1	0.582	0.008	0.006
	1.037	1.070	
2	0.223	-0.005	0.003
	0.413	-0.694	

**Coefficient is significant at the 0.01 level (2-tailed)
*Coefficient is significant at the 0.05 level (2-tailed).

Hence the dividend increase (decrease) indicates that current year earnings will be higher (lower) than the previous year's earnings. For subsequent years there is no significant relation between dividend change and earning change.

B. Alternative Specifications

In this section, relation between dividend change and return on equity with earning change is investigated. Where change in earning deflated by book value is dependent variable and change in dividend and return on equity is independent variable. For this purpose the following regression equation has been regressed:

$$\frac{(E_r - E_{r-1})}{B_{-1}} = \alpha_0 + \alpha_1 R\Delta DIV_0 + \alpha_2 ROE_{r-1} + \varepsilon_r$$

Table 4.4

Summary Statistic from Regression of Future Earnings Change, Deflated by Book Value, on the Dividend Change and Control variables

Er denotes earnings in year r relative to the dividend event year (year 0). $R\Delta DlV_o$ is the rate of change in dividend per share. ROE_r is calculated as Er1Br, where Br is the Book value of equity at the end of year relative to the dividend event year. DPC (DNC) is a dummy variable that equation for dividend increase (decrease). For each regression, the first row reports the coefficient and the second row reports t-statistics.

Panel A: $\frac{(E_r-E_{r-1})}{B_{-1}} = \alpha_0 + \alpha_1 R\Delta DIV_0 + \alpha_2 ROE_{r-1} + \varepsilon_r$				
r	α_0	α_1	α_2	R^2
1	3.861	0.003	-0.099	0.012
	2.268*	0.263	-1.475	
2	4.078	-0.022	-0.156	0.057
	2.381*	-1.999*	-2.284*	

Panel B: $\frac{(E_r - E_{r-1})}{B_{-1}} = \alpha_0 + \alpha_1 DPC_0 \times \alpha_1 R\Delta DIV_0 + \alpha_2 DNC_0 \times \alpha_2 R\Delta DIV_0 + \alpha_3 ROE_{r-1} + \frac{\alpha_4(E_0 - E_{-1})}{B_{-1}} + \varepsilon_r$						
r	α_0	α_1	α_2	α_3	α_4	R^2
1	4.428	0.003	-0.013	-0.150	0.134	0.031
	2.178 *	0.195	-0.520	-2.001 *	1.749	
2	4.723	-0.030	-0.010	0.034	-0.169	0.060
	2.435 *	-1.904	-0.391	0.475	-2.352*	

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

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

The result reported in Table 4.4 show that in both the year (r = 1 and 2), a1 is insignificant and a2 is insignificant for year (r = 1) but negative and significant for year (r = 2). Hence this result does not support the information content of dividend hypothesis, so dividend changes are not informative about future earnings changes in each of the two subsequent years.

To allow for different coefficients on dividend increase and decrease, following model has been regressed

$$\frac{(\boldsymbol{E_r - E_{r-1}})}{\boldsymbol{B_{-1}}} = \boldsymbol{\alpha_0 + \alpha_1 DPC_0 \times \alpha_1 R\Delta DIV_0 + \alpha_2 DNC_0 \times \alpha_2 R\Delta DIV_0} + \boldsymbol{\alpha_3 ROE_{r-1}} + \frac{\boldsymbol{\alpha_4(E_0 - E_{-1})}}{\boldsymbol{B_{-1}}} + \boldsymbol{\varepsilon_r}$$

For r = 1 and 2, where DPC (DNC) is a dummy variable that equation for dividend increase (decrease) and zero otherwise. Results are reported in Panel B of Table II. For year (r = 1 and 2) the coefficient of dividend increase and decrease both are insignificant.

C. Dividend Changes and the Level of Future Profits

Regression models is estimated where the dependent variable is earnings in year r relative to the dividend change year (r= 1 and 2). In all cases the dependent variables are the dividend change (allowing for different coefficient for increase and decrease), the instruments for expected earnings. The regression model is:

$$\boldsymbol{E_r} = \boldsymbol{\alpha}_0 + \alpha_1 \mathrm{DPC}_0 \times \mathrm{R\Delta DIV}_0 + \alpha_2 \mathrm{DNC}_0 \times \mathrm{R\Delta DIV}_0 + \alpha_3 \mathrm{E}_{-1} + \alpha_4 \mathrm{B}_{-1} + \alpha_5 \mathrm{P}_{-1} + \alpha_6 \mathrm{DIV}_{-1} + \alpha_7 E_0 + \varepsilon_r$$

Table 4.5

Summary Statistic from Regression of Future Profits on the Dividend Change, Instruments for Expected profits and Current Profits

The Equations are deflated by the book value of common equity at the beginning of the dividend event year, B_{-1}. E_r is earnings in year t relative to the dividend event year. RΔDlV is the change in dividends. DPC (DNC) is a dummy variable that

equation for dividend increase (decrease). P_{-1} is the market value of equity at the beginning of the dividend event year. DIV_{-1} is total common dividend in the year before the dividend change. For each regression, the first row reports the coefficient and the second row reports t-statistics.

$$E_r = \alpha_0 + \alpha_1 \mathrm{DPC}_0 \times \mathrm{R}\Delta\mathrm{DIV}_0 + \alpha_2 \mathrm{DNC}_0 \times \mathrm{R}\Delta\mathrm{DIV}_0 + \alpha_3 \mathrm{E}_{-1} + \alpha_4 \mathrm{B}_{-1} + \alpha_5 \mathrm{P}_{-1} + \alpha_6 \mathrm{DIV}_{-1} + \alpha_7 E_0 + \varepsilon_r$$

r	α_0	α_1	α_2	α_3	α_4	α_5	α_6	α_7	R^2
1	2.637	0.123	0.031	-0.079	0.041	0.006	0.324	0.593	0.629
	0.444	2.159*	0.360	-0.660	1.241	1.239	2.116*	6.991**	
2	17.383	0.088	0.052	0.232	-0.041	0.010	0.417	0.244	0.517
	3.302**	1.745	0.679	2.182*	-1.388	2.425*	3.075**	3.242**	

** Coefficient is significant at the 0.01 level (2-tailed)
*Coefficient is significant at the 0.05 level (2-tailed).

Table 4.5 presents summary statistics from regressions of equation for r = 1 and 2. As shown, dividend increase is positively related to earnings in each of the year and dividend decrease is not related to future earnings. The lack of correlation coefficient between dividend decrease and future earnings does not necessarily imply that dividend decreases are not informative about future earnings. The informative content of divided may be captured by current year's earnings, which are disclosed after the dividend decrease announcement.

4.2 Dividend Policy and Stock Price Volatility

In this section, secondary data has been used to explain the dividend policy and stock price volatility. For even this purpose different statistical tool like average, standard deviation, correlation and multiple regressions analysis is used to analyze relationship among different key variable. Table 4.6 presents descriptive statistics for the sample. The total no of sample consist of 131 observations. The average volatility is calculated as 0.307 and standard deviation of 0.541.

Table 4.6

Descriptive Statistics Mean Std. Deviation

	Mean	Std. Deviation
Price Volatility (PV)	.30705778	.541665557
Dividend Yield (DY)	3.7367	3.73349
Price Earning Ratio (PE Ratio)	20.2993	27.74653
Pay Out Ratio (POR)	43.3484	49.25912
Debt to Assets Ratio (DA)	89.3051	11.17281
Growth in Assets (ASg)	46.0110	224.28005
Size of firm (logSZ)	7.1146	1.44871

Table 4.7 reports the correlation between the variables utilized for the overall period. The correlation between price volatility and PE ratio is 0.447, which is highest positive correlation and significant at 0.01. The second highest correlation exists between price volatility and growth in assets, which is positive and significant. Which means that higher growth in assets and PE Ratio firms have higher price volatility.

Table 4.7

Correlations

	PV	DY	PE Ratio	POR	DA	ASg
DY	.000					
PE Ratio	.447(**)	-.311(**)				
POR	.078	.364(**)	.215(*)			
DA	- .231 (**)	-.161	-.103	-.069		
ASg	.438(**)	-.063	.031	-.095	-.05	
Log SZ	-.151	-.414(**)	.238(**)	-.021	.365(**)	-.188(*)

** Correlation is significant at the 0.01 level (2-tailed).
* Correlation is significant at the 0.05 level (2-tailed).

The third highest correlation is between dividend yield and Size of firm, which is negative and significant. This indicates that larger size firm has low dividend yield. The correlation between price volatility and dividend yield is almost zero

and it is insignificant. No relationship exists between price volatility and dividend yield.

To avoid the multi co linearity, there should be weak correlation between independent variables. The correlation between PE Ratio and Debt to Assets ratio is week and insignificant as well as correlation between other two independent variables Debt to total assets and growth in assets is lower and insignificant.

Table 4.8

Summary Statistic from Regression of price volatility on dividend yield, Price earning ratio, debt to assets ratio and growth in assets

PV denotes for price volatility. DY is for dividend yield. PE Ratio is price earning ratio. DA is the ratio of debt and total assets for the event year and ASg is the growth in assets.

$PV=\alpha_0 + \alpha_1 DY + \alpha_2 PE\ Ratio + \alpha_3\ DA + \alpha_4 ASg + \varepsilon_r$				
Variables	Coefficient	Beta	t-value	Sig.
Constant	0.663		2.081	0.039
DY	0.021	0.147	2.026	0.045
PE Ratio	0.009	0.463	6.459	0.000
DA	-0.007	-0.154	-2.230	0.028
ASg	0.001	0.430	6.382	0.000
R^2=0.413				

Multiple regression analysis is used to analyze the dependent variable Le. Price volatility with respect to three independent variables like debt assets ratio, price earning ratio, growth in assets and dividend yield. When the multiple regression models having three independents variables are run, the result are obtained as presented in table 4.8.

The result estimated from equation having dividend yield and debt to assets ratio are significant at 5% level of significance and other two independent variables PE Ratio and growth in assets are significant at 1 % level of significance. The coefficient of dividend yield (0.021) is much greater then other independent variables. The growth in assets has smallest coefficient (0.001) compared to other independent variable. The variable debt to assets ratio is negatively correlated with price volatility.

Table 4.9

Summary Statistic from Regression of price volatility on Price earning ratio, debt to assets ratio and growth in assets

PV denotes for price volatility. PE Ratio is price earning ratio. DA is the ratio of debt and total assets for the event year and ASg is the growth in assets.

$PV=\alpha_0 + \alpha_1 DA + \alpha_2 PE\ Ratio + \alpha_3 ASg + \varepsilon_r$				
Variables	Coefficient	Beta	t-value	Sig.
Constant	0.887		2.931	0.004
PE Ratio	0.008	0.415	6.061	0.000
DA	-0.009	-0.183	-2.670	0.009
ASg	0.001	0.422	6.197	0.000
$R^2 = 0.398$				

Now, one of the variable dividend yield is dropped and another regression result was obtained presented on table 5.9 where price earning ratio, debt to assets ratio and growth in assets is dependent variable.

The above derived result shows that, all the independent variables are significant at 1 % level of significance. The debt to assets ratio has highest and negative coefficient of 0.009. even after dropping one of the independent variable result has not improved so it indicate that dividend yield plays significant role in price of stock in Nepal. Hence dividend yield has become

more important determinant of share price volatility as compared to payout ratio. This shows that the Nepalese corporations have improved the market and now companies are paying dividend more and investors are also pricing the shares in this basis.

However there may be difference in result based on secondary data and practices and view of respondents based on primary analysis through questionnaire survey. Hence next section carried out for primary analysis based on questionnaire survey of respondents selected from listed corporation.

4.3 Dividend change and Future Earning Changes: A Survey

Decision of executive have great influence on success of business sectors, so study on how executive make dividend decisions are one of the objective of this study. This study will also help on development of realistic theoretical modals and test empirically the different hypothesis concerning dividend policy. Hence, this chapter is based on primary data analysis mainly deals with qualitative aspects of corporate dividend policy.

For the purpose of collecting primary data, total 100 structured questionnaires have been distributed among business sectors' Chairman, managing director, general manager, financial manager, and branch manager, but only 60 respondents respond on those questionnaires.

4.3.1 Major Aspects of Corporate Dividend Policy

The major aspect of questionnaire includes assessing priority for major decisions of finance, motives for paying cash and stock dividends, factors affecting corporate dividend policy, suggestion and recommendation on dividend policy, views regarding own share purchase, views on observations on corporate dividend policy. The pro-forma of structured questionnaire is presented in annex A. These respondents are from those business sectors, which stocks are held by general public. Among that five questionnaires are

from Manufacturing sector, twenty six questionnaires are from Commercial Banks, nine questionnaires from Insurance and twenty questionnaires from Finance companies listed in Nepal Stock Exchange. The respondents consist of ten Chief Finance Officers, fourteen Chief Executive Officers and thirty six Middle Managers. Among these respondents fourteen of them have 1-3 years of experience, twenty nine of them have 4-6 years of experience, sixteen of them have 7-9 years of experience and only one has above 10 years of experience.

4.3.2 Priority for Dividend Decision

For the importance of major decisions of finance like financial decision, investment decision and dividend decision, respondents are asked to rank for there preference. Among 60 respondents, they ranked there preference according to their view.

Table No. 4.10

Priority for Dividend Decision

For first rank 1 dummy variable has been assigned, for second rank 2 dummy variable has been given and for third rank 3 Dummy variable has been assigned.

	Mean	Std. Deviation	t-value	Sig. (2-tailed)	Overall Rank
Financial decision	1.57	.698	-4.810	.000	1
Investment decision	1.70	.619	-3.755	.000	2
Dividend decision	2.73	.578	9.822	.000	3

After observing the result, the total weighted average of financial decision is lowest that is 1.57 with standard deviation of 0.698. Then second position occupies by investment decision scoring 1.70 weighted average ranks and finally dividend decision has lowest rank. For all the decision t-value is significant. It indicates that the management of business sectors most prefers

for financial decision and second preference gives to investment decision. Last preference is given to dividend decision. So, the manager is putting their more effort for managing their surplus fund to invest in better opportunity and gives less preference to dividend decisions.

4.3.3 Important Dividend Decision

Regarding the motives for paying cash dividend, majority of respondents approximately 40% expresses that cash dividend is distributed to increases the market price of share. Where as 25% of the respondents support the view that it is to convey positive information to its stack holder. However, 18.3% express that it is to fulfill shareholders expectation and only 16.7% each of respondents express their view that to draw attention of investor.

With respect to dividend as a residual decision, 51.7% of respondent doesn't support that dividend as a residual decision but at the same time 43.3% respondent support this decision as residual decision in the context of Nepalese business environment. Whereas 5% respondents feel that they are indeterminate with respect to this decision. This proposition indicates that in spite of dividend policy is given less preference, new trend has been emerged not to treat dividend as a residual decision. So slowly the manager's preference toward dividend policy has been changing.

Table 4.11

Responses on Major Aspects of Other Dividend Policy

With respect to questionnaire survey relating some of the major dividend decision, the respondents responses are summarize in the table.

Dividend Decision		Yes		No		No idea	
		No.	%	No.	%	No.	%
A	Residual decision	26	43.3	31	51.7	3	5
B	Indifferent Shareholders	20	33.3	38	63.3	2	3.3
C	Influence on price due to announcement of earning	31	51.7	24	40	5	8.3
D	Affordable price of listed company	14	23.3	40	66.7	6	10
E	Stock split for more popularity	17	28.3	40	66.7	3	5
F	Influence of Share repurchases	37	61.7	18	30	5	8.3

For the response from respondent about Nepalese shareholders' indifference whether the company pays or does not pay dividend. Majority of respondents, nearly 63.3% expresses that Nepalese shareholders are really not indifferent whether the company pays or does not pay dividend. 20% indicate that shareholders are still indifferent in this aspect. Remaining 3.3% respondents are neutral in this aspect.

With respect to whether the announcement of earning will help to increase market price of a share or not, 51.7% respondents express their view that the announcement of earning will help to increase the market price of a share, because it increases in goodwill of the bank and safe guard the shareholders' investment. At the same time 40% disagree that announcement of earning will help to increase market price of share but there are other factors that also influence the price. Only 8.3% of respondents have no ideas regarding this matter.

Regarding the view that stocks of listed banking sectors have popular and affordable price range, 66.7% respondents have negative consideration and 23.3% respondents have positive outlook. 10% respondents refuse to give any idea on this matter.

At the suggestion of listed company to go for stock split so that shares can be placed within a more popular trading range, q6.7% respondents suggested that stock split may not be the solution for placing stock trading at more popular range but 28.3% respondents recommended to go for stock split so that stock price will reduce and affordable by small investor. 5% of respondents have no ideas regarding benefits or weakness of stock splits.

Regarding own share re-purchase decision as favorable influence on shareholder wealth, majority of respondents, nearly 61.7% have supported the decision of own share repurchase decision. Where as 30% respondent neglect

to support this decision as a shareholder's wealth maximization but they thought that it may bring evil practice to raise the market price and due to speculation the share price would increase. 8.3% respondent has no idea, because in Nepal the decision of share repurchase is not frequently practiced and not all the managers are well informed about it.

Regarding the suggestion of when the bank has no sufficient cash to pay dividend, what policy should be adopted. 58.3% respondents indicate to pay stock dividend would be better option but 21.7% respondent are not in the favor of paying cash dividend and suggested do not pay cash or stock dividends at all. However 20% suggested that fund can be borrowed from other source and then cash dividend can be distributed.

4.3.4 Motive of Stock Dividend

With respect to motives of stock dividend, the lowest average value is 1.78 for the variable "to provide high psychological value to shareholders" hence it is . ranked as first and second rank is given to variable "to preserve cash". The first preference given by respondents is to provide high psychological value to shareholders.

Table 4.12

Motives of Stock Dividend

For most important variable 1 dummy variable has been assigned, for important variable 2 dummy variable has been given 3 dummy variable given to neutral, 4 for unimportant and for least important 3 Dummy variable has been assigned.

	Mean	Std. Deviation	t	Sig. (2-tailed)	Overall Rank
To provide high Psychological value	1.78	.783	-12.034	.000	1
To conserve cash	1.95	1.096	-7.422	.000	2
To indicate high future profits	3.50	1.372	2.824	.006	3
To raise future dividend	3.83	1.028	6.280	.000	4
To lower the firm's price	3.93	.972	7.438	.000	5

Consider that nothing pleases shareholder more than receiving stock dividend, so stock dividend distributed for psychological value. Second preference is given to conserve cash balance in banking sectors. Stock dividend stops cash from outflow from bank and it helps to maintain liquidity position. The t- value for the first two ranks is significance at 1 % level of significant.

4.3.5 Determining of Firms' Dividend Policy

With the view .to explore factors determining corporate dividend policy, ten possible factors are taken into consideration. The respondents are asked to circle the level of important factors. Dummy variable 1 was given to low level of importance and dummy variable 4 was assigned to high level of importance.

Table 4.13

Determining of Firms' Dividend Policy

For level of importance none 1 dummy variable has been assigned, for low level of importance 2 dummy variable has been given 3 dummy variable given to moderate level of importance and 4 for high level of importance has been assigned.

	Mean	Std. Deviation	t	Sig. (2-tailed)	Over all Rank
Level of current earning	3.2	.708	7.655	.000	1
Stability of earning	3.1	.775	6.000	.000	2
Pattern of past dividend	2.97	.938	3.853	.000	3
Level of expected future earnings	2.75	.773	2.505	.015	4
Concern about affecting the stock price	2.7	1.013	1.529	.132	5
Desire to maintain a given payout ratio	2.4	.848	-.914	.365	6
Desire to send favorable signal	2.37	.758	-1.362	.178	7
Liquidity constraints (availability of Cash)	2.28	.940	-1.785	.079	8
Current degree of financial leverage	2.02	.813	-4.606	.000	9
Legal rule and constraints	1.67	.681	-9.484	.000	10

The based on average score, highest average value is ranked as 1 and respectively for lower values ranks are assigned. The Level of current earning receives highest average score hence ranked as 1. It indicates that when there is higher level of earning in the corporation the dividend determination becomes easy. Similarly second and third rank is given to Stability of earning and Pattern of past dividend respectively. These variables also play big role on determination on dividend policy. When level of current earning is high and past dividend pattern is in increasing trend then level of expected dividend increases. The t-value of these three variables is significant at 1 % level of significance. Other variable are either not significant at 5% level of significant or they are ranked as low level of importance.

4.3.6 Issues Involving Corporate Dividend Policy

At the second last part of the questionnaire, respondents are given ten statement of different proposition to give their reaction as strongly agreed, agree, neutral disagree and strongly disagree regarding issues involving corporate dividend policy. The respondents are asked to circle the level of Agreement and disagreement regarding the statement. Dummy variable 1 was given to strongly disagree and dummy variable 5' was assigned to Strongly Agree. The based on average score, highest average value is ranked as 1 and respectively for lower values ranks are assigned.

The variable Dividend gives free publicity is ranked as 1 as its average score is highest. When corporation distribute dividend then it gives positive signal about the corporation and hence boost up the image. The second and third rank was given to short term positive reaction of cash dividend and stock dividend preferred then cash dividend respectively.

Table 4.14

Issues Involving Corporate Dividend Policy

For Strongly disagree 1 dummy variable has been assigned, for Disagree dummy variable 2 has been given, dummy variable 3 given to no opinion, 4 for agree and Dummy variable 5 for Strongly Agree.

	Mean	Std. Deviation	t	Sig. (2-tailed)	Overall Rank
Dividend gives free publicity	3.60	1.153	4.032	.000	1
Short term positive reaction of Cash dividend	3.57	.673	6.521	.000	2
Stock dividend preferred then cash	3.50	.911	4.250	.000	3
Shareholder like regular dividend	3.37	.991	2.866	.006	4
Shareholder expect Cash dividend	3.17	..668	1.932	.058	5
Institutional Investor prefer Cash	3.10	1.053	.736	.465	6
Dividend help keep the stock price Up	3.02	1.017	.127	.899	7
Increasing shareholder important objective	2.73	.936	-2.206	.031	8
Firm like Share owned by institutions	2.63	.901	-3.151	.003	9
Not believe that shareholder are interested in dividend	2.27	.841	-6.754	.000	10

Due to declaration of dividend the price of the corporation increase for short term period hence stock dividend is preferred by shareholders. The t- value is significance at 1 % level of significant. Other variable are either not significance at 5% level of significant or the respondents are strongly disagree that those factors are issues of dividend policy.

4.3.7 Suggestion and Recommendation Regarding Dividend Policy

When respondents are asked give their suggestion regarding dividend policy for Nepalese corporation then around 46.7% of respondents suggested that the corporation should plan and maintain adequate cash balance to provide cash dividend because some of the shareholder may depend upon dividend income.

Table 4.15

Suggestion regarding dividend policy

With respect to questionnaire survey relating some of the suggestion regarding dividend policy for Nepalese corporation, the respondents responses are summarize in the table.

Suggestion	Frequency	Percent
Cash balance for dividend be adequately planned and maintained	28	46.7%
Stability of dividend and un-haphazard payout ratio	14	23.3%
Legislation regarding minimum dividend be enacted	13	21.7%
Treatment of dividend as an obligation	5	8.3%

At the same time 23.3% respond suggested on stable dividend payout ratio and 21.7% respondent focus on government should pass legislation regarding minimum dividend amount.

Regarding the recommendation for Nepalese corporation 45% respondents recommended for Steady dividend at a level higher than present level because the current level is not satisfactory for the shareholder.

Table 4.16

Recommendation regarding Dividend Policy

With respect to questionnaire survey relating some of the recommendation regarding dividend policy for Nepalese corporation, the respondents responses are summarize in the table.

Recommendation	Frequency	Percent
Steady dividend at a level higher than present level	27	45%
Steady dividend at the present level	15	25%
Steady dividend at a level lower than present level	10	16.7%
No dividend at all and conserve cash for future investment	8	13.3%

If current level of dividend can not be increased then at least the corporation should maintain the present level of dividend. But 16.7% respondents recommended decreasing the current level of dividend and 13.3% suggested that dividend should not be distributed and the profit should be retained for future profitable investment.

4.4 Major Findings of the Study

1. The study shows that increase in earnings depends on increase in dividends for the first two years and after two years such relationship does not exist.
2. The analysis revealed that Nepalese firms reexamine its dividend policy annually.
3. The study noticed that some of Nepalese firms do not have regular dividend payout policy.
4. Shareholders prefer stock dividend then cash dividend and it also gives free publicity for the organization.
5. Stability of earning and current level, of earning helps to determine the dividend policy of firms so these factors plays vital role on divined policy determination.
6. The cash balance for dividend should be adequately planned and maintained so that dividend policy would be stable.

CHAPTER-V

SUMMARY CONCLUSION AND RECOMMENDATIONS

5.1 Summary

Dividend policy is considered to be one of the most important financial decisions that corporate managers encounter. This is because it is hypothesized to perform a series of often conflicting roles in financial management to manage the various capital market imperfections prevalent in the real world. The enhanced corporate dividend practice is thus a vital means to work out the problem of asymmetric information between management of newly established Nepalese corporation and investors who have invested their funds therein.

The study mainly aims to review dividend practices of corporate sectors in Nepal. Its specific objectives are: (i) To analyze the factors influencing in making the dividend policy decision, (ii) To study the issues involving corporate dividend policy in general, (iii) To examine the relationship between dividend change and earning change. (iv) To analyze the change in future profits due to change in dividend. And (V) To find the role of dividend policy measures i.e. dividend yield and on share price change in the long run.

The study is based on secondary data of 14 fiscal years as well as primary sources of information. The entire sample taken from banking and non banking sectors are listed in Nepal Stock Exchange (NEPSE) Ltd. To analyze the impact of change in dividend on future profitability the various key variables such as earning per share, dividend per share, market value, return on equity, book value of 29 banking and non banking sectors for the period of 1993 to 2006 are considered. With the help of correlation coefficient, the relationship of these variables are determined and analyzed. To study the relationship between changes in dividend and its impact on future profitability various model has been used. For primary data and information, the survey of financial

executives is based on a structured questionnaire. Total 60 respondents gave their response regarding different aspects of corporate dividend practice of corporate sectors of Nepal. The Major findings of the studies are stated as follows:

1. The correlation coefficient between book value and earning per share is highly positive. It shows strong relation between the two variables. Correlation coefficient between book value and rate of change in dividend is very week.
2. The regression result where dividend change is independent variable and earning changes deflated by lag market price is dependent variable, shows that the dividend increase (decrease) indicates that current year earnings will be higher (lower) than the previous year's earnings. For subsequent years there is no significant relation between dividend change and earning change.
3. The modified regression model where change in earning is deflated by book value reported that the result does not support the information content of dividend hypothesis, so dividend changes are not informative about future earnings changes in each of the two subsequent years.
4. In the regression model where earning is taken as dependent variable which depends upon different control variable. The result shows that dividend increase is positively related to earnings in each of the year and dividend decrease is not related to future earnings. The informative content of divided may be captured by current year's earnings, which are disclosed after the dividend decrease announcement.
5. The dividend policy measure i.e. dividend yield has significant impact on the share price volatility and suggest that dividend policy affects stock price volatility.
6. The other variables like growth in assets, debt to assets ratio and PE ratio also influence the price volatility of the firm.
7. Among the major decisions of finance, the management of corporate sectors most prefers for financial decision and second preference gives

to investment decision. Last preference is given to dividend decision. It indicates that dividend decision is relatively less important.

8. Regarding the motives for cash payment, majority of the respondent support the view that cash dividend is distributed to increases the market price of share. Where as some of them expresses that it is to convey positive information to its stack holder. With respect to dividend as a residual decision, the majority of respondent doesn't support that dividend as a residual decision.
9. Majority of respondents expresses that Nepalese shareholders are really not indifferent whether the company pays or does not pay dividend and few point out that shareholders are still indifferent in this aspect. With respect to whether corporate sectors announcement of earning will help to increase market price of a share or not, majority respondents express their view that the announcement of earning will help to increase the market price of a share, because it helps in increase in goodwill of the banks and safe guard the shareholders' investment.
10. Regarding the view that stocks of listed corporate sectors have popular and affordable price range, majority of respondents have negative consideration. At the suggestion of, banking sectors to go for stock split so that shares can be placed within a more popular trading range, majority of respondents recommended to go for stock split. Regarding own share purchase decision as favorable influence on shareholder wealth, majority of respondents have supported the decision of own share repurchase decision.
11. Regarding the suggestion, if the bank has no sufficient cash to pay dividend, what policy should be adopted. Majority of respondents indicate to pay stock dividend but few also suggested that fund can be borrowed from other source and then cash dividend can be distributed. With respect to motives of stock dividend, the first preference given by respondents is to provide high psychological value to shareholders. Second preference is given to conserve cash balance in banking sectors.

12. With the view to explore factors determining corporate dividend policy, ten possible factors are taken into consideration. Among the first three ranks was given to variable like stability of earning, level of current earnings, and pattern of past dividend respectively.
13. To explore the issues determining dividend policy of corporate sector, the respondents have ranked dividend gives free publicity as first rank, short term positive reaction of cash dividend and st9ck dividend preferred then cash dividend was ranked as second and third rank respectively.

5.2 Conclusion

The above mentioned major findings led this study to conclude that after controlling for the expected change in future earnings, dividend changes are positively related to earnings changes in each of the two years following the dividend change. The dividend changes are positively related to the level of future profitability after controlling for book value, past and current profitability, market expectations of future profitability, as reflected in price. prior to the dividend change. The findings are not symmetric for dividend increase and decreases. The dividend increases are associated with future profitability where as dividend decreases are not related to future profitability after controlling for current and future profitability. The dividend yield has significant impact on price volatility. The result of secondary survey clearly indicate that the dividend decision influence future earning as well as it has significant impact on price volatility, but primary result contradict with it. Dividend decision is given least priority by executives of corporation.

5.3 Recommendations

1. The study shows that increase in earnings depends on increase in dividends for the first two years and after two years such relationship does not exist. Hence company should try to maintain the increasing

trend of dividend, if it is supported by current earning, so the earning can be maximized in future years.

2. The analysis revealed that Nepalese firms reexamine its dividend policy annually. The firms should start reexamine their dividend policy quarterly then it would help shareholders in assessing the liquidity position of the firm and help the firms to manage their fund optimally in order to take decision for the declaration of dividend to its shareholders.
3. The study noticed that some of Nepalese firms do not have regular dividend payout policy. The firms should set a long-term dividend policy and should distribute dividend regularly, which gives the direction to the firm to achieve their target goal in long run.
4. Shareholders prefer stock dividend then cash dividend and it also gives free publicity for the organization, hence the firm should go for stock dividend rather then cash dividend.
5. Stability of earning and current level, of earning helps to determine the dividend policy of firms so these factors plays vital role on divined policy determination. The firms should consider these factors in to consideration at the time of determining dividend policy.
6. The cash balance for dividend should be adequately planned and maintained so that dividend policy would be stable and the, level of dividend should be higher then the present level of dividend.

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APPENDICES

PRACTICES OF DIVIDEND POLICY IN NEPAL

This survey is conducted to prepare a dissertation as a partial fulfillment towards the requirement for Masters of Business Study. I humbly request you to fill up this questionnaire. Your responses will be kept strictly confidential and will be used at aggregate level only. If you are interested, the survey results can also be mailed to you. Please indicate the same. Thanking you.

I. BACKGROUND INFORMATION

Directions: Answer the following questions as they apply to your firm's by placing a check mark (✓) next to the referred answer.

1. Name of the Company: _____

2. Nature of the Company

a) Manufacturing ____ b) Commercial banks ____ c) Insurance ____

d) Finance ____ e) others ____

3. Your position in the organization

a) Chief Finance Officer ____ b) Chief Executive Officer ____

c) Middle manager ____

4. Your work experience

a) 1-3 years ____ b) 4-6 years ____ c) 7-9 ____ d) 10 and above ____

II. GENERAL INFORMATION

1. **Which of the following decisions, do you think, is more important? (Please rank in order of their importance. Mark 1 to very importance, 2 just below and 3 to least important)**

   A) Financial decision ( )

   B) Investment decision ( )

   C) Dividend decision ( )

2. **What do you think is the major motive for paying cash dividend? (Please make a tick mark)**

   A) To convey information to shareholders that the company is doing well. ( )

   B) To draw attention from the investment companies. ( )

   C) To increase the market value of the firm's stock. ( )

   D) To fulfill shareholders' expectation ( )

   E) Others (please specify) _____ ( )

3. **Do you think that dividend is distributed only when there is no Investment opportunity?**

   A) Yes:…….. B) No: ……. C) No idea:-.....

4. **Nepalese shareholders are indifferent whether the company pays or does not pay dividend. Do you agree?**

   A) Yes:-..... B) No:-……..... C) No idea:-.....

5. **Do you think that company's announcement of earnings will help to increase market price of a share?**

   A) Yes:-..... B) No:-..... C) No idea:-.....

6. **Should stocks of listed companies have popular and affordable price range?**

   A) Yes:……. B) No:-……. C) No idea:-.....

7. **Do you suggest these companies to go for stock split so that shares can be placed within a more popular trading range?**

   A) Yes:-..... B) No:-..... C) No idea:-.....

8. Do you think that the own share purchase decision of commercial bank has favorable influence on shareholder wealth?

A) Yes:-..... B) No:-..... C) No idea:-.....

9. What do you suggest if the company has no cash to pay dividends?

A) Borrow funds and pay cash dividend ( )

B) Pay stock dividends ( )

C) Do not pay cash or stock or cash dividend ( )

D) Others (please specify) ( )

10. How do you rank the following motives of stock dividend (bonus share) payment in Nepalese corporate sector?

A) To conserve cash. ( )

B) To indicate higher future profits. ( )

C) To raise future dividends for shareholders. ( )

D) To provide high psychological value to shareholders. ( )

E) To lower the firm's stock price. ( )

III. DETERMINANTS OF DIVIDEND POLICY

Directions: Circle the number corresponding to the level of importance of each factor in determining your firm's dividend policy (a firm's decision about the size of dividends to pay to its shareholders).

	Level of Importance				Circle One Level of Importance			
	None	Low	Moderate	High	None			High
	1	2	3	4				
1. Stability of earnings					1	2	3	4
2. Pattern of past dividends					1	2	3	4
3. Level of current earnings					I	2	3	4
4. Level of expected future earnings					1	2	3	4
5. Concern about affecting the stock price					1	2	3	4
6. Current degree of financial leverage					1	2	3	4
7. Legal rules and constraints					1	2	3	4
8. Desire to maintain a given payout ratio					1	2	3	4
9. Liquidity constraints such as the availability of cash					1	2	3	4
10. Desire to send a favorable signal to current or potential investors (or lenders)					1	2	3	4

IV ISSUES INVOL VING CORPORA TE DIVIDEND POLICY

Directions: Circle the number corresponding to your level of agreement or disagreement with each statement about dividend policy in general.

	Level of Agreement					**Circle One Level of Importance**				
	Strongly Disagree	**Disagree**	**No Opinion**	**Agree**	**Strongly Agree**	**Disagree**				**Agree**
	1	**2**	**3**	**4**	**5**					
1. Stockholders like to receive a regular dividend.						1	2	3	4	5
2. Some stockholders prefer a stock dividend instead of a cash dividend.						1	2	3	4	5
3. Institutional investors always prefer a cash dividend instead of a stock dividend.						1	2	3	4	5

4. Our firm would like to see a large portion of its shares owned by institutions.	1	2	3	4	5
5. Increasing the number of stockholders in our firm is one of our important objectives.	1	2	3	4	5
6. We don't believe our stockholders are interested in dividends.	1	2	3	4	5
7. A dividend gives us favorable free publicity in the financial press.	1	2	3	4	5
8. Dividends help keep the stock price up within a range we think is optimal.	1	2	3	4	5
9. There is only a short-term positive price reaction to the announcement of cash dividend.	1	2	3	4	5
10. Paying cash dividends is necessary because stockholders expect it.	1	2	3	4	5