

# CHAPTER - I

## INTRODUCTION

### 1.1 General Background

Dividends are the share of the profits of a company which is received by the shareholders. However, they do not become the property of the shareholders and shareholders have no right to them until the directors of the company have passed a resolution declaring a dividend. The study of dividend policy attempts to explain how a firm divides its net earning into retaining earning and dividend. In general, a firm can choose among different forms of dividend policies based on their earning and capital investment requirement. The practices of firm on dividend policy vary from firm to firm and industry to industry. As Modigliani and Miller (1961) stated, in the world without taxes, the price of the stock is unaffected by dividend policy because the total yield on stock is simply the sum of dividend yield and capital gain yield. The corporate taxes and individual taxes may be important part of the dividend puzzle (Weston and Copeland, 1992). In the presence of corporate and personal taxes, the rational attempt of the firm is to maximize the value of the firm by balancing risk and return associated which lead to the notion of the optimal dividend policy.

The financial decisions of the firm cannot be taken in isolation but must be related to the objectives of the firm. That is to say that management must determine how the decisions will affect the firm in seeking to achieve its objectives. At this stage it is relevant to state that the objective of the firm in making its financial decision should be to maximize the economic welfare of its owners. Dividend policy, as one of the major

financing decisions of firm, has been regarded as an unsolved economic puzzle, which require rational solution if the prevailing economic paradigm of corporate finance is to continue (Miller, 1986), however, the corporate dividend policy decision is not an easy, straight forward and simple job as many people conceive it (Hackett, 1981). There is controversy among financial economists, practitioners and researcher on whether or not the dividend affects on stock prices. Due to the complex nature of the problem, corporate dividend policy has been a subject of considerable study particularly since the emergence of Modigliani and Miller's (1961) paper. They state that under given the investment decision of the company, shareholders, in a perfect capital market are indifferent whether the company distributes dividend or retains earnings in the business. Their dividend irrelevancy hypothesis gained much popularity in the finance literature.

Theory of firm states that firms exist in operation from the profit motive. Shareholders supply equity capital, hoping to share in these earnings either directly or indirectly. When a company pays out a portion of its earnings to shareholders in the form of a dividend, the shareholder benefit directly. It is believed by some that in order to maximize wealth under uncertainly, the firm must pay enough dividends to satisfy investors. If instead of paying dividends, the firm retains the funds to exploit other growth opportunities because the distribution of cash dividends causes the reduction in internal funds available to finance profitable investment opportunities consequently, either constrains growth or requires the firm to find out costly sources of financing (Myers, 1984). In this case the shareholder can expect to benefit indirectly through future increase in the price of their stock. Thus shareholder wealth can be increased through future increase in the price of their stock.

Thus shareholder wealth can be increased through either dividends or capital gains. Dividend may not increase at the rate profit increases because use the first function dividend is to keep. Firms in the capital markets would not expect to see a vary strong correlation between short term profits and dividends (Dewenter and Warther, 1988). As the division of company's profits between dividend and retention is considered as dividend policy, all aspects and questions related to payment of dividend are contained in dividend policy. The long run objectives can be achieved by maintaining adequate funds for investment. Financing growth can be considered as a secondary objective of dividend policy. Therefore, the firm should forecast the future need for funds and determine the amount of retained earnings available after payment of dividends.

Dividend amount is that portion of earning which paid to the shareholder as a return on investment. The retained earning provides funds to finance the firm's long term growth. A dividend policy that allows stockholders to get their share of the profits by always paying out a fixed percentage of earnings tend to be preferred over one that regularly pays stable or increasing dividend (Gitman, 1988, p. 602). Dividend payout of course reduces the total amount of internal financing. The dividend policy means some kind of consistent approaches to the distribution versus retention decision, rather than making the decision on the purely ad hoc basis from period to period. Consequently it must be considered in relation to the overall financing decision. Net earning may not be an appropriate measure of the ability of the firm to pay dividend. So what and how much it is desirable to pay dividend is always a controversial topic because shareholders expect higher dividend but corporation ensure towards setting aside funds for maximizing the shareholder wealth. Hence the Modigliani and Miller (1961) claim that corporate dividend practice was

a more detail in the context of their analysis, the air has been filled with the debate on the importance of dividend.

The concept of the banking and its development has been closely attached with socio-economic development. Banking sector as a monetary agent of economic development plays important role to build up the confidence to businessmen for promoting their businesses and industrialists for encouraging opening new industries. It maintains economic confidence of various segments and extends credit to people.

The establishment of Nepal Bank Ltd (NBL) in 1937 A.D. is the foundation stone of development of financing sector, particularly banking and the concept of finance companies are even new in Nepalese practices. To regulate the banking activities and monetary policy, Nepal Rastra Bank, the central bank has been established. The first commercial bank fully owned by government named 'Rastriya Banijaya Bank' was established in 1966. The commercial bank has its own role and contribution in the economic development. It has a source of economic development; it maintains economic confidence of various segments and extends credit to people. In global perspective, Joint Ventures (JVs) are the modes of trading through partnership among nations and also a form of negotiation between various groups of industries and traders to achieve mutual exchange of goods and services for sharing competitive advantages. A joint venture is the joining of forces between two or more enterprises for the purpose of carrying out a specific operation i.e. industries or commercial investment and production or trade.

Following the economic liberalization, financial sector reform introduced in eighties by Nepal Rastra Bank, eased entry restrictions with an amendment to the Commercial Bank Act 1974. As a result, three banks

namely Nabil Bank Limited (initially, it was registered as Nepal Arab Bank Ltd.), Nepal Investment Bank Limited (initially, it was registered as Nepal Indo-Suez Bank Limited) and Standard Chartered Bank Ltd (initially, it was registered as Nepal Grindlays Bank Limited) come into operation prior to 1990s. In the same regard, in 1992, Himalayan Bank was established as a joint venture with Habib Bank Limited of Pakistan. The bank is the first joint venture bank managed by Nepali CEO. However it was only in 1992, after Nepal Rastra Bank adopted a liberal attitude in permitting commercial banks to open, the financial liberalization really took place. Six, new banks, all in joint ventures of foreign banks have come in to operation making the total number of the commercial banks to eleven. In addition, letter of intent has been given to three more commercial banks to operate on regional basis and currently there are 17 commercial banks (including JVBs).

Finance companies include captive financing subsidiaries of non financial corporation, general finance consumer and business finance companies, leasing companies, factors all of which are non depository financial institutions involved primarily in extending credit to business and consumers. The organization set up of finance company is new to Nepal. Finance companies are the effective investments for mobilizing public, private and external financial resources and canalizing them into productive areas as short-term loan and long term loan in different commercial business activities. There has been mushroom growth of finance companies about registration with wide diversified functions of varying age group, capital sizes, national and international joint venture features professional expertise, management background and experience determine the nature, scope and volume of financial activities and service network.

Reforms introduced in the financial sector of Nepal over the past 10 years including liberalization of interest rates, creation of basic regulatory framework and development of longer term government securities market have led to some significant improvements in the financial sector. Like in other sectors, active participation of private sector in financial sector will play an important role in the economic development of the country. In order to enhance the role of this sector in economic activities, it is essential to flow financial resources easily and in a simple manner which would, in turn, help to achieve desired results from the economic development. Though the present development and expansion of financial sector are directed towards the same objective, the country has not been able to realize the desired outcome. For this, there might be various responsible causes; one of them is the poor capital market condition. The capital market of Nepal is small and it is at early stage of growth. There is a problem of asymmetric information between management of newly established Nepalese companies and Nepalese investors who have poured their funds therein. The establishment of joint venture banks has brought new hopes for productive mobilization of funds according to their new trends of dividend distribution among foreign joint venture bank; Nepal Arab Bank Ltd has been able to pay a token dividend in the future. But the appreciations in the market value of the share of these Joint venture banks have without any doubt, provided adequate sense of protection to shareholders.

Having given the overall dividend implications among companies and financial institutions, this study is more specific in assessing the dividend practices (policies) of joint venture banks and finance companies of Nepal and their comparative study.

## 1.2 Statement of the Problem

As a controversial financial puzzle, which is better for the shareholder, or for management, paying earnings out in dividends, for the shareholders to reinvest wherever they choose, or retaining the earnings, to fund the best internal growth projects that management can identify? Miller and Modigliani (1961) posited and proved that dividend policy shouldn't matter in an ideal world, absent tax arbitrage considerations. Why? Because capital is fungible: a company has no reason to care whether it garners capital for projects from bond issuance, from stock issuance or from retained earnings; therefore they should go wherever the risk-adjusted cost of capital is best. Reciprocally, an investor has no reason to care whether an investment pays a dividend, which the investor can reinvest, or whether the company reinvests earnings to fuel earnings growth *equivalent to the foregone dividend yield*. Thus, changes in dividend policy should not affect the value of a firm. Similarly, investment policy and dividend policy should be independent.

Since the work of Lintner (1956), numerous studies have examined the dividend policies of corporations from different perspectives. The effect of dividend policy on a corporation's market value is a subject of long standing controversy (Baker *et al.* 1985). Black (1976) epitomizes the lack of consensus by stating that the harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just don't fit together. Hence, corporate dividend policy is not clearly understood by a large segment of the financial community.

There are many empirical studies on dividends and stock prices in developed capital market (Lintner, 1956; Gordon, 1959; Modigliani and Miller, 1961; Friend and Puckett, 1964; Walter, 1966; Van Horne and

McDonald, 1971). However, no simple and conclusive relationship exists between the amount paid out in dividend and the market price of share. There is still a considerable controversy concerning the relation between dividends and common stock prices.

The capital market is the part and parcel for corporate development. Though it is in early stage of development, Nepalese investors in recent years have poured funds in newly established companies encouragingly. This trend which is the corner-stone to the development of capital market, would continue until investors are by the decisions made by the management of the companies. It is to follow pragmatic approach by the management with regard to providing returns to investors on their investment. Dividend is the most inspiring aspect for the investment on shares of the corporations. In a world in which verbal statements can be ignored or led, dividend action does provide a clear-cut means or 'making a statement' that 'speaks louder than a thousand words' (Soloman, 1963, p. 142). Solomon (1963) contends that dividends may offer tangible evidence of the firm's ability to generate cash, and as a result, the dividend policy of the firm affects share price. Even if dividends do affect a firm's value, unless management knows exactly how they affect value, there is not much that they can do to increase the shareholders' wealth. The implication of corporate dividend practices thus provides an empirical question for this study.

Since mid 1980s when the HMG/N adopted the economic liberalization policy, many joint venture banks and finance companies have been established in Nepal. Many investors are curious to invest in these financial institutions to get dividend and maximize wealth. In Nepalese context Pradhan (1993) in his study states that stocks paying higher dividends have higher liquidity, lower leverage, higher earnings,

higher turnover, and higher interest coverage. Similarly, Timilsena (1997) finds the positive relationship between dividend per share and stock price. However, pertinent question arises as to what extent these findings are still relevant in the recent day context, although many changes have taken place. This study tries to study on dividend practices of Nepalese joint venture banks and finance companies from different perspectives.

Companies/firms can adopt different dividend policies as it is the outcome of the firm's profitability and growth opportunities (investment opportunities). Some firms practice residual policy, some practice fixed dividend policy and even some practice fixed dividend payout policy. There is complete dividend theory which explains this cross-sectional variation. Modigliani and Miller (1961) state that the dividend policy is irrelevant because the dividend payment is simply an act of dividing the shareholder's residual claim into retained earnings and dividend. The total yield on the stock is simply the sum of dividend yield plus capital gain yield. When the firm pays more dividends, the capital gain will be low and vice versa. In real practice, there is direct relationship between dividend and the stock price; however the relationship is not yet clear and controversial issue in finance literature. This study will explore to shed some light on dividend practices of Nepalese firms and its impact on stock prices. Hence, this study will mainly focus following issues:

1. What are the earning and dividend patterns of the banks and finance companies? Do they have uniformity in dividend practices?
2. Do the banks have similar earning and dividend patterns with finance companies? What are the similarities and dissimilarities between banks and finance companies?

3. What are the determinants of Dividend Per Share and Market Price Per Share? How the dividend per share, retained earning and lagged price-earning ratio affect on stock price?
4. How the earning per share, lagged dividend and lagged price earning ratio affect in dividend?

### **1.3 Objectives of the Study**

The major objective of this study is to assess the corporate dividend practices of banks and finance companies listed in NEPSE. The specific objectives are as follows:

- a. To study (identify, analyze and compare) the dividend policies and patterns adopted by the commercial banks.
- b. To study (identify, analyze and compare) the dividend policies and patterns adopted by the finance companies.
- c. To compare the earning and dividend pattern of commercial banks and finance companies.
- d. To identify the determinants of the stock price.
- e. To identify the determinants of the dividend per share.

### **1.4 Significance of the Study**

The role of capital market in economic development is important which is signified from economic history of developed countries. Stock market, in one hand is important functionary of stock market is highly influenced by dividend policies including others. The rationale behind investing in stock is in hope of higher dividend. From the long-term investment perspective, dividend is in first glance where as from the short-term perspective, capital gain is in the first glance to the investors (Brealey and Myers, 2003). However, dividend policy of the firm may highly influence to both

the investors and dividend attracts new investors too. Dividend policy of the firm also helps to minimize the agency problem (Myers, 1984).

While investing in shares the investor foregoes opportunity income that he could have earned. The income of capital market is secured from two ways (i) by means of dividend and (ii) by capital gains i.e. appreciation in stock prices. Due to the lack of enough knowledge, people are investing hit-or-miss in shares. It is necessary to clear conceptions about the return that results from investing in securities. In Nepal, as a result, enough study is essential.

Therefore, considering all these facts, the study is undertaken which will help to meet deficiency of the literature relating to dividend decision and factors affecting dividend policy. Lastly, this study will also be useful literature for the further study about the relating topics. Similarly the company may also follow the suggestion of this study to make their policy. Thus the study of dividend policy is significant.

### **1.5 Limitations of the Study**

Notwithstanding the analysis performed and generalization drawn regarding the influence of dividend policy of a company on variation in its market price of shares, there is considerable place for arguing about its accuracy and reliability. There are limitations, which weaken the generalization e.g. inadequate coverage of industries, time periods taken, reliability of statistical tools used and other variables. This study is simply a partial requirement of MBS program, so this study is limited by following factors.

- This study relies on secondary data collected from Annual Reports of the respective companies available in NEPSE and SEBO database.
- The study period covers only ten years i.e. 1997 to 2006.
- For the purpose of this study only 3 commercial banks and 3 finance companies have been considered as sample which may not be able to represent the whole population.
- There are many factors that affect dividend decision and valuation of the firm. However only those factors related with dividend will be considered in this study.
- The related data are considering only cash dividend and exclude the bonus (stock) dividend.

## **1.6 Organization of the Study**

The study has been organized into five chapters, as prescribed by the university, as follows:

CHAPTER I: INTRODUCTION

CHAPTER II: REVIEW OF LITERATURE

CHAPTER III: RESEARCH METHODOLOGY

CHAPTER IV: PRESENTATION AND ANALYSIS OF DATA

CHAPTER V: SUMMARY , CONCLUSION AND RECOMMENDATIONS

Chapter I: It contains the introductory part of the study. This chapter describes the major issues to be investigated along with the objectives and significance of the study.

Chapter II: It is devoted to theoretical analysis and brief review of related and pertinent literature available. It includes a discussion on the conceptual framework and review of the major empirical studies.

Chapter III: It describes the research methodology employed in the study. This chapter deals with the matter and sources of data, population and sample, statistical and financial tools.

Chapter IV: It deals with presentation and analysis of relevant data and information through definite courses of research methodology.

Chapter V: It states summary, conclusion and recommendation of the study. This chapter states main findings, issues and gaps and suggestive framework of study.

## CHAPTER - II

### REVIEW OF LITERATURE

#### 2.1 The Theoretical Framework

##### 2.1.1 Conceptual Considerations

Dividend policy of a company is the division of its net earnings between distribution to shareholders as dividend and retention for its investment. Therefore, a firm's dividend policy has the effect of dividing its earnings into two parts retained earnings and dividends. All aspects and questions related to payment of dividend are contained in dividend policy. There is a reciprocal relationship between retained earnings and cash dividends. The increase of one may cause decrease of another. Dividend decision is the major decision of managerial finance. It is important because dividend policy is to determine the amount of earnings to be distributed to shareholders and the amount to be retained in the firm. The decision depends upon the objective of the management for wealth maximization. The firm will use the net profit for paying dividends to the shareholders, if the payment will lead to maximization of wealth of owners. If not, it is better to retain them to finance investment programs. The relationship between dividend and value of the firm should, therefore, be the criterion for decision-making.

Shareholder expects two types of return from the purchase of stock, i.e., capital gain and dividend. Since dividends would be more attractive to shareholder, one might think that there would be a tendency for corporations to increase distribution of dividends to shareholder. But one might equally pressure that gross dividends would be reduced somewhat with an increase in net income after tax dividends still available to

shareholders, and increase in the retained earning for the corporation (Smith, 1977, pp. 90-91). It is therefore, a wise policy to maintain a balance between shareholder's interests with that of corporate growth from internally generated funds. It is better to pay dividend when earnings cannot be profitably reinvested by a firm. Financial management is, therefore, concerned with the activities of corporation that affect the well being of shareholders. That well being can be partially measured by the dividend received, but a more accurate measure in the market value of share (Dean, 1973). Shareholders usually think that the dividend yield is less risky than capital gain.

Dividend policy is of great importance because it affects the financial structure, the flow of funds, corporate liquidity and investor's attitudes. Thus, it is one of the central decision are a seeking to maximize the value of firm's common stock. Due to its rapidly increasing importance and aspects many thoughts and provoking ideas in this area are to be reviewed. This chapter highlights upon the literature that were concerned in this connection. Similarly, what other have said, done or written etc. about the dividend policy are also reviewed which has provide useful input in this study. Therefore in this chapter conceptual framework given by different authors in this area, review from books, thesis, journals, procedure of dividend payment, factors affecting dividend policy and rules regarding dividend policies are presented.

### **2.1.2 Theories of Dividend Policy**

Corporations need to use different forms of dividend in view of the objectives and policies which they implement. The major forms of dividends are cash dividends and stock dividends.

**a. Cash Dividends:** Cash dividend refers to the portion of earnings paid as cash to the investors in proportion to their shares of the company. Both the total assets and net worth of the company are reduced when the cash dividend is distributed. The market price of the share drops in most cases by the amount of cash dividend distributed. The firm has to maintain adequate balance of cash for the payment of cash dividend otherwise funds to be borrowed for this purpose may be difficult. Cash planning is useful for the company paying stable dividend. To what extent cash dividend is popular and adopted by companies in Nepal may be an interesting study.

**b. Stock Dividends and Stock Splits:** A stock dividend is a payment in the form of additional shares of stock instead of cash. A stock split is essentially the same. When a stock splits, shareholders are given a larger number of shares for the old shares they already own. In either case, each shareholder retains the same percentage of all outstanding stock that he or she had before the stock dividends or split. Thus, for example, a 10 percent stock dividend would mean that each shareholder was given one share of stock for every ten shares already owned. Under a two-for-one stock split, each shareholder would be given one additional share of stock for every share already owned, thus doubling the number of shares owned by each shareholder.

A stock dividend or split does not change the assets of the firm, since nothing is received by the firm for new shares issued. In spite of the fact that stock dividends and splits do not change the underlying assets, liabilities, or equity of the firm, there is some empirical evidence that the total market value of a company's equity increases when the stock dividend or split occurs, roughly a 2 to 6 percent increase (Grinblatt et al.,

1984). Some of the joint-venture banks of Nepal have followed the practice of paying stock dividend along with cash dividend.

*c. Corporate Share Repurchase:* Corporate share repurchase is often viewed as an alternative to paying dividends. If a firm has some surplus cash (or it can borrow), it may choose to buy back some of its own stock. It is instructive to see why share repurchases may be viewed as an alternative to paying dividends. By repurchasing stock, a company is reducing the number of shares outstanding. If the price earning (P/E) ratio does not change after the repurchase, the stock price must rise. If a firm has excess cash and insufficient profitable investment opportunities to justify the use of these funds, it is in the shareholder's interests to distribute the funds. The distribution can be accomplished either by the repurchase of stock or by paying the funds out in increased dividends (Van Horne, 1997). It is thus corporate share repurchase is often viewed as an alternative to paying dividends. A repurchase is a signal that managers, who possess an insider's knowledge of the firm, are convinced that their stock is worth more than its current price (Asquith and Mullins, 1986). In addition, their conviction is strong enough to lead them to pay a premium for the stock despite the risk of dilution if they are wrong. The Company Act, 2063, has allowed company from purchasing its own shares.

*d. Developing Dividend Policies:* The dividend practice should reflect the different factors as well as the firm's present operating and financial position. In this total framework, the firm finds that it has a choice of several dividend policies to follow. These are as follows:

1. Steady dividends at the Present Level: Perhaps the most common dividend practice is to declare the same rupee dividend as

paid last period. This meets the shareholders' expectations for current income and is not likely to affect market price. This policy may result in shortages of funds during years when earnings have declined. For mature firms with unused borrowing capacity, this is not a serious drawback.

2. **Steady Dividends at a Level Lower than Present Level:** The practice to reduce dividends would be considered if the firm has high-profit investment opportunities and needs the funds to finance them. This might alienate shareholders seeking current income and affect the market price of the stock. To minimize this impact, the firm might announce that the new level will be maintained in the near future and the board of directors does not anticipate further lowering of dividends. This will reduce some of the uncertainty associated with the reduction of dividends. The firm may also indicate that dividends may be raised if the new investment opportunities are as profitable as expected.

3. **Steady Dividends at a Level Higher than Present Level:** This is a practice to raise the regular dividend declared by the firm. It is warranted when the firm's earnings have risen, when the earnings are stable at the higher level, and when the firm does not need the excess earnings to finance growth. Frequently, the dividend announcement will favourably affect the price of the common stock. In many cases, the higher earnings will already have caused a rise in the stock price, and the dividend declaration will have no effect.

***e. The Informational Content of Dividends:*** It has often been pointed out that a company that raises its dividends often experiences and increase in

its stock price and that a company that lowers its dividends has a falling stock price. This causal relationship has been refuted by several researchers on the grounds that dividends per se do not affect stock prices; rather, it is the informational content of dividends that affects stock prices. Since management may have greater insight than the rest of the market as to the level of presents and future earning power, they may use dividend payments as the medium through which their expectations are conveyed (Pettit, 1976). Recent evidence demonstrates that dividend announcements convey information over and above that contained in alternative announcements (Asquith and Mullins, 1986). A number of writers have suggested that a considerable amount of information is conveyed by changes in dividends. In light of this, the management of a firm may use divided payments (or a lack of them) as a method of indicating their estimates of the firm's earning power and liquidity (Pettit, 1972).

***f. The Residual Theory of Dividends:*** Dividend policy can be viewed as one of a firm's investment decisions. A firm that behaves in this manner is said to believe in the residual theory of dividends. According to this theory, dividend policy is a residual from investment policy. Whether or not a company pays dividends depends on its investment policy. It assumes that the internally generated funds are comparatively cheaper than the funds obtained from external sources. The theory is based on the premise that investors prefer to have the firm retain and reinvest earnings rather than pay them out in dividends if the returns of reinvested earnings exceeds the rate of return the investor could, himself, obtain on other investments of comparable risk. The dividend under a residual dividend policy equals the amount left over from earnings after equity investment. If equity investment equals earnings, no dividends are paid. If equity

investment is greater than earnings, then no dividends are paid and new shares are sold to cover any equity investment not covered by earnings. If there is no any investment opportunity, then cent percent earnings are distributed to shareholders. The dividend is therefore merely a residual remaining after all equity investment needs are fulfilled (Schall and Haley, 1991).

Although the residual theory of dividends appears to make further analysis of dividend policy unnecessary, it is indeed not clear that dividends are solely a means of disbursing excess funds. It would therefore be imprudent to conclude that there are no other implications of dividend policy, and so this study shall take a closer look at the relationship between dividends and value.

### **2.1.3. Common Factors Affecting Dividend Policy**

A number of things come into play while establishing a corporate dividend policy. In what follows, various factors that financial executives in practice should consider when approaching a dividend decision, be taken up.

**a. Amount of earnings:** The availability of profits to pay dividends is a sine qua non of dividend policy. The whole subject of what constitutes profit is itself the topic of considerable controversy and as such lies outside the scope of this study. Suffice it to say that company law, through the statutes and cases, has imposed constraints and guidelines for the directors' decisions regarding the payment of dividends.

**b. Cash flows:** When considering the payment of cash dividends the firm's cash flows must be taken into account. There is a liquidity constraint. Even if a dividend is paid by means of 'bonus shares' the

impact of such an issue on the personal tax liability of the individual shareholders must be considered. If a shareholder considers that the future stream (of hopefully increased) dividends will not, when discounted, cover the tax that he will have to pay on the scrip dividend he may sell shares to pay for his tax or for consumption or investment and such sales if sufficiently widespread could depress the value of the firm's shares.

**c. Incidence of taxation:** One aspect of taxation has already been mentioned above but all aspects of taxation, corporate and personal, must be regarded as relevant factors to be taken into account.

**d. Financial needs of the firm:** Both pragmatists and theorists recognize the importance of retained earnings as a means of financing the investment decisions of the firm. Every dividend payment has associated with it a funds source, or financing opportunity undertaken - dividends are a use of funds, and any use of funds must have a source (Solomon, 1963, p. 100). In other words, the payment of a cash dividend has an opportunity cost in the form of an investment opportunity which may be foregone. When capital rationing exists this is an important factor which must be considered.

**e. Contractual and legal constraints:** Apart from the legal constraints, tax and company laws already mentioned, there maybe other legal and contractual constraints. For example the articles of association of a company may impose certain obligations before dividends can be paid. The repayment of a particular class of debentures may be a prerequisite to the payment of any dividends, or specific reserves may have to be created and maintained before dividends can be declared.

**f. Effect of dividend policy on liquidity and solvency:** During periods of high inflation when the costs of replacing fixed and current assets are increasing it may well be that a firm's previously determined payout ratio cannot be maintained without jeopardizing its liquidity and even its solvency. This problem is of course largely, if not wholly, attributable to the defects of the conventional historical cost accounting model.

**g. Risk of take-over bids:** If the dividend policy of the firm is perceived by shareholders as unsatisfactory their action of disinvesting in the firm's securities would force the price down. If the aggregate of such price was to fall below the true asset values of the firm then the firm could become the target for a take-over bid.

Management today is and must be conscious of maintaining a satisfactory relationship with its workers. If a firm's management decided on a dividend policy which was perceived by a relevant trade union or the workers themselves as being an excessively high payout ratio, especially during inflationary periods when the purchasing power of the workers' earnings is being diminished, a dangerous strain on labour relations within the firm could develop.

## **2.2 Review of Empirical Works**

This section is devoted to the review of the major studies in general concerning dividends and stock prices, management views on dividend policy, and management views on stock dividends. This study draws heavily from these studies to carry it out.

### 2.2.1 Lintner Study (Lintner, 1956)

Lintner (1956) made an important study focusing on the behavioral aspect of dividend policy in the American context. He investigated a partial adjustment model as he tested the dividend patterns of 28 companies. He concluded that a major portion of the dividend of a firm could be expressed in the following way:

$$DIV^*_t = pEPSt \quad \dots\dots (1)$$

\And

$$DIV_t - DIV_{t-1} = a + b(DIV^*_t - DIV_{t-1}) + e1 \quad \dots\dots (2)$$

Or,

$$DIV_t = a + b DIV^*_t + (1-b) DIV_{t-1} + e1 \quad \dots\dots\dots (3)$$

Where,

$DIV^*_t$  is firm's desired payment,  $EPSt$  is earnings,  $p$  is targeted payout ratio,  $a$  is constant relating to dividend growth, and  $b$  is the adjustment factor relating to the previous period's dividend and new desired level of dividends where  $b < 1$ .

The major findings of this study were as follows:

- Firms generally think in terms of proportion of earnings to be paid out. Investment requirements are not considered for modifying the pattern of dividend behaviour.

- Firms generally have target payout ratios in view while determining change in dividend per share (or dividend rate).

### **2.2.2 Modigliani and Miller Study (Modigliani and Miller, 1961):**

In their 1961 article Modigliani and Miller, for the first time in the history of finance, advocated that dividend policy does not affect the value of the firm, i.e., dividend policy has no effect on the share prices of the firm. They argued that the value of the firm depends on the firm's earnings which depend on its investment policy. Therefore, as per MM theory, a firm's value is independent of dividend policy.

Their study of irrelevance of dividend was based on the following critical assumptions:

- The firm operates in perfect capital market.
- There are no taxes.
- The firm has a fixed investment policy which is not subject to change.
- 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,  $P_0 = \frac{D_1 + P_1}{1 + K_e}$ , Where,

- Po = Market price at the beginning or at the zero period
- Ke = Cost of equity capital (assume constant)
- D1 = Dividend per share to be received at the end of the period
- P1 = 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:

$$nP_o = \frac{n(D_1 + P_1)}{1 + K_e},$$

where, n = number of equity shares at zero period

Step 3: If the firm's internal sources of financing its investment opportunities fall short of the funds required, and  $\Delta n$  is the number of new shares issued at the end of year 1 at price P1, then

$$np_o = \frac{nD_1 + p_1(n + \Delta n) - \Delta nP_1}{1 + K_e},$$

Where, n = No. of shares at the beginning

$\Delta n$  = 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.

$$nP1 = I - (E - nD1) \quad \text{or,} \quad nP1 = I - E + nD1,$$

where,

$nP1$  = The amount obtained from the sale of new shares to finance capital budget.

I = The total amount requirement of capital budget

E = Earnings of the firm during the period

$E - nD_1$  = Retained Earnings

Step 5: By substituting the value of  $nP_1$  from equation of step 4 to equation of stem 3, the finding is:

$$np_o = \frac{nD_1 + p_1(n + \Delta n) - \Delta nP_1}{1 + K_e} \quad \text{or} \quad np_o = \frac{P_1(n + \Delta n) - I + E}{1 + K_e}$$

Step 6: Conclusion: There is no role of dividend in above equation. So Modigliani and Miller concluded that dividend policy has no effect on the share price.

In this way, according to Modigliani and Miller's study, it seems that under conditions or perfect capital markets, rational investors, absence of tax discrimination between dividend income and capital appreciation, given the firm's investment policy, its dividend policy may have no influence on the market price of the shares (p. 345). However, the view that dividend is irrelevant is not justified, once the assumption is modified to consider the realities of the world. In practice, every firm follows one kind of dividend policy or another. The selection of a certain dividend policy depends on the age and nature of the firm.

### **2.2.3 Gordon Study (Gordon, 1962):**

Myron Gordon (1962) in his study concluded that dividend policy of a firm affects its value. In his model, he pleaded that investors are not indifferent between current dividends and retention of earnings. The conclusion of his study is that investors value the present dividend more than future capital gain. His argument insisted that an increase in divided

payout ration leads to increase in the stock prices for the reason that investors consider the dividend yield ( $D_1/P_0$ ) is less risky than the expected capital gain.

Hence, investors required rate of return increases as the amount of dividend decreases. This means there exists a positive relationship between the amount of dividend and the tock prices.

His model is based on the following assumptions:

The firm is an all-equity firm.

No external financing is available.

Internal rate of return,  $r$ , appropriate discount rate,  $k_e$ , are constant.

The firm and its stream of earnings ae perpetual,

The corporate taxes do not exist.

The retention ratio,  $b$ , once decided upon, is constant. Thus the growth rate,  $g = br$ , is constant forever.

The discount rate is greater than growth rate,  $k > br = g$ .

Based on the above assumptions, Gordon provided the following formula, which is a simplified version of the original formula (Francis, 1972) to determine the market value of a share.

$$P = \frac{E(1 - b)}{K - br}, \text{ where}$$

$P$  = Price of share

$E$  = Earnings per share

$B$  = Retention ratio

$1-b$  = Percentage of earnings distributed as dividend

$E(1-b)$  = Dividend per share

$K$  = Capitalization rate or cost of capital

$Br$  = Growth rate in  $r$ , i.e. rate of return on investment of an all equity firm

According to his model, the following facts are revealed.

In the case of growth firm, share price tends to decline in correspondence with increase in payout ratio or decreases in retention ratio, i.e. high dividend corresponding to earnings leads to decrease in share prices. Therefore, dividends and stock prices are negatively correlated in growth firm. In the case of normal firm, share value remains constant regardless of changes in dividend policies. It means dividend and stock prices are free from each other in normal firm, i.e.  $r$  is equals to  $k$  firm. In the case of declining firm, share prices tend to rise in correspondence with rise in dividend payout ratio, it means dividends and stock prices are positively correlated with each other in a decline firm.

#### **2.2.4 Friend and Puckett Study (Friend and Puckett, 1964):**

Friend and Puckett (1964) conducted a study on the relationship between dividends and stock prices, by running regression analysis on the data of 110 firms from five industries in the years 1956 and 1958. These five industries were chemicals, electric utilities, electronics, food and steels. These industries were selected to permit a distinction made between the results for growth and non growth industries and to provide a basis for comparison with result by other authors for earlier years. They also considered cyclical and non-cyclical industries which they covered. The

study periods covered a boom year for the economy when stock prices leveled off after rise (1956) and a somewhat depressed year for the economy when stock price, however, rose strongly (1958).

They used dividends, retained earnings and price earnings ratio as independent variables in their regression model of price function. They used supply function, i.e. dividend function also. In their dividend functions, earnings, last year's dividends and price-earnings ratio are independent variables. They quoted that the dividend supply function (equation) was developed by adding to the best type of relationship developed by Lintner.

Symbolically, their price function and dividend supply functions are,

$$\text{Price function: } P_t = a + b D_t + c R_t + d (E/P)_{t-1} ,$$

Where,

$P_t$  = Per-share price at time  $t$

$D_t$  = Dividends at time  $t$

$R_t$  = Retained earnings a time

$(E/P)_{t-1}$  = Lagged earnings price ratio

$$\text{Dividend supply function: } D_t = e + f E_t + g D_{t-1} + h (E/P)_{t-1}$$

Where,

$E_t$  = Earnings per share at time  $t$

$D_{t-1}$  = Last year dividend

Their study was based on the following assumptions:

- Dividend do react to year to year fluctuations in earnings.

- Price doesn't contain speculative components.
- Earnings fluctuations may not sum zero over the sample.

Their regression results based on the equation of  $P_t = a + bD_t + cR_t$  showed the customary strong dividend and relatively weak retained earnings effects in three of the five industries, i.e., chemicals, foods and steels. Again they tested other regression equations by adding lagged earnings price ratio to the above equation and resulted the following equation:  $P_t = a + bD_t + cR_t + d(E/P)_{t-1}$  They found the following results: They found that more than 80% of the variation in stock prices can be explained by three independent variables. Dividends have a predominant influence on stock prices in the same three out of five coefficients are closer to each other for all industries in both years except for steels in 1956, and correlation are higher, again except industries but they found the differences between the dividends and retained earnings coefficients are not quite so marked as in the first set of regressions. They also found that the dividends and retained earnings for steels.

They also calculated dividend supply equation, i.e.,  $D_t = e + fE_t + gD_{t-1} + h(E/P)_{t-1}$  and the derived price equation for four industry groups in 1958. In their derived price equation it seems that there was no significant changes from those obtained from the single equation approach as explained above. They argued that the stock prices or more accurately the price earnings ratio does not seem to have a significant effect on dividend payout. On the other hand, they noted that the retained earnings effect is increased relatively in three of the four cases tested. Further, they argued that their results suggested price effect on dividend supply are probably not a serious source of bias in the customary derivation of dividend and retained earnings effects on stock prices,

though such a bias might be marked if the disturbing effect of short run income movements are sufficiently great.

Further, they used lagged price as a variable instead of lagged earnings price ratio and showed that more than 90% of variation in stock prices can be explained by the three independent variables and retained earnings received greater relative weight than dividends in the most of the cases. The only exception was steels and foods in 1958. They considered chemicals, electronics and utilities as growth industries, in these groups; the retained earnings effect was larger than the dividend effect for both years covered. For the other two industries, namely foods and steels, there was no significant systematic difference between the retained earnings and dividend coefficients.

Similarly, they tested the regression equation of  $P_t = a + bD_t + cR_t$  by using normalized earnings again. They obtained normalized retained earnings by subtracting dividends from normalized earnings. They added prior year's normalized earnings price variable and they compared the result. Comparing the result they found that there was significant role of normalized earnings and retained earnings but effects of normalized price earnings ratio was constant. When they examined the later equation, they found that the difference between dividend and retained earnings coefficients disappeared. Finally, they concluded that management might be able to increase prices some what by raising dividends in foods and steels industries.

They conducted more detailed examination of chemical samples. That examination disclosed that the result obtained largely reflected the undue regression weighting given the three firms with price deviating most from

the average price in the sample of 20 firms and retained earnings as price determinant.

Finally, Friend and Puckett concluded that, it is possible that management might be able, at least in some measure, to increase stock prices in non-growth industries by raising dividends and in growth industries by greater retention, i.e. low dividends.

### **2.2.5 Walter Study (Walter, 1966):**

Walter studied on dividend and stock price in 1966. According to him, the dividend policy of a firm can not be looked aside from investment policy. His argument is just the opposite of what Modigliani and Miller said. Walter argued that dividend policy affects the stock prices, i.e., dividend is relevant with stock prices. The relationship between firm's internal rate of return and cost of capital is determining factor to retain profits or distribute dividends. As long as the internal rate is greater than the cost of capital, the stock price will be enhanced by retention and will vary with dividend payout.

His model was based on number of assumptions as given below:

- Retained earnings constitute the exclusive source of financing. The firm does not resort to debt or equity financing.
- The firm's internal rate of return and its cost of capital are constant.
- The firm distributes its entire earnings or retains it for reinvestment immediately.
- There is no change in values of earnings per share and the dividend per share.
- The firm has perpetual life.

Considering the above assumption, Walter's model to determine the market price per share is as follows:

$$\frac{\text{Div}}{k} + \frac{r(\text{EPS} - \text{DPS})/K}{K} \text{ or } P = \frac{\text{DPS} + r/k(\text{EPS} - \text{DPS})}{k}$$

Where

P = Market price per share

DPS = Dividend per share

EPS = Earnings per share

R = Internal rate of return

K = Cost of capital

According to him the given firm may have three situations. They are:

$r > k$

If the firm's internal rate of return exceeds the cost of capital, the relation between dividends and stock prices is negative, i.e. more dividends leads to low stock prices. This kind of firm is referred to as growth firm. Walter argued that zero dividends would maximize the market value of shares for growth firms.

$r = k$

If the firm has  $r = k$ , there is no role of dividends on stock prices, i.e., dividends are indifferent from stock prices. In other words, dividend payout does not affect the value of share whether the firm retains the profit or distributes dividends, is a matter of indifference. This kind of firm is referred to as normal firm.

$r < k$

If the firm's internal rate of return ( $r$ ) is less than the cost of capital ( $k$ ), the relation between dividends and stock prices is positive, i.e. increase in dividend per share yield increase in stock prices. This kind of firm is referred to as declining firm. He argued, cent percent dividend policy would maximize the market price of shares for declining firm.

To conclude, according to Walter, when the firm is in growth stage, then dividends are negatively correlated with stock prices. In the declining firms, dividends are positively correlated with stock prices. In the normal firm, there is no relationship between dividends and stock prices, i.e., dividend are indifferent to variation in market price of shares.

#### **2.2.6 Van Horne and McDonald Study (Van Horne and McDonald, 1971):**

Van Horne and McDonald conducted a more comprehensive study on dividend policy and new equity financing. The purpose of this study was to investigate the combined effect of dividend policy and new equity financing decision on the market value of the firm's common stocks. They explored some basic aspects of conceptual framework, and empirical tests were performed during year end 1968, for two industries, using a well known valuation model, i.e. a cross-section regression model. The required data were collected from 86 electric utility firms included on the COMPUSTAT utility data tape and 39 firms in the electronics and electronic component industries as listed on the COMPUSTAT industrial data tape.

They tested two regression models for the utilities industries.

First Model was,

$$P_0/E_0 = a_0 + a_1(g) + a_2(D_0/E_0) + a_3(lev) + u$$

Where,

$P_0/E_0$  = Closing market price in 1968 divided by average EPS for 1967 and 1968.

G = Expected growth rate, measured by the compound annual rate of growth in assets per share for 1960 through 1968.

$D_0/E_0$  = Dividend payout, measured by cash dividend in 1968 divided by earnings in 1968.

Lev = Financial risk, measured by interest charges divided by the difference of operating revenues and operating expenses

U = Error term

The Second Model was,

$$P_0/E_0 = a_0 + a_1(g) + a_2(D_0/E_0) + a_3(lev) + a_5(F_b) + a_6(F_c) + a_7(F_d) + u$$

Where,

$F_a$ ,  $F_b$ ,  $F_c$  and  $F_d$  are dummy variables corresponding to 'new issue ratio' (NIR) groups A through D.

It is noted that they had grouped the firms in five categories A,B,C,D and E by NIR. For each firm the value of dummy variables representing its NIR group is one and the value of remaining dummy variables is zero. Again, they tested the following regression equation for electronics-electronic components industry.

$$P_0/E_0 = a_0 + a_1(g) + a_2(D_0/E_0) + a_3(lev) + a_4(OR) + u$$

Where,

Lev = Financial risk, measured by long-term debt plus preferred stock divided by net worth as of the end of 1968.

OR = Operating risk, measured by the standard error for the regression of operating earnings per share on the for 1960 through 1968, and rest are as in First Model above.

By using these models or methodology, they compared the result obtained for the firms which both pay dividends and engage in new equity financing with other firms in an industry sample. They concluded that the electric utility firms in an industry sample. They concluded that for electric utility firms in 1968, share value was not adversely affected by new equity financing in the presence of cash dividends, except for those in the highest new issue group and it made new equity a more costly form of financing than the retention of earning. They also indicated that the payment of dividends through excessive equity financing reduces share prices. For electronics, electronic-components industry, a significant relationship between new equity financing and value was not demonstrated.

#### **2.4.7 H.K. Baker, G.E. Farrelly, and R. B. Edelman Study (Baker et al., 1985)**

H. Kent Baker, Gail E. Farrelly, and Richard B. Edelman surveyed management view on dividend policy. They asked corporate financial managers what they considered most important in determining their firm's dividend policy. The objectives of their survey were as follows.

- To compare the determinants of dividend policy today with Lintner's behavioral model of corporate dividend policy and to assess management's agreement with Lintner's findings;
- To examine management's perception of signaling and clientele effects; and
- To determine whether managers in different industries share similar views about the determinants of dividend policy.

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: (i) 15 closed-end statements about the importance of various factors that each firm used in determining its dividend policy; (ii) 18 closed-end statements about theoretical issues involving corporate dividend policy, and (iii) 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 wholesale/retail (5.3%). Based on dividends and earnings per share data provided by the respondents, the 1981 average dividend payout ratio was computed. They found that

payout ratio of the responding utilities (70.3%) was considerably higher than for manufacturing (36.6%) and wholesale/retail (36.1%).

The results of their survey on the aspect of determinants of dividend policy were as follows:

- The first highly ranked determinant is the anticipated level of a firm's future earnings and the second factor is the pattern of past dividends. They found the high ranking of these two factors is consistent with Lintner'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 in importance.

Similarly, the results of their survey on the aspect of attitudes on theoretical issues were as follows:

- Respondents from all three industry groups agreed relatively strongly that dividend payout affects common stock prices.
- 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.
- The respondents also demonstrated a high level of agreement that the reasons for dividend policy changes should be adequately disclosed to investors.
- Respondents from all three industry groups thought that investors have different perceptions of the relative riskiness of

dividends and retained earnings and hence are not indifferent between dividend and capital gain returns.

#### **2.2.8 H.K. Banker and A. L. Phillips Study (Banker and Phillips, 1992):**

H.K. Baker and Aaron L. Phillips surveyed management views on stock dividend. They addressed two major research questions in this survey. First, why do some managers continue to support stock dividends given the apparently limited benefits of these distributions to shareholders? 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 1988-90 period 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 a 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. Part I contained 15 closed-end questions on issues drawn from the finance literature about stock dividends. Part II 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%.

The findings of their survey were as follows:

- Managers strongly agree that stock dividends have a positive psychological impact on investors receiving them.
- 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.
- The dominant motive for applying 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.

### **2.2.9 Shrestha Study (Shrestha, 1985):**

The study on Dividend policy in selected public limited companies is based on the data collected for altogether 18 public limited companies of the year 1982/83. The study is devoted to streamline dividend policy under three fold aspects that cover (a) Firstly to provide conceptual glimpse of dividend and dividend models (b) secondly to analyze and interpret the dividend payment implications in selected public limited companies through the use of dividend models in accordance.

With the available data that are manageable and (c) lastly, to provide suggestions that help guide in the determination and appropriate adoption of a suitable dividend policy in the proposed public limited companies.

After analyzing the data using different models, it is concluded that, it can be said that dividend policy constitutes one of the most critical it is concluded that, it can be said that dividend policy constitutes one of the most critical issues of the public limited companies. In empirical terms, many of the public limited companies are found to pay negligible dividend to the shareholders in which HMG provide to be a potential investor. Dividend implies paying left-over earnings and theories of dividend policy do differ since some prefer residual theory that conveys passive residual available for payment and the controversial M.M. hypothesis insists on dividend irrelevance in the sense that dividend policy does not matter. There are others who argue that dividend policy des affect value due to the factors of uncertainty. Many factors affect the payment depending upon investors' needs and preferences o none hand and the financing needs of the public limited companies to top potential investment opportunities on the other hand. Dividend policy cash or stock or split and other forms as well as determining stable, fluctuating and extra dividend payment. The dividend models have their own assumptions in the determination of value in terms of dividend per share, earnings per share, retained earning per share and also comparing these variables through the mathematical relationships with actual and normal capitalization rate. The application of Walter's and Gordon's dividend models in calculating the stock value of selected public limited companies reveals both acceptable and fantastic results. And the need for public limited companies to resort to the formulation of an appropriate dividend policy in terms of developing target dividend payout ratio can not be ignored.

In another study 'Finance companies in Nepal, Shrestha has discussed about the finance companies of Nepal. Finance companies are the

outcome of the government's economic liberalization policy. All together 56 finance companies have been registered and only 23 finance companies have gained more than a year of experience. Out of this, only 6-8 finance companies have floated shares to the investing public. The other 15 finance companies have not yet floated shares to the public. The analysis of their lending and investing activities show only very few finance companies have aggressive investment strategy compared to most of them following conservative strategy, Major part of their lending is in consumer durable through hire purchase and then to lesson loan. But later on there has been a gradual shift in lending policy towards impact of finance companies at a time when the commercial banks are providing inefficient and other one considering the negative of finance companies bringing no significant contribution to national economy in a situation when they are encouraging imports to drain on scarce foreign exchange.

The interest rate on various time deposits to be attractive compared to commercial banks. They have also provided various alternatives to depositors in enabling them to deposit according to their needs and preference. But, Finance companies are allowed to charge higher interest rate on loans. However interest rate disparity between deposits and loans are not allowed to fluctuate more than 6 percent at present at present under guidelines of Nepal Rastra Bank. The need to strong them the institutionalization of finance companies is important to have meaningful relationship between finance companies and national development through shift of credit to the productive industrial sectors. At the same time, the series of reforms such as consolidation of finance companies, maintaining relationship between finance companies and commercial banks, directing attention to venture capital financing, appropriate risk return trade off by linking credit to timely repayment schedules, deposit

insurance scheme, achieving expectation impacts of depositors and clients, avoiding imperfections, allowing flexibility in lending, one widow service from NRB, diversify scope of activities to fee based services, allow funds transfer, refinancing facilities for finance companies, professional culture within finance companies etc. All these are necessary to ensure better future performance of finance companies that have already been established and growing in Nepal.

### **2.2.10 Pradhan Study (Pradhan, 1993):**

This study on stock market behaviour in a small capital market: A case of Nepal was based on the data collected for 17 enterprises from 1986 through 1990. The objectives of his study were as follows, to assess the stock market behaviour in Nepal; to examine the relationship of market equity, market value to book value, price-earnings, and dividends with liquidity, profitability, leverage, assets turnover, and interest coverage. The empirical model he used was as follows:

$$V = b_0 + b_1LIQ + b_2LEV + b_3EARN + b_4TURN + b_5COV + U_1$$

Where, V chosen for the study were market equity (ME), market value of equity to its book value (MV/BV), price-earnings ratio (PE), dividend per share to market price per share (DPS/MPS), and dividend per share to earnings per share (DPS/ EPs).

- LIQ = Current ratio (CR) or Quick ratio (QR)
- LEV = Long term debt to total assets (LTD/TA) or long-term debt to total capitalization (LTD/TC)
- EARN = Return on assets, that is, earnings before tax to total assets (EBT/TA) or earnings before tax to net worth (EBT/NW)

- $TURN = \text{Fixed assets turnover, that is, sales to average fixed assets (S/FA), or total assets turnover, that is, sales to average total assets (S/TA)}$
- $COV = \text{Interest coverage ratio, that is earnings before tax to interest}$
- $U = \text{Error term}$

Some findings of his study, among others, were as follows:

- Higher the earnings on stocks, larger the ratio of dividends per share to market price per share.
- Dividend per share and market per share are positively correlated.
- Positive relationship between the ratio of dividend per share to market price per share and interest coverage.
- Positive relationship between dividend payout and liquidity.
- Negative relationship between dividend payout and leverage ratio.
- Positive relationship between dividend payout and profitability.
- Positive relationship between dividend payout and turnover ratios.
- Positive relationship between dividend payout and interest coverage.
- Liquidity and leverage ratios are more variable for the stock paying lower dividends.
- Earnings, assets turnover, and interest coverage are more variable for the stock paying higher dividends.

### **2.2.11 Bhattarai Study (Bhattarai, 1990):**

A Master's Degree thesis titled 'Share market in Nepal' written by Anjani Raj Bhattarai in 1990 throws some light on the dividend performance of some companies. He concluded some findings related to his study as follows:

- Relationship between earnings, dividend, growth and expansion program of the firm do not exist. So the retention policies do not match with the actual financing need of the companies have been realized.
- Majority of the companies are declaring dividend less than risk free rate or return and market risk premium.
- Adopting haphazard dividend policy rather than due regard is not paid on sound dividend policy.
- Most of the companies are under rating the expectation of investors and there by resulting the low market ability of shares on trading floor of stock exchange.
- Joint venture Banks of Nepal are almost in a good position regarding their performance and be a growth firm. Their market value per shares is traded on high price. The dividend per share of these banks is correlated with their earning per share. Earning per share of these banks is raised at the satisfactory level of the company. Retained earnings ratios of these banks are fluctuation is smaller proportion. Earning yield ratios and price earning ratios are inconsistent. Regarding the dividend payment these banks are declaring higher dividend payment these banks are declaring higher dividend return than other most of the companies.

### **2.2.12 Timilsena Study (Timilsena, 1997):**

In this MBA thesis, the author studied about the effect of dividends on stock price stock prices by using the data of 16 enterprises from 1990 through 1994.

The objectives of this study were to test the relationship between dividends per share and stock prices; to determine the impact of dividend policy on stock prices; to determine the impact of dividend policy on stock prices; to identify whether it is possible to increase the market value of the stock changing dividend policy or payout ratio; and to explain the price behavior, the study used simultaneous equation model as developed by Fried and Puckett (1964).

The findings of his study were the relationship between dividend per share and stock prices is positive variedly in different sectors; changing the dividend policy or dividend per share might help to increase the market price of shares; and the relationship between stock prices and retained earnings per share is not prominent - the relationship between stock prices and retained earnings price ratio is negative.

### **2.2.13 Paudel Study(Paudel, 1999):**

A MBA thesis 'Dividend Policy: A case study of different listed finance companies' conducted by Rabindra Paudel has concluded that:

Dividend practices of all the sample companies are neither stable nor constantly growing. Moreover, haphazard way is adopting but in growing trend.

Relationship between DPS with EPS, NPAT and NW are positive in all these finance companies. Whereas relationship between DPS with average stocks price is in improving condition with compare to previous year.

Change in DPS affects the MPS differently in different finance companies.

The situation of capital markets of Nepal is in improving condition. So the capital markets are efficient with compare to previous years. But still capital markets of Nepal are inefficient.

Though there were above mentioned studies in the context of Nepal, it has now become necessary to find out whether their findings are still valid. Pradhan's study was based on 55 observations only covering the financial data up to 1990. Many changes have taken place in and outside Nepal after 1990. Like other countries, Nepal has also followed a policy of economic liberalization, privatization and globalization. Many changes have taken place in and outside Nepal after 1990. Considering all these facts, it is necessary to carry out a fresh study in Nepal. This study tries to analyze the dividend practices of commercial (joint venture) banks and finance companies with help of sample of 3 companies of each by employing more strong analytical tools. This study also tries to compare the pattern of earning and dividend of banks and finance companies. The findings of this study will provide some meaningful insights to the investors to make their investment decisions.

#### **2.2.14 Shah Study (Shah, 2002):**

In his MBS thesis, the author has studied about dividend practices of commercial banks. With a sample size of 5 commercial banks, the author has found that:

- Commercial banks are highly profitable and paying higher dividend amounts.
- The banks are found to follow different dividend policies and no single or consistent dividend policy is observed in sample banks.
- The market yield for sample banks are found similar to each other.

The authors further observed about impact of dividend on stock prices by using Friend and Puckett (1964) Model. And found positive effect of dividend on stock price.

#### **2.2.15 Gajurel Study (Gajurel, 2005):**

In his MBS, thesis, Ram Prasad Gajurel studied about dividend practices of joint venture banks and finance companies. By using financial tools and statistical tools, the author found similar earning pattern among the joint venture banks and finance companies but different dividend practices among the firms. Major findings of his study are:

- Joints venture banks are found more profitable than finance companies.
- Dividend payout ratio and market yield of joint venture banks are found similar and equal to finance companies.

### **2.2.15 Bista Study (Bista, 2006):**

Sarita Bista, in her MBS thesis, studied about dividend practices of commercial banks and its impact on stock price. With 6 sample firms and from 1996-2005 10 years panel data, she observed commercial banks more profitable but inconsistent dividend policies. By using Friend & Puckett (1964) Model, she observed highly positive effect of dividend on stock price. Furthermore, she concludes that however, the banks have higher earning pattern, its market yield (return on market value of stock) is nominal, about 12.3 percent.

### **2.3 Research Gap:**

However, there are many studies regarding dividend policy, there is gap of recent studies on comprehensive comparative study on dividend practices of commercial banks and finance companies. Furthermore, there is gap of recent empirical studies on determinants of dividend and determinants of stock price. This study is one more attempt to fulfill gap and author has tried to come up with interesting findings by using financial and statistical tools of analysis.

## **CHAPTER - III**

### **RESEARCH METHODOLOGY**

Research methodology is important to carry out a research, which describes the entire methodological approaches employed in the study. Mostly, in the case of the empirical studies, the consistencies of the findings are solely based on empirical methodologies it has employed. Therefore, this chapter focuses on research design, nature and sources of data, data population and samples, method of analysis and the methodological limitations of this study as described in consecutive sections.

#### **3.1. Research Design**

This empirical study attempts to analyze the dividend patterns and its determinants of Nepalese banks and finance companies. It tries to compare the dividend practices of banks and finance companies. It further tries to study the relationship between EPS and DPS; and DPS and MPS. Hence, this empirical study has followed both analytical and descriptive research design.

#### **3.2. Nature and Sources of Data**

This study is based on accounting data of firms listed in Nepal Stock Exchange Limited (NEPSE) for the period of 1997-2006. The required data have been extracted from annual reports and financial statements of the firms available in Securities Board (SEBO) database and NEPSE database. Hence, this study mainly relies on secondary data.

### 3.3. Population and Sample

Among the commercial banks and finance companies listed in NEPSE for the period of 1997-2006, three commercial banks (joint venture) and three finance companies have been chosen randomly. In result, Standard Chartered Bank, Nabil Bank and Himalayan Banks were selected for the sample study. Similarly, Ace Finance Company (currently converted into Ace Development Bank), National Finance Company, Kathmandu Finance Company were selected for the sample study from the finance company category.

**Table 3.1**  
**Sampling Description**

<b>Population (N)</b>	<b>Sample Size (n)</b>	<b>Sample Ratio (n/N)</b>
Listed Commercial Banks = 15	3	20%
Listed of Finance Companies = 57	3	5.26%

Source: <http://www.nepalstock.com>, accessed on 09/01/2008

### 3.4. Variables and Measures

Variables used in this study are described in following paragraphs.

#### a. Earning Per Share (EPS)

Earning per share calculation assess to know whether the banks and finance companies earning power on per share basis have changed over the period or not EPS is calculated by dividing the net profit after taxes by the total number of the common shares outstanding.

$$\text{EPS} = \text{Net Profit after Tax} / \text{No. of Outstanding Shares}$$

#### b. Dividend Per Share (DPS)

Dividend per share indicates that the part of net profit after interest and preference dividend paid to ordinary shareholders per share basis. Dividend per share is calculated by dividing the total dividend to equity share holders by the total number of share.

$$\text{DPS} = \text{Total Dividend Amount} / \text{No. of Outstanding Shares}$$

c. Dividend Payout Ratio (DPR)

This ratio reflects the percentage of the profit is distributed as dividend and the percentage is retained as reserve and surplus for the growth of the banks and finance companies. It is calculated by dividing DPS by EPS.

$$\text{DPR} = \text{DPS} / \text{EPS}$$

d. Price Earning Ration (P/E Ratio):

Price earning ratio reflects the price which is currently paid by the market for each rupees of price which is currently reported earning per share. The P-E ratio could be calculated by dividing the market value per share by earning per share.

$$\text{P/E Ratio} = \text{MPS} / \text{EPS}$$

e. Market Yield

Market Yield simply refers to the ratio of earning per share (EPS) and the market price of the share. Symbolically, it can be written as follows:

$$\text{Market Yield} = \text{EPS} / \text{MPS}$$

g. Book Yield

Book Yield simply refers to the ratio of earning per share (EPS) and the book value per share, where book value per share is total net worth divided by number of equity share outstanding. Symbolically, it can be written as follows:

$$\text{Book Yield} = \text{EPS} / \text{BVPS}$$

### **3.5 Method of Analysis**

The analysis of the joint venture banks and finance company's data will be conducted according to pattern of data available. Various financial and statistical tools have been applied to analyze the variables regarding the study topic. The analysis will be done by using various financial and statistical tools. The various calculated results have been obtained through financial and statistical tools are tabulated under different headings by using various financial and statistical tools, the relationship between different variables dividend will be drawn out. There after, the results will be compared with each other to interpret. Most of the statistical values (mean, standard deviation, correlation coefficient, regression models, etc.) are derived with the help of Microsoft Office Excel 10.0 version.

#### **Financial Tools**

Ratio analysis is mostly used financial tool to analyze the financial position of the company. As it is very easy to understand, it holds greater significance. Here, in this study different financial ratios have been employed to derive in meaningful conclusion.

#### **Statistical Tools**

Hypothesis Test: In this study T-test has been conducted to test the hypothesis about similarity and dissimilarity between the earning patterns and different patterns of commercial banks and finance companies. Six different hypotheses have been developed to test for uniformity of EPS, DPS, DPR, P/E Ratio, Market Yield and Book Yield of commercial banks and finance companies. Chapter Four, section three describes in more details.

### **T-statistics**

$$T = [\bar{X}_1 - \bar{X}_2] / \sqrt{S^2 \left[ \frac{1}{n_1} + \frac{1}{n_2} \right]}$$

Where,  $\bar{X}_1$  and  $\bar{X}_2$  are the mean statistics of banks and finance companies respectively.  $S^2$  is the unbiased estimate for population variance and computed as  $S^2 = n_1 s_1^2 + n_2 s_2^2 / n_1 + n_2 - 2$ . The  $s_1^2$  and  $s_2^2$  are the sample variances of the banks and finance companies respectively and said to be biased estimates (Sthapit *et al.*, 2003). The  $n_1$  and  $n_2$  are number of observations of respective estimates.

### **Mean**

Mean has been used to compute the sample period average as well as to compare banks and finance companies.

$$\text{Mean} = \frac{\sum X}{n},$$

where  $X$  is the unit measurement of variable at given period and  $n$  is the total number of period. For simplicity, Microsoft Excel 10.0 has been used to compute the mean.

## Standard Deviation

Risk of market return is measured by the standard deviation of the return of market. It is the square root of the variance of the return around the mean.

$$\sigma_j = \sqrt{\frac{\sum (R_j - \bar{R}_j)^2}{n-1}}$$

$\sigma_j$  = Standard Deviation of Return on Stock j.

## Correlation Coefficient

Pearson's Correlation Coefficient has been used to conduct correlation analysis. It is a measure of the relative association between two variables. It describes how much linear co-movement exists between two variables. Correlation of coefficient is negative or positive which range from +1 to -1. It can be calculated as:

$$P_{ij} = \frac{\text{Cov}_{ij}}{\sigma_i \sigma_j}$$

Where,  $P_{ij}$  = Correlation Co-efficient for variables.

$\text{Cov}_{ij}$  = Co-variance between variables i and j of the firm

$\sigma_i \sigma_j$  = Standard Deviation of Variable of firm i and j.

For simplicity, Microsoft Excel 10.0 has been used to compute correlation coefficient between variables.

## Graph & Charts

For the purpose of data presentation, Graphs and Charts have been used. Bi-virate table, linear chart, multiple bar diagram, etc have been developed with the help of Microsoft Excel 10.0 and presented.

### **Regression Method**

In this study, Friend and Puckett's (1964) Dividend Supply Function and Stock Price Function has been empirically tested in Nepalese context.

Dividend ( $D_t$ ) is the function of the earning per share ( $E_t$ ), lagged dividend payment ( $D_{t-1}$ ) and lagged price earning ( $P/E_{t-1}$ ) ratio (Friend and Puckett, 1964). Similarly, the price of the stock ( $P_t$ ) is the function of the dividend per share ( $D_t$ ), retained earning per share ( $R_t$ ) and lagged price earning ( $P/E_{t-1}$ ) ratio (Friend and Puckett). In this study, to identify the determinants of the dividend and stock price, the Friend and Puckett's (1964) Dividend Supply Function and Price Function have been used. Symbolically,

$$\text{Dividend Supply Function: } D_t = \alpha_0 + \alpha_1 E_t + \alpha_2 D_{t-1} + \alpha_3 P/E_{t-1} \quad \dots (1)$$

$$\text{Stock Price Function: } P_t = \beta_0 + \beta_1 D_t + \beta_2 R_t + \beta_3 P/E_{t-1} \quad \dots (2)$$

The above models assume the following reasonable priori hypothesis:

$$D_t > 0 \text{ and } R_t > 0$$

The equation (1) and (2) are useful for estimating price behaviour within the observed range of dividend payout and price of the stock (Pradhan, 2003).

To estimate the model, SPSS, the statistical program has been used.

## **CHAPTER IV**

### **PRESENTATION AND ANALYSIS OF DATA**

Dividend payment of the firm is the function of the earning (profitability) of the firm, corporate and personal taxes and the capital investment requirement of the firm including other behaviour issues, particularly, the agency problem. The general perception is that the growing firms require more funds to invest, hence pays less dividend and retain more and vice versa. If the personal tax on shareholder's earning is higher the cash dividend will be lesser. As managers prefer internal financing for their capital requirement (Myers, 1984), firm having more capital investment requirement pays less dividend. Beside these, company may adopt various dividend policies under the given context. This chapter deals with dividend practices of commercial banks and finance companies and organized into four sections. Dividend practices of commercial banks are dealt under Section 1, whereas, dividend practices of finance companies are dealt under Section 2. In Section 3, the dividend practices of commercial banks are compared with finance companies. Finally, the impact of earning and dividend on stock price is analyzed in Section 4.

#### **4.1. Analysis of Dividend Practices of Commercial Banks**

The role of banks is very important. The growing importance of financial institutions in economic development has given new dimensions in the functions of the banks. However, the banking industry, around the world, are highly regulated, they are one of the highly profitable industry in the world. In Nepalese context, banks are the most profitable business entities and their shares have dominated the stock market.

In following paragraph, the dividend practices of sample commercial banks are studied by using different financial and statistical tools.

#### 4.1.1. Dividend Practices of Standard Chartered Bank:

Earning per share (EPS), dividend per share (DPS), market price per share (MPS), book value per share (BVPS), dividend payout ratio (DPR), price-earning ratio (P/E), and market and book yield of Standard Chartered Bank for 1997-2006 are summarized in Table 4.1. Data are extracted from financial statements of the bank and Nepal Stock Exchange (NEPSE) database.

**Table 4.1**  
**Dividend Practices of Standard Chartered Bank**

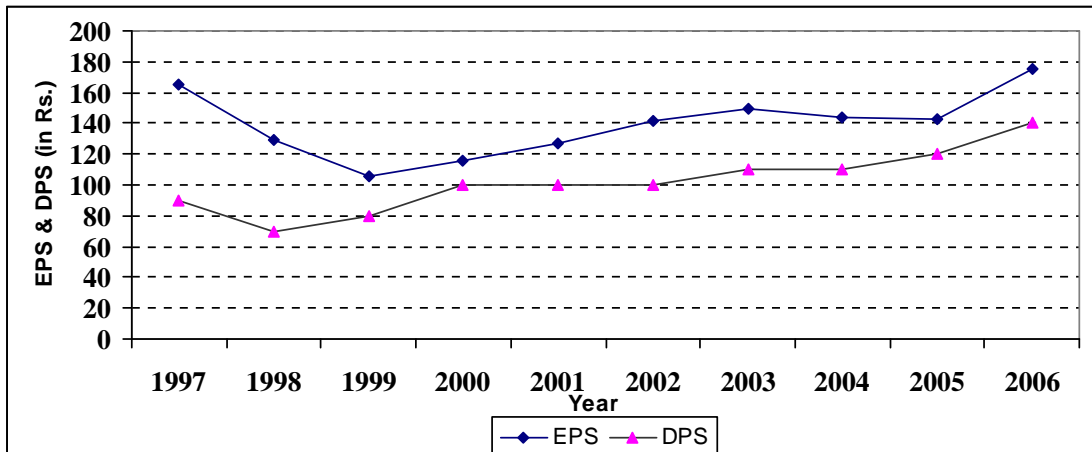
<b>YEAR</b>	<b>EPS (Rs.)</b>	<b>DPS (Rs.)</b>	<b>MPS (Rs.)</b>	<b>BVPS (Rs.)</b>	<b>DPR (%)</b>	<b>P/E Ratio</b>	<b>Market Yield (%)</b>	<b>Book Yield (%)</b>
1997	165.40	90.00	1050.00	538.82	54.41	6.35	15.75	30.70
1998	129.62	70.00	840.00	445.17	54.00	6.48	15.43	29.12
1999	105.86	80.00	1162.00	318.19	75.57	10.98	9.11	33.27
2000	115.62	100.00	1985.00	298.88	86.49	17.17	5.82	38.68
2001	126.88	100.00	2144.00	327.50	78.81	16.90	5.92	38.74
2002	141.13	100.00	1550.00	363.86	70.86	10.98	9.11	38.79
2003	149.30	110.00	1640.00	403.15	73.68	10.98	9.10	37.03
2004	143.55	110.00	1745.00	399.25	76.63	12.16	8.23	35.95
2005	143.14	120.00	2345.00	422.38	83.83	16.38	6.10	33.89
2006	175.84	140.00	3775.00	468.22	79.62	21.47	4.66	37.56
<b>Average</b>	<b>139.63</b>	<b>102.00</b>	<b>1823.60</b>	<b>398.54</b>	<b>73.39</b>	<b>12.98</b>	<b>8.92</b>	<b>35.37</b>

*Source: Appendix A*

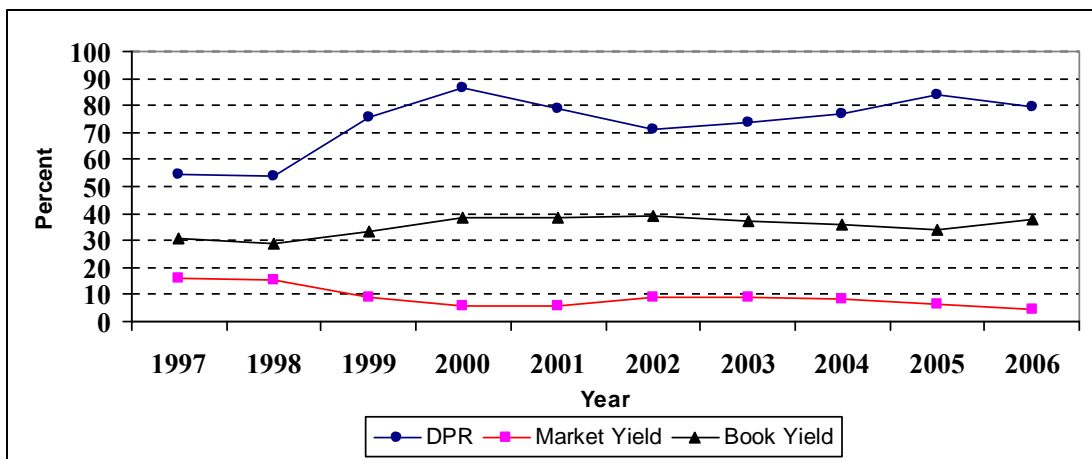
Regarding the earning pattern of the Standard Chartered Bank, Table 4.1 above reveals that the EPS is higher in respect to the paid-up value of the share. The figure is highest in 2006, which is Rs. 175.84, and lowest in 1999, which is Rs. 105.9. The average EPS over the sample period is Rs. 139.63. The SCB stock has the highest market yield in 1997, which is 15.75% and lowest in 2006, which is 4.66; the sample period average market yield is 8.92%. Similarly, the average book yield is 35.37%. All these statistics show that the bank has good performance and yielding

higher profitability. Figure 4.1 (b) shows market yield and book yield along with DPR. Over the sample period, the bank has 12.98 P/E ratio in average.

**Figure 4.1 (a)**  
**EPS and DPS: Standard Chartered Bank**



**Figure 4.1(b)**  
**DPR, Market Yield and Book Yield: Standard Chartered Bank**



Regarding the dividend practices, the bank has paid lowest dividend in 1998, which is Rs. 70 and highest in 2006, which is Rs. 140. The bank has the lowest DPR in 1998, which is 54% and highest in 2000, which is 86.5%. The average DPR is 71.65%. This evidence implies that the bank has followed the higher dividend payout policy. However, the Table 4.5

does not clearly show the pattern of dividend policy, the Figure 4.5(a) indicates that the bank might have followed the fixed dividend policy that mean equal amount of dividend per share every year with growth. The market price of the stock reached at apex during 2001 and lowest during 1996 over the sample period.

**Table 4.2**  
**Correlation Matrix: Standard Chartered Bank**

	EPS	DPS	MPS	BVPS
EPS	1.00			
DPS	0.62	1.00		
MPS	0.46	0.91	1.00	
BVPS	0.82	0.16	0.03	1.00

*Source: Table 4.1*

The Correlation Matrix Table 4.2 above shows that there is positive relationship between EPS and DPS, as measured by correlation coefficient 0.62. The correlation coefficient between DPS and MPS is 0.91. Correlation coefficient between EPS & MPS is 0.46. The correlation coefficient 0.03 signifies that there is no significant correlation between MPS and BVPS.

#### **4.1.2. Dividend Practices of Himalayan Bank:**

In this section, the earning pattern and the dividend practices of the Nabil Bank has been presented and analyzed. Table 4.3 presents the earning per share (EPS), dividend per share (DPS), market price per share (MPS), book value per share (BVPS), dividend payout ratio (DPR), price-earning ratio (P/E), and market and book yield of Himalayan Bank Limited for 1997-2006. Data are extracted from financial statements of the bank and Nepal Stock Exchange (NEPSE) database.

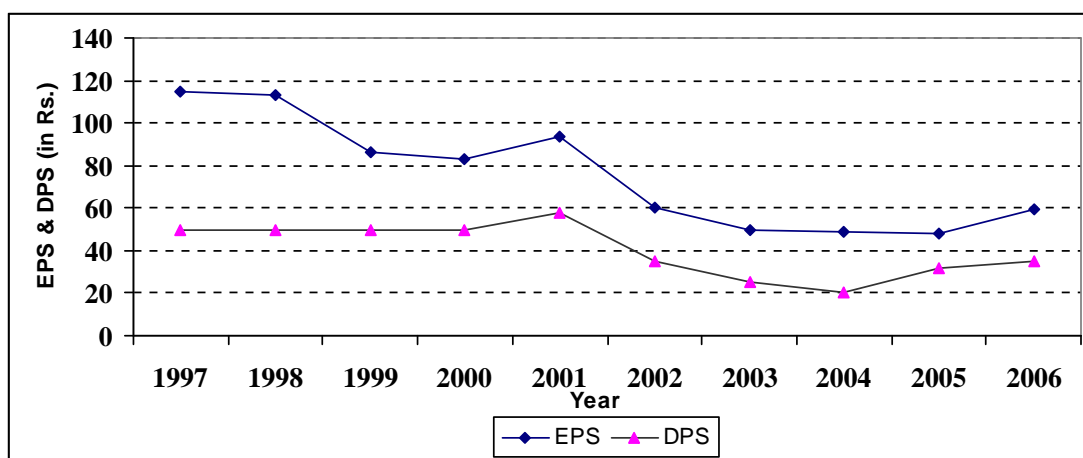
**Table 4.3**  
**Dividend Practices of Himalayan Bank**

YEAR	EPS (Rs.)	DPS (Rs.)	MPS (Rs.)	BVPS (Rs.)	DPR (%)	P/E Ratio	Market Yield (%)	Book Yield (%)
1997	115.08	50.00	640.00	274.48	43.45	5.56	17.98	41.93
1998	113.32	50.00	755.00	320.05	44.12	6.66	15.01	35.41
1999	86.07	50.00	1000.00	234.99	58.09	11.62	8.61	36.63
2000	83.08	50.00	1700.00	219.19	60.18	20.46	4.89	37.90
2001	93.56	57.50	1500.00	240.20	61.46	16.03	6.24	38.95
2002	60.26	35.00	1000.00	220.03	58.08	16.59	6.03	27.39
2003	49.45	25.00	836.00	247.82	50.56	16.91	5.92	19.95
2004	49.05	20.00	840.00	246.93	40.77	17.13	5.84	19.86
2005	47.91	31.58	920.00	239.59	65.92	19.20	5.21	20.00
2006	59.24	35.00	1100.00	228.72	59.08	18.57	5.39	25.90
<b>Average</b>	<b>75.70</b>	<b>40.41</b>	<b>1029.10</b>	<b>247.20</b>	<b>54.17</b>	<b>14.87</b>	<b>8.11</b>	<b>30.39</b>

*Source: Appendix A*

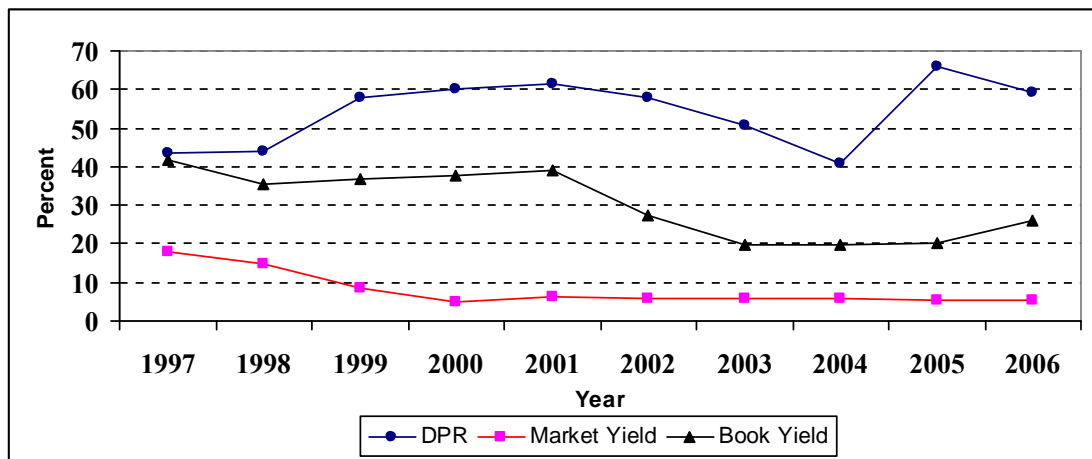
Regarding the dividend practices, the bank has paid Rs. 50 dividend during 1997 to 2000 each year, however, the DPS in 2004 is Rs.20. On an average, the bank has been paying around 54% earning to its shareholders as dividend as indicated by sample period average dividend payout ratio.

**Figure 4.2**  
**EPS and DPS: Himalayan**



The Figure 4.2 shows the trend of dividend practices of the bank over the sample period. The figure reveals that the bank has followed both the constant and fixed dividend policies as under the organizational constraints. However, the retention ratio is lower than dividend payout ratio. The average retention ratio is 46% (100-54). This evidence implies that the bank is retaining less of its profit for further capital investment projects.

**Figure 4.2(b)**  
**DPR, Market Yield and Book Yield: Himalayan**



However, the price of the stock is determined through the demand and supply in the stock market, the future earning possibility and dividend play significant role to determine the stock price. Over the sample period, the stock price is highest in 2000 and lowest in 1997. The average P/E ratio is 14.87 times. The market yield and book yield can also be observed from Figure 4.3.

**Table 4.4**  
**Correlation Matrix: Himalayan**

	<b>EPS</b>	<b>DPS</b>	<b>MPS</b>	<b>BVPS</b>
EPS	1.00			
DPS	0.87	1.00		
MPS	0.00	0.41	1.00	
BVPS	0.61	0.22	-0.58	1.00

*Source: Table 4.3*

The Correlation Matrix Table 4.4 above shows that the EPS and DPS are highly correlated which is signified by the correlation coefficient 0.87. Under the bivariate analysis, about 76% variation in DPS is explained by earning variability, measured by R-Squared. It is also revealed that EPS and MPS have not relation because the correlation coefficient between these two variables is zero. However, EPS and DPS have positive relationship with BVPS. It is observed that DPS and MPS are not highly correlated. The correlation coefficient 0.41 signifies it. As stock valuation models advocate that price of the stock is function of dividend, to some extent, the evidence is less supportive to the theory.

#### 4.1.3 Dividend Practices of Nabil Bank:

In this section, the earning pattern and the dividend practices of the Nabil Bank has been presented and analyzed. Table 4.5 presents the earning per share (EPS), dividend per share (DPS), market price per share (MPS), book value per share (BVPS), dividend payout ratio (DPR), price-earning ratio (P/E), and market and book yield of NABIL Bank Limited for 1997-2006. Data are extracted from financial statements of the bank and Nepal Stock Exchange (NEPSE) database.

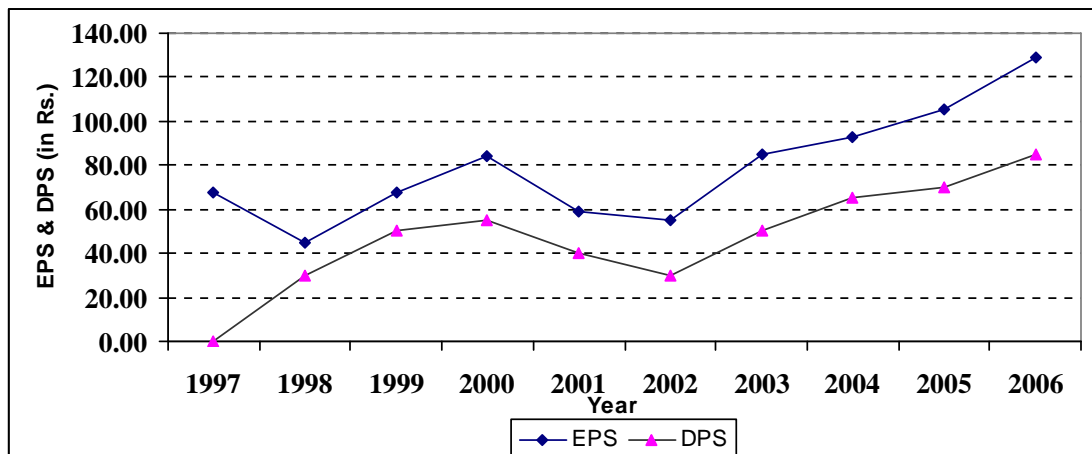
**Table 4.5**  
**Dividend Practices of Nabil Bank**

YEAR	EPS (Rs.)	DPS (Rs.)	MPS (Rs.)	BVPS (Rs.)	DPR (%)	P/E Ratio	Market Yield (%)	Book Yield (%)
1997	67.68	0.00	500.00	294.62	0.00	7.39	13.54	22.97
1998	44.50	30.00	430.00	210.92	67.42	9.66	10.35	21.10
1999	67.84	50.00	700.00	223.45	73.70	10.32	9.69	30.36
2000	83.79	55.00	1400.00	250.53	65.64	16.71	5.99	33.45
2001	59.26	40.00	1500.00	216.18	67.50	25.31	3.95	27.41
2002	55.25	30.00	700.00	233.18	54.30	12.67	7.89	23.69
2003	84.66	50.00	740.00	267.30	59.06	8.74	11.44	31.67
2004	92.61	65.00	1000.00	301.00	70.19	10.80	9.26	30.77
2005	105.49	70.00	1505.00	337.00	66.36	14.27	7.01	31.30
2006	129.21	85.00	2204.00	381.00	65.78	17.06	5.86	33.91
<b>Average</b>	<b>79.03</b>	<b>47.50</b>	<b>1067.90</b>	<b>271.52</b>	<b>58.99</b>	<b>13.29</b>	<b>8.50</b>	<b>28.66</b>

*Source: Appendix A*

In Table 4.5, it is revealed that the EPS is highest in 2006, that is, Rs. 129.21; and lowest in 1998, that is, Rs. 44.5 during the sample period. The sample period average EPS is Rs. 79.03. The earning of the bank can also be analyzed from market and book yield. The market yield figure in 1997 is highest and it is lowest in 2001. The average market yield is 8.5%, whereas, the book average book yield is 28.66%. The book yield figures show that the good earning pattern of the firm/bank. The sample period average P/E ratio is 13.29.

**Figure 4.3(a)**  
**EPS and DPS: Nabil Bank**



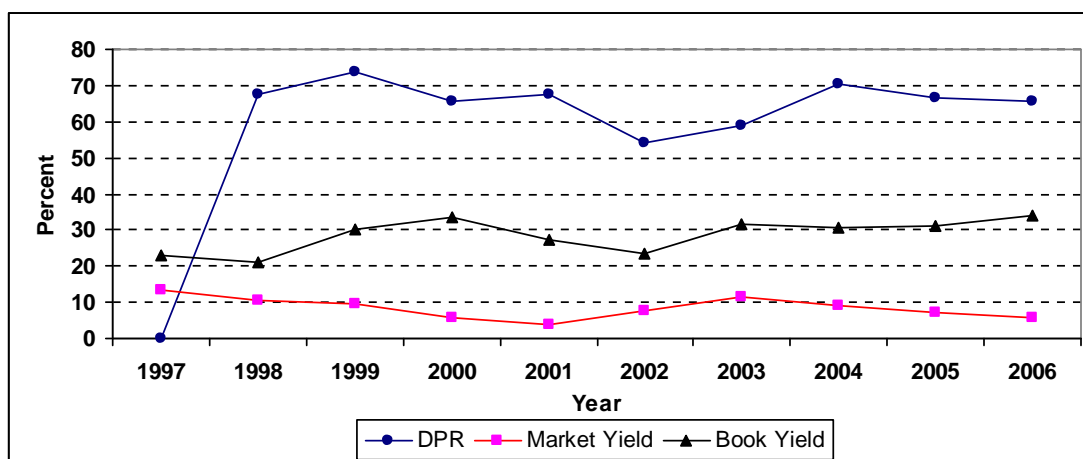
Similarly, the bank has paid highest dividend during 2006, which is Rs. 85. In 1997, the bank did not pay any cash dividend. On an average, the bank has been paying around 59% earning to its shareholders as dividend. Except than in 1997, the DPR is higher than 50%. This evidence implies that the shareholders of the bank prefer more dividend than retained earning. It also might be the consequences of higher earning of the firm.

Over the sample period, the stock price is highest in 2006 and lowest in 1998. From figure 4.4 and 4.5, it is revealed that before 1998, the bank might have residual dividend policy, however, after the date; it has followed the constant dividend payout ratio policy as signified by the

figures. The average P/E ratio is 13.29 times. The market yield and book yield can also be observed from Figure 4.5.

Figure 4.3(b)

DPR, Market Yield and Book Yield: Nabil Bank



In 2006, the price of the NABIL Bank's stock is highest, that is Rs. 2204 and in 1998, the figure is lowest over the sample period.

To analyze the relationship between EPS, DPS, MPS and BVPS, Table 4.4 above summarize it. The correlation coefficient between EPS and DPS is 0.80, which implies that there is high degree of correlation between these variables.

Table 4.6

Correlation Matrix: Nabil Bank

	EPS	DPS	MPS	BVPS
EPS	1.00			
DPS	0.80	1.00		
MPS	0.77	0.76	1.00	
BVPS	0.92	0.56	0.62	1.00

Source: Table 4.5

The correlation coefficient between EPS and MPS is revealed 0.77, that mean, under the bivariate analysis, the changes in MPS is explained about 59% by EPS - measured by R-square. Similarly, the correlation coefficient between DPS and MPS is revealed 0.76 that mean, under the

bivariate analysis, the changes in MPS is explained about 58% by DPS. The correlation coefficient between EPS and BVPS is high, that is, 0.92. The correlation coefficient, 0.62 between MPS and BVPS implies that the movements of variables are positively correlated.

#### 4.1.4. Comparative Analysis of Dividend Practices of Commercial Banks

From the study of individual analysis of dividend practices of sample commercial banks, it is stimulated to make a brief comparison among sample bank. This section briefly compares the earning and dividend pattern of the banks.

Table 4.7 summarizes the average sample statistics for three sample banks. The statistics are derived from Table 4.1, 4.3 and 4.5.

**Table 4.7**  
**Comparative Statistics of Commercial Banks**

Financial Indicators	STANDARD		HIMALAYAN		NABIL	
	Mean	SD	Mean	SD	Mean	SD
EPS (Rs.)	139.63	21.29	75.70	26.09	79.03	25.52
DPS (Rs.)	102.00	19.89	40.41	12.70	47.50	24.07
MPS (Rs.)	1823.60	838.45	1029.10	331.67	1067.90	566.77
BVPS (Rs.)	398.54	74.49	247.20	30.13	271.52	56.42
DPR (%)	73.39	11.09	54.17	8.76	58.99	21.43
P/E Ratio (x)	12.98	4.89	14.87	5.18	13.29	5.33
Market Yield (%)	8.92	3.86	8.11	4.59	8.50	2.91
Book Yield (%)	35.37	3.49	30.39	8.72	28.66	4.59

Regarding the dividend practices of sample commercial banks, among others, the Table 4.7 above reveals as follows:

- Standard Chartered Bank has the highest EPS, which is Rs. 139.63 and the Himalayan Bank has the lowest, which is Rs. 75.70 earning per share among others. Nabil Bank has slightly higher EPS than Himalayan which is Rs. 79.03 The earning variability of Standard

Chartered is also lower. The earning patterns on Nabil and Himalayan are found similar or approximately equal.

- Similarly, the Standard Chartered Bank has paid highest dividend that is Rs. 102, the 10-year average statistics. The DPS of Himalayan is 40.41 and Nabil is 47.50. The dividend payment ratio of Standard Chartered is highest, that is, around 73% where as Nabil has 59% and Himalayan has 54%, the lowest. From the Figure 4.1, 4.3 (a) and 4.4, it is observed that Nabil has adopted ‘residual and constant dividend policy’, whereas the Standard Chartered has followed the ‘fixed dividend policy’ and Himalayan has followed the ‘constant and fixed dividend policy’.
- Both the market price and the book value of the stock of the Standard Chartered are highest among others. The Himalayan has lowest market price and book value per share. The stock of Himalayan has the highest P/E Ratio and the Standard Chartered has the lowest. However, the Standard Chartered has the highest market yield and book yield among others.

The above analysis provides some tentative information about the dividend practices of three commercial joint venture banks. The evidences show that the performances of the sample firms are good over the sample period. However, there is consistency on relationship between earning patterns and dividend patterns of sample banks to some extent, the relationship between earning patterns and stock price patterns have mixed outcomes with dividend theories as signified by their correlation coefficients.

## 4.2. Analysis of Dividend Practices of Finance Companies

Financial institutions are important functionaries in corporate business world. As an intermediate, the finance companies not only provide the agency works to both investors (lender) and borrowers but also mobilize the individual savings. In recent days, the function of finance companies are widening, however their functions are limited and constrained by laws. In the development of Nepalese industrial development and corporate business practices, the roles of financial companies are important. In this section, the dividend practices of Nepalese finance companies are studied with the sample of three.

### 4.2.1 Dividend Practices of Kathmandu Finance:

Table 4.8 presents the earning per share (EPS), dividend per share (DPS), market price per share (MPS), book value per share (BVPS), dividend payout ratio (DPR), price-earning ratio (P/E), and market and book yield of Kathmandu Finance Company for 1997-2006. Data are extracted from financial statements of the bank available at Nepal Stock Exchange (NEPSE) database.

**Table 4.8**  
**Dividend Practices of the Kathmandu Finance**

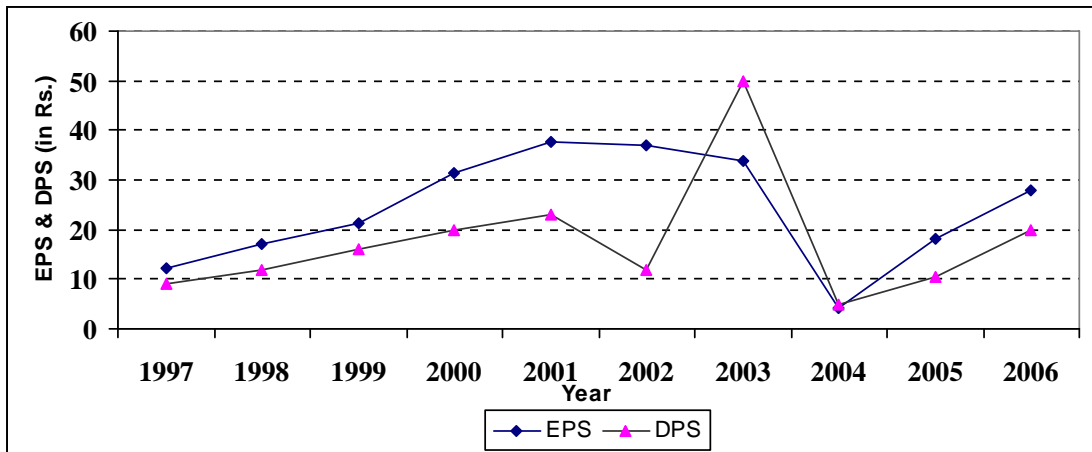
YEAR	EPS (Rs.)	DPS (Rs.)	MPS (Rs.)	BVPS (Rs.)	DPR (%)	P/E Ratio	Market Yield (%)	Book Yield (%)
1997	12.35	9.00	77.00	105.50	72.87	6.23	16.04	11.71
1998	17.00	12.00	95.00	110.60	70.59	5.59	17.89	15.37
1999	21.35	16.00	98.00	116.80	74.94	4.59	21.79	18.28
2000	31.25	20.00	295.00	128.05	64.00	9.44	10.59	24.40
2001	37.60	23.00	321.00	142.55	61.17	8.54	11.71	26.38
2002	37.05	12.00	305.00	169.64	32.39	8.23	12.15	21.84
2003	33.85	50.00	235.00	154.88	147.71	6.94	14.40	21.86
2004	4.34	5.00	205.00	139.36	115.21	47.24	2.12	3.11
2005	17.97	10.50	250.00	149.80	58.43	13.91	7.19	12.00
2006	28.05	20.00	270.00	163.07	71.30	9.63	10.39	17.20
<b>Average</b>	<b>24.08</b>	<b>17.75</b>	<b>215.10</b>	<b>138.03</b>	<b>76.86</b>	<b>12.03</b>	<b>12.43</b>	<b>17.21</b>

*Source: Appendix A*

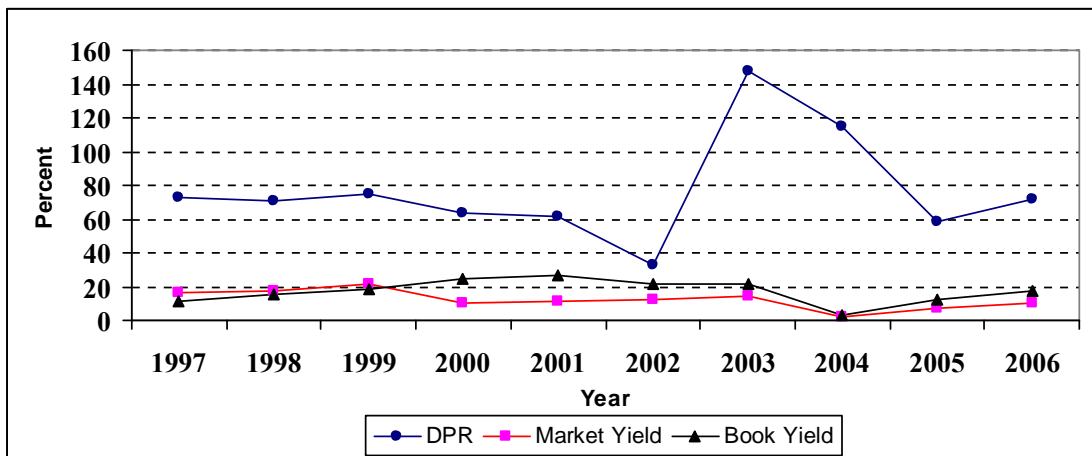
From table 4.8, it is revealed that the EPS is highest in 2001, that is, Rs. 37.6; and lowest in 2004, that is, Rs. 4.34 during the sample period. The sample period average EPS is Rs. 24.08. Similarly, the company has paid highest dividend during the year 2003 which is Rs. 50 and more than earning of that year. The market price of the stock of Kathmandu Finance Company in 2001 is highest, which is Rs. 321 and lowest in 1997, which is Rs. 77. The market and book yield show the earning pattern of the company. The market yield figure in 1999 is highest and it is lowest in 2004. The average market yield is 12.43%, whereas, the book average book yield is 17.21%. The book yield figures show that the good earning pattern of the firm.

Regarding the dividend practices, the company has been following high dividend payout policy as signified 76.86% DPR . In 2003, the firm has paid highest dividend, which is Rs. 50 per share. Interestingly, the DPS in 2003 is higher than EPS for the year. This evidence indicates that the company has paid its retained earning (including previous year earnings) as dividend. It might be the cause of less investment opportunities in the market as the consequence of the recessive economic scenario. The yearly high dividend payout ratio also implies that the shareholders of the company prefer more dividend than retained earning. It also might be the consequences of the less capital investment opportunities available to the firm. From the Figure 4.6 (a, b), it reveals that during 1997-2001, the company has followed the constant dividend growth policy.

**Figure 4.4 (a)**  
**EPS and DPS: Kathmandu Finance**



**Figure 4.4 (b)**  
**Market Yield, Book Yield and DPR: Kathmandu Finance**



**Table 4.9**  
**Correlation Matrix: Kathmandu Finance**

	EPS	DPS	MPS	BVPS
EPS	1.00			
DPS	0.61	1.00		
MPS	0.68	0.28	1.00	
BVPS	0.53	0.32	0.80	1.00

*Source: Table 4.8*

From the Table 4.9, among other, it is revealed that the EPS &DPS and EPS and MPS have positive correlation as indicated by correlation

coefficient 0.61 and 0.68 respectively. The correlation coefficient between DPS & MPS 0.28 implies that the price of stock is less determined by dividend. Under the bivariate analysis, about 9% in variation in MPS is explained by DPS. It implies that the movement of market price of the stock is not directly depending on the dividend. Again, the correlation coefficient between MPS & BVPS revealed positive and high which is 0.80.

#### **4.2.2 Dividend Practices of National Finance:**

Table 4.10 presents the earning per share (EPS), dividend per share (DPS), market price per share (MPS), book value per share (BVPS), dividend payout ratio (DPR), price-earning ratio (P/E), and market and book yield of National Finance Company for 1997-2006. Data are extracted from financial statements of the bank and Nepal Stock Exchange (NEPSE) database.

Table 4.10 below reveals that the EPS is highest in 2005 over the ten year sample period which is Rs. 69.12; and lowest in 2006, that is, Rs. 17.37. The sample period average EPS is Rs. 49.62. The earning of the company can also be analyzed from market and book yield. In 1998, the market yield figure is highest and its book average book yield is 20.36%.

**Table 4.10**  
**Dividend Practices of National Finance**

YEAR	EPS (Rs.)	DPS (Rs.)	MPS (Rs.)	BVPS (Rs.)	DPR (%)	P/E Ratio	Market Yield (%)	Book Yield (%)
1997	39.13	18.00	187.00	202.27	46.00	4.78	20.93	19.35
1998	53.37	22.00	204.00	184.53	41.22	3.82	26.16	28.92
1999	52.40	24.00	300.00	211.30	45.80	5.73	17.47	24.80
2000	63.93	28.00	470.00	243.67	43.80	7.35	13.60	26.24
2001	67.23	30.00	560.00	277.43	44.62	8.33	12.01	24.23
2002	55.70	20.00	545.00	291.79	35.91	9.78	10.22	19.09
2003	35.75	20.00	455.00	307.51	55.94	12.73	7.86	11.63
2004	42.15	21.00	360.00	252.83	49.82	8.54	11.71	16.67
2005	69.12	10.52	412.00	271.94	15.22	5.96	16.78	25.42
2006	17.37	10.53	297.00	237.73	60.62	17.10	5.85	7.31
<b>Average</b>	49.62	20.41	379.00	248.10	43.90	8.41	14.26	20.36

*Source: Appendix A*

Regarding the dividend practices, the company has paid highest dividend during 2001, which is Rs. 30 and it is lowest in 2005 & 6, which is Rs. 10.5. On an average, the company has been paying around 44% earning to its shareholders as dividend. The DPR of the company is highest in 2006, which is 61% and lowest in 2005, which is 15%. Over the sample period, the stock price of the company is highest in 2001 and lowest in 1997.

**Figure 4.5(a)**  
**EPS and DPS: National Finance**

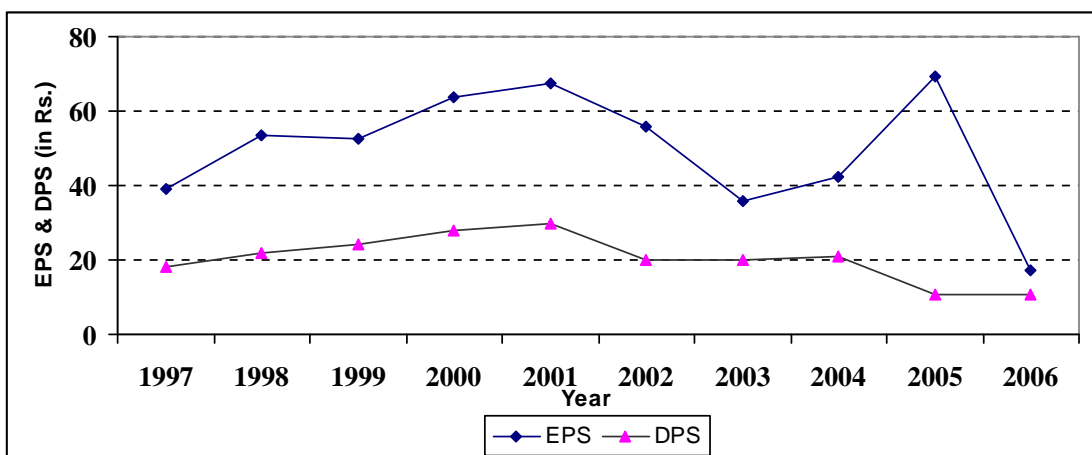
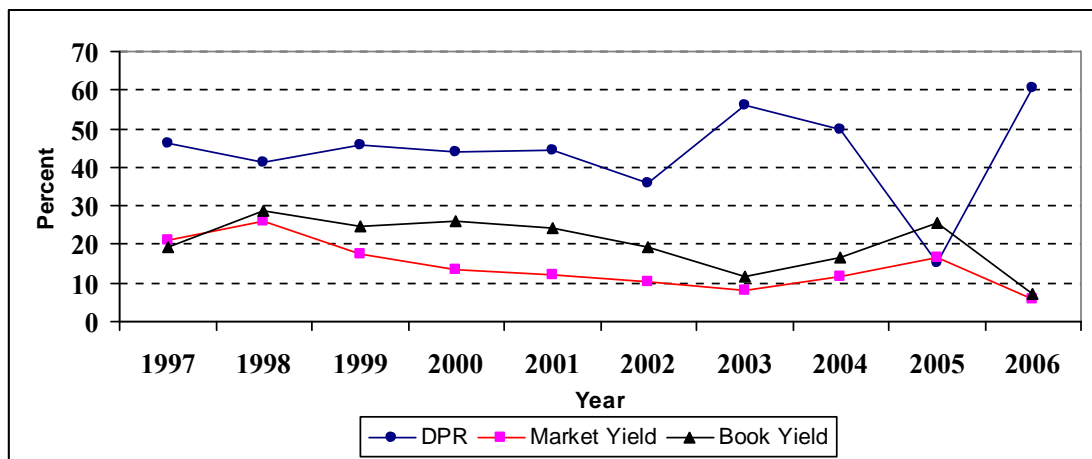


Figure 4.7 shows the trend of DPS and EPS over the sample period. With some exceptions, the figure shows that the company has followed constant and residual dividend policy. It is also observed that during the 1997-2001, the company has followed constant dividend growth policy.

The average market yield on stock of the company is 14% over the sample period, whereas the average book yield is 20%. The market yield is found highest in 1998, that is 26% and lowest in 2006, that is 7%.

**Figure 4.5(b)**  
**Market Yield, Book Yield and DPR: National Finance**



Similarly, the book yield is found highest in 1998 but the lowest in 2003. Figure 4.8 shows the market yield and book yield along with DPR. The market price of the stock in 2001 is highest, which is Rs. 560 and it is lowest in 1996, which is Rs. 176.

**Table 4.11**  
**Correlation Matrix: National Finance**

	EPS	DPS	MPS	BVPS
EPS	1.00			
DPS	0.48	1.00		
MPS	0.47	0.36	1.00	
BVPS	0.14	-0.02	0.86	1.00

*Source: Table 4.10*

From the Table 4.11 above, it is revealed that there is moderate degree of correlation between EPS & DPS and EPS and MPS as indicated by coefficient 0.48 and 0.47 respectively. It is also revealed that there is low degree to correlation between DPS and MSP as indicated by correlation coefficient 0.36. The correlation coefficient 0.86 for MPS and BVPS indicates that price of stock moves as book value of stock moves.

#### 4.2.3. Dividend Practices of Ace Finance<sup>1</sup>:

Table 4.12 presents the earning per share (EPS), dividend per share (DPS), market price per share (MPS), book value per share (BVPS), dividend payout ratio (DPR), price-earning ratio (P/E), and market and book yield of Ace Finance Company for 1997-2006. Data are extracted from financial statements of the bank available at SEBO Database.

**Table 4.12**  
**Dividend Practices of the Ace Finance**

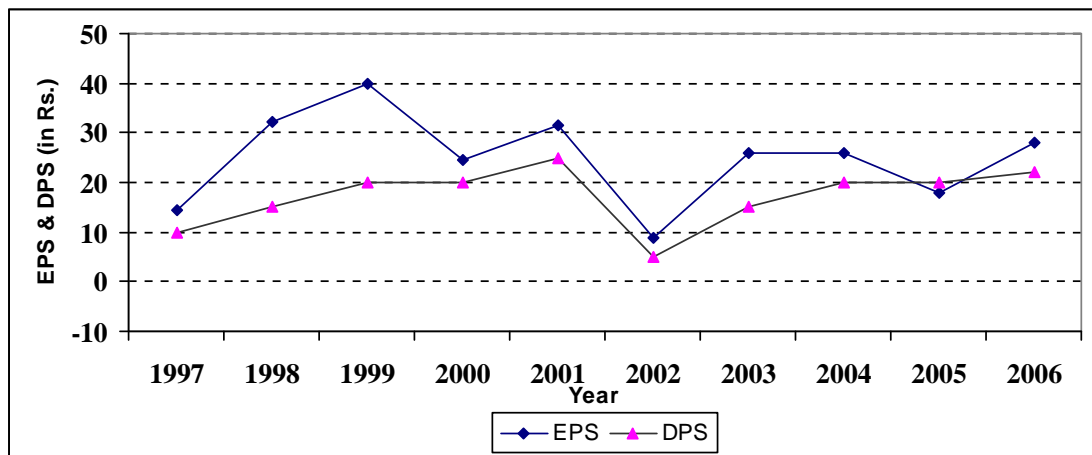
YEAR	EPS (Rs.)	DPS (Rs.)	MPS (Rs.)	BVPS (Rs.)	DPR (%)	P/E Ratio	Market Yield (%)	Book Yield (%)
1997	14.31	10.00	110.00	103.91	69.88	7.69	13.01	13.77
1998	32.37	15.00	110.00	119.50	46.34	3.40	29.43	27.09
1999	39.97	20.00	220.00	134.90	50.04	5.50	18.17	29.63
2000	24.47	20.00	411.00	127.40	81.73	16.80	5.95	19.21
2001	31.53	25.00	500.00	132.40	79.29	15.86	6.31	23.81
2002	9.00	5.00	230.00	153.00	55.56	25.56	3.91	5.88
2003	26.00	15.00	240.00	163.00	57.69	9.23	10.83	15.95
2004	26.00	20.00	173.00	165.00	76.92	6.65	15.03	15.76
2005	18.00	20.00	251.00	179.00	111.11	13.94	7.17	10.06
2006	27.94	22.11	320.00	201.00	79.13	11.45	8.73	13.90
<b>Average</b>	<b>24.96</b>	<b>17.21</b>	<b>256.50</b>	<b>147.91</b>	<b>70.77</b>	<b>11.61</b>	<b>11.85</b>	<b>17.51</b>

*Source: Appendix A*

In Table 4.12, it is revealed that the EPS is highest in 1999, that is, Rs. 39.97; and lowest in 2005, that is, Rs. 9 during the sample period. The sample period average EPS is Rs. 25. The market price of the stock of the company in 2001 is highest, which is Rs. 500 and lowest in 1997, which

is Rs. 110. The market and book yield show the earning pattern of the company. The market yield figure in 1998 is highest and it is lowest in 2002. The average market yield is 11.85%, whereas, the book average book yield is 17.51%. The book yield figures show the good earning pattern of the firm.

**Figure 4.6(a)**  
**EPS and DPS: Ace Finance**

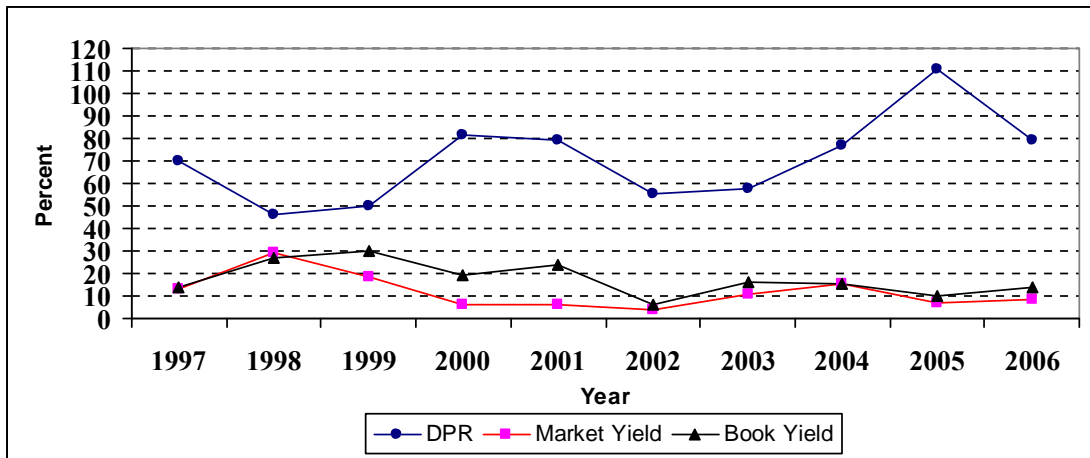


Regarding the dividend practices, the company has followed high dividend pay out policy as indicated by 71 percent dividend payout ratio. It also implies that the shareholders of the company prefer more dividend than that of retained earning. The high dividend payout ratio may be the because of unavailability of additional capital investment opportunities to the company. The least figure of dividend amount occurred on the year 2002 which is Rs. 5; the EPS figure for the year is also low.

<sup>1</sup> Recently the Ace Finance Company has been converted into Ace Development Bank.

**Figure 4.6(b)**

**Market Yield, Book Yield and DPR: Ace Finance**



From the Figure 4.9, it reveals that the company has followed fixed dividend payout ratio policy over the sample period. The average market yield statistics is 11.85% whereas book yield is 17.51%.

**Table 4.13**

**Correlation Matrix: Ace Finance**

	EPS	DPS	MPS	BVPS
EPS	1.00			
DPS	0.69	1.00		
MPS	0.20	0.60	1.00	
BVPS	-0.06	0.29	0.17	1.00

*Source: Table 4.12*

From the Table 4.13, among other, it reveals that the EPS and DPS are highly correlated. The correlation coefficient is 0.69. The correlation coefficient between EPS and MPS is 0.20 which indicates less dependency of MPS on EPS; however the correlation coefficient between DPS and MPS is high, which is 0.60. It implies that under the bivariate analysis, about 36% in variation in MPS is explained by DPS. The correlation coefficients between other variables are low, that is less than 0.4.

#### 4.2.4. Comparative Analysis of Dividend Practices of Finance

##### Companies

From the study of individual analysis of dividend practices of sample finance companies, it is stimulated to make a brief comparison among sample firms. This section briefly compares the earning and dividend pattern of the banks.

Table 4.14 summarizes the average sample statistics for three sample finance companies. The statistics are derived from Table 4.8, 4.10 and 4.12.

**Table 4.14**  
**Comparative Statistics of Finance Companies**

Financial Indicators	NATIONAL		KATHMANDU		ACE	
	Mean	SD	Mean	SD	Mean	SD
EPS (Rs.)	49.62	16.17	24.08	11.23	24.96	9.14
DPS (Rs.)	20.41	6.38	17.75	12.64	17.21	6.02
MPS (Rs.)	379.00	131.77	215.10	92.87	256.50	124.47
BVPS (Rs.)	248.10	40.16	138.03	22.19	147.91	29.64
DPR (%)	43.90	12.30	76.86	32.16	70.77	19.31
P/E Ratio (x)	8.41	4.01	12.03	12.64	11.61	6.63
Market Yield (%)	14.26	6.17	12.43	5.54	11.85	7.61
Book Yield (%)	20.36	6.92	17.21	6.99	17.51	7.49

Regarding the dividend practices of sample finance companies, among others, the Table 4.14 above reveals as follows:

- National Finance has the highest EPS, which is Rs.49.62 and the Kathmandu Finance has the lowest, which is Rs. 24.08. The Ace Finance has slightly higher EPS than Kathmandu Finance, which is Rs. 24.96. The earning pattern of the Katmandu Finance and Ace Finance are found similar or approximately equal.
- Similarly, the National Finance pays a higher dividend that is Rs. 20.41, the 10-years average statistics. The DPS of Kathmandu and Ace Finance Rs. 17.75 and Rs. 17.21 respectively. However, the

Kathmandu Finance has the highest dividend payout ratio and the National Finance has the lowest. However, the individual analysis of dividend practices does not clearly show the dividend policies adopted by the finance companies, based on the Figure 4.6, 4.8 (a) and 4.9 (a), it can be concluded that the finance companies have followed different dividend policy over the period, however the constant 'dividend payout policy' has dominated the sample firms.

- Both the market price and the book value of the stock of the National Finance are highest among others followed by Ace Finance. The P/E Ratio of the National Finance is 8.41 times; of the Kathmandu Finance is 12.03 times; and of the Ace Finance is 11.61 times.
- The market and book yields of the National Finance are highest among others. However the book yield and market yield of Kathmandu and Ace are found similar.

The above analysis provides some tentative information about the dividend practices of three finance companies. The evidences show that the performances of the sample firms are good over the sample period.

### **4.3. Comparative Analysis of Dividend Practices of Commercial Banks and Finance Companies**

In this section, the dividend practices of sample commercial banks are compared with finance companies with the help of diagram and parametric test statistics.

**Figure 4.7**  
**Comparative Statistics of Banks and Finance Companies**

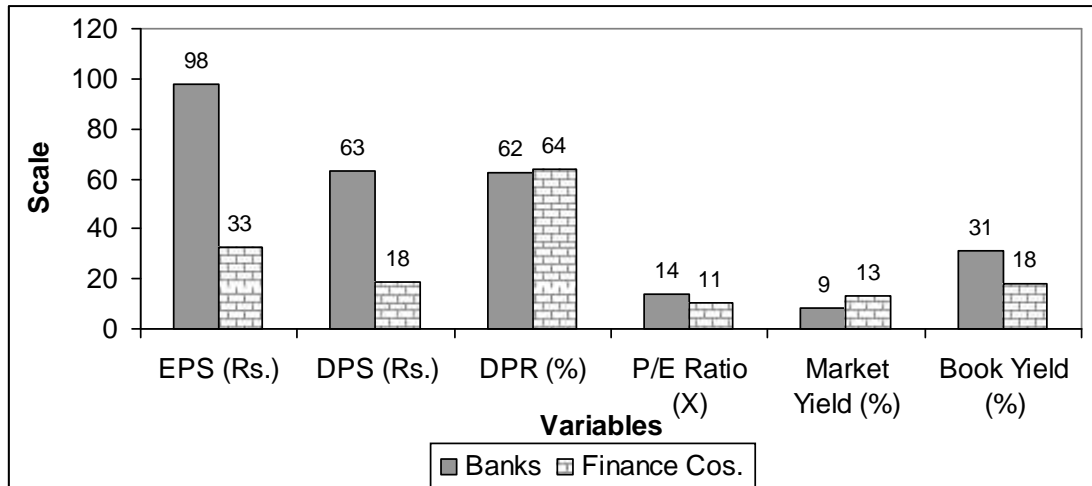


Figure 4.11 show the different variables of banks and finance companies. In term of economies of scale, banks are larger in size and volume of transactions; hence have higher earning capacity than finance companies, which is shown by EPS. The average EPS of banks is Rs. 98 whereas finance companies have Rs. 33. Similarly, the average DPS of banks is Rs. 63 whereas the average DPS of finance companies is Rs. 18. The average dividend payout ratios of finance companies and commercial banks are found similar which is round 63%. The finance companies has lower P/E ratio than banks. The market yield of banks is observed lower than that of finance companies. The average statistics is 9% vs. 13% however, the book yield of banks are greater than that of finance companies as observed 31% vs. 18%. From the individual study of dividend practices of sample firm, it is observed that different sample firms are following different dividend policies.

To test whether there are similarities or not between average EPS, DPS, DPR, P/E Ratio, Market Yield and Book Yield of commercial banks and finance companies; t-test has been conducted.

Table 4.15 presents the mean and variance statistics of EPS, DPS, P/E Ratio, Market Yield and Book Yield for commercial banks and finance companies separately. The sample statistics are the pooled data statistics.

**Table 4.15**  
**Average Statistics for Banks and Finance Companies**

<b>Variables</b>	<b>Mean</b>	<b>Standard Dev.</b>	<b>Sample Size</b>
<i>Commercial Banks</i>			
EPS	98.12	38.04	30
DPS	63.30	33.70	30
DPR	62.19	16.53	30
P/E Ratio	13.72	5.03	30
Market Yield	8.51	3.73	30
Book Yield	31.48	6.50	30
<i>Finance Companies</i>			
EPS	32.89	17.06	30
DPS	18.46	8.69	30
DPR	63.84	26.38	30
P/E Ratio	10.68	8.42	30
Market Yield	12.85	6.36	30
Book Yield	18.36	7.04	30

a. Hypothesis Development:

Null Hypothesis ( $H_0$ ):

1. There is no significant difference in the mean EPS between commercial banks and finance companies.
2. There is no significant difference in the mean DPS between commercial banks and finance companies.
3. There is no significant difference in the mean DPR between commercial banks and finance companies.
4. There is no significant difference in the mean P/E Ratio between commercial banks and finance companies.

5. There is no significant difference in the mean Market Yield between commercial banks and finance companies.
6. There is no significant difference in the mean Book Yield between commercial banks and finance companies.

Alternative Hypothesis ( $H_1$ ):

There is significant difference in the mean EPS between commercial banks and finance companies.

There is significant difference in the mean DPS between commercial banks and finance companies.

There is significant difference in the mean DPR between commercial banks and finance companies.

There is significant difference in the mean P/E Ratio between commercial banks and finance companies.

There is significant difference in the mean Market Yield between commercial banks and finance companies.

There is significant difference in the mean Book Yield between commercial banks and finance companies.

b. Test statistic:

$$T = [\bar{X}_1 - \bar{X}_2] / \sqrt{S^2 \left[ \frac{1}{n_1} + \frac{1}{n_2} \right]}$$

Where,  $\bar{X}_1$  and  $\bar{X}_2$  are the mean statistics of banks and finance companies respectively.  $S^2$  is the unbiased estimate for population variance and computed as  $S^2 = n_1s^2_1 + n_2s^2_2/n_1+n_2-2$ . The  $s^2_1$  and

$s^2_2$  are the sample variances of the banks and finance companies respectively and said to be biased estimates (Sthapit *et al.*, 2003). The  $n_1$  and  $n_2$  are number of observations of respective estimates.

c. Degree of Freedom:

$$n_1 + n_2 - 2 = 30 + 30 - 2 = 58$$

d. Level of significance ( $\alpha$ ):

1 % level of significant (two-tailed).

e. Critical Value:

The tabulated value of t for two tailed test at 1% level of significance and 58 degree of freedom is 2.66 (approximately).

**Table 4.16**  
**t-test Result**

Variables	$[\bar{X}_1 - \bar{X}_2]$	$\sqrt{s^2 \left[ \frac{1}{n_1} + \frac{1}{n_2} \right]}$	t-calculated	t-critical ( $\alpha = 0.01$ , df = 51)	Decision
EPS	65.24	7.742	8.426	2.66	<b>Reject <math>H_0</math></b>
DPS	44.85	6.463	6.939	2.66	<b>Reject <math>H_0</math></b>
DPR	-1.66	5.781	-0.286	2.66	<b>Accept <math>H_0</math></b>
P/E Ratio	3.03	1.822	1.665	2.66	<b>Accept <math>H_0</math></b>
Market Yield	-4.34	1.369	-3.168	2.66	<b>Accept <math>H_0</math></b>
Book Yield	13.11	1.779	7.372	2.66	<b>Reject <math>H_0</math></b>

f. Decision:

- As calculated value of t is greater than tabulated value of t, the null hypothesis of no significant differences of EPS, DPS and Book Yield are rejected and hence alternative hypothesis are

accepted. It implies there is significant different between EPS, DPS and Book Yield of Banks and Finance Companies.

- As calculated value of t is smaller than tabulated value of t, the null hypothesis of no significant differences of DPR, P/E Ratio and Market Yield are accepted and hence alternative hypothesis are rejected. It implies there is no significant different between DPR, P/E Ratio and Market Yield of Banks and Finance Companies.

From the above analysis, it is revealed that, however the sample firms have followed different dividend polices, the earning pattern of the banks are greater than finance companies but dividend patter (DPR) and market yield of banks and finance companies are found similar.

#### **4.4. Determinants of Dividend and Stock Price**

Dividend ( $D_t$ ) is the function of the earning per share ( $E_t$ ), lagged dividend payment ( $D_{t-1}$ ) and lagged price earning ( $P/E_{t-1}$ ) ratio (Friend and Puckett, 1964). Similarly, the price of the stock ( $P_t$ ) is the function of the dividend per share ( $D_t$ ), retained earning per share ( $R_t$ ) and lagged price earning ( $P/E_{t-1}$ ) ratio (Friend and Puckett). In this study, to identify the determinants of the dividend and stock price, the Friend and Puckett's (1964) Dividend Supply Function and Price Function have been used. Symbolically,

$$\text{Dividend Supply Function: } D_t = \alpha_0 + \alpha_1 E_t + \alpha_2 D_{t-1} + \alpha_3 P/E_{t-1} \quad \dots (1)$$

$$\text{Stock Price Function: } P_t = \beta_0 + \beta_1 D_t + \beta_2 R_t + \beta_3 P/E_{t-1} \quad \dots (2)$$

The above models assume the following reasonable priori hypothesis:

$$D_t > 0 \text{ and } R_t > 0$$

The equation (1) and (2) are useful for estimating price behaviour within the observed range of dividend payout and price of the stock (Pradhan, 2003).

#### 4.4.1 Determinants of Dividend

Data for this study are derived from the pooled cross section data of the sample firms (banks and finance companies). Table 4.17 shows the empirical result of the model (1). The estimates are output from SPSS 11.0 (statistical software program). The lagged function and priori hypothesis reduced the total observation to 51 in Dividend Supply Function.

From the Table 4.17, it is found that EPS and Lagged DPS are the strong influencer of dividend per share. The coefficient of EPS is significant at 5% level and the coefficient of lagged DPS is significant at 1% level. The coefficient of lagged price earning ratio exert negative.

**Table 4.17**  
**Regression Result of Dividend Supply Function**

	Coefficients	Standard Error	t-Stat	P-value
Intercept ( $\alpha_0$ )	-6.280	3.5265	-1.7809	0.0814
EPS ( $\alpha_1$ )	0.416	0.0883	4.7094	0.0000
$D_{t-1}$ ( $\alpha_2$ )	0.489	0.1169	4.1810	0.0001
$P/E_{t-1}$ ( $\alpha_3$ )	0.124	0.1781	0.6956	0.4901
R Square		0.9658		
Adjusted R Square		0.9328		
Standard Error		0.9285		
F-Statistics		217.3735		
Prob. (F-Stat)		0.0000		
Observations		51		

*Sources Appendix A*

The estimates of model (1) can be expressed as:

$$D_t = -6.280 + 0.416E_t + 0.489D_{t-1} + 0.124P/E_{t-1} \quad \dots (1.a)$$

The y-intercept value -6.280 does not hold any economic value. The slope coefficient of  $E_t$  0.416 (significant at 1% level) indicates that keeping other variables constant one unit change in EPS changes 0.416 unit changes in DPS in positive direction. The slope coefficient of lagged DPS,  $D_{t-1}$  0.489 (significant at 1% level) is simply the short-run adjustment speed and shows that the lagged dividend also plays important role in determination of current period dividend. The slope coefficient of lagged P/E Ratio 0.124 (statistically not significant at normal level) indicates that there less impact of lagged P/E Ratio on DPS.

The independent variables in the model (1.a) explain about 93% variation in the DPS, measured by adjusted R-Square. The F-Statistic signifies the validity of the model. In the model it is assumed that it fulfills the ordinary least square assumptions.

#### **4.4.2 Determinants of Stock Price**

Data for this study are derived from the pooled cross section data of the sample firms (banks and finance companies). Table 4.17 shows the empirical result of the model (2). The estimates are output from SPSS 11.0 (statistical software program). The lagged function and priori hypothesis reduced the total observation to 51 in Stock Price Function.

**Table 4.18**  
**Regression Result of Stock Price Function**

	Coefficients	Standard Error	t Stat	P-value
Intercept ( $\beta_0$ )	-203.497	123.0215	-1.6542	0.1081
DPS ( $\beta_1$ )	19.547	1.4544	13.4401	0.0000
RE ( $\beta_2$ )	1.904	3.4271	0.5556	0.5811
P/E <sub>t-1</sub> ( $\beta_3$ )	15.318	6.1056	2.5088	0.0156
R Square		0.837541		
Adjusted R Square		0.827172		
Standard Error		309.2025		
F-Stat.		80.7682		
Prob. (F-Stat)		0.0000		
Observations		51		

*Source: Appendix A*

The estimates of the model (2) can be expressed as:

$$P_t = -23.497 + 19.547D_t + 1.904R_t + 15.318P/E_{t-1} \quad \dots (2.a)$$

Table 4.18 shows the regression result of the stock price function. In the model, the DPS exist as positive influencer of the market price of the share. The coefficient of DPS is 19.547 and it is statistically significant at 1% level. It implies that one unit change in DPS will change 19.547 units change in MPS, keeping other variables constant. Also, the retained earning also reveals as positive influence of market price of the stock; however the estimate is not statistically significant at normal level. The slope coefficient 1.904 states that 1 unit change in RE positively changes the MPS by 1.904 units, keeping other variables constant. The lagged P/E ratio is also found as positive determinants of market price of the stock. The coefficient is significant at 5% level. The negative y-intercept does not hold economic significance.

In the model (2), about 83% variation in market price of the stock is explained by independent variables, namely; DPS, Retained Earning Per Share and lagged P/E Ratio. The F-Statistic of the model signifies the

validity of the model. In the model, it is assumed that fulfills the assumptions of ordinary least square.

The obvious caveats of the models are the estimates may not be significant at normal level and it may suffer from the limitations of the ordinary least square method of estimation. Since the data are panel set, the estimates may not be consistent in such cases (Gujarati, 2003).

From the above analysis, it is found that earning per share and lagged dividend are the positive determinants of the dividend payment and the evidence is consistent with dividend theories. Also, the evidence is obvious because the firm pays dividend out of its earning and higher earning leads to higher dividend payment, *ceteris paribus*. As advocated by stock valuation models, the price of the stock is the function of the dividend payment. The evidence is inline with this theory. The dividend per share reveals as significant positive determinants of the stock price. The evidences also support the findings of the Friend and Puckett (1964) and Pradhan (2003) with some limitations.

#### **4.5 Major Findings:**

The major findings of the study are described in following paragraphs.

- The Standard Chartered Bank has the highest EPS among the banks which is Rs. 139.63 and Himalayan Bank has the lowest, which is Rs.75.70. Similarly, National Finance has the highest EPS among the finance companies, which is Rs. 49.62 and the Kathmandu Finance has lowest, which is Rs. 24.08.
- The Standard Chartered Bank has the highest DPS among the banks, which is Rs. 102 and Himalayan has the lowest, which is

Rs. 40.41. Similarly, again, the DPS of National Finance is highest and Ace is lowest.

- The DPR of Himalayan, Nabil, and Standard Chartered are observed 54%, 59% and 73% respectively. This evidence shows that Himalayan bank is retaining more its earning and it might be the consequences of the higher growth opportunities or investment opportunities. However, the Kathmandu has the highest dividend payout ratio, where as National has lowest. In general, it is observed that finance companies and banks have more or less similar divided payout ratio and revealed 62% for banks and 64% for finance companies.
- The market yields of the sample banks are found less than finance companies. In contrast, the book yield of banks are greater than that of finance companies. The pooled average market yield of the banks and finance companies are 9% and 13% respectively, whereas the book yields are 31% and 18% respectively.
- The dividend policies among the banks vary accordingly. Generally, it is observed that Nabil has adopted ‘constant dividend payout policy’, whereas the Standard Chartered has followed the ‘fixed dividend policy’ and Himalayan has followed the ‘constant and fixed dividend policy’. Similarly, the finance companies have followed different dividend policy over the period; however the constant ‘dividend payout policy’ has dominated the sample firms.
- The P/E Ratio of finance companies exert higher than that of banks, which indicates the better earning pattern of the finance companies based on the market price. It might signals for either miss-price of the stocks of banks or finance companies or both.
- However, the individual study of the sample firms shows the difference between and among sample firm in terms of earning

pattern and dividend pattern, the t-tests show that there is significant difference in mean ( $\mu$ ) EPS, DPS, and Book Yield whereas there is no significant difference in DPR, P/E Ratio, and Market Yield of banks and finance companies. Hence, it can be concluded that however the earning pattern (in terms of scale) of banks are different than that of finance companies, the return to investors are similar as indicated by DPR and Market Yield.

- The high degree of positive correlation between MPS and BVPS of finance companies indicates those investors are more concerned with book-value for their investment. However the correlation of BVPS and MPS is low and less significant.
- From t-test it is revealed that Null Hypothesis of no significant difference of EPS, DPS and Book Yield between banks and finance companies were rejected and where as the null hypothesis of no significant difference of DPR, P/E ratio and Market Yield were accepted.
- In dividend supply function, the EPS, lagged DPS and lagged P/E ratio exert as determinants of DPS. The EPS is revealed as strong positive influencer of DPS. The slope coefficient of EPS on DPS is found 0.361. Similarly the lagged DPS has also positive influence on determination of current year DPS. In the regression model, the explanatory variables explain changes in DPS by approximately 93% measured by adjusted R-Square.
- In Stock Price Function, the DPS exerts as strong positive influencer of stock price determination and the estimate is statistically significant at 1% level. The coefficient of RE also exert as positive determinants of MPS, however the coefficient is not statistically significant at normal level. The coefficient of DPS is revealed 18.836 and the coefficient of RE is revealed 1.49 and P/E-

$\beta_1$  is 28.373. These findings are consistent and inline with dividend theories and some empirical early findings (Friend and Puckett, 1964; Pradhan, 2003).

## CHAPTER V

### SUMMARY ,CONCLUSION AND RECOMMENDATIONS

#### 5.1 Summary and Conclusion

This study mainly aims at examining the dividend practices of listed commercial banks and finance companies Its specific objectives are: (i) to identify and compare the dividend practices between and among commercial banks and finance companies; (ii) to examine the relationship of dividend with market price, earning per share, book value per share; (iii) to recognize the major determinants of dividend policy; and (iv) to test whether the earning and dividend pattern of commercial banks are similar to finance companies or not.

This study covers the sample of 3 commercial banks and 3 finance companies listed in NEPSE for the period 1997-2006. For the purpose of the study, the necessary data were collected from NEPSE database and SEBO database.

This study used financial tools and statistical tools to accomplish most of the objectives. More specifically, it has employed figure to highlight the dividend practices. For the purpose of comparative study between banks and finance companies, t-test has been used. And to determine dividend supply function and stock price function regression tool has been used.

From the comparative study among sample firms, it is observed that the Standard Chartered Bank has the highest EPS among the banks which is Rs. 139.63 and Himalayan Bank has the lowest, which is Rs.75.70. Similarly, National Finance has the highest EPS among the finance companies, which is Rs. 49.62 and the Kathmandu Finance has lowest, which is Rs. 24.08.

Similarly, the Standard Chartered Bank has the highest DPS among the banks, which is Rs. 102 and Himalayan has the lowest, which is Rs. 40.41. The DPR of Himalayan, Nabil, and Standard Chartered are observed 54%, 59% and 73% respectively. This evidence shows that Himalayan bank is retaining more its earning and it might be the consequences of the higher growth opportunities or investment opportunities. Similarly, again, the DPS of National Finance is highest and Ace is lowest. However, the Kathmandu has the highest dividend payout ratio, where as National has lowest. In general, it is observed that finance companies and banks have more or less similar divided payout ratio and revealed 62% for banks and 64% for finance companies.

In addition, the market yields of the sample banks are found less than finance companies. In contrast, the book yield of banks are greater than that of finance companies. The pooled average market yield of the banks and finance companies are 9% and 13% respectively, whereas the book yields are 31% and 18% respectively.

The dividend policies among the banks vary accordingly. Generally, it is observed that Nabil has adopted 'constant dividend payout policy', whereas the Standard Chartered has followed the 'fixed dividend policy' and Himalayan has followed the 'constant and fixed dividend policy'. Similarly, the finance companies have followed different dividend policy over the period; however the constant 'dividend payout policy' has dominated the sample firms.

The P/E Ratio of finance companies exert higher than that of banks, which indicates the better earning pattern of the finance companies based on the market price. It might signals for either miss priced of the stocks of banks or finance companies or both. However, the individual study of the

sample firms shows the difference between and among sample firm in terms of earning pattern and dividend pattern, the t-tests show that there is significant difference in mean ( $\mu$ ) EPS, DPS, and Book Yield whereas there is no significant difference in DPR, P/E Ratio, and Market Yield of banks and finance companies. Hence, it can be concluded that however the earning pattern (in terms of scale) of banks are different than that of finance companies, the return to investors are similar as indicated by DPR and Market Yield.

The high degree of positive correlation between MPS and BVPS of finance companies indicates those investors are more concerned with book-value for their investment. However the correlation of BVPS and MPS is low and less significant.

From t-test it is revealed that Null Hypothesis of no significant difference of EPS, DPS and Market Yield between banks and finance companies were rejected and where as the null hypothesis of no significant difference of DPR, P/E ratio and Market Yield were accepted.

In dividend supply function, the EPS, lagged DPS and lagged P/E ratio exert as determinants of DPS. The EPS is revealed as strong positive influencer of DPS. The slope coefficient of EPS on DPS is found 0.361. Similarly the lagged DPS has also positive influence on determination of current year DPS. In the regression model, the explanatory variables explain changes in DPS by approximately 93% measured by adjusted R-Square. In Stock Price Function, the DPS exerts as strong positive influencer of stock price determination and the estimate is statistically significant at 1% level. The coefficient of RE also exert as positive determinants of MPS, however the coefficient is not statistically significant at normal level. The coefficient of DPS is revealed 18.836 and

the coefficient of RE is revealed 1.49 and  $P/E_{t-1}$  is 28.373. These findings are consistent and inline with dividend theories and some empirical early findings (Friend and Puckett, 1964; Pradhan, 2003).

## **5.2 Recommendations**

However, which dividend policy the company would follow is the function of its earning capacity, investment opportunities, shareholders' interest and other contextual variables, it is very difficult to suggest or follow particular dividend policy. Also, in absence of particular standard, it is not only difficult to make comparison but also lead to the inconsistency.

As the capital structure theories and empirical studies suggest that managers prefer internal financing first followed by debt financing and lastly, external new equity (Myers, 1984; Myers and Majluf, 1984; Pradhan and Ang, 1994; Gajurel, 2005), company pays less or few amount as dividend if it has capital requirement and pays more if the investment opportunities are less.

Here are the suggestions/recommendations of the study based on its findings:

- As the market yield and dividend payout ratio of banks and finance companies are found similar, the investors can be indifference to invest in banks or finance companies' stock.
- As the dividend payout ratio of sample firms revealed high (more than 60 percent), and in one extreme case, the DPS observed more than EPS, which could question on the managerial efficiency to grow the company. When the dividend payout ratio increases, it

decreases the retention ratio; as retention ratio decreases, the growth rate of the firm also decreases. Therefore, if the banks and finance companies require growth of their business/firm, they should retain more (however, it is more subjective function).

- Since the dividend policy directly effects on the price of the stock, value of the firm and capital structure decision of the firm, firm should adopt such policy which optimizes the value of the firm, the ultimate objective of the firm because from the sample study the it is found that the firms had not been using 'a proper guidelines for its divided policy'. So, the companies should come up with dividend policy guidelines to increase the value of the firm.

For further research avenue, following suggestions are outlined:

- One can increase the sample size to obtain more reliable and valid conclusions. Also, a study extending the survey regarding optimal dividend policy is anticipated.
- A study similar to this should be conducted from time to time. The long term stability of results needs to be reviewed from time to time. Also, the dividend policy varies from one period to another period and from one firm to another firm. Hence, a study of dividend policies of individual firms, particular industry should be conducted.
- One can further study on the impact of dividend on stock price. Also, new methodologies in the study of dividend have been emerged; one can apply those methodologies applicable in Nepalese context.

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## Appendix

FIRM	YEAR	EPS	DPS	MPS	BVPS
NABIL BANK	1997	67.68	0.00	500.00	294.62
	1998	44.50	30.00	430.00	210.92
	1999	67.84	50.00	700.00	223.45
	2000	83.79	55.00	1400.00	250.53
	2001	59.26	40.00	1500.00	216.18
	2002	55.25	30.00	700.00	233.18
	2003	84.66	50.00	740.00	267.30
	2004	92.61	65.00	1000.00	301.00
	2005	105.49	70.00	1505.00	337.00
	2006	129.21	85.00	2204.00	381.00
STANDARD CHARTERED BANK	1997	165.40	90.00	1050.00	538.82
	1998	129.62	70.00	840.00	445.17
	1999	105.86	80.00	1162.00	318.19
	2000	115.62	100.00	1985.00	298.88
	2001	126.88	100.00	2144.00	327.50
	2002	141.13	100.00	1550.00	363.86
	2003	149.30	110.00	1640.00	403.15
	2004	143.55	110.00	1745.00	399.25
	2005	143.14	120.00	2345.00	422.38
	2006	175.84	140.00	3775.00	468.22
HIMALAYAN BANK	1997	115.08	50.00	640.00	274.48
	1998	113.32	50.00	755.00	320.05
	1999	86.07	50.00	1000.00	234.99
	2000	83.08	50.00	1700.00	219.19
	2001	93.56	57.50	1500.00	240.20
	2002	60.26	35.00	1000.00	220.03
	2003	49.45	25.00	836.00	247.82
	2004	49.05	20.00	840.00	246.93
	2005	47.91	31.58	920.00	239.59
	2006	59.24	35.00	1100.00	228.72
NATIONAL FINANCE	1997	39.13	18.00	187.00	202.27
	1998	53.37	22.00	204.00	184.53
	1999	52.40	24.00	300.00	211.30
	2000	63.93	28.00	470.00	243.67
	2001	67.23	30.00	560.00	277.43
	2002	55.70	20.00	545.00	291.79
	2003	35.75	20.00	455.00	307.51
	2004	42.15	21.00	360.00	252.83
	2005	69.12	10.52	412.00	271.94
	2006	17.37	10.53	297.00	237.73
KATHMANDU FINANCE	1997	12.35	9.00	77.00	105.50
	1998	17.00	12.00	95.00	110.60
	1999	21.35	16.00	98.00	116.80
	2000	31.25	20.00	295.00	128.05
	2001	37.60	23.00	321.00	142.55
KATHMANDU FINANCE	2002	37.05	12.00	305.00	169.64
	2003	33.85	50.00	235.00	154.88
	2004	4.34	5.00	205.00	139.36

	2005	17.97	10.50	250.00	149.80
	2006	28.05	20.00	270.00	163.07
ACE FINANCE	1997	14.31	10.00	110.00	103.91
	1998	32.37	15.00	110.00	119.50
	1999	39.97	20.00	220.00	134.90
	2000	24.47	20.00	411.00	127.40
	2001	31.53	25.00	500.00	132.40
	2002	9.00	5.00	230.00	153.00
	2003	26.00	15.00	240.00	163.00
	2004	26.00	20.00	173.00	165.00
	2005	18.00	20.00	251.00	179.00
	2006	27.94	22.11	320.00	201.00