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Impact of Dividend Policy/Announcement on Prices of Shares Indexed With Bse

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Abstract

Dividend policy has been an issue of interest in financial literature since Joint Stock Companies came into existence. Dividends are commonly defined as the distribution of earnings (past or present) in real assets among the shareholders of the firm in proportion to their ownership. . Dividends are usually given as cash (cash dividend), but they can also take the form of stock (stock dividend) or other property. Dividend payment affects a significant impact on wealth of shareholders of accompanies. However, some theories such as the Miller-Modigliani hypothesis theory say thatdividend has no relevance on value of firms. On the other hand Walter and Gordon propagated a theorywhich supposed that investment policy and dividend policy of a company are interlinked andsignificantly affects price of its shares. This descriptive research proposes to test the Walter and Gordontheory by analysing the impact exerted by dividend policy made by companies on prices oftheir shares. The study is based on secondary data, pertaining to share prices of companies indexed inBombay Stock Exchange (BSE), which have made dividend policy. For the result of the study researcher analysed the data by using the Statistical package of SPSS, employing the statistical tool of T Test Analysis. Resultsof the study reveal that a dividend policy exerts a significant impact on share prices ofcompanies.

1. Introduction

A dividend is a payment made by a corporation to its shareholders, usually as a distribution of profits. When a corporation earns a profit or surplus, it can either re-invest it in the business (called retained earnings), or it can distribute it to shareholders. A corporation may retain a portion of its earnings and pay the remainder as a dividend. Distribution to shareholders can be in cash (usually a deposit into a bank account) or, if the corporation has a dividend reinvestment plan, the amount can be paid by the issue of further shares or share repurchase. Hence, a company can pay dividend only if it is earning sufficient profits and the dividend declaration is recommended by the Board of Directors and approved by the shareholders in annual general meeting. The board of directors decide whether to declare dividend and if so, the quantum of dividend to be paid after taking into account, the financial position and requirements of the company. This recommendation of the board needs to be approved by the company's shareholders in the meeting and once this approval is obtained, dividend becomes payable.

1.1 Dividend Policy

Dividend policy is concerned with financial policies regarding paying cash dividend in the present or paying an increased dividend at a later stage. Whether to issue dividends and what amount, is determined mainly on the basis of the company's unappropriated profit (excess cash) and influenced by the company's long-term earning power. When cash surplus exists and is not needed by the firm, then management is expected to pay out some or all of those surplus earnings in the form of cash dividends or to repurchase the company's stock through a share buyback program. According to Weston and Brigham, “Dividend policy determines the division of earnings between payments to shareholders and retained earning”. Gitman, “The firm's dividend policy represents a plan of action to be followed whenever the dividend decision must be made”.

The MM hypothesis (Miller-Modigliani) Theory has advocated that dividends are of no relevance and effect on the valuation of a firm. On the other hand Walter and Gordon have prorogated that investment policy and dividend policy of accompany are interlinked and affects the price of shares of a company. Hence, dividend assumes immense significance in deciding the value of a firm.

1.2 Factors Affecting Dividend Policy

The boards of directors of a company have the sole right to declare dividend and decide the quantum of dividend. In addition to legal restrictions, there are many factors affecting the dividend policy of a company such as Preference of Shareholders, Current Year's Earnings, Past Dividends, Management Control Motive, Liquidity Position, Future Financial Requirements, and Access to Capital Market, Contractual Restrictions, Taxation Policy, Inflation, Stability of Earnings and Legal Restrictions.

1.3 Dividend Policy and Share Prices

Financial management having major three functions, one of them is dividend policy. Financial management has to make an important decision on deciding the part of profits of company to be distributed to shareholders and the part to be retained by it for future expansion endeavors. Dividend policy has to be formulated on the light of impact

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the decision about dividend is likely to have on shareholders wealth. Dividend payment shall be determined such that it leads to maximization of shareholders wealth. In case dividend payment does not lead to maximization of shareholders wealth, then the company should rescind from paying dividend and retain its earnings. However, financial experts have not expressed a unanimous view on this issue. A brief description about different schools of thought on the issue is given under.

1. **Traditional Position:** According to the traditional position expounded by Graham Benjamin and David L. Dodd, stock Market places considerable weight age on dividends than on retained earnings. They have propagated that the stock market is highly responsive to liberal dividend rather than conservative dividend. They have found that value of shares of a company is affected by dividend payments four times as that of retained earnings. This can be evident from their version of equation in which E is replaced by (D + R).
   P = m [D + (D+R)/3]
   The weights arrived at by Graham and Dodd are based on their subjective judgments and not objective and empirical analysis. Notwithstanding the subjectivity of these weights, the major contention of the traditional position is that a liberal dividend payout policy has a favorable impact on stock price.
2. **Walter's Model of Dividend Relevance:** James E. Walter has presented a model in 1963, which explains the relevance of dividend for valuation of shares or maximization of shareholders wealth. According to Walter, investment policy of a company cannot be alienated from its dividend policy and both are interlinked. An appropriate dividend policy favorably affects the company's value. The key argument in support of the relevance proposition of Walter's model is the relationship between return on firm's investment or its internal risk of return (r) and its cost of capital or required rate (k). The firm would have an optimum dividend policy, which will be determined by the relationship of r and k.
   Share Valuation Formula
   Walter put forward the following share valuation formula:
   P = D/k + [r (E-D)/k] /k
   Where, P = Price per share
   D = Dividend per share
   E = Earnings per share
   (E-D) = Retained earnings per share
   r = Rate of return on investments
   k = Cost of capital
   The above equation may alternatively be written as:
   P = [D + (E – D) r / k] / k.
3. **Gordon's Model of Dividend Relevance:** Gordon's Model is based on the principle that dividend payment is relevant to value of company. According to Myron J. Gordon, dividends are highly relevant and dividend policy significantly affects value of firm. This theory is based on compounded relationship between dividend policy and market value of shares of a company.
4. **Gordon's Model versus Walter's Model:** Gordon's model contends that dividend policy of the firm is relevant and the investors put a positive premium on current incomes/dividends. He argues that dividend policy affects the value of shares even in a situation in which the return on investment of a firm is equal to the required/capitalization rate (i.e. r = ke). Walter's model is of the view that the investors are indifferent between dividends and retention.
5. **Modigliani and Miller Hypothesis of Dividend Irrelevance:** Franco Modigliani and Merton H. Miller advocated that dividend policy of a firm is irrelevant, as it does not affect the wealth of the shareholders. Thus, dividends are irrelevant and the value of firm is independent of its dividend policy. The value actually depends on the firm's earnings, which results from its investment policy. Once the investment policy of a firm is formulated, dividend decisions are of no significance in influencing value of firm.

2. Statement of Problem

Income earned in the form of dividend is highly uncertain. Those shareholder lies in the low income want to take dividend on the basis of liberal dividend policy. It is a policy of distributing a major part of its earnings to its shareholders as dividend and retains a minimum amount as retained earnings. Thus, the ratio of dividend distribution is very large as compared to retained earnings. The rate of dividend or the amount of dividend is not fixed. It varies according to earnings. The higher is the profit, the higher will be the rate of dividend.

Majority of investors fall under the low income slab. Hence, those companies following a liberal dividend policy earn the goodwill of investors, which will have a positive impact on market price of their shares. However, liberal dividend policy will deplete the financial resources of firms, leading to liquidity problems for the firm, which will adversely affect the company. Hence, impact of dividend policy on share prices has always been a debated and unsettled argument. Hence, the researcher felt the need to conduct a study, exploring the existence of any relationship between dividend announcements of companies and market price of their shares.

3. Objectives of the Study

To examine the stock market reaction to dividend policy

4. Limitations of the Study

1. The duration of the research will not sufficient to lay down thorough emphasis on the various financial aspects of the companies.
2. Resources available for the analysis will not sufficient as mainly the annual report of the companies was available which will not revealing the detailed aspects of financial matters in the company.
3. The data used for the analysis is secondary in nature as it was taken from the annual reports of the companies.
4. This study has been conducted at micro level, covering only 30 companies which have been listed in the BSE. Results of this study cannot be generalized.

5. Review of Literature

Black (1976) in his study concluded with the following question: “What should the corporation do about dividend policy? We don't know". A number of factors have been identified in previous empirical studies to influence the dividend policy decisions of the firm. Profits have long been regarded as the primary indicator of the firm's capacity to pay dividends. Lintner (1956) conducted a classic study on how U.S. managers make dividend decisions. He developed a compact mathematical model based on survey of 28 well established industrial U.S. firms which is considered to be a finance classic. According to him the current year earnings and previous year dividends influence the dividend payment pattern of a firm.

Fama and Babiak (1968) studied the determinants of dividend payments by individual firms during 1946-64. The study concluded that net income seems to provide a better measure of dividend than either cash flows or net income and depreciation included as separate variables in the model. Baker, Farrelly and Edelman (1986) surveyed 318 New York stock exchange firms and concluded that the major determinants of dividend payments are anticipated level of future earnings and pattern of past dividends.

Pradhan (2003) explored the effect of dividend payment and retained earnings on stock prices of Nepalese companies. His study revealed that stock prices of Nepalese companies were strongly influenced by dividend payment while this impact was weak in case of retained earnings. Hence, this study revealed that Nepalese investors attach utmost importance to regular dividend income than capital gains from their share investments. Gunasekarage and Power (2006) also confirmed that dividend announcements influence stock prices though this influence was short lived. The study revealed that those companies following strict dividend policy were able to magnify their earnings.

Nazir et al. (2010) found that dividend payout and dividend yield significantly influenced stock prices while earnings and growth of companies have a positive effect on their stock prices. The study also exposed a negative relationship of size and leverage with stock prices.

Muhammad Akbar and Humayun Habib Baig (2010) have tested the semi-strong form of market efficiency by investigating the reaction of stock prices to dividend policy. They have analysed dividend in the form of cash, stock and both cash and stock of 79 companies listed in Karachi Stock Exchange during the period of July 2004 to June2007. Using t-test and Wilcoxon Signed Rank Test, the researchers have found that cash dividend policy resulted in negligible abnormal returns while dividend policy in the form of stock and combination of cash and stock led to a higher and much significant average abnormal and cumulative average abnormal returns.

6. Research Methodology

The proposed research is descriptive in nature, based on secondary data. The samples taken for this study constitute the 30 companies listed in the BSE, which have made dividend policy during the financial year of 2011-12. For the result of the study researcher analysed the data by using the Statistical package of SPSS, employing the statistical tool of T Test Analysis. The researcher has selected some parameters relating to prices of shares to study the impact of dividend policy on share prices. Average share price (opening price + closing price / 2) and the maximum and minimum price of the shares prevalent during the day have been considered for this study. Further, total volume of shares traded, number of trades of the shares and the net turnover of shares before and after dividend policy in respect of the 30 companies listed in BSE have been considered in this study to assess the change in investment decision of investors relating to buying, holding and selling the shares of the companies making dividend announcements.

HDFC, HDFC BANK, HERO MOTOCORP, HINDALCO, HUL, ICICIBANK, INFOSYS, ITC, JINDAL STEEL, LARSON & TURBO, MAHINDRA & MAHINDRA, MARUTI SUZUKI, NTPC,ONGC, BAJAJ AUTO, BHARTI AIRTEL, BHEL,CIPLA, COAL INDIA, Dr. REDDY'S, GAIL,RELIANCE, SBI, STERLITE, SUN PHARM, TATA MOTORS, TATA POWER, TATA STEEL, TCS, WIPRO are the companies that are taken for the study.

6.1 Hypotheses for the Research

H1: There is no significant difference in the average share prices of companies before and after announcing dividend.

H2: There is no significant difference in the maximum share price of companies before and after announcing dividend.

H3: There is no significant difference in the minimum share prices of companies before and after announcing dividend.

H4: There is no significant difference in the number of shares traded before and after announcement of dividend by the companies.

7. Data Analysis And Discussion

Impact of dividend announcement on stock prices of companies has been seen using many variables such as average share prices, maximum and minimum share prices, number of trades of shares of the 30 companies listed in BSE and the results have been displayed in the following below.

8. Impact of Dividend Announcements

Results of t-test reveal that dividend announcements affects significant impact on average share prices as there is significant difference in the average prices of shares after announcement of dividend.

Further it is found that dividend announcements affects significant impact on the maximum share prices of the companies making such announcements as there is a significant difference in maximum price of shares after dividend announcement.

Similarly, a dividend announcement affects significant impact on the minimum prices of shares of companies making dividend announcements.

However, it is found that dividend announcements do not exert any impact on the number of trades of shares of the companies making such announcements as there is no significant difference in the number of trades of shares after the companies announcing dividend Hence, it can further be elaborated that the first three null hypotheses have been rejected leading to the acceptance of the irrespective alternative hypotheses while the last null hypotheses have been accepted.

9. Conclusion

At last researcher founds that Dividend announcements/policy affects significant impact on share prices of companies. Hence, researcher should accepts the theory of Walter and Gordon's i.e. prices of shares are significantly affected by dividend announcements/policy

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