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Accessing Determinants that Affect the Dividend Policy and Cause Agency Problems: Evidence from Pakistan

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Abstract—*The purpose of this paper is to examine the relationship between dividend policy and determinants of the dividend policy by changing ownership structure. Panel data was collected from the financial statements of the companies for the year 2010-2016. Determinants of dividend policy have significant positive and negative effect on the dividend policy of the company either of financial institutes or government-owned companies. The research was conducted in Pakistan so the results can be generalized in particular country. These results can be cross-checked by comparing the results of developed and developing countries to get more generalized results. The future researcher should incorporate more variables in their research and can increase the sample size and time span. Determinants of dividend policy are helpful for the policy maker of the company in deciding more suitable dividend policy and the results also helpful for the investors while investing. This study provides a comparison between financial institutions and government-owned institutions and also it highlights those factors which cause agency problems that is why this study is unique in its nature.*

Keywords—Dividend policy; Firm Size; Agency Cost; Investments decisions; Determinants of Dividend policy

1. INTRODUCTION

The decision of paying a dividend to the shareholders of the firm is very crucial for the firms around the globe. Dividend payout decisions become an important issue as it has a significant impact on the decisions of the firm. If a firm decides to pay low or no dividend to its shareholders' this will result in an increase in the internal earnings of the firm in the form of retained earnings (Anil and Kapoor, 2008, Hashemi and Zadeh, 2012, Lintner, 1956). Contrary to this, if a firm decides to pay higher dividends to its shareholders it will result in lower retained earnings and thus increase its reliance on debt or external financing, and this will enforce the firm to raise funds as it is directly related to the dividend policy of the firm. Moreover, the capital structure of the firm is affected by the firm's dividend policy. Dividend policy will also affect the investment decisions of the firm (Chen et al., 2010). Dividend policy depends upon the efficiency of the top executives of the company so that agency cost can be minimized (Naser et al., 2013).

An optimal dividend policy is required or crucial for every firm as future investment decisions are based on dividend policy. In the previous studies, it has been concluded that the dividend policy of the firm is affected by many variables like earnings of the firm, lagged dividends (previous year dividend), debt, investment opportunity, firm size, and free cash flows (Al-Shubiri, 2011, Lease et al., 2000, Sim, 2011). Though most of the research work has been done on this problem, the study remains questionable because most of the research work has been carried out in the developed countries. While on the other hand, few have investigated it in developing countries (Chen et al., 2010, Mkhize and Msweli, 2011, Subramaniam, 2011, Utami and Inanga, 2011) however, less research has been undertaken in developing countries to compare the performance of dividend policy on the ownership structure of the firm but no study has been undertaken to check the performance of dividend policy on ownership structure in Pakistan. This study was undertaken to check the impact of dividend policy on changing ownership structure (Charitou, 2000, Hashemi and Zadeh, 2012, Imran, 2011, Nizar Al-Malkawi, 2007, Ramli, 2010, Sim, 2011).

The industry that has been selected to study the determinants of dividend policy is financial institutes, and government-owned companies as both fall in the service sector and this present study is inspired by the rareness of this study in developing economies, unsettled problem of dividend policy and due to the fast growth of Pakistan's economy as compared to other emerging economies. This research focuses on to examine the significant factors of dividend policy of financial institutes and government-owned companies in emerging economies or developing economies (Pakistan). The research not only contributed in enhancing the empirical evidence of the determinants of dividend payout policy by using past data but also contributed to the literature by identifying the gap and solving the issue by focusing on financial institutes and government-owned companies in Pakistan. The findings of this research will be helpful for the investors i.e. shareholders in making an investment in the companies and these findings will also be helpful for the board of directors in deciding an optimal dividend payout policy. In this way, we can compare the performance of both financial institutes and government-owned companies based on dividend payout policy.

2. Literature Review

A dividend is an amount paid to the shareholder and the main objective of the firm is to maximize the shareholder's wealth but considering in view the investment opportunities of the firm. A dividend can be paid in the form of cash, stock dividend etc. Dividend payout decisions made by the top executives and it can be different over the period of time (Lease et al., 2000) Dividend payout policy is very challenging for the managers to decide what part of earning should be distributed among the shareholders of the firm because managers had to decide either to give dividend or invest the amount in some profitable projects or what part should be given to shareholder in order to maximize their wealth (Lease et al., 2000).

2.1 Earnings & Lagged Dividend on Dividend Policy

According to Lintner, (1956) executives develop the dividend payout policy very sensibly rather than just distribute the part of earnings to the shareholders. This study was considered to be the first study on the dividend policy which leads towards the development of Linter model and the empirical study which is carried out in the American companies revealed the results as the earnings of the firm and previous year dividend payout (Lagged Dividend) are the factors that can be used in determining the current payout policy. Pruitt and Gitman (1991) undertaken this study to check the effect of earnings and lagged dividend on the dividend policy in USA firms. The results were found that the dividend decisions are made from earnings of the firm and previous year dividends and these findings supported the findings of Linter Model. (Fama and MacBeth, 1973, Lintner, 1956).

Many studies have been undertaken over the time to examine the factor that affects the dividend policy and which factor determining the dividend policy. According to Signaling theory, firm performance can be determined by the dividend payout policy by the shareholders (Miller and Modigliani, 1961). Because dividend payout indicates the firm's profitability. If a company pays a higher dividend to its shareholders, it shows the higher profitability of the firm. It suggests that the firm’s earning per share is higher (Bhattacharya, 1979). Dividend payout policy of a company increases when a company earns higher earnings/profits. Several studies explain the effect of earnings on dividend payout policy (Al-Kuwari, 2009, Jensen et al., 1992, Subramaniam, 2011). While according to Gill et al. (2010) the earnings have a negative effect on dividend payout.

H1: The dividend policy of the firm is positively affected by the earnings.

H2: The dividend policy is directly linked to the lagged dividend of the firm.

2.2 Cash Flow on Dividend Policy

When the company announces its dividend payout policy, it also indicates the firm's stability for future cash flows (Kale and Noe, 1990). According to Charitou (2000), a study which carried out on Japan in which the study investigated the effect of cash flow on dividend payout policy. The study results found out that earnings have a positive effect on dividend payout. And similarly, it was also revealed that cash flow of a firm has a positive effect on the dividend payout. These results were also supported by these studies (Anil and Kapoor, 2008, Hashemi and Zadeh, 2012, Nizar Al-Malkawi, 2007).

H3: The dividend policy is directly affected by the firm’s cash flow.

2.3 Free Cash Flow on Dividend policy

According to agency cost theory, a conflict arises between the shareholders of the firm and the management where management tries to increase the shareholder's wealth, and shareholders keep an eye on the management behavior. Agency cost which arises to mitigate the conflict between the shareholder and management and dividend payout is the solution of reducing the agency cost which is related to the factors that affect the dividend payout policy like debt, free cash flow, investment opportunity, growth, firm size (Jensen and Meckling, 1976, Rozeff, 1982, Utami and Inanga, 2011). A study was taken out in New Zealand stock exchange, and results were revealed that free cash flows have a positive effect on the dividend payout policy (Chen et al., 2010). In contrast to this (Imran, 2011, Utami and Inanga, 2011) found out that free cash flow has a negative effect on the dividend payout policy. Some studies found no relationship between dividend payout policy and free cash flow (Al-Shubiri, 2011, Mehrani et al., 2011).

H4: The dividend policy of the firm is positively affected by the firm’s free cash flow.

2.4 Debt on Dividend Policy

Another variable that affects the dividend payout policy is debt. The company with more debt tends to pay more cash to creditors to settle their debt obligations and thus giving less dividend to its shareholders. According to Nizar Al-Malkawi (2007) debt financing have a negative effect on dividend payout policy as he carried out his research in Jorden listed companies. Some other researchers also reported the same results that debt has a negative association with the dividend payout policy (Al-Shubiri, 2011, Kowalewski et al., 2007, Ramli, 2010). While some studies concluded that debt has a positive relationship with dividend payout policy (Chang and Rhee, 1990, Gill et al., 2010, Sim, 2011), which articulates that the more the debt, the more the dividend payout ratio. But some researchers concluded that debt has an insignificant effect on dividend payout policy (Al-Kuwari, 2009, Mehrani et al., 2011).

H5: The dividend policy is negatively affected by the firm debt.

2.5 Growth and Dividend Policy

The growth of the firms affects the dividend payout policy. The companies with more growth tend to pay higher dividends as explained by many researchers that the firms who are growing tend to pay more dividend as compared to firms with low growth. This relationship has been discussed by many researchers and found out that growth of the firm positively affects the dividend payout policy (Al-Kuwari, 2009, Al-Shubiri, 2011, Gill et al., 2010, Jensen et al., 1992, Rozeff, 1982).

H6: The dividend policy is directly affected by the firm's growth opportunities.

2.6 Investment and Dividend Policy

Shareholders wealth is not affected by the dividend payout policy but can be affected by the investment opportunities a firm have (Miller and Modigliani, 1961). The investment opportunity is one of the main determinants of dividend payout policy. The firms with more investment opportunities tend to pay the lower dividend which causes the agency problem as shareholders want higher dividend payments. But if the firm wants to overcome its agency problem it had to pay a higher dividend to its shareholders. Investment opportunities have a negative effect on the dividend payout policy (Jensen, 1986). It was evident for the past studies that investment opportunities have a negative impact on the dividend payout policy such as (Al-Kuwari, 2009, Chang and Rhee, 1990, Jensen et al., 1992, Rozeff, 1982, Subramaniam, 2011). In contrast, many studies concluded that investment opportunities have a positive impact on the dividend payout policy (Al-Shubiri, 2011, Foroghi et al., 2011, Imran, 2011, Nizar Al-Malkawi, 2007).

H7: The dividend payout policy is indirectly affected by the firm's investment opportunity.

2.7 Firm Size and Dividend policy

Firm size is one of the most important determinant of dividend policy as it is explained by many researchers in their studies such as (Al-Kuwari, 2009, Al-Shubiri, 2011, Eddy and Seifert, 1988, Holder et al., 1998, Jensen et al., 1992, Kouki and Guizani, 2009, Lloyd et al., 1985, Manos, 2002, Subramaniam, 2011). The firms who are larger tend to pay a higher dividend as compared to companies who are smaller in size. As in larger firms, the ownership is widespread, so shareholders have less access to the information about the firms financing activities thus increasing the agency cost so to reduce this problem larger firms pay a higher dividend so that they can minimize the agency cost. Many empirical results have been concluded that firm size is directly related to the dividend payout policy such as (Hashemi and Zadeh, 2012, Juma'h and Pacheco, 2008, Kowalewski et al., 2007, Mehrani et al., 2011, Ramli, 2010). While some past studies have concluded that the firm size is indirectly related to the dividend payout policy, these researchers are (Huda and Farah, 2011, Imran et al., 2013).

H8: The dividend policy is positively affected by the firm's size.

Many studies have been undertaken in Pakistan determining the factors affecting the dividend payout policy although the results of several studies were mixed and not conclusive. (Imran, 2011). The past study focuses on one particular sector in Pakistan such as (Imran, 2011, Imran et al., 2013). This study carried out to cover the ownership structure of the firms how determinants of dividend policy are affected by ownership structure like financial institutes and government-owned companies in a broader scope and extending the past literature. Using the Linter model and different theories regarding determinants of dividend policy such as signaling theory, agency cost theory and using the empirical results of the past research theoretical framework has been developed and above-mentioned hypotheses are the result of this theoretical framework and the above-mentioned hypothesis are developed to determine the determinants of dividend payout policy on ownership structure in Pakistan.

3. RESEARCH METHODOLOGY

The present study is conducted to analyze which factors affect the determinants of the dividend policy by changing ownership structure. This study will report the results as it is because this study falls into the category of positivism in which we do not interpret the results by our meanings. The researcher will remain unbiased during the whole research. The approach that will be used while conducted this research is deductive because we will move from general to specific. As this research is to analyze the effect of dividend policy on the ownership structure of the firm. Quantitative method is used to carry out this research because finance studies are usually number based. As this research will collect and extract data from the company's annual reports in the form of numbers.

As mean, median and standard deviation will be calculated which is easy to interpret. The nature of this research is explanatory as the same model is tested in the context of Pakistan, but this research is comparing the effect of dividend policy on the ownership structure of the firms. Linter model is used in this study.

Firstly, to check the impact of determinants of dividend policy on the dividend payout policy of financial institutes and government-owned companies are tested by using time series data and in time series we use panel and balanced panel data as our variable is more than one and we collected data for more than one year. This study collects data from 50 companies of Pakistan as 30 financial institutes were selected, and 20 government-owned companies were selected. The data collected from the period of 2010 to 2016 and the data of the variables were extracted from their annual reports. The main reason behind selecting these companies is that these firms pay a dividend to its shareholders. These criteria were used by prior studies as (Imran, 2011, Imran et al., 2013, Mkhize and Msweli, 2011, Salin and Rahman, 2010) and it is the main justification for selecting these firms. Several companies were excluded from the study because they do not pay a dividend to its shareholders during that period from 2010 to 2016.

The explanation of variables, the proxies of each variable and the measurement of the proxies are listed below in Table 1:

Table- 1. Variable and their Proxies

Variables	*Denoted By*	*Proxies*	*Calculation*
Dividend	D	Dividend per share	Dividend Paid/No of share
Earnings Per Share	E	Earnings per share	Earnings per share
Lagged Dividend	D(t-1)	Dividend per share	Last period dividend
Cash Flow	CF	Cash Flow Operating Activities	Cash Flow/ no of shares
Free Cash Flow	FCF	Cash Flow O.A-Capital Exp.	Net/No of shares
Debt	DEBT	Total Assets/Total Liabilities	Total Assets/ Total Liabilities (B.S)
Size	SIZE	Log of Total assets	Log (Total Assets)
Growth	GR	Sales Growth	(Current -base year/base year) *100
Investment Opportunities	INV.OP	Retained Earnings/Total Assets	Retained earnings or reserves/TA

3.1 Model

The linter model is used to carry out this research, and the model of this research is following:

$$D = \beta_o + \beta_1(E) + \beta_2(LD) + \beta_3(CF) + \beta_4(FCF) + \beta_5(DEBT) + \beta_6(GR) + \beta_7(INV) + \beta_8(SIZE) + e$$

3.2 Data Analysis

E-Views 7 software is used to analyze the data. Furthermore, correlation test is used to analyze is there any heteroscedasticity and multicollinearity in the data and found out that the data is free from these. A regression equation is run and found out the following results.

Correlation and regression analysis is run on E-Views and found out the following results. Out of the eight factors that affect the dividend policy, earnings of the firm, debt, size of the firm and investment opportunities of the firm have a significant effect on dividend policy while earnings, size and investment opportunities of the firm assert a significant positive effect on the dividend policy. Contrary to this debt of the firm have a significant negative effect on the dividend policy. The following hypothesis has been accepted in Table 1.1 in which results of financial institutes have been disclosed: As shown in Table 1.1 determinants of dividend policy have been explained. Out of 8 factors, debt, earnings, investment opportunities and size of the firm have a significant impact on the dividend payout policy. Similarly, earnings of the firm, investment opportunities' and firm size have a significant positive impact on the dividend policy while debt has a negative impact on dividend policy.

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Table- 2. Financial Institutes

Regressors	*Regression Coefficient*	*t-statistic*	*Probability*
Constant	0.83	2.43**	0.000
E	0.06	2.53**	0.0001
LD	0.01	0.07	0.32
CF	0.005	0.13	0.27
FCF	0.003	0.14	0.25
DEBT	-0.02	-1.99**	0.005
SIZE	0.14	3.1**	0.000
GR	0.002	0.6	0.4
INV	0.06	4.4**	0.000

Adjusted R-square = 0.79

F-statistic = 94.4

P-Value = 0.000

Durbin Watson = 2.39

Hence the following hypothesis has been accepted for financial institutes H1 (earnings of the firm), H5 (debt ratio of the firm), H7 (investment opportunities) and H8 (size of the firm). While other hypotheses like H3 (cash flow), H4 (Free Cash Flow), H6 (growth) and H2 (lagged dividend) are rejected for financial institutes. Adjusted R-squared shows how much these variables explain the dividend policy which is 79% for financial institutes.

As shown in table 1.2 determinants of dividend policy have been explained. Out of 8 factors, debt, earnings, investment opportunities size of the firm and growth of the firm have a significant impact on the dividend payout policy for government-owned companies. Similarly, earnings of the firm, investment opportunities, the growth of the firm and firm size have a significant positive impact on the dividend policy while debt has a negative impact on dividend policy. Hence the following hypothesis has been accepted for government-owned companies H1 (earnings of the firm), H5 (debt ratio of the firm), H6 (growth), H7 (investment opportunities) and H8 (size of the firm). While other hypotheses like H3 (cash flow), H4 (Free Cash Flow), and H2 (lagged dividend) are rejected by government-owned companies. Adjusted R-squared shows how much these variables explain the dividend policy which is 75% for government-owned companies.

Table- 3. Government Owned Companies

Regressors	*Regression Coefficient*	*t-statistic*	*Probability*
Constant	0.63	2.14**	0.000
E	0.12	2.69**	0.000
LD	0.003	0.77	0.42

CF	0.008	0.88	0.31
FCF	0.007	0.79	0.37
DEBT	-0.15	-2.75**	0.004
SIZE	0.2	2.98*	0.000
GR	0.13	2.72*	0.000
INV	0.08	4.13*	0.000

Adjusted R-square = 0.75

F-statistic = 110.2

P-Value = 0.000

Durbin Watson = 2.24

4. Discussion

The purpose of this study is to check the impact of dividend policy on financial institutes and government-owned companies which falls in the service sector. This study carried out to help the board of directors in deciding and revising the dividend payout policy to maximize the shareholder's wealth and analyze which main factors affect the dividend policy. The earnings have a positive effect on the firm's dividend policy implies that when a company earns higher earnings, it will give a higher dividend to her shareholders which supports the signaling theory as it states that when a company earns higher earnings pays a higher dividend to its shareholders, signals the good performance of the company. The higher earnings depend upon how well the company is performing. So, if a company is performing it will give a higher dividend to its shareholders. Contrary to this if a company is not earning higher profits, it will lead to a lower dividend. This finding has been supported by many past studies such as (Al-Kuwari, 2009, Al-Shubiri, 2011, Charitou, 2000, Gill et al., 2010, Imran, 2011, Kowalewski et al., 2007, Mehrani et al., 2011, Nizar Al-Malkawi, 2007, Ramli, 2010), they all in their studies found a positive significant effect of earnings on dividend payout policy.

Contrary to this, Sim (2011), found a negative significant effect of earnings on dividend policy. Firm size found to have a positive significant effect on the dividend policy. These results have been supported by the agency cost theory the higher the firm size, the more the dividend payout ratio will be because larger firms can earn huge amount of money or have the potential or capabilities to earn huge amount of profit or generate funds. These findings have been supported by many other researchers and found a consistent result. The researchers which supported this hypothesis are (Al-Kuwari, 2009, Al-Shubiri, 2011, Foroghi et al., 2011, Hashemi and Zadeh, 2012, Huda and Farah, 2011, Jensen and Meckling, 1976, Kowalewski et al., 2007, Mehrani et al., 2011, Nizar Al-Malkawi, 2007, Ramli, 2010). The studies that contradict this finding and found a negative relationship between firm size and dividend payout policy is (Sim, 2011). Debt is one of the most important determinants of the dividend policy that effects the dividend policy.

This study found a negative effect of debt size of the firm on dividend payout policy as debt level of a firm increases the dividend paid to shareholder's decreases. The reason behind this negative effect is that when a company has a huge level of debt they have then certain obligations such as to pay interest on loans and to pay back the debt to creditors. And the main priority of the firm is to pay back the loan and interest to its creditors then after paying all these the remaining is distributed to shareholders. Thus, this leads to the lower of the dividend to the shareholders of the firm. This reason and findings have been supported by many other researchers and found the same consistent results in their findings such as (Al-Shubiri, 2011, Kowalewski et al., 2007, Nizar Al-Malkawi, 2007, Ramli, 2010). The other variable that has a positive significant effect on dividend payout policy is investment opportunities of the firm, which means the higher the investment opportunities of, the firm the more the dividend the firm will pay to her shareholders. Because the company will grow quickly and will be in a position to pay more dividends to its shareholders to maximize their wealth.

The other reason is that the companies with higher investment opportunities have higher access to external financing, so they do not rely on internal financing that is retained earning that's why they pay more dividend to its shareholders. This finding has been supported by many researchers and found out the same consistent results in their results such as (Foroghi et al., 2011, Juma'h and Pacheco, 2008, Nizar Al-Malkawi, 2007). Contrary to this, some studies found out the negative relationship between the investment opportunities of the firm and dividend payout policy such as (Subramaniam, 2011). The growth of the firm has a positive significant effect on the government-owned companies only. It shows that the firm with the higher growth tends to pay more dividend to its shareholders as compared to companies with low growth. Because companies with high growth tend to have more money to pay more dividend to its shareholders. These findings have been supported by many past researchers in which the same findings were shown (Al-Kuwari, 2009, Al-Shubiri, 2011, Gill et al., 2010, Jensen et al., 1992, Rozeff, 1982).

5. Implications, Limitations & Future Research Indications

The present study carried out to check the factors affecting the dividend policy of the firm and checked the factors that affect the dividend policy of financial institutes and government-owned companies. The analysis was carried out on 50 companies including financial institutes and government-owned companies and found out that these factors affect the dividend policy significantly includes earnings of companies, debt, size of firm and investment opportunities. This was also revealed that the firm who are larger pays more dividend, earnings also affect positively, and the firms with low debt ratio tends to pay more dividend to its shareholders. Board of directors of financial institutes and government-owned companies can use this study in formulating or revising their dividend payout policy, and this is the most useful input of this study. The factors that must be given importance by the board of directors of financial institutes and government-owned companies while making dividend payout policy are Debt, size of the firm, earnings of firms and investment opportunities of the firm.

The main objective of the shareholder is to get a reward on their investment that's why shareholders prefer to invest in those companies who are larger and have low debt ratio because these firms usually pay more dividend. There are always two aspects of everything one aspect is good, the other is bad that's why this study is not without limitations. Firstly, this study was carried out in Pakistan's financial institutes and government-owned companies which fall in the service sector. Secondly, the study does not include any control and mediating variable. Thirdly, the study uses only secondary data of the firms to analyze and does not include qualitative study. Fourthly, the sample size which was taken is not enough. The future research indications for the future researcher is that they use control variables in their study and increase the sample size. In future, the context should be increased by doing a comparative study of service sector and manufacturing sector or different sector according to their easiness. The future researcher also uses the qualitative studies such as conduct interviews and questionnaire can also be used to collect data so that richer data can be obtained on the factors affecting the dividend payout policy. The current study has its limitation, but this study contributes a lot to the existing literature by analyzing the factors that affect the dividend policy of financial institutes and government-owned companies in Pakistan.

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