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The Effect of Dividend Policy on Corporate Profitability: An Empirical Study on Beverage, Food and Tobacco Industry in Sri Lanka

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Abstract- The purpose of the study is to examine the relationship between dividend pay-out and corporate profitability. The study conducted as a panel sectional survey and exploited the sample frame of the Beverage, Food & Tobacco (BFT) industry in Sri Lanka. 10 companies were taken from the listed companies in Colombo Stock Exchange (CSE) under the Beverage, Food & Tobacco (BFT) industry in Sri Lanka. Secondary data for the period of 2012 to 2015 was used for this study based on financial statement. The objective of this study is to find out the impact of dividend payout on corporate profitability in Sri Lanka. The dividend policy measured using the dividend payout ratio, while return on equity (ROE) used as a measure of profitability. The study concluded that there is a positive significant relationship between dividend policy and the profitability in Beverage, Food & Tobacco (BFT) industry in Sri Lanka. The time horizon for this study is limited when compared with other studies.

Index Terms- Beverage, Food & Tobacco, Corporate Profitability, Dividend Policy, Sri Lanka

I. Introduction

Dividend policy refers to the payout policy that a firm follows in determining the size and pattern of cash distributions to shareholders over time. The Board of Directors (BOD) of the company frames dividend policy in order to make decisions of how much earnings distributed among the shareholders as the reward for making investment and taking risk in certain company and how much retained within the company as retained earnings. Dividend policy is an essential area of research in corporate finance. Under real world conditions, determining an appropriate payout policy often involves a difficult choice because of the need to balance many potentially conflicting forces. According to conventional wisdom, paying dividend affects both shareholders wealth and the firm's ability to retain earnings to exploit growth opportunities. Because investment, financing, and dividend decisions are interrelated (Pruitt & Gitman, 1991), management cannot consider dividend policy in isolation from these other decisions. In addition may investors view dividend policy as important because the supply cash to firm with the expectation of eventually receiving cash in return (Baker, 1944)

The dividend policy remains as an unsettled puzzling topic in the finance literature. Notwithstanding, several theories and models have been developed regarding the dividend policy, the corporate dividend policy is still an unsolved and controversial concern in the corporate finance field thus still open for debate. Black, (1976) expressed, "The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just don't fit together". Even after three decades, the circumstance remains much more similar today.

Dividend or profit allocation decision is one of the four decision areas in finance. Dividend decisions are important because they determine what funds flow to investors and what funds are retained by the firm for investment (Ross et al., 2002).

The effect of dividend policy on the corporate profitability is a significant problem in corporate industry. Therefore, the main idea of this study is to examine the relationship betweendividends policy andthe corporate profitability. In other hand, the issue of concern is how the corporate profitabilityaffectsdividend policy of selected Beverage Food and Tobacco (BFT) industry in Sri Lanka.

In the present, Dividend policy is one of the significant parts of firm policies viewed as an interesting topic. Dividend policy decisions affect the business valuation. Cash dividend takes a distinctive position among the shareholders' perspective. On the other hand, the main problem is implementing a policy of divided payout. Dividend policies determined by some factors. Those are nature of industry, capital requirement, cash flow requirement, corporate governance, business cycle, government policies & taxation. Dividend payouts determine by principles and guidelines that the company practices and decide to make dividend payments to shareholders.

II. LITERATURE REVIEW

Dividend Payout

Miller & Modigliani, (1961) stated theory for dividend payout on capital structure. They made a comprehensive argument for irrelavancy. They state that, given the investment decision of the firm, the dividend payout ratio is mare detail. It does not affect the wealth of share holders.

The use of cash dividends as signed by managers mostly debated in the finance literature. Miller & Modiglianinoted that the effect of a firm's dividend policy on the current price of its shares is a matter of considerable significance, not only to the corporate officials, who must set the policy, but also to investors organizing portfolios and to economists seeking to acknowledge and appraise the functioning of the capital markets. Further, they establish that in a perfect capital market optimal investment decisions by a firm are independent of how such decisions financed.

Black & Scholes(1974) stated that increase in dividend might have no definite effect on share price. They further emphasizetemporary changes in share price may occur due to the change in dividend policy. According to Gitman, increased dividends generally increase share price, this may not always be the case; if a firm overall performance is questionable, then raising dividends may not encourage investors.

Oyejide, (1976)states that a significant part of returns investors can realize from putting money into stocks comes from dividends paid by companies. The amount of money acompany pays in form of dividends varies significantly from one business to the other. Companies use dividend policy to determine how much they will distribute. There is a connection between dividend policy and retention policy.

Corporate profitability has long regarded as the primary indicator of a firm's capacity to pay dividends. Lintner, 1956 indicate that the current year's earnings and previous year's dividends influence the dividend payment pattern of a firm.

Profitability

The decision to pay dividends starts with profits. Therefore, it is logical to consider profitability as a threshold factor, and the level of profitability as one of the most important factors that may influence firms' dividend decisions. The theory suggests that dividends usually paid out of the annual profits, which represents the ability of the firm to pay dividends. Thus, firms incurring losses are unlikely to pay dividends. In his classic study, Lintner, (1956) found that a firm's net earnings are the critical factor of dividend changes. Furthermore, several studies have documented a positive relationship between profitability and dividend payouts

Sheridan & Roberto ascertains that firms with high profit rates all factors held constant would maintain relatively lower debt ratio since they are able to generate such funds from internal sources.

The pecking order hypothesis suggests that firms finance investments first with the internal finance, and if external financing is necessary, firms prefer to issue debt before issuing equity to reduce the costs of information asymmetry and other transactions cost (Myers & Majluf, 1984). This financing hierarchy thesis might also have an effect on the dividend decision. That is, taking into account the costs of issuing debt and equity financing, less profitable firms will not find it optimal to pay dividends, ceteris paribus. On the other hand, highly profitable firms are able to pay more dividends and to generate internal funds (retained earnings) to finance investments. Therefore, the pecking order hypothesis may provide an explanation for the relationship between profitability and dividends.

Fama & French, (2002) used the expected profitability of assets in place for testing the pecking order hypothesis. They interpreted their results of the positive relationship between profitability and dividends as consistent with the pecking order hypothesis.

Myers, (1984) ascertains that a negative relationship between debt and profitability exist on the basis that successful companies do not need to depend on so much external funding but rather they should instead rely on their internal reserves accumulated from past profits. Titman& Wessels, (1988)andBarton, et al., (1989) agree that firms with high profit rates all factorsheld constant would maintain relatively lower debt ratio since they are able to generate such funds from internal sources.

Financial researchers who analyzed the dividend policy empirically articulated different views about the relationship between dividend policy and corporate profitability.

Harmoniously, (Carrol , 1995) using quarterly data of 854 firms over the 1975-1984 periods found a significant positive relationship between earnings forecast revisions and dividend changes. More specifically, his results suggested that dividend increases followed by an increase in future earnings and dividend decreases were followed by a decline in future earnings. Nissim & Ziv,(2001) found a positive association between current dividend changes and future earnings changes considering a particular model of earnings expectations.

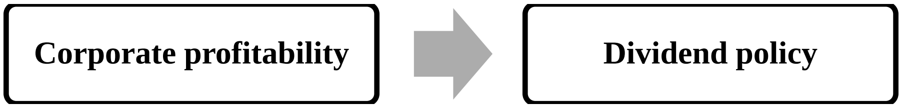
In this concern, this research tries to clarify the relationship between dividend policy and corporate profitability for the listed Beverage Food and Tobacco (BFT) industry in Sri Lanka.

III. METHODOLOGY

There are significant literatures, which investigate the relationships between dividend policy & corporate profitability, across a number of different stock markets and over a range of different time horizons. Following methodological approach proposed to use in this study in establishing the relationship between dividend policies on the corporate profitability and Beverage, Food and Tobacco (BFT) industry in the emerging Sri Lanka Stock Market (Colombo Stock Exchange).

IV. CONCEPTUAL FRAMEWORK

Based on this research study the following conceptualization model formulated.Purpose ofthisstudyis seeking the impact of corporate profitability on the dividend payout inthisdynamiceconomy.Therefore,conceptualizationofthis problemreceivedconsiderableattention,sincetheoutputwilldepend onthederived concept.



Operationalization Framework

CONCEPT	VARIABLE	MEASUREMENT
Corporate Profitability (IV)	Return on Equity	$\frac{\text{Profit after tax}}{\text{shareholders' equity}}$
DividendPayout (DV)	Dividend Payout	$\frac{\text{Dividend per share}}{\text{Earnings per share}}$

Secondary data collected using the annual report of the sampled for the financial year 2014/2015. Data on dividends derived from the financial statements, directors' proposals and the rate of dividend. Corporate profitability derived from the main financial ratios in the financial statements.

- Independent variable- Profitability of food & beverage industries listed in Colombo Stock Exchange (CSE)
- Dependent variable- Dividend policy of food & beverage industries listed in Colombo Stock Exchange (CSE)

Regression model used to establish the causal relationship between two variables, that is, an independent (corporate profitability) and a dependent variable (Dividend policy). A well-known statistical package like 'Statistical Package for Social Sciences' (SPSS) 20.0 Version was used in order to analyze the data.

Considering the dependent, independent variables are engaged in the study, the researcher modeled the study as follows:

$$DPO = \beta 0 + \beta 1\ ROE + e$$

Where;
DPO = Dividend Pay Out
ROE = Return on Equity
$\beta 0$ = Constant (y- intercept)
$\beta 1$ = Coefficients of Determination
e = random error

HYPOTHESES

Followingtwo hypotheses have employed for thisstudy.
H1: There is a positive significant relationship between the Dividend Policy and Corporate Profitability
H2: There is a negative relationship between the Dividend Policy and Corporate Profitability.

V. DATA ANALYSIS

Coefficient of determination explains the extent to which changes in the dependent variable can be explain by the change in the independent variables or the percentage of variation in the dependent variable (Dividend Pay Out) that is explained by the independent variables (Return on Equity).

Table: 1
Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.843[a]	.711	.704	.0443240

a. Predictors: (Constant), ROE

Table: 2
ANOVA[a]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.184	1	.184	93.554	.000[b]
	Residual	.075	38	.002		
	Total	.258	39			

a. Dependent Variable: DPO
a. Predictors: (Constant), ROE

Table: 3
Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	.059	.016		3.614	.001
	ROE	.917	.095	.843	9.672	.000

a. Dependent Variable: DPO

That the coefficient of determination (R2) is shows as 0.711. This implies that 71.1% of the variations in the dividend payout ratio are account for by the included explanatory variable profitability (ROE). The adjusted coefficient of determination (adjusted R2) is give as 0.704. This means that precisely 70.4% of the variations in the dividend payout ratio are account for by profitability (ROE), after the co-efficient of determination has been adjust to make it insensitive to the number of included variables.

From the ANOVA statistics in table 2 indicates that the model explains the most possible combination of predictor variables that could contribute to the relationship with the dependent variables. Overall model created by the researcher is significant at 1% level of significance (high significant level). The processed data, which are the population parameters, had a significance level of 0%, which shows that the data is ideal for making a conclusion on the population's parameter. It shows that the parameters in the model have a strongly significance which shows that there is a highly positive and very significant relationship between Dividend Payout (DPO) and Return on Equity (ROE).

This model can interpret as follows
DPO = 0.059 + 0.917 ROE

No	Hypothesis	Results
H1	There is a positive relationship between the Dividend Payout(DPO) and Return on Equity (ROE)	Accepted
H2	There is a negative relationship between the Dividend Payout(DPO) and Return on Equity (ROE)	Rejected

VI. SUMMARY, CONCLUSION AND RECOMMENDATIONS

This study explored the relationship between dividend payout and profitability of the Beverage Food and Tobacco (BFT) industry in Sri Lanka.The study came up with findings that are of conspicuous importance to scholars investigating dividend issues in the Sri Lankan context.

Based on the study findings and discussion, the study concluded that there is a positive significant relationship between dividend policy and the profitability of the Beverage Food and Tobacco (BFT) industry in Sri Lanka. A certain percentage earning is pay out to shareholders in the form of dividends. Since the dividend, policy of the Beverage Food and Tobacco (BFT) industry is quantify by its dividend payout ratio.This project examines the effects of dividend policy on profitability of Beverage Food and Tobacco (BFT) industry. The dividend policy was measure using the dividend payout while return on equity was use as a measure of profitability. Based on the study findings and discussion, the study concluded that there is a positive significant relationship between dividend policy and the profitability of Beverage Food and Tobacco (BFT) industry.

An important limitation of this study is the period for which the data sampled. First, the sample horizon is short, compared to samples in the prior literature. Second, as far as the Beverage Food and Tobacco (BFT) companies are consider only 50 percent of the companies selected for the sample.

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