

# Determinants of Dividend Payout Policy of listed Financial Institutions in Ghana

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## Abstract

This paper seeks to examine the determinants of dividends payout policy of listed financial institution in Ghana using fixed and random effects. Panel data covering 2005-2009 from the selected company were used for the study. The results shows statistically significant and positive relationship between Age and liquidity but saw statistically insignificant relationship between profitability, collateral and dividend payment. Therefore, the major determinants of dividend policy of financial institutions in Ghana are age of the firm, collateral and liquidity.

**Key words:** Dividends policy, Financial Institutions, Profitability, Leverage

## 1. Introduction

Companies that are seen to be performing well generate income. There are various ways in which such income generated can be put to use. Based on the residual theory of dividend, there is the tendency for companies to reinvest such profit in the business. Because of clientele effect there has been increasing pressure on companies to pay dividends. Dividends are referred to as reward for providing finance. (Kumar, 2003). The question is should all income be paid out as dividends or part? What percentage should be retained and what percentage to be paid? The dividends and dividend policy were the subject of many studies for many years from past to present (Lintner, 1956; Miller and Modigliani, 1961; Amidu and Abor, 2006). Dividend payout policy has been the primary puzzle in the economics of corporate finance since the work of Black (1976).

Base on these it is logical to follow that there are so many controversy surrounding dividend policy in corporate finance. Black (1976) put it that “the harder we look at the dividends picture, the more it seems like a puzzle, with pieces that just do not fit together”.

Explaining why companies pay dividend and some do not pay dividends is still problematic to explain and therefore dividend policy remains controversial. Some researchers like Amidu and Abor (2006) believe that setting dividend policy involves judgmental decision making and that there has been emerging concern that there is no single explanation of dividend. Because of increasing complexities, competition, global and corporate structure, it is difficult to single out one single factor affecting dividend and dividend policy. Brook et al (1998), stress that there is no single reason to believe that corporate policy is driven by a single goal.

Researchers follow different approaches being theoretical and empirical, simple to complex models to study factors that are expected to have effects on dividend policy. However, recent empirical studies have been focused on developed countries where their corporate characteristics are different from developing countries. One of the few empirical studies focusing on the developing and emerging market is that of Amidu and Abor (2006), on the determinant of dividend payout ratio using figures from selected listed companies on the Ghana Stock Exchange over a period of six years (1998-2003). However, companies listed on the Ghana Stock Exchange vary in terms of the industry they do business. Examples of such industries include the financial, manufacturing, merchanding, agricultural and etc.

Marfo-Yiadom Agyei (2011) looked at dividend payment of banks in Ghana which includes those listed and those that are not listed. However, it is important to note that companies that are listed may behavior differently from those that are not listed since a policy may affect its market value on the stock market. It is in this regards that the researchers investigates determinants of dividends policy of listed financial institutions in Ghana.

The financial industry in Ghana has seen tremendous improvement over the last decade. This had led to influx and establishment of financial institution and some been listed on the Ghana Stock Exchange. It has been observed that when share from financial institutions are floated they are oversubscribed. Perhaps return on equity or the dividend payout ratio on such share has been observed to be high. It is because of this that the researchers wanted to study the dividend and dividend policy of financial institutions listed on the Ghana stock exchange over a period of six year period. This study is expected to guide corporate managers in developing appropriate and comprehensive dividend and dividend policies and strategies. Also to it will guide investors in developing their investment portfolio in the financial sector.

## 1.2 Objectives of the study

The objectives of the study are to

- Identify the variables with expected influence on the dividends and payout ratio in the financial sector in Ghana
- Determine the relationship between dividend payout ratio and these explanatory variables.

## 2.0 Review of related literature

### 2.1 Dividend policy

Dividend policy has become a major decision in corporate finance in recent times. Dividend is a distribution or appropriation of profit to shareholders. The amount is decided by the board of directors and is usually paid quarterly semi yearly or yearly depending on the policy of the firm. Study on dividend policy was provoked by Miller and Modigliani's (1961) research which concluded that under perfect capital markets dividends are not relevant. However, later investigations which lighten up the assumption of perfect market and documented the presence of market imperfections, such as information asymmetry, tax consideration and agency cost discovered that dividend policy was indeed relevant to the value of a firm. Within corporate finance, dividend policy represents one of the most intensively-researched topics that academics have studied. Numerous researchers have attempted to solve the "dividend puzzle" identified in Black (1976) but these studies have not yet arrived at a common solution. A mix of opinion therefore exists about why firms pay dividends and whether the selection of a particular dividend policy can influence the value of a firm. Generally, financial researchers are divided into three groups on the basis of their beliefs about the impact of dividend policy on firm value. The first group believes that dividends have information content: an increase in the dividend payout increases firm value (e.g. Lonie et al., 1996; McCluskey et al., 2006). The second group are of the opinion that an increase in dividend tends to reduce share price because (i) it suggests that firms have a dearth of positive NPV projects needing investment (e.g. Woolridge and Ghosh, 1985; Soter et al., 1996) or (ii) it leads to higher taxation payments when the tax on income is higher than that a capital gains (e.g. Lasfer, 1995; Bell and Jenkinson, 2002) The third group claims that dividend policy has no effect on firm value (e.g. Uddin 2003; Kaleem and Salahuddin, 2006).

### 2.2 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. Profitability can be defined as the ability of the firm to create profit. The profit size of a firm has been a determinant of dividend policy standing for years. Directors more often than not recommend the payment of dividend when the firm has made adequate profit to necessitate such payments. Dividend policy has been largely, strongly and directly influenced by profitability as among the main characteristics, Al-Kuwari (2009). It is projected that money-making (profitable) firms are most likely to pay dividend compared to non profitable firms (Eriostis and Vasilio, 2003; Ahmed and Javid, 2009). Accordingly, Pruitt and Gitman (1991) bring to a close that current and past years' profits, the year-to-year and earlier years' dividend are important factors that influence dividend policy. The ratio dividend payout depends on the current earnings of the firm (Baker and Powell, 2000). They argued that, the higher the earnings, the more dividends will be paid to the investors. Al-Najjar and Hussainey (2009) has mentioned that the profitability of the firm plays an important role in increasing the dividend paid to the shareholders. They were quick to add that profitability is supported by signaling theory as the firm wants to boost the standing of its performance. However, Al- Kuwari (1998) noted that managers settle on to pay smaller amount of dividends now to cope with the changes in the future when a company expects less cash flow in the future. Furthermore, Kowalewski (2007) noted that whenever a firm less investment opportunities it pays higher dividend from the profit made. In his classic study, Lintner (1956) found that a firm's net earnings are the critical determinant of dividend changes. Accordingly, Al-Malkawi (2007) concludes that profitability is a critical determinant of the level of Dividends paid by firms.

Reddy (2006) show that the dividends paying firms are more profitable. Amidu and Abor (2006) agreed to the existing theories that dividend payout policy decision of listed firms in Ghana Stock Exchange is influenced by profitability.

### 2.3 Liquidity/ Cash Flow

Another important determinant of dividend policy is the liquidity position of a company for dividends payments. Under the Ghana's company's code, Section 71 of the Company Act 1963, (Act 179) stipulates that a company cannot pay a dividend to its shareholders until and unless it is able after such payments to pay its debt when they fall due, without any embezzlement. Section 30(1) of Banking Act 2004, (Act 673) adds that a bank shall not declare or pay dividend on its shares unless it has: completely written off all its capitalized expenditure; made the required provisions for non-performing loans and other erosions in asset values; supplied the minimum capital adequacy ratio requirements; and completely written off all its accumulated operating losses from its

normal operations.

La Porta et al. (2000) argued that when a firm has a free cash flow, its managers will engage in wasteful practices, even when the protection for inventors improves. A number of studies have suggested that firms with a greater “cash flow” need to pay more dividends to reduce the agency costs of the free cash flow ( La Porta et al., 2000). Based on the findings of the above studies, it can be speculated that there is a positive relationship between the cash flow and the dividend payout ratio.

On the contrary, Marfo-Yiadom and Agyei (2011) although, cash had a negative relationship with dividend policy, the results were not significant. In investigating the determinants of dividend policy Naceur *et al.* (2006) find that the high profitable firms with more stable earnings can manage the larger cash flows and because of this they pay larger dividends. Moreover, the firms with fast growth distribute the larger dividends so as attract to investors.

#### **2.4 Leverage**

This shows total debt as a percentage of the shareholders’ fund and it also measures the extent to which a firm is financed by external funds (Al-Najjar & Hussainey 2009). A mounting number of studies have found that the level of financial leverage negatively affects dividend policy ( Gugler and Yurtoglu, 2003; Al-Malkawi, 2005). Their studies argued that highly levered firms instead of sharing existing cash to shareholders and protect their creditors they rather look ahead to maintaining their internal cash flow to fulfill duties of future financial obligations. Companies that finance their operations mostly with debt put anxiety on their liquidity. Debt principal and interest payments reduce the capacity of firms to have residual income to warrant dividend payment. Thus, it is expected that debt would impact negatively on the amount of dividend paid for a period. Kowalski *et al* (2007) argued that more indebted firms prefer to pay lower dividends. Also, Al-Kuwari (2009) confirms that dividend policy is negatively related to leverage ratio. However, Mollah et al. (2001) examined an emerging market and found a direct relationship between financial leverage and debt-burden level that increases transaction costs. Thus, firms with high leverage ratios have high transaction costs, and are in a weak position to pay higher dividends to avoid the cost of external financing.

#### **2.5 Collateral Capacity**

Bradley et al, (1984), in the world of business, companies that have a superior percentage of their assets as tangible assets is in better position to raise capital through debt and get it at a cheaper cost and this will result in reducing undue pressure on the internally generated fund, thus, all thing being equal, collateral capacity is anticipated to have a positive outcome on a firm’s dividend policy. Firms that have most of it assets as tangible is collaterally position in the eyes of the investing public.

#### **2.6 Growth**

Recent experiences have shown that growth in revenues tend to pay lower dividends (Chen and Dhiensiri, 2009). There will be a high demand of capital if a firm is fast growing. The pecking order theory states that firms should finance new projects first with least information-sensitive sources. Also, firms with high growth opportunities are likely to retain a greater portion of their earnings to finance their expansion projects as against returning these dividends to shareholders.

Several studies compared investment opportunity ratios to distinguish growth from non-growth firms (Gavers and Gavers, 1993; Moh’d et al., 1995). These studies established that growth firms, as compared to non-growth companies, showed a lower debt to trim down their dependence on external financing, which is costly in many cases. This explanation is consistent with Myers (1984), who suggested that investment policy can be substituted for dividend payouts, hence, because it reduces the free cash flow and also reducing the agency problem. La Porta et al. (2000) investigated countries with high legal protection and revealed that fast-growth firms paid lower dividends, as the shareholders were legally protected. On the other hand, in countries with low legal protection for shareholders, firms kept the dividend payout high, to develop and maintain a strong name, even when they had better investment opportunities

#### **2.7 Age of a Firm**

Companies that have been in business for so long a time are positioned to have a good reputation for themselves against companies with short period in business. When Reputation of a firm is managed as it should be can be used as a foundation for attracting cheaper credit to finance expansion and operational ventures. This is why Diamond (1989) ended by saying financial institutions use firm reputation to evaluate the credit worthiness. This goes to suggest that age and dividend policy would be negatively related. In spite of the Diamond concluded, firms that are old and aging tend not to have more growth opportunities to fund because they may either be at their maturity or decline stages of their life cycle. Such firms therefore are likely to pay more dividends. The research seeks to test this by using age squared due to the apparent variation.

### **3.0 Methodology**

Since the study seeks to identify variables expected to have influence on dividend payout ratio, the major data

used for the study was taken from the fact book compiled by the Ghana Stock Exchange. These include the financial statements of the selected companies from 2005 to 2009. In all eleven financial institutions listed on the stock exchange was considered for the study. These were made up of nine major Banks and the only two Insurance companies listed on the exchange.

### 3.1 Model specification

Since the study seeks to determine the variables influencing dividends policy of listed financial institutions in Ghana over a five year period, the study uses panel data regression analysis of cross-sectional and time series data. The panel data from the financial institutions were collected.

The general model for the study is:

$$DPO_{it} = \beta_0 + \sum \beta_i X_{it} + \epsilon_{it} \quad (\text{Eq. 1})$$

$DPO_{it}$ : Dividend payout ratio of firm  $i$  at time  $t$

$\beta_0$ : The intercept of equation

$\beta_i$ : Coefficients of  $X_{it}$  variables

$X_{it}$ : The different independent variables for the dividends payout of firm  $i$  at time  $t$

$i$ : Financial institution = 1,- 11 firms

$t$ : Time= 1,2,3,4,5 years

$\epsilon$ : The error term

Actually, when the researcher convert the above general least squares model into specified variables it becomes:

$$DPO_{it} = \beta_0 + \beta_1 ROA_{it} + \beta_2 GRO_{it} + \beta_3 FAT_{it} + \beta_4 CTA_{it} + \beta_5 AGE_{1it} + AGE_{2it} + \epsilon_{it} \quad (\text{Eq. 2})$$

**TABLE 1: DEFINITION OF VARIABLES (PROXIES) AND EXPECTED SIGNS**

VARIABLE	DEFINATION	EXPECTED SIGNS
<i>DPO</i>	Dividend Payout strategy (Dependent Variable) = the ratio of cash dividend paid to financial institutions in time $t$	
<i>ROA</i>	Profitability = Return on Assets (Net Income to Total Asset Ratio) for financial institutions $i$ in time $t$	Positive
<i>GRO</i>	Growth = Growth in firm net income, year on year.	Positive
<i>AGE</i>	firm Age = the log of firm age in time $t$	Negative
<i>AGE2</i>	Non linearity of Age= the square of log of age	Positive
<i>CTA</i>	Ratio of Cash and cash equivalent to Net Total Assets financial institutions $i$ in time $t$	Negative/Positive
<i>FAT(Collateral)</i>	Ratio of Net Fixed Assets to Net Total assets for Financial institutions $i$ in time $t$	Positive
<i>E</i>	The error term	

## 4.0. Discussion of Empirical Results

### 4.1. Descriptive Statistics

The table 2 gives a descriptive statistics of the variables explaining the dividend payout policy of financial institutions in Ghana. Paid out dividend was averagely 50.10% whereas return on assets was 3.44% while the CTA showed an average result of 1.59. The average growth rate for the period was 1.14. The average age was 1.36 whereas the average log of the age was 1.92.

**TABLE 2 DESCRIPTIVE STATISTICS**

Variable	Mean	Std. Dev.	Minimum	Maximum
<b>DPO</b>	<b>.5010888</b>	<b>.92196</b>	<b>0</b>	<b>6.716113</b>
<b>ROA</b>	<b>.0344278</b>	<b>.0173454</b>	<b>.0071726</b>	<b>.0922274</b>
<b>GRO</b>	<b>1.146305</b>	<b>1.35809</b>	<b>-.3260779</b>	<b>9.893576</b>
<b>FAT</b>	<b>.3441825</b>	<b>.1756561</b>	<b>.0976952</b>	<b>.8988319</b>
<b>CTA</b>	<b>1.590637</b>	<b>1.589789</b>	<b>-.0110591</b>	<b>6.438392</b>
<b>AGE1</b>	<b>1.366856</b>	<b>.2358585</b>	<b>.90309</b>	<b>1.748188</b>
<b>AGE2</b>	<b>1.92854</b>	<b>.6368865</b>	<b>.8155715</b>	<b>3.056161</b>

### 4.2 CORRELATION ANALYSIS

In order to establish whether the coefficient estimates may change in response to small changes in the model, the correlation coefficients the repressors' have shown in the table 3 below. The results show minimal multicollinearity among the variables.

**TABLE 3 CORRELATION MATRIX OF THE REGRESSORS**

	ROA	GRO	FAT	CTA	AGE1	AGE2
ROA	1.0000					
GRO	0.0561	1.0000				
FAT	-0.1223	-0.0344	1.0000			
CTA	-0.2149	-0.0335	0.3956	1.0000		
AGE1	0.0745	0.0907	-0.5097	-0.4473	1.0000	
AGE2	0.0744	0.0932	-0.8413	-0.4344	0.9966	1.000

### 4.3 DISCUSSION OF REGRESSION

The result of the regression is depicted in the table 4 below. The results show that CTA, AGE1, and AGE2 are statistically significant in explaining dividend policies of listed financial institutions in the Ghana Stock Exchange (GSE).

Profitability positively affects dividend payment but was not statistically significant enough. This may suggest that financial institution may pay dividend not necessarily considering the level of profit but will pay only when the managers think is appropriate to do so.

Consistent with our expectation, Growth positively affects dividend payment. However, that was statistically insignificant. This is consistent with other empirical studies (Amadu and Abor, 2006; Marfo-Yiadom and Agyei, 2011). Collateral capacity of the financial institution positively affect dividend payment, however, this was not statistically significant.

Liquidity measured by CTA positively affects dividend payment. Not only was it positive, it was statistically significant. This does not conform to our expectations but consistent with other empirical studies (Amadu and Abor, 2006). This shows that financial institutions with less cash and cash equivalent are less likely to pay dividend. This could also be partly explained why non cash payment of dividends is not popular in Ghana by financial institutions. Both ages that is the log of the institutions age and the square of the age positively affects dividends payment. This indicates that financial institutions that are in existence for a long term pay more dividends as compared with the new institutions.

**TABLE 4 REGRESSION RESULTS**

Explanatory Variable	FIXED EFFECTS			RANDOM FIXED EFFECTS		
	Coef.	t-stat.	Prob.	Coef.	z-stat.	Prob.
ROA	6.23852	0.88	0.381	6.174429	0.91	0.364
GRO	.0112608	0.11	0.910	.0287104	0.34	0.735
FAT	-.8752498	-1.04	0.304	-.9371098	-1.13	0.260
CTA	.2207824	2.55	0.014	.2015306	2.39	0.017
AGE1	-15.17954	-2.29	0.027	-15.71853	-2.41	0.016
AGE2	5.402329	2.25	0.029	5.563713	2.36	0.018
CONSTANT	10.5531	2.27	0.028	11.0127	2.42	0.016
	F- test	0.93		Wald chi(6)	16.76	
	Prob.>F	0.4569		Prob.>chi2	0.0102	
	R <sup>2</sup>	0.8444865		R <sup>2</sup>	0.6772	

### 5.0 CONCLUSION

The study was aimed at establishing variables affecting dividend policies listed financial institution in Ghana Stock Exchange. The results shows statistically significant and positive relationship between Age and liquidity but saw statistically insignificant relationship between profitability collateral and dividend payment. Therefore, the major determinants of dividend policy of financial institutions in Ghana are age of the firm, collateral and liquidity. It is suggested that future studies should look at dividend policy of rural banks in Ghana.

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