The Role of Internal and External Auditing in Non-Financial Firms on Dividend Distribution Policy

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Abstract

This research studies the impact of taxes, company policies as well as market conditions of a given company on its dividend distribution. It was discovered after research that the effect of internal auditing and external auditing in any given firm determines the level of dividend distribution in that particular firm.

Introduction:

Corporate finance is concerned with three long-term issues and these are capital investment, financing, and dividend policy (AL-Qaisi and Omet (2010). In developing stock exchange markets, the issue of dividends forms one of the major subjects of argument. Dividend distribution in the developing market is usually affected by both internal as well as external factors surrounding the enterprise. Internal conditions in an enterprise encompass factors related to the policies and taxes whereas the external conditions relate to factors such as market conditions as well as the manner in which the stakeholders view the firm (Black, 1976). The wide variation which exists in the conditions are the reason as to why the policies used in determining dividends in a given firm are referred to as “dividend puzzle.”

Several researches have been conducted in the developed stock market with the aim of determining factors affecting dividend distribution. Nonetheless, due to the lack of stability, most of the researches conducted in this area did not determine the policies used in the firm in dividend distribution (Lintner, 1956).Researchers observed varied attitudes as concerns dividend distribution. For instance, US researchers, DeAngelo, et al. (2004), observed an increase in dividend distribution between 1974/2000, a phenomenon which they attributed to the concentration of dividends as well as earnings of the employees of the firm. According to these researches, dividend distribution of a given firm is affects the firm’s policies. Moreover, recent researches conducted by Ramcharran (2001) observed that emerging markets yielded low dividends as compared to the older ones.

The reason behind the low dividend is that emerging firms encounter more financial constraints while at the same time they lack access to funds necessary to finance investment opportunities (Allan &Michaely, 1995). These factors force the emerging capital markets to heavily rely on retained earnings, which reduces the payout ratios.

Consequently, La Porta et al. (2000a) maintain that variations in the dividend policy of various nations are analyzed best by considering the laws put in place by such a nation to guide its business operations. They observed that in countries, which are governed by common laws, firms register higher dividend payout than civil law nations. This is because common laws ensure better stakeholder protection than civil laws.

Factors which Influence the Policy of Dividend

Dividend policies usually vary from one firm to another. This variation is affected by various factors. Internal factors affect dividend distribution policies of any given corporation together with the corporation's management perspectives. Examples of key dynamics which influence the dividend distribution policy in any given firm include its taxes, incomplete contracts, institutional constraints, and costs of transaction as well as the information which is asymmetrical

Taxes

The tax system in a given country affects the dividend policies put in place by a given firm. There are two strands of taxes which affect dividend policy of a firm. They include; static tax clientele models as well as dynamic trading tax models. Static tax clientele model is where the investors in the given firm engage in the buy-and –hold strategy whereby they retain the option of choosing stock that will enable them minimize their tax liabilities. In the event of adjustments in the environment, the static tax model is able to predict the changes allowing the investor to adjust his/her dividends in order for them to fit the tax model. This therefore allows for changes in the ownership shift.

On the other hand, dynamic trading tax models is whereby investors falling in different tax brackets in an attempt to transfer tax liability to distribution investors belonging to low tax brackets, trade around ex-dividend days. Whenever there is lack of transaction costs and in the event where foreseeable risks can be fully hedged, the investor is allowed to avoid the tax. Hence, the portfolio choice of the investor becomes independent of the dividend policy. Researches carried out to determine the influence of dynamic trading tax on dividend policy observed that large abnormal trading volumes are transacted carried out in various nations around the globe.

Nonetheless, the level of drop in prices during the days when there are no dividends is mostly on medium level as compared to the dividend in most of the countries. This is a clear indication that tax cannot be avoided entirely by dynamic trading but rather by either cost of transaction or business risks which are unhedged or in some cases by both.

Asymmetric information

The dividend policy is viewed as a consequence of the separation between the control and ownership of the firm whenever there exists an issue of incomplete contracts within the firm. In a widely held firm, there are high chances of the management allocating resources to projects which will only benefit the managers as opposed to the shareholders. In order to avoid the occurrence of such sub-optimal use of resources, it is significant for the stakeholders to minimize cash in the hands of the management. According to a research conducted by Grossman and Hart (1980) as well as by Easterbrook (1984) and Jensen (1986), they maintain that this can be done through making a considerable amount of dividend payment. It is also suggested by some scholars that the management can enhance accountability by voluntarily committing to make payments with fear of being punished.

Gugler and Yurtoglu (2003) explain the role played by mega corporations in a manner different from previous explanations. The two argue that, in firms located in the European continent, management vs stakeholder conflicts are not as severe as those existing among large scale and small scale shareholders. This is because as the shareholding rises, the securities of the large and the small shareholders comes out clearly thereby making small shareholders less motivated to request cash paid out

as dividends. For instance, researches conducted in a German dataset discovered that the level of dividend payout decreased in the case of largest shareholdings and increased as the shareholdings reduced.
The level of exploitation of the managers of the firm on the control they have on the particular firm is highly dependent on the level at which the corporation grows. There are high cases of overinvesting and stealing of the corporations funds in well-established corporations which have limited opportunities for investing.

In contrast, small scale corporations operating with a lean budget limit are not likely candidates for this agency issue. To support this position, Lang and Litzenberger (1989) in their research observed that the announcements of changes in dividends of the firm impacts significantly on stock prices of firms with probable problems of over-investment. To support this position, Lie (2000) points out that firms which choose to increase dividends lean towards an average cash level. Moreover, the effect of dividend announcement impacts positively on the corporation’s excess cash while at the same time it is negatively associated with the firm’s growth potential.

Research Problem

A good example of an emerging market whose dividend policies are influenced by several factors is Jordan Stock Market. As one of its major features, the market is marked by ownership which is concentrated. Similarly, the emerging markets in Jordan are reliant on banking unlike the old markets whose dividend distribution was impacted by the shifts in the stock market. Furthermore, distribution dividend policies are guided and controlled by existing laws and rules applicable in investment. This has made the conditions that surround dividend distribution to vary from those in the developed markets in one direction while at the same time making it unique to conditions in other existing markets of other nations across the globe (Ambarishet al.1985).However, the high variation in conditions brings issues during the determination of the distribution dividend policies in a good number of corporations in the Exchange Stock Market of Jordan. For the interest of coming up with general features which could help determine best dividend policies for the emerging market, it is important for extensive studies and researches to be conducted in this area.

Research Importance

Stocks exchange markets play a crucial part in the investment process. The manner in which investors and stakeholders behave in relation to the dividend distribution policies by various companies has an impact on the policies formulated by corporations. This research intent to offer a direct evaluation of the policies of dividend distribution which are used by organizations which are recorded on “the Stock Exchange” of Amman in Jordan. These studies give information about policies of share distribution adopted by the Jordanian firms.

The research intents to study and provide information on the dividend policies that are used in the non- financial enterprises as well as in the developing market of non -financial enterprises in Jordan. As pointed out earlier, developing markets have varied features unlike developed markets. As a result, it is of essence to note that policies of payout put in place by corporations which operate in such environments could be different as compared to those operating in markets that are more developed. Moreover, this research compares the Jordanian dividend policy as well as the resemblances with the other markets that are still emerging. Furthermore, this research will formulate trends affecting the distribution of dividends used in the sectors that are not financial which will assist firms establish better models and dividend distribution policies to be used by investors and stakeholders in the non-financial institutions.

Research Objectives

The objectives of this research include;

1. Provide information on elements determining distribution of shares.
2. Compare situations impacting dividend distribution against those listed in subsequent studies of other emerging stocks markets.
3. To find out how tax models determine the bases of the distribution of the dividends.
4. To formulate the best dividend distribution policies this will promote operations in the non-financial sectors in Jordan.

Literature Review

Due to the significance of dividend policies, various researches have been conducted with the aim of coming up with the best dividend distribution policies. One of the key pioneers of dividend policy is Lintner (1956) who through research was able to analyze the determinants of dividend policy using both empirical as well as survey research methodology. He was able to review various literatures on financial factors which determine a corporation’s dividend policy which led to his identification of fifteen variables.

Among the most notable variables postulated by Lintner include; size of the firm, costs spend on the plant and equipment, readiness to embrace the use of finances from external sources, use of dividends obtained from the corporation’s stock as well as stability of earnings. Through his empirical study, he discovered that companies make a determination on the target dividend payout ratio while at the same time enable determination of the dividend distribution policy and tune it in accordance with the target share payout ratio. Moreover, Lintner maintains that firms pursue steady policies of dividend distribution and where there emerges a considerable rise in earnings, dividends are not raised by a large figure, but are rather slowly raised putting into consideration the dividend payout ratio that is targeted. Furthermore, according to Lintner, the management believes that investors choose corporations that keep an eye on dividend policies which are steady.

Adjustments in the amount of dividend are centered on a fundamental shift in the actions of the corporation while at the same time; firms raise bonuses only when managers observe a “permanent” rise in incomes. To support this position, researches conducted in 1985 by Baker et al. as well as in 1991 by Pruitt and Gitman using the survey approach came to the conclusion after getting replies from interviewees that the management consider the steadiness of dividends to help them device the dividend policy decision process of the firm. To emphasize on this position, Baker et al. points out that the key factors determining dividend policy in the present world resembles Lintner's behavioral model which was coined in the mid-1950's” (p.83).Lintner’s research forms the basis of empirical studies conducted to evaluate determinants of dividend policy.

Future researches would make improvements on Lintner’s findings. For instance, in 1964 and 1966, Brittain, whose position was supported by Fama and Babiak in 1968, took a more comprehensive empirical approach than that taken by Lintner. In their research, they agree with Lintner’s findings that corporations usually pursue dividend distribution policies which are stable. In making their contributions to Lintner’s model, Fama and Babiak quash the constantly used terminology while at the same time add new stages of wadded earnings. Later in 1974, Fama conducts a similar study using a larger sample. However, he records similar findings and hence comes to the similar conclusion on the stability of dividend policy.

In 1998, Dewenter and Warther used Lintner’s model in their research and applied it to the U.S as well as to corporations in Japan. They discovered that between 1982/1993, managers in the U.S corporations were able to smoothen dividends evenly as compared to earlier periods of 1946-1964 as outlined in the Fama and Babiak’s study. They also discovered that the management of companies in

Japan was more enthusiastic to overlook dividends by adopting fairly less steady dividend policy as compared to their counterparts in the American corporations.

Previous researches conducted in 1995 by Kato and Loewenstein had also discovered that companies in Japan adopted steady dividend distribution policies. In 1979 and 1982 respectively, Chateau and Shevlin carried out studies applying Lintner model to the big companies in Canada as well as Australian. In 1975, McDonald, Jacquillat and Nussenbaum conducted similar researches in the French market. Research in this area continues into the 1990s with researchers. For instance, in 1993, Leithner and Zimmermann tested the steadiness of dividends on renowned markets in Europe such as the United Kingdom, Germany, France as well as Switzerland. In 1996, Lasfer studied profit-making as well as industrialized companies in the United Kingdom using Lintner's model. Research conducted in nations with advanced capital markets discovered that firms in these markets embrace stable dividend policies.

Later, researches on dividend policy distribution would focus on emerging markets as opposed to developed capital markets. For instance, Glen et al. (1995) points to the existence substantial of variations in the share policies employed in the developed markets and emerging markets. In their research, they discover that the dividend payout ratio of emerging markets is two thirds that of developed countries. To them, corporations in upcoming markets have target share ratios nonetheless do not pay attention on stable share policies. These observations are premised on observations made on dividend policy of a few corporations in the upcoming market. Glen et al suggest that extensive research ought to be conducted in this area to understand the dividend behavior of emerging market corporations with a view to developing better dividend distribution policy.

Apart from the interactive contributing factors of share policy coined by Lintner, hypothetical and experimental studies indicate the existence of five deficiencies in the market which impacts the dividend policy making process of any corporation. According to research conducted in 1995 by Allen and Michaely, such deficiencies include asymmetric information, contracts that are not completed, taxes, institutional limitations as well as costs of transaction. For instance, a given corporation will be forced to adjust its dividend policies whenever there is a shift in the earning potential of such a corporation. However, in case the management of such a corporation feels that there is a possibility of earnings improving in the future to a level which they can sustain, there are high chances of them increasing the dividend level of the corporation.

Studies carried out in 1997 by Benartzi, Michaely and Thaler point out that the model by Lintner is the most ideal offering an explanation of the behavior of the share policy of firm and as it explains that only a "permanent shift" in the earnings can result in changes or in the "share policy" of a given corporation. Therefore, in the event there are poor prospects and a lack of hope for recovery in the future earnings, there are high chances of the management opting to decrease the dividends. Studies carried out in 1990 by DeAngelo and DeAngelopoint out that in times of financial problems, firms with a positive past record of share payments end up cutting dividends instead of ignoring dividends with the intention of altering the image of the corporation. Subsequently, because of the sticky nature of the dividend distribution policy, any alteration in the share distribution policy is deduced to mean a shift in the prospects of future earnings of the management.

In 1961, researches conducted by Miller and Modigliani observed that since firms adopt steady share distribution policies, alterations in the share distribution policy of the corporation is cautiously appraised by investors to indicate the future profitability of the corporation. This phenomenon is what is referred to as the dividend information content and considerable researches have been conducted in this regard leading to writings dating back to early 1970s. Generally, empirical researches conducted point out that an affirmative market reaction to shares rises whereas a negative reaction in the market to dividend declines. It is worth noting that market responses towards decreases in dividends are far superior as opposed towards market reactions to an increased dividend.

The correlation existing between dividend distribution policy and organization cost in the recent developments in “corporate finance theory” that focuses on issues regarding “how dividend distribution” policy is applied in reduction of the “agency cost. “Dividend distribution policy” is of significance to shareholders in guiding the management in the right direction while at the same time it helps in wealth recovery from debt holders.

One of the solutions to such conflicts is reduction of “amount of cash” controlled by the company’s leadership which can be done through the distribution of enough rates of dividends to the shareholders.

Various researches have been conducted with an aim of assessing the effect of taxes on the “dividend policy”.

Research Methodology

This research uses a questionnaire designed to enable for the measurement of factors affecting distribution of dividends from the view point of the investors. The use of the questionnaire will enable a study of factors affecting the stability as well as the distribution of dividends in the stock market while at the same time study the manner in which different factors correlate with the intention of finding out the group of factors which has an effect on others.

Research Population and Sample

The research will be carried out on a homogenous population sample made up of both internal auditors as well as external auditors working in the non- financial corporations which are “registered in” the “Amman Stock Market”. The determinations of sample sizes that shall be based on “statistical laws” of sampling which allows for use of a simple randomized population sample.

Results

In order to ascertain factors affecting “distribution of dividends” within non financial firms of the “Amman Stock Exchange Market”, this research employed the use of samples consisting of 30 internal and external auditors selected randomly.

1. The demographic characteristics of sample

It was found out that males were dominant in the randomly selected sample constituting of up to 80%. Similarly, people falling in the age bracket of between 31-40 years with 35%, B.Sc, dominated the sample respondents constituting 70% of the respondents. Furthermore, the sample was dominated by respondents falling in the income bracket of between 500-1000JD who made up to 35%. The analysis of sample composition is as shown in the table below (Table1).

Table 1: The Frequency and percentage of demographic features of auditors

"Items"	"Frequency"	"Percentage"
Gender/sex		
Males	20	80
Females	10	20
"Age"		
20 and below	0	0
20-30	5	10
31-40	10	70
41-50	7	10
51-60	8	10
61 and above	0	0
Education		
Less than Tawjeihi	0	0
Tawjeihi	3	5
Diploma	15	10
B.Sc.	7	70
Postgraduate	5	15
Income		
500 and below	5	15
500-1000	15	40
1001-3000	6	20
3001-5000	4	25
5001 and above	0	0

It was discovered that dividend distribution is dependent on the decision made by the "Board of Directors of" a corporation having mean (4.3). The "second rank" indicates that when effecting policies of a corporation, dividend distribution of this corporation affect the future plans that the corporation is able to implement with a mean of up to 4.2. In the third factor, it is discovered that the recommendations put forward by the internal auditor and the external auditor affect dividend distribution in the corporation.

For the case of taxes, it was discovered that laws put in place have an impact on the dividend distribution within the corporation constituting a mean of 4.4. As regards the double tax payment, it is discovered that the double tax payment leads to dividend minimization with a mean of 4.2. It was highly agreed that profits ought to be distributed in order to avoid payment of high taxes with a mean of 4.1. Furthermore, it was discovered that market conditions have an impact on the dividend distribution in the corporation. The earnings of the corporation played a great role in the distribution of dividends in corporation with a mean of 4.4. The table below shows the means and standard deviation of the attitudes of auditors as well as the factors which affected the distribution of dividend in a corporation

#	Items	Mean	Standard Deviations
	Policies		
1.	The Distribution of dividends is dependent upon the decision of the "board of directors" of a company.	4.3	0.611
2.	The "future plans of this corporation" have an impact on dividend distribution of that corporation.	4.2	0.71
3	The opinion of the internal auditors has an impact on dividend distribution.	4.0	0.80
4	The opinion of external auditors impact on the dividend distribution	3.9	0.91
	Taxes		
1	Tax laws have an impact on "dividend distribution" in an organization	4.4	0.74
2.	By avoiding "double taxes paid", a company is able to decrease the distribution of dividends	4.2	0.60
3	Through distribution of "dividends in the form of stocks", a corporation is capable of avoiding taxes.	4.1	0.55
	Market conditions		
1	Company earnings have an impact on dividends distribution	4.4	0.13
2	Companies consider their financial position in their dividend distribution.	3.3	0.31

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and US Firms, Journal of Finance 53, 879-904.
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Questionnaire

The research measures factors affecting dividend distribution in accordance with the point of view of the stakeholders. Answer the questionnaire by putting a tick on the most appropriate answer.

Personal information

1. Gender
   - ☐ Male ☐ Female
2. Age
   - ☐ Below 20 ☐ 20-29 ☐ 30-39 ☐ 40-49 ☐ 50-59 ☐ 60 and above
3. Level of Education
   - ☐BelowTawjeihi ☐Tawjeihi ☐ Diploma ☐ B.Sc.
   - ☐ Postgraduate
4. Level of Income
   - ☐ Less 500 ☐ 500-1000 ☐ 1001-3000 ☐ 3001-5000
   - ☐ 5001 or more

Tick the most appropriate answer applicable to your case. (1) indicates low contribution, while (5) indicates high contribution in dividend distribution

#	**Item**	**1**	**2**	**3**	**4**	**5**
	Policies					
1	The distribution of dividends isdependent on the decision of board of directors of the company.					
2	The future plans of the company have an impact on dividend distribution of the company.					
3	The opinion of internal auditors have an impact on dividend distribution					
4	The opinion of external auditors have an impact on dividend distribution					
	Taxes					
1	Tax laws have an impact on dividend distribution in the company					
2	The company reduces dividend distribution by avoiding payment of double taxes.					
3	To avoid taxes, the company distributes dividends in the stock form.					
	Market conditions					
1	Company earnings have an impact on dividend distribution.					
2	Companies took into consideration the company financial position in dividends distribution					