

## **Expected Dividend and Dividend Payment: Are They Related?**

**Norashikin Ismail\*, Rashidah Abdul Rahman\*\*and Normah Omar\*\***

\*University Teknologi MARA, Shah Alam, Selangor, Malaysia

\*\*Accounting Research Institute, Higher Institutions' Centre of Excellence, Malaysia

Corresponding author: norashikin.ismail@yahoo.co.uk

### **Abstract**

We examine the association between dividend payment policy and expected dividend, controlling for profitability, leverage and growth opportunity in a developing economy. Based on evidences from prior management surveys on determinants of dividend policy and empirical evidence on investor's negative reaction towards dividend cut, we hypothesise that there is a significant positive relationship between expected dividend measured in terms of past dividend payment and dividend policy of the firms. Our sample comprise of 524 firms listed on Malaysian Stock Exchange (Bursa Malaysia) over a period of 5 years. We provide evidence to support prior survey findings. Multivariate results show that expected dividend is positive and it significantly influenced Malaysian firms' dividend payment. The result is consistent with one of the renowned dividend behaviour of smoothing of firm's dividend vis-à-vis earnings and growth.

**Keywords:** Expected dividend, Dividend Policy, Developing Market

### **1. Introduction**

Dividend policy is one of the important decisions made by the firm. Healy and Pelepu (1989) suggest that besides the choice of how much debt to hold in the firm's capital structure, the choice of how much earnings to pay as dividends also has significant impact on stock price. Since dividend payment has a great influence on stock prices and prior evidence in both developed and developing markets show that investor react negatively to dividend cut (Bajaj and Vijh, 1990; Denis, Denis and Sarin, 1994; Norhayati, 2006), maintaining smooth dividend payment is crucial. These evidences confirmed Lintner's (1956) pioneering study that managers are reluctant to cut dividends.

This renowned behaviour is consistent with DeAngelo and DeAngelo's (2006a) contention that dividend is of first-order importance to investors. Later study on earnings management motivation (Daniel, Denis and Naveen, 2008) found that firms view expected dividend levels as important earnings thresholds and thus, they managed earnings to meet expected dividend levels. Their results also suggest that firms are relatively reluctant to cut dividends, even when they are faced with decline in earnings.

In this study, we examine the impact of expected dividend on dividend policy of a sample of Malaysian firms. Prior studies of survey questionnaires showed that the most important determinant of dividend policy is the pattern of past dividend ( Baker et al. (1985, 1999, 2001 and 2007), Pruitt and Gitman (1991), Allen (1992), Al-Twaijry (2007), Baker and Powell (1999), Baker and Smith (2006), and Pourherdari (2009)). The finding of this study therefore, provides an empirical quantitative result to support survey findings. Testing the effect of expected dividend on firm's dividend policies in an emerging capital market is a contribution to the literature and investors since little evidence currently exists on emerging market.

Our results show that expected dividend has a positive and highly significant association with dividend payment. The result is consistent with one of the renowned dividend behaviour i.e smoothing of firm's dividend vis-à-vis earnings and growth. Our result is also consistent with Daniel et al. (2008) who found that managers managed earnings to meet expected dividend.

This paper proceeds as follows. Section 2 briefly reviews prior literature and discusses expectation on the relation between expected dividend and dividend payment. Section 3 describes the data and research methodology. Section 4 presents the empirical results on the relation between expected dividend and dividend payment. Section 5 concludes the paper.

## **2. Literature Review and Hypotheses Development.**

### **2.1 Expected dividend**

The study of dividend policy and factors influencing has been widely researched. A number of theoretical models and hypotheses have therefore been put forward in the attempts to explain the corporate dividend behaviour. Jensen and Meckling (1976) agency theory argues that dividend payouts helps reduce the amount of free cash flows and control agency problem. Consistent to this, Easterbrook (1984) hypothesizes that dividends are used to take away the free cash from the control of managers and pay it off to shareholders. Higher dividends increase the likelihood that the firm will have to approach capital market for funding needs, and therefore, expose firms to frequent inspection and thus reducing the cost of monitoring the managers.

Litner (1956) managerial surveys found that dividend policy is an important decision variable because managers believe that stable dividends lessen negative investor reactions. This was later supported by Fama and Babiak (1968). A number of studies have confirmed the dividend policy beliefs of managers in the US as described by Lintner (1956). Robinson (2006), Anand (2004) and Baker et al. (2007) are among the researchers whose results were found to be consistent with Lintner's model. An in-depth study of Barbados dividend policy by Robinson (2006) found that the average annual dividends of publicly listed firms of Barbadian firms are ranged between 45 to 321 percent. His result also suggests that firms are relatively reluctant to cut dividends, even when faced with a decline in earnings. This perhaps can be explained by significant price changes in response to the dividend changes. (Pettit, 1972; Grullon et al., 2002).

Similarly, a survey on managers in Canadian capital market by Baker et al. (2007) found that 93 percent of respondents believe that a firm should avoid increasing its regular dividend if it expects to reverse the dividend decision in a year. They also found that managers in Toronto Stock Exchange listed firms set dividend consistently with the dividend model of Lintner. The above findings imply that prior year dividend payment is an important factor for firm's dividend policy. Based on the above discussion, the following hypothesis is developed:

H<sub>1</sub>: Dividend payment of Malaysian listed firms is significantly associated with its expected dividend.

### **2.2 Profitability**

A firm's profitability is considered to be an important factor that affects dividend policy. This is because profitable firms can afford larger free cash flows and therefore are willing to pay higher dividends. Ahmed and Javid (2009) and Mitton (2004) provide evidences that dividend tends to be more sensitive to current earnings than prior dividends. Short et al. (2002) found a positive and significance association between earnings and dividend changes.

Measuring profitability in terms of return on assets (ROA), Baker et al. (2007) found that dividend payers in Canadian capital market have higher return on equity and return on assets. This result is consistent with Fama and French (2001) who found that propensity to pay dividends is higher for larger firms with higher profitability.

From the above discussion, the following alternative hypothesis is formed:

H<sub>2</sub>: There is a significant positive association between dividend policy and current earnings per share.

### **2.3 Leverage**

The liquidity hypothesis suggests that leverage is negatively related to dividend payment. Dividend and debt financing can serve as a mechanism to reduce cash flow under management control, and help to mitigate the agency problem. Rozeff (1982) and Al-Malkawi (2007) points out that firm with high financial leverage tend to have low payout ratios to reduce transaction costs associated with external financing. Firms with higher leverage subjected to debt covenants stipulated the maximum funds available for dividends. From above findings, the following alternative hypothesis is formed:

H<sub>3</sub>: There is a significant negative association between leverage and dividend policy

### **2.4 Growth opportunities**

The concept of growth opportunities refers to the extent to which a firm sustains the level of growth at a rate which is deemed to be high in comparison to the majority of firms. Firm with high growth and investment opportunities will need the internally generated fund to finance those investments, and thus tend to pay little or no dividends. Accordingly, this study expects the firm's growth and investment opportunities, as measured by market-to-book ratio to be negatively related to dividend policy.

H<sub>4</sub>: There is a significant negative association between dividend payment policy and firm's market-to-book ratio.

## **3. Data, Variables and Methodology**

### **3.1 Research Model**

The dividend policy in this study is represented by the amount of cash dividend paid per share (DPS). The dividend per share values replaces the variables in the original Lintner formulation to account for frequent capital increases and bonus dividend issues by firms (Robinson, 2006). Following Daniel et al. (2008), expected dividend is measured by dividend paid in prior year while current earnings are measured as current year earnings per share. Firm's performance is included as a control variable since firm's

accounting performance may be associated with its growth opportunities (Skinner, 1993), and firms with high profit pay higher dividends to signal their performance (Miller and Rock, 1985; Gul, 1999a). Firm performance is measured in terms of its earnings per share while firm's future prospect and growth opportunities is measured in terms of ratio of market to its book value. Accordingly, this study expects the firm's growth and investment opportunities, as measured by market-to-book ratio to be negatively related to dividend payment. The model also controlled for leverage, measured by the ratio of total debt to total assets. Following Jensen's (1986) free cash flow argument, debt and dividends are substitutes in controlling the agency problem of free cash flow. Firms with higher leverage also have fewer incentives to pay dividends due to monitoring influence of debt-holders such as banks and other financial institutions.

To provide empirical testing to the hypotheses addressed in the study, the following model is tested:

$$DPS_{i,t} = \alpha_1 + \beta_1 EXPECTDIV_{i,t} + \beta_2 EPS_{i,t} + \beta_3 LEV_{i,t} + \beta_4 MKTBR_{i,t} + \varepsilon_{i,t} \dots\dots (1)$$

Where:

$DPS_{i,t}$  = Dividend per share for the current year  
 $EXPECTDIV_{i,t}$  = Expected dividend for firm i in year t  
 $EPS_{i,t}$  = earnings per share  
 $LEV_{i,t}$  = leverage  
 $MKTBR_{i,t}$  = Market to book ratio

### 3.2 Sample Selection and Data Description

Our initial sample consisted of all firms listed on the Bursa Malaysia in 2005 to 2008. The number of firms examined in this study determined by the availability of firm annual report. To be included in the sample, we also require dividend payment data to be available both in the current and in the preceding year. The sample is also narrowed down by eliminating firms with negative earnings and firms with missing data. Firms in the finance, finance-related, REIT industries were excluded from the sample for reasons of comparability with prior research. Mining, hotel and closed-end funds firms were also excluded because these industries have very few observations. For all variables, observations below 1% and above 99% of the distribution were removed. This resulted in a final sample of 524 firms with 1537 firm years. The frequency distribution of sample firms by year and industry sector is presented in Table 1.

**Table 1: Frequency Distribution of Examined Firms**

No	Sector	No. of firms (%)	Number of firm years				TOTAL
			2005	2006	2007	2008	
1	Construction	37 (7.1%)	26	26	27	28	107
2	Consumer Product	90 (17.2%)	69	74	72	72	287
3	Industrial Product	169 (32.2%)	111	111	129	129	480
4	Plantation	33 (6.3%)	26	25	30	30	111
5	Properties	55 (10.5%)	37	43	38	39	157
6	Technologies	16 (3.1%)	12	14	11	11	48
7	Trading & Services	124 (23.6%)	78	87	91	91	347
TOTAL		524	359	380	398	400	1537

## 4. RESULTS

### 4.1 Descriptive analysis

Table 2 presents the descriptive statistics for our examined firms. The average dividend per share for the period of study is RM 0.07 or seven cents per share with a minimum of 1 cent and a maximum of 50 cents per share. The mean current dividend per share (RM 0.07) is slightly higher than the expected dividend or last year's dividend of RM 0.064. Except for technology sector, the results presented in Table 3 also show that the mean dividend per share for other sectors is higher than the mean expected dividend. This indicates that firms are paying higher dividend in the current year compared to the previous year. The mean market to book ratio of more than one indicates that Malaysian firms in general have high growth opportunities.

Table 2: Descriptive Statistics for the Dependent and Independent Variables

	Mean	Median	Std. Deviation	Minimum	Maximum
DPS (RM)	0.070	0.04	0.077	0.01	0.5
EXPECTDIV (RM)	0.064	0.04	0.078	0.00	0.79
CUREPS (RM)	0.211	0.15	0.220	0.01	2.56
LEVERAGE (%)	0.84	0.59	0.86	0.01	9.66
MKTBR	1.032	0.750	0.99	0.03	9.69

Table 3: Descriptive Statistics for dividend per share and expected dividend per share by industry sector

	Construction	Consumer	Industrial product	Plantation	Property	Technology	Trading & services
Mean DPS (RM)	0.054	0.074	0.060	0.106	0.063	0.085	0.074
Mean EXPECTDIV (RM)	0.052	0.068	0.056	0.092	0.058	0.086	0.065

#### 4.2 Regression results

Table 4 shows the results of the OLS regression. The dividend per share is regressed against the four explanatory variables of expected dividend, current earnings per share, leverage, and market to book ratio. The model is significant with an exploratory power of 74.1per cent (adjusted R square = 0.741). Variance inflation factor (VIF), eigen value and condition index for all variables in the model shows that multicollinearity is not a problem. The regression coefficient of expected dividend ( $DPS_{i,t-1}$ ) and current earnings ( $EPS_{i,t}$ ) are highly significant. The largest beta coefficient and the associated t-statistic of EXPECTDIV (coefficient = .663; t-stats = 41.789) means that this variable makes the strongest unique contribution to explaining the dependent variable of current year dividend cash payment, when the variance explained by all other variables in the model is controlled for. The higher beta coefficient of expected dividend (beta = .669) compared to current earnings imply the greater importance of expected dividend in determining the amount of dividend per share, as compared to the current level of earnings (coefficient = .094; t-stats = 17.576; beta = .267).

This indicates that expected dividend measured in terms of dividend paid in prior year is an important dividend threshold for the firm. The finding support the first empirical survey study of dividend policy provided by Lintner (1956) who found that an existing dividend rate forms a bench mark for the management. This result supports our hypothesis that the firm dividend payment is influenced by its expected dividend. The result of matching expected dividend by dividend payer firms perhaps can be associated with avoiding dividend surprise behaviour as prior evidence shows that negative dividend surprise may result in big market penalty (Grullon et al., 2002). The result is also consistent with prior survey studies on factors determining dividend policy. Baker et al. (1985, 2001 and 2007), Allen (1992), Baker and Powell (1999), Baker and Smith (2006) and Pourherdari (2009) found that dividend is affected by the pattern or continuity of past dividends.

The result of significant positive association between current earnings and dividend payment is consistent with Mitton (2004) and Ahmed and Javid (2009) who found that earnings is one of the determinants for dividend policy in emerging markets. Daniel et al. (2008) in their study on whether firms manage earnings to meet prior year dividend payment also found that firms tend to manage earnings upwards to circumvent their dividend payment restrictions. This perhaps can be explained by “information content” explanation, where dividends are regarded as credible source of signalling to investors in capital market. Firms with higher performance were more likely to take a decision of distributing dividends ( Abdelsalam, 2008).

The result of significant negative association between leverage and dividend per share is expected. Consistent with Jensen’ (1986) free cash flow argument, Debt are used as substitutes in controlling the agency problem of free cash flow. For highly levered firms, the higher cost of external financing makes them lee likely to pay dividends. A market-to-book value ratio on the other hand shows inconsistent result with earlier findings using US data. A statistically significant positive association between growth and dividend per share indicates that dividend is paid irrespective of the firm’s investment opportunities.

Dividend in this case perhaps is being used by managers as a mechanism for financial signalling to the outsiders.

Table 4: Regression model results

variable	B	beta	t-stats	p-value
Intercept	.008		3.994	.000
Expected dividend	.663	.669	41.789	.000***
Current EPS	.094	.267	17.576	.000***
Leverage	-	-.052	-3.929	.000***
Market to book ratio	.005	.048	3.466	.001***
R-squared (%)			74.1	
Adj. R-squared (%)			74.0	
N			1537	
F-statistic			1092.93	
Sig.			0.000	

## 5. SUMMARY AND CONCLUSION

This study examines the influence of expected dividend payment on dividend policy of Malaysian listed firms. The use of dividend payment instead of dividend pay-out ratio as estimated by Lintner model is consistent with the responses made by corporate managers that market places greater value on stable dividends than stable dividend payouts (Brav et al. 2003; Robinson, J. 2006). The motivation behind this study is to provide empirical evidence to prior survey evidence on the importance of past dividend as key determinants for firm's dividend payment. We hypothesise that payer firms are relatively reluctant to cut dividend payment and therefore expected dividend payment becomes an important factor.

Our results show that the hypothesis of positive association between dividend per share and expected dividend is highly supported. This is consistent with prior survey evidences that ranked past dividends as key determinants for dividend payments (Lintner (1956), Baker et al. (1985, 2001 and 2007), Pruitt and Gitman (1991), Allen (1992), Al-Twaijry (2007), Baker and Powell (1999), Baker and Smith (2006), and Pourherdari (2009). Another study on earnings management suggests similar result that firms view expected dividend levels as important earnings thresholds where they consequently manage earnings to meet dividend levels (Daniel et al., 2008). This is consistent with avoiding negative surprise behaviour which may have a negative impact on the firm's market value. Our study adds to this literature by documenting empirical evidence supporting prior survey findings that the pattern of past dividends represents an important determinant for current dividend payment in developing market.

## **References**

- Abdelsalam, O., El-Masry, A., & Elsegini, S. 2008, 'Board composition, ownership structure and dividend policies in an emerging market: Further evidence from CASE 50', *Managerial Finance*, vol. 34, no.12, pp. 953-964.
- Ahmed, H., & Javid, A. 2009, 'Dynamics and determinants of dividend policy in Pakistan (Evidence from Karachi stock exchange non-financial listed firms)', *International Research Journal of Finance and Economics*, vol. 25, pp. 148-171.
- Al-Malkawi, H.-A. N., 2007, 'Determinants of corporate dividend policy in Jordan: An application of the Tobit Model'. *Journal of Economic and Administrative Science*, vol. 23(2), pp. 44-70.
- Allen, D. E. 1992, 'Target payout ratios and dividend policy: British evidence', *Managerial Finance*, vol. 18, no.1, pp. 9-21.
- Al-Twaijry, A. A. 2007, 'Dividend policy and payout ratio: Evidence from the Kuala Lumpur stock exchange', *The Journal of Risk Finance*, vol. 8, no. 4, pp. 349-363.
- Anand, M., 2004, 'Factors influencing dividend policy decisions of corporate India.' *The ICFAI Journal of Applied Finance*, vol. 10(2), pp. 5-16.
- Bajaj, M. And Vijh, A.M.1990, 'Dividend clienteles and the information content of dividend changes', *Journal Of Financial Economics*, vol. 26, pp. 193-219.
- Baker, H. K., Farrelly, G. E., & Edelman, R. B. 1985, 'A survey of management views on dividend policy', *Financial Management*, vol. 14, no. 3, pp. 78-84
- Baker, H. K., & Powell, G. H.1999, 'Dividend policy issues in regulated and unregulated firms: A managerial perspective', *Managerial Finance*, vol. 25, no. 6, pp. 1-20.
- Baker, H., Veit, E. and Powel, G. 2001, 'Factors Influencing Dividend Policy Decisions of NASDAQ firms', *The Financial Review*, vol. 36, no. 3, pp. 19-37.
- Baker, H. K., Saadi, S., Dutta, S., & Gandhi, D. 2007, 'The perception of dividends by Canadian managers: New survey evidence', *International Journal of Managerial Finance*, vol. 3, no. 1, pp. 70-91.
- Brav, A., Graham, J., Harvey, C., and Michaely, R. 2003, 'Payout policy in the 21<sup>st</sup> century', NBER working paper #9657.
- Daniel, N.D., DENIS, D.J., and Naveed, L. 2008, 'Do firms manage earnings to meet dividend thresholds?', *Journal of Accounting & Economics*, vol. 45, pp. 2-26.
- DeAngelo, H., DeAngelo, L. 2006, 'The irrelevance of the MM dividend irrelevance theorem', *Journal of Financial Economics*, Vol. 79, pp. 293-315.
- Denis, D.J., Denis, D.K. and Sarin, A. 1994, 'The information content of dividend changes: cash flow signalling, overinvestment, and dividend clienteles', *Journal of Financial and Quantitative Analysis*, vol. 29, pp. 567-87.
- Easterbrook, F. 1984, 'Two agency cost explanations of dividends', *American Economic Review*, vol. 74, pp. 650-659.
- Fama, E and Babiak, H. 1968, 'Dividend policy: an empirical analysis', *American statistical association Journal*, vol. 63, pp. 1132-1161.
- Fama, E.F. and French, K.R. 2001, 'Disappearing dividends: changing firm characteristics or lower propensity to pay?', *Journal of Financial Economics*, vol. 60, pp. 3-43.
- Grullon et al. 2002, 'Are dividend changes a sign of firm maturity?', *Journal of Business*, vol. 75, pp.387-424.
- Gul, F.A.1999, 'Growth opportunities, capital structure and dividend policies in Japan', *Journal of Corporate Finance*, vol. 2.



- Healy & Palepu 1988, 'Earnings information conveyed by dividend initiations and omission', *Journal of Financial Economics*, vol. 21, pp. 149-176.
- Jensen, M.C.1986, 'Agency cost of free-cash flow, corporate finance, and takeovers', *American Economic Review*, vol. 76, pp. 323-329.
- Lintner, J. 1956, 'Distribution of incomes of corporations among dividends, retained earnings and taxes', *American Economic Review*, vol. 46, pp. 97-113.
- Miller,M.H., Rock, K. 1985, 'Dividend policy under asymmetric information', *Journal of Finance*, vol. 40, pp. 1031-1051.
- Mitton, T. 2004, 'Corporate governance and dividend policy in emerging markets', *Emerging Market Review*, vol. no 5, pp. 409-426.
- Norhayati, M., Mohamad Ali, A. H., Annuar, M. N. & Shamsheer, M. (2006). Information Content of Dividend Changes: Cash Flow Signaling, Dividend Clientele and Free Cash Flow Hypothesis. *Malaysian Accounting Review*, 5(1), pp 65-84
- Pettit, R. Richardson 1972, 'dividend announcements, security performance, and capital market efficiency', *The Journal of Finance*, vol. no 27, pp 993-1007.
- Pourheydari, O. 2009, 'A survey of management views on dividend policy in Iranian firms', *International Journal of Islamic and Middle Eastern Finance and Management*, vol. 2, no.1, pp. 20-31.
- Pruitt, S.W. and Gitman, L.J.1991, 'The interactions between the investment, financing, and dividend decisions of major US firms', *Financial Review*, vol. 26, no. 3, pp. 409-30.
- Robinson, J. 2006, 'Dividend policy among publicly listed firms in Barbados', *Journal of Eastern Caribbean Studies*, vol. 31, no.1, pp. 1-36.
- Rozeff, M. S. 1982, Growth, beta and agency costs as determinants of dividend payout ratios', *The Journal of Financial Research*, vol. 5, pp. 249-259.
- Short, H., Zhang, H., & Keasey, K. 2002. 'The link between dividend policy and institutional ownership', *Journal of Corporate Finance*, vol. 8, pp. 105-122.
- Skinner, D.J. 1993, 'Asset structure, financing policy, and accounting choice: preliminary evidence' *Journal of Accounting and Economics*, vol. 16, no. 4, pp. 407-45.

**Norashikin Ismail (Ph.D)**

Dr Norashikin Ismail is an associate professor at the faculty of Accountancy , Universiti Teknologi MARA Malaysia. Her research interest is in the area of earnings quality, corporate governance and market-based research. She has published research papers in an index journal internationally (ISI and ERA indexed) and has presented many papers in national and international conferences.

E-mail: [norashikin.ismail@yahoo.co.uk](mailto:norashikin.ismail@yahoo.co.uk)

**Rashidah Abdul Rahman (Ph.D)**

Dr Rashidah Abdul Rahman is a professor in Financial reporting and corporate governance. She is currently the Deputy Director of the Accounting Research Institute, Higher Institutions' Centre of Excellence. She has presented and published more than 90 articles in refereed journals. She sits on the Editorial Board of Malaysian Accounting Research Journal and has reviewed articles for both local and international journals.

E-mail: [shidah@salam.uitm.edu.my](mailto:shidah@salam.uitm.edu.my)

**Normah Omar (Ph.D)**

Dr Normah is a professor in management Accounting and Financial Criminology. She is currently the Director of the Accounting Research Institute, Higher Institutions' Centre of Excellence. She has presented more than 200 conference and seminar papers at both the national and international levels. Currently she is the managing editor of two journals: Malaysian Accounting Review (MAR) and Asia Pacific Management Accounting Journal (APMAJ).

E-mail: [normah645@salam.uitm.edu.my](mailto:normah645@salam.uitm.edu.my)