



Universiti Utara Malaysia

College of Business

DISSERTATION

**The Impact of Dividend Policy on Shareholders' Wealth
Based on Agency Cost and Residual Dividend Theory**

PREPARED BY:

Ahmed Abubakar Ahmed Siad

PREPARED FOR:

Assoc. Prof. Dr. Yusnidah Bt Ibrahim

AG
4028
DS
55621
2010

DEDICATION

I dedicate this effort to the soul of my father Abubakar Ahmed Siad, who is my wise teacher in this life, my kindhearted mother Shahida Shiekh Mohamud, my eldest brother Abdi Fitah, my dear brothers Abdi karim, Mohamed, Zakaria and my beloved sister Nasteha Keyf.

DECLARATION

I hereby declare that the project paper is based on my original work except for quotations and citations that have been duly acknowledged. I also declare it has not been previously or concurrently submitted for any other master's programme at UUM or other institutions.

AHMED FIURE

AHMED ABUBAKAR AHMED SIAD

17 OCTOBER 2010

PERMISSION TO USE

In the presenting this dissertation in partial fulfilment of the requirements for apostgraduate degree from University Utara Malaysia, I hereby agree that the University library may make it freely available for inspection. I further agree permission for copying of this dissertation in any manner, in the whole or in part, for scholarly purpose may be granted by my supervisor or, in her absence, by the Dean of college of Business. It is understood that any copying or publications or use of this thesis or parts of thereof for financial gain shall not be allowed without my written permission. It is also understood that due recognition shall be given to me and to the University Utara Malaysia for any scholarly use which may be made of any material from my dissertation.

Request from permission to copy or to make use of material in this dissertation, in the whole or in part, should be addressed

**Dean of College of Business
University Utara Malaysia
06010 Sintok
Kedah Darul Aman
Malaysia**

ABSTRACT

This study attempts to shed light on dividend policy for Malaysian companies by seeking to understand the explanations for corporate dividend policy's effect on shareholder's wealth (Market Price Share), for the year 2007 to 2009, with the focus on Agency Cost Theory and Residual Theory. Three variables associated with Residual Theory namely Size, Growth opportunity (GO) and Capital expenditure (CAPEX) and two variables associated with Agency Cost Theory, namely Leverage (LEV) and Free cashflow (FCF) are the focus of the study where their interaction effect with Dividend Per Share (DPS) are hypothesised to have significant effect on share price. Earnings per share (EPS), Exchange rate (EXR) and Inflation (INF) are used as control variables. Results show that the interaction variables between DPS and CAPEX, DPS and Growth Opportunity have significant influence on share price but in the direction opposite to that hypothesized under Residual Dividend Policy. Nevertheless, the interaction effect between DPS and Size is also significant in influencing share price in the manner predicted by Residual Dividend Policy. Variable associated with agency Cost Dividend Theory are shown not to play a significant mediating role in the relationship between stock price and DPS.

ACKNOWLEDGEMENTS

In the name of Allah SWT, the Most Gracious and the most Merciful, i thank you for given me the strength to complete this thesis. This thesis would not have been completed without the support and assistance of many people.

Firts and foremost, my sincere gratitude and appreciation goes to my supervisor Assoc. Prof. Dr. Yusnidah Bt Ibrahim for her constructive ideas, criticisms, guidance and patience throughout the duration of preparing this thesis. She has successfully guided me through some stressful times and always help me to sharpen my understanding of this thesis and other academic writings.

I would like to express my never ending apperciation and gratitude to people in Somalia. Firstly, i would like to remember the soul of my father who had been a great teacher in my life and my lovely mother for her infinite patience specially during my absence, and her sincere flow of love has accompanied me all the way in my long struggle and has pushed me to pursue my dreams. And special thanks to my eldest brother and my dear sister for their honest and continuous assistance, substantial suggestions, encouragement, contribution and preparation during my research.

Last but not least, to my family, friends, brothers and sisters, thank you so much for continuously giving me the undivided support and internal prayers. To all of you, i have this to say: i love you, respect you, pray for you, and my Allah bless you.

CONTENTS

DEDICATION.....	I
DECLARATION.....	II
PERMISSION TO USE.....	III
ABSTRACT.....	IV
ACKNOWLEDGEMENTS.....	V
TABLE OF CONTENTS.....	VI
LIST OF TABLES.....	VII

CONTENTS	Page
CHAPTER ONE: RESEARCH BACKGROUND.....	1
1.0 Introduction.....	1
1.1 Problem statement.....	3
1.2 Objective of the study.....	7
1.3 Reasearch questions.....	7
1.4 Scope & Limitations of the study.....	8
1.5 Organization of the study.....	8
CHAPTER TWO: LITIRATURE REVIEW.....	9
2.0 Introduction.....	9
2.1 Dividend policy theories.....	9
2.2.1 Modigliani and Miller Theory.....	10
2.2.2 Clientele effect.....	11
2.2.3 Siganaling theory.....	12

2.2.4 Bird-in-hand theory.....	12
2.2.5 Agency cost dividend theory.....	13
2.2.6 Residual dividend theory.....	14
22 Related empirical studies.....	15
2.3 Literature on determinants of shareholder's wealth.....	17
2.4 Conclusion.....	19
CHAPTER THREE: RESEARCH METHODOLOGY	20
3.0 Introduction.....	20
3.1 Research framework	21
3.2.1 Dependent Variable.....	21
3.2.2 Independent Variable.....	22
3.2.3 Interaction Variables.....	22
3.2.4 Controlling Variables.....	25
3.2 Population & Sample selection.....	27
3.3 Data collection.....	28
3.4 Data analysis & Measurements.....	29
3.5 Conclusion.....	31
CHAPTER FOUR: ANALYSIS AND FINDINGS.....	32
4.0 Introduction.....	32
4.1 Results of descriptive statistics.....	32
4.2 Results of correlation analysis.....	34
4.3 Regression analysis.....	36
4.4 Conclusion.....	44

CHAPTER FIVE: CONCLUSION.....	45
5.1 Introduction.....	45
5.2 Overview of the research process.....	45
5.3 Summary of the findings.....	46
5.3 Direction for futher reseach.....	47
REFERENCES.....	48
APPENDIX.....	51

LIST OF TABLES

Table 3.1 Summarizes The Observation Of The Study

Table 4.1 Descriptive analysis of the variables understudy

Table 4.2 Correlation Analysis between variables understudy

Table 4.3: Results of multiple regression analysis of SP on EPS, DPS, INF

(Based on White's Heteroscedasticity-adjusted Standard-errors)

Table 4.4 Results of multiple regression analysis of SP on EPS, DPS, and EXR

(Based on White's Heteroscedasticity-adjusted Standard-errors)

Table 4.5 Results of multiple regression analysis of SP on EPS, INF, D_Size, D_Lev,
D_FCF and D_CAPEX

(Based on White's Heteroscedasticity-adjusted Standard-errors)

Table 4.5: Results of multiple regression analysis of SP on EPS, INF, D_Size, D_Lev,
D_FCF and D_CAPEX

(Based on White's Heteroscedasticity-adjusted Standard-errors)

Table 4.6: Results of multiple regression analysis of SP on EPS, EXR, D_Size, D_Lev,
D_FCF and D_CAPEX

(Based on White's Heteroscedasticity-adjusted Standard-errors)

CHAPTER ONE

RESEARCH BACKGROUND

1.0 INTRODUCTION

The impact of dividend over shareholders' wealth has been a controversial issue in financial research over last few decades. For more than half a century, financial economists have engaged in modeling and examining corporate dividend policy. Black (1976) hinted that, "The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that don't fit together". What might be important to mention, is that researchers have primarily focused on developed markets, while little attention has been paid to dividend policy in emerging markets.

Dividends are commonly defined as the distribution of earnings (past or present) in real assets among the shareholders of the firm in proportion to their ownership. Dividend policy connotes to the payout policy, which managers pursue in deciding the size and pattern of cash distribution to shareholders over time. Managements' primary goal is shareholders' wealth maximization, which translates into maximizing the value of the company as measured by the price of the company's common stock. This goal can be achieved by giving the shareholders a "fair" payment on their investments. However, the impact of firm's dividend policy on shareholders wealth is still unresolved.

The contents of
the thesis is for
internal user
only

REFERENCES

- Abdullah et al. (2002). The effect on dividend announcements on stock returns for companies listed on the main board of Kuala Lumpur stock exchange. *Malaysian management journal*, 1&2, 81-89.
- Aggarwal, R. (1981). Exchange rates and stock prices: A study of the US capital markets under floating exchange rates. *Akron Business and Economic Review*, 12, 7-12.
- Ajayi, R. A. & Mougou, M. (1996). On the dynamic relation between stock prices and exchange rates. *The Journal of Financial Research*, 19, 193-207.
- Ajayi, R. A., Friedman, J. & Mehdian, S. M. (1998). On the relationship between stock returns and exchange rates: Tests of Granger causality. *Global Finance*, 9, 241-251.
- Allen, F., and R. Michaely, 2003, "Payout Policy," North-Holland Handbook of Economics, G. Constantinides, M. Harris, and R. Stulz, Elsevier, forthcoming.
- Alli, K., A. Khan and G. Ramirez, 1993, Determinants of Corporate Dividend Policy: A Factorial Analysis, *The Financial Review* 28, 523-547.
- Al-Qenae, R, Li, C. & Wearing, B. (2002) "The Information Content of Earnings on Stock Prices: The Kuwait Stock Exchange," *Multinational Finance Journal*, 6 (3&4),197-221.
- Azman-Saini, W.N.W., Habibullah, M.S., Law, S.H. and Dayang-Afizzah, A.M. (2006). Stock Prices, exchange rates and causality in Malaysia: a note. *The ICFAI Journal of Financial Economics*, 5, 7-13.
- Baker, H. K., Veit, E. T., & Powell, G. E. (2001). Factors influencing dividend policy decisions of Nasdaq firms. *The Financial Review*, 36(3), 19–39.
- Ball, R., & Brown, P. (1968). An empirical evaluation of accounting income numbers. *Journal of Accounting Research*, 6, 159–178.
- Beaver, W.H., 1968. The information content of annual earnings announcements. *Journal of Accounting Research* 6 (Suppl.), 67–92.
- Benartzi, S., Michaely, R., & Thaler, R. (1997). Do changes in dividends signal the future or the past? *Journal of Finance*, 52(3), 1007–1034.
- Bhattacharya, S., 1979. Imperfect Information, Dividend Policy and 'The Bird in the Hand' fallacy. *Bell Journal of Economics* 10, 259–70.
- DeAngelo, H. and DeAngelo, L. (2006). The irrelevance of the MM dividend irrelevance theorem. *Journal of Financial Economics*, 79(2), 293–315.

Docking, Diane S.; Koch, Paul D. (2005), "Sensitivity of Investor Reaction to Market Direction and Volatility: Dividend Change Announcements," *Journal of Financial Research*, 28 (1), 21-41.

Easterbrook, F. (1984), "Two agency-cost explanations of dividends", *American Economic Review*, 74, 650-659.

Eddy, A., & Seifert, B. (1988). Firm size and dividend announcements. *Journal of Financial Research*, 11, 295-302.

Fama, E. (1974) "The empirical relationship between dividend investment decisions of firms." *American Economic Review*, pp, 263-292.

Fama, E., French, K., 2001. Disappearing dividends: changing firm characteristics or lower propensity to pay? *Journal of Financial Economics* 60, 3-43.

Gan, C., Lee, M., Yong, H.H.A., & Zhang, J (2006). Macroeconomic variables and stock market interactions: New Zealand evidence. *Investment Management and Financial Innovation*, 3(4), 89-101.

Giovannini, A. & Jorion, P. (1987). Interest rates and risk premia in the stock market and in the foreign exchange market. *Journal of International Money and Finance*, 6, 107-124.

Gordon, M.J ,1963 , 'Optimal investment and financing policy', *Journal of Finance*, Vol. 18No. 2, 264-72.

Healy, P., and Palepu, K. 1988. Earnings information conveyed by dividend initiations and omissions. *Journal of Financial Economics* 21: 149-175.

Higgins, R. (1972) "The corporate dividend- saving decision." *Journal of financial and quantitative methods*, pp 1527-41.

Hill. Black F., 1976, 'The Dividend Puzzle', *Journal of Portfolio Management*, 2, 5-8.

Holder, M., F. Langrehr, and J. Hexter, 1998, Dividend Policy Determinants: An Investigation of the Influences of Stakeholder Theory, *Financial Management* 27, 73-82.

huberman, G. (1990), "Dividend neutrality with transaction costs." *journal of business*, pp, 93-106.

Islam, M. (2003). The Kuala Lumpur stock market and economic factors: a general-to-specific error correction modeling test. *Journal of the Academy of Business and Economics*.

Jensen, M. and W. Meckling, 1976. Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, *Journal of Financial Economics* 3,305-360.

Jensen, M. C. and Warner, J. B. (1988). The Distribution of Power Among Corporate Managers, Shareholders and Directors, *Journal of Financial Economics*, 20, 1: 3-24.

Jorion, P., 1991. The pricing of exchange risk in the stock market. *Journal of Financial and Quantitative Analysis* 26, 362–376.

Jun, A.L., Gallagher, D., Partington, G., 2006. An examination of institutional dividend clienteles: evidence from Australian institutional portfolio holdings. University of New South Wales Australian School of Business Working Paper 2006-01.

Kouki, M., 2009. Stock Options and firm dividend policy: evidence from toronto stock exchange. *International Research Journal of Finance and Economics* 25, 97–113.

Kross, W., & Schroeder, D. (1984). An empirical investigation of the effect of quarterly earnings announcement timing on stock returns. *Journal of Accounting Research*, 22, 153–176.

Michaely, R., Thaler, R. H., & Womack, K. L. (1995). Price reactions to dividend initiations and omissions: Overreaction or drift? *Journal of Finance*, 50, 573–608.

Miller M H and Rock K (1985) Dividend Policy Under Asymmetric Information”, *Journal of Finance*, 40, 1031-1051.

Miller, M. and Scholes, M., 1978, ‘Dividends and taxes’, *Journal of Financial Economics*, Vol.6 No. 4, 333-64.

Miller, M.H. and Modigliani, F. (1961), “Dividend policy, growth, and the valuation of shares”, *Journal of Business*, 34, 411-433.

Nissim, D., & Ziv, A. (2001). Dividend changes and future profitability. *Journal of Finance*, 56(6), 2111–2134.

Okpara, Godwin Chigozie, 2010. A Diagnosis of the Determinant of Dividend Pay-Out Policy in Nigeria: A Factor Analytical Approach, *American Journal of Scientific Research* pp, 57-67.

Ralph I. Udegbumam and P. O. Eriki (2001), “Inflation and Stock Price Behavior: Evidence from Nigerian Stock Market,” *Journal of Financial Management & Analysis*, , XX (14) (1), 1-10.

Ralph I. Udegbumam and P. O. Eriki (2001), “Inflation and Stock Price Behavior: Evidence from Nigerian Stock Market,” *Journal of Financial Management & Analysis*, , XX (14) (1), 1-10.

Redding, L., 1997, Firm Size and Dividend Payouts. *Journal of Financial Intermediation* 6, 224-248.

Smith Jr., C.W., Watts, R., 1992. The investment opportunity set and corporate financing, dividend and compensation policies. *Journal of Financial Economics* 32, 263–292.

Soenen, L. A. & Hennigar, E. S. (1988). An analysis of exchange rates and stock prices: The US experience between 1980 and 1986. *Akron Business and Economic Review*, Winter, 7-16.

Tsoukalas, D. (2003) "Macroeconomic Factors and Stock Prices in the Emerging Cypriot Equity Market," *Managerial Finance*, 29(4), 87-92.27.