



Finance & Accounting Research Journal
Vol. 2(2), pp. 76-81, February, 2020
Fair East Publishers
Journal Homepage: www.fepbl.com/index.php/farj



DIVIDEND POLICY DECISIONS AND SHARE PRICES RELATIONSHIP

Shamik Tiwari¹, Debajyoti Pal²
^{1,2} Stie YKPN Business School, Indonesia

*Corresponding Author: Shamik Tiwari

Article Received: 15-10-19

Accepted: 19-01-20

Published: 05-02-20

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ABSTRACT

Dividend policy is about a company's decision related to the retention of profit and distribution of profit. In this study, the objective is to understand the effects of dividend policy on share prices for the selected companies in the Indonesian stock exchange. The findings of the study are that higher dividend yield stocks along with higher pre-tax risk adjusted returns give investor some compensation for the disadvantageous position of tax return. The findings are matching with the Brennan's model (Brennan, 1970). The findings of the study also pointed out that increase in a company's stock trading volume influence the share prices and investors who wanted current investment income owned shares in high dividend payout firms. Free cash flow is causing conflict between management and shareholders and this is another important finding of the study. Overall, results shows that a company's dividend policy influence its share prices.

Keywords: Share Prices, Dividend, Policy, Company, Stock Exchange, Indonesia

INTRODUCTION

Proportion of earning distributed to shareholder and proportion of earning retained in the business is based on a company's dividend policy. One main research area in this domain is the relationship between dividend policy and share prices in the stock exchange market. Generally, dividend policy decides how much portion of profit is retained by a firm and what portion of profit will be distributed to satisfy the shareholders (Davis, 2006). The dividend

policy based on the relevance theory describe it as a practical approach which treats dividends as an active decision variable and retained earnings as the residue (Capstaff, Klaeboe, & Marshall, 2004). Furthermore, there can be type categories of dividend policy including the managed and the residual. The managed dividend policy is based on a firm's life cycle; whereas, the residual dividend policy is based on the dividend which is left over after a company makes suitable investment using the NPV rule. In this study, the relationship between dividend policy and the share prices are investigated.

Objectives of the Study

The study objectives are as follows;

To test how clientele effects influence the share prices of Indonesian stock exchange market

To test how tax incentives influence the share prices of Indonesian stock exchange market

To test how free cash flows influence the share prices of Indonesian stock exchange market

LITERATURE REVIEW

First we present the clientele effect theory which is based on shareholder's varying tax status which causes shareholders to have varying preference for return on investment (Botha, 1985). The theory further differentiate between three major groups of shareholders including those who want earlier return on their investment; those seeking for capital appreciation; and those who remains indifference. Thus, based on this theory, a firm have to fulfill the needs of different shareholders groups while making dividend decisions. Furthermore, there are different dividend clienteles who may be more found in particular stage of companies. Furthermore, Allen, Bernardo, and Welch (2000) suggest that clienteles such as institutional investors tend to be attracted for companies which pay higher dividend since these institutional investors may enjoy tax advantage compare to the individual investors.

There are numerous studies which tested the influence of dividend policy on the share prices. For example, a study by Black and Scholes investigated the influence of changes in divided payout on share prices. The study however, did not find any significant relationship between dividend payout policy or dividend changes and the share prices in the stock exchange market. A study by Karanja (1987) investigated the dividend practices on the share prices. The study found significant effects of dividend payout on share prices. The nature of relationship found in the study was positive which means if firm offer higher dividend, it tends to increase share prices; while, reduction in dividend decrease the share prices. Overall, literature shows that dividend policy has some significant influence on the share prices. However, the nature of relationship is not clear in previous studies.

RESEARCH METHODOLOGY

Data Collection

The data for the study is collected from the 35 listed companies in the Indonesian stock exchange. The selected companies belong to different industries such as construction, real estate, banking, consumer products, electronics, retailing and so on. The data collection was primary means we used a survey questionnaire for collecting the data. The questionnaire was administered to the management of the selected companies.

Reliability and Validity

For establishing the reliability, we used the Cronbach alpha statistics. For all variables in the study, we found reliability of above 0.60 which shows satisfactory level of reliability. For validity, the study instrument was shown to academics and practitioners and their feedback was taken for improving the survey. Furthermore, we also administered a pilot study of 10 respondents for identifying any problems in the instrument. The use of expert opinion and the pilot study helped in improving the validity of the instrument.

RESULTS

Table 1

Reliability

Variable	Cronbach's Alpha	No of Items
Clientele Effects	.734	4
Tax Incentives	.787	5
Free Cash flows	.776	4

The reliability for the three variables is provided in the above table. The results show that all variables had satisfactory reliability.

Table 2

Descriptive Statistics

Variable	Mean	S.D.
Clientele Effects	3.14	.2331
Tax Incentives	2.87	.1989
Free Cash flows	3.67	.4343

The clientele effects mean value is 3.23 with standard deviation of .1878 which shows that mostly clientele effects are high in terms of influence on the share prices. The tax incentive mean value is 2.77 which shows that most participants we surveyed had average level of preference for tax incentives. The free cash flows mean value is 3.45 with standard deviation of .4343 which shows that most respondents we surveyed had higher preference for free cash flows and this is found to be causing a conflict between management and the shareholders.

Hypothesis Testing

We used regression analysis for testing the influence of dividend payout policy options on the share prices. The results are provided below.

Table 3
Model summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.786	.617	.584	.3242

The independent variables in the study were clientele effects, tax incentives, and free cash flows; while, the dependent variable of the study was the share prices. The R value indicate that independent variables and dependent variables are 78.6% associated. The Rsquare value shows that independent variable explains 61.7% variation in the dependent variable.

Table 4
ANOVA (b)

Model	Sum of Squares	Df	Mean Square	F	Sig.
Regression	33.456	3	11.879	15.656	.000(a)
Residual	26.422	32	.989		
Total	59.878	23			

a. Predictors: (Constant), Clientele effect, tax incentives and free cash flows

b. Dependent Variable: share price

The Fstatistics indicate that our proposed model shows high degree of fitness with the data. This is because F statistics is greater than the critical value of 4 and is 15.656 with higher level of significance value.

Table 5
Coefficients

Model	Unstandardized Coefficients		t	Sig.
	B	Std. Error		
(Constant)	.323	.369	.8730	.434
Clientele effect	.545	.148	3.680	.000
Tax incentives	.343	.123	2.788	.001
Free cash flow	.434	.138	3.144	.000

The coefficient table indicate that clientele effects has positive and significant effects on the share price with beta value of .545 and significance value of less than 0.05. The tax incentive has positive and significant effects on the share price with beta value of .343 and significance value of less than 0.05. The free cash flows has positive and significant effects on share prices with beta value of .434 and significance value of less than 0.05. Overall, our result shows that all independent variables including clientele effects, tax incentives, and free cash flows has positive and significant effects on the share prices in the Indonesian stock exchange context.

CONCLUSION

The objective of the study was to test the influence of the dividend payout practices on the share prices in the Indonesian stock exchange market. For this purpose, we selected random companies and collected data through survey method. The findings of the study shows that clientele effects, tax incentives, and free cash flows has positive and significant effects on the share prices. From these results, we can also conclude that dividend payout policies are important and exert higher degree of influence on share prices; therefore, management need to be very careful while deciding about the dividend payout as it can improve the share prices and the associated image among the investors. On the other hand, significant reduction in the dividend payout can damage the reputation of a firm and can cause management problems because of reduced share prices in the stock exchange market.

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