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Patterns of capital structure and dividend policy in Pakistani corporate sector and their impact on organization performance

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The purpose of this study is to determine the patterns of capital structure decisions and dividend policy as well as their level of application in Pakistani corporate sector and also to check the impact of capital structure and dividend policy on organization performance. A total of ninety one questionnaires were distributed in different companies but seventy three filled were received and sixty one were processed for the analysis. The potential respondents were finance executives and financial analysts of the companies. The study concludes that capital structure decisions are being properly practiced while dividend policy is a major concern in most of the organizations. It is also concluded that there is a significant and positive relationship between capital structure decision, dividend policy and organization performance.

Key words: Capital structure decisions, dividend policy, organization performance corporate sector, finance executives, analysts.

INTRODUCTION

Corporate sector plays a pivotal role to make up of the economic outlook. The corporate sector is responsible for the production of goods and services, takes into account the labor and makes investment decisions that enhance the productive capacity of the economy. Financing strategies and investment moves by the firm result in the performance of corporate. The reward to executives (or punishment) for their work, is not necessarily written in company policy, but refers to be an important corporate culture's components. In the last decade, the concept of corporate culture has attracted increasing interest among business writers (Monique, 1992). The crises that took place in 1997 are the result of very poor corporate sector stated by Lindgren et al. (1999).

Financial literature suggests that capital structure impacts the economic system of the company (Myers and Majulf, 1984). Harvey et al. (2004) described that, debt is mostly used by firms where managerial agency costs are high. Faulkender and Petersen (2006) declared that firms

with access to the public bond market have higher leverage compared to those that only have access to bank lending. Capital structure decision is influenced by the economic condition of the country (Rajan and Zingale, 1995; Yong et al., 2008), and debt ratio of the organization is the function of rate of economic growth and capital market development. The value of dividend decision was found critical primarily by Miller and Modigliani (1961). They believed that the markets without capital market imperfections like transaction costs and taxes, dividend policy can bring no changes to the value of the firm. This has given rise to continuous discussions on the dividend policy and the firm value (Black, 1976). Two arguments have been proposed to explain why firms pay dividends. The first argument, initiated by Bhattacharya (1979), affirmed that dividends perform a signaling role. The second argument defended by Easterbrook (1984) claimed that dividend policy helps to mitigate the agency cost of free cash flows. Studies provide foundations for arguments related to asymmetric flow of information between shareholders and managers (Bhattacharya, 1979; John and Williams, 1985; Miller and Rock, 1985). In this scenario, the management should signal positive, firm specific, private information to its

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stockholders. Negative information should be withheld until certain financial constraints force the disclosure of this information. Studies find that for over investing firms dividend policy gives more forecast, regarding information, than the firms maximizing their value (Koch and Shenoy, 1999). Study conducted by Anderson (2009) indicated the separation of dividend signal from the earnings signal. The focal point of these series of studies is the assumption that changes in dividend policy may or may not have a significant effect on company's market value. The application of pattern of financial management practices and their role in the development of corporate sector has already been discussed in literature but most of these studies are focusing on developed countries. Further, McCaffery et al. (1997) have reviewed the application of these practices in UK retailing sector. Financial management discloses that working capital management is unavoidable for corporate growth and survival (Pandey, 2006). However, in Pakistan there is no such evidence is available and the present study is the pioneer in this field and explores the patterns of capital structure and dividend policies in Pakistani corporate sector. Since these practices are very useful for organizational performance and their applications are invaluable, therefore, needs to be investigated. Pakistani corporate sector has grown over the period of time through the courtesy of privatization and liberalization, yet capital structure and dividend policies are not properly implemented. There is decline in the performance of manufacturing sector in the last part of this decade as compared to initial years where the growth was satisfactory (Government of Pakistan, 2008-2009). The extent to which Pakistani corporate sector is following these practices needs to be investigated, especially in the period where economic indicators are declining after steady growth in last decade. The purpose of this study is to examine the patterns and level of application of capital structure decisions and dividend policy in Pakistani corporate sector. Further, this study determines the relationship between organization performance and capital structure and dividend policy and to suggest measures to improve the level of application of these practices in Pakistani corporate sector.

Research theory and model

Financial literature supports that the companies which are financially well managed are operationally efficient. Some evidence suggested that some very large corporations, strictly as a matter of public policy, avoided aggressive international fund management because it might possibly disturb the international payment situation of their host countries. There were various propositions on financial leverage which was the extent of the use of debt in capital structure; Pandey (1999) identified two extreme views of financial leverage: the net income and net operating income approaches. The net operating

income was in line with propositions of Modigliani and Miller (1958), refers to as the irrelevancy theory of capital structure which is also supported by many scholars (Ben-Zion, 1971; Baron, 1974; Schneller, 1980). Corporate investment, dividend, compensation and financial policies interconnected and debt and equity substituted governance structures rather than just financial structures. A firm with higher asset would find debt financing very costly. The board of directors not only supervised the management team, but also as a way by which to cut down the cost of capital for projects that involved limited redeployed ability (Williamson, 1988). Safieddine and Titman (1999) found a positive relationship between increasing leverage and long term performance. Analysis of U.S. industries by Brigham and Ehrhardt (2001) revealed that wide variations in capital structure existed among industries and among individual firms within those industries. Niazi et al. (2011) have conducted research on two financial management practices (i.e. working capital policy and performance assessment financial ratios) of Pakistani corporate sector and found the significant relationship among capital structure and organizational performance. The better performance leads to quality gave rise to an immense challenge for corporations. The development of capital market also influenced capital structure (Booth et al., 2001). On the other hand, Jandik and Makhija (2005) found that, target leverage increases following withdrawn takeover bids and do not necessarily improve the target's subsequent long term performance unless the type of debt and its structure are also considered. Booth et al. (2001) examined capital structure in 10 developing countries. Their findings indicated that, overall, capital structure choices in developing countries were affected by the same variables as in developed countries. Agarwal and Mohtadi (2004) focused on the impact of financial sector size and structure of debt-equity ratios in 21 developing countries. However, in all these cases, only listed firms were covered. The aim of several studies has been to understand capital structure decisions in the light of firm specific features, industry affiliation, and institutional environments. Return on assets (ROA), non-debt tax shields, ownership, tangibility, size, and growth opportunities affect capital structure. Various studies suggested that financing obstacles faced by enterprises translated into slower growth (Beck and Demirgu-C-Kunt, 2006). Frank and Goyal (2008) suggested that, firms maximize their value when the benefits from debt (tax shield, the disciplinary role of debt, and the fact that debt suffers less than outside equity from informational costs) equal the marginal cost of the debt (bankruptcy costs, agency costs between shareholders and bondholders, lack of financial flexibility). Hunjra et al. (2011) have done research on the application of finance techniques in Pakistani corporate sector and found that the finance executives are well aware about finance techniques but these techniques are not being implemented properly in Pakistani corporate

sector. Bhattacharya (1979), John and Williams (1985), and Miller and Rock (1985) developed theoretical models in which managers have better knowledge about the firm's future cash flows than outside investors. Butt et al. (2010) conducted a research to determine the relationship between financial management practices and organization performance and proved that there is significant and positive relationship between organization performance and financial management practices and financial management practices play an important role in growth of corporate sector. Asquith and Mullins (1983) and Michaely et al. (1995) found positive and significant abnormal returns associated with the announcement of dividend increases. Healy and Palepu (1988) documented that announcements of dividend omissions are associated with significantly negative returns. Denis et al. (1994) and Yoon and Starks (1995) reported that analysts increase their earnings forecasts following dividend increase announcements. The relationship between the reaction of stock price and the direction of change in dividend is explained by Jensen's (1986) hypothesis of free overinvestment/cash flow (FCF). It further argued that in order to invest in projects of negative NPV managers tend to hold cash for the maximization of their own utility. Further, dividend decision should also consider the dividend yield (Bajaj and Vijh, 1990). Without the pressure to make regular payments to investors, managers are prone to divert corporate resources. Dividend policy and capital structure are important for the growth of organizations (Butt et al., 2010). Dividend changes were examined by the use of dividend omissions and initiations complementation (Denis et al., 1994; Yoon and Starks, 1995). Aharony and Swary (1980), Asquith and Mullins (1983) and others document a positive market reaction to dividend increase announcements. On the other hand, Watts (1973) and Benartzi et al. (1997) found that, firm performance does not improve following dividend increases. Fukuda (2000) documented a negative change in firm performance although there appears to be a positive stock price reaction to the announcement of a dividend increase. In Kato et al. (2002), dividend changes are positively, but insignificantly, related to future earnings growth. When information asymmetries exist between managers and investors, dividend policy can play a signaling role. Studies conducted on Japanese firms fail to provide evidence of a positive relationship between future earnings and dividend changes (Kato et al., 2002). The following theoretical framework has been developed on the basis of evidence available in above mentioned literature. The dependent variable is organization performance and two independent variables are capital structure decision and dividend policy. The conceptual model is shown in Figure 1.

Hypotheses statements

To test the relationship between organization

performance and capital structure decision and dividend policies, the following hypotheses have been developed:

H₁: Dividend policy has a significant impact on Organization Performance

H₂: Capital Structure Decision has a significant impact on Organization Performance

RESEARCH METHODOLOGY

Sample

In this study, non-probability purposive sampling was used. Companies related to ten leading sectors (banking, telecommunication, oil and gas, cement, insurance, sugar, oil and ghee, automobiles, textile and fertilizer) of the economy were the population of this study. The companies in each sector were selected on the basis of listing at Karachi stock exchange, profitability and consistent dividend payments. The potential respondents were the finance executives and financial analysts of the companies. A total of 91 questionnaires were distributed to different companies of selected areas and 73 filled questionnaires were collected and 61 properly filled questionnaires were processed in this study. Thus, a response rate of 80% was achieved in this study.

Instrument and measures

The questionnaire comprised of two sections, the first section contains the general information about the company and respondents including company name, industry, years in business, respondent name, contact number, company revenue/sales and capital expenditure for the period 2008- 2009. The second section is related to questions that covered organizational performance, capital structure decision and dividend policy. In section, one nominal scale was used. The scale to measure second section of the instrument was Likert scale ranking (5-Point) where 1 is highest degree of agreement and 5 is the least degree of agreement. The statistical package social sciences program (SPSS) was used for analysis. The questionnaire was adopted from the study of McCaffery et al. (1997) and to measure the organization performance scale was taken from Jimenez and Navarro (2006).

Table 1 demonstrates the reliability of each dimension of the questionnaire. The organization performance having three items with reliability of 0.74, and the capital structure decision section has the reliability of 0.7924, whereas, the dividend policy section has reliability of 0.8416. The reliability of the overall instrument is 0.8807.

Procedure

The questionnaire was personally distributed among 91 companies in Islamabad, Rawalpindi, Lahore, Multan, Karachi, Faisalabad, Gujarat, Gujranwala and Peshawar. The concern financial personnel were identified in each company through company profile, telephone, and reference. The sample was limited to listed companies with Karachi Stock Exchange (KSE) of ten different sectors operating in Pakistan. Hence, convenient sampling method was followed. After the data was collected from the entire companies selected for the study, it was coded and entered into SPSS sheet for analysis. Dependent variable organizational performance and independent variables (capital structure decision, dividend policy) were computed using SPSS. To review the

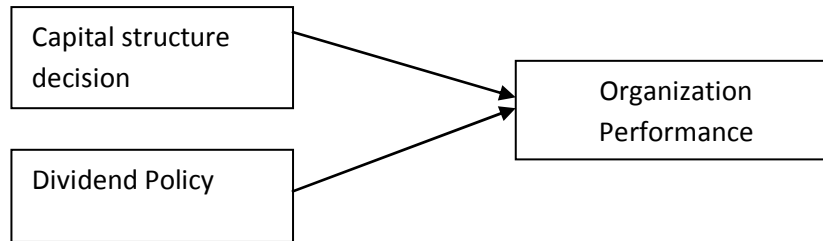


Figure 1. Conceptual model.

Table 1. Reliability of measurements instrument.

Dimension	Number of Item	Cronbach alpha
Organization performance	3	0.7354
The capital structure decision	8	0.7924
Dividend policy	14	0.8416
Total	25	0.8382

Table 2. Company Revenues/Sales and Expenditure for the year 2008-2009.

Company revenue/sales	Number of companies	Capital expenditure	Number of companies
Under Rs 100M	2	Under Rs 5M	9
Rs(100-500)M	9	Rs(5-50)M	12
Rs(500-1000)M	13	Rs(50-100)M	11
Over Rs 1000M	37	Over Rs 100M	29

Table 3. Descriptive statistics with respect to "Organization Performance".

Item	Percentage response rate (N=61)				
	Agree	Neutral	Disagree	Mean	St. deviation
Market share	72	24	4	1.9811	0.8658
Profitability	78	28	4	2.1321	0.8095
Productivity	87	11	2	1.7170	0.7436

characteristics of respondents and collected data, descriptive statistics were performed and in order to test hypotheses, multiple-regression test was applied. The confidence interval for the present study is 95% with 5% Level of significance.

RESULTS

The result of Table 2 shows the companies' annual revenues/sales for the period 2008/09 ranges from under Rs 100 M to over Rs 1,000 M, and their annual capital expenditures from under Rs 5 M to over Rs 100 M. Out of sixty one companies, thirty seven organizations have more than Rs 1,000M revenue/sales for the period of 2008-09 and 29 companies' capital expenditures exceed Rs 100M. Table 3 depicts that more than two-third of the finance executives agreed that market share is very

important for the organization growth. Since 78% respondents are in agreement with the statement that, profitability has a significant impact on companies' value, whereas 87% respondents replied that productivity plays an important role to enhance the performance, growth and success of the company. The mean values suggest that majority of the respondents have the response in positive side and the mean values are 1.9811, 2.1321 and 1.7170, respectively.

Table 4 shows that majority of finance executives believe that capital structure policy does matter. Since 85% respondents agreed with the statement that the balance between long term debt and equity has a significant impact on companies' value, whereas 75% respondents agreed with the statement that companies should pursue a target debt equity ratio and 65% respondents

Table 4. Descriptive statistics with respect to “Capital Structure Decision”.

Item	Percentage response rate (N=61)				
	Agree	Neutral	Disagree	Mean	Std deviation
The balance between long-term debt and equity has a significant impact on a company's value	85	15	-	1.7222	0.7112
Companies should pursue a target debt equity ratio	75	20	5	2.0000	1.0259
A company should leave some of its debt financing capacity unused to provide financial slack	65	25	10	2.2778	0.9064

Table 5. Descriptive statistics with respect to “Use of alternative source of financing”.

Item	Percentage response rate (N=61)				Mean	Std. deviation
	Important	Unsure	Unimportant			
Short-term bank borrowings	75	10	15		2.0000	1.2139
Long-term debt	75	15	10		2.1053	1.0709
Equity rights issue	65	15	20		2.2632	1.0683
New equity issues	45	20	35		2.9474	1.1909
Retained earnings	75	15	10		2.4211	1.2697

Table 6. Descriptive statistics with respect to “Dividend Policy (Target Payout Ratio)”.

Item	Percentage response rate (N=61)				
	Agree	Neutral	Disagree	Mean	Std deviation
Management have a target payout ratio	65	25	10	2.2778	1.0665
Management should adjust their annual payout ratio towards the target	80	10	10	2.0588	1.0498

are agreed that there is a need to employ a safety margin in terms of financial slack.

Results from Table 5 revealed that decision makers consider short-term bank borrowings, long-term debt capital and retained earnings as the most important source of financing (75% of the respondents' identified these sources as important). Equity right issue is the other important source of financing with 65% response rate, whereas new equity issue is the least preferred source of financing according to the respondents (40% rate).

Table 6 reveals that majority of the respondents (65%) are agreed to the statement that management have a target payout ratio and also (80%) are agreed that management should adjust their annual payout ratio towards the target.

The results of Table 7 reveal the internal and external factors influencing the corporate dividend policy. According to the respondents, future long term earnings growth and the availability of cash (80 and 75% response rate, respectively) are the two important internal determinants of corporate dividend policy. Historical long term earnings growth and pattern of past dividend payments are less important factors (50 and 45% response rate, respectively). On the other hand, general economic

conditions, access to capital markets and expectations of the stock market are the external important determinants of dividend policy (with response rates of 90, 65 and 55%, respectively). The concern over maintaining share price is the less important factor with response rate of 45%. The result of Table 8 shows that almost 60% of corporate managers use dividend policy to signal information about future earnings performance. Moreover, they believe (70% response rate) that cuts in dividends pass on negative signals and should be avoided. Conversely, majority (65%) of the respondents are not agreed with the statement that dividend cuts signal positive information in terms of good investment projects. Dividends are only one means of signaling and their importance should not be overestimated, 65% of the respondents are agreed with the statement.

Table 9 presents the results of regression analysis for organizational performance. The results show that the model is significant ($P < 0.05$) and there is substantial positive relationship between organizational performance and capital structure and dividend policy (R -Square=0.630 and the F -value=19.271). The independent variables of the model account for 63% variation in dependent variable. The variables when reviewed on individual basis, both the independent variables are

Table 7. Descriptive statistics with respect to “Determinants of Corporate Dividend Policy”.

Item	Percentage response rate (N=61)				
	Important	Unsure	Unimportant	Mean	Std deviation
Internal					
Historical long-term earnings growth	50	15	35	2.7368	1.4812
Future long-term earnings growth	75	15	10	2.1579	1.1816
Pattern of past dividends	40	25	35	3.0526	1.1909
Availability of cash	80	5	15	2.1053	1.1189
External					
Expectations of the stock market	55	10	35	2.6842	1.4887
Concern over maintaining share price	45	35	20	2.6842	1.2162
Access to capital markets	65	20	15	2.3684	1.0863
General economic conditions	90	5	5	1.6842	0.9762

Table 8. Descriptive statistics with respect to “Dividend policy as a means of Information Signaling”.

Item	Percentage response rate (N=61)				
	Agree	Neutral	Disagree	Mean	Std deviation
Management use dividend policy to signal information on future earnings performance	60	20	20	2.4211	1.3105
Cuts in dividends signal negative information and should be avoided	70	20	10	2.6111	1.0331
Dividend cuts signal positive information in terms of good investment projects	35	40	25	3.0556	0.9444
Dividends are only one means of signaling and their importance should not be overestimated	65	20	15	2.5556	1.0869

Table 9. Regression analysis for organizational performance.

Constant	Capital structure decision	Dividend policy	R-Square	F-Statistics
2.135	0.315	0.337	0.630	19.271
(1.338)	(0.350)	(0.197)		
[1.720]	[2.079]	[3.592]		
0.098	0.019	0.000		0.008

Regression coefficients, standard errors in parentheses, t-values in brackets.

significant ($P < 0.05$) and positively related to organizational performance. The regression coefficient for capital structure decision is 0.315, which suggests that it contributes 31.5% to organization performance. In the case of dividend policy, the regression coefficient is 0.337 which demonstrates that dividend policy contributes up to 33.7% to organization performance and is significant ($P < 0.05$).

The results of regression analysis suggest that both independent variables have positive and significant impact on organization performance and financial managers perceive these variables valuable for organizational

performance and growth. These results validate both hypotheses (H_1 and H_2).

DISCUSSION

The result of the present study are in line with the following studies, Financial literature suggests that capital structure has an impact on the economic system (Myers and Majulf, 1984) and managers should identify the ideal corporate structure for the company. Titman and Wessels (1988) and Ozkan (2000) found a positive relationship

between the importance of tangible assets in total assets and total debt ratios. U.S industries analysis conducted by Brigham and Ehrhardt (2001) indicated that among individual firms, within industries, and among those industries there exist a wide capital structure variation. The study of Safieddine and Titman (1999) indicated a positive relationship between leverage and long term performance. It should be emphasized that Rajan and Zingales (1995), and Booth et al. (2001) found similar results respectively and listed companies in developed countries. The development of capital market also influenced capital structure (Booth et al., 2001). Welch (2004) indicated that rather than having a target capital structure firms let the leverage to, automatically, move with stock returns. Harvey et al. (2004) described that debt is mostly used by firms where managerial agency costs are high. Capital structure decision is influenced by the economic condition of the country (Rajan and Zingale, 1995; Booth et al., 2001; Yong et al., 2008) and debt ratio of the organization is the function of rate of economic growth and capital market development.

Studies regarding signaling arguments provide foundation for arguments related to asymmetric flow of information between shareholders and managers corporate sector (Bhattacharya, 1979). Studies found that for over investing firms dividend policy gives more forecast, regarding information, than the firms maximizing their value (Koch and Shenoy, 1999). Dividend decision should also consider the dividend yield (Bajaj and Vijn, 1990). Aharony and Swary (1980), Asquith and Mullins (1983) documented a positive market reaction to dividend increase announcements. When information asymmetries exist between managers and investors, dividend policy can play a signaling role. Studies conducted on Japanese firms fail to provide evidence of a positive relationship between future earnings and dividend changes (Fukuda, 2000; Kato et al., 2002). Study conducted by Anderson (2009) indicated the separation of dividend signal from the earnings signal.

Conclusion

This study explains the major issues in corporate finance and reports the results of a survey based analysis on patterns of capital structure and dividend policy in the Pakistani corporate sector through descriptive analysis. It is quite evident from the results that theory and practice in different areas are closely related, for instance, the requirement for an optimal capital structure and the signaling effect with reference to dividends. However, regarding the patterns of dividend policies are not appropriate, as well as respondents are not agreed with concern over maintaining share price and dividend cuts stand. The dividend pattern over time, by the corporate sector can be used to assess the degree to which this construct is useful for passing information to management's understanding of the growth potential. Dividend

policy is considered as a means for passing information to the capital markets on a company's performance. However, the results of this study are based on a selected sample of firms that are applying these practices but during the survey, it is revealed that a substantial number of firms in Pakistani corporate sector are not following these practices either partially or completely. This study explores the application of capital structure and dividend policies in various sectors of the economy. This study enhances the awareness of stakeholders about the capital structure decisions and dividend policies and their role to improve the performance and growth of the Pakistani corporate sector.

RECOMMENDATIONS

On the basis of above results, here are few suggestions for the improvement of the patterns of capital structure and dividend policies in this area. Both companies and policymakers should devise strategies to promote and encourage issuance and subsequently purchase of equity shares (being one of the most important component of capital structure), this can be achieved by pursuing persistent dividend policy and effective corporate governance. One crucial issue which came across during a visit to the companies was the services of relevant and expert finance personnel. Companies should hire new employees or train existing employees to exercise high value these practices.

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