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Hunjra, Ahmed Imran and Ijaz, Muhammad Shahzad and Chani, Muhammad Irfan and Hassan, Sabih ul and Mustafa, Umer

Lecturer, UIMS, PMAS-Arid Agriculture University Rawalpindi, and PhD Scholar, Iqra University, Islamabad, Pakistan, MS Scholar, UIMS-PMAS-University of Arid Agriculture Rawalpindi, Pakistan, PhD Scholar, National College of Business Administration Economics, MBA Student, UIMS-PMAS-University of Arid Agriculture Rawalpindi, Pakistan, MBA Student, UIMS-PMAS-University of Arid Agriculture Rawalpindi, Pakistan

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Impact of Dividend Policy, Earning per Share, Return on Equity, Profit after Tax on Stock Prices

Ahmed Imran Hunjra ^{a,*}, Muhammad Shahzad Ijaz^a, Muhammad Irfan Chani^b, Sabih ul Hassan^a, Umer Mustafa^a

^a UIMS-PMAS-University of Arid Agriculture Rawalpindi, Pakistan

^b National College of Business Administration and Economics

Highlights

- The paper investigates the stock prices function in case of Pakistan.
 - The paper has used OLS for empirical analysis.
 - Dividend yield is inversely related with stock prices.
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Abstract

Purpose: *The volatility in stock prices is one of the most discussed topics in finance. Many studies have been conducted to find the factors which cause fluctuation in stock prices and different results have been found. In this study an attempt has been made to see the affect of dividend yield, dividend payout ratio, return on equity, earning per share and profit after tax on stock prices in Pakistan. For this purpose four non financial sectors (Sugar, Chemical, Food and personal care, Energy) have been selected. A sample of 63 companies listed at Karachi stock exchange was analyzed for the period of 2006-2011. **Methodology:** Ordinary least square regression model has been applied on panel data. **Findings:** The results indicate dividend yield and dividend payout ratio which are both measures of dividend policy have significant impact on stock price. Dividend yield is negatively related with stock price and dividend payout ratio is positively related with stock price which means that these results are against dividend irrelevance theory. For other independent variables profit after tax and earnings per share have significant positive impact on stock price and return on equity which shows positive insignificant impact on stock price. **Recommendations:** This paper shows new insights for policy makers to improve the performance of Karachi stock exchange.*

Key words: Dividend policy, Stock price, Dividend irrelevance theory

JEL Classification: O12

* Corresponding Author: ahmedhunjra@gmail.com

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I. Introduction

Stock price is the price of a single share of a number of saleable stocks of a company. Share price is the biggest concern for the companies, if the share price of company is high or increasing then the board of directors and the management are happy. Share price is the indicator of the overall strength of the company, if the share price of company continues to increase then it shows that company and its management is doing their job excellently. Management of a company with high share price is likely to see a raise and there are fewer chances that they will be fired. If management is unable to create returns for investors then there is a greater risk that they will be replaced. Another concern for the companies is that if their share price is low then there are more chances of takeover because companies become relatively cheaper and chances of takeover increases and in condition of takeover old management have to go so. Managers are actually trying to protect their own interest because no one wants to be fired. The dividend policy is an important part of corporate financial management policies. This is the policy in which company take decision about two things (i) How much of the cash should be retained in the business i.e. for expansion of the business or to repurchase shares. (ii) How much of the cash should be given to the share holders as dividends. Dividend policy is a decision taken by the company about dividend payment which is distributed among shareholder of the company. For a long time, the issue of the dividend policy of the company has captured the interest of many academics and researchers as a result much theoretical explanation arises for dividend policy. Investors prefer those companies whose dividend policy is stable that is why companies try to maintain stable dividends because dividend give indications to investors about the strength and stability of the business. In developed countries lot of work is done on dividend policy and its implication on the stock price but in developing markets like Pakistan very less studies have been made but now in Pakistan researchers started to feel the need to study dividend policy and its implications in the financial and non financial sectors. There is extensive need to study the impact of dividend policy and some other variables like EPS, ROE, PAT on stock price because the market in Pakistan is not stable. Changes are occurring every day so market should be analyzed with the latest data to provide updated information to investors. Nishat and Irfan (2003) considered the financial sector of companies which are listed in Karachi stock Exchange to check the effect of dividend policy on the stock prices. Their research was unique and different because previous studies were made in the market of developed countries and their study was first which was conducted in the emerging market like Pakistan. The study conducted by Nishat and Irfan (2003) opened ways for other studies on this topic, then Nazir et al. (2010), Habib et al. (2012), Azeem and Kouser (2011), Asghar et al. (2011) also conducted studies to find the impact of dividend policy on stock price and found conflicting results due to which no generalization was made yet. In previous studies only impact of dividend policy on stock prices are measured and variables like return on equity, earning per share, and profit after tax are used only as a control variables and their combined impact on stock price were not measured. In this study we have measured the combined impact of return on equity, earning per share, and profit after tax and dividend policy on stock prices.

Mostly it is considered that management have no control on stock prices because many investors believe that fluctuations in stock prices are due to external factors such as political situations of country. This study elaborates the impact of internal factors on stock prices these factors are under management control and by controlling these internal factors managers can control stock price to some extent. This study can facilitate managers so that they can organize dividend policy and they can also control other internal variables which has some impact on stock price. This study is will provide the information to investors to make their investment strategies accordingly. The objective of this paper is to determine the impact of dividend policy, return on equity, earning per share and profit after tax on stock price in firms listed in KSE and to suggest better measure towards these variables.

II. Literature Review

Lintner (1956) paid attention to dividend policy and developed a theory based on two important things which are about dividend policy; first the firms are mainly concerned with the stability of the dividend policy. Managers do not make changes in dividend policy unless it is necessary because they feel that market puts a premium on the firms with stable dividend policy. Secondly Lintner believed that the level of earning is the most important thing. If there is sudden increase in earnings then firms slowly adjust their dividends, similarly firms are reluctant to cut dividends. Miller and Modigliani (1961) gave dividend irrelevance theory. Their study showed that dividend has no impact on stock prices and it is only affected by investment policy. Black and Scholes (1973) also gave their views in favor of dividend irrelevance theory. Many others researchers like Adesola and Okwong (2009) found no relation between dividend policy and stock prices. Pradhan (2003) found the effect of dividends payments and retained earnings in companies listed in Nepal's stock market price and found that the payments of dividends

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and stock prices have strong correlation, retained earnings and stock market prices have a very weak relationship. Study further explained that shareholders in Nepal put more emphasis on dividend income than capital gains. Nishat and Irfan (2003) studied the relationship between dividend policy and stock price in Pakistan. This study was the first which was made on companies listed in Karachi Stock Exchange, 160 companies listed in Karachi Stock Exchange for a period of 20 years from 1981 to 2000 were selected as a sample. Cross sectional regression analysis was used to find the relationship between stock price and dividend policy after controlling some variables. Stock price was taken as dependent variable and independent variable include dividend policy measure and some other variables such as size of firm, earning volatility, payout ratio dividend yield, long term debt and growth in assets. Correlation between different variables was also calculated. Results showed that both dividend yield and payout ratio have significant negative relation with dependent variable stock price. Dividend yield showed more impact than payout ratio because coefficient of Dividend yield was much greater than Payout ratio, after that they regressed PV by adding some other variables to check whether correlation was weakened or not by adding these variables. The result showed that three variables debt, size and asset growth have positive significant impact on PV while the fourth variable earning volatility has negative significant impact on PV. Two main measures of Dividend policy e.g. dividend yield and payout ratio remain significant. The correlation results showed that there were significant negative correlation between dividend yield and earning volatility which mean that firms whose earnings were more fluctuating pay less dividend and were more risky. Dividend yield and debt have significant negative correlation which showed that firms with high debt pay fewer dividends. Similarly payout ratio and size of the firm were negatively correlated which means that large firms pay more dividends than small firms.

Myers and Bacon (2004) studied the impact of dividend policy on stock price. Samples of 483 companies from Multex investors' database were taken. Their results showed that there exists a positive relationship between the price-earnings ratio and dividend payout ratio. Their findings also indicated that there is a significant positive correlation between the debt equity ratio and dividend payout ratio. Azeem and Kouser (2011) studied the effect of dividend policy on stock price in Karachi Stock Exchange and took large sample size which was almost one fourth of the total companies listed in KSE. A sample of 131 dividend paying companies listed in KSE for the period of 10 years from

2001 to 2010 was taken. The study used panel data approach. Stock price was taken as dependent variable while independent variables are stock dividend, retention ratio, profit after tax, earning per share, and return on equity. Results of the study showed that PAT has positive significant relationship with stock price which means if company is earning high profit its share price will become high. EPS has significant positive relation with stock price. Results also showed significant positive relation with stock price and ROE. Study explained that if company is utilizing the funds provided by shareholders efficiently it will produce positive impact on stock price otherwise it has negative impact on stock prices. Stock dividend also showed positive relation with stock price while retention ratio has negative insignificant relationship with stock price. Overall model was significant. Results further showed that dividend policy has positive significant relation with stock price. Raballe and Hedensted (2008) studied the characteristics of dividend payers in Denmark. They used ROE as one of the factor that can affect the dividend policy and stock price they found that ROE is positively related with stock price. They also found that dividend payers were those who have high ROE. In Denmark share repurchases were dividend payers of firms with high ROE the most generous dividend payers. Liu and Hu (2005) studied the empirical analysis of cash dividend payment in Chinese listed companies they took 299 firms. They found that companies which pay more cash dividend have high EPS and ROE they also found that EPS and ROE are positively related with stock prices of the firms. On the basis of the relationship and variables discussed above, we have developed the following assumptions.

- H₁: Dividend Yield (**DY**) has significant effect on Stock Price.
- H₂: Dividend payout ratio (**DPR**) has significant effect on Stock Price.
- H₃: Earning per share (**EPS**) has significant effect on Stock Price.
- H₄: Return on Equity (**ROE**) has significant effect on Stock Price.
- H₅: Profit After Tax (**PAT**) has significant effect on Stock Price.

III. The Method

In this research, Panel data approach was used to find the relationship between stock price, dividend policy, EPS, ROE and profit after tax. A sample of 63 companies listed in KSE was used for the period of 6 years from 2006 to 2011. Stock price was taken as dependent variable while Independent variables were dividend policy, dividend payout ratio, earning per share, return on equity, profit after tax. Ordinary least square (OLS) regression model

was used to find the effect of different variables on stock price. Many other researchers like Afza and Mirza (2010) and Azeem and Kouser (2011) used OLS model in their studies 5% level of significance is used to accept or reject the null hypothesis. In this model following equation is used

$$SP = \alpha_0 + \alpha_1 DY + \alpha_2 DPR + \alpha_3 EPS + \alpha_4 ROE + \alpha_5 PAT \quad (1)$$

Data for dependent variable which is Stock price was collected from KSE website and Brecorder.com, data for all the independent variables such as dividend yield, dividend payout ratio, earning per share, return on equity and profit after tax was obtained from the site of State Bank of Pakistan (SBP) in balance sheet analysis 2006 to 2011 as it is reliable source throughout the country. The time span included in this study was six years from (2006 to 2011). Sectors and their population and sample details are given in Table-1.

Table-1: Population and Population of the Study

Industries	Population	Sample
Sugar	36	17
Chemical industry	43	25
Food and Personal care sector	18	12
Energy Sector	18	9
Total	115	63

IV. Results and Discussion

Table- 2: Descriptive Statistics

Variables	SP	DY	DPR	ROE	EPS	PAT
Mean	222.34	0.01	0.39	31.71	17.33	130278.2
Median	58.73	0	0.31	25.24	7.43	1888.14
Maximum	5475.09	0.09	9.58	212.04	307.11	5492068
Minimum	2.86	0	-15.46	-122.85	-87.92	-17446.1
Std. Dev.	582.39	0.01	1.09	35.67	37.03	570198
Skewness	5.46	4.49	-5.62	1.29	4.06	5.89
Kurtosis	40.08	41.35	140.63	8.83	23.9	41.78
Observations	378	378	378	378	378	378
Jarque-Bera	23533.6	24436.3	300340.7	640.06	7878.52	25864.9

Table-2 shows the details of descriptive statistic of the variables used in the study. Stock prices is taken as dependent variable ranges from 2.86 to 5476.09, its mean is 222.344, and standard deviation is 582.38. First independent variable used in the study is dividend yield it ranges from 0 to 0.08571 and its mean value is 0.00581 and standard deviation of dividend yield is 0.007338, second independent variable is dividend payout ratio. It has minimum value -15.4581 and maximum value is 9.5846. Mean value of dividend payout ratio is 0.3887 its standard deviation is 1.0868. Third independent variable used in the study is return on equity. It ranges from -122.85 to 212.04. Its mean value is 31.711 and standard deviation of return on equity is 35.673. Next variable used as independent variable in the study is earning per share. It has minimum value -87.92 and maximum value is 307.11. Mean value of earning per share 17.33 and its standard deviation is 37.034. Last variable is profit after tax it ranges from -17446.1 to 5492068 with mean 130278.2 and standard deviation of profit after tax is 570198. Results in Table-3 show that stock price is positively correlated with all variables except dividend yield with which stock prices has negative correlation. Positive correlation means any increase in explanatory variable causes increase in stock prices and decrease in explanatory variables causes decrease in stock prices similarly in case of negative correlation it is vice versa i.e. increase in explanatory variable causes decrease in stock prices. Results further indicate that correlation between stock prices and dividend yield is -0.0982. Correlation between stock prices and dividend payout ratio is 0.1098, correlation between ROE and stock prices is 0.4829, correlation between EPS and stock prices is 0.2928 and correlation between profit after tax and stock prices is 0.3719. The relationship between stock price and the entire explanatory variable are significant at 5% level of significance. Dividend yield has positive significant correlation with dividend payout ratio and Return on equity.

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Table-3: Correlation Matrix

		SP	DY	DPR	ROE	EPS	PAT
SP	Pearson Correlation	1					
	Sig. (2-tailed)	-----					
	N	376					
DY	Pearson Correlation	-0.0982	1				
	Sig. (2-tailed)	0.05	-----				
	N	376	376				
DPR	Pearson Correlation	0.1098	0.3114	1			
	Sig. (2-tailed)	0.0332	0	-----			
	N	376	376	376			
ROE	Pearson Correlation	0.483	0.1792	0.1167	1		
	Sig. (2-tailed)	0	0.000	0.0235	-----		
	N	376	376	376	376		
EPS	Pearson Correlation	0.2928	0.0156	0.1199	0.3275	1	
	Sig. (2-tailed)	0	0.1629	0.02	0	-----	
	N	376	376	376	376	376	
PAT	Pearson Correlation	0.3719	-0.0448	0.0838	0.4476	0.4447	1
	Sig. (2-tailed)	0	0.386	0.104	0	0	-----
	N	376	376	376	376	376	376

Note: **Correlation is significant if p value is less than 0.05

The correlation between dividend yield and dividend payout ratio is 0.3114 correlation between dividend yield and return on equity is 0.1729. There exist positive but insignificant relation between EPS and dividend yield and coefficient of correlation between them is 0.0156. Profit after tax and dividend yield has negative insignificant correlation between them and coefficient of correlation is -0.0448. Dividend payout ratio has positive correlation with all variables. There exist positive significant correlation between dividend payout ratio and return on equity coefficient of correlation between return on equity and dividend payout ratio is 0.1167. The correlation between EPS and dividend payout ratio is 0.1199. Profit after tax and dividend payout ratio has statistically insignificant correlation coefficient 0.0838. Return on equity has insignificant positive correlation with earning per share, coefficient of correlation between return on equity and earnings per share is 0.3275 and correlation between return on equity and profit after tax is 0.4447. There exist positive and significant correlation between return on equity and profit after tax.

Table-4: Regression Analysis

Variable	C	DY	DPR	ROE	PAT	EPS	R-Square	F-statistic
Coefficient	61.2509	-7365.7	20.9477	0.3052	0.0006	6.14388	0.8588	450.35
Std. Error	17.0361	1674.43	11.1002	0.3898	2.66E-05	0.43101		
t-Statistic	3.59535	-4.399	2.18715	0.7829	23.1975	14.2543		
Prob.	0.0004	0.000	0.04	0.4342	0.000	0.000		0.000

Table-3 shows that p-value is less than 0.05 so, overall model is significant. Value of R-square is 85.88% which explained the stock price with the given independent variables. Out of five independent variables four variables have significant impact on stock prices and one variable has insignificant impact on stock prices. Dividend yield has a p-value less than 0.05 which means it has significant impact on stock prices. Its coefficient is -7365.737 which shows negative relation between DY and stock prices. Dividend payout ratio has p-value 0.0499 which is greater than 0.05 which means that it has significant on stock price its Beta is 20.94 which shows positive impact with stock prices. Return on equity has p value greater than 0.05 and its coefficient is 0.3520 which indicate insignificant impact on dependent variable. Profit after tax is the fourth independent variable results show that PAT has significant positive impact on stock prices. Its coefficient is 6.14 which mean that 1 unit increase in EPS causes 6.14 units increase in stock price. From the above results we found that dividend yield has p-value is less than 0.05 which means that dividend yield has significant impact on stock prices on the basis of this result we have accepted first hypothesis of the study.

Results of dividend payout ratio indicated that DPR has significant impact on stock price on the basis of this result we have accepted the second hypothesis. ROE has P-value 0.4342 which is greater than 0.05 which means that ROE has insignificant impact on stock price so third hypothesis was rejected. EPS showed significant effect on stock price because its p-value is less than 0.05. On the basis of this result we have accepted fourth hypothesis. PAT has p-value less than 0.05. It showed significant impact on stock price so fifth hypothesis was accepted. It is found that there exists a relationship between stock prices and independent variables. Impact of dividend policy and dividend yield on stock price always provided conflicting results. Results of present study showed that there is significant negative relationship between dividend yield and stock prices. Nishat and Irfan (2003) and Hussainey and Mgbame (2011) also found similar results in their studies. Dividend payout ratio has positive significant relation with stock prices. This result is same with Myer and Bacon (2004), Nishat and Irfan (2003), Asghar et al. (2011). This positive relation between stock prices and DPR show that shareholders prefer those companies who has high DPR because when companies pay dividend they will retain less this will positively affect the stock price. Khan et al. (2011) used retention ratio instead of DPR in his study and found negative relation between stock prices and retention ratio. He also mentioned that when companies retain their money in order to fulfill their internal needs this will impact stock price negatively. Earnings per share have positive significant impact on stock price. This result is consistent with Liu and Hu (2005), Baskin (1989) and Adesola and Okwong (2009) who also found positive relation between EPS and stock prices. This result indicates that shareholders rated those companies higher which have high values of EPS. Return on equity has insignificant relationship with stock prices. Habib et al. (2012), Liu and Hu (2005) and Raballe and Hedensted (2008) also found positive relation of ROE with stock prices. This positive relation between ROE and stock prices shows that when management are performing efficiently and utilizing the resource powerfully and gives good returns on investment it will affect stock price positively otherwise it has negative effect on stock price. Result showed that profit after tax has significant positive relation with stock price. Main concern for the shareholders is the amount of profit because profit gives that is indication of the company's success. Pani (2008), Adesola and Okwong (2009) and Ahmed and Javed (2009) also used PAT in their studies and found positive relation between PAT and stock prices.

V. Conclusion, Recommendation and Practical Implications

This study is conducted to find the impact of dividend yield, dividend payout ratio, earning per share, return on equity and profit after tax on stock price in the emerging market of Pakistan. Results showed dividend yield and dividend payout ratio has significant impact on stock price. Dividend yield has negative significant impact on stock prices and dividend payout ratio has positive significant impact on stock prices. These results are against the dividend irrelevance theory, earning per share and profit after tax have significant positive relation with stock price which means that the firms with high earning per share and profit after tax has high stock price. Return on equity has insignificant positive impact on stock prices. Overall model is significant. These results are reliable and applicable only in emerging markets like Pakistan. The area of study is wide while time horizon was short therefore we are unable to cover all areas which we have selected. This research focuses on firms which are listed in Karachi stock exchange and a sample of 63 companies was chosen for analysis, however in future the sample size could be increased and also other sectors and companies can be used which are listed in Islamabad and Lahore stock exchange. This study includes only five independent variables for analysis. For future direction number of independent variables could be increased so that results can become more valid and reliable. Time period of study can be increased as we have used only 6 years data it can be increased from 10 to 15 years so that results become more valid and reliable. We have targeted few sectors such as Sugar, Chemical, Energy and Food these can be changed and other sectors can be added.

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