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ABSTRACT

The Long-term return behavior of dividend-changing firms has been investigated in the study and it is estimated that 23 percent only incremental profits are transformed into dividend. The remaining profits are utilized for the additional investment. It is also concluded that concentration of ownership is also an important factor of the dividend payments. The results support the hypothesis that companies start to pay dividends after a certain level of growth. At the earlier stage companies concentrate on retained earnings. The Ordinary Least Square (OLS) technique has been applied in the study and the model has been estimated through the pooled data of annual audited accounts of 180 listed companies of the Karachi Stock Exchange.

(A) AN OVERVIEW OF THE CORPORATE GOVERNANCE AND DIVIDEND POLICIES IN PAKISTAN

From the reputation's point of view, the payment of dividend is not less important than interest payment, at due time. The risk and the rate of return are the only difference between these two types of finances. The payment of dividend is considered extremely important, in some economies. The firms are even forced to pay dividend through external finances. However, in Pakistan, the dividend pay out ratio is low as compared to other emerging markets and it is thought that payment of dividend is directly concerned with the availability of surplus funds after payments of the expenditures and financing for the additional investment in the company. It is observed that firms decide their dividend payments on the basis of their net profits after tax. The external finances are not related with the firm’s decision for dividend payments. While in the other emerging markets, dividends payment depends largely on the availability of external finances.

In Pakistan, it is observed that payment of dividend is highly correlated with the type of governance. From the dividends' payment point of view, we can divide the companies in Pakistan in the following three categories: -

1. **The Modaraba companies:** According to the Modaraba Companies Ordinance, a Modaraba company would be exempted from the corporate tax if it distributed at least 90 percent profit in dividend. It is obvious that pay out rate of those companies should be higher and they should pay higher dividend as compared to the other companies. Since 1995, the law has been amended and Modarba companies have to pay the tax like other companies. So, their pay out policy has also been changed.

2. **The Local Subsidiaries of the Multinational Corporations:** A significant large part of the capital of such companies belongs to the sponsor' equity. Usually, the companies have a large capital in the form of sponsor's equity. The sponsors’ equities are invested by the parent companies. Due to the availability of surplus capital and good liquidity position, they do not require much retention. Moreover, Pakistani laws permit the transfer of dividend income to abroad. So, they pay good dividends. But, it is important that those are the closed companies, from the distribution of ownership point of view. Their ownership is highly concentrated and the individual investors hold a negligible part of their equities.

3. **The Other Companies:** The companies other than the above-mentioned categories may be included in this category. Their dividend payments depend on the after tax profits, and financing for expansion.

The domestic investors prefer to work as a director rather than as an ordinary shareholder. So, they prefer to launch a new company rather than the investment in other companies. This is the reason that numbers of companies are larger in relation to the volume of investment, in Pakistan. The phenomenon has been shown in the TABLE: 2 and TABLE: 3. Similarly, the ownership is highly concentrated and directors work in the companies on salary bases. The salaries of directors are higher than salaries of other employees of same qualification and experience. In fact, the insider can achieve two types of benefits. They can get their return on investment in the form of executive compensations. They hold their control over the company by which they can get some other benefits. They can use their influence in recruitment of the staff, they can influence the contracts of supplies, and they can maintain their social status in the society as a corporate officer.

As regards the payments of dividends, it is directly related with the accounting profits. The shareholdings' patterns show that the majority of companies belong to the closed companies. The Board of Directors or their family members holds the significant part of the company's shares. The majority of elected directors are usually belonged to the same family. In a large number of cases, at least six directors (out of the seven) belong to the sponsors. The managing director appoints the other directors or their family members on the key positions of management and finance. The directors enjoy the facilities provided by the company. They draw handsome salaries and fringe benefits including company maintained car, furnished accommodation, children education's expenditure, and the reimbursement of personal expenditures for utility bills, family medical services, clubs' membership fee and traveling expenses etc. Their salaries are much higher than the average salaries in the market. By such a way they receive the extra ordinary returns on their investment. However, It is obvious that such expenditure may be a cause of lower profits. So, company cannot declare the dividends and the minority shareholders suffer.

The majority of companies belong to the small scale and services industries. There is no application of the accounting principle of "Separate Entity." It is almost impossible to isolate the business and personal expenditures because of the managerial and accounting problems. The statuary auditors cannot check such managerial problems and the accounting and internal audit departments cannot involve at the board level decisions making. The Corporate Law Authority and the Stock Exchanges cannot check and advise the companies for their internal matters. However, after the formation of the Securities and Exchange Commission (SECP) it is being expected that the commission will issue the guidelines to control such type of managerial expenditures.

It is mentioned earlier that sizes of companies are smaller in Pakistan. Their white-collar directors cannot afford the termination of their directorship, through the change in the pattern of ownership, due to insufficient funds to exercise their rights. So for expansion, the companies do not prefer to issue the right shares, because, issuance of right shares can affect the pattern of ownership if some of the directors do not have a good liquidity position.

As a result, a higher retained earnings is the only option (other than debt financing) for a company to expand its operation. So, lower dividend (or no dividend) is a natural consequence of higher retention.

TABLE: 1
DIVIDEND HISTORY OF LISTED COMPANIES IN PAKISTAN

Return to Investors	Number of Companies								
	1994-95			1995-96			2000-01		
	Up to 20%	Above 20%	Total	Up to 20%	Above 20%	Total	Up to 20%	Above 20%	Total
Cash Dividend	140	101	241	115	123	238	165	141	306
Bonus	71	64	135	38	25	63	18	15	33
Right	16	97	113	06	66	72	03	28	31
Total	**227**	**262**	**489**	**159**	**214**	**373**	**186**	**184**	**370**
Source: Karachi Stock Exchange (Guarantee) Limited									

TABLE: 2
GROWTH OF LISTED COMPANIES IN PAKISTAN

Year	No. of Companies	Paid up Capital (Rs./Billion)	Market Capitalization (Rs./Billion)
1960	81	1	2
1970	318	4	4
1980	314	8	6
1990	487	28	62
2000	762	229	392
2001	759	240	339
2002	725	261	408
Source: Karachi Stock Exchange (Guarantee) Limited			

(B) THE DEBT FINANCING IN PAKISTAN

To understand the reasons for lower pay out ratio, it is necessary to see the pattern of external finances in Pakistan. There is no established market for public debt. In Pakistan, a debt means the borrowing from commercial banks or financial institutions, because the corporate bond market has not been developed in the country. The large part of the corporate debts belongs to the nationalized banks and financial institutions. The sanctions of loan depend mainly on socio-political factors rather than business requirements. Moreover, the loans are not directly contributed in the employed capital of a firm, but assign to a particular project of the company. So, this type of financing cannot be directly related with the dividend policy.

It is also important that debts from the nationalized banks and financial institutions are granted with the other benefits like as concessional rate of interest, supply of the utilities on discount and priority bases, free land and tax benefits. Such benefits are usually attached with the borrowing and granted on the political basis. Another dimension of the debt financing is the rescheduling and written off option in future. All such decisions are made on the political basis. So, domestic companies prefer to such priority financing.

TABLE: 3
AVERAGE SIZE OF COMPANIES

Million US Dollar

Country	Number of Companies	Market Capitalization	Average size of company (Market Capitalization)
World	40593	23541385	580
Emerging Markets	19937	2229508	112
Switzerland	216	575338	2664
U.S.A.	8851	11308779	1278
Japan	2387	2216699	929
India	5843	128466	22
Pakistan	781	10966	14

TABLE: 4
PATTERN OF FINANCING BY FINANCIAL INSTITUTIONS

Disbursements of Loans (Rs./billion)						
Type of Financing	1994-95			2001-02		
	Working Capital	Fixed Assets	Total	Working Capital	Fixed Assets	Total
Scheduled Banks	165	167	332	328	120	448
Modarabas	4	1	5	2	3	5
Leasings	1	8	9	0	14	14
Investment Banks	24	5	29	4	1	5

C) WHY INVESTMENT AT LOWER DIVIDEND YIELDS?

Now, the question is that why the minority shareholders are ready to buy the shares despite of lower yield? The capital gain is the only reason. It is notable that dividend is a taxable income of the investors, but capital gain is exempted from tax. This is the reason that the investors in Pakistan are more sensitive to share price changes rather than the change in dividend. Other than the concentration of ownership and executive compensation, the tax benefit is another reason of investment in the shares of listed companies.

It should be explained at this stage that increase in the value of a firm despite of the lower pay out ratio is not against the axiom of ‘rationality’. When companies achieve the level of targeted growth and when they reach at a level near to their competitor company, they start to pay dividend. In Pakistan, the Retention is a part of financial policy rather than a part of dividend policy. The investors, analysts, and evaluators have been estimating the value of shares through their break up values. The break up value can go up by the addition in Reserves Funds, if number of shares remain constant.

(D) THE DETERMINANTS OF DIVIDEND

Empirical investigations tell us that Net Profit after Tax (NPAT), Working Capital (NCRASST) and Insider shares in equity (SHNMBR) affect the firm’s decision regarding dividend pay-out (DIVEDN). Brittain (1966) verified a positive relationship between dividend (DIVEDN) and Net Profit after Tax (NPAT). We also included those variables in our model. Working capital (NCRASST) is an indicator of the probability of Cash Dividend.

Econometric techniques, do not only help us in selecting the most significant explicative factors, they also determine numerically how much each factor is actually contributing in explaining the behavior of economic indicators. For some sectors income tax and statuary reserves are predetermined in Pakistan. They more depend on legal and constitutional structure of Pakistan than the economic behavior. Provision for Tax (TXPROV) is a below the line head of account. So, it has been included in the equation of dividend (DIVEDN). Bonus shares may be a substitute of Cash Dividend. So, we also included those variables in the dividend's equation.

Companies in chemical and pharmaceutical sectors belong to the large multinational groups. They do not emphasis on Retained Earnings. Because, their investment depends on their Initial Equity (Parent companies’ investment). So, they have higher pay out ratio. Therefore, a dummy variable (D2) has been introduced in the equation to capture this phenomenon.

It is also observed that a high percentage of shares held by management (Board of Directors) lead the high dividend. So, we also included the number of shares held by the Board of Directors (SHNMBR) as an explanatory variable. In most of the studies, insider ownership (SHNMBR) has been assumed to be an exogenous factor. According to Jenson, Solberg and Zorn (1992) Insider Ownership (SHNMBR) choice are endogenous outcomes of value- maximizing behavior. However, due to the limitation of our study, we are considering it as an exogenous variable.

The Ordinary Least Square (OLS) technique has been applied in the study. The model has been estimated through the pooled data of annual audited accounts of 180 companies listed on the Karachi Stock Exchange. These accounts cover the period of 1981 to 2002 giving us 3960 observations (180 companies and 22 years). The data have been obtained from a variety of sources, depending upon the definitions and the nature of the variables. A large data on different variables have been extracted from the annual reports of the listed companies. However, the data for some variables have also been extracted from the various issues of the Balance Sheet Analysis (State Bank of Pakistan: 2001-02; 1995-96; 19990-91; and 1986-87). All the variables are in million of rupees except D2 which is a dummy variable. The variables have been defined in TABLE: 5.

TABLE: 5
DESCRIPTION OF THE VARIABLES

SR. NO.	VARIABLE	DESCRIPTION
1	DIVIDEN	Total amount of dividend declared for the year
2	NCRASST	Net current assets (or Working Capital)
3	NPAFTX	Net profit after tax
4	SHNMBR	Number of shares held by the management (Board of Directors)
5	TXPROV	Amount of corporate tax shown in the Profit and Loss Appropriation Accounts
6	BNSSHR	Amount of Bonus Shares issued by the company during the year
7	D2	Dummy variable equal to one if a company belong to the Chemical / Pharmaceutical industry

The estimated results reveal some interesting findings. The important thing is that the corporate governance has significant relations with dividend policy. The estimated results have been presented in TABLE: 6.

TABLE: 6
DETERMINANTS OF DIVIDEND
(ESTIMATED RESULTS)

$$\underset{(-12.82)}{\text{DIVEDN}= -\ 2.921} - \underset{(-31.25)}{0.156*\text{NCRASST}} + \underset{(6.21)}{0.231*\text{NPATX}} + \underset{(4.53)}{0.532*\text{SHNMBR}}$$

$$+ \underset{(13.54)}{0.325*\text{TXPROV}} + \underset{(1.79)}{0.053*\text{BNSHR}} + \underset{(2.01)}{2.635*\text{D2}}$$

Adjusted R-square =0.7159

TABLEs in parenthesis are t-statistics

(i) Dividend and Liquidity

The hypothesis of a positive relation between dividend and liquidity position of a firm has not been accepted in the study. A negative relationship between dividend and liquidity position of a firm has been observed. If a firm has a good liquidity position, it does not mean that it will pay higher dividend. The relation is inverted in the context of Pakistan, where dividend will be lower, if a company has a positive working capital. Basically, this paradigm indicates the importance of dividend in determination of working capital. A positive working capital on the closing date of balance sheet indicates that firm does care for financial health and indicators. The dividend declares after few weeks of the closing date of the balance sheet. If a firm is maintaining (or trying to show) a good liquidity position, there will be a few chances of dividend payments.

(ii) Divined and Profit Relationship

Linter's (1956) famous investigation of dividend policy stresses that firms only increase dividends when management believes that earnings have permanently increased. A bit later, Miller and Modigliani (1961) explicitly suggested that dividends can convey information about future cash flows when markets are incomplete. Indeed, as demonstrated by Miller and Rock (1985), through the sources and uses of funds identity the dividend decisions could reveal information about current earnings to the market. The idea that changes in dividends have information content is an old one.

Unlike many of the previous studies, we utilize a large number of firms and events. We also control for many other factors that can create spurious relationship between dividends and subsequent earnings changes.

We also investigated the long-term return behavior of dividend-changing firms and it is concluded that about 23 percent additional profit is only transformed into dividend. The remaining profits are utilized for additional investment. The higher retention shows that firm adopts a self-financing way for growth and expansion. This is not an appropriate policy for the small companies in public sector, because it is based on the cost of minorities' interest. The insiders can earn their required return through executive salaries and higher fringe benefits, but outsiders have to scarify the returns.

(iii) Insider's Ownership

It is observed in the study that a large number of shares held by the board lead to high dividends or low retention, which lead to the low Reserves Funds. The magnitude attached with the dummy of pharmaceutical companies' (D2) show that dividend payments in this sector are higher as compare to the payment of dividend in the other sectors. So, our hypothesis that foreign affiliated companies pay higher dividend has been accepted. In fact, the foreign affiliated companies have sufficient capital, so they do not require much internal financing. As a result their ability to pay the dividend is much higher than domestic companies.

The coefficient attached with the insiders' share (SHNMBR) is clearly showing that the magnitude of shares held by the directors has a direct relation with the amount of dividend. It is concluded that if a company has a large concentrated ownership then chances of dividend would be higher, because by such a manner dividend will go into the pockets of the directors. The chances of dividend payment will be low, if a significant large amount is paid as a dividend to the outsiders. In this case directors will compensate themselves through the executive compensatory benefits. The directors compare that how can they maximize their earnings, either through dividend or through the executive salaries.

(iv) Re-capitalization and Dividend Policy

The volume of equity financing can be changed by two different ways: Retained earnings and addition in the share capital. As regards, retained earnings it has an accounting relation with dividend. Retained earnings will directly decrease the amount of dividend. But, the decision of dividend depends also on the addition in paid up capital.

The term re-capitalization is being applied here, in limited meanings. By re-capitalization we mean the addition in paid up capital. If the addition is through bonus issue, the dividend should be reduced. But, in our analysis dividend and bonus shares are classified as complements, they are not substitutes. A positive sign with the bonus shows that at the time of expansion, companies pay dividend. This indicates that payment of dividend is important for growing companies. This result supports the above-mentioned hypothesis that companies pay dividend after a certain level of growth. At early stage of growth companies concentrate on retained earnings, then they are expanded through bonus and start to pay the dividend.

It is noteworthy that issuance of right shares depends largely on market conditions. But, issuance of bonus is the indicator of expansion through permanent financing. We can also conclude that growth is an objective of a firm, and a growing firm must pay the dividend.

A positive sign with the tax liability is surprising. But, it is the indicator of the volume of divisible profit. If capital outflow for tax payment increases, the outflow for dividend will also increase.

(E) POLICY RECOMMENDATIONS

The payment of dividend is directly related with the change in market capitalization and the pattern of investment in the economy. So, as a policy the Securities and Exchange Commission of Pakistan (SECP) must be involved in the corporate affairs regarding dividend. The small investors can be divided in two groups in Pakistan. The first group belongs to traders and jobbers. They take interest in buying and selling of the shares for capital gain. This group belongs to the stock brokers, agents, dealers and their friends, relatives and family members. They do speculations and can change their position on weekly basis. They are risk lovers. Much of the trading activity at the Karachi stock exchange belongs directly or indirectly with the activities of those traders. They involve in short selling and long buying, and apply various techniques of the technical analysis.

The second group of small investor belongs to the upper middle-class income peoples, who want to invest their savings in the stock. Retired civil servants, army officers, businessmen, professionals, and corporate employees are included in this category. They are ready to invest theirs savings for a medium term (usually 1 to 3 years). However, they expect a return on investment higher than return on fixed deposits in commercial banks. Usually, they expect a return between 25 and 40 percent. But, on average, only twelve-percent dividend is declared in the Pakistani stock market. The higher return can be earned through speculation and capital gain only. But, the small investor of this category cannot afford the risk of speculation. They also pay the expenditures of transfer and registration of shares. While, speculators avoid transferring the shares at their own name to save the cost of transfer.

On the basis of above statistical results and common observations, we recommend the following policy measures: -

1) The Securities and Exchange Commission of Pakistan (SECP) should impose a minimum pay out ratio to discourage the tendency of higher retention.
2) The central board of revenue should continue to provide tax incentives to those firms who pay higher dividend. The tax benefit in Modarabas before 1995 is the best example of the effects of tax policy on the stock market.
3) The salaries and benefits of the directors should be correlated with the net profit of a company. A higher limit of those benefits can be imposed in the same manner as mentioned for the Investment Management Companies Ordinance for the investment advisors, the Assets Management Companies Ordinance for the trustees and the Venture Capitalists Ordinance for the funds managers.
4) The limit of paid up capital for listed companies should be enhanced further. It is the chronic problem of the small listed companies that they don't pay dividend. They will have to expand for survival and competition. So, they finance themselves through retained earnings. In case of large companies, sufficient capital may available so, companies will not create reserves through retained earnings. The size of firm is a root cause of the concentration of ownership. Only diversification will not give meaningful results unless the SECP determines the minimum capital requirements.
5) The family ownership should be discouraged. The Monopolies and Restrictive Trade Practices Ordinance should be amended and it should be arranged through policy measures that dividend policy cannot be decided for the insiders wishes. The Companies' Ordinance does not give any opportunity to small shareholders for up ward revision of the dividend. In the Australian corporate sector, a concept of corporate senate is applied. The corporate senate is a supreme body other than the Board of Directors. When a decision made by the shareholders, it goes to the corporate senate for approval. The membership of corporate senate is based on the one-shareholder one-vote basis (Not one shares one vote basis). Such a body provides a strong position to the small investors.

6) The common observation in the finance departments of public limited companies that conservative and tight regulations create excess precautions in the financial management is also verified in this study. The management concentrates on sustainability of financial ratios. So, independent decisions cannot be made. The economic theories cannot work in the presence of tight and excess regulations. Majority of companies pay their attention to maintain the working capital (or current ratio) and leverage position. In this situation, financing for growth depends largely on internal equities. In a weak capital market issuance of right shares is not a right option. So, for a leverage cautious firm, retention is the only option. Similarly, in struggle to improve the working capital position, the chances of higher dividend will decrease. To avoid such anomalies, the prudential regulations should be based on realistic freedom. The recent observation proved that corporate sector prefers the retained earning option for expansion and development. The debts facilities from bank and financial institutions are being unutilized even at the lower rate of interest. This condition will lead lower profits in banking industry and low dividend for the investors.

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