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The Impact of Dividend Policy on The Value of Firm: Mediating Role of Institutional Quality

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Abstract

One of the most significant and well extensively examined areas of financial management is the choice of dividends, however not much investigation has been done in nations with poor institutional quality, notably Pakistan. This study contributes to the body of knowledge by identifying the critical variables that, in the face of corruption, influence Pakistani companies' judgements about dividend distribution as a crucial measure of institutional quality. The current study is unique in the sense that it explores the relation of dividend payout policy of the firm on the value of the firm in the presence of mediating variable, Institutional quality IQ which is measure through control of corruption. Pakistan is developing country with low Institutional Quality. The study used quantitative approach took a sample of 484 Non-financial firms from 2010 to 2021. The Haussmann Test recommended fixed Effect technique for Regression Model. The analysis was performed in two steps first the effect Dividend distribution policy was examined on the value of a firm in the absence of mediation (Institutional Quality). The dividend distribution policy showed a positive and a strong impact on the value of the firm. In the second step with inclusion of Mediating variable Dividend policy showed negative but a significant influence on the value of the firm.

Keywords: *Institutional Quality, Payout Ratio, Signaling Theory.*

Introduction

The dividend policy of a firm, is discernible through the Dividend Payout Ratio (DPR), which denotes the proportion of a company's profits disbursed to its shareholders in the form of cash dividends. Bataha and Ilat (2023). According to signaling theory, investors interpret a dividend policy as a positive indicator for investment, as it signifies a guaranteed return on investment, which is preferable to investors. The Market-to-Book Value of Equity Ratio provides insights into the company's valuation, shedding light on the correlation between the company's expenditure and its intrinsic worth. Therefore, the company's growth potential is normally gauged through the Market-to-Book Value of Equity Ratio, suggesting that the stock price reflects, to some extent, the company's growth prospects. Consequently, the Market-to-Book Value of Equity Ratio serves as a valuable alert for prospective investors.

Research Questions

1 Does Firm's dividend policy influence Firm Value?
2 Does Institutional Quality mediate the relation between Dividend distribution policy and value of a Firm?

Research Objectives

1 To investigate the impact of dividend distribution policy on a value of a Firm.
2 To examine the relationship between the Dividend policy and value of the firm with mediating role of Institutional Quality.

Literature Review

Dividend Policy

Capital market has key mechanism that facilitates businesses in meeting their capital requirements, thereby supporting their growth and sustainability. Companies heavily rely on the capital market to raise funds from investors to fuel their operational activities and expansion plans (Przychodzen & Przychodzen, 2013). In this context, investors carefully evaluate financial statements to make informed decisions about capital allocation. A critical aspect of the firm's funding decisions is its dividend policy, which involves the distribution of profits to shareholders as dividends or their retention for future investment (Miller & Rock, 1985; Hoang et al., 2020). Investors actively participate in the capital market with the expectation of receiving returns in the forms of dividend or capital gain.

Research conducted in the past has primarily focused the developed economies and developing economies such as the United States, United Kingdom, Australia Europe, and others, as financial markets of these countries are well-regulated and well-structured further most of the firms are held by a huge and diverse investor (Nguyen and Li, 2020).

The emerging and developing economies exhibit significant variations in the business environment, economic system, market size, tax system, market structure, and company management (Hasan et al., 2021). The minority stockholders in emerging economies face rigorous tax rules and regulations, along with limited legal safeguards. Developing economies differ from industrialized markets in that they have a notable prevalence of highly concentrated companies with a restricted number of owners. Claessens et al. (2000) found that a dominant owner holds control over nearly 69% of publicly traded companies in East Asia. Young et al. (2008) found that in emerging economies, the majority shareholders possess around 50% of a company's shares, while in mature economies, this figure is around 40%. These types of differences are more communal in the enterprises of South Asia, especially in the context of Pakistani firms (Kumar, 2017).

Moreover, experimental evidences showed that emerging economies are not entirely unified with worldwide economies and their markets, which motivates the authors' interest in to conduct research study in emerging markets (Zainudin et al., 2018). Exceptional organizational, social, commercial, and political structures, are different from that of developed markets and due to the vast extension of its capital market in developed markets; there is a dire need to investigate the phenomena of profit distribution in more comprehensive way to extend the literature of finance, which is primarily characterized by an abundance of academic research done in the developed markets. Secondly, the agency conflict among the managers and owners with the impact of corporate governance investors along with majority stockholders and minority stockholders is even worse in developing economies, especially in case of Pakistan which is also developing economy (Moin et, al. 2021).

The typical trait of developing economy such as inadequate administration and weak legal structural framework in Pakistani markets. (Farooq and Noor, 2021), firm operating in Pakistani market can change their dividend distribution policy with ease and comfort due to weak governance frame work, and suits it according to insiders. Thirdly, dissimilar to Anglo American countries, where the ownership is widely distributed, Pakistani firms are mainly conquered by block holders. As the block holders in most of the cases in Pakistani firms are relatives and family. (Yousaf et al, 2019). Conferring to Javid (2012), who argued that 59%, of the total non-financial firms listed on PSX are categorized as family firms. In a family-owned firm, a board or the annual general meeting (AGM) seldom makes choices about the future of corporation. Interlocking the directors to retain simple majority helps to control, which in fact causes serious violations on the part of minority shareholders and their legal rights.

H_1: Dividend payout policy has significant effect on the value of the Firm.

Firm Value

Value of firm is the perception of investors about the firm's degree of success, which is frequently proxied with the firm stock prices. A high value of the price of share makes the value of corporation more as well. If a firm is valued highly, investors will assume that both its present and future performance prospects are great. Additionally, the investors' prosperity is directly proportional to the enterprise's stock price (Suri & Sedana, 2020). Maximization of shareholder wealth means that mangers should adopt policies that maximizes the present value of the future expected returns. Park and Byun (2022) argued that value of corporation or firm is reflected in its share price.

Value of firm explains the Management's performance in describing out the work assigned to them by the owners of the firm about the administration of the corporation (Park and Byun 2022). Owners expect one thing from the managers that is to increase their wealth as their the firm's worth reflects the goal of maximizing wealth. when the value rises, the better off the stockholders are of corporation as established by Suri and Sedana (2020).

Several studies have reexamined the effects of investments and financing decisions and their impact on firm value like for instance the research findings conveyed by Resti et al. (2019), Suartawan and Yasa (2016), Suardana et al. (2020), SyamsudinI et al. (2020), Mumpuni and Indrastuti (2021), along with Agustin and Anwar (2022), which specified that firm financing and investment decisions positively affects the value of firm. Contradictory results were presented by Komala et al. (2019), Amaliyah and Herwiyanti (2020), formerly by Attarie et al. (2018) established that investment decisions taken by the firm had no impact on firm value. The effect of managers' investment decisions on the firm's value has been the subject of numerous academic articles that have used moderating variables to examine the relationship between managers' choices in capital structure and the firm's performance. Other studies have looked at the relationship between good corporate governance and debt as a moderating variable (Ardini et al. 2022; Pramartha et al. 2020) and tested the dividend distribution policy of a firm (Juwinta et al. 2021).

The optimal mix of three most important financial management decisions that a finance manager has to take regarding effectively executing his investment decisions, funding decisions, and dividend policies can enhance the firm's value. in fact, each decision about the polices taken by the corporation is related to one another (Ernayani et al., 2017).

Fatma, and Chouaibi (2021) examined the role of corporate strategic decisions and its role in determining the firm value. They found a positive significant relationship among the corporate decisions and firm value; the study took a sample of 109 financial institutions in twelve different European markets for the period of 2007 to 2019.

Liu, Qing Li, and Yu-En Lin, (2023) conducted on the corporate transparency measured by institutional quality and its influence on the value of firm in the United States they used panel data approach by taking a sample of 12,665 observations for the period end, representing 1,644 individual firms form the year 1996 to 2018. Their sample included banks and investment banks they concluded that stronger transparency of the market and Increasing the value of a company is positively influenced by the improvement of the company itself, and the presence of competition in the market further strengthens this link.

In their study, Abdullah and Rasul (2023) investigated the impact of a corporation's dividend distribution policy on its value within the financial sector of an emerging country. In addition, they examined the impact of adopting IFRS accounting standards and eliminating the mandatory dividend distribution policy, while also taking into account the Lintner model of dividend smoothing. The study utilized a sample of 111 companies registered on the Borsa stock exchange in Istanbul, Turkey, operating in the financial sector, throughout the time frame of 1995 to 2017. The study's findings revealed a strong and statistically significant correlation between the dividend policy and the firm's worth after adopting IFRS norms.

Institutional Quality

An issue that arises throughout this entire body of literature is the presence of both consensus and differences regarding the definition of institutional quality. The phrase "institutional quality" is highly encompassing, and a cursory examination of the aforementioned studies clearly reveals the absence of a universally accepted definition. Charles Sawyer (2011). The author asserts that institutional excellence is a concept that is universally comprehensible. Providing a comprehensive definition of it is a slight challenge. Amidst the present circumstances, the optimal choice for institutional quality remains uncertain among the several options available.

For the purpose of providing a theoretical framework for the depiction of companies, the phenomena of institutional theory has been extensively and often applied.' behaviors about firm corporate decisions under various institutional dimensions. There is a bulky and increasing literature on the impact of quality of environment institutions has on its Value (Vatn, 2020; Karmanni &Boussada, 2021; Dong et al, 2022; Kaufman & Lafarre, 2021).

The institutional setting of a country has a significant impact on the efficacy, legitimacy, and efficiency of corporate strategies, is known as the "rules of the game." These rules have a substantial influence on daily operations and the decision-making process of a firm, which can also shape management behaviour towards sustainable objectives.. This technique is referred to as institutional equality within the macroeconomic context (Drucker, 1984). The relationship between institutional quality characteristics and corporate performance is hypothesized, indicating how the macro institutional environment shapes the performance of a firm. Furthermore, firms that actively prioritize sustainable performance can achieve the objectives set by shareholders, given the backdrop of well-established formal institutional systems. They fulfill shareholders' expectations more effectively (Laczniak and Murphy, 1991). To cater to a broader group of individuals with an interest in the company, it is necessary for the firm to uphold certain criteria and assess its level of acceptability, which in turn affects its reputation (Dong et al., 2017).

Ellahie and Kaplan (2023) conducted a similar study exploring the relationship among the dividend distribution polices in the nations with weak institutions. This variable measures the efficacy of the government, the quality of regulations, the rule of law, and the control of corruption. It is part of the World Bank's Global Governing Indicator database, and which also measures other elements of institutions. The researchers discovered a weak negative correlation between Dividend Policy and the quality of institutions. They validated what is already known: businesses in less developed nations are more likely to pay dividends at an earlier stage of their lifecycle, have a more rapid rate of adjusting to their desired payout ratio, and are more likely to publicly declare a dividend policy that promises to pay a certain percentage of their earnings.

Pakistan exhibits lower institutional quality due to an inefficient legal system, less enforceable investor protection laws, widespread corruption across all societal sectors, and political instability that obstructs financial development and subsequently economic growth (Ahad and Imran, 2023). Countries with elevated levels of corruption, limited transparency, and inadequate accountability suffer from the absence of stable institutions and financial sectors.

H_2: Dividend payout policy has significant effect on the value of a firm through mediation of Institutional Quality.

Theoretical Framework

Agency Theory

The perception of an agency cost association represents that a manager referred to as an (agent) and shareholder referred (principal) acts in their personal interests which creates conflict of interest, which yields in high costs of the enterprise, normally recognized as "agency costs" (Hoang et al. 2019). The relation among dividend distribution decisions and the value of the firm is affected by agency problems. Louziri and Oubal (2022) argued that company's dividend distribution policy can align the interests of managers with interests of shareholders, which makes it possible to decrease agency costs. Certainly, the clarifications presented by the scholar to describe why a company should pay dividends. One reason is to control the agency cost which is reduced by paying dividend. By controlling the managers, shareholders reduce the availability of cash flows through which they avoid unnecessary spending by the managers. Secondly the cost of risk aversion by firm managers.

Eluyela et al. (2019), explored the dividend pattern and agency cost relationship they reported that mature companies give more dividends as to reduce the agency costs. The findings of their study were in line with that of Grace et al. (2019) who examined the relationship among sales growth, leverage and dividend policy. The findings of their study validated the Agency theory.

Signaling Theory

According to this notion, the corporation distributes dividends to shareholders as a means of indicating the company's anticipated future profitability (Trisna & Gayatri, 2019). An increase in dividends is a positive indicator of future high earnings, but a fall in dividends suggests a projection of low profits in the future. Furthermore, a favorable dividend distribution signifies proficient earnings management and promising future prospects for the organization.

Ariani, et, al. (2023). The authors explained, based on the signaling hypothesis, dividends serve as a mechanism to mitigate the information imbalance between a corporation and an investor. Investors can assess a company's financial position and cash flow by analyzing the magnitude of dividend payments. Additionally, dividend payments can serve as a tool for investors to forecast the company's future prospects.

Kanojia and Bhatia (2023). Analyzed the impact of a company's dividend policy on its signaling effects in emerging markets (India, Brazil, China, and Taiwan) throughout the period of 2010 to 2020, based on data from 4,630 company observations. The Indian market demonstrates a higher level of responsiveness to the signaling model, although no similar reactions were observed in the Brazilian and Taiwanese markets. In addition, the study found that the Lintner partial adjustment model indicated that Indian companies change their dividends at a somewhat slower pace than corporations in other rising countries such as China, Brazil, and Taiwan. The researchers discovered that the Lintner model is the result of whether or not the idea of dividend signaling is applicable in these developing economies.

Theoretical Frame Work

Figure No1: Theoretical Frame Work

Methodology

Population and Sampling

The study uses Panel Data as. from year 2010 to year 2021 of 484 non-financial companies. At the time of study there were a total of 676 firms, listed at Pakistan stock exchange the study included 484 non-financial firms through purposive sampling.

Operational Definitions

Dividend Policy

It refers to the percentage of profit distribution form the Net income of the company to its shareholders (owners). Siregar (2019).

$$\text{Payout Ratio} = \frac{\text{Distribution Amount}}{\text{Net Income}}$$

Firm Value

It is an economic measure reflecting the market value of business. It shows how effective is the management performance. It is calculated by dividing Firms Market share price on total value of Book Equity Rahmawati, & Darmawan (2021).

$$\text{Firm Value} = \frac{\text{Market Price of Firm's Share}}{\text{Total value of Book Equity}}$$

Institutional Quality

Institutional quality encompasses the comprehensive aspects of law, control of corruption, and effective government regulation and services. Ricardo & Buitrago (2021) utilized the World Bank's Worldwide Governance Indicators database, which encompasses many indicators to assess the overall quality of institutions. These indicators include government effectiveness, the accountability and voice, the quality of regulatory framework, rule of the law, and control of corruption. It is measured by World Bank Index. The study takes control of corruption, as a measure of institutional quality. The data for indices is retrieved from

the data bank of World Bank available on the website i.e. databank.worldbank.org/Institutional-Quality.com.

Model

$Y = \beta_0 + \beta_{1it}\ DIV_{1it} + \beta_{2it}\ INSTQ + €_t$

Where.

Y = represents Firm value
DIV = represents Dividend Policy
INSTQ = represents Institutional Quality in the above Model

Without Mediation

$Y = \beta_0 + \beta_{1it}\ DIV_{1it} + €_t$

Mediating variable become Dependent Variable

$M = \beta_0 + \beta_{1it}\ DIV_{1it} + €_t$
Where M is the mediating variable i.e., INSTQ Institutional Quality

Analysis

Table 1: Hausman Test

	---coefficients---			
	(b) fixed	(B) random	(b-B) difference	sqrt(diag(v_b-V_B)) S.E
Payout ratio	-17322.76	-11876.05	-5446.706	1855.688
control of corru	-217.5651	-159.9049	-57.66013	17.11053
int_coc	1209.919	1035.352	174.5672	87.06817

b = consistent under Ho and Ha; obtained from xtreg
B = inconsistent under Ha, efficient under Ho; obtained from xtreg
Test H_0: difference in coefficients not systematic
Chi 2 (3) = (b-B) { (V_b-V_B) ^ (-1)} (b-B)
= 18.79
Prob > Chi2 = 0.0003

The current study has used panel data as it has taken 484 Non-financial firms listed at Pakistan stock exchange PSX from year 2010 to year 2021. So, there is no possibility of the data to be pooled data. The Hausman test was employed to check for whether to use fixed effect model or random model, the null hypothesis result revealed that Random Effect (RE) should be applied, over the Fixed Model (FE) as the p value of 0.000 < 0.05, which suggests for the rejection of Null hypothesis, and accepting the alternate hypothesis suggesting that fixed effect technique should be used as the p value is less than 0.05 as shown in table 1.

Table 2: Fixed Effect Regression Model

Fixed effects within regression				Number of Obs	=5,854	
Group variable: Serial				Number of Groups	=468	
R - Sq:				Obs per group:		
within = 0.0197				min	=1	
between = 0.1443				avg	=10.6	
Overall =0.0702				max	=12	
				F (3,4492)	=30.07	
				Prob > F	=0.0000	
corr(u_i, Xb) = 0.1473						
Log of Firm value	Coef.	Std. Err.	t	P > | t |	[95% conf. interval]	
Payout ratio	0.2082412	0.0701261	2.97	0.003	0.0707596	0.3457228
_cons	0.058624	0.1160734	69.43	0.000	7.831063	8.286185
sigma_u	1.1393711					
sigma_e	0.94059151					
rho	0.59470387	(fraction of variance due to u_i)				
F test that all u_i = 0: F(467, 4492) =14.86						
Prob > F = 0.0000						

As per the recommendations of Haussmann Test Fixed effect Model is applied. Firm value as dependent variable is checked with independent variable payout policy of the company. The result form the fixed effect technique also validates the recommendation of Haussmann Test as the F statistic value is 0.000 which is less than 0.05 suggesting the model to be a good fit.

The co efficient values in the table 2 are suggesting the magnitude of impact of independent variable over dependent variable. Which says if Payout ratio of the firm is increased by one percent it will bring an increase in the value of the firm by 20 units. Which shows a positive and significant impact on the value of the firm which also calls for the rejection of Null hypothesis and calls for the acceptance of the alternate hypothesis H_3 that states Dividend payout policy has significant impact on the value of the company. (Agustin, & Anwar. 2022).

The table 3 below shows the output of the regression Model with the inclusion of Mediation effect of Mediating variable i.e. Institutional Quality proxied by control of corruption. The results of the model in case of Mediating variable suggests that Model is a good fit as verified by the Prob > F value 0.000 which is less than 0.05 indicating the verification of the model goodness to fit.

In the presence of the mediating variable control of corruption shows that independent variable payout policy of the company has a negative but significant impact on the Value of the company or firm so null hypothesis of the study is rejected while alternate Hypothesis of the study H_3 is accepted which claims that Dividend payout policy has also a significant impact on the value of the firm, through mediation of Institutional Quality. (Wario, Ali and Nassir 2022), (Bhaumik et, al, 2012). The results of contradicted with findings of Matemilola et, al. (2022).

Table 3: Mediation Analysis Institutional Quality: Control of Corruption

xtreg control of corruption payout ratio, fe						
Fixed effects withi regression				Number of Obs	5,854	
Group variable: Serial				Number of Groups	488	
R - Sq:				Obs per group:		
within = 0.1154				min	11	
between = 0.0008				avg	12.0	
overall = 0.0371				max	12	
				F (3,5362)	233.06	
				Prob > F	0.0000	
corr(u_i, Xb) = 0.1473						
Control of corruption	Coef.	Std. Err.	t	P > | t |	[95% conf. interval]	
payout ratio	-4.052743	0.2320539	-17.46	0.000	-4.50766	-3.597823
_cons	22.56644	0.1877823	120.17	0.000	22.19831	22.93457
sigma_u	1.5819521					
sigma_e	3.1546069					
Rho	0.20094339	(fraction of variance due to u_i)				
F test that all u_i= 0: F(487, 5362) = 0.75 Prob > F = 0.0000						

The below table 4 shows the results of fixed effect regression analysis with mediating variable institutional quality, which is measured through control of corruption. The value of Prob > F 0.000 suggesting the model goodness of fit as the value is less than 0.05 which verifies that model is a good fit. As looking into the variable of institutional quality measured by control of corruption establishes that if the value of control of corruption is increased by 1 percent it will decrease the value of the firm by 0.06 units. Which shows that institutional quality has an inverse relationship with the value of the company. Further the relationship is found to be insignificant as shown by the P value of 0.148 as it is greater than .05 which verifies that the relationship between control of corruption and value of the firm is insignificant. The findings are in the contradiction with (Ahad and Imran 2023; Karmani, & Boussaada 2021).

The variable payout policy has shown a positive impact on the value of the firm. As it recommends that if payout ratio of a firm is increased by 1 percent the value of the firm will be increased by 18.31 units. Further the payout policy of firm shows a significant association with the value of the firm through a P value of 0.011 < 0.05 which verifies that the association is significant similar to (Hoang et al. 2021; Liu, et al 2023).

Table 4: Regression with the presence of Mediation Institutional Quality; Control of corruption

xtreg log of firm value controlof corruption payoutratio, fe	
Fixed effects within regression	Number of Obs 5,854
Group variable: Serial	Number of Groups 488
R - Sq:	Obs per group:
within = 0.0201	min 1
between = 0.1436	avg 10.6
overall = 0.0694	max 12
	F (3,4493) 30.66
	Prob > F 0.000
corr(u_i, Xb) = 0.1479	

Control of corruption	Coef.	Std. Err.	t	P > | t |	[95% conf. interval]	
Control of corruption	-0.0063337	0.0043501	-1.46	0.145	-0.014862	0.0021947
payout ratio	0.182726	0.0722095	2.53	0.011	0.0411599	0.3242921
_cons	22.56644	0.1445121	56.87	0.000	7.935386	0.502016
sigma_u	1.1416684					
sigma_e	0.94036516					
Rho	0.59579042	(fraction of variance due to u_i)				
F test that all u_i = 0: F(467, 4493) = 14.90						
Prob > F = 0.0000						

Findings and Conclusions

The present study made an attempt to explore the association among the dividend distribution policy of the firm on its value in the presence of Institutional quality as Mediating variable. The study included 484 non-financial firms for the period starting form 2010-2021 in its sample. The study is conducted because Pakistan is an emerging economy with weak institutional frame work (Ahad and Imran, 2023). So the current study made an attempt to look whether the major corporate decisions are affected by the weak institutional effect. Or if there is any impact of weak institutional quality on the firm decisions behavior. It is found that Dividend payout policy has significant impact on the value of the company. Which validated Agency theory in the light of profit distribution policy along signaling hypothesis in regard to dividend payout ratio.

Upon examining the institutional quality effect on value of the firm through the dividend payout policy of the firm has revealed that institutional quality positively and significantly effects the value of the firm which establishes the signs of mediation role (wario, Ali, and Nassir 2022).

So, it is concluded that weak institutional quality (Control of Corruption) in Pakistani market influences the capital structure decisions and dividend distribution decisions of the firm negatively along with growth of the firm. Which shows that there is a mediating role of institutional quality in influencing major corporate decisions taken by Manager.

Limitations

The study has used only cash mode for measuring the dividend payout ratio of a firm. Further the study has only taken Non-financial sector in the sample, hence it ignored the financial sector of Pakistan.

Future Directions

As the current study had ignored the financial sector future studies can be carried out by including financial firms in the sample further other forms of dividends like stock dividends and stock repurchases can also be tested by scholars in the future

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