Impact of Dividend Policy on Capital Structure: A Study of Select Indian Companies (BSE 30)

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Abstract

This research paper examines the relationship between dividend policy and capital structure (financial leverage) of 30 companies listed on Bombay Stock Exchange during the period 2008 to 2019. Panel data was used in this study. The study made use of secondary data from annual reports of the selected companies and Prowess CMIE data base. Debt-Equity ratio was used as the Dependent variable whereas Dividend Payout ratio had taken as independent variable in the study. Few variables such as Profitability, Size, Current Ratio, Investment opportunity and Business Risk had been taken as proxy variables in the selected model to study the impact of Dividend policy on Capital Structure of the firm. At first, descriptive analysis was used to identify the preliminary relationship among the selected variables, followed by multiple regression analysis. The sample size was divided into two sub categories: Banking & Financial Sectors and Other Sectors (Remaining companies). The results of the study revealed that there is a significant impact of Dividend policy on Capital structure of the selected firms (BSE 30). All the hypotheses were evaluated at 5% level of significance. The research paper recommended that companies must focus on Dividend payout ratio along with other proxy variables while deciding the capital structure of the firm.

INTRODUCTION

The determination of capital structure plays a very important role in each firm. A Proper mix of debt funds and equity funds always gives economic benefits to companies. "Capital structure mix" affects decisions making in a firm. When the decision is taken by for financing increment in assets with the involvement of fixed cost, this indicates that the firm has introduced financial leverage in the financial structure. Hence, financial leverage could be expressed in the terms of "ratio of debt to total fund". Leverage is being used by the company as an instrument through the calculation of costs and benefits which are required to be earned by stockholders. This technique is employed by management more frequently for increasing the "company's return on equity capital".

Prasanna Chandra[1] has defined leverage as "the extent to which the firm has fixed operating costs or the extent to which the firm has fixed financing costs arising from the use of debt capital."

As per **M.Y. Khan and P.K. Jain**[2] "Leverage may be explained as the employment of an asset (Fixed) or sources of funds for which the firm has to pay a fixed cost or fixed return as interest.''

Financial Leverage can be referred to as the employment of securities or a source of finance that has a fixed charge involved. The concern of any firm here will be towards fulfilling a contractual obligation and still changes in "Earnings before Interest and Tax (EBIT)" should be higher than "Earning per Share (EPS)".

Table 1: Parameters of Financial Leverage

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[1]   Chandra, P. (2007). *Financial Management: Theory and Practice*. Sixth Edition. New Delhi. Tata McGraw Hill Publishing Company Ltd. p. 505

[2]   Khan, M. Y., & Jain, P. K. (2019).*Financial Management: Text, Problems and Cases*. Eight Edition. New Delhi. Tata McGraw Hill Publishing Company Ltd. p.18.3

Sr. No.	Parameters	Ratios
1	Financial Leverage	Debt Equity Ratio

The **"dividend policy"** of any firm determines the proportions[3] of earning that is paid to the shareholders through dividends and the amount which is invested back in the firm for the purpose of reinvestment. The "dividend policy" is based on the choice of financing. In case, a decision related to the capital budgeting of any organization is dependent on a dividend decision, then higher payment of dividends would cause shrinkage of the capital budget, this effect could also be vice versa.

In this study, the researcher has used the dividend payout ratio as a measure of dividend policy following Aivazian et al. (2003), Amidu and Abor (2006), and Musiega etal. (2013). Due to the non-availability of data for DPS, DPR has been taken for the study.

The researcher selected five determinants[4] of leverage association with capital structure theories for analyzing the association between dependent and independent variables.

Table 2: Parameters of Dividend Policy

Sr. No.	Parameters	Ratios
1	Profitability	EBIT to Total Assets
2	Size	Natural Log of Total Assets
3	Liquidity	Current Ratio
4	Investment Opportunities	Market Value of Equity to Book value of Equity
5	Business Risk	Difference between Operating Profit in current year divided by Operating Profit in previous year
6	Dividend Policy	Dividend Payout Ratio

LITERATURE REVIEW

Asif, Rasool and Kamal (2011) examined the association between financial leverage and dividend policy of 403 companies, listed on the KSE (Karachi Stock Exchange) during the period 2002 to 2008. The panel data was used and regression model was applied to study the impact of financial leverage over dividend policy on the selected companies. The model revealed that there is a significant impact of leverage and dividend yield on DPS but the leverage association is negative with DPS. The researcher recommended injecting a judicious amount of equity to get a better capital structure along with a leverage ratio.

Javed (2012) conducted a study to explore the impact of financial leverage on the dividend policy in Pakistan. The sample in the study included 30 companies listed on Karachi Stock Exchange. The period of the study is five years from 2005 to 2010. A multiple regression model has been applied to examine the impact of financial leverage on dividend per share of the selected companies. The result showed that the debt management system of the firm is not performing and selected companies are unable to increase their profitability which leads to a decrease in the dividend per share.

Farahani and Jhafari (2013) examined the relationship between financial leverage and dividend policy. 33 Food Companies were selected from Tehran Stock Exchange during the period 2003-2010. Regression (Fixed and Random Effect models) on panel data was applied to find the relationship between two variables. The results revealed a positive effect on variables in dividend yield and change income, but no meaningful relation was found between debt ratio and DPS.

Khan et al. (2013) discussed in the research paper that dividend declaration represented the income and profitability of the firms in a country. This study has its main focus on examining the impact of profitability and leverage on the dividend payout policy of the firms belonging to the Pharmaceuticals and Chemicals industry. This study is based on 34

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3   Satheeshkumar, R. (2005). *A study of capital structure Leverage and Dividend policy of Sambandam spinning mills limited Salem* [Doctoral dissertation, Department of Commerce. Periyar University].INFLIBNET. http://hdl.handle.net/10603/23138. p.2

4   Kaur, R. (2018). *Capital Structure dividend policy and their interrelation a study with reference to select Indian companies*[Doctoral dissertation, Department of Commerce. The University of Burdwan].INFLIBNET. http://hdl.handle.net/10603/257407

firms for a period from 2003-2010. The regression model confirmed the overall significance of the model and also indicated that independent variables have been responsible for a 49.7per-cent change in dependent variables. These statistics indicated that there is an existence of a relationship concerning this issue. The result revealed profitability of a firm positively affected dividend payout while the leverages have "no significant effect" on a firm's dividend payouts. Further, the control variable i.e. log of the total assets positively affected the dividend payout of the two industries. The decline in stock prices affected funds flow towards finance and they also affected debt financing eventually.

Kaur (2018) conducted a study on the analysis of factors of capital structure and dividend policy and their interrelationship. The researcher focused on three capital structure theories, Peacking Order Theory, Trade off Theory and Agency Cost Theory. Panel Data Regression Technique was applied to study the relationship between variables. 90 companies were taken into consideration. The results of the study revealed that profitability, size, liquidity, income variation, Non debt Tax Shield and growth were observed as major determinants of capital structure of selected companies belongs to various industries. Researcher used Granger Causality Test to determine the relationship. The findings of the study revealed that there was no significant relationship between leverage ratio and dividend payout ratio.

METHODOLOGY

Research Methodology provides information regarding the manner which will be followed while conducting research. It describes a procedure that has been followed by the researcher.

RELEVANCE OF THE STUDY

The main purpose of this study is to analyze the impact of Dividend Policy on financial leverage. The study will help the financial manager of the organizations to understand the linkage of leverage with Dividend policy along with some proxy variables, so that firm can minimize its cost of capital and maximize the return to its stakeholders. The study will also help the investors to take their investment decisions with respect to the risk associated with the capital mix in the organization. Intermediates, investment companies, and financial institutions are some other parties that can take the benefits from this study from a different perspective of return on shareholder's wealth.

OBJECTIVES OF THE STUDY:

1. To study the capital structures pattern of selected companies

2. To study the impact of dividend on leverage of the selected firms.

3. To study the impact of other variables (Proxy variables-already mentioned) on financial leverage of the selected firms

HYPOTHESIS OF THE STUDY

H_01: There is no significant impact of the dividend policy of the firm on financial leverage.

$H_01.1$: There is no significant impact of the dividend policy of the firm on financial leverage of Banking and Financial services sectors.

$H_01.2$: There is no significant impact of the dividend policy of the firm on financial leverage of other sectors.

RESEARCH DESIGN

This study is based on an analytical research design. The analytical research design involves the evaluation of facts and information. This design requires the researcher to have critical thinking skills so that he or she could understand the cause-effect relationship between two or even more than two variables.

VARIABLES OF THE STUDY

For analyzing Financial Leverage, the debt-equity ratio has been considered. But the ratio of financial leverage taken in this study is different from the common debt-equity ratio that is applied to companies belonging to Banks and financial services sectors. The variables included in the Dividend Policy are Profitability, Size, Current Ratio, Investment Opportunity, Business risk, and Dividend Payout Ratio.

1. **Financial Leverage:** D/E Ratio (Debt Equity Ratio)

2. Dividend Policy: Profitability: (PAT/Total Shareholder's Wealth), Size (Total Assets), Liquidity: CR (Current Ratio), Investment Opportunity, Business Risk, DPR (Dividend Payout Ratio)

ACCOUNTING ANALYSIS OF VARIABLES

1)   FINANCIAL LEVERAGE ON PROFITABILITY OF FIRM

1. Debt Equity Ratio (For Other Companies) = Debt/Equity[5]

2. Debt Equity Ratio (For Banking and Financial Services) = Tier 1 Capital / Total[6] Assets

2)   DIVIDEND POLICY[7]

1. Profitability = PAT/Total Shareholder's Funds

2. Size = Natural Log of Total Assets[8]

3. Current Ratio/Liquidity = CA/CL

4. Investment Opportunity = Market Value of Equity/Book Value of Equity

5. Business Risk = (Operating Profit$_{CY}$ – Operating Profit$_{PY}$)/Operating Profit$_{PY}$

6. Dividend Payout Ratio = DPS/EPS

TIME PERIOD OF THE STUDY

In this study, the period has been considered from the year 2008 to 2019. A period of 12 years has been considered so that an overview of the impact which one variable has on the other could be understood analytically.

SAMPLING METHOD

30 companies that are a part of BSE's Sensex as shown in Table 3 for the study have been chosen as on dated 23rd November 2021. The following are the companies that have been selected for studying Financial Leverage and Dividend Policy.

Table 3: List of Companies in BSE30 Index

Sr. No.	Company Name	Industry
1	Asian Paints Ltd.	Furniture, Furnishing
2	Axis Bank Ltd.	Banks
3	Bajaj Finance Ltd.	Finance (including NBFCs)
4	Bajaj Finserv Ltd.	Holding Companies
5	BhartiAirtel Ltd.	Telecom Services
6	Dr. Reddy'S Laboratories Ltd.	Pharmaceuticals
7	H C L Technologies Ltd.	IT Consulting & Software
8	H D F C Bank Ltd.	Banks
9	Hindustan Unilever Ltd.	Personal Products
10	Housing Development Finance Corpn. Ltd.	Housing Finance
11	I C I C I Bank Ltd.	Banks
12	I T C Ltd.	Cigarettes, Tobacco Products
13	Indusind Bank Ltd.	Banks

[5]   Aggarwal J. (2014). Ph. D. Thesis titled "Comparative study of impact of financial leverage on the financial performance of selected Indian industries". School of Commerce. Gujarat University, p. 86

[6]   Jain S. (n.d.). *Leverage Ratios for Banks*. Retrieved June 28,2022 from the world wide web: https://www.wallstreetmojo.com/leverage-ratios-for-banks/#:~:text=Aper-cent20bank'sper-cent20leverageper-cent20ratioper-cent20indicates,otherper-cent20securitiesper-cent20afterper-cent20subtractingper-cent20goodwill, fetched on 28/6/2022

[7]   Kaur R. (2018). Ph.D. Thesis titled "Capital Structure dividend policy and their interrelation a study with reference to select Indian companies". Department of Commerce. The University of Burdwan, p. 263

[8] Natural log required for non-ratio variables

14	Infosys Ltd.	IT Consulting & Software
15	Kotak Mahindra Bank Ltd.	Banks
16	Larsen & Toubro Ltd.	Construction & Engineering
17	Mahindra & Mahindra Ltd.	Cars & Utility Vehicles
18	Maruti Suzuki India Ltd.	Cars & Utility Vehicles
19	N T P C Ltd.	Electric Utilities
20	Nestle India Ltd.	Packaged Foods
21	Power Grid Corpn. Of India Ltd.	Electric Utilities
22	Reliance Industries Ltd.	Integrated Oil & Gas
23	State Bank Of India	Banks
24	Sun Pharmaceutical Inds. Ltd.	Pharmaceuticals
25	Tata Consultancy Services Ltd.	IT Consulting & Software
26	Tata Steel Ltd.	Iron & Steel/Interm.Products
27	Tech Mahindra Ltd.	IT Consulting & Software
28	Titan Company Ltd.	Other Apparels & Accessories
29	Ultratech Cement Ltd.	Cement & Cement Products
30	Wipro Ltd.	IT Consulting & Software

Source: Website of Bombay Stock Exchange

DATA COLLECTION

This study is based on secondary data collection to achieve research objectives. The data has been collected through various sources like the Prowess database developed by CMIE, the company's websites, and the website of the Bombay Stock Exchange, National Stock Exchange, moneycontrol, etc.

STATISTICAL TECHNIQUES USED

The data has been analyzed by applying suitable statistical techniques like Descriptive statistics, Correlation, Multiple regression, ANOVA, etc. with the help of SPSS software.

RESEARCH GAPS

It is quite evident from the review of the above research studies that in India, very limited research work has been done in Oil & Gas Industry, Hotel Industry, Consumer Durables Industry, and Capital Goods Industry. India is a developing country and there is a remarkable change in the economy and rate of interest after 2010. The methods applied for analyzing the data collected from different sources were also different. The results of the empirical literature on the relationship between financial leverage and financial performance are contradictory which justifies further research. This study intends to cover the most debatable variables to further clarify the relationship among variables.

DISCUSSION AND CONCLUSION

The variables have been analyzed using arithmetic mean and percentage. For analyzing the impact of one variable on the other, Linear Regression and Multiple Regression has been applied through SPSS 20. Based on the result as indicated by SPSS 20, the hypothesis framed for finding out the impact of one variable on the other has been accepted or rejected.

IMPACT OF DIVIDEND POLICY ON FINANCIAL LEVERAGE

H_01: There is no significant impact of dividend policy of the firm on financial leverage

For testing the above hypothesis, Multiple Regression has been applied through SPSS 20. Financial Leverage has been considered as the dependent variable and the independent variable considered for regression is Dividend Policy. The following variables are included as proxies in the regression model for Dividend Policy: Profitability, Size, Current Ratio, Investment Opportunity, Business risk, Dividend Payout Ratio.

Mathematical Equation of Multiple Regression analysis for selected model of the study:

F L = α + β1 (Profitability) + β2 (Size) + β3 (Current Ratio) + β4 (Investment Opportunity) + β5 (Business Risk) + β6 (Dividend Payout Ratio)

The companies considered in this study have been divided into two segments i.e. Banking and Financial Services Sector and the other companies.

(A) Companies from Banking and Financial Services Sector

IMPACT OF DIVIDEND POLICY ON FINANCIAL LEVERAGE

Table 4: Summary Statistics-Impact of Dividend Policy on Financial leverage

Relationship	Banking and Financial Service Sector			
	Statistics	t Stats	Sig Value	Hypothesis Decision
	F=10.537		0.000	
P $\longrightarrow$ FL	$\beta 1$= -.246	-2.18	0.032	
S $\longrightarrow$ FL	$\beta 2$= .021	0.164	0.870	
CR $\longrightarrow$ FL	$\beta 3$= -.580	-4.011	0.000	
IO $\longrightarrow$ FL	$\beta 4$= .139	1.151	0.252	Reject Null
BR $\longrightarrow$ FL	$\beta 5$= -.098	-1.149	0.253	
DPR $\longrightarrow$ FL	$\beta 6$= .213	2.228	0.028	
	R^2=.385			
Note: FL: Financial Leverage; P: Profitability; S: Size; CR: Current Ratio; IO: Investment Opportunity; BR: Business Risk; DPR: Dividend Payout Ratio; β: Regression Coefficient				
Source: SPSS's Calculation				

The above table (Table 4) has been generated by application of Multiple Regression through SPSS 20. The value of β indicates the regression coefficient between the independent and dependent variable. The correlation between Financial Leverage (debt equity ratio) and Dividend Policy is 0.620. The value of R square indicates the proportion of variance in dependent variable i.e. financial leverage which is explained by independent variable i.e. Dividend Policy. The value of r square is 0.385.

The significant value in the above table is 0.000. While testing the hypothesis, 5per-cent level of significance has been applied and this indicates that the significant value needs to be compared to 0.05. The significant value 0.000 and it is less than 0.05, hence this indicates that the null hypothesis i.e. **H$_0$1.1:** There is no significant impact of the dividend policy of the firm on financial leverage of Banking and Financial services sectors has been *rejected* and the independent variable i.e. Dividend Policy has a significant impact on the dependent variable i.e. financial leverage (debt-equity ratio).

Financial Leverage = 120.500 – .246 (Profitability) + .021 (Size) – .580 (Current ratio) + 0.139 (Investment opportunity) – .098 (Business risk) + .213 (Dividend Payout ratio)

The above equation has been derived through the application of Multiple regression from SPSS 20. In the above table the significant value for each independent variable has also been mentioned and it ranges from 0.000 to 0.870. All the independent variables have made a different impact on the dependent variable i.e. financial leverage. The significant value of three variables are less than 0.05 i.e. profitability, current ratio and dividend payout ratio and the analysis suggests that these variables have a significant impact on financial leverage.

(B) Companies from Other Sector

Impact of Dividend Policy on Financial Leverage

Table 5: Summary Statistics-Impact of Dividend Policy on Financial leverage

Relationship	Other Sectors			
	Statistics	t Stats	Sig Value	Hypothesis Decision
	F=12.129		0.000	
P $\longrightarrow$ FL	$\beta 1$= -.238	4.256	0.000	
S $\longrightarrow$ FL	$\beta 2$= .283	4.093	0.000	
CR $\longrightarrow$ FL	$\beta 3$= .286	-3.515	0.001	Reject Null

IO ⟶ FL	$\beta4= .088$	1.261	0.208	
BR ⟶ FL	$\beta5= -.008$	-0.146	0.884	
DPR ⟶ FL	$\beta6= -.203$	-3.015	0.003	
	$R^2=.229$			
Note: FL: Financial Leverage; P: Profitability; S: Size; CR: Current Ratio; IO: Investment Opportunity; BR: Business Risk; DPR: Dividend Payout Ratio; β: Regression Coefficient				
Source: SPSS's Calculation				

The above table (Table 5) has been generated by application of Multiple Regression through SPSS 20. The value of β indicates the regression coefficient between the independent and dependent variable. The correlation between Financial Leverage (debt equity ratio) and Dividend Policy is 0.479. The value of R square indicates the proportion of variance in dependent variable i.e. Financial Leverage which is explained by independent variable i.e. Dividend Policy. The value of r square is 0.229.

The significant value in the above table is 0.000. While testing the hypothesis, 5per-cent level of significance has been applied and this indicates that the significant value needs to be compared to 0.05. The significant value 0.000 and it is less than 0.05, hence the null hypothesis has been *rejected* i.e. **$H_01.2$:** There is no significant impact of the dividend policy of the firm on financial leverage of other sectors and this indicates that the independent variable i.e. Dividend Policy has a significant impact on the dependent variable i.e. financial leverage (debt-equity ratio).

Financial Leverage = -101.303 + 0.283 (Profitability) + .286 (Size) – .238 (Current ratio) + 0.088 (Investment opportunity) – 0.008 (Business risk) – 0.203 (Dividend Payout ratio)

The above equation has been derived through the application of Multiple Regression from SPSS 20. In the above table the significant value for each independent variable has also been mentioned and it ranges from 0.000 to 0.884. All the independent variables have made a different impact on the dependent variable i.e. financial leverage. The significant value of four variables is less than 0.05 i.e. profitability, current ratio, size and dividend payout ratio and the analysis suggests that these variables have a significant impact on financial leverage.

FINDINGS AND RECOMMENDATIONS

FINDINGS

The impact of the Dividend Policy on Financial Leverage has been analyzed through Multiple regression which has been applied through SPSS 20. Financial Leverage has been considered as the dependent variable and the independent variable considered for regression is Dividend Policy. The variables included in the Dividend Policy are Profitability, Size, Current Ratio, Investment Opportunity, Business risk, and Dividend Payout Ratio. While testing the hypothesis, a 5per-cent level of significance has been applied and this indicates that the significant value needs to be compared to 0.05. The significant value is 0.000 (Banking and Financial Sectors and Other Sectors) and it is less than 0.05, hence the null hypothesis has been rejected i.e. **H_01:** There is no significant impact of the dividend policy of the firm on financial leverage and this indicates that the independent variable i.e. Dividend Policy has a significant impact on the dependent variable i.e. financial leverage (debt-equity ratio).

MANAGERIAL RECOMMENDATIONS

As a financial manager, companies need to manage different factors of dividend policy for managing the financial leverage of the firms. Companies should manage asset size, liquidity, investment opportunity, and Business risk in advance to reduce the negative impact on leverage.

LIMITATIONS

- This study covered only the financial information about selected companies and ignored the qualitative aspects for valuation.

- Resources in terms of time and money were limited at the disposal of the researcher.

- Limitations of secondary data may be present in the study. However, the data has been collected from authentic sources.

- The research covered only 30 companies listed on BSE.

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