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Aims and Scope

The Journal of ARSYM (JARSYM) is a refereed bi-annual journal committed to publishing undergraduate research papers of the Faculty of Business Studies and Finance, Wayamba University of Sri Lanka. The JARSYM publishes theoretical and empirical papers spanning all the major research fields in business studies and finance. The aim of the JARSYM is to facilitate and encourage undergraduates by providing a platform to impart and share knowledge in the form of high-quality and unique research papers.

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- Priority is given to novelty, originality, and to the extent of contribution that would make to the particular field.

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Do Financial Constraints Throw a Wet Blanket on Corporate Dividend Decision: Empirical Evidence from a Frontier Market

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ABSTRACT

This study investigates the impact of financial constraints on the corporate dividend decision in a frontier market, focusing on the 50 listed companies on the Colombo Stock Exchange in Sri Lanka. Secondary data were collected from the annual reports of selected companies for the period from 2017 to 2021. The combined effect of the size and the firm age, external capital implications, and collateral assets were used as the proxies for financial constraints, while the dividend payout was used to indicate the dividend decision of listed firms. Descriptive, regression, and correlation analyses were used to evaluate the collected data. According to our findings, only collateral assets constraint has a significant positive impact on the corporate dividend decision. These results considerably support the previous findings indicating that when firms are less financially constrained, firms are motivated to pay more dividends. Findings will guide and provide a signal to shareholders and potential investors to make effective investment decisions while management can use the findings to develop the optimum dividend policy.

Keywords: Dividend Decision, Dividend Payout, Financial Constraints, Colombo Stock Exchange, Frontier Market

1. INTRODUCTION

In the context of shareholder attraction, dividend plays a vital role. The dividend policy is a reflection of the company's prospects, while it is a signal of the current performance of the company. The shareholders can gain two types of returns, dividend and capital gains, of which dividend plays a key role in attracting external investors. Dividend payments depend on the company's policy of dividends and can be in various forms, including cash, stock, assets, special dividend, options, and warrants. The dividend policy determines the way in which and how much dividend is paid. Companies mainly keep the dividend as a tool for demonstrating the company's growth, development perspectives, and financial strength to the shareholders.

Financial limitations are a common problem for businesses in developing countries where capital is scarce and financial institutions are immature (Chan, 2014). Financial constraints in a company ensue from the inability to get outside funding and the reduction of internal resources as a result of the negative effects of liquidation (Holt, 2003). Multiple factors, such as credit market inefficiencies, a lack of financial resources, unpredictable surroundings, or a lack of tools for contract enforcement, could result in external financing limits

(Stiglitz & Weiss, 1981). Businesses with limited resources do not prioritize internal funding sources; instead, they increase their spending to secure external finance (Chen & Wang, 2012). When there are financial restrictions, a firm's many forms of expenditure compete for the available limited funds, and therefore, financial decisions are made concurrently (Kirch & Terra, 2020). This leads to the question of whether or not such constrained enterprises' internal funds can be utilized to pay out dividends.

Accordingly, when a firm faces financial difficulties, the management strategy for maintaining the dividend policy is crucial. However, the management approach for preserving the dividend policy is essential when a company has financial issues. Financial limitations have an impact on a company's financial status in relation to the available financing within the company. Almeida and Campello (2007) claim that financially troubled organizations may find it advantageous to use internal funds as a substitute source of capital expenditure since they face a high possible opportunity cost of investment. Financially restricted enterprises must consider future investment in addition to the current investment, unlike unconstrained organizations that make investment decisions exclusively on the availability of viable options. Therefore, businesses that are struggling financially are concerned about improving their ability to raise capital from outside sources in the future. These businesses employ dividends to increase their ability to obtain outside funding (Pathan et al., 2015). Especially, Small and Medium Enterprises are more likely to attract new investors using dividends as a profitability measure. Even if firms are in financial trouble, they are motivated to pay dividends. And it is more helpful to get better external financing facilities (Falavigna & Ippoliti, 2021).

The decision on dividends is one of the contentious issues that has been a factor in a variety of disputes leading to innovative concepts and theories on the dividend; as a result, the focus of a great deal of research has been directed toward this field. Though the impact of financial constraints on the dividend decision was investigated in different contexts, they yielded divergent and inconclusive findings. Moreover, in earlier studies, many scholars employed univariate firm-level variables to assess financial constraints, including firm age, size, liquidity, property, plant and equipment, cost of debt, and credit rating though using univariate firm-level measurements or sensitivity measurements is not appropriate everywhere. Considering the lack of research that uses indices to quantify financial constraints, the authors of this study focus on using a few indices that quantify financial constraints to obtain more reliable outcomes while filling the literature gap. Furthermore, it is challenging to find studies that in-depth examine the effect of financial limitations on dividend decisions in Sri Lanka, a frontier market. Accordingly, this study is conducted to understand better how financial constraints affect corporate dividend decisions to pay dividends in Sri Lanka, a frontier market.

Since this research is conducted with the objective of identifying the impact of financial constraints on the dividend decision of firms listed on the Colombo Stock Exchange (CSE), Sri Lanka, findings of this study will facilitate fulfilling the research gap in this field in frontier markets. This study's outcomes will mainly benefit the management and investors of the listed entities on the CSE.

Particularly, the companies which are subject to financial constraints will be able to assess the impact of their current situations and will be further benefited from managing both dividend policy and their financial position optimally. This study will further help the researchers looking to do more research regarding the effect of financial constraints on the firm's dividend decision.

2. LITERATURE REVIEW

The effect of financial constraints on different aspects of the firms has been widely discussed in the literature, and the impact made by financial constraints on firm growth and capital structure is the most popular among them (Cava, 2005). While the researchers have attempted to develop several ways to determine whether an entity is financially constrained, the combination of certain observable characteristics that can be used to measure the extent of constraints can be seen as widely used and popular.

Measuring financial constraints is a widely discussed matter in the literature. Authors have discussed several methods of measuring financial constraints from different perspectives, and determining whether a company is financially constrained is a debatable area in the literature. Wiersma (2017) states that every company is constrained for a certain level, while most authors argue that financially constrained entities are characterized by a certain behaviour that indicates their extent of being financially constrained. Based on these characteristics, several methods of measuring financial constraints can be identified as index-based measures, sensitivity-based measures, and specific measures, including firm size, firm age, liquidity position, profitability, creditworthiness, and free cash flows (Wiersma, 2017).

According to Kirch & Terra (2020), financial decisions, including dividend decisions, are affected by financial constraints. Pathan et al. (2016) emphasize that financially constrained firms tend to schedule their dividend increase declarations to precede seasoned equity offering (SEO) announcements. They are the first contributors to this area to discover the connection between the timing of dividend increases for financially constrained firms with SEO announcements with innovative signalling hypotheses. The authors further noticed that financially constrained firms face a considerable dividend increase in abnormal short-run performance compared to unconstrained firms. Furthermore, Chen & Wang (2012) also concluded that the dividend decision of a business is affected by financial constraints. Similarly, Skinner & Soltes (2011) proved that financially constrained firms also pay dividends. With an extensive view, Kim et al. (2020) highlight that financially constrained companies that pay dividends to experience a more favourable influence on R&D than those that do not.

However, Almeida & Campello (2007) and Acharya et al. (2007) suggest that when other variables keep unchanged, unconstrained firms tend to invest more and pay higher dividends compared to constrained firms. Despite this, Kirch & Terra (2020) show that financial decisions are interconnected when taking credit limitations into account, in contrast to the claim made by Modigliani and Miller (1958); when there is a capital shortage, investments in fixed assets, the

management of cash reserves, and dividend payouts are all susceptible to the availability of internal and external funds. In other words, when capital limits are imposed, a firm's many forms of expenditure contend for the available funds, and as a result, financial decisions are made concurrently.

In contrast, Young corporations with a favourable development perspective have a larger possibility of expanding and retaining cash, according to Holt (2003), whereas matured businesses pay dividends through internal funds. Falavigna and Ippoliti (2021) also identified a positive association between dividend payouts and credit rating class. According to their analysis, a company with a AAA rating pays 96.57 times more in dividends than a company with a D or CCC rating. It was found by Hoshi et al. (1991) that companies that are not financially constrained embrace a greater dividend distribution approach, while organizations that are financially constrained will use internal funds to finance their investment projects since obtaining external financing is more difficult.

In order to measure the specific level of financial constraints, Whited and Wu (2006) developed an accounting-based constrained measure which is called the Whited and Wu Index (WW). The WW index has six components, namely cash flow, dividend dummy, leverage, total assets, industry sales growth and the firms' sales growth. When a firm's WW index takes a higher half value is identified as more constrained, while the WW index takes a lower half value and is identified as less constrained (Habib et al., 2018).

Hadlock & Pierce (2010) used firm size and age to develop the SA index. Then they found that only two of the five components of the KZ index (Kaplan-Zingales Index by Kaplan and Zingales, 1997) are related to constraints reliably. This led them to investigate further an index that caters to the broader requirements of indicating the entities' financial constraints that paved the path to originate the HP Index. The HP index implies that the firm size and age are the most useful proxy for financial constraints. This HP index is a size-age index that can measure financial constraints in which the size is the natural logarithm of inflation-adjusted total assets. According to the HP index, a higher value of the HP index is more constrained. As far as the HP index is concerned, these measures may capture young and small firms that are especially like to have time-varying investment opportunities (Dang & Xu, 2018).

Collateral assets state any loan, security, cash or other asset owned or held by the borrower. Simply this implies an asset that the borrower offers up as a way of qualifying for a particular loan. The lender is comfortable extending the loan since it protests their financial stake if the borrower fails to repay the loan in full (Clementi & Hopenhayn, 2006). Purnawati et al. (2019) prove that collateral assets have a significant positive impact on the dividend policy. However, The findings of Wahjudi (2020) revealed that the dividend policy is negatively, but not significantly, impacted by collateralizable assets.

The function of effectively managing the working capital while maintaining sound dividend payments often reflects how successful an entity is, its operational elements of the business, and its focus on managing disposable resources. Over or under-investment in working capital by an entity creates

adverse liquidity conditions where the companies need to find alternatives for managing routine operations. This, in return, has an adverse impact on dividend payout (Ikunyua, 2020). Profitability is one of the fundamental factors that determine the capability of the entity to pay dividends. While profitability is a key performance indicator of a firm, it is an indicator of the firm's capability of paying dividends to its shareholders (Makenzi, 2018). Adverse fluctuation of earnings has a significant impact on the dividend payout. In line with the dividend signalling theory by Bhattacharya (1979), the firm uses dividends as a signal to its shareholders of the firm's prospects. When the dividend is increased due to higher profits, shareholders expect the same level of dividend to maintain in the future. In contrast, when the dividend is reduced for any reason, including management decisions on future investments and operational profits, shareholders may assume that the management has dropped the prospects of the company's earnings. Accordingly, the reduction of profits may impose a constraint on the firm in paying dividends.

In a holistic light, it is depicted from the empirical findings that dividend decisions are affected by financial constraints in some contexts, and some research is concluded with mixed results. These previous studies led to emerging conflicting arguments regarding the connection between financial constraints and the dividend policy with no definitive answer. Furthermore, it is difficult to locate research that thoroughly investigates the connection between financial constraints and dividend decisions in frontier markets such as Sri Lanka. Therefore, this study was conducted to investigate the impact of financial constraints on dividend decisions made by listed companies in Sri Lanka, a frontier market.

3. METHODOLOGY

The research uses the quantitative method to analyze the effect of financial constraints on corporate dividend decisions. This uses the deductive approach as the method of reasoning the facts and justifying hypotheses. The population of the study is the listed companies of the Colombo Stock Exchange in Sri Lanka as of 31st August 2021, and the sample was selected covering nine industries of Sri Lanka; energy, material, capital goods, consumer durables & apparel, retailing, food & staples retailing, food beverage & tobacco, household & personal products, healthcare equipment & services. Accordingly, the study selected 50 companies listed in the CSE as the sample for the study based on the availability and completeness of data using the simple random sampling method as the sampling technique. Data were collected for a five-year period, from 2017-2021, using the annual reports of the selected companies. The collected data were analyzed using E-views statistical software. Descriptive statistics analysis was employed to define the characteristics of the data set, and correlation analysis was used to identify the relationship between financial constraints and dividend decisions. Panel data regression analysis was performed to identify the effect of financial constraints on the corporate dividend decision.

The variables were identified, and the conceptual framework was developed referring to the previous studies (Whited Wu, 2006; Hadlock & Pierce, 2010; Pathan, Faff, Méndez, & Masters, 2016; Wahjudi, 2020).

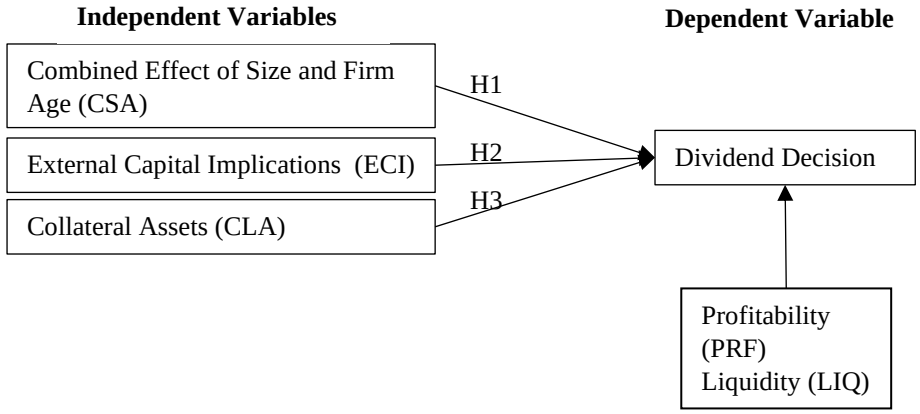

Figure 1. Conceptual framework

The dividend decision is the dependent variable that was measured using the dividend payout ratio. The combined effect of size and firm age is indicated based on the calculated value of the Hadlock-Pierce Index (HP Index). According to the HP index, a higher value of the HP index shows that a company is more constrained (Hadlock & Pierce, 2010). Whited and Wu Index (WW Index) was designed by Whited and Wu (2006) as an accounting-based measure to quantify the degree of financial constraints. Accordingly, the impact of the external capital implications is measured through the calculated value of the Whited Wu Index (WW Index). When a firm's WW index takes a higher value, the firm is identified as more constrained, while the WW index takes a lower value, and the particular firm is considered less constrained (Whited & Wu, 2006). Referring to Pathan et al. (2016), collateral assets were indicated through the natural logarithm of tangible assets. The profitability is measured through the return on assets, while the liquidity is proxied through the current ratio. The leverage is indicated through the debt-to-equity ratio.

The hypotheses for the study are developed based on the previous studies and the conceptual framework.

H_1: The combined effect of the size and the firm age significantly affect the dividend decision.

H_2: The external capital implications significantly affect the dividend decision.

H_3: The collateral assets significantly affect the dividend decision.

The research model is developed, as shown by Equation 1, to achieve the objectives of the study.

$$DD = \beta + \beta_1 CSA - \beta_2 ECI + \beta_3 CLA + \beta_4 PRF + \beta_5 LIQ - \beta_6 LEV + \varepsilon \quad (1)$$

Where,

DD shows the dividend decision, CSA depicts the combined effect of size and firm age, ECI denotes the external capital implications, CLA denotes the collateral assets, PRF shows profitability, LIQ represents liquidity, and LEV denotes leverage. β is the constant, β1- β6 are coefficients, and ε is the error term.

4. RESULTS AND DISCUSSION

Table 01 reports the results of the descriptive statistics, considering all dependent, independent, and control variables (DD, CSA, ECI, CLA, PRF. LIQ, LEV). It displays the mean, the median, the standard deviation, and the minimum and maximum values of the dependent, independent, and control variables. Accordingly, the average dividend payout ratio is 0.358, while 8.75 and -0.714 are the highest and lowest dividend payouts, respectively. The mean value of the combined effect of size and firm age is -0.718, indicating that the firms in the sample are less constrained as an average. The average value of external capital implications is 0.704 indicating the firms are financially less constrained. The mean value of collateral assets is 14.181, which is a higher value indicating that firms have a higher level of tangible assets that can be used as collateral assets. Therefore, the firms are financially less constrained. However, the average values of profitability, liquidity and leverage are 0.205, 2.191, and 2.246, respectively, indicating that firms in the study sample have less profitability, less liquidity, and less leverage.

Table 01. Descriptive statistics

	DD	CSA	ECI	CLA	PRF	LIQ	LEV
Mean	0.358	-0.718	0.704	14.181	0.205	2.191	2.246
Median	0.248	-0.737	0.383	14.330	0.090	1.342	0.956
Maximum	8.750	1.780	6.764	18.474	16.986	43.224	76.059
Minimum	-0.714	-1.538	-1.824	5.624	-1.002	0.123	-46.610
Std. Dev.	0.720	0.188	1.401	2.237	1.118	3.910	7.309

Table 02 presents the correlation analysis. Accordingly, it is evident that there are no-multicollinearity issues among the independent variables. There is a significant negative relationship between dividend decisions and external capital implications. However, a significant positive relationship exists between dividend payouts and collateral assets. The combined effect of the size and the firm age shows a negative insignificant relationship with the dividend decision.

Table 02. Correlation analysis

Variable	DD	ECI	CSA	CLA	PRF	LIQ	LEV
DD	1						
ECI	-0.064*	1					
CSA	-0.069	-0.290	1				
CLA	0.014**	0.373	-0.359	1			
PRF	0.006*	0.021	-0.027	0.068	1		
LIQ	-0.015	-0.160	0.044	-0.411	-0.023	1	
LEV	-0.058	0.015	0.069	0.134	-0.023	-0.104	1

*** and * demonstrate statistical significance at levels 5% and 10%, respectively*

Hausman test was conducted to select between the fixed effect model and the random effect model, and the results are indicated in Table 03. The probability

value of the Chi-square statistic is 0.0043, which is less than 0.05. Accordingly, the fixed effect model was indicated as the most appropriate model to interpret the data set.

Table 03. Result of the Hausman test

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	18.926	6	0.0043

Regression results are presented in Table 04. Accordingly, R squared value shows that 52% of the changes in the dividend decision are described by selected proxies of financial constraints. The value of F-statistics (1.661, p-value<0.01) indicates that the evidence provided by the sample data is adequate to prove that the regression model fits the data better.

Table 04. Regression analysis

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-3.712***	1.220	-3.043	0.003
CSA	-0.034	0.263	-0.129	0.897
ECI	-0.169	0.281	-0.602	0.548
CLA	0.293***	0.089	3.300	0.001
PRF	-0.010	0.044	-0.237	0.813
LIQ	0.015	0.024	0.610	0.543
LEV	-0.006	0.008	-0.742	0.459
R-squared	0.520	F-statistic		1.661
		Prob. (F-statistic)		0.006

*** *demonstrate statistical significance at level 1%.*

According to the regression results, the research model can be estimated as follows.

DD = –3.712 – 0.034CSA – 0.169ECI + 0.293CLA – 0.01PRF + 0.015LIQ - 0.006 LEV

According to the regression analysis results, only H3 is accepted, indicating that collateral assets (0.293, p-value<0.01) significantly and positively affect the dividend payout of listed firms. It implies that firms tend to pay more dividends when they are less financially constrained. These findings agree with Pathan et al. (2016) and Purnawati et al. (2019). On the other hand, the combined effect of size and firm age (-0.034, p-value>0.05) and external capital implications (-0.169, p-value>0.05) have a negative impact on dividend decisions. It indicates that when firms are more constrained, dividend payouts are discouraged though results are not statistically significant. Profitability and leverage have an insignificant negative impact on the dividend decision, while liquidity has an insignificant positive effect on the dividend payouts.

5. CONCLUSION

This study comprehensively investigates the effect of financial constraints on the corporate dividend decision in Sri Lanka, which is a frontier market. When forming the hypotheses, financial constraints were expected to impact dividend decisions significantly. To test the hypotheses, a sample of 50 firms listed in

the Colombo Stock Exchange was selected over 2017-2021 using the simple random sampling method.

The descriptive analysis revealed that listed companies on the CSE are, on average, less financially constrained. However, the dividends that companies pay out are, on average, lower. The correlation analysis revealed that external capital implications have a significant negative relationship with dividend payouts, while collateral assets have a significant positive relationship. According to the outcome of the panel data regression analysis, only H3 is accepted, indicating that the collateral asset constraint significantly and positively affects the dividend decision. Accordingly, when firms have more tangible assets that can be used as collateral assets, it indicates that they are financially less constrained and tend to pay higher dividend payouts. Though it is statistically insignificant, the combined effect of size and firm age, and external capital implications have a negative impact on the corporate dividend decision indicating that highly constrained firms pay fewer dividends. This outcome is consistent with previous studies (Pathan et al., 2016; Purnawati et al., 2019). Accordingly, we can draw the conclusion that in the Sri Lankan context, financial constraints throw a wet blanket on the corporate dividend decision.

The results also give practical implications for all decision-makers and other parties engaged with listed companies in Sri Lanka. Considering the findings of the study, management can develop the optimum corporate dividend policy in order to achieve company goals. In addition, the findings will offer light on the decision-making process that shareholders and potential investors go through when it comes to making investments. They will be capable of evaluating the financial constraints of companies and the potentiality of dividend payouts, which enables them to make the best possible investment decision that is in line with their individual goals.

The recommendations for future research are to investigate further the impact of financial constraints on the dividend decision by employing more variables while expanding the sample size and period to oversee the connection in a wider way.

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