

Impact of Dividend Policy on Firm Profitability: Case of British American Tobacco (BAT)

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Abstract

This study aims to study the relationship between dividend policy and profitability of a company. This will be a case study research and aims to provide and add to existing empirical evidence by focusing on the dividend policy and profitability of British American Tobacco and studying the relationship between the two variables in general and in the context of the selected company. This study will be based on the positivist paradigm because the phenomenon under consideration is quantifiable and subject to hypothesis testing. This study will be based on deductive reasoning as it uses existing theories about the relationship between dividend policy and profitability and then continues to test the theories in specific circumstances, i.e., by applying them on the case study of British American Tobacco. The research design of this study would be a quantitative method based on case study strategy. The study will collect financial information and data from annual statements of British American Tobacco. Finally, the study will use financial ratio analysis to study the trends between dividend pay-outs and profitability.

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Chapter 1: Introduction

1.1. Research Background

In the contemporary business environment, one of the main issues for strategic management of firms is to formulate the most appropriate dividend policy. Dividend policy refers to the guidelines and regulations and corresponding decisions of managers of a company regarding dividend payments to the shareholders of the company. This decision has a significant impact on shareholders' wealth and investing decisions, and thus it is a main concern of a corporate strategy. Dividend is the actual benefit that shareholders of a company obtain for their wealth invested. This is also called the return on their investment. A range of factors affect the dividend decisions which include financing constraints, investment choices and prospects, size of the firm, expectations of shareholders, and regulatory requirements among other factors. The dividend payments not only reflect the current state of the financial health of a company, but also serve as a signal to the future performance (Kajola, Adesunmi, and Oworu, 2015).

Although dividend policy and its impact on financial performance of a company is one of the most debated issues in financing literature yet there is no universal consensus (Bremberger, et al., 2016). Some authors have identified a positive relationship (Bremberger, et al., 2013) between dividend policy and profitability of a business while some authors conclude negative relationship (Zameer et al., 2013). There are also some researchers that conclude that there is no significant relationship between the two variables (Tahir et al., 2016).

1.2. Aim and Objectives

This study aims to study the relationship between dividend policy and profitability of a company. This will be a case study research and aims to provide and add to existing empirical evidence by focusing on the dividend policy and profitability of British American Tobacco by studying the relationship between the two variables. For this aim, the following objectives are proposed:

- To identify the determinants of dividend policy in British American Tobacco (BAT)
- To explore the role of dividend policy as a determinant of profitability of British American Tobacco (BAT)

- To assess the impact of dividend policy of British American Tobacco (BAT) on its profitability
- To make recommendations for BAT to improve its dividend policy

1.3. Research Question

What is the impact of dividend policy of British American Tobacco (BAT) on its profitability?

1.4. Structure of the Proposal

Following discussion shows a brief review of literature that focuses on the relationship between dividend policy and profitability of a company. This review serves as a foundation for readers to understand the topic and leads the reader to potential gaps in the literature which this study would attempt to address. The proposal then continues to provide a brief discussion of the research methodology proposed for this study and discusses the research paradigm, research approach, research design, data collection and analysis method, accessibility issues and ethical considerations. Finally, the proposal concludes with a research schedule detailing the duration of the proposed study.

Chapter 2: Literature Review

2.1. Relationship between Dividend Policy and Profitability

Although dividend policy and its impact on financial performance of a company is one of the most debated issues in financing literature, yet there is no universal consensus (Bremberger, et al., 2016). Considerable studies attempted to uncover problems of the dividend dynamics to explore the main determinants of dividend policy; however, there is no universally acceptable justification for the dividend policy behaviours of organisations. There are several decades of literature on the topic yet the puzzle remains to be resolved (Cambini, Gugler and Rondi, 2014).

2.2. M&M Theory

Miller and Modigliani (1961) (commonly referred as M&M theory) argued that there is no impact of dividend decisions on the value of a firm. The authors presented a set of fundamental assumptions upon which their theory was grounded. Overall, M&M argued that there is no relationship between the dividend policy and profitability of a company. These findings were in conflict with the traditional wisdom which advocated that dividend decisions must be properly managed as they affect the share prices of the company as well as shareholder's wealth (Bremberger et al., 2013).

This relationship is grounded on two basic assumptions: a) when dividends are received by shareholders they do not face any tax disadvantage, and b) when firms need to raise funds for new investments they can do so with negligible issuance costs from the capital market. There is another school whose proponents advocate that dividend payments have a negative impact on shareholders' wealth because of the tax implications. There is also a third school of thought that argues that dividends have a positive impact on shareholder's wealth (Ajanthan, 2013).

2.3. Signalling Theory

Zameer et al., (2013) concluded contradicting results to the principle and implications of the signalling hypothesis which states that there is a positive relationship between an increase in dividend rate and a firm prosperity in the future. The authors suggested that an increase in dividends lead to an improvement in the profitability of firms measured in terms of return on asset, free cash flow to capital expenditures ratio and other performance indicators. However, the study also reported that subsequently a sustained and significant reversal across all measures can

be observed. The study concluded that after dividend initiation, the profitability of the firm decreases and thus the study conflicted with the signalling hypothesis.

The study conducted by Tahir et al.,(2016) also reported contradicting results with the perception that high payout ratio leads to a decrease in future growth. The authors argued that in the American stock market,they observed a positive relationship between higher aggregate-dividend-payout ratios and higher future earnings growth. Mehta (2012) concluded that when businesses increase pay-outs,they reflect surplus financial flexibility and low income volatility. However, there is very little evidence that indicates subsequent performance improvements. The study also indicated lower income volatility among firms that increase payouts. The author based his findings on the argument that managers only increase payoutsif they are sure that there is a high probability that they can maintain the current high levels of income. On the other hand, businesses only decrease dividend payout if there is a high level of volatility as compared to other companies.

2.4. Empirical Evidence

Renneboog and Szilagyi, (2015) conducted a study on the performance of firms under distress that were using dividend and debt signals. The study showed that there were consistent results with dividend payouts sending relative signals. The study concluded that the financial performance of firms that either increase or maintain dividend payouts is superior as compared to those who reduce or stop dividend pay-outs. Overall, the study showed that businesses which maintained their dividends had outperformed their non-dividend pay-out counterparts.

Fairchild, Guney and Thanatawee (2014) concluded that dividend policy has a positive impact on the performance of firms, particularly on the profitability of the company in terms of return on assets. The study showed that there is a significant and positive relationship between dividend policy and growth in sales, return on equity, and return on assets. Overall, the study showed that dividend payments increase the profitability of the company. Furthermore, the study provided evidence to support a statistically significant relationship between dividend payout ratio and profitability. Another study conducted by Liew(2013) reported that when there are positive changes in dividends, there is a positive change in mean real earnings per share of the firm in the future.

Adediran and Alade, (2013) also concluded that dividend payments are considered to be one of the major determinants of the performance of a company. Likewise, Murto and Terviö (2014) emphasised that the future earnings and future dividend payment potential of a company is affected by the investment decision of a company and thus if a company invests profits instead of paying dividends, there is a positive impact on its future profitability. Ahmad and Wardani (2014) also showed that an increase in dividend has a direct relationship with an increase in earnings of the firm in future.

Booth and Zhou (2015) also studied the relationship between the firm performance and dividend pay-out focusing on the listed firms in the Nairobi Securities Exchange from the year 2002 to 2010. The study used regression analysis and found that there is a positive relationship between dividend payout and firm performance. The results concluded that dividend payout can be considered as a major influencing factor in the profitability of a firm. Thus, it shows that the dividend policy is related to and has a direct influence on performance.

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Chapter 3: Research Design and Methodology

It is critical for researchers to understand and explain their choices regarding the research design and methodology adopted in their studies. This is because these choices affect the reliability and validity of the results. The following section provides brief summary and relevant justifications for the researcher's choices in the proposed study.

2.5. Research Paradigm

Research paradigm refers to the assumptions of the researcher about acceptability of the knowledge gained by conducting the research. Positivists argue that in order to gain acceptable knowledge, ethos and principles of natural sciences can be applied in social research. However, the interpretivists argue that the subject matter of social phenomena is different than natural phenomena; therefore, social researchers should use a different research strategy (Bryman, 2012). The phenomena under consideration of proposed study are dividend policy and profitability. Both of these phenomena are quantifiable and thus methods and ethos of natural sciences are applicable. Therefore, the proposed study is based on positivism.

2.6. Research Approach

There are two types of research approach. The first is top-down approach which follows deductive reasoning. The study begins with general information and uses existing theories to test them in specific circumstances. The bottom-up approach, in contrast, follows inductive reasoning. The study begins with specific information and based on patterns formulates general theories and explanations (Bryman and Bell, 2011). The proposed study begins with reviewing broad literature and uses existing theories about the relationship between dividend policy and profitability and then continues to test the theories in specific circumstances by applying them on the case study of BAT. Thus, this is top-down or deductive approach.

2.7. Research Design

There are a number of research designs such as descriptive research design, case study, survey study, grounded theory, ethnography, etc. This study is based on case study design. The main benefit of choosing case study design is that it enables the researcher to test theoretical relationships within practical or real time scenario (Creswell, 2013). The literature review shows

that there are contradicting opinions about the relationship under consideration and thus this study aims to provide empirical evidence about this relationship in a specific context of a company. Therefore, case study design is most suitable for the proposed study.

Furthermore, this study will be based on quantitative data as dividend policy and profitability of the BAT are to be studied. The main benefit of quantitative design and data is that it is highly verifiable and therefore the results and conclusions drawn have a higher reliability and validity as compared to the qualitative data and analysis (Denzin and Lincoln, 2011). Thus, to improve reliability and validity this study will be based on quantitative research.

2.8.Data Collection Method

There are two types of data and corresponding type of sources of data. The first is primary data and primary data sources which are described as first-hand data and information collected by the researcher from the target population. Secondary data, in contrast, refers to data obtained from existing publications such as research articles, academic books, government publications, business reports, newspapers, etc. (Eriksson and Kovalainen, 2008). The proposed study will be based on secondary data sources and secondary data only. The study will review the existing literature to study the relationship between dividend policy and profitability of organisations. Furthermore, the study will collect financial information from annual statements from past 10 years of British American Tobacco Company to study its dividend policy and profitability.

2.9.Accessibility Issues

The study will use the internet to gather required data for the study. British American Tobacco publishes its annual statements in which income statement, balance sheet, and cash flow statements are presented. This study will require financial information from these statements to study the profitability and dividend policy of British American Tobacco. Since annual statements of the company are available without any price and without any time limitations, therefore there is no significant accessibility issue. However, considering the review of literature there are a large number of studies that require subscription or membership fee or have a price tag. Due to the limited budget, this study will access only those studies that are freely available on the internet.

2.10. Data Analysis Plan

Data analysis plan refers to the set of methods and techniques that are applied on data gathered in the study to derive meaningful results and information. The choices made regarding data analysis techniques are important as they affect the reliability and validity of the results and conclusions drawn in a study. It is recommended that researchers use well-established and replicable methods and techniques so that other researchers can use the same to conduct similar study and at another point of time (Hennink, Hutter and Bailey, 2010).

This study will use financial ratio analysis to explore dividend policy and profitability of British American Tobacco. The main benefit of using financial ratios is that they are most commonly used techniques and provide easy to understand information about the financial health of a company. However, there are inherent weaknesses in financial ratios. According to Levy and Lemeshow(2013), financial ratios are vulnerable to creative accounting practices and thus interpretations of financial ratios must be supplemented by qualitative analysis. This study will conduct financial ratio analysis of the last 10 years of British American Tobacco to ensure valid and reliable results.

Furthermore, this study will conduct regression and correlation analysis between dividend payout and net profit of British American Tobacco to identify the relationship between the two variables.

2.11. Ethical Issues

Ethical considerations refer to the set of moral principles and values to which researchers must adhere to so that they can maintain integrity with fellow researchers as well as the research participants (Myers, 2013). Since this study will be based on secondary data only, therefore following ethical considerations will ensured. In this regard, this study will use Harvard referencing style to prevent plagiarism. Plagiarism is a serious academic offense and refers to presenting work of other authors as one's own. In order to show integrity with fellow researchers, this study will provide in-text citations and corresponding references to pay proper credit to all authors whose works will be used in the study.

2.12. Research Schedule

This study will begin by conducting review of literature and to explore existing theories about relationship between dividend policy and profitability of a company. This review will consume around two weeks. The literature review will be followed by the methodology chapter. This chapter will detail about all methodological choices and relevant justifications. Chapter will probably take one week for completion. This will be followed by the chapter of results and discussion. In this chapter, the researcher will present and analyse data using financial ratios. This chapter will also consume around 7 to 8 days. Similarly, the researcher will write the last chapter of conclusion and recommendations. This chapter will take around 4 days. At last, the writer will draft the introduction chapter. This chapter will also take around 3 to 4 days. Overall, this study will be completed in five to six weeks.

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