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The Relationship between Financial Flexibility and Dividend Policy at Tehran Stock Exchange based on Rapp et al. Method

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Abstract. the objective of this research is to study the relationship between financial flexibility and dividend policy at listed companies in Tehran Stock Exchange. In this regard, two single criterion and one criteria based on model is applied. The study population consists of all companies listed in the Tehran Stock Exchange from 2009 to 2014. The sample consists of 98 companies. Three research hypotheses were tested using panel data based regression models. The research findings have indicated that although there is a significant relationship between financial flexibility and dividend policy in the listed companies in Tehran Stock Exchange based on conventional criteria, i.e. financial leverage and cash flows, this relationship is not significant based on Rapp et al.

Keywords: Financial Flexibility, Dividend Policy, Financial Leverage, Cash.

Introduction

Profit maximization and method of cash distribution are important aspects that shall be considered by managers of commercial units and they shall thought of them as their most important duty. If an entity has failed in making profit and cash flow planning and it is unable to repay the debts and obligations when due and timely distribution of dividends, it will definitely not able to achieve the desired objectives and the continuation of its activity is questioned (Rezvaniraz et al., 2009). The policy and strategy of the company in the possession or distribution of profits is called "dividend policy". Although dividends payment benefits the shareholders directly, it affects the company's ability to accumulate earnings in order to take advantage of growth opportunities; in addition, the main factor that investors consider in their decisions is the rate of return. In fact, the investors wish to earn maximum profit, after considering the risk factors. The dividend which is one of the components of stock returns, have an important role in investors' financial decisions (Golestani et al., 2014). According to Black (1976), if dividend policy will be discussed further, we learn more about its complexity, because its puzzle is not match; therefore dividend policy is one of the most controversial topics in corporate finance (Mahta, 2012). One of the ways of financing is through retained earnings. Therefore, the decisions regarding dividend should be evaluated and analyzed considering the financing decisions (Biabani and Razi Kazemi. 2013). One of the most important issues in company's financing is their financial flexibility. Financial flexibility is not a new topic, but the impact of the financial flexibility on financial policy of companies was not considered seriously until recently (Dennis, 2011). Therefore, the objective of this research is to evaluate the relationship between financial flexibility and dividend policy in the listed companies in Tehran Stock Exchange. The results have a practical application for the two major groups of beneficiaries in the capital market:

- Investors: The main goal of most investors from investing in the stock market is to gain profit and increase their wealth. Therefore, one of the applied objectives of this research is to inform the investors of stock exchange market regarding the relationship between financial flexibility and dividends policy of company, because the financial flexibility will increase the potential of company for cash dividend payment and the investors may expect to receive dividends.

- Directors of Companies: One of the options for financing investment projects is to use internal resources and particularly, the retained earnings that are directly affected by dividend policy. Therefore, in case of proving the existence of a significant relationship between financial flexibility and dividend policy, the directors of companies may use financial flexibility strategy to manage dividends policy and therefore, manage the financial resources of company.

Review of Literature

Due to ambiguities in the usage of financial flexibility term, making judgments about it is often subjective and informal; thus, the amount of flexibility is rarely measured and analyzed. Various methods and standards have been proposed to assess the level of financial flexibility. Most of these methods rely on the use of a single criterion based on which decisions are made about financial flexibility. Nevertheless, some combined criteria also are discussed in financial resources lately. In Iran, Many studies have been done in the field of financial flexibility. But based on our studies, they often have used single and

individual criteria for determining the financial flexibility. Some studies also have used the available models in this area. The importance of this study can be indicated in at least two aspects.

1. From shareholders' point of view: Shareholders buy shares to increase their capital, and one of their incentives to invest in the Stock Exchange is to receive dividends in cash. Therefore, the study of the relationship between financial flexibility and dividend policy can be important for shareholders.

2. From chief financial officers' (CFO) point of view: one of the methods to increase value of company is to use investment opportunities. Only companies can use this opportunity that have enough and proper financial resources. On the other word, they shall have flexibility in financial status. Therefore, the study of the relationship between financial flexibility and dividend policy can be important for CFOs of companies.

The objective of private sector for investment is one of below subjects: 1) to gain annual earnings as dividends; 2) to gain revenues from capital; 3) to gain annual profits and to use revenues of capital. Investors are interested to receive annual interest earned from investments, but at the same time, director of companies consider the non-dividend as the cheapest and the most important resource for the development and fulfillment of their financial needs. Thus, there is a conflict of interest between these 2 groups that needs an optimize solution. The directors may make 2 decisions regarding dividends (Tehran Stock Exchange, 2010) as follows:

- Initially, they try to finance investment projects approved by the company through earnings, and then distribute the remainder dividends among shareholders. In this case, dividends will be passive balance. This decision of company directors likely causes the sever fluctuations in the payment of dividends from year to year.

- They first distribute determined dividends between shareholders and then use the balance for reinvestments. In this case the dividend is considered as a variable of active decision and the company expects the decision to make more productivity than holding the dividends.

Therefore, successful companies are making profit and this profit can be invested in operating assets and be used for purchase of securities, payment of debts or be divided between shareholders. The profits distributed between shareholders is called "dividend". If a company decides to distribute dividends between shareholders, it is faced with several issues (Amidu & Abor 2006):

a) What proportion of the profits must be distributed to the shareholders?

b) Is the distribution of profits shall be made in cash or through share repurchases?

c) How far should continue the dividend?

The above mentioned questions and others such as "Why companies distribute profits?" or "why investors pay attention to dividends?" are not fully answered. This issue has introduces dividends distribution as a puzzle in the financial affairs (DeAngelo and DeAngelo, 2004). Company policies regarding the amount and duration of the distribution of profits is called "dividend policy" and after the

separation of ownership and management, the topic of division of asset and profit is very important therefore, dividend policy is gained a lot of attention (Golestani et al., 2014). Dividend reduces agency cost through the distribution of free cash flow that is invested in useless projects funded by managers (Fakhari and Yousefalitabar, 2010). Topic of dividend policy has always been one of the most controversial issues of finance; So that it draws the attention of economists in the current century and has attracted them for more than five decades and it was the subject of comprehensive theoretical models and experimental studies. Dividend distribution is very important and debatable from 2 aspects:

- From one point of view, dividend is an effective factor on future investments of company. The more dividends is paid, the less company has internal resources for implementation of its investment projects and it will need more external resources and this factor can affect the price of shares of company in future.

- On the other hand, most of shareholders want cash dividends.

The managers (with the aim of maximizing shareholder wealth) should always maintain a balance between the interests of different stakeholders, so that profitable investment opportunities are not lost and also to pay cash dividends needed by some shareholders. Therefore, dividend decisions taken by managers is very sensitive and important (Manual of Roodposhti et al., 2013). Retained earnings are one of the most important and easiest tools for financing, but it shall be considered that the shareholders want their cash dividend resulted by their annual investment. Accumulation or dividend is both acceptable but opposed goals (Biabani and Razi Kazemi, 2013). Generally, detection of expansion and contraction dividend policy (change in dividend distribution) as well as determining the source of financing for the distribution of dividends for executives, shareholders and investors is important for corporations and companies with profitable investment opportunities (Rezvaniraz et al., 2009). Hoiberg et al (2014) investigated the effect of competition in the market on the relationship between financial flexibility and dividend policy of US companies through introduction of a new index for competition inside the market, named "Market Liquidity". The findings of research shows that when market liquidity is high, companies that have limited access to financial markets (do not have the financial flexibility), make fewer dividend distribution. Rapp et al. (2014) presented a combined criterion to assess financial flexibility and its relationship with three financial decisions i.e. pays cash dividends, holding the cash and leverage ratio was examined. Given the role that financial flexibility and dividend policy variables have in this study, conceptual model can be as indicated in the figure below. In fact, financial flexibility is considered as an exogenous variable and dividend policy as an endogenous variable.



Figure 1- Conceptual Model (Rupp et al., 2014)

The financial flexibility is the company's ability to mobilize financial resources to deal with unexpected circumstances in the future. On the other words, financial flexibility is the ability of company to achieve the financial resources and repair its financial structure at low cost. The companies with financial flexibility have the ability to avoid financial crises and can easily provide the necessary capital for profitable investment opportunities. The policy and strategy regarding amount of possession or distribution of profits and its methods is called "dividend policy".

Dividend distribution is one of short term and long term strategies of companies that its results are evident in each fiscal year in general meetings of company and the company's performance is evaluated based on it. Dividend policy is a policy that based on it the amount of dividends, the retained earnings, bonuses of Board of Directors, the date of payment, financing method and other related topics are compiled and presented to the general meeting of shareholders. According to Rapp et al (2014) model based criteria, as opposed to individual criteria, are based on market and prospective; and is not directly affected by the decisions of the previous fiscal year. VOFF index is in fact a combination of 5 variables, i.e. growth, profitability, effective costs of cash possession, the cost of external financing and return on investment.

Hypotheses

The main hypothesis 1: There is a significant relationship between financial flexibility and payment of dividends.

Sub-Hypothesis 2: there is a significant relationship between the financial flexibility based on financial leverage and cash dividend payout.

Sub-Hypothesis 3: there is a significant relationship between the financial flexibility based on cash reserves and cash payment of dividends.

Sub-Hypothesis 4: here is a significant relationship between the financial flexibility based on VOFF index and cash payment of dividends.

Method of Research

Research method in terms of the objective, nature, logic, data types and time periods is as follows: based on objectives, the study is an applied research. Considering its nature, it is an Analytical – Correlation study. Based on its logic, this study is posteriori and also, all of the variables used in this research are quantitative. In terms of time, according to the fact that historical data of companies in the Tehran Stock Exchange database are used for the analysis, it is a retrospective study. Therefore, statistical population included all companies listed on the Tehran Stock Exchange in the period 2009- 2014 is presented in Tables 1, 2 and 3.

It shall be mentioned that the information of fiscal year of 2009 is only used for some research variables. From the population the samples are selected by screening using the following criteria: 1) the companies are listed in stock exchange market prior 2009. 2) Data required for calculation of the variables are available.3) the company has no change of fiscal year during the term of research. 4) It shall not be one of the investment firms, banks and insurance companies. 5) Its fiscal year shall be ended to March 20th or

19th. Based on these Criteria, 98 companies were selected as Samples. The variables used in this study are generally divided into three categories i.e. dependent, independent and control variables; financial flexibility (FLEX) plays the role of the independent variable and based on the study of King'wara (2015), it is calculated in three ways: 1) the ratio of total debt to total assets 2) the ratio of cash reserves to total assets 3) Rapp et al. (2014) model.

In the first and second methods, financial flexibility is an indicator variable and in this way if the ratio of debt to total assets will be less than the median and the ratio of cash reserves to total assets is greater than the total median of sample, the company shall be considered as a company with financial flexibility. However, in the 3rd method the financial flexibility is a continuous variable; to be more precise, in the Rupp et al. (2014) method, financial flexibility is calculated based on the total weight of five variables, i.e.: growth opportunities, profitability, effective costs of cash possession, the cost of external financing and return on investment.

Dependent variable is dividend policy that is the result of cash dividend of each share divided on the dividends per share and we show it with "DPO". This definition of dividend policy is applied in most of the domestic studies, such as Izadi et al (2010), Rezai et al (2011) and Biabani and Razi Kazemi (2013). In addition, in order to eliminate the effect of other variables that may have any effect on the relationship between financial flexibility and dividends policy based on King'wara (2015), the 3 variables of the size of company (SIZE), Return on Assets (ROA) and Earned Capital (RE) are used as control variables.

Table 1 – Research Variables & their Method of Calculation

Variable	***Symbol***	***Calculation Method***	***Variable Group***
Financial Flexibility	FLEX_LEV	Based on the ratio of debt to total assets	Independent
	FLEX_CASH	Based on the ratio of cash reserves to total assets	
	FLEX_VOFF	Based on Rapp et al model	
Dividend Policy	DPO	Cash dividend per share to earnings per share	Dependent
Return on Assets	ROA	After tax profit to total assets	Control

Size of Company	SIZE	Natural logarithm of total assets	
Earned Capital	RE	ratio of retained earnings to total assets	

Research Findings

Table 2 – Descriptive Indicators of Main Variables

Variable	***Number of Observations***	***Mean***	***SD***
Cash Dividend Payment	490	2.113	27.900
Financial Flexibility (VOFF Index)	490	0.174	0.319
Earned Capital	490	0.206	0.310
Return on Assets	490	0.159	0.185
Size of Company	490	13.726	0.437

Table 3 – Results of Jarque–Bera Test

Variable	***No. of Observations***	***Jarque–Bera Statistics***	***Significance Level***	***Skewness Coefficient***	***Kurtosis Coefficient***
Cash changes in the market value of stock	490	24402.48	0.000	2.287	37.268
Abnormal Return	490	4345.55	0.000	2.879	16.405
Ratio of Dividend	490	4716660	0.000	21.853	481.654

Table 4 - Results of Jarque–Bera Test after Performing Normalization Transformations

Variable	***No. of Observations***	***Jarque–Bera Statistics***	***Significance Level***	***Skewness Coefficient***	***Kurtosis Coefficient***
Cash changes in the market value of stock (Johnson Transformation)	490	24402.48	0.000	2.287	37.268
Abnormal Return (Logarithmic Transformation and Elimination of Observations)	490	4345.55	0.000	2.879	16.405
Ratio of Dividend (Logarithmic Transformation and Elimination of Observations)	490	4716660	0.000	21.853	481.654

One of the basic assumptions in the linear regression analysis is normal distribution of the dependent variable. T-test statistics have Student's t-distribution only if the assumption is true. In order to check this, the results of Jarque–Bera test are indicated in table 3. In addition, the Skewness and kurtosis coefficients of these variables are indicated to be compared to corresponding values of normal distribution (Skewness and kurtosis coefficients of normal distribution is equal to 0 and 3). Based on the results, normal distribution of the variables, i.e. cash changes in the market value, abnormal return and the ratio of dividend is not statistically confirmed (Sig. <0.05). The Skewness and kurtosis coefficients of these three variables are highly different with normal distribution values.

In order to normalize the statistical distribution of a variable, there are several techniques. The studies showed that in the case of variable's abnormal returns, using logarithmic transformation along with the removal of one percent of outlier observations in the distribution will normalize the variable. In regard with the changes of cash on market value, Johnson Transformation was useful. For ratio of dividend the situation is a little different and the studies show that the best result is gained from elimination of 3% of the observations and then, using logarithmic transformation. The results of Jarque–Bera test are indicated in table 3 after performing these changes are shown in table 4. According to the results, assumption of normality if cash changes in market value is confirmed after using Johnson Transformation at the level of 0.05 (JB-1.336, SIG>0.05). This assumption about the abnormal returns log is accepted at 0.01 error level (JB-7.267, SIG>0.01). But in the case of dividends, normality assumption can be accepted in 0.0001 error level (JB-19.162, SIG>0.0001). Skewness and kurtosis coefficients indicate that the used transformations managed to make distribution of dependent variables to the characteristics of normal distribution' so that, first, their symmetry is increased and secondly their kurtosis is reduced.

Sub-Hypothesis 1: there is a significant relationship between the financial flexibility based on financial leverage and cash dividend payout.

The results of sub-hypothesis 1 are indicated in table 5 and based on the results there is an inverse relationship between the financial flexibility based on financial leverage and dividend policy; Because the

obtained regression coefficient for this variable is negative and this relationship is statistically significant in all three models (Sig. <0.01). Therefore, sub-hypothesis 1 is confirmed. The findings show that co-linearity between return on assets and earned capital has no effect on the test result of sub-hypothesis one. The statistics of model show that all of the estimated models were significant and there is no serial correlation between their balances (1.5 <DW <2.5). Also, according to the coefficient of determination, almost 50 percent of the variance in the dependent variable was explained by the explanatory variables included in the estimated model.

Sub-Hypothesis 2: there is a significant relationship between the financial flexibility based on cash reserves and cash payment of dividends.

The results of sub-hypothesis 2 are indicated in table 6 and based on the results there is an inverse relationship between the financial flexibility based on cash reserves and cash payment of dividends; Because obtained regression coefficient for this variable is negative and this relationship is statistically significant in all three models at least at 0.1 error level (Sig. <0. 1). Therefore, sub-hypothesis 2 is confirmed. The findings show that co-linearity between return on assets and earned capital has no effect on the test result of sub-hypothesis 2. The statistics of model show that all of the estimated models were significant and there is no serial correlation between their balances (1.5 <DW <2.5). Also, according to the coefficient of determination, almost 50 percent of the variance in the dependent variable was explained by the explanatory variables included in the estimated model.

Table 5 – Results of Estimation of Regression Model for Sub- Hypothesis 1

Variable	***Symbol***	***Model 1***		***Model 2***		***Model 3***	
		Regression Coefficient	***T-Statistics***	***Regression Coefficient***	***T-Statistics***	***Regression Coefficient***	***T-Statistics***
Constant Coefficient	-	1.438	*2.257	1.715	***2.688	1.995	***3.292
Financial Flexibility (Financial Leverage)	FLEX_LEV	0.116	***-2.962	-0.114	*** -2.188	-0.133	***-3.408
Size of Company	SIZE	0.064	-1.376	-0.087	*-1.873	-0.104	**-2.359
Return on Assets	ROA	0.634	***-3.065	-	-	-0.179	-1.175
Earned Capital	RE	0.331	***2.625	0.007	0.102	-	-

F-Statistics	3.633	3.494	3.542
Significance Level of F	0.000	0.000	0.000
coefficient of determination (R^2)	0.506	0.493	0.497
Durbin–Watson Statistic (DW)	2.069	2.085	2.064

** Significant at 0.1 error level*

*** Significant at 0.05 error level*

**** Significant at 0.01 error level*

Table 6 – Results of Estimation of Regression Model for Sub- Hypothesis 2

Variable	***Symbol***	***Model 1***		***Model 2***		***Model 3***	
		Regression Coefficient	***T-Statistics***	***Regression Coefficient***	***T-Statistics***	***Regression Coefficient***	***T-Statistics***
Constant Coefficient	-	1.895	***2.958	2.167	***3.384	2.625	***4.340
Financial Flexibility (Cash Reserves)	FLEX_CASH	-0.068	**-1.879	-0.072	**-1.985	-0.066	*-1.800
Size of Company	SIZE	-0.100	**-2.171	-0.123	***-2.661	-0.154	***-3.548
Return on Assets	ROA	-0.608	***-2.914	-	-	-0.047	-0.422
Earned Capital	RE	0.396	***3.161	0.085	1.258	-	-

F-Statistics	3.531	3.410	3.381
Significance Level of F	0.000	0.000	0.000
coefficient of determination (R^2)	0.499	0.487	0.458
Durbin–Watson Statistic (DW)	2.086	2.110	2.078

** Significant at 0.1 error level*

*** Significant at 0.05 error level*

**** Significant at 0.01 error level*

Table 7 – Results of Estimation of Regression Model for Sub- Hypothesis 3

Variable	***Symbol***	***Model 1***		***Model 2***		***Model 3***	
		Regression Coefficient	***T-Statistics***	***Regression Coefficient***	***T-Statistics***	***Regression Coefficient***	***T-Statistics***
Constant Coefficient	-	1.869	***2.877	2.111	***3.235	2.603	***4.286
Financial Flexibility (Cash Reserves)	FLEX_VOFF	-0.068	-1.082	-0.052	-0.823	-0.090	-1.433
Size of Company	SIZE	-0.099	**-2.123	-0.120	**-2.560	-0.153	***-3.508
Return on Assets	ROA	-0.644	***-3.067	-	-	-0.125	-1.065
Earned Capital	RE	0.375	***2.965	0.052	0.733	-	-

F-Statistics	3.484	3.347	3.358
Significance Level of F	0.000	0.000	0.000
coefficient of determination (R^2)	0.495	0.482	0.483
Durbin–Watson Statistic (DW)	2.057	2.083	2.041

** Significant at 0.1 error level*

*** Significant at 0.05 error level*

**** Significant at 0.01 error level*

Sub-Hypothesis 3: there is a significant relationship between the financial flexibility based on VOFF index and cash payment of dividends.

The results of sub-hypothesis 3 are indicated in table 7 and based on the results there is an inverse relationship between the financial flexibility based on VOFF index and cash payment of dividends; because obtained regression coefficient for this variable is negative but this relationship is not statistically significant in any of three models (Sig. > 0.05). Therefore, sub-hypothesis 3 is not confirmed. The findings show that co-linearity between return on assets and earned capital has no effect on the test result of sub-hypothesis 3. The statistics of model show that all of the estimated models were significant and there is no serial correlation between their balances (1.5 <DW <2.5). Also, according to the coefficient of determination, almost 50 percent of the variance in the dependent variable was explained by the explanatory variables included in the estimated model.

In Iran a lot of studies are done on dividend policy of listed companies in Tehran Stock Exchange; but research on the impact of financial flexibility on dividend policy is very little. Therefore, the findings of our study are only compared with foreign studies. The results of this research indicates that although based on financial leverage and cash reserves, financial flexibility has statistically significant impact on dividend policy, the VOFF index shows no statistically significant impact. This means that listed companies in the Tehran Stock Exchange set their dividend policy regardless of financial flexibility. This is despite the fact that according to surveys conducted in developed countries, the financial flexibility is the most decisive factor for the company's capital structure. The findings in relation to the hypothesis 3 is in conflict with the results of Rapp et al. (2014), King'wara (2015) and Yang et al (2015) respectively on Capital Markets of USA, Kenyan and developing countries. In this study, to calculate the dividend policy of companies, the ratio of divided by earnings per share was used. This method is also used by a lot of domestic authors including Rezvaniraz et al. (2009). While in some other studies different criteria were used to assess the dividend policy. (The ratio of dividends to proceeds from the sale was used).

Conclusion

The objective of this research is to investigate the relationship between financial flexibility and dividend policy in the listed companies in Tehran Stock Exchange Market. In this study, two single criterions (median of financial leverage and median of possessed cash) and one model-based criterion (VOFF index) were used to assess financial flexibility. The results indicated 3 conclusions:

a) There is a significant relationship between the financial flexibility based on financial leverage and cash dividend payout. It means that with increase or decrease of financial flexibility of sample companies based on financial leverage, the amount of cash dividend payment of companies is significantly affected.

b) There is a positive relationship between the financial flexibility based on cash reserves and cash payment of dividends. It means that with increase or decrease of financial flexibility of sample companies based on cash reserves, the amount of cash dividend payment of companies is significantly affected.

c) There is no significant relationship between the financial flexibility based on VOFF index and cash payment of dividends. It means that with increase or decrease of financial flexibility of sample companies based on VOFF index, the amount of cash dividend payment of companies is not significantly affected.

Therefore, although based on financial leverage and cash reserves, financial flexibility has statistically significant impact on dividend policy, the results of VOFF index indicates that this relationship is not statistically significant. This means that listed companies in the Tehran Stock Exchange set their dividend policy regardless of financial flexibility. This is despite the fact that according to surveys conducted in developed countries, the financial flexibility is the most decisive factor for the company's capital structure. Thus, although based on old and traditional criteria financial leverage and cash reserves, the financial flexibility has a significant impact on dividend policy of the company, based on modern and model-based criteria; there is no significant relationship between these 2 phenomena. Therefore using modern financial methods and criteria can always disclose facts that older and conventional criteria are not able to explain.

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