

CHAPTER 2: LITERATURE REVIEW

2.1 Introduction on Dividend Policy

As corporate finance reminds us, there are two operational decisions that a finance manager is faced with: capital budgeting and financing decisions.

Capital budgeting decisions are those which are concerned with the assets that a firm must acquire, while financing decisions focus on how to finance these assets.

When a company starts generating profits, another decision may be raised: whether to distribute a portion of the earnings to the shareholders or reinvest in the business (Al-Malkawi, 2008).

Dividend policy refers to the “distribution of cash to shareholders over time”. As the level of equity retained in the company is affected by dividend decisions, financial managers are very careful in choosing the dividend policy. Dividend payouts influence the firm’s value and most importantly, the wealth of the shareholders (Lease, John, Kalay, Loewenstein, & Sarig, 2000).

Over the years, dividend policy is one of the controversial topics among financial economists- although many studies have been carried out to solve the dividend puzzle, it still remains unsolved. Due to the extensive range of debate about dividend policy, a significant amount of literature grows every day.

This chapter attempts to review past literatures on corporate dividends policy and those theoretical models summarized here will be the basis of the hypotheses of the current study.

Over the years, four main topics have been addressed in dividend policy literature, i.e. the manner of determining dividend payout, the relevancy of dividends, inter-country differences in company's dividend distribution and disappearing dividends in emerging markets (Robinson, 2006).

There have been three different approaches found for the setting of dividend policy among US companies.

First, there are companies that target long term payout ratio and determine dividend payout as a percentage of earning. Secondly, there are firms that have stable dividend payments over time as they believe this is the preference of investors. Lastly, some managers consider the change in level of dividend payouts really important because it gives valuable information to the investors.

In addition, from the manager's point of view, the current rate of dividend payouts is usually used as a bench mark to set the dividend policy (Lintner, 1956).

Since a change in dividend policy in a firm means a change in financial policy of that firm, there are some questions about why firms enact dividend changes, with some companies attempting to reduce dividends while others deciding not to pay dividends to shareholders.

As reported by Lintner (1956), changing dividend policy illustrates changes in the firms' earnings. Firms with stable dividend policy are more preferred by investors and managers. On the other hand, as omitting the dividends can be a negative signal to the market which conveys information about the firms' financial distress; the managers are usually unwilling to omit or reduce the dividends as stated by

DeAngelo and De Angelo (1990).

According to their extensive study of dividend changes, Brav et al (2005) argued that keeping the level of dividends constant is a main concern for investment decisions. In contrast with Lintner's findings, managers are reluctant to increase dividend payment at the same time with any rise in earnings, because they no longer consider dividends as the main decision variable (Brav, Graham, Harvey, & Michael, 2005).

In terms of dividend policy in emerging markets, one important characteristic of emerging markets has to be considered, i.e. the government exerts a control on the firms' financial decisions through some fiscal policies (Glen, Karmokolias, Miller, & Shah, 1995). Adaoglu (2000) supports this view, based on evidence from his study regarding dividend instability in public listed firms in Turkey.

2.2 Dividend Policy Theories

This section analyzes theories about dividend policy including dividend irrelevance hypothesis and relevancy theories such as bird in hand, signaling, tax preference and agency costs.

Researchers identified three contradictory theories about dividend decisions in firms. Some state that raising the dividend payouts influence and increase the firm's value (this is called the bird in hand theory). On the other hand, some others argue that high dividend payments have a reverse effect on the value of the firm (tax preference theory). The third approach is known as dividend irrelevance theory. All these theories will be discussed in the following sections.

2.2.1 Dividend Irrelevance Theory

In the 1960's, with a new wave of finance, Miller and Modigliani explain the dividend payment is irrelevant to the value of the company based on certain conditions of perfect capital market and rational behavior (Miller & Modigliani, 1961). Based on the M&M's model, in a perfect market the share price of a firm and shareholder's wealth is not affected by the dividend policy since they believe the value of the firm is determined by its investment decisions. In other words, the value of firms is independent of how they set their dividend policy.

Assumptions of a perfect capital market that Miller and Modigliani based their theory on can be summarized as follows:

1. No tax differences between dividends and capital gains.
2. No transaction costs.
3. Information is equally available to everyone at no cost. (symmetrical information)
4. Conflict between managers and shareholders do not exist. (No agency cost)
5. All investors are price takers and do not have power to control the security price.

Miller and Modigliani's (M&M) model (1961) assumed the investment of a firm is fixed because all positive net present value projects are financed irrespective of the firm's dividend strategy, accordingly dividends are firm's residual free cash flow. Conventional wisdom recommends that dividend payments are critical to the firm's value and an appropriate dividend policy is important to shareholders because it will affect their wealth as well as the share price. Usually investors faced with inaccurate information regarding a firm's performance consequently

they use dividend payments as a signal (Frankfurter & Wood, 1997).

To summarize, in the perfect capital market, the only determinant of firm's value is the future cash flow from investment decisions.

Market imperfections such as asymmetric information, agency costs, transaction costs and taxes should be considered in dividend relevancy (Lease, et al., 2000).

Over years of researches, four main theories of dividends relevancy have been offered: The bird-in-hand theory, signaling theory, tax preference theory and agency cost theory.

2.2.2 Bird in Hand Theory

The bird in hand theory was developed by Myron Goldon (1959) and John Lintner (1962) and argues that there is a relationship between dividend payments and a firm's value. Since investors value dividends less risky compared to capital gains, firms have to set a higher dividend payout ratio to maximize the share price. In other words, high dividends increase the stock price (Robinson, 2006).

In view of the fact that the risk of a firm is determined by the risk of its cash flows, which is not changed by dividend policy; therefore, the bird in hand explanation may not hold true. In other words, the risk of a firm cannot be reduced by an increase in the dividend payments (Bhattacharya, 1979). Generally, the bird in hand explanation for dividend relevance is rejected by most of the financial economics literatures.

2.2.3 Signaling Hypothesis

The second explanation is the signaling model which argues the existence of asymmetric information between managers and shareholders. M&M's model assumed that in a firm, information is available for insiders and outsiders equally; but managers may have information relevant to the value of the firm which outside investors do not have (Robinson, 2006). This information gap explains the way managers use dividends announcements as a signal which conveys valuable information about future performance of the firm to investors.

Based on the signaling hypothesis, shareholders may interpret an increase in dividend payment as a signal of future profitability; hence in a positive reaction, the share price will rise. In the same way, a decrease in dividend payouts may be considered as a bad news about future earnings; therefore, the share price may react unfavorably (Al-Malkawi, 2008).

Signaling perspective of dividend policy is supported and cited by many researchers such as Bhattacharya (1979) and Miller and Rock (1985).

2.2.4 Tax-Effect Hypothesis

The M&M's model assumes that there is no tax difference between dividends and capital gains. However, in the real word of finance, taxes may have influence on dividend payments and more importantly, on the value of a firm. The tax preference explanation suggests a low level of dividend payouts is preferable in order to maximize value for shareholders. This argument is based on that dividends are taxed immediately and also at a higher rate compared to capital

gains, which are postponed until the stock is sold.

The advantages of tax for capital gains motivate investors to prefer firms that retain earnings rather than pay dividends. As a result, a low level of dividends will raise the stock price.

In most of the countries like US, UK and Jordan, dividends and capital gains are taxed differently; usually dividends are taxed at a higher rate. Hence, investors in these countries prefer higher pre- tax return to keep stocks with higher dividend yields (Al-Malkawi, 2008).

From the perspective of tax preference, some investors prefer dividends since dividends can provide cash flow to a firm (Gordon & Bradford, 1980).

2.2.5 Agency Costs and Free Cash Flow Hypothesis

Based on the M&M's theory, there is no conflict between managers and shareholders. However, in practice this assumption may not hold true since managers' interest is not exactly the same as investors'. Therefore, the shareholders may incur agency cost, resulting from the potential conflict between manager and shareholder.

The agency costs theory suggests that increasing dividends is one way of reducing the agency costs. By paying higher dividends the level of internal cash will reduce and firms have to search for more external financing. The agency explanation for dividends has been supported by previous empirical studies (for example (Rozeff, 1982)). In addition, Easterbrook (1984) stated that dividends can be used to reduce free cash flow available for managers; and by paying

dividends, managers may need to raise funds from external sources.

In this way shareholders can monitor managers at a lower cost and prevent managers from acting in self interest.

2.3 Factors Influencing Dividend Decisions

This part discusses about different factors that may influence dividend payments as well as the relevant proxies for each variable. These factors were found in previous studies, as mentioned earlier in this chapter.

2.3.1 Agency Costs

As discussed in the previous section, one of the basic assumptions of M&M's perfect capital market is that there is no disagreement between managers and shareholders; however, in the real world, as managers are the shareholders' agents, they may have interests inconsistent to those of the shareholders. Analyzing such conflicts became an important part of financial literature.

By paying cash to shareholders as dividends, these resources under the managers' control would be reduced accordingly; hence, managers may lose their power (Easterbrook, 1984; Rozeff, 1982). In addition, by distributing cash to shareholders, the internal fund available to the managers is reduced; as a result, the managers may be forced to seek external financing.

As Easterbrook (1984) argued, there are two forms of agency costs. The first one is the cost of monitoring managers, which is borne by shareholders. The second form of agency cost is the risk aversion on the part of the managers.

A risk averse manager does not like to take risks and prefers to choose projects that have lower expected returns than riskier ventures. On the other hand, the shareholders have a reverse preference and would want managers act as a risk preference and take high risk ventures since shareholders believe a riskier venture would enrich them (Easterbrook, 1984).

According to Jensen and Meckling (1976), another problem which might be affected by dividend payments is the conflict between shareholders and bondholders. The shareholders are agents of the bondholders, therefore a high level of dividend payments to the shareholders may be considered as confiscating the bondholders' wealth; as a result, the bondholders may prefer to limit dividend payments.

Managers are required to go to the capital market in order to raise the funds while they pay dividends. In this way, the financial analysts and the other investment professionals are also able to check the managers' behavior. Hence, the cost of monitoring managers would be lower for shareholders. It is argued that paying dividends enhance scrutiny of managers by insiders. On the other hand, it might oblige managers to make undesirable decisions such as increasing leverage which is a risky action (Easterbrook, 1984). A rational shareholder however, would prefer dividends in order to minimize the agency costs of external equity (Rozeff, 1982).

When a firm has growth opportunities, the agency problem become more serious since there is free cash flow available to the managers, but the high level of dividends would reduce available funds. Consequently, the shareholder-manager

conflict would be minimized. Thus, it is important to motivate the managers to return free cash rather than using it inefficiently (Jensen, 1986).

According to Jensen (1986), there is another aspect of paying dividends based on agency problems. When a company has free cash flow, which is excess of funds needed for positive net present value projects, then the managers would have the power and opportunity to use these funds to benefit not only shareholders but also themselves. He contended that when a firm has surplus cash, the managers may accept projects with negative NPV. Thus, by increasing dividend payments, free cash flow under manager's control will be alleviate and prevent them from investing in less profitable projects. Having a lower level of free cash flow will result in lower agency costs.

Higher dividend payouts help to decrease the funds available for managers, and then they have to find more financial resources. In addition, the shareholders have to bear the risk of having a highly leveraged firm. In other words, the shareholders should have the incentive to trade off between the advantages and the disadvantages of paying more dividends.

There are different measures which have been used in prior studies to proxy agency cost between managers and stockholders. The larger the number of shareholders, the more dispersed the ownership; hence, monitoring the managers becomes more costly, as argued by Rozeff (1982).

A dispersion of ownership would cause an increase in the agency costs. In firms whose owners are more dispersed, a higher level of dividend payments is required to control agency problems, because when ownership of a firm is widely

dispersed, the level of shareholder control would also diminish.

In this way, they can mitigate the agency problem and reduce the available cash to the managers in order to protect themselves from being seized (Alli, Khan, & Ramirez, 1993).

The percentage of shares held by the insiders is widely used as a second proxy to measure agency cost in literatures such as (Al-Malkawi, 2008; Alli, et al., 1993; Deshmukh, 2005; Holder, Langrehr, & Hexter, 1998; Jensen, Solberg, & Zorn, 1992). It is argued that when insiders increase their ownership in a firm, the agency problem is reduced because the interest of managers and shareholders can be aligned in this way (Jensen & Meckling, 1976).

Hence the higher the insider ownership, the lower the agency costs. Therefore, other things being equal, the dividend payout should be inversely related to fraction of equity owned by insiders (managers, directors) (Deshmukh, 2005).

Another proxy to measure agency cost is the amount of free cash flow of a firm- a greater retention of free cash flow in a firm predicts a potential agency problem (Henry, 2006).

It is expected that in emerging markets like Malaysia, the agency problem is a more serious topic for firms due to the nature of their ownership structure and legal issues regarding the investors in these markets. Lack of evidence to support or reject this declares in emerging markets especially in Malaysia is one of the motivations to do this research.

2.3.2 Size

Another factor may influence a firm's decisions on whether to pay dividends or not, is the size of the firm. Studies showed that about 87% of large companies paid dividends compared to 49% of small firms (Mozes & Rapaccioli, 1995).

A research done by Lloyd, Jahera and Page (1985), showed that the size of firms played an important role in their dividend policy. In other words, the larger the firm, the easier it can gain access to the capital market because the large firms are more mature compared to the small companies. Therefore, the dependency to internal funds would reduce and firms can make higher dividend payouts (Lloyd, Jahera, & Page, 1985).

Studies indicate that large firms can easily increase funds at a lower cost compared to the small companies. In this way, the dependency to internal funding would be reduced and they would manage to pay a higher dividend to shareholders.

Lots of studies have recognized size of firms as an important determinant of dividend payments. Based on these researches, it is expected that the relationship between dividend payout and size of a company is positive (Barclay, Smith, & Watts, 1995; Holder, et al., 1998; Lloyd, et al., 1985; Redding, 1997).

In contrast, Mahadwartha (2002) concluded that in Indonesia, the dividend payout is inversely related to firm size. In other words, the larger the firms in Indonesia, the less they pay dividend to their shareholders. Mahadwartha reasoned that in large firms, management may take advantage of the free cash

flow for their interest while shareholders have less power to monitor the managers.

As Gugler (1997) contended, in the United States most of the large companies pay dividends to control managers from self interest investments.

Since Small firms have to reinvest to grow; consequently, funds available for dividend payouts would be reduced (Ingram & Lee, 1997).

Based on literatures, there are different measures for a company's size, such as sales, assets, employment and capitalization. Here in this study, market capitalization is used as a proxy for the firm's size. This proxy has been used in other researches see for example (Deshmukh, 2005; Isa, 2000; Mozes & Rapaccioli, 1995).

2.3.3 Profitability

Bearing in mind that a company pays dividends from its annual profits, therefore only firms with a profit have the ability to pay dividends and those experiencing losses are unlikely to pay dividends. Thus considering the level of profitability as one factor in determining dividend payments is logical.

Myers and Majluf (1984) asserted that profitable firms increased their demand for debt since firms use internal funds to invest. They explained this idea through the pecking order hypothesis. According to the pecking order theory, firms prefer to use their internal resources to invest and whenever external financing is needed; they prefer to issue debt rather than equity to reduce the information asymmetry and transactions costs (Myers, 1984; Myers & Majluf, 1984).

This theory can also provide explanation for a firm's dividend payments. The discussions of the pecking order theory focused on how dividend payouts vary with profitability.

While managers issue risky securities by private information, the existence of the asymmetric information helps the investors to discount new issued and existing securities. Managers usually prefer to use retain earnings to finance a project because no asymmetric information is involved. Since discount prices are expected, managers are hesitant to issue risky debt and equity.

Firms try to finance investment first with retain earnings, then with safe debt, and finally with equity, to minimize the asymmetric information and other financing costs (Fama & French, 2002).

Since outside funds are costly to gain, for companies with less profitable assets dividends are less attractive. As a result, more profitable firms pay more dividends to control investment opportunities.

As concluded by Lintner (1956), a firm's profit is one of the most critical factors that affect dividend payouts. Moreover, the relation between profitability and dividend payout expected to be positive as concluded by other studies.(Fama & French, 2002; Han, Lee, & Suk, 1999; Jensen, et al., 1992). Additionally, some researches about dividend policy in emerging markets support that earning is the key determinant of dividend distribution. For example, Adaoglu (2000) noted that in Turkey because of regulation, companies had to distribute half of their profits as cash dividends to investors until 1994. (Also see Pandey, 2001)

Based on these discussions, profitability is chosen in this study as a determinant of dividend payments and to measure profitability, after tax earnings per share is used. It is expected that dividend and profitability are positively related.

2.3.4 Financial Leverage

In order to have a comprehensive examination of the determinants of dividend policy among Malaysian public listed companies, the relationship between dividend payments and capital structure of the companies also have to take into consideration. Debt (liabilities) and equity make up the financial structure of a firm and the level that a firm relies on debt is referred "financial leverage". The use of debt can lever up shareholders return on equity. Leverage involves risk. Once a company acquires debt, it is contractually obligated to pay the interest payment and the principal amount. The commitment of paying these fixed fees consist risk. In other words, if a company cannot meet its obligations, this may cause its liquidation (Al-Malkawi, 2008).

As Rozeff (1982) pointed out, leverage creates fixed charges and dividends are proxy for these charges. His research showed that companies with a higher level of debt are likely to pay low dividend payments in order to reduce transaction costs (Rozeff, 1982). In addition, a study done by DeAngelo and Masulis (1980) showed that in tax and non-equilibrium condition, dividend payments and leverage are relevant.

Agrawal and Jayaraman (1994) examined that all equity firms pay higher dividends than leveraged firms since they want to reduce the agency problems of

free cash flows. Their findings showed the inverse relationship between dividend payouts and financial leverage.

By contrast, Mahadwartha and Jogiyanto (2002) found that leverage affects dividend positively and significantly. They argued that a higher level of debt results in a higher level of risk (bankruptcy cost). Consequently, the shareholders would demand for a higher level of dividend distribution in order to compensate the high level of risk. Another research done by Koch and Shenoy (1996) emphasized the simultaneous interdependence between leverage and dividend payout had affected future cash leverage considerably.

In addition, results of a study done in Japan showed that the debt ratio of high dividend payers was significantly lower than the low dividend payers (Kato, Loewenstein, & Tsay, 2002). According to all the discussions above, financial leverage has been known as one of the key factors that influence the dividend payments and according to prior researches, the relationship between dividend policy and firm's leverage is expected to be negative.

2.3.5 Growth Opportunities

According to the perfect capital market theory by Miller and Modigliani (1961), dividend policy and investment decisions are independent of each other. However, with the existence of market imperfections, such as taxes and agency costs, the linkage between dividend and corporate investment is possible.

The relationship between investment and dividend policies can be seen from two different angles. First, a cheap source of financing (retain earnings comparing to

debt and new equity issues) is forgone when a company pays dividends. The second point of view is by paying dividends, available funds for investment would be reduced. In other words, dividends and investments are competing to get the low cost internal funds (Elston, 1996).

The investment size is a function of the company's growth opportunities because the firm has to rely on external funds. By increasing the amount of available slacks, the underinvestment problem, which is probably rising with the growth opportunities, can be controlled. Thus, a firm which is expecting a growth should reduce its dividend payment in order to gain more financial slacks. Consequently, the probability of underinvestment would be reduced (Deshmukh, 2005).

As espoused by Milgrom and Robert (1992, p 507) in slow growth industries dividend payments are higher. On the other hand, those firms with profitable growth opportunities have limited free cash flows and pay lower dividend in order to decrease their dependence on external financing.

In other words, high growth firms need funds to finance in investment opportunities. As a result, they tend to pay no or low dividends. In contrast, firms with low investment opportunities would probably pay more dividends. This reasoning is consistent with the free cash flow hypothesis (Gul, 1999). Free cash flow hypothesis, the low growth firms want to limit their manager's activity by paying dividends (Jensen, 1986; Lang & Litzenberger, 1989)

The negative relationship between investment opportunities and dividend payments supports the pecking order theory of Myers and Majluf (1984). As proposed by Myers and Majluf, firms with high growth opportunities have to

pay low dividend payouts.

The residual theory implies that dividends should be paid after all investment opportunities have been financed. Based on the residual theory, a negative relationship between dividends and external financing would be expected (Alli, et al., 1993). According to Barclay (1995), investment opportunity is a significant factor of corporate dividend decisions. In addition, Fama and French (2002) also asserted that dividend payments in a firm are influenced by firm's growth opportunities.

Moreover, based on the maturity hypothesis, when a firm becomes more mature, its growth and investment opportunity would shrink. In other words, when a company is faced with a decline in growth opportunities, it then starts to increase its dividends. Declining growth opportunities will create more available cash flow; consequently, dividends will increase. The most important result for a mature company is its systematic risk is lower. Furthermore, because of a decline in investment opportunities and a decrease in risk, the capital expenditure would also be reduced. They concluded that dividend increases are a sign of the company's maturity (Grullon, Michaely, & Swaminathan, 2002).

The increase in dividends conveys two types of information. A decrease in dividends conveys good news while the bad news is that there is a decline in profitability.

The result showed that a positive reaction of the market indicates that news about profitability dominated by news about risk (Grullon, et al., 2002). In

addition, Grullon et al. (2002) asserted that an increase in dividend payments also conveys information about the management's commitment not to over invest. The results from Grullon et al. are consistent with free cash flow hypothesis but it is inconsistent with signaling theory.

As price earnings ratio is an indicator for future growth of a company, investors would always want to pay a premium for firms with high growth opportunities. Price earnings ratio has a positive relation with growth opportunities, meaning that those firms with a higher price earning have higher investment opportunities. Hence, the relationship between price earnings ratio and dividend payments is expected to be negative.

On the other hand, the mature companies prefer to stay in the low growth stage. These companies do not have any inducement to increase reserves as a result of low investment opportunities. In contrast, the new firms have to raise their reserves in order to meet the financial requirements; accordingly, they pay low dividends to keep their earnings (Deshmukh, 2005; Grullon, et al., 2002).

Based on the above discussion, as firms become more mature and less risky with lower growth opportunities, the probability of paying high dividends to shareholders would increase.