



Dividend Theory and Empirical Evidence: A Theoretical Perspective

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Abstract

Objective: The objective of this study is to theoretically review the existing theoretical and empirical literature on dividend policy to understand the status and applicability of the theory in different economies and to discover any potential knowledge gaps for further research.

Study Design and Methodology: This is a descriptive analysis of existing theoretical literature and its application in different economies. The study used a sample of empirical studies to gather empirical evidence.

Findings: Dividend policy has a significant role in the firm decision-making process, a uniform dividend policy for all firms may not be feasible because of the differences in firms' ownership, investor's preference and firm characteristics, firms maintain a consistent dividend policy to avoid giving wrong signals to investors. The study also confirms inconsistency in the application of existing dividend theory with empirical evidence in different markets. We find that the ownership structure of a firm has greater influence in the firm decision-making process and recommend future studies should explore the extent to which ownership structure influences dividend policy and firm value.

Significance of the study: This study provides a framework for evaluating dividend policy practices between developed and developing countries, evaluate the relevance and applicability of dividend theory within the context of developing economies and identify the best dividend policy practices. The study will form part of the body of knowledge in the finance literature that will enable scholars to appreciate the critical issues involved in dividend policy decisions and provide a base for identifying knowledge gaps for further research.

Introduction

This paper aims at examining the applicability of dividend theory in different market context through an analysis of existing theoretical literature and empirical evidence on dividend policy. Several theories have been put forward to explain the relationship between dividend policy and firm value, before the landmark paper by Modigliani and Miller in 1961 it was a commonly held view that dividend policy had a significant positive influence on the company value and managers could easily influence the behaviour of investors by changing its dividend payment policy. Subsequent empirical studies have refuted and often contradicted this perception, the most prominent dividend theories include: Dividend irrelevance theory; Bird in hand theory; Clientele effect theory; Tax preference theory; Signalling theory and Agency theory. The residual policy implied by Myers (1984) hierarchical financing model suggests that firms will apply the available earnings to investments and any balance can be distributed as dividends. The stable predictable policy suggested by Linter (1956) describes firms as having a target dividend payout based on their level of profitability and this is adjusted with growth in profitability. Kristianti (2013) defines the value of the firm as the price of a stock that has been outstanding on the stock market on a particular trading day. The value of a firm is an important consideration in managerial decisions because firms exist to create wealth for their owners and therefore all managerial decisions must be geared towards creating value for the owners. The dividend payment is the return shareholders receive for investing in a particular firm, the payment either in cash, scrip dividend or capital gains. Dividend policies are decisions managers make regarding the amount of dividend to pay, amount to be retained for reinvestment the and forms of dividends that investors should be paid. Hashemijoo, Ardekani, Younesi, (2010) have suggested that stability in dividend policy can influence stability in investors wealth and dividend policy is one of the tools managers can apply to influence the stability of shareholders wealth.

Extensive research has been done on dividend policy to date but as Brealey and Myers (2003) observe, "dividend policy is still one of the top ten unresolved issues in

finance”, Allen and Michealy (2003) have suggested that before a consensus on dividend policy is reached, extensive empirical studies need to be done. Naceur, Goaid and Belanes, (2006) notes that dividend policy is one of the most debated topics in finance. The current finance theory literature is based on empirical findings that have been largely developed through research and empirical tests in developed countries, like USA (NYSE), Great Britain (LSE), Germany (Frankfurt), New York Stock Exchange (NYSE), London Stock Exchange (LSE), Chicago Board of Exchange (CBOE). The landmark studies that define most of today finance theory and its related disciplines have their roots in the United States of America, Markovitz (1952) portfolio theory, Modigliani and Miller (1961) seminar papers on capital structure and dividend policy; Fama (1970) market efficiency; Black and Scholes (74) option pricing theory; Sharpe, Litner and Mossin (1964,65,66) respectively on Capital Asset pricing theory(CAPM); Ross (1977) Arbitrage pricing theory(APT); Gordon (1959) dividends earnings and stock price.

There is a contradicting perception among African scholars regarding the uniformity of dividend policies with developed countries: Nnadi, Nyema and Kabel (2012) observe that listed firms in both developed and developing countries share the similarity in dividend payment practices, Ashiq (2007) find no similarity of dividend policies in Tunisian stock exchange with developed countries, Taneem, Shania and Yuce (2011) saw dividend policies of developed countries were different from those in developing countries. Based on the above observations it would be imperative to investigate dividend policies of less developed countries within their context and equally the need to enrich finance theory through empirical research studies based on the context of the less developed countries which is different from developed countries. This study aims at exploring the status of research on dividend policy as presented in various empirical findings and their influence on the value of the firm through the analysis of theoretical and empirical literature. A survey of factors that influence the relationship between dividend policy and firm value will be examined.

Theoretical Literature

Modigliani and Miller (1961) suggest that a firm's choice of dividend policy has no impact on shareholders wealth because the value of the firm depends on its earnings and investment strategy and not the way the earnings are distributed. Based on assumptions of perfect capital market conditions where the cost of buying and selling stocks and taxes does not exist, that all investors have equal information pattern and managers would work in the best interest of the firm. They reinforced the dividend irrelevance theorem by arguing that if the dividend practice adopted by any firm corresponds to the dividend preference of its shareholders each firm would attract its clientele based on its dividend policy practice. In the long run, equilibrium in terms of choice of investment and dividend preference will be attained and shareholders valuation of the firm will not be different from those of firms with different dividend policy. Given perfect market conditions, a change in dividend policy will not materially affect any firm valuation because we have several firms in the market who may not act by the preference of their shareholders and there could be a movement across firms as investors try to align with firms whose dividend practice corresponds with their dividend preference.

Bird in Hand

The bird in hand theory suggests that dividend would be preferred to capital gains because dividend paid today is more certain than the future capital gains. According to Walter (1963), Investors prefer to receive dividends now so that they can reinvest and earn a further return. Litner (1956) argued that dividend is desired because it helps to reduce the level of information asymmetry, a firm that pays dividend assures investors that the firm is performing well and Gordon (1962) saw dividend as preferred to capital gains because dividend payment reduces risks associated with investments because it is more certain. The bird in hand theory sees investor's risk arising from reinvestment of profits. The implication here is that dividend payment induces a higher expected return from investors and this increases the cost of capital. Easterbrook (1984) argues that the risk of the firm is determined by the nature of the investments and not how the investments are financed. Investors can lower their risk

by reinvesting their income in the same firm or other better firms, therefore, reducing their risk.

Signaling Theory

The signaling hypothesis suggested by Linter (1956) is derived from the level of information asymmetry between managers and investors' dividend changes convey information about the firm's prospects. Linter noted that managers are more willing to raise rather than reduce dividend levels, and this is construed to mean that dividend decreases are associated with negative signals while dividend increases signal positive news. Bhattacharya (1979) presents a signaling model where the liquidation of the firm is related to the actual dividend paid and any change in dividend alters the liquidation value of the firm. Ross (1977) suggested a signaling hypothesis in which the use of debt by managers was seen by investors as an explanation for the quality of earning by assets the use of debt, therefore, is a signal for the quality of firm's assets.

Agency Theory

Jensen and Meckling (1976) have argued that separation of control and ownership gives rise to a conflict of interest and since managers have the responsibility of acting in the best interest of the owners, however, there are possibilities for conflicts between the interests of the two. Jensen (1986), explained a high level of retained earnings will motivate managers to pursue their interest, therefore shareholders will minimize the number of funds available to managers so that they are not tempted to act in their self-interest. Jensen (1986) through his free cash flow theory stated that "when a firm has financed all its positive net present value investments, it should distribute all its free cash flow as dividends". This will help reduce the conflicts of interest between managers and shareholders because the former given the opportunity would misuse the funds by indulging themselves in perquisites and non-value enhancing projects.

Empirical Evidence

Empirical studies on dividend policy have mixed findings but most studies on dividend policy and firm value confirm that dividend payment positively influences the value of the firm. Asquith & Mullins (1983) found that changes in the market price of shares were positively related to the size of dividend payment and subsequent increases in dividends had an impact on the value of the firm. Aduda and Kimathi (2011) while examining the applicability of the constant dividend model at Nairobi securities exchange, noted that dividend payment did not have any significant effect of share prices. Yegon, Cheruiyot and Sang (2014) investigated the relationship between dividend policy and financial performance for listed manufacturing companies in Kenya and found that dividend policy is positively related to a fixed asset, return on capital employed and earnings per share. Elton and Gruber (1970) Examined shares listed on the NYSE paying and observed that share prices fell by less than the amount of the dividend on ex-dividend days.

Factors that influence dividend policy

Maladjian and Rim (2014) studied the determinants of dividend policy on the Lebanese listed banks found that dividend policies were positively affected by firm size, risk and previous year's dividends and negatively affected by growth opportunities and profitability. Parua and Gupta (2009) studied 607 listed companies in India and found past, current and future earnings had a positive role in determining the dividend payout, and cash flow had a significant positive effect. Amidu & Abor (2006) have argued that liquidity increases the firm's ability to pay dividends while Franfurter *et al* (2003) and Adedeji (1998) found a positive relationship between liquidity and dividend payout. Gupta & Charu (2010) identified debt policy, liquidity, profitability, growth and ownership structures as the major factors influencing the dividend policy of Indian firms. Naceur, Goaid and Belanes (2006) observed that profitable firms had more stable earnings and could pay out higher dividends. Marfo-Yiadom and Agyei (2011) identified profitability, leverage, collateral capacity and changes in dividends as variables that had a positive

significant influence on dividend policy in Ghana and growth and firm age as variables that impacted negatively on dividend payout. Parua and Gupta (2009) found past, current and future earnings had a positive role in determining the dividend payout and cash flow had a significant positive effect for Indian companies. Dickens, Casey, & Newman, (2002), in their study of US firms in the period 1998-2000 saw a negative relationship between dividend payments and growth opportunities but a positive relationship with size and previous dividends. Maladjian and Rim (2014) in their study of the determinants of dividend policy on the Lebanese listed banks found that dividend policies were positively affected by firm size, risk and previous years' dividends and negatively affected by growth opportunities and profitability.

The level of Information asymmetry has been suggested by several empirical studies as positively affecting dividend payment policy of a firm: Miller and Rock (1985); Bhattacharya (1979); John & Williams (1985); Khan and King (2006). But Kai and Zhao (2008) examined the effect information asymmetry on dividend policy and found that firms that were subject to higher information asymmetries were reluctant to pay, increase or initiate dividends. Hashem, Vahab & Mahdi (2009) examined the relationship between dividend policy and the level of information asymmetry in Tehran stock exchange and found a significant reverse relationship. Khang and King (2006) observe a positive relationship between dividend policy and asymmetric information and explain that payment of dividends reduces free cash flow, forcing firms to enter the capital markets more often and release information as they attempt to get financing for their investments and this impacts positively to the firm value because of reduced agency costs. Information asymmetry represents the imperfections in the markets, payment of dividend helps to reduce the level of information asymmetry between managers and investors (John & Williams, 1985). Empirical evidence so far offers inconclusive evidence on the role of dividend as a signaling mechanism.

Factors that influence firm value

Kristianti (2013) identified insider ownership, institutional ownership and dividend policy as factors that had a significant negative effect on firm value with debt policy as moderating variables in Indonesia stock exchange. Thanatawee (2013) examined the relationship between ownership structure and dividend policy in Thailand and found that firms with large institutional shareholding paid more dividend. Randall, Masao & Anil (2000), investigated the relationship between ownership of banks and their value in Japan and found that firm value rises with increased managerial ownership of banks and equity ownership by corporate block holders is positively related to firm value in Japan. Jayesh (2004) in his study on the effect of ownership structure on firm value in India observed that managers have more influence on firm performance and external shareholders and holding companies did not significantly influence firm value. Georgeta and Stefan (2014) found a significant positive relationship between ownership by second, third and the sum of three largest shareholders in Bucharest stock exchange (BSE). Abdul *et al*, (2015) have empirical test results that show that company size, profitability and ownership structure affect dividend policy while company size, profitability had a positive impact on company value.

Summary of the literature review

Dividend irrelevance proposition identified profitability and investment strategy as the key to improved value of the firm. The bird in hand theory saw earnings and dividends as influencing firm value. Clientele effect saw investors as choosing their investment habitant based on the dividend payment policy of the firm. Agency theory saw the dividend as a mechanism for making managers observe financial discipline. Signaling theory presents information asymmetry as a determinant for dividend policy, the higher the level of information asymmetry, payment of dividend helps to sustain or improve the value of the firm. The pecking order hypothesis suggests that firms tend to follow an established financing pattern beginning with the easily available funds (internal funds) and graduate hierarchically through debt and issue equity as a last alternative. The implication for this hypothesis is that in the presence

of profitable investments projects firms pay fewer dividends to finance their investments. Free cash flow hypothesis and the pecking order hypothesis provide a framework for integrating both the firm dividend and debt policy to enhance firm value. Under the two hypothesis growth opportunities take precedence in financing and internal funds are applied first before dividends are paid. Based on the theoretical literature; firm profitability, liquidity, information asymmetry and size of the firm will most likely influence the dividend policy of the firm, information asymmetry is influenced by the firm ownership structure and therefore has implication for both dividend policy and firm value relationship.

Empirical studies provide compelling evidence in support of the relevance of dividends in influencing the value of the firm, (Fisher, 1961; Baskin, 1989; Asquith & Mullins, (1983). In this study profitability is a key variable in the dividend policy firm value relationship. Empirical studies by Maladjian & Rim (2014); Marfo-Yiadom & Agyei (2011); Parua & Gupta (2009) have identified liquidity and profitability as the most important variable that influences dividend policy. Gupta & Charu (2010); Kamal (2012); Kristianti (2013) have identified Ownership structure and investment opportunities as important variables that influence dividend policy and firm value. Empirical findings on the signalling role of dividends have mixed findings so far but an important application for dividend policy by managers is to signal positive prospects for the firm but as Miller & Rock (1985) observe, this can be costly signalling. Empirical tests by Ball *et al.* (1979) and Baskin (1989) found no support for dividend irrelevance but Black and Scholes studies in NYSE on the relationship between stock prices and dividend yield seemed to support the irrelevance of dividends.

Empirical tests on dividend theories are inconclusive and this suggests that more empirical studies on dividend theories need to be done. Initially, empirical studies focused on the relationship between dividend policy and firm value. Later, studies increasingly focused on other variables like agency costs, signalling, ownership structures and debt policy as factors that directly or indirectly influence dividend policy. Recent studies are increasingly focused on the role of dividend policy as a

corporate governance mechanism. Theoretical literature and empirical studies to a larger extent agree that profitability and liquidity of the firm influence positively the dividend policy of the firm which in turn affects firm value. The dividend policy can negatively be affected to some extent by the growth opportunities and ownership structure, while most studies agree on the negative effect of growth opportunities.

In this study, we found strong support for dividend policy as an important factor in the value generation in a firm. The clientele effect theory has strong implication for theory and practice in finance, under Agency theory, the dividend payment is used as a substitute for corporate governance mechanism that helps to reduce agency costs and therefore increase the value of the firm. Paying high dividends increases the cost of capital (equity) and this impact negatively on the company's cash flow for investments and value of the firm. Signally theory by Litner (1956) has been strongly supported by most researches as the most plausible reason why organizations pay dividends. Empirical evidence confirms that liquidity and profitability are key factors that positively influence the dividend payment policy of a firm (Yegon, et. al., 2014; Amidu & Abor, 2006; Gupta & Charu, 2010) and this is in line with the existing knowledge in finance. The analysis also suggests that the profitability of the firm influences the number of dividends to be paid, how the dividend is distributed is irrelevant to the shareholders (MM, 1961). Firms attract shareholders depending on the dividend policy so that shareholders who desire regular income will be attracted to high dividend-paying companies. Test by Elton Gruber (1970) and Frank and Jagannathan (1998) found no significant clientele effect on the ex-dividend date price change.

Paying dividends reduces agency costs, but also increases the transaction costs of issuing new debt this reduces a firm's cash flows and eventually the value of the firm. A cost-minimization model where an optimum dividend policy would be at a point where the transaction cost of new external finance would be equal to agency costs was suggested by Myers (1984). In this study, we observed that empirical evidence to be inconsistency in explaining the role of information asymmetry in dividend policy. Insider ownership and institutional shareholding are ownership structures

that play a key role in dividend policy decisions, managerial shareholding gives firms the flexibility in decision making, managers as shareholders are expected to make decisions that will add value to the firm, as Jensen (1986) observes managers as shareholders bear the consequences of benefits and costs that arise because of their decisions. Institutional ownership affects firm value in two different ways, first, some prefer cash dividends because they are income tax-exempt, others invest in dividend-paying companies because of excess cash which they might wish to realize in near future or their nature demands that they should realize their return early to meet their cash demands. Empirical evidence is not consistent about the role of institutional shareholders, but the presence of significant insider shareholders affects dividend policy.

Conclusion

In this study, we have established that dividend policy influences firm value, but the extent to which this happens depends on the contingent and situational factors surrounding each firm. The impact of dividend policy on firm value is mediated by the level of the firm's profitability, liquidity, information asymmetry and size of the firm. In the presence of information asymmetry dividend policy influences the actions of shareholders and therefore affects firm value. Growth investment opportunities, managerial ownership are key variables in dividend payment and firm value relationship. Empirical evidence is unanimous that dividend policy will have less or no impact where significant shareholding of the firm is owned by managers (insider ownership). Availability of growth opportunities is seen as the most compelling reason why firms will not pay or most likely decrease dividends. The presence of investment opportunities limits the availability of free-cash-flow hence limiting the payment of dividend.

This study concludes that a unique dividend payment policy for all firms may not be feasible because of the differences in firms' ownership, investor's preference and factor endowment, firms try to maintain a consistent dividend policy to avoid giving wrong signals to investors. A good dividend payment policy must balance the needs of the shareholders in the form of dividends and the organization positive net

present value investments. High dividend payments increase the cost of capital which translates into the low share price, most companies avoid changing their dividend policy unless the positive change can be sustained into the future. Most developing countries like Kenya, have few empirical studies examining the applicability of the dividend theories. For example, empirical studies that have been done so far have focused on the relationship between dividend policy and shareholder wealth (Yegon, Cheruiyot & Sang, 2014; Nnadi, Nyema, & Kabel, 2013), whilst the share price represents the shareholders' wealth expectations, it is important to recognize that dividend policy can influence the ability of the company to generate more income which is derived from assets purchased with the retained and reinvested income. Studies on the relationship between dividend policy and firm value should incorporate variables like profitability, liquidity, and information asymmetry firm size, leverage, and ownership structure and investment growth opportunities. Frankfurter and Wood (2003) observe that there is no single model that would explain dividend policy practices for firms, they suggest that behavioural and social-economic variables influence dividend policies of firms and should be incorporated in dividend policy research. We noted several empirical studies had contradicting outcome especially on the role of information asymmetry and the pecking order hypothesis.

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