



LITERATURE REVIEW ON FACTORS INFLUENCING DIVIDEND DECISIONS

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Abstract: Dividend decisions determinants is one of the most controversial topic in the field of finance. Dividend policy as an instrument to communicate information on the present and future prospects of the firm and it has impact on the market value of the firm. The various factors affecting the dividend decisions of the firm are varying under different sectors in different circumstances. This study provides the theoretical empirical review of different factors influencing dividend payout. Major factors from different studies have been combined together to create a new model. This model has to be tested under different circumstances.

Keywords: Dividend decisions, Factors, Firm size, Earnings, Profitability

I. Introduction

One of the important area in finance is dividend decisions. The harder we look at the dividend picture the more it seems like a puzzle, with pieces that just do not fit together (Black 1976). Even Brealey and Myers (2005) said that dividend policy as one of the top ten most difficult unsolved problems in financial economics. In the developed markets, researchers give more importance to dividend than emerging markets. Since the development of joint stock companies, dividend policies gained significance in financial literature. A large number of financial and non-financial determinants of corporate dividend policy have been discussed in the work of Lintner (1956).

II. Review of Literature

In the past five decades, several theories were propounded for dividend. Theoretical and empirical results were contradictory to each other. Miller and Modigliani (1961) assumed the markets were perfect so, dividends were irrelevant and it had no influence on the stock price of the company. Many researchers provided empirical evidence that if the markets are imperfect, it affect the share price of the company. In bird in the hand theory, it was explained that investors preference towards dividend is more than retained earnings so that the firms should plan for huge payout ratio in order to maximize the share price. (Gordon, 1956; Lintner, 1956; Fisher, 1961; Walter, 1963; Brigham and Gordon, 1968). Gordon and Walter (1963) present the bird in the hand theory which says that investors always prefer cash in hand rather than a future promise of capital gain due to minimizing risk. According to tax preference theory (Brennan, 1970; Elton and Gruber, 1970; Litzenberger and Ramaswamy, 1979; Litzenberger and Ramaswamy; Kalay, 1982; John and Williams, 1985; Poterba and Summers, 1984; Miller and Rock, 1985; Ambarish et al., 1987) dividends are taxed heavily than capital gain. Only when stocks are sold, capital gains are taxed but dividends are taxed directly. This made the investors to prefer for capital gain than dividend which in turn lead to low payout ratio for the companies. The agency theory of Jensen and Meckling (1976) is based on the conflict between managers and shareholder and the percentage of equity controlled by insider ownership should influence the dividend policy. Miller and Scholes (1978) find that the effect of tax preferences on clientele and conclude different tax rates on dividends and capital gain lead to different clientele.

According to signalling theory, it was revealed that the information asymmetry between managers and outside shareholders allows managers to use dividends as a tool to signal private information about a firm's performance to outsiders (Aharony and Swary, 1980; Asquith and Mullins, 1986; Kalay and Loewenstein, 1985; Healy and Palepu, 1988). Bhattacharya (1980) and John Williams (1985) dividends allay information asymmetric between managers and shareholders by delivering inside information of firm future prospects. Easterbrook (1984) gives further explanation regarding agency cost problem and says that there are two forms of agency costs; one is the cost monitoring and other is cost of risk aversion on the part of directors or managers. Transaction cost and residual theory indicates that firms incurring large transaction costs will be required to reduce dividend payouts to avoid the costs of external financing (Mueller, 1967; Higgins, 1972; Crutchley and Hansen, 1989; Alli et al., 1993; Holder et al., 1998). A different explanation, which received little consideration prior to the 1980s, relates dividend policy to the effect of agency costs (La Porta et al., 2000). Agency costs, in

this case, are costs incurred in monitoring company management to prevent inappropriate behaviour. Large dividend payouts reduce internal cash flows, forcing managers to seek external financing, and thereby, making them liable to capital suppliers, thus, reducing agency costs (Rozeff, 1982; Easterbrook, 1984; Lloyd, 1985; Crutchley and Hansen, 1989; Dempsey and Laber, 1992; Alli et al., 1993; Moh'd et al., 1995; Glen et al., 1995; Holder et al., 1998; Saxena, 1999). Life Cycle Theory explanation given by the Lease *et al.* (2000) and Fama and French (2001) is that the firms should follow a life cycle and reflect management's assessment of the importance of market imperfection and factors including taxes to equity holders, agency cost asymmetric information, floating cost and transaction costs Catering theory given by Baker and Wurgler (2004) suggest that the managers in order to give incentives to the investor according to their needs and wants and in this way cater the investors by paying smooth dividends when the investors put stock price premium on payers and by not paying when investors prefer non payers.

Empirical Review

Many researchers have analyzed different markets to identify the factors that influence the dividend policy of the companies. There are several literature on determinants of dividend policy is related to Lintner (1956) seminal work. Then the model is extended by the Fama and Babiak (1968). The following are the list of factors which influence the dividend decision of a firm. The empirical review have been segregated based on the impact of the factor in the review.

Beta: Alli, Khan and Ramirez (1993) find that dividends do not convey information regarding a firm's future cash flows. They report that at beta, firm's capital expenditure and financial slack are inversely related to the dividend payout.

Liquidity: Kanwal and Kapoor (2008) examine the dividend policies of companies in the information technology sector in India. They explore various factors such as profitability, cash flows, corporate tax, sales growth and growth opportunities that have an impact over the dividend policies of such companies. They report that only cash flows indicating liquidity and beta indicating risk are the foremost determinants. Thus over the years different strands of research have emerged in the area of dividend policy both in India and abroad

Profitability: A number of factors have been identified in previous empirical studies to influence the dividend payout ratios of firms including profitability, risk, cash flow, agency cost, and growth (see Higgins, 1981; Rozeff, 1982; Lloyd et al., 1985; Pruitt and Gitman, 1991; Jensen et al., 1992; Alli et al., 1993; Collins et al., 1996; D'Souza, 1999).

In Indian case Reddy (2006) show that the dividends paying firms are more profitable, large in size, and growing. The corporate tax or tax preference theory doesn't appear to hold true in Indian context

The financial literature documents that a firm's profitability is a significant and explanatory variable of dividend policy (Jensen et al., 1992; Han et al., 1999; Fama and French, 2000). However, there is a significant difference between dividend policies in developed and developing countries. This difference has been reported by Glen et al. (1995), showing that dividend payout rates in developing countries are approximately two-thirds of those in developed countries. Moreover, emerging market corporations do not follow a stable dividend policy; dividend payment for a given year is based on firm profitability for the same year. Profitability (PROF) is the ratio of net profits to the amount of money that shareholders have put into the company. ROE has been used in several studies as a proxy for firm profitability (Aivazian et al., 2003, ap Gwilym et al., 2004.) and is calculated as follows: $PROF = (\text{Net profit/shareholder's equity}) \times 100$. This creates the assumption that the dividend ratio per year is based on firm earnings for the same year. Amidu and Abor (2006) find dividend payout policy decision of listed firms in Ghana Stock Exchange is influenced by profitability, cash flow position, and growth scenario and investment opportunities of the firms. Profits have long been regarded as the primary indicator of a firm's capacity to pay dividends. Pruitt and Gitman (1991), in their study report that, current and past years' profits are important factors in influencing dividend payments. Al Kuwari (2009) too found a significantly positive relationship between the two.

Bose and Husain (2011) examined the determinants of Indian dividend Policy in case of five sectors i.e. Software, Finance, Steel, Electrical machinery and Pharmaceutical. The results disclosed that majority of firms increased their dividend payment due to increase in profits and decrease their dividend payment due to decrease in profits. The Lintner's model failed to explain the asymmetric dividend policy behavior of Indian firms.

Naceur et al. (2006) find that the high profitable firms with more stable earnings can manage the larger cash flows and because of this they pay larger dividends. Moreover, the firms with fast growth distribute the larger dividends so as attract to investors. Appannan and Sim (2011) concluded that the Profit-after-tax that has the strongest relationship with dividend per share. The debt-to- equity ratio and past dividend per share were the important determinants of dividend payment.

Earnings: The empirical analysis by Adaoglu (2000) shows that the firms listed on Istanbul Stock Exchange follow unstable cash dividend policy and the main factor for determining the amount of dividend is earning of the firms.

Eriotis (2005) reports that the Greek firms distribute dividend each year according to their target payout ratio, which is determined by distributed earnings and size of these firms. Baker et al. (1985) also find that a major

determinant of dividend payment was the anticipated level of future earnings. Eriotis (2005) reports that the Greek firms distribute dividend each year according to their target payout ratio, which is determined by distributed earnings and size of these firms. Rao and Sarma (1971) conducted an empirical study to enquire into the determinants of dividends of public and private limited enterprises. Their efforts revealed that the basic Lintner model was adequate for explaining the dividend behaviour in the case of majority of the industries such as coal mining, sugar, jute textiles, chemicals and cement industries.

Bhat and Pandey (1994) supported the Lintner's findings and revealed that Indian managers maintained an uninterrupted record of dividend payments and also try to avoid abrupt changes in their dividend policies.

Musa (2009) analyzed the dividend behavior by using Parsimonious multiple regression model developed by Musa (2005). The empirical results revealed that the five metric variables have significant impact and non-metric variables have insignificant impact on the dividend policy of Nigerian firms. However, three of the variables-current earnings, previous year dividend and cash flow have been found to be significant in the model. Okpara and Godwin Chigozie (2010) aimed at investigating the factors determining dividend pay-out policy in Nigeria. The results showed that three factors-earnings, current ratio and last year's dividends impact significantly on the dividend payout and dividend yield in Nigeria.

Raj kumar & Pawan kumar jha (2012) analysed the determinants of equity dividend in Indian IT sector which revealed that net profit after tax, cash flow and the amount of depreciation charged have significant impact on the equity dividend.

Myers (2004) finds strong support for earnings, profit margin, institutional ownership and debt-equity ratio on the dividend decision.

Kevin (1992) analyzes the dividend payment behavior of 650 Indian companies during september 1983 to August 1984 and finds that profitability and earnings of the firms are the two foremost actors determining dividends.

Firm size: There is highly significant association between the decision to pay dividends and size of the firm, profitability, growth, leverage, cash balance and history of dividends. (DeAngelo *et al.* (2004).

Research by Lloyd, Jahera, and Page (1985), and Vogt (1994) indicates that firm size plays a role in explaining the dividend-payout ratio of firms. They find that larger firms tend to be more mature and thus have easier access to the capital markets, which reduces their dependence on internally generated funding and allows for higher dividend-payout ratios. The hypothesized relationship between firm size and dividend-payout ratios is positive. Firm size (SIZE) is measured as a natural logarithm of total assets. This is due to the fact that large firms will pay large dividends to reduce agency costs (Ghosh and Woolridge, 1988; Eddy and Seifert, 1988; Redding, 1997).

Eddy and Seifert (1988), Jensen *et al.* (1992), Redding (1997), and Fama and French (2000) indicated that large firms distribute a higher amount of their net profits as cash dividends, than do small firms. Several studies have tested the impact of firm size on the dividend-agency relationship. Lloyd *et al.* (1985) were among the first to modify Rozeff's model by adding "firm size" as an additional variable. They considered it an important explanatory variable, as large companies are more likely to increase their dividend payouts to decrease agency costs. Their findings support Jensen and Meckling's (1976) argument, that agency costs are associated with firm size. Holder *et al.* (1998) revealed that larger firms have better access to capital markets and find it easier to raise funds at lower costs, allowing them to pay higher dividends to shareholders. This demonstrates a positive association between dividend payouts and firm size. The positive relationship between dividend payout policy and firm size is also supported by a growing number of other studies (, Eddy and Seifert, 1988; Jensen *et al.*, 1992; Redding, 1997; Holder *et al.*, 1998; Fama and French, 2000; Manos, 2002; Mollah 2002; Travlos *et al.*, 2002; Al-Malkawi, 2007).

Growth: In investigating the determinants of dividend policy of Tunisian stock Exchange Naceur *et al.* (2006) find that the high profitable firms with more stable earnings can manage the larger cash flows and because of this they pay larger dividends. Moreover, the firms with fast growth distribute the larger dividends so as attract to investors.

D'Souza (1999) however shows a positive but insignificant relationship in the case of growth

Higgins (1972) shows that payout ratio is negatively related to a firm's need for funds to finance growth opportunities. Rozeff (1982), Lloyd *et al.* (1985), and Collins *et al.* (1996) all show a significantly negative relationship between historical sales growth and dividend payout. Higgins (1981) indicates a direct link between growth and financing needs: rapidly growing firms have external financing needs because working capital needs normally exceed the incremental cash flows from new sales. Growth rate is measured as the growth rate of sales (Rozeff, 1982; Lloyd *et al.*, 1985; Jensen *et al.*, 1992; Alli *et al.*, 1993; Moh'd *et al.*, 1995; Holder *et al.*, 1998; Chen *et al.*, 1999; Sexsena, 1999; Manos, 2002; Travlos, 2002). Thus, growth rate has been identified in this study by Annual Sales Growth. Overall literature portrays a negative as well as a positive relationship between the dependent variable and sales growth. Growth was inversely related to dividend payout and was found to be significant .The main conclusion were that dividend decisions are better explained by Lintner's model with current profit and lagged dividend as explanatory variable

Corporate tax: Omet (2004) comes to the same conclusion in case of firms listed on Amman Securities Market and further the tax imposition on dividend does not have the significant impact on the dividend behaviour of the listed firms.

Corporate tax has been taken as an explanatory variable with the expected negative association with dividend payout by Anil and Kapoor (2008) in their study on IT sector of India and found it to be insignificant, consistent with Reddy's conclusion. It would be interesting to note the effect of corporate tax in Pakistan

Mahira Rafique (2012) empirically tested the determinants of dividend payout of non financial firms listed in KSE100 index. The results shown that corporate tax and firm's size have significant relationship with dividend payout.

Narasimhan and Asha (1997) look at the changes in dividend tax regime proposed in the Indian Union Budget of 1997-98 and analyze the impact of dividend tax on a firm's dividend decision.

Financial leverage: A growing number of studies have found that the level of financial leverage negatively affects dividend policy (Jensen et al., 1992; Agrawal and Jayaraman, 1994; Crutchley and Hansen, 1989; Faccio et al., 2001; Gugler and Yurtoglu, 2003; Al-Malkawi, 2005). Their studies inferred that highly levered firms look forward to maintaining their internal cash flow to fulfil duties, instead of distributing available cash to shareholders and protect their creditors. However, Mollah et al. (2001) examined an emerging market and found a direct relationship between financial leverage and debt-burden level that increases transaction costs. Thus, firms with high leverage ratios have high transaction costs, and are in a weak position to pay higher dividends to avoid the cost of external financing. To analyze the extent to which debt can affect dividend payouts, this study employed the financial leverage ratio, or ratio of liabilities (total short-term and longterm debt) to total shareholders' equity. Al Kuwari (2009) too found a significantly negative relationship between the two. The proxy used for financial leverage is Debt to Equity Ratio as used in all these studies. Asif, Rasool and Kamal (2011) examined the relationship between dividend policy and financial leverage of listed companies of Pakistan during the period of 2002-2008 by using extended Lintners (1956) model. The results showed the negative relationship between dividend payout and financial leverage while dividend yield showed the positive relationship between dividend yield and dividend per share. Amithabh Gupta & Charu Banga (2010) analysed companies from BSE 500 index and found that leverage and liquidity were the factors which influence the dividend decisions of the companies.

Cash flow: Alli et al. (1993) reveal that dividend payments depend more on cash flows, which reflect the company's ability to pay dividends, than on current earnings, which are less heavily influenced by accounting practices. They claim current earnings do not really reflect the firm's ability to pay dividends. The proxy used for earnings is the ratio of company's operating earnings before interest and tax (EBIT) to total assets.

Brittain (1966) studied the tax structure and corporate dividend policy over a period of 1919-1960. The results indicated that the capacity of a firm to pay dividends has been better explained in terms of cash flows as a variable, i.e., profits after taxes plus depreciation as against the Lintner's profits net of taxes, as it reflected true earnings.

Capital Expenditure: There is a negative relationship between agency cost and market risk with dividend payout but not between dividend payout and investment opportunities (D'Souza, 1999)

History of dividends: Naeem and Nasr (2007) observed the determinants and trends of dividend policies. Results of their study show that Pakistani companies are either reluctant to pay dividends or pay very low amount as dividends and their current dividend decisions depend on previous year dividends and Profitability Ratio.

Ownership structure: Husam et.al.(2007) examined the determinants of corporate dividend policy in Jordan using Tobit specifications. The results suggested that the proportion of stocks held by insiders and state ownership significantly affected the amount of dividends paid. Size, age, and profitability of the firm seemed to be determinant factors of corporate dividend policy in Jordan

Kania and Bacon (2005) find that variables such as sales growth, expansion and insider ownership have a negative impact on dividend decision but institutional ownership has an inverse relation with dividend payout, which is contrary to the existing literature Other factors include financial slack, age of the firm, no. of common stockholders, agency cost, cash balance and risk.

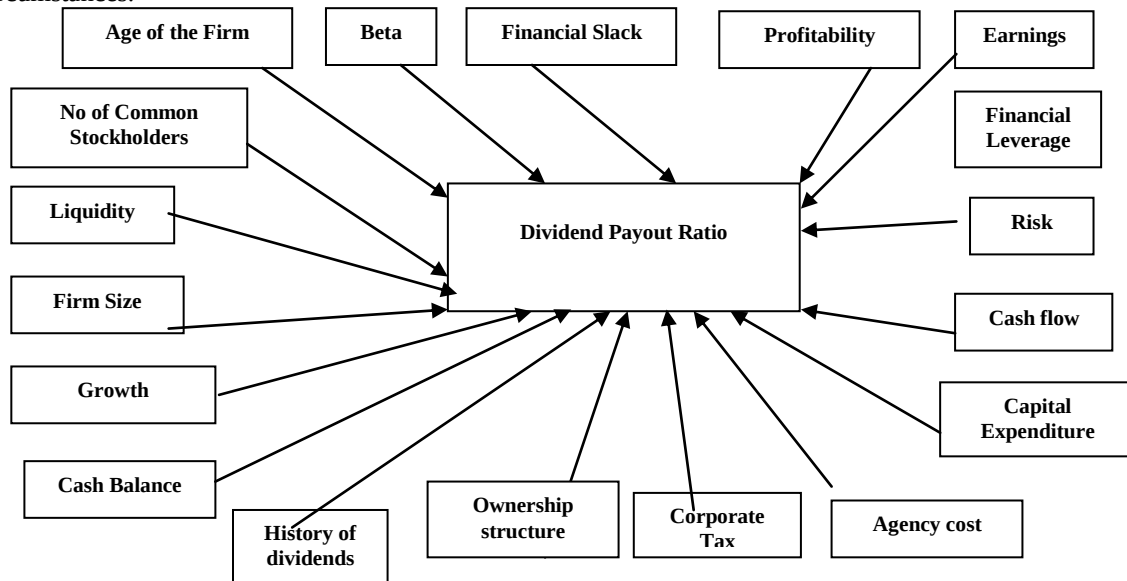
III. Determinants of Dividend decisions

There are many factors which influence the dividend decision of the companies. Based on theoretical and empirical review, the following factors have been identified as significant. These factors have been used for different sectors of the companies across different countries. It has to be tested under Indian conditions.

IV Conclusion

Many researchers have done the study on factors influencing dividend decisions under different circumstances. Some of the researchers have found that earnings and firm size are the major factors which influence the dividend decisions, while some others found that ownership structure, leverage, cash flow, corporate tax were

the major factors. Others have found that beta, corporate tax, investment opportunities were not influencing the decisions. Major factors used in different studies were combined together to find its impact under Indian circumstances.



Source: (Author's Compilation)

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