

## Dividend Policy Decisions: Theoretical Views and Relevant Issues

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### **Abstract**

This paper provides literature on dividend policy decisions by the corporates in the perspective of shareholder's wealth. Dividend payment is a signal of performance of firms. If dividend increases, share price will also increase, which leads to the creation of shareholder's wealth. Although, extant literature review have examined issues of dividend policy, still they produced inconclusive results on the dividend policy decisions. Thus a good model that combines dividends with share buybacks is a fairly good compromise due to its advantage of flexibility, tax treatment and intangible gains. Share repurchases leads to better tax treatment than dividend and are more flexible than regular dividends for the company.

**Keywords:** Dividends, Dividend Policy decisions, Share buybacks, Shareholders wealth

# 1 Introduction

The creation of shareholder value is one of the important goals in the organization. The importance of company valuation has been increasing eventually over the past decades. In the capital market the valuation of company plays a crucial role and shows dynamic growth of the company transactions [1]. The concept of company valuation includes investment, operational and financial decisions. When focusing on the valuation of company question arises of who might be interested in the resulting numbers. A more specific and general answer would be all the stakeholders [2]. It is still not clear, whether shareholder have enough knowledge to pick a company's new direction accurately. Thus it becomes the responsibility of the managers or company's decision makers to provide accurate information about company's future directions. Having made an investment in a business, shareholders are concerned with assessing the profitability of their investment. The decisions made by managers determine what they can expect both in terms of dividends, or profits, and capital growth, both of which are reflected through the share price.

Different stakeholders have different objectives in the firm that leads to create mainly the agency problems. The idea of agency problems is the owners (shareholders) have their own objective of shareholder's wealth maximization whereas the manager will have their own objective such as getting good bonuses, getting good pay and getting good incentives and compensations etc. arising conflict between each other. Manager's pay includes fixed wages, share options and performance related pay. Managers get fixed wages for the wealth maximization of shareholders increasing the market price of the shares. So when the manager benefits also includes share options increases their willing to work smart for increasing share price in the market. The other pay is in the form of performance related pay like bonuses, incentives. All of this management pay is performed to increase their job satisfaction.

The policy of dividend decisions is one of the most important issues in finance. The concept of dividend policy has been heavily focused by financial scholars for the past decades. Several issues in relation to theories and dividend patterns towards the behavior of corporate have been investigated. [3] defined dividend policy as the practice of dividend payout decisions made by the management of the organization. In the corporate finance theory dividend decisions of the companies have been a debatable issue in the literature. According to [4] dividends are paid to the minority shareholders due to their pressures to discharge cash in the form of dividend. The study of dividend puzzle by [5] comprehended that when the investment policy by the firm is kept constant; there is no effect on dividend policy on the shareholder value. It has been debatable issues for the researchers and academicians that is why companies pay dividends when high taxation is imposed on them. [6] claimed

that high taxable dividends increase the firm future value. Therefore, it is important to address and confirm the importance of dividend policy decisions taken by the firms towards wealth maximization of the shareholders.

Apart from value drivers, shareholder value is also affected by the dividend policy decisions taken by the management. Dividend policy has been an emerging issue in the financial literature. Dividends are usually defined as the distribution of earnings among the shareholders of the firms on the basis of their ownership [7]. [8], investigated the behavior of dividends in the Indian firms and found that not all the firms paid regular dividends. All the firms were having different patterns to pay dividend. According to the approach by two noble winners Miller and Modigliani (MM) the dividend policy does not affect the shareholder value. The net dividend payout was the difference between earnings and investment also considered as residual. These findings were based on assumptions that: Information disclosed to investors are free and is available to all the investors, no tax distortion exists, non-existence of flotation and transportation costs, and non-agency cost exists[9].

However, there has been growing awareness on the traditional measures to be non-reliable to risk and inflation [10],[11]. Other reasons for the failure of earnings to measure the value of the business are:

1. Employment of an alternative accounting methods
2. Dividend policy is not considered
3. Ignorance of time value of money

[12] stated that an organization that treats its stakeholders unethically will not be able to create long run business. [13] suggested that managers must prioritize stakeholders' interests, but added further that such sentiments are not guided for decision making.

[14] pointed out that dividend payment is a signal of performance of firms. If dividend increases, share price will also increases, which leads to the creation of shareholder's wealth. Nevertheless, in reality, most of companies focused more on making profit rather than maximizing the shareholder's wealth. Even in most of the developing countries particularly, companies do not emphasis so much on dividend and do not have a proper dividend policy except for several large, well-established companies. [15] also supported that, since there is no standard policy or procedure governing dividend payments, companies therefore decides freely on how much dividend to pay to its shareholders. Ideally, companies should give or distribute profits earned on a particular year in the form of dividend to the shareholders as satisfied shareholders will have confidence in the companies and ultimately contribute more to the company to support its growth. This is actually increasing the value of the company's shares, which will lead to the maximization of shareholder's wealth.

## **2 A Review of Dividend Theories**

The issue of conflict between managers and shareholders has been an important problem to consider in the corporation [16]. Dividend policies addressing the agency issues between managers and minority shareholders have not received much attention by researchers and academicians [17], [18], [19].

According to the substitute model cash dividend is a substitute of legal protection of investors. When the legal protection of the shareholders is disorganized, the companies are likely to discharge high dividend. Governance quality is improved when the minority shareholders force corporate managers to pay cash dividends. However, when dividend is utilized for other governance mechanisms, the consistent role of dividend is diminished. Thus, in the context of economic bubble, the small firms are most likely to distribute earnings freely in the form of dividends which are also consistent with the substitute model which confirms that the dividend payout helps the managers to raise future equity value and cash flows [20].

Theories based on dividend policies were argued in order to explain the rationale in relation to dividend payment by the corporate. There are always mixed opinions in the top management of the firms in between paying dividends or reinvesting their profits on the business. Even those firms which pay dividends do not appear to have a stationary formula of determining payout ratios. [21] stated that, "Dividends are periodic payments to holders of equity which together with capital gains are the returns for investing in a firm's stock." The prospects of earning period dividends and sustained capital appreciation are therefore the main drivers of investors' decisions to invest in equity. Furthermore, previous studies [22], [23] claimed that, "It is very difficult to provide empirical test on the dividend distribution policy and rate of return on stocks". Theoretically firms with higher dividend payouts also have higher rate of returns. It is very difficult to provide empirical test on the dividend distribution policy and rate of return on stocks. Theoretically firms with higher dividend payouts also have higher rate of returns. In order to explain the major arguments relating to payment of dividends by firms, below are some of the dividend policy theories put in place:

### **2.1 Modigliani and Miller (MM) Theory**

The MM theory was first proposed by Franco Modigliani and Merton Miller in 1961. They suggested that dividends and capital profits are equal when an investor considers return on investment. Only earnings are the direct result of the company's investment policy and can affect corporate value. Thus according to this theory, if the investors know the investment decision that is considered by the company, then there is no need for the investors to make

their decision based on dividend policy. This theory further explains that investors need to maintain their own cash inflows regardless of whether the stocks pay dividends or not. Dividend distribution to shareholders was claimed by MM as irrelevant as the price of the stock decreases due to the distribution of dividends. This theory also implies that the cost of debt is equal to the cost of equity as the cost of capital is not affected by the leverage [24].

This theory believes that there is no transaction or flotation cost and there is no influence of investors on the market value of the share. Further this theory also assumes that there is no existence of taxes, in terms of the assumption relation to investment policy, this theory claimed that the company does not change their investment policy. There is no change in the risk and the return for future financing.

The assumptions made by the MM theory are not logically strong and thus have been criticized [25]. The assumption of no transaction cost and no taxes is not possible in the real world. However, both internal and external financing are different, but this theory assumed them to be logically equal which is also not possible. The MM theory of dividend policy is an interesting and a different approach to the valuation of shares. It is a popular model which believes in the irrelevance of the dividends. However, the policy suffers from various important limitations and thus, is critiqued regarding its assumptions.

## 2.2 Walter's model of dividend policy

Walter's theory on the dividend policy believes in the relevance concept of dividend. The valuation of the shares is affected due to its dividend decisions as per the concept of Walter's theory. The value of the companies is increased when they pay high dividends as compared to the companies paying low dividends. This concept has been approved by many studies like [26], [27], [28]. To get high return, shareholders reinvest the dividends received by the company, and is bound to pay the cost of these dividends which is referred as the opportunity cost or the cost of capital. This theory also postulated that if the firm does not pay dividends and reinvest the funds in profitable ventures it would increase future returns for the shareholders. According to the Walter's model if the rate of return is less than the cost of capital, the firm must distribute the profits in the form of dividends, further, if the rate of return is higher than the cost of capital, then the firm must invest the retained earnings in the profitable ventures. Thus it is important to understand the relationship between the rate of return ( $r$ ) and the cost of capital ( $K_e$ ).

This model also was not able to exclude some assumptions which are as follows:

- The first assumption was made based on internal financing where all the investments are financed by the firm through retained earnings and no

new equity or debt is issued.

- The second assumption was based on constant IRR and cost of capital and the business risks remains equal for all the investment decisions.
- EPS and DPS were constant and never change while determining a value.
- All the earnings of the company are distributed as dividends
- The Company has a very long life

The Walter's theory was also being criticized due to: No external financing assumptions which is very difficult in today's real investment world. The firm will need external financing for future new investments. The cost of capital and internal rate of return was kept as constant which is also very hard to accept as due to future new investments, the business risks are more likely to increase or change. Thus in summary, the assumption made by this theory is unrealistic as the concept mentioned that the dividend policy has impact on the market value of the share.

### **2.3 Gordon's theory on dividend policy**

The Gordon's theory on dividend policy is one of the theories that believe in the "relevance of dividends" concept. It is also called the "Bird-in-the-hand" theory that states the current dividends as important in determining the value of the firm. Gordons model is one of the most popular mathematical models to calculate the market value of the company using its dividend policy. Gordon's model is related market value of the company to its dividend policy. The determinants of the market value of the share are the perpetual stream of future dividends to be paid, the cost of capital and the expected annual growth rate of the company.

The Gordon's theory on dividend policy stated that the company's dividend payout policy and the relationship between its rate of return ( $r$ ) and the cost of capital ( $k$ ) influences the market price per share of the company. The dividend yield and the future growth of the dividends provide the total return of the equity investors. This model insists that dividend yield is an important measure for the total return to the equity investors than the future growth rate of the dividends. Future growth and capital gains cannot be estimated with accuracy and are not guaranteed at all as it may lose the entire market value of the stock.

This theory assumed that there is no debt and all the capital structures achieved are from the equity. This theory also assumed that there is no external financing and the capital is financed by retained earnings. Furthermore, corporate taxes are not accounted in this model. This model indicates that

the market value of the company's share is the sum total of the present values of infinite future dividends to be declared. The Gordon's model can also be used to calculate the cost of equity, if the market value is known and the future dividends can be forecasted. The Gordon's model believes that the dividend policy impacts the company in various scenarios. If the growth rate of return is above the cost of capital, shareholders will be benefited more if the company reinvests the dividends rather than distributing it. In addition, when the internal rate of return is equal to the cost of the capital, the reinvestment of the dividends would not make any difference. This model has also been criticized due to the assumption of constant IRR and CoC, which is not accurate, as it means business risks are not accounted.

From the investigation of the theories in relation to dividend policy, the Gordon's theory is the most suitable for this study as it determines the market price of the share and calculates the cost of capital effectively while forecasting dividends. Furthermore, according to Gordon (1959) there are three possible hypotheses why investors would buy a certain stock. First is to obtain both dividend and earnings, second is to obtain dividends and finally to get earnings. Dividend plays an important role on share price than retained earnings, which was also empirically evidenced by [25], [26],[29],[30].

The information gap between insiders and outsiders may cause the true intrinsic value of the firm along with the shareholder wealth. Due to lack of complete information and accurate information available to shareholders, the cash flow provided by the firms to the investors is the main basis of market valuation. Many scholars have suggested that dividends might have implicit information about a firm's prospects. In this way dividends came to provide a useful tool for managers and shareholders to convey their private information to the market because investors used cash flow to equity as a market value.

Thus, final suggestion for the theoretical and empirical underpinnings is to rectify the empirical limitations that appear to dominate this field. Examination of dividend payout decisions signaling with a share buybacks is crucial for the shareholders as it would reflect to uncertainty amongst them about what management will do with excess funds. Examination of longer time frame would increase the empirical certainty on its role to measure the shareholder value. Similarly, when the company pays cash to all the shareholders in the form of dividends or the company buys back shares, it is considered as a decrease in the equity market value and not the shareholder value added. Thus in summary, the Gordon's theory of dividend policy is one of the prominent theories in the valuation of the company. Though it comes with its own limitations, it is a widely accepted model to determine the market price of the share using the forecasting dividends.

### **3 Empirical Evidence on Dividend Policy**

The source of funds and the amount of financing are important value considerations when the investment and financing decisions are considered to be dependent functions [31]. In real world, the financing decisions are affected by the dividend policy and despite of influencing liquidity, investor's expectations dividend policy is a very important aspect of corporate financial decision making [32]. However, the importance of dividend policy is not a modern discussions, as [33] mentioned that, "the effect of a firm's dividend policy on the current price of its shares is a matter of considerable importance.

During the years of 1960s Modigliani and Miller raised questions like, Do companies distribute dividends consistently at a premium over those with niggardly payouts? If so, under what conditions? Is there an optimum payout ratio that maximize current value of the shares? these questions raised by [33] have been investigated by many empirical studies [7],[8],[34],[35] in the recent years, but still it remained unanswered. However, [8] mentioned that the dividends payout would disappear in the emerging markets and the shareholders would get their return based on the valuation of the company in the market. Furthermore, [36] stated that, "although one-third of the firms have corporate block holders, 68% of the firms pay no dividends and ownership is not gathered. Furthermore, they added that financial investors are not attracted to dividend paying firms and tend to be passive. For instance, [37] wrote that, "Corporates prefer to invest in high dividend stocks, even if there is no preference for the current income". Similarly, [38] mentioned that, "corporates pay dividends only because of tax reason".

[39] argued that agency conflicts can be circumvented by large dividend payments to shareholders. [18] affirmed this view by indicating that dividend payments control the agency problems by facilitating capital market monitoring of the firm's activities and performance. Yet another argument, advanced by [40], suggests that managers may actually be willing to pay dividends in order to avoid disciplining action by shareholders. The literature on signaling hypothesis builds upon the pioneering work of [6]. The signaling theory suggests that dividends are used to signal the management's private information regarding the future earnings of the firm [41]. As per [42], investors interpret announcements of dividend initiations and omissions as manager's forecast of future earnings changes. Dividends are generally used in signaling the firm's future prospects, and dividends are paid even if there is profitable investment opportunity [43].

However [44] acknowledged that whatever is the policy line chosen by the board of directors, it should be aimed at maximizing shareholder wealth in line with the corporate objectives. The firm can only pay dividend if the value of the firm after payments falls by no more than the value of the dividends.

Otherwise, the firm would be better advised to retain the funds and invest them on behalf of the shareholders, thereby enhancing the value of the firm as well as maximizing shareholder value.

Dividend policy has been the most popular due to issues like information asymmetry between managers and shareholders, theories on dividend payment such as stakeholder's theory, pecking order theory, agency cost, signaling theory and stewardship theory. Share price volatility is the systematic risk on the other hand that is faced by shareholders holding ordinary shares. Thus investors pay a close attention to the company's dividend payout and their riskiness on the valuation of firm's shares [45]. Yet another study, advanced by [46] formulated dividend payout as the ratio of dividend to earnings while investigating the relationship between corporate governance and dividend payout ratio. The findings showed that corporate governance has negative relationship with dividend payouts.

In addition, [47] investigated determinants of dividend payout ratio defined as the ratio of yearly dividend paid and net income after tax paid. However, [48] calculated dividend payout ratio as the percentage of profit paid as dividend and the result found negative association between dividend payout ratio and risk, market to book value and growth. Similarly, [7] investigating on the relationship between dividend policy and shareholder value found there is negative association between them. The argument made was as dividend is paid to the shareholders, it will eventually decrease the retained earnings followed by the excess cash drops. Thus there is a need to adjust the dividend payout ratio in order to know for the shareholders whether the company is able to pay dividends in the future. The adjusted dividend payout formula undertaken for this study is:

$$\text{Modified Dividend payout ratio} = \frac{\text{Dividend} + \text{Share buyback}}{\text{Net income}} \quad (1)$$

The share buyback will result in cash outflow thereby, reducing the cash flow and working capital of the firm. However, the quantum of it depends on the purchase price of the shares and the number of shares repurchased. When the company is using external borrowings to purchase its own shares, it is important to ensure that it has sufficient funds to repay the external borrowings. The working capital and the cash flow of the company will increase upon reselling the shared purchase which is retained as treasury shares. However, the positive working capital and cash flow will depend on the actual selling price of the treasury shares resold. Thus the transaction of treasury shares for the existing shareholders play an important role in its dividend payout in future.

Dividend payout ratio reveals that when there is cash outflow due to dividend paid, buying back shares would allow the company to reduce the extra cash that is required for the firm's strategic business plan. Share repurchase

is an alternative to paying as dividend and that a company can reduce the investor's tax bill [49], [50]. [51] examined the dividend payments and share repurchases over the period of 1989–2005 of company members of European Union and found that capital gain can be achieved by buyback shares from the secondary market. It has also been suggested by [52] that stock repurchases increase the volatility along with the increase in financial leverage. Share buyback is appreciated by the shareholders but not by other stakeholders including managers, employees and creditors as they want the firm to grow and expand and buyback may be considered as a sign of poor investment. Thus on the shareholder perspective share buyback signals as an alternative on capital gains and it makes it obvious to investigate dividend payout decisions including share buyback.

Many researchers discussed different models in order to identify factors that influence dividend decisions from one country to another. It has been challenging issues for the identification of driver variables of dividend payout ratio in an emerging market. [53] investigated the relationship between dividend payout ratio with profitability, size, growth, opportunities, and market to book value taking 248 Malaysian firms listed in the Bursa Malaysia stock exchange and found that the return of asset, return on equity has high influence on dividend payout ratio. [34] examined the impact of dividend payout policy decision on Malaysian companies found that dividend payout decision like profit after tax have high influence on dividend per share. The study also confirmed that debt equity ratio and past dividend per share are major determinants for dividend payment.

The wealth of the shareholders can be determined by the increased market value of company shares which in turn represent the investment, financing and dividend decisions. Furthermore, to maintain the sector competitiveness and increase the firm value, managers must be able to take critical business decisions. By contrast, shareholder return calculates the change in the market capitalization including dividends, paid from this year to the next expressing this change as a market value of equity and dividends. Many shareholders are closely looking for the performance measures because they offer the possibility of generating higher returns on their capital investment.

## **4 Summary**

The literature on dividend policy has been produced using a large body of theoretical and empirical studies. The irrelevance of M & M is still argued in the empirical literature and no general unity has yet appeared. Share repurchase in the form of payouts can be a substitute to help managers hit EPS based compensation targets. Share buyback is crucial for the shareholder's wealth as the buybacks impact on share price. Furthermore, due to no operational

change in the corporate, the return on operating capital is equal after the buyback. Theoretically, the share price increases from a buyback resulting purely from the tax benefits of a corporation's new capital structure. In summary, dividend payout focusing on share buybacks would create value for shareholders as it would result increase in share price, removing tax penalty. The market responds quickly to the announcements of share buybacks as they offer new information that is often called a signal to the shareholders or investors about a company's future and hence its share price. Share repurchases are acceptable when the company is currently priced at a level shareholders would buy shares at.

Although, extant literature review have examined issues of dividend policy, still they produced inconclusive results on the dividend policy decisions. Thus a good model that combines dividends with share buybacks is a fairly good compromise due to its advantage of flexibility, tax treatment and intangible gains. Share repurchases leads to better tax treatment than dividend and are more flexible than regular dividends for the company.

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