



# Dividend Policy and Firm Performance: A Review of Theories and Empirical Literature

Salwa Said

DBA holder from Arab Academy for Science, Technology and Maritime Transport, Alexandria, Egypt

Email: salwa.said91@yahoo.com

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## Abstract

Corporate dividend policy is one of the most challenging issues in the corporate finance field. The decision of dividend policy is considered an important managerial decision as it could have a serious impact on firm performance and firm value. Many researchers have investigated the association between dividend policy and firm performance in different countries and contexts. Different theories and a large body of theoretical and empirical literature have addressed the relationship between dividend policy and firm performance, yet there is no consensus on this issue, and the debate on dividend policy is still open. This study aims to present a comprehensive review of theories and empirical literature concerning the association between corporate dividend policy and its performance for more explanation and understanding of this important topic. This study contributes to corporate dividend policy literature by identifying the potential gaps in previous literature and presenting suggestions for further research.

## Subject Areas

Finance

## Keywords

Dividend Policy, Firm Performance, Literature Review

## 1. Introduction

Corporate dividend policy, for a long time, has been an unsolved issue, which attracted a lot of interest from practitioners and academics. Dividend policy is considered the core component of a corporate's overall financial policy. The decision regarding dividend policy is one of the most significant decisions that corporates'

managers encounter. Many authors continue to present different findings from their research on the relevance of dividend policy. Although there are many findings on this issue, it has not yet been resolved. Beginning with John Lintner works and Modigliani and Miller the seminal works, dividends policy of a firm is still an open subject [1]-[3].

Many researchers have defined corporate dividend policy, [4] stated that dividend policy refers to the practices followed by management in making dividend decisions or the size and pattern of cash distributions to stockholders over time. According to [5], dividend is a portion of profit that is distributed among shareholders. Therefore, when a company makes more profits, the stock price increases and vice versa. [2] defined dividend as the distribution of a company's earnings to shareholders after paying taxes and other payments on borrowed funds. [6] revealed that dividend payout ratio refers to a policy by which the managers of a company determine the portion and pattern of cash distribution to a company's shareholders over a specified period of time.

Many researchers have emphasized the importance of the corporate dividend policy and its potential impact on firm performance and value. According to [6] the importance of dividend payout ratio is due to the possibility of using it as a tool to demonstrate the stability of the company. [1] stated that the value of a company and consequently, the wealth of shareholders can be impacted by the dividend policy. Therefore, one of the most crucial decisions that a company's managers face is dividend policy. [7] explained that companies may distribute dividends for various reasons, such as rewarding their current shareholders and encouraging potential investors to invest in stocks, while investors are interested in dividends because through dividend distribution, they get on their investments.

However, financial academics are divided into two groups regarding the impact of dividend policy on corporate value. While one group believes that dividend policy has no effect on the value of companies, the other group believes that dividend policy may affect the value of companies. However, the last group was divided into two groups, one of which suggests that this effect is positive, while the other suggests that this effect is negative [8].

[9] explained that dividend policy of a firm is still a matter of debate because distributing dividends to shareholders will reduce retained earnings and thus, reduce the total internal financing source. When internal financing is insufficient, this will force the company to seek external financing and issue stocks or bonds. On the contrary, if the company retains the profits earned to reinvest them in order to further grow the company, the dividend to shareholders will be reduced. Therefore, a balance should be made between the distributed profit and withheld profit while maintaining the firm's goal of increasing its value.

The objective of this paper is to study the relationship between dividend policy and firm performance in the context of alternative dividend policy theories, and to present a comprehensive review of empirical literature related to the association between corporate dividend policy and its performance.

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## 2. Methodology

In order to fulfill the research objective, the research was conducted using secondary data, which is the main source of data for this study. Databases such as Research Gate, Google Scholar, and Emerald were chosen to search for research papers using keywords of this study: “dividend policy” and “firm performance”. The collected research papers cover the period from 2007 to 2023. Thus, the present study investigates the most recent research papers related to dividend policy and firm performance. Using the selected data, the literature review is divided into two main parts. First part presents theoretical background and reviews the different theories related to the relationship between dividend policy and firm performance, while in the second part prior empirical research papers that examined the association between dividend policy and firm performance were reviewed.

## 3. Literature Review

Many studies have been conducted to demonstrate the relationship between dividend policy and firm performance in different countries and contexts, but there is no consensus on this issue. Therefore, reviewing different theories and empirical studies concerning corporate dividend policy could be beneficial for more explanation and understanding of this important topic.

### 3.1. Reviewing Theoretical Literature

Many dividend theories were proposed in order to explain dividend decisions and their effect on firms' value. These theories proposed three explanations regarding the impact of dividend policy. While conservative group suggests that increasing payout ratio will be resulted in an increase in firm value, the other group suggests that a higher dividend payout decreases firm value. However, Modigliani and Miller, 1961, proposed that payout dividend policy has no effect on the value of the firm [4].

#### 1) Irrelevant theory

According to irrelevance hypothesis of Miller and Modigliani, all dividend policies are the same, and there is none that can maximize stockholders' value in an efficient capital market [2]. Dividend Irrelevant theory (M &M, 1961) proposes that the stockholders of a firm are not affected by a firm's dividend payout policy since they may sell a part of their equities if they want to obtain cash. However, M&M dividend payout policy is considered irrelevant in a perfect capital market as it doesn't change the firm's value. The value of a given firm is based on its earnings that result from its investment policy [6].

M&M theory suggests that in a capital market without imperfections such as agency costs, taxes, and asymmetric information, dividend policy of a firm is irrelevant to its market value. Thus, financial managers of a firm can't alter firm's value by changing dividend policy. They revealed that firms' value can be increased through investing in productive assets, rather than the dividend policy decision [1].

## 2) Bird in hand theory

Bird-in-the-hand theory proposes that dividend is relevant to the firm and market value, as total return is the equivalent of the sum of capital gains and dividend yield [6]. This theory suggests that shareholders often prefer current dividends over capital gains due to uncertainty in the business environment. Since capital gains are expected in the future and are riskier than current profits, investors will pay a higher price for dividend-paying companies, which will result in an increase in the value of the company [8]. According to [10], bird-in-hand theory (Bhattacharya, 1979) assumes that there are market imperfections where taxes, information asymmetry, and transaction costs exist. Under these assumptions, firm value can be affected by dividend policy. Shareholders always prefer dividends payout over capital gains. Therefore, firms that pay dividends could attract a higher valuation from shareholders.

## 3) Signaling theory

The signaling hypothesis assumes that there is asymmetric information between managers and owners where managers may have information regarding the value of the firm that outside shareholders do not have. In order to bridge this information gap, managers use dividend declarations as a signal to outside investors about firm's future profitability. Then, in a positive response, the price of share will increase [11]. However, [12] stated that distribution of dividend could improve the welfare of the stockholders and also send a signal to the capital market and potential investors regarding the firm's growth and performance. This signal could lead to an increase in firm's stock price. According to [1] signaling theory postulates that companies can use dividend as a tool to send information about a company's future prospects to investors. The announcement of cash dividend sends information about a company's future profitability to shareholders, which reduces information asymmetry. Shareholders may use this information in evaluating company's stock price.

## 4) The agency cost theory

The stand point of agency theory is that by using debt and dividend payments, corporate managers are required to make efficient investments in order to increase profit and meet their commitments to both debtholders and shareholders, which reduces a company's monitoring cost. [13]. Agency conflicts occur because of differences in goals and risk preferences between insider parties and outsider parties of the company. This conflict could arise not only between managers and shareholders but also between minority shareholders and insider parties of the company; corporate dividend policy could be an important mechanism to reduce agency conflicts in the company [14].

According to the agency cost theory, dividend policy of a company is determined by agency cost that results from the difference between ownership and control. Managers may not often select the dividend policy that maximizes shareholders' value but would adopt a dividend policy that maximizes their own benefits. Dividend payouts reduce available free cash flow, ensuring that firm managers

maximize shareholder wealth and do not use the funds for their own benefit [1].

Agency theory suggests that unless profits are distributed to outside stockholders, corporate managers may divert these profits to their own benefit or allocate them to unprofitable investments that provide benefits for corporate managers. Therefore, agency cost suggests that stockholders prefer dividends over profit. Thus, corporations with greater dividend payments will improve their value by reducing the amount of cash available to managers [8].

### 5) Tax preference theory

Tax Preference theory (Litzenberger and Ramaswamy, 1979) suggests that investors want firms to retain earnings and hence provide returns in the form of less taxable capital gains rather than more taxable dividends. That is, low dividend payments reduce the required rate of return, and thus the market price of firm's share will increase [15]. The theory supposes that when a company adopts low dividend payout ratios, the cost of capital will decrease, and thus the stock price will increase, leading to an increase in the value of the company [16]. Moreover, [6] explained that when a company distributes dividend, stockholders have to bear double taxation since they are taxed on the investment and taxed on dividend they receive. Under this scenario, many stockholders don't prefer to get dividends. However, tax preferences of individual investors may affect their dividend preferences. Thus, investors who are afraid of high taxes tend to prefer low or no dividend payments [1].

Based on the literature review, it can be concluded that there is no consensus among researchers regarding corporate dividend policy. Therefore, the existence of multiple theories on dividend policy could be beneficial in explaining the possible relationship between dividend policy and firm performance in different countries and contexts.

## 3.2. Reviewing Empirical Literature

The relation between dividend policy and firm performance was the subject of many research papers. Many studies investigated this relationship empirically in different countries and different contexts and showed mixed results. [8] examined the effect of dividend payments on firms' value using a sample of 44 listed firms in the Istanbul Stock Exchange over the period from 2007 to 2015. The results of his study indicated a positive and significant association between dividend payments and firms' value. Therefore, the results support the explanation of agency theory. In the same vein, [16] examined the effect of dividend policy on firm performance in Pakistan using a sample of 122 listed companies over the period 2006 to 2011. Tobin's Q and return on assets are used as firm performance measures. The results showed a positive significant relationship between dividend payout ratio and firm performance measures.

Moreover, [9] conducted their research in Indonesia with the aim of examining the impact of dividend policy on the value of companies listed in Indonesia Stock Exchange for the period from 2011-2015. A sample of 44 companies was used for

this purpose. The results revealed that dividend payout ratio has a significant impact on the value of the firms.

On the other side, [17] examined the association between dividend payout ratio and firm's profitability in Pakistan. For this purpose, he selected two sectors, energy and textile. The findings revealed that, there is a negative effect of dividend payout ratio on the next year's earnings of a company. Moreover, [18] in Indonesia analyzed the effect of profitability on dividend policy and its effect on the firm value. For this, 58 listed firms over the period 2013 to 2015 were selected. The findings showed that, profitability has a negative and significant impact on dividend policy, while dividend policy has a positive insignificant impact on firm value.

However, [4] in Nigeria studied the effect of dividend payout ratio and other factors, such as profitability, on firm value using a sample of listed companies for the period from 2007-2016. They reported that profitability and leverage have a positive and significant effect on firm value, while cash holding is related negatively to firm value. Moreover, dividend pay ratio was found to have no effect on firm value. In the same vein, [19] investigated to what extent the payout ratios of firms can affect their share price in Nigeria. The results revealed that payout ratio has an insignificant impact on the share price of companies.

[20] studied the impact of dividend policy on firms' value using a sample of 63 companies listed on Bucharest Stock Exchange and found a positive effect of dividend pay-out ratio on firms' value. On contrary, [21] conducted their research in India with the aim of examining the impact of dividend policy on the firm's market value and shareholders' wealth. A sample of 72 companies was taken into consideration. The findings indicated a negative non-linear relationship between a share's market value and the dividend yields.

[6] conducted their research in Pakistan with the aim of examining the determinants of dividend payout ratios using a sample of cement companies listed in KSE over the period 2003-2012. The findings revealed that cash flow, profitability and tax, have a significant association with dividend payout ratio, while sales growth and debt to equity have insignificant relation with dividend payout ratio. [1] in Kenya examined the impact of dividend payout on firm performance using a sample of listed companies over the period 2002-2010. Net profit after tax was used as a measurement of firm performance, while actual dividends paid, Total assets and revenue were used as independent variables. Regression results showed a significant and positive relationship between Net Profit after Tax and dividends.

[12] studied how financial ratios affect the dividend payout ratio and stock price of a firm in Indonesia. The results showed that there is a positive impact of operating cash flow and profitability on dividend payout ratio. Also, there is a positive impact of dividend payout ratio on firms' stock price. They concluded that higher profitability and operating cash flow lead to a higher payout ratio, which in turn lead to higher stock price

[7] in South Africa analyzed the association between dividend payout ratio as a

dependent variable and firm performance as an independent variable. They used leverage, net profit margins, liquidity, firm size and growth as measurements of firm performance. The results showed a positive association between dividend payout ratio and net profit margins, growth, leverage and firm size.

Reviewing previous empirical studies that examined the relationship between corporate dividend policy and its performance in different countries and different contexts showed inconclusive results. While most research revealed a positive relationship (e.g. [1] [8] [9] [16]), other research showed negative relationship (e.g. [17] [18]). Also, some research showed an insignificant relationship (e.g. [4] [19]). However, most previous studies have revealed a significant association between corporate dividend policy and its performance and value.

#### 4. Conclusions

This paper attempts to present a comprehensive review of the relationship between corporate dividend policy and its performance for more explanation and understanding of this relationship. Reviewing dividend policy theories and empirical literature revealed inconclusive results. Dividend policy theories start with irrelevance theory (M&M 1961), which assumes that dividend policy has no effect on firm performance. However, the Irrelevance theory is followed by other dividend policy theories, which propose that dividend policy is relevant to firm performance and value. Examples of these theories are bird-in-the-hand theory, the Signaling theory and the agency cost theory. These theories suggest that dividend payout has a positive effect on firm performance. On the other hand, there is the tax preference theory, which assumes that dividend payout has a negative effect on firm performance.

Moreover, reviewing previous empirical literature regarding the relationship between corporate dividend policy and its performance in different countries and contexts revealed inconclusive results. While most of research revealed a positive relationship, other research showed a negative relationship. Also, some research showed an insignificant relationship. However, it can be noticed that most of research showed a significant relationship between corporate dividend policy and its performance, which emphasizes the importance of corporate dividend policy with regard to corporate performance and value. Moreover, it can be observed that most of research is conducted in developed countries, which implies the need for further research on corporate dividend policy in developing countries. Moreover, further studies on corporate dividend policy could expand the research area to include other variables, such as the level of firms' disclosure and corporate governance mechanisms, such as ownership structure and board characteristics.

#### Conflicts of Interest

The author declares no conflicts of interest.

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