CHAPTER-III

REVIEW OF LITERATURE

3.1 Introduction

A clear understanding of the research problem and the procedure is a prerequisite for any investigation. This is possible only when the researcher is familiar with the related literature. Hence it is important for the researcher to make a review of the studies made earlier. Review of literature in a study accomplishes several purposes. It provides a framework for establishing the importance of the study as well as comparing the results of the study with other findings. Hence, in this third chapter, a review of previous studies has been made and the review is classified as profitability and dividend.

3.2 Review of Literature on Profitability

Greiner (1972) described the relationship between company growth and profitability can be positive or negative. On the one hand, increased growth can contribute a breakdown of informal relationship established over time in companies, greater growth requiring greater formality in relationships at work, which in the short-term can be difficult to achieve efficiency, thus leading to diminish company profitability. On the other hand, greater growth can result in greater profitability.

Singh and Whittington (1975) studied about the growth and profitability that are important dimensions of firm performance, when the study of growth is undertaken in terms of systematic influence which may affect growth, rather than regarding growth as wholly chance phenomenon, then most important systematic influence on growth is that of profitability, it may consider by industry condition and economic cycles which affects the competitiveness of the market environment, and in turn both growth and profitability.
Jensen and Meckling (1976) studied the separation of ownership from control that leads to conflicts of interests within the firm and results in costs that are ultimately paid by shareholders. Although a possible method of reducing these conflicts is for shareholders to monitor the firm and its management, the problem of collective action typically results in too little monitoring taking place.

Myers (1984) found that profitability is considered to be an important factor in determining the capital structure of firms. Different views prevail with regard to the relation between profitability and capital structure. Static trade off theory works only to a certain extent but pecking order theory recognise both asymmetric information and cost of financial distress.

Kester (1986) found that there is a negative relationship between capital structure and profitability under market value and book value basis for both U.S and Japanese manufacturing firms. There is no significant difference in U.S and Japanese company’s growth, profitability, risk, size, and industry classification.

Lieberman and Montgomery (1988) argued that growth displays a favourable impact on its profitability except for samples of bigger firms. It might be argued that smaller firms are being more flexible which tend to take chance more readily than their bigger rivals, it may also be that smaller firms can profitably exploit chances by expanding sales at unreduced price. It suggests that new entrants can create a lasting advantage by building a dominant position for themselves in the market.

Pienegar and Wilbricht (1989) suggest that the works on asymmetric information put production roughly in line with pecking order theory. Hence managers follow the general rule, issue safe securities before risky ones. The corporate managers are more likely to follow a financing hierarchy than to maintain a target debt-equity ratio which support the pecking order theory.
Soenen (1993) investigated the relationship between the net trade cycles as a measure of working CapitaLand return on investment in US firms. The results of the study indicated a negative relationship between the duration of net trade cycle and return on assets (ROA). A significance relationship for about half of the industries studies indicated that results might vary from industry to industry.

Shin and Soenen (1998) studied about the short term and long term solvency position of the company will lead to company’s profitability. Further the strength of working capital management also leads to participation of corporate profitability. They found that there is a strong negative relation between the cash conversion cycle and corporate profitability.

Debashish Rai and Debashish Sur (2001) studied about how the firm’s growth rate affects the profitability and analysed the various categories in relationship with growth and profitability. They concluded that the studies support the general notion which shows a positive relationship between growth and profitability.

Markman and Gartner (2002) studied the use of growth as a measure of firms' performance is generally based on the belief that growth is a precursor to the attainment of sustainable competitive advantages and profitability in addition, larger firms have higher rates of survivals.

Delmar, Davidson and Gartner (2003) explored heterogeneity in how firms have achieved high growth. From this population of all firms in Sweden, multiple criteria were used to define a sample of high growth firms. Using nineteen different measures of firm growth (such as relative and absolute sales growth, relative and absolute employee growth, organic growth versus acquisition growth, and the regularity and volatility of growth rates over the ten year period) they identified seven
different types of firm growth patterns. These patterns were related to firm age and size as well as industry affiliation. Implications for research and practice are offered.

Marc Deloof (2003) stated that the companies have large amounts of cash invested in working capital. It can be expected that the way in which working capital is managed will have a significant impact on profitability of companies. Hence, he found that there was a significant negative relation between gross operating income and the number of day’s accounts receivable, inventories and accounts payable.

Abdul Raheman (2007) investigated that there is a strong negative relationship between the variables of the working capital and profitability of the firm. It means that the cash conversion cycle, increase will lead to decrease profitability of the firm, and manager can create a positive value for the shareholders by reducing the cash conversion cycle to a possible minimum level, and found that there is a significant negative relationship between liquidity and profitability.

Eldos Mathew punnoose (2008) postulated negative relationship between growth and profitability; in short the empirical evidence on the relationship between growth and profitability performance is inconclusive. There is no evidence for substantial, universal and positive relationship between growth and profitability.

Fulbag Singh and Monica Mogla (2008) discussed about profitability on merger in an expanding economy, one should expect a positive association between growth and profitability of firms because profits provide the ability to grow. However, the factors affecting the willingness to grow and that are likely to vary between different industries.

Samiloglu and Demirgunes (2008) examined the effect of working capital management on firm profitability about companies listed at the Istanbul Stock exchange (ISE). Using the multiple regression models, the study examined the effect
of working capital on firm profitability for the period of 1998–2007. The findings of the study show that accounts receivables period, inventory period and leverage affect firm profitability negatively; while growth (in sales) affects firm profitability positively.

Ahmed Arif Karim Almazari (2009) found evidence that growth had a positive impact on profitability providing support indicates a positive relationship, and also suggested that growth and profitability are positively related, one would be expect the empirical evidence to clearly demonstrate a positive association between the two, whether or not the research can determine the direction of casualty.

Balram Dogra and Gupta (2009) examined that the optimum capital structure enhances the profitability and the value of the firm. The result of a study on SMEs in India showed that they relied more on their own funds and comparatively less on borrowed funds,

Zelia Serrasqueiro (2009) measured firm's profitability in the analysis of the relationship between growth and profitability, return on assets and return on sales, the profit rates measured by sales will give a short term perspective of profitability because sales are annual flows. On the other hand, the return on assets and return on capital employed will give us a long term perspective of profitability concludes that there is a positive relationship between growth and profitability.

Rajagopalan (2009) concluded that profitability analysis by taking into account, the combined effect of sales related and assets related ratios is in the inception stage. In the context of widening opportunities, challenging competition, merger and acquisition wave, strategic investment in subsidiaries and associates and increased depends upon debt financing.
Chandra Kumaramangalam and Govindasamy (2010) found a negative sign in all regressions, asset profitability (measured as net profit before tax over total assets) and also a significant effect on short term and long term solvency ratios, since the cost of debt and external equity are higher for small firms, it is noted that during the period the firms are facing very high interest rates. A negative relationship between gearing and profitability was found in other empirical research.

Vijayakumar (2011) concluded that the selected variables explain 99 percent of variation in profitability in the Indian automobile industry, 94 percent in the commercial vehicles sector, 95 per cent in passenger cars and the Multi utility vehicles sector and 94 per cent in two and three wheeler sector. It is evident from the results that size is the strongest determinant of profitability followed by the variable vertical integration, past profitability, growth rate of assets and inventory turnover ratio. The selected variables have both positive and negative contribution in variation of the profit rate. In a nutshell, it can be concluded that firms should consider all these possible determinants while considering its profitability.

Vijaykumar and Sieve (2011) investigated the behaviour of growth rate and profitability for the Indian automobile companies; it was found that growth rates were highly volatile over time and relationship with profitability was not clear, however the positive effects of growth on profitability were greater than the negative effects. These results are consistent with the result of Singh and Whittington (1995) who also found a positive relationship between growth and profitability in their study. Also extent of this positive relationship was different in different companies, depending upon their ability and willingness to grow, which may further depend upon factors like the extent of monopoly power, growth of demand, market share, better labour relations and other managerial condition.
Ramachandran Azhagaiah and Raju Deepa (2011) studied about the profit earned by firms was a major contribution to the profitability and its impact of various predictors variable such as liquidity, capital intensity, growth, volatility on profitability, when income earned was controlled. It was found that the firms, with varying income level, were influenced by different determinants in deciding their profitability.

Karthik and Titto (2011) have found that profitability more or less depends upon the better utilisation of resource, cut-off expenses and quality of management, it is worthwhile to increase production capacity and use advance technology to cut down the cost of production in order to increase profitability, not only against the investment, but also from investor’s return point of view. These programs are helpful to increase profitability of the company.

Sathy (2012) studied to measure the composite profitability of a firm by a single index. The analysis shows that in order to rank the selected companies in terms of composite profitability, ratio-wise scores have been aggregated and the firm who is getting the highest total score has been ranked as 1 and the firm who is securing the lowest total score has been ranked as 30. The return of a business may be measured by studying the profitability of investment in it. Profitability may be defined as the ability of given investment to earn a return from its use

Sasikala (2012) investigated that there is no relationship between liquidity and profitability, risk and profitability and concluded that the excessive liquidity may lead to lower profitability. So, the negative association between liquidity and profitability must control with effective liquidity management.
**KrishnaMoothi and Ramesh** (2012) have found that the companies belong to steel industry are maintaining different level of profitability, the profitability strength level determine on the basis of difference in gross profit, net profit, operating profit, return on investment and dividend payout ratio. They conclude that there is no correlation of net profit and operating profit among the selected companies, and there is no significant difference in return on Investment of selected companies in India.

**Venkatesan and Nagarajan** (2012) examined that profitability more or less depends upon the better utilization of resources, cutoff expenses and quality of management function in the products, customer services and in manpower, goodwill and market share. It is worthwhile to increase the production capacity and use of advance technology to cut down the cost of production and wage cost in order to increase profitability, not only against the investment but also investors return point of view. These programs are helpful to increase profitability of selected steel companies in India in future prospects.

**Bhaskar Bagchi Jayanta Chakrabarti and Piyal Basu Roy** (2012) investigated the effect of working capital management on firm’s profitability as measured by return on total assets and return on investment using a sample of Indian FMCG companies found a strong negative relationship between the measures of working capital management with corporate profitability using fixed effect model. Hence, the findings of the study highlight the importance of proficient working capital management to ensure an improvement in firm’s profitability and this aspect must form part of the company's strategic and operational thinking in order to operate effectively and efficiently in India’s new challenging economic environment.
Amir Hossein Jamali and Asghar Asad (2012) investigated the relationship between the management efficiency and the firm's profitability for a sample of 13 auto manufacturing companies listed on the Bombay Stock Exchange and the study conclude that profitability and management efficiency are highly correlated to each other and based on the results of the study; recommendations for improving the management efficiency and profitability in this industry are given.

Ketan (2012) examined that the profitability ratios are calculated to measure the operating efficiency of the business enterprise. Besides management of the company, creditors and owners are interested in the profitability of the firm. The investor wants to get a reasonable return on their investments. This is only possible when the company is having satisfactory profit. For this purpose, the researcher would like to evaluate the profitability analysis with reference to various ratios like PBDT to Gross Sales, PAT to Gross Sales, PAT to Net Sales, PAT to Shareholders fund and PAT to Total Assets to examine the financial result of selected steel industries in India. This research gives us the result of profitability with reference of the study period from 2006-07 to 2010-11.

3.3 Review of Literature on Dividend

Lintner (1956) studied the recognized companies in the United States of America and concluded that the recent earnings power and past dividend records are key determinants of changes in dividend payout, and it helps to maintain the regular increase in dividend policy of the companies.

Alex Kane, Young Ki Lee and Alan Marcus (1984) examined that the abnormal stock returns surrounding contemporaneous earnings and dividend announcements in order to determine whether investor evaluate the two announcements in relation to each other. They found that there is a statistically
significant interaction effect. The abnormal return corresponding to any earnings or dividend announcement depends upon the value of other announcement.

**Warren Bailey** (1988) indicated that the premium is largely explained by the relative value of dividend paid and cost imposed on investor by stock dividend payment and shares conversion procedures. Premium for few firms also reflects the relative liquidity of two classes of shares.

**Michael Brennan and Anjan Thakor** (1990) developed a theory of choice among alternative procedures for distributing cash dividend from corporations to shareholders. The majority of a firm’s shareholder may support the dividend payment for small distribution. For larger distributions, an open market stock repurchase is likely to be preferred by a majority of shareholders.

**David** (1990) found that special dividend payments generally increase the wealth of target firm’s shareholders, regardless of payout type, those firms remaining independent after the outcome of corporate control contest experience an abnormal share price increase over the duration.

**Claudio Loderer and David Mauer** (1992) investigated that they rely on dividend to obtain a higher price in a stock offering and stock price reaction to dividend and offering announcement does not support either conjecture. Issuing firms are not more likely to pay or increase dividend than no issuing forms. There is little evidence that firms time stock offering announcement right after dividend declarations.

**Harry De Angelo, Linda De Angelo, and Douglas Skinner** (1992) found that dividend reduction depends on whether earnings include unusual item that are likely to temporarily depress income. Dividend reductions are more likely given greater current losses, less negative unusual item, and more persistent earnings
difficulties. Dividend policy has information content in the knowledge that a firm has reduced dividends improves the ability of current earnings to predict future earnings.

Lucy Ackert and Brain Smith (1993) found that the apparent evidence of excess volatility when the narrow definition of cash flow (dividend only) is applied and they reject the hypothesis market efficiency when the cash flow measures also include sharing repurchase and take over distribution in addition to ordinary cash dividend.

Upinder and Herb Johnson (1994) studied about stock and bond price reactions to dividend changes. The positive stock response to dividend increases has several potential explanations and they found that the bond price reaction to announcement of large dividend changes is opposites of the stock price reactions.

Kenneth Eades, Patrick Hess and Han Kim (1994) studied about the ex-dividend day return vary over time, the ex-day return of high-yield stocks are persisting for some time period and negative for others and they found that corporate dividend capturing is affecting ex-day return.

Roni Michaely, Richard Thaler, and Kent Womack (1995) have investigated about market reaction to initiations and omission of cash dividend payment and they found that the magnitude of short run price reactions to omission is greater than initiations of dividend.

James Hines (1996) discussed about American corporations earn a significant share of their profits from foreign sources, out of which they appear to pay dividends at rate that are three times higher than their payout rates from domestic profits.
Yakov Amihud and Maurizio Murgia (1997) found that the stock price reaction to dividend news in Germany is similar to the United States and this suggests other reason beyond taxation that makes dividend informative.

Kathryn Dewenter and Vincent Warther (1998) studied the comparison of dividend policies of US and Japanese firms and found that Japanese firms face less information asymmetries and fewer agency conflict than US firms and that asymmetries and agency conflict affect dividend policy. Japanese firms experience smaller stock price reactions to dividend omissions and initiations, they are less reluctant to omit and cut the dividend and their dividend is more responsive to earning changes.

Andy Naranjo, Nimalendran and Mike Ryngaert (1998) discussed about an improved measure of a common stock annualised dividend yield and found that the magnitude of yield effect is too large to be explained by a tax penalty on dividend income. The effect is primarily driven by smaller market capitalisation stock and zero yield stock.

Rafael La Porta, Florencio Lopez-Di-Silanes, Andrei Shleifer and Robert Vishny (2000) outlined and tested two agency models of dividend. According to the outcome model, the dividend is paid because minority shareholders pressure corporate insiders to disgorge cash. According to substitute model, insiders interested in issuing equity in the future dividend to establish a reputation for decent treatment of minority shareholders.

Andy Naranjo, Nimalendran and Mike Ryngaert (2000) found that average abnormal ex-dividend day returns are uniformly negative in every year after the introduction of negotiated commission rates and during that commission rates era is consistent with corporate tax based dividend capture, Ex-day returns are more
negative when tax advantages to corporate dividend capture is the greatest and more positive when increase in transaction cost and risk reduce incentives to engage in corporate tax based dividend capture.

**Franklin Allen, Antonio Bernardo and Ivo Welch** (2000) studied about firms paying dividend attract relatively more institution, which have a relative advantage in detecting high firm quality and in ensuring firms are well managed and suggested the prediction that it is the tax differences between institutions and retailers investors that determines dividend payments.

**Doron Nissim and Amir Ziv** (2001) studied about the relation between dividend changes and future profitability and measured in terms of either future earnings or future abnormal earnings, they found that dividend changes provide information about the level of profitability in same period, incremental to market and accounting data.

**Eugene A. Pilotte** (2003) examined the possibility that inflation also proxies for variance between real price and dividend ratios and found that the covariance between real price/dividend ratios and inflation is nonzero, the relationship between return and expected inflation differ for the two components of return: dividend yields and capital gain returns.

**Lubos Pastor and Pietro Veronesi** (2003) developed a simple approach for valuing stock in the presence of learning about average profitability. The market to book ratio increases with uncertainty about average profitability and found the prediction that younger stock and stock that pay no dividends have more volatile returns. Firm’s profitability has become more volatile.

**Malcolm Baker and Jeffrey Wurgler** (2004) proposed that the decision to pay dividends is driven by prevailing investor demand for dividend payers. Managers
cater to investors by paying dividends when investor put a stock price premium on
payers and not paying when investor prefer non payers and measured non payers tend
to initiate dividends when demand is high. But sometimes payers tend to omit
dividends when demand is low.

**Adam Koch and AmyX. Sun** (2004) studied whether the market interprets
changes in dividends as a signal about the persistence of past earning changes. Prior
to this signal, investor may believe past earnings changes are not necessarily
indicative of future earnings level. And found that the changes in dividend cause
investors to revise their expectation about the persistence of past earning changes.
This effect varies predictably with the magnitude of the dividend change and sign of
past earnings change.

**Philip Brown and Alex Clarke** (1993) have documented shifts in ex-day
pricing of Australian companies that paid cash dividend and relate these shifts to three
major changes in taxation of capital gains, dividend and superannuation funds.
Despite the changes, which on the whole increasingly favoured dividend over capital
gain shareholders, have continued to prefer capital gain.

**Campbell and Beranek** (1955) and **Durand and May** (1960) have found that
the ex-dividend day drop in share price was not significantly different from the
amount of the dividend. Dividend seemed to have no intrinsic value beyond their face
value, and marginal investor was indifferent between dividend and capital gains.

**Miller and Modigliani** (1961) explained dividend irrelevance theorem for a
(tax free) perfect capital market given the firm’s investment policy, how investors are
received their income, whether it is through dividend or capital gain, would be
irrelevant share price in such a market.
**Miller and Scholes (1978)** extended the irrelevant argument to allow for differential rates of tax on dividend and capital gains. They argued that all personal tax payable by investor on dividend and capital gains could be laundered by tax minimising strategies.

**Miller and Scholes** (1982) argued that evidence of significant positive yield effect was biased, with bias arising from the use of a rate of return that was contaminated by the announcement effective of the dividend and concluded that the yield related dividend effect was both statistically and economically insignificant once bias had been eliminated.

**DuhaAl-Kuwari** (2009) investigated the determinants of dividend policies for firms listed on Gulf Cooperation Council country stock exchanges and resulted that the main characteristics of firm dividend payout policy and dividend payment related strongly and directly to government ownership, firm size and firm profitability, but negatively to the leverage ratio in addition and as a result of the significant agency conflict interacting with need to build firm reputation, a firm’s dividend policy was found to depend heavily on firm profitability.

**Nickolaos Travlos, Lenos Trigeorgis and Nikos Vafeas** (2001) found that positive impact of dividend increase may reflect apparently effective attempts by Cyprus listed firms to bridge the information asymmetry gap with investor via their dividend payout policy. The understanding of such efforts may be enhanced through an examination of the signalling value of alternative financial policy decision and an alternative interpretation of the positive impact of dividend increase may be that they serve to reduce potential exploitation of smaller shareholders by large ones.
Jayesh Kumar (2006) analysed the relationship among the ownership structure, corporate governance and dividend payout using large panel of Indian corporate firms, this attempt to use the well established dividend payout model to examine the impact of ownership structure on dividend payout policies in context of an emerging market economy, India. And found that ownership is the important factor that influences the dividend payout policy.

Han Ki, Suk Hun Lee and David Suk (1999) tested the agency cost based hypothesis which predicts dividend payout to be inversely related to the degree of institutional ownership and tax based hypothesis predicting the dividend to be positively related with institutional ownership, provide support for the tax based hypothesis, suggesting a dividend clientele for institution preference for higher dividend.

Faccio Mara, Lary, Lang and Leslie Young (2001) examined group-affiliated corporations in Europe pay higher dividends than in Asia, dampening insider expropriation. Dividend rates are higher in Europe, but lower in Asia, when there are multiple large shareholders, suggesting that they dampen expropriation in Europe, but exacerbate it in Asia.

Bhattacharya, Sudipto (1979) derived the existence condition for a non dissipative signalling model and showed that dividends are signals for future cash flow, under the assumption that outside investors have imperfect information about firm’s profitability and that cash dividends are taxed at a higher rate than capital gain.

Fenn and Liang (2001) analysed how corporate payout policy is affected by managerial stock incentives. They found that managerial stock incentives mitigate the agency cost for firms with excess cash flow problem. They also found that a strong relationship between dividend and management stock option.
Kevin (1992) shows that dividend stability is the primary determinate of payout while profitability is only secondary importance.

Bhat, Ramesh and Pandey (1994) found that payments of dividends depend on current and expected earnings as well as the pattern of past dividend. Dividends are used in signalling the future prospects and dividends are paid even there is profitable investment opportunity.

Mohanty and Pitabas (1999) examined the behaviour of payout after the bonus issue and found that bonus issuing firms yielded greater issues to their shareholders than those that did not make any bonus issue but maintained a steadily increasing dividend rate.

Reddy (2002) examined the dividend behaviour and attempts to explain the observed behaviour with help of trade of theory and signalling hypothesis the paper support the earlier findings that dividend omission have information content about the future earnings but does not find any evidence in the support of tax preference theory.

Manos (2003) estimated cost minimisation model of dividend and found that government ownership, insider ownership, risk, debt and growth opportunity have a negative impact on the payout ratio, whereas institutional ownership, foreign ownership, and dispersed ownership have a positive impact on the payout ratio.

Kothari and Walia (2004) guide lined for payment of dividend by Haryana state public enterprises, it is too early to comment on the impact of the guidelines on the working performance of various state public undertakings. However, a strict and stringent compliance as well as proper monitoring will go a long way in making the public sector undertakings accountable and responsible and also improving their performance and profitability.
Janice How, Kian Ngo and Peter Verhoeven (2011) studied that dividend initiations are an economically significant event that has important implication for a firm’s future financial capacity. Given the market expectation of a consistent payout, managers of IPO firms must approach the initial dividend decision cautiously and found that post initiation firm performance is explained mostly by dividend theory of signalling rather than free cash flow.

Mohammad Al-Gharaigeh, Ziad Zurigat and Khaled Al Harahsheh (2013) investigated the impact of ownership structure on dividend policy of Jordanian firms, by using two models, full adjustment model and partial adjustment model to test the relationship. It found that institutional ownership provides incentives for board to extend their influence to reduce the use of funds in the projects with lower returns in turn distributing better dividends. The direction of relationship contrast with the suggestion by the Linter’s (1956) theory of dividend smoothing by which claims that managers adopt a policy of progressiveness in order to stabilise dividend distribution and avoid erratic rates thus dividend are smoothed and rarely decreased.

3.4 Chapter Summary

It may be understood that, many studies have analysed the profitability and dividend declaration and payment at national and international level. But only few of the studies dealt with both profitability and dividend and to examine the relationship. It is a research gap and the present study is undertaken in order to fill the gap.