<table>
<thead>
<tr>
<th>Chapter Section</th>
<th>Page Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1 Introduction</td>
<td>80</td>
</tr>
<tr>
<td>3.2 Dividend Theories</td>
<td>80</td>
</tr>
<tr>
<td>3.3 Previous Research</td>
<td>84</td>
</tr>
<tr>
<td>Select References</td>
<td>94</td>
</tr>
</tbody>
</table>
CHAPTER 3
REVIEW OF LITERATURE

3.1 INTRODUCTION:
The objective of this chapter is to discuss and analyze critically some of the
models formulated on dividend. In this chapter, the researcher reviews different
models, reviews the existing literature on the dividend decision. The Literature
review has been carried out to cover various aspects of dividend policy. This, in
short is the review of the available literature on Dividend Policy. All the studies
and works undertaken by different authors’ and scholars have their own
significance.

Some more research papers can be added in the existing list. But to avoid
replication only few published papers and every publication has contributed
something new and is related to some specific area. They have touched upon
different aspects of the problem from different angles and as a result each study
has contributed immensely on the subject. Despite extensive research on a
dividend theory, consensus still lacks a theory which can best explain the
dividend policy.

3.2 DIVIDEND THEORIES:
Dividend theories explain the relationship between dividend policy and the
market price of shares or value of the firm. Theories can be grouped in two
categories. One category is Dividend Relevance and another category is
Dividend Irrelevance.

1. Dividend Relevance Theories:
This implies that shareholders prefer current dividends and there is no direct
relationship between dividend policy and market value of the firm. Dividend
relevance theories consider dividend decision is to be an active variable in
determining the value of the firm. Relevance theories can be broadly explained by the following two models.

i) Walter’s Model:
According to this model, dividends are relevant. Further, investment policy of a firm cannot be separated from its dividend policy and both are interlinked. The choice of an appropriate dividend policy affects the value of the firm.

The key argument in support of this model is the relationship between the return on a firm’s investment or its internal rate of return ($r$) and its cost of capital or the required rate of return ($k$). The firm would have an optimum dividend policy which will be determined by the relationship of $r$ and $k$. In other words, if the return on investments exceeds the cost of capital ($k$), the firm should retain the earnings, whereas it should distribute the earnings to the shareholders in case the required rate of return exceeds the expected return on the firm’s investments.

Walter’s model relates the distribution of dividends to available investment opportunities. If a firm has adequate profitable investment opportunities, it will be able to earn more than what the investors expect so that $r > k$. Such firms may be called **Growth firms**. For growth firms, the optimum dividend policy could be given by a dividend payout ratio of zero. It means the entire earnings of the firm is retain within the firm. As a result the market value of the shares will be maximized.

If suppose a firm does not have a profitable investment opportunities (when $r < k$), the shareholders will be better off if earnings are paid out to them so as to enable them to earn a higher return by using the funds elsewhere. In such a case, the market price of shares will be maximized by the distribution of the entire earnings as dividends. A dividend payout ratio of 100 would give an optimum dividend policy.

Finally, when $r = k$ (normal firms), it is a matter of indifference whether earnings are retained or distributed. This is so because for all dividend payout ratios
(ranging between 0 to 100) the market price of shares will remain constant. For such firms, there is no optimum dividend policy.

**Assumptions:**

1) All financing is done through retained earnings; external sources of funds like debt or new Equity capital is not used.
2) There is no change in the key variable, namely, earnings per share, and dividend per share, the values of these may be changed in the model to determine results, but, any given value of these assumed to remain constant in determining given value.
3) The firm has perpetual (or very long) life.

**Criticism of Walter Model:**

Walter model explains the relationship between dividend policy and value of the firm under certain assumptions. Some of the assumption does not stand critical evaluation. In the first place, the Walter’s Model assumes that the firm’s investments are financed exclusively by retained earnings, no external financing is used. This model would be applicable to the firm who has raised their funds through Equity Capital. Secondly, the model assumes that r is constant. This is not a realistic assumption because when investments made by the firm are increased, r also varies. Finally in relation to the constant, $k_e$, the risk complexion has direct bearing on it. While assuming a constant $k_e$, this model ignores the effect of risk on the value of the firm.

ii) **Gordon’s Model:**

This model is also similar to the Walter’s Model. According to this model, dividend policy of the firm affects its value, on the basis of the following assumptions:-

1) The firm is an all- equity firm. A firm does not have external financing and Investments are financed through retained earnings.
2) r and $k_e$ are constant.
3) The firm has perpetual life.
4) The retention ratio is constant. Hence, growth rate (g=br) is also constant.
5) Cost of Equity ($K_e$) > Growth rate (br)
The essence of this model is a two-fold: - i) investors are risk averse; ii) they put a premium on a certain return and discount/penalize uncertain returns. This model is also called as a bird-in-the-hand argument. Gordon argues that, if current dividends are withheld to retain profits, then receiving it in future is uncertain. Therefore, investors would naturally like to avoid uncertainty. If payment of dividend is low or zero, it would lower the value of shares.

1. Dividend irrelevance Theories:
This implies that the value of a firm is unaffected by the distribution of dividends and is determined solely by the earning power and risk of its assets. This theory is explained by the following model.

i) Modigliani and Miller (MM) Hypothesis:
The most comprehensive argument in support of the irrelevance of dividend is described by the MM Hypothesis. According to MM hypothesis, the dividend policy has no effect on the share price of the firm and is, therefore, of no consequence. According to this model, the value of a firm is solely dependent on the earning capacity of the firm. How a firm is distributing its earning is not the deciding factor in the valuation. The MM argument says that a firm may retain its earnings or it may distribute them. If the earnings are retained, it will lead to capital appreciation. On the other hand, if dividends are distributed, the shareholders will enjoy dividend income which is equal to the amount by which his capital would have appreciated if the company would have retained its earnings. The shareholders, therefore, do not make any differentiation between present dividend and retained earnings.

Assumptions:-
1. There are perfect capital markets and the investors are rational.
2. Information is freely available and there are numerous transactions.
3. An investor cannot influence prices.
4. Floatation costs are nil.
5. There are no taxes.
6. The firm has a fixed investment policy.
7. Risk of uncertainty does not exist.
3.3 PREVIOUS RESEARCH:
Lintner (1956) conducted an empirical research over dividend pattern of 28 companies for the period of 1947-53. Lintner surveyed corporate chief executive officers and chief financial officers, and found that dividend policy is an active decision variable because managers believe that stable dividends lessen negative investor reactions. Quite contrary to this, Miller & Modigliani (1961) advanced the view that the value of firm depends solely on its earnings power and is not influenced by the manner in which its earnings are split between dividends and retained earnings. Miller & Modigliani view dividend as irrelevant.

Modigliani and Miller (1961) realized that stock prices do respond to announced changed in dividends. They called this phenomenon the “information content of dividends.

Brittain (1966) used the cash flow version of the Lintner’s model. The model was proposed by lintner and obtained statistically significant results, but at the same time, he found that better results could be obtained by certain modifications and adjustments. Brittain argues that cash flow is a more appropriate measure of the company’s capacity to pay dividends as it more reflects faithfully, true earnings. Further, dividend payment is considered as a charge prior to depreciation and hence, which is the ultimate basis of ability to pay dividend.

Fama and Babiak (1968) studied the determinants of dividend payments by individual firms during 1946-64. The study concludes that net income and previous year dividends are the basic determinants of dividend changes.

Uzoaga and alozienwa (1974) in their study highlighted the pattern of dividend policy pursued by Nigerian firms and found little evidence to support the classical determinants of dividend policies in Nigeria.

Jensen and Meckling (1976) found that information asymmetry between agents (Managers) and Principals (Equity Shareholders) may also lead to agency cost.
One of the mechanisms of reducing expropriation of outside shareholders by agent is high payout (dividend).

Theoretically, corporate dividend polices are known to be a function of many factors. Van Horne (1977) and Weston and Brigham (1981) assert that these relevant factors include: legal considerations, liquidity position, repayment of debt, restrictions on debt contracts, re-investment opportunities, profitability of operations and stability of earnings. Other factors include access to the capital market, cost of raising new funds, need for ownership control, national income policies as well as the tax positions of the stockholders. The interplay of these factors remains a critical issue in distribution of corporate after tax earnings between retained earnings and dividends.

Bhattacharya (1979) in his pioneering work derived the existence conditions for a non-dissipative signaling model and shows that dividends are signals for future cash flow.

Murray (1981) used non-capital market data to test the theoretical implication that dividend payout is negatively correlated with earning uncertainty. The study concluded that earnings uncertainty is a determinant of the corporate dividend decision.

Rozeff (1982) was among the first to explicitly recognize the role of insiders in monitoring the managers. Rozeff finds that firms with higher level of insider holdings have less need to signal firm value through dividends that comparable firm with lower levels of insider holdings.

Miller and Rock (1985) found that the dividend announcement provides shareholders and the market place the missing piece of information about current earning upon, which their estimation of the firm’s future (expected) earning is based.

March and Mertons (1987) studied dividend behaviour of aggregate stock market in order to determine the relationship between dividend and earnings (losses) by
using the data from the years 1926 to 1981. The results show the permanent earning is the basic component of dividend changes.

Ambrish et al. (1987) found that since the tax on dividend itself is not economical signal. By combining the dividend signal with other signals such as debt or investment changes the firm may be able to obtain a less-costly signaling mix.

Kim (1987) found that the transaction costs and agency costs are likely to influence company’s dividend policy. Frankfurter and Lane (1992) states that dividend payout can be viewed as the socioeconomic repercussion of corporate evolution- the information asymmetries between managers and shareholders cause dividends to be paid to increase the attractiveness of equity issues.

Pruitt and Gitman (1991) surveyed financial managers of the 1,000 largest US firms about the interplay among the investment, financing, and dividend decisions in their firms. Their evidence suggested that important influences on the amount of dividends paid were current and past year’s profits, the year-to-year variability of earnings, and the growth in earnings.

DeAngelo, and Skinner (1992) studied the relationship of dividend changes and net income, annual losses (dummy), special items and extraordinary items using 167 firms as a loss sample and 440 firms as non-loss sample from the period of 1970 – 1985 and the testing period of 1980 – 1985. The results indicate that an annual loss is a necessary condition for dividend reductions in firms with established earnings and dividend records.

In a survey study, Isa (1992) finds that firms in Malaysia follow stable dividend policies and a number of internal and external factors govern these policies.

Sharma and Rao (1992) identify the signaling aspects of corporate dividend policy concluding that the dividends are perceived as signals from management’s point of view, performance point of view, and also market’s point of view.
Kevin (1992) analyzes the dividend distribution pattern of 650 non-financial companies which closed their accounts between September 1983 and August 1984 and net sales income of one crore or more. He finds evidence for a sticky dividend policy and concludes that a change in profitability is of minor importance.

Karak (1993) concludes that Management in India, as a rule, has recently followed conservative policies with regard to dividends. There is an increasing tendency on their part to finance the expansion out of internal resources as far as possible.

Mahapatra and Sahu (1993) find cash flow as a major determinant of dividend followed by net earnings.

Simons (1994) studied the relationship between dividend changes and cash flows data from the years 1984 to 1985 with explanatory variables of cash flow from operations, free cash flow, total cash flow and net income show that none of the proposed cash flow measures convey information about dividend changes beyond earnings.

Hansen et al. (1994), in a study of electric utilities, focus on the role that dividends play in the monitoring process to reduce equity agency costs. Their paper concludes that the use of higher payout raises likelihood of monitoring by both management and the regulatory authority.

Bhat and Pandey (1994) study the managers’ perceptions of dividend decision for a sample of 425 Indian companies for the period 1986-87 to 1990-91. They find that on an average profit-making Indian companies have distributed about one-third of their net earnings and that the average dividend payout ratio is 43.6 percent.

Jensen and Johnson (1995) studied the dynamics of corporate dividend reductions by using 268 observations consisting of 218 cases of dividend reductions and 50 cases of dividend omissions for the periods 1974 to 1989. The explanatory
variables used are twenty one firm characteristics three years before and three years after a dividend drop: net income, operating income, stock price sale, cost of goods sold, current liabilities, acid assets, debt ratio, long term debt financing, equity financing, sales and purchases of fixed assets, labour expenses, number of employees, R&D and advertising expenses. The results indicate that firm earnings drop prior to a dividend reduction and increase afterwards. Following a dividend drop, firms tend to reduce assets expenditures, external financing activities, employees, and spend on R&D. Firms tend to sell more assets and their sales level remains dropped in the post-dividend-drop period. Overall, a dividend-drop marks the end of a firm’s financial decline and the beginning of firm restructuring.

Mishra and Narender (1996) analyze the dividend polices of 39 state owned enterprises (SOE) in India for the period 1984-85 to 1993-94. They find that EPS is a major factor in determining the dividend payout of SOEs.

Mohanty (1999) analyzes the dividend behaviour of more than 200 firms for a period of over 15 years. He finds that in most bonus issue cases firms have either maintained the pre-bonus level or only decreased it marginally thereby increasing the payout to shareholders. The study also finds that firms that declared bonus during 1982-1991 showed higher returns to their shareholders compared to firms which did not issue bonus shares but maintained a steady dividend growth. He finds evidence for a reversal of this trend in the 1992-1996 periods. He attributes such a reversal in trend to the changed strategy of multi-national corporations and their reluctance to issue bonus shares.

Saxena (1999), identified that firm’s past revenue growth rate, forecasted growth rate of earnings, number of common stockholders of the firm and systematic risk as the major determinants of dividend payout policy.

Baker and Powell (2000) found that the most important factors influencing a firm’s dividend policy are the level of current and expected future earnings and the pattern or continuity of past dividends.
In Turkey, Adaoglu (2000) finds that earnings are the main determinant of dividend payments. Until 1994, companies in Turkey were required to distribute 50 percent of the distributable profits as cash dividends. His results show that because of regulation of compulsory distribution of profits, the Istanbul Stock Exchange (ISE) companies were given the flexibility of choosing their own dividend policy, they followed unstable dividend policies.

Auret and De Villiers (2000), using a multiple linear regression technique, found that earnings per share (EPS) had greater explanatory power than dividends per share (DPS) in the explanation of share prices.

Fenn and Liang (2001) find that managerial stock incentives mitigate the agency costs for firms with excess cash flow problems. They also find a strong negative relationship between dividends and management stock options.

Adelegan (2001) studied the impact of growth prospect, leverage and firm size on dividend behaviour of corporate firms in Nigeria between 1984 - 1997, observed that the conventional Lintner’s model does not perform quite creditably in explaining the dividend behaviour of corporate firms for the period under review. Factors that mainly influenced the dividend policy of quoted firms are after tax earnings, economic policy changes, the growth potentials and long term debts.

Fama and French (2001) analyzed the issue of lower dividends paid by corporate -firms over the period 1973 – 1999 and the factor responsible for the decline. In particular, they analyzed whether the lower dividends were the effects of changing firm characteristics or lower propensity to pay on the part of firms. They observed that the proportion of companies paying dividend has dropped from a peak of 66.5 percent in 1978 to 20.8 percent in 1999. They attributed this decline to the changing characteristics of firms. The decline in the incidence of dividend payers is in part due to an increasing tilt of publicly traded firms towards the characteristics – small size, low earnings, and high growth – of firms that which have never paid dividends.
Baker, Viet and Powell (2001) study the factors that have a bearing on dividend policy decisions of corporate firms traded on the NASDAQ. The study based on a sample survey (1999) response of 188 firms out of a total of 630 firms that paid dividends in each quarter of calendar years 1996 and 1997, finds that the following four factors have a significant impact on the dividend decisions, pattern of past dividends, stability of earnings and the level of current and future earnings. The study also finds statistically significant differences in the importance that managers attach to dividend policy in different industries.

Ramacharran (2001) analyzes the variation in dividend yield for 21 emerging markets (including India) for the period 1992-1999. His Macroeconomic approach using country risk data finds evidence for pecking order hypothesis; lower dividends are paid when higher growth is expected. The study also finds that political risk factors have no significant impact on dividend payments of firms in emerging markets.

Baker et al. (2002) in their pioneering study investigated the dividend puzzle from the point of view of perception of dividend rather than through the complex statistical analysis of market data and concluded that these cannot be a single dividend model for all firms and that optimal models should fit a group of firms, given their temporal and spatial circumstances.

Lee and Ryan (2002) analyze the dividend signaling-hypothesis and the issue of direction of causality between earnings and dividends- whether earnings cause dividends or vice versa. For a sample of 133 dividend initiations and 165 dividend omissions, they find that dividend payment is influenced by recent performance of earnings and free cash flows. They also find evidence of positive (negative) earnings growth preceding dividend initiations (omissions).

Reddy (2002) examines the divided behavior of Indian corporate firms over the period 1990 – 2001. Analysis of dividend trends for a large sample of stocks traded on the NSE and BSE indicate that profit and firm’s size are the major determinant of dividends. However, firm’s growth doesn’t seem to deter Indian firms from paying higher dividends. The analysis of influence of changes of tax regime on dividend behaviour shows that the tradeoff or tax-preference theory does not appear to hold true in the Indian context.

Kanwal Anil & Sujata Kapoor have examined determinants of dividend payout ratio of CNX IT Listed companies in India. They concluded that existing variables do not explain the dividend payment pattern of IT sector. Only Liquidity and beta (year to year variability in earnings) is found to be a noteworthy determinant. The study period was 2000-2006 covers both recessionary and booming phase of IT sector.

For the emerging market, Norhayati (2005) studied dividend trends of companies listed on the Kuala Lumpur Stock Exchange (now known as Bursa Malaysia). She found that the pattern seemed to relate very much to the economic cycle. Her sample excluded companies in the Finance and Unit Trusts sectors and was limited only to final dividend announcements. Her findings showed from years 1981 to 1991, the percentage of firms that paid dividends went down from 75 percent to 63 percent, however, the percentage of payers increased to 83 percent in 1992 and continued to increase up until 1997, and went on a downward trend from that year where there were only 55 percent final dividend payers in year 2000.

Osuala (2005) in his study, determinants of corporate dividend policy in Nigeria found that profitability (EAT) and return on equity (ROE) affect dividend payments.

Liu and Hu (2005) in his study of Chinese listed firms found that cash dividend payout ratio of most of firms were between 20 to 50 percent, meaning that cash dividend payment was higher than the accounting profit. However, he found that 50 percent of the sample firms had dividend cash payment higher than the free
cash flow. He attributed this finding to the ruling made by the security commission of China in 2000 which stated that listed companies must have cash dividend payment in the past three years. This shortage of cash was usually financed through selling shares or right issue.

Naceur et al (2006) conducted the study on the determinants and dynamics of dividend policy of Tunisian stock exchange. They selected 48 firms (non financial) and examined whether the managers of the listed firms smooth their dividends or not. They attempted to explain if the Tunisian firms follow stable dividend policy? Do dividend yield differ across the industry sector? What are the main factors that determine the dividend policies in Tunisia?

Li and Lie (2006) reported that firms are more likely to raise their dividends if they are large and profitable and the past dividend yield, debt ratio, cash ratio, and market-to-book ratio are low. Firms are more likely to cut their dividends if they have poor operating income, low cash balances, and a low market – to book – book ratio.

Some firms in Malaysia have very high dividend payout ratio. According to a survey performed by Normah et al. (2006), the highest dividend payout average for years 2003 – 2005 of 212 companies surveyed was about 83 percent. This showed the heavy emphasis that some firms placed on dividend payment. On the other hand, it is not surprising if some firms also paid out dividends even though they reported a loss for that year. This is due to the reluctance of firms to cut or omit dividends due to research finding which have shown that investors, in both developed and emerging markets, react negatively to a dividend decrease.

Baker and Smith (2006) surveyed 309 sample firms exhibiting behaviour consistent with a residual dividend policy and their matched counterparts to learn how they set their dividend policies. Their results showed that for the sample and matched firms, the pattern of past dividends, the level and stability of earnings, and desire to maintain a long-term dividend payout ratio elicit the highest level of agreement from respondents.
Manickam & Naleson (2008) studied 10 major industries which have been selected on the basis of convenience sampling method for the period of 10 years during 1992-2001. They found in the frequency distribution of dividend per share that maximum numbers of companies are distributed in the medium category of chemical, cotton, textiles, electrical, metal and alloy, paper, sugar and synthetic textiles industries. Among the selected 10 industries, more number of companies in the automobile, chemical and electrical industries have paid maximum dividend of Rs.2 and above more number of companies in the cement, engineering and metal. Further, Alloy industries have paid minimum dividend of below Rs.0.5 frequency class intervals, the study concluded that maximum number of companies has paid dividend per share of below Rs.5.

R. Azhagaiah and Sabari Priya N. (2008) analyzed the impact of dividend policy of shareholders wealth in Organic and Inorganic Chemical Companies in India during 1996-1997 to 2005-2006. To measure the impact of dividend policy on shareholders wealth multiple regression method and stepwise regression models are used. The study proves that the wealth of shareholders is greatly influenced mainly by five variables viz., growth in sales, Improvement in Profit Margin, Capital Investment Decisions (both working capital and fixed capital), Capital Structure Decisions, and Cost of Capital (Dividend on Equity, Interest on Debt). There is a significant impact of dividend policy on shareholders wealth in Organic Chemical Companies while the shareholders wealth is not influenced by dividend payout as far as Inorganic Chemical Companies are concerned.

Ahmed and Javid (2009) in their study on the determinants of dividend policy show that Pakistan’s listed firms rely more on the current earnings and the prior dividends.

Nnamdi (2009) in his study of earning dividend relationship in corporate Nigeria identified the existence of a significant relationship between dividend and current and past earnings in Nigeria.
Lalitha Mani & Priya (2010) studied dividend behaviour of five Indian steel companies are considered for the analysis. The study revealed that Tata steel has highest earnings per share with high dividend amount declaration. SAIL which has the impressive growth rate during the study.

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