CHAPTER 2: LITERATURE REVIEW

2.1 Introduction

This section mainly highlights portion of collected works review which consists of theoretical part related to dividend policies. The chapter mainly focused on some of concepts of dividend policy and its role that how it shows significant role for the investors of the organisation and for the company itself. Two dividend policies have also discussed in this portion which are being accepted by the organisation management. There are diverse features that are accountable for the policies of dividends and those three factors are also highlighted in this chapter. Shareholders' are also regarded as asset for company as they paly significant role in this regard. Furthermore, EPS and firm performance are related to those methods by the help of them shareholders' wealth can be measured. This chapter explained them too that how they are important and how the significantly the role is being played by them.

In the same firm's performance is measured by the help of different factors and financial ratios. Two of the ratios among them are being highlighted and discussed in detail that how they these ratios are calculated what outcomes can be achieved from these ratios. These ratios are ROE and ROA. As dividends policy have great impact on the shareholders' wealth as well as on financial performance of any firm. These factors are being explained in detail in the same chapter. Last part of chapter is theoretical portion and in that few dividends based theories have been discussed in detail. These theories will be considered in this report. These are bird in hand theory, agency theory and signaling effect theory. Conceptual framework relates to the pictorial representation of the studies that will indicates that how the flow of study will be carryout. In that framework variables have been defined in both ways (i.e. dependent and independent) in order to evaluate results after computations are performed on them.

2.2 Concept of Dividend Policy

Concept of dividend policy is concerned with different policies connected to finance. The terminology of dividend policy is related to dividend's amount that is being paid out by the corporate organisations. This amount is being paid the company shareholder according to intervals. Moreover, dividends are being paid out according to some policies that are defined. Amount of payment will only be compensated to the stakeholder if and only if company or firm successfully manage to earn profit (Becker and Ivković, 2011). Therefore, when the profit is made by a company than the management is going to decide that which decision is going to be taken by it. Either it had decided to keep that profit as a retained earnings of the company or it had decided to distribute it among shareholders. On the other hand, there is also another terminology in this regard and that is of "*dividend puzzle*" which refers extent of effect on dividend policy (Shapiro and Zhuang, 2015).

Dividend policy also explained by the help of different earnings strategies that are being adopted by management of companies. On the basis of these strategies, they are able to decide well regarding distribution of dividends. There are two policy options in this regard and that are as *"No Dividends*" and "*Regular Dividends Policy*". In the first policy, (i.e. No Dividend Policy) there is no obligatory for the companies to pay disbursements to the investors and in this way profits of companies are being used for expansion of company. Expansion can be made by acquiring new plant etc. However, in other policy of dividends (i.e. Regular Dividends Policy), dividends are being distributed on regular predetermined intervals. These intervals can be, quarterly, monthly and every six months or yearly (Zakaria, Muhammad, 2012).

2.3 Importance of Dividend Policy

As shares are the amount of extra profit that is earned by the organisation in different ways. These dividends are of great significance in terms of investors of companies as well as for the company itself. Amount of dividends are being paid out form the portion of real earnings and moreover this amount cannot be manipulated by creative accounting. Ian Mortimer and Matthew Page in (2015), have published a research article which describes the importance of dividend and its policies for the perspective of shareholders of company as well as for company itself. They have studied that investors are mostly interested in those stocks which are dividend paying stocks and for that purpose S&P have been taken as an example. In S&P during the last 10 years, it has been a trend that their dividends paying stocks have more weightage as compared to others. There is another key factor to investors from these dividends policies as well as dividend strategies that systematic approaches are being offered in order to reach financial goals of companies. Moreover, these goals are being achieved by the strategy of "*buy low*" and *"sell high*" strategy.

2.4 Factors of Dividend Policy

There are number of ratios that are being used by the investors in order to have access to their portfolio. Following are few ratios in this regard that mostly used by the investors.

2.4.1 Dividend Pay-out Ratio

According to Gill along with other two members in 2010, DPR (Dividend Pay-out Ratio) is regarded as ratio that is mostly being used in order to calculate dividend that can be obtained from a stock of company. This ratio explains the amount in Euro going to be rewarded by the firm as the compared to the amount of net revenue in Euros. Moreover, it also expresses the amount in percentage being paid out by company to its owners. On the other hand, if company is

failed to do so even after earn profit than there may be the reason of retained earnings of company. Whereas reserved earnings of the organisation is an amount that is invested in order to expand the business. Furthermore, Surplus Pay-out Ratio is not capable to define the financial health of company rather it provides knowledge to investors regarding the priority of investment of a company for future goals. From the given formula it can be calculated.

$$Dividend\ Payout\ Ratio = \frac{Dividends}{Net\ Income\ of\ Company\ for\ same\ year}$$

2.4.2 Dividend Yield

DY is all about the proportion of yearly dividend of a company along with its comparison to the share value of a business. In the same way it is being measured by dividing the yearly dividend to share price. It is also the money amount that is paid by an organisation to its stakeholders because shareholders' have owed the shares of that company. The mature companies always have a tendency to to pay payments to their financiers and in the same way those companies which are retail based pay high dividend as compared to other according to the studies concluded by Maio and Santa-Clara (2015). Moreover, DY is also calculated by the help of following mathematical equation.

$$Dividend\ Yield = \frac{Annual\ Dividends}{Share\ Price\ of\ a\ Comapny}$$

It is not always mandatory that investors always attracted towards those companies whose dividend yield are higher. This is due to the reason that increase in the percentage of DY can lower amount of share price of a particular company.

2.4.3 Dividend per Share

Third and last factor of dividend policy with respect to this study is DPS. As there are two types of shares in organisations and that are of preferred shares and outstanding shares. Outstanding shares are those which are sold out to investors. Therefore, terminology of "*DPS*" is related to these holders of outstanding shares. It is about sum of declared dividends that are paid by company against each outstanding shares to investors (Bawa and Kaur, 2013). In this way, it mainly dependent on three factors and it is calculated by the help of following equation.

$$Dividend\ per\ Share = \frac{Sum\ of\ dividends\ over\ time - One\ time\ dividend}{Ordinary\ Shares\ Outstanding\ for\ the\ Period}$$

2.5 Concept of Shareholder's Wealth

Concept of shareholder's wealth is related to business term which is also known as shareholder value. The term simply implies in order to measure the rate of success of a company in order to evaluate that to which extent shareholders have been enriched by company. This value is being delivered to its investors by the company as they have owned stocks of that company. Furthermore, there is an association among stockholders and organisation management. This is due to the reason that if there will be an increases in the amount of shareholder's wealth, ultimately it will indicate the efficiency of management of that particular company that how well different segments are being managed efficiently in order to gain profit (Krüger, 2015).

2.6 Maximising Shareholder wealth

Whenever management of a firm decided to increases the wealth of a company than actually they are try to raise value of its stock. This is due to the reason of two factors that are highly dependent on share price of a company. These factors are market value of firm and wealth

of shareholders'. In this way if there will be change in one variable ultimately it will have impact on other variables as well. Wealth of an investor is such a difficult task to influence by manager, therefore, it is divided into sub parts which are usually known as value drivers. Ruth Bender have also studied a model which is comprised of seven values in order to provide guidance to managers. Those seven values are of income, functioning profit, rate of cash tax, incremental capital expenses, asset in operational capital, capital cost and the last value is competitive advantage period (Sharfman, 2014).

In this way, established on these seven components, all functions are planned in order to have positive impact on these values and ultimately it influence the wealth of shareholder. However, this model is also being criticized widely after the financial crises. According to many of the researchers it provides information and benefit to the owners of the company only but it is unable to provide measurement of some issues. These issues are like employment, ethical business practices and environmental issues. Moreover, studies in this regard have concluded that decisions of management can only maximise the wealth of shareholder but for that it can also lower the amount being utilized for third party (Jones and Felps, 2013).

2.7 Importance of Shareholders' Wealth

Shareholders are considered as integral part of the organisation because they play vital role in rise the value of the business in stock market and contributes greatly in development of the firm through substantial amount of financial investments (Kieschnick et al, 2013). In current era where economic prospects of the country undergo constant reform and possess the greater influence over the corporate firms it has become essential for organisations to keep the potential shareholder adhered with them to get the investments for large scale profitable projects (AsmaTahir, 2014). According to the study conducted by Oberholzer (2012) highlights that

shareholders are considered as the principle agent and driving source for the sustainable development of the organisation. In this regard, Mujahid and Abdullah (2014) asserted that shareholder wealth hold significant position in growth of the firm and increasing the market price of organisation's share. Profit rates and generated income are key features to measure business performance and convincing the shareholders to invest in certain projects initiated by the particular organisation (Chenchehene and Mensah, 2015). In addition to this Arowoshegbe and Emeni (2014) advocated that shareholders' wealth represents the value and market price of share that is outcome of dividend policy decisions and financial investments made by the organisation. However, Mishra and Modi (2016) implied that selection and implementation of optimal dividend policy is necessary to give the substantial and adequate profit to the customers that can add value to their wealth and motivate them to invest in the future projects of the frim.

In the study accumulated by Gul et al (2012) implies that expansion of the investor's wealth is considered as one the prime and eventual goal of the organisation because usually value of the firm is estimated and measured according to the price of the common stocks of the firm. Moreover, in order to attain the specified goals, it is imperative for upper management and board members to fair return to shareholder in their investments that can increase their wealth and create the sense of satisfaction among them that it is profitable to invest in the projects related to certain firm (Sarwar, 2013). Shareholders possess the authority to pull back investments if they do not manage to retain the reasonable amount in return according to their investments. However, in the study assembled by Iqbal et al (2014) argued that the firms that totally inclines towards the maximisation of the shareholder wealth might indulge in poor business practices and decline in recession. Sometimes to increase the shareholder wealth and grab sufficient investments from them organisation include false information in financial

statements and there is a lack of transparency between management and shareholders (Alam and Hossain, 2012). Moreover, Hussainey et al (2011) asserted that in the efforts of increasing the shareholder's wealth organisation losses the focus over the customers and provide them with poor quality of services or product because most of the returned profits are presented to the shareholders. Shareholders wealth holds great significance for the development of firm as well as the economic conditions of the country. When shareholder get the sufficient return number of investments on project increases accordingly that adds value to the economy of the country and that strengthen the market position of organisation operating in corporate sector (Oyinlola and Ajeigbe, 2014).

2.8 Measures of Shareholder's Wealth

Investors of company are always interested to gain more profit and minimum level of risks. There are number of ways through which wealth of shareholders can be measured. There are always smart decisions that are taken by the management which make unable to company to increase their productivity. Following are two measures through which shareholder's wealth can be measured.

2.8.1 Earnings per Share

It is known as the significant terms in the finance field which try to indicate profitability of company. Incomes per Share is regarded as one of the portion of profits of company that is allocated to each individual stock of company. All those people who interested to invest in the capital markets and in this way they buy some of the shares of companies, these investors pay high importance to these ratios. The main reason behind this is that more the value of the Earnings per Share is, more the chances of profitability for an investor (Talamati and

Pangemanan, 2015). Earnings per Share is calculated by dividing the net income of the company to the total number of outstanding shares. Investors are always get help regarding the sources of income of companies by this ratio.

$$Earnings\ per\ Share = \frac{Net\ Income\ of\ the\ Company}{Number\ of\ Outstanding\ Shares\ of\ the\ Company}$$

2.8.2 Firm Performance

The terminology of "*firm Performance*" is need to calculate financial performance of a particular firm. Although company performance is not mainly dependent on a single factor but it also depends on many factors. These factors can be explained like efficiency and market share of company where it operates. Moreover, it also the financial stability of company which is mainly depends on revenue stream, return on assets, return on equity, liquidity ratio, net profit margin, operating profit and stock prices as well as market value of company etc. Nature of a firm also very important in this regard as there are few financial ratios which are established on operations nature that are being supported out by a company (Margaritis and Psillaki, 2010). For instance, firm performance can be measured for a manufacturing company by total number of units that are being sold, return gain from its assets and inventory turnover ratio etc.

2.9 Measures of Firm Performance

As the financial performance of a company is mainly dependent on measurements of its financial ratios. Following two ratios are of great significance in this regard as they are directly related to the return that is being earned by company by efficiently managing their assets.

2.9.1 ROA (Return on Assets)

According to Khadafi along with other two members in (2014), Return on Assets is the ratio that is calculated by net income dividend of company to its overall assets. It is regarded as

one of the financial indicator for company as well as for investors which determines the profitability of a company. An idea is being given by the help of this ratio to investors that how well, assets are being managed and used efficiently by a company. RAO can be calculated by following formula.

$$Return\ on\ Assets = \frac{Net\ Income\ of\ the\ Company}{Total\ Assets\ Aquirred\ by\ Company}$$

Above formula explains that how earnings are being generated and from the term "*Invested Capital*". In this way this is regarded as one of the important ratio for perspective of investors as higher the value is calculated of this ratio, higher will be interest of investors because more earnings are being generated by less amount of investment.

2.9.2 Return on Equity

Return on Equity is on the other hand that looks same to that Return on Assets ratio but there is little difference in this ratio. This is measured by dividing net income of the company to the normal amount of shareholders' equity. Net income is mainly comprised of revenue, cost of sold goods, operating profit, EBIT and EBT etc. In this way the comparison of Return on Equity is being done from industry to other industry. This ratio is calculated by the help of following equation.

$$Return\ on\ Equity = \frac{Net\ Income\ of\ the\ Company}{Average\ Shareholder'Equity\ of\ Company}$$

There is another significance of Return on Equity ratio as it helps to estimate growth rates as well as dividend growth rates of companies. However, as there are advantages of this ratio, it also has some limitations which cannot be ignored as well (Khadafi, 2014).

2.10 Impact of Dividend Policy on Shareholder's Wealth

The current age of rapid development and technological advancement has made the economic dynamics of all the country highly critical and increased the competition in business sector substantially (Iqbal et al, 2014). It has made the organisation quite apprehensive and anxious to compete with the leading players and manage to gather the adequate amount of investments to drive their organisation. In this regard, shareholder plays vital role in investing the projects development and drive the company towards achievement (Hashemijoo et al, 2012). However, in this concern Ansar et al (2015) asserted that dividend policy holds dominant position in convincing the shareholder to purchase the shares of the certain firm and invest in their projects. If dividend pay out to shareholders is not fair and optimal they can pull back their resources and sell of the shares to unreliable third party or to the competitors that might overtake the business (Azhagaiah and Priya, 2008). The study accumulated by Sarwar (2013) highlighted that there is important influence of surplus policy on stakeholders' wealth because structuring of returns and rate of pay out shareholders can get relates with the rise and fall in their wealth.

However, the study assembled by Hussainey et al (2011) that there is no important impact of dividend policy on shareholder because firm value is not related to dividend policy therefore it does not impact the shareholders' wealth because it is evident that the investment by shareholder depends upon the value and firm performance. However, in the survey carried out by Kapoor (2011) implies that the firm dividend policy has imperative impact over the shareholders' wealth because when investors earns constant return and favourable amount of pay out on their profit it increases their wealth and boosts up the confidence. In this regard, Suwanna (2012) asserted that investors selects to participate in the organisation that offers the high share of dividend to them because it increase their wealth and permits them to invest in more projects.

The research carried out by AsmaTahir (2014) implies that in UK market dividend policy is considered as the significant variable because positive change in dividend and its announcement increase the market value of shares that contributes in maximising the wealth of the shareholders.

Generally, there are there different kinds of dividend policy such as unchanging, constant and remaining (Majanga, 2015). Stable dividend policy follows the pursuit of giving the predictable and predefined pay out to the shareholders disregarding the fact that earnings of the organisation are rising or falling. This category of dividend policy are mostly preferable by the shareholder because poor firm performance do not affect their wealth in negative way and they continuously get their share according to the stable dividend policy, On contrary, constant dividend policy pays the shareholders according to percentage of their earnings it allows the shareholders to enjoy the high share when organisation is earning well rather than stable dividend policy where shareholders are required to adhered with single specified amount (Profilet, 2013). Moreover, residual dividend policy pays out to the shareholder from the amount that is remained after paying for the capital expenditures of the firm. Saravanakumar (2011) highlighted that residual dividend policy is the least preferable by shareholders because no investors wants to engage with the firm where they have to compromise with the return in their investments and wealth.

2.11 Impact of Dividend Policy on Firm Performance

Adediran and Alade (2013) advocated that dividend policy of the firm creates the attractive pathways for the organisation to gain the effective financial outcomes. However, it is crucial to draw the optimal dividend policy that prove as beneficial for both shareholders as well as organisation (Ali et al, 2015). Effective dividend policy and financial decisions helps the frim to fetch the adequate amount of investments from the potential shareholders the can contribute in

development and progress of the different organisational project that increases the firm performance. The study conducted by Hafeez et al (2018) implied that there is a major control of dividend policy over the organisation performance because when the wealth of shareholders is high it contributes in increasing the shares prices of the organisation in the market that attracts more potential investors. However, Hunjra et al (2010) argued that continuous high dividend pay-out can threaten the financial position of the firm effecting their performance. It is essential to for the firm to manage their dividend pay-out by considering the financial conditions of the firm instead of declining in recession. It can be analysed by the dividend pay-out of Barclays, multinational bank based in UK, in 2017 Barclays total dividend pay-out to shareholders was 392 million GBP that was raised to 680 million GBP in 2018 (Statista, 2019). Profits earned by the organisation should be divided accordingly and share policy must be flexible according to the financial position of the firm.

In the frim sector dividend policy and organisation's performance are most discussed and argued prospects because these both phenomenon holds prominent issue in competitive market environment (Uwuigbe et al, 2012). The research accompanied by Farrukh et al (2017) advocated that performance of the firm has significant impact over rise and falls of the shares assessment in the market. Moreover, financial managers tend to make the dividend pay-out decisions according to the financial conditions, resources and earnings of the organisation (Agyei et al, 2011). If the larger share of the earning goes to the shareholders and organisation left with the insufficient balance they might decline into debts to pay the capital expenditures and run the daily business operations. Moreover, improper dividend policy can engage the organisation in fraudulent activities such as lack of accountability and transparency with shareholders including the data manipulation in financial investments of the firm. Kajola et al (2015) asserted that

dividend policy of the firm should not be inclined towards the maximisation of wealth of shareholders' financial performance of firm should be regarded before returning the amount to shareholders on their investments. It is not essential that increase in shareholder wealth through optimal dividend policy can definitely upscale the organisation performance because expenditures related to operating cost and human capital needs to be paid that reduces the financial balance of the firm (Mujahid and Abdullah, 2014).

2.12 Theoretical Framework

2.12.1 Agency Theory

Agency theory also referred as free cash flow theory highlights the relation between to significant components of the organisation that is principal as shareholders and agents as executive of the firms. Agency theory highlights the disputes amid agent regarding priorities of utilising and investing the finances of the firm (Farukh et al, 2017). The agency theory emphasis over the prospects pertaining to struggles of concern among management and shareholders (Al-Malkawi, 2010). The manager intends to increase the wealth of shareholders and control the business operations accordingly. However, agency issues occur amid both parties when there is as excessive cash flow into the organisation and all the earned profits are used for the personal interests rather than investing them in other profitable projects or returning to the shareholders (Aggarwal et al, 2010). For this purpose, shareholder is required to observe every action of managers and demands for high level transparency and accountability from them. Dividend policy is essential to take along the division of profits in the structured and logical manner. Executives of the firm might intend to expand the business into different market and invest the earnings into while shareholders might oppose to the idea and demands for immediate returns.

2.12.2 Bird-in-hand Theory

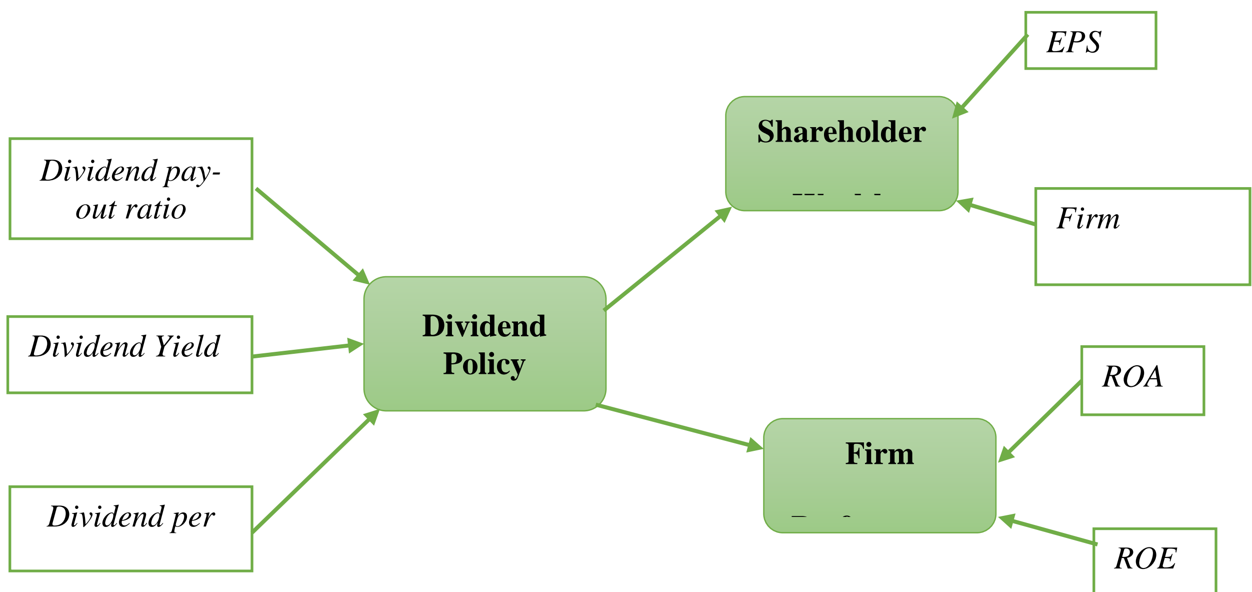
The bird-in-hand theory also refers as the share preference theory highlights that shareholders only prefer those stocks that possess the potential to given them stable and high dividends. Bird-in-hand theory implies that investors prefers the dividend above any sort of capital gains of the organisation. Furthermore, the underlying theory implies that investors and shareholders are risk avoiders and always aims to grab the substantial amount of dividend instead of capital gains (Farukh et al, 2017). Hussainey et al (2011) asserted that shareholders observes and dividend policy of the firms over anything else before making investment in certain organisation and compare both dividend and capital gains with each other. This particular theory follows the pursuit that it is better to have the bird in hand rather than bird in bush. Here, bird hand refers to dividend while bird in bush is taken as capital gains (Aggarwal et al, 2010). It means that it is logical to receive the return on investment immediately and short time rather than waiting for the organisations to achieve their long term goals and wait for future gains. Farukh et al (2017) highlighted that the birds in hand theory was proposed in the response of irrelevancy theory which implies that stockholders are not concern with the firm's dividend policy because they have the choice available to sell off their equities to get the cash.

2.12.3 Signaling effect theory

The signalling effect theory suggests that announcement by the organisation to increase their dividend pay-out indicates the future development and performance of the organisation. It implies that shareholders forecast the performance and profits of the firm by considering the rate or percentage of dividend certain firm is offering to its shareholders (Farukh et al, 2017). High share of dividends demonstrates the positive signal for the profitability and gives the information to investors concerning the performance of the organisation. Habib et al (2012) advocated that

announcement of the dividend policy in the market increases the value and prices of firm's share and potential investors can predict the market position of organisation in terms of profitability. Generally, rise in dividend payment signals for the sustainable performance of the firm and builds the positive reputation that motivates the shareholders to purchase the shares and invest in the firm. On other hand, low dividend rate creates the contrasting effect that is share prices of the firm declines along with its reputation and market value. Moreover, it gives the negative signal to the shareholders.

2.13 Conceptual Framework



The aforementioned conceptual framework highlights the association among independent and reliant on components of the research. Dividend policy has been taken as the independent variable along with its factors named as dividend pay-out ratio, dividend yield and dividend per share that can influence the shareholder wealth and firm performance. Furthermore, there are two dependent variables in the underlying study that are shareholder wealth and firm performance. EPS and Firm performance has been taken as the factors of shareholder wealth that can

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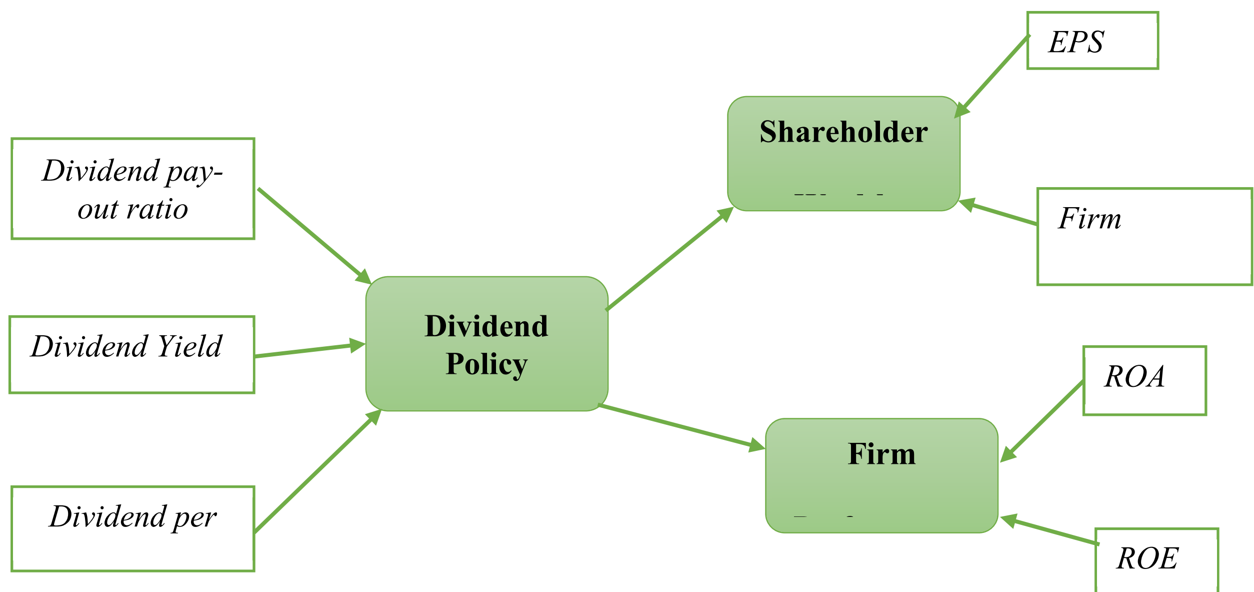

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influenced by dividend policy. Moreover, ROE and ROA has been taken as the factors of firm performance that can impact the impact of dividend policy over firm performance.

2.14 Chapter Summery

In current era of rapid development and growth has made the business dynamics quite complicated and dynamic. Every minor prospects creates the substantial effect on organisation's performance and its financial position. In this chapter of research different in-depth discussion over different aspects pertaining to dividend policy and its influence on wealth of shareholder and organisation performance. Dividend policy discusses to the share or percent of pay-out share should be given to shareholder as the return on their investment. From the analysis carried out in this chapter it is obvious that share policy of the firm can impact the shareholder's wealth and frim performance by the influence of numerous factors. Therefore, Firm performance, EPS, ROA and ROE has been taken as the factors of dependent variable. Whereas, dividend pay-out ratio, dividend yield and dividend per share has been taken as the factors of independent variable. For this purpose, theories, findings and reasoning from the previous journal articles has been incorporated in this chapter to critically analyse the phenomenon based on evidence including the detailed theoretical and conceptual framework.