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The Relationship Between Dividend Policy And Financial Performance: A Review Of Literature

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***Abstract:** The study investigates the effects of dividend policy on financial performance of quoted manufacturing firms in Nigeria. The objective of the study is to review the theoretical and empirical literature underpinning dividend policy and financial performance. This was necessitated by the desire to determine the relevance or irrelevance of dividend on financial performance of firms. From the review of the available literature, it was discovered that dividend policy is an important decision area of any business organization, it was also discovered that previous studies on the effect of dividend policy on financial performance has not adequately captured quoted manufacturing firms in Nigeria. The study recommends that further studies should be carried out to exhaustively examine the relationship between dividend policy and financial performance with emphasis on quoted manufacturing firms in Nigeria.*

I. INTRODUCTION

A. BACKGROUND TO STUDY

The importance of dividend policy in the current business world of significant agency problems between the principal and agent cannot be over emphasized. Those saddled with the responsibility to oversee the affairs of the organization are confronted with the decisions to improve the firm value; such decisions bother on financing structure, investment in assets and dividend policy. Dividend policies are crucial aspect of organization management and it serves as a mechanism for rewarding owners of a company for their investment. According to Nssim and Ziv (2001) dividend policies provide a guideline for deciding dividend payments to shareholders dividend represents the return accruing to shareholders for investing in an organization in order to acquire stocks (Eriki and Okafor,2002) dividend policy on the other hand deals with the division of profit (Net) between shareholders.

Financial performance on the other hand, can be viewed as how well a firm enhances its shareholders' wealth and the capability of the firm to generate earnings from the capital invested by shareholder. Financial statements are yardsticks for measuring a firm's performance.

Dividend payout can be used as a device to communicate information about a company's financial performance to investors. Cash dividend announcement conveys valuable information which shareholders do not have about management and assessment of a firm's future profitability thus reducing information asymmetry. Such information can be used by investors in assessing the firm's financial performance and making investment decision (Murekefu et al., 2012)

Dividend decisions are important because they determine what funds flow to investors and what funds are retained by the firm for investment (Ross et al., 2002). Firm investment determines future earnings and future potential dividend, and influence the cost of capital (Foong et al., 2007).

B. STATEMENT OF THE PROBLEM

Despite the numerous studies (Uwuigbe 2002, Mesut and Yusuf 2004, Mohammed 2007) that have been done, dividend policy remains and unresolved issue in corporate finance. Brealy and Myers (2005) described dividend policy as one of the top ten most difficult unsolved problems in financial economics. This description is consistent with Black (1976) who stated "The harder we look at the dividend picture, the more it seems like a puzzle with pieces that don't fit together".

Although several theories have been proposed to explain the relevance of dividend policy and whether it affects firm value, but there have not been any universal agreement (Stulz, 2000, Pandy, 2003 and De Angelo et al,. 2006) One major area of conflict is whether or not dividend policy affects the value of a firm and by extension the shareholders' wealth. In this regard, two main schools of though exist: the first represent researchers who are of the opinion that dividend policy affects the value of a firm. (Uwuigbe, Jafaru and Ajayi, 2012).

The second view relates to those with the contrary view that dividend policy does not affect the values of a firm. (Farsio et al,. 2004, Gill and Tibre wala 2010, Osegbu et al 2014) The contradictory and conflicting views on the relevance of dividend policy on firms financial performance inspired the current study to investigate the effect dividend policy may have on the financial performance of quoted manufacturing firms in Nigeria.

C. OBJECTIVE OF THE STUDY

The main objective of this study is to review the theoretical and empirical literature on the effect of dividend policy on financial performance. The essence is to gain understanding on the relationship between dividend policy and firm's performance.

D. METHODOLOGY

To address the concern, (i.e. the effects of dividend policy on the financial performance of companies). The study sought data from secondary sources. This entails the review of related textbooks, Journals and other publications.

II. REVIEW OF RELATED LITERATURE

A. THEORETICAL FRAMEWORK

Diverse studies have adopted different theories that are relevant in any discourse relating to dividend polices and performance of firms, although, they looked at it from different directions depending on the context of their work. Despite the existence of a large number of theories. A general consensus has not been reached in literature.

IRRELEVANCE THEORY

Irrelevance theory by Miller and Modiglaini (1961) forms the foundational bedrock of modern corporate finance theory. Miller and Modiglaini argued that dividend policy is irrelevant to the cost of capital and the value of a firm in a perfect capital market condition. This shows that investors can create an income pattern by selling and buying shares. According to this theory, the only thing that impacts the valuation of a company is its earnings which are the direct result of a company's investment policy and the futures prospects. That once the investment policy is known to the investor, he will not need any additional input on the dividend policy of the company.

Modiglaini-Miller theory goes a step further and illustrates the practical situations where dividends are not relevant to investors irrespective of whether a company pays dividend or not. The investors are capable enough to make their own cash flow from of stocks depending on their need for cash, if the investors need more money than the dividend they received, they can always sell a part of their investment to make up for the difference, likewise if the investors have no present cash requirement, they can always reinvest the received dividend in the stock. Thus, the Modiglaini-Miller theory firmly states that the dividend policy of a company has no influence on the investment decisions of the investors.

Modiglaini-Miller theory is based on the following assumptions.

- ✓ Perfect capital markets: This theory believes in the existence of perfect capital market. It assumes that all the investors are rational and have free access to information; they are no floatation of transaction cost and no large investor to influence the market price of the share.

No taxes: There is and existence of taxes. Alternatively both dividend and capital gains are taxed at a same rate.

Fixed investment policy: The Company does not change its existing investment policy. This means that new investment that are financed through retained earnings do not change the risk and the rate of required return of the firm.

No risk of uncertainty: All the investors are certain about the future market prices and the dividend.

BIRD IN HAND THEORY

The "bird in hand" theory is one of the major theories concerning dividend policy in an enterprise. This theory was developed by Myron Gordon (1963) and John Lintner (1964) as response to Modiglani and Miller dividend irrelevance theory.

Gordon and Lintner claimed that Modiglani and Miller made a mistake assuming lack of impact of dividend policy on firms cost of capital. They suggested that investors prefer dividend as it is more certain than capital gains that might or might not appear, if they let the firm retain its earnings.

The authors indicated that higher capital gains/dividend ratio is, the larger total return required by investors due to increased risk. In other words, Gordon and Lintner claimed that one percent drop in dividend payout has to be offset by more than one percent of additional growth.

Investors are risk averse and believe that incomes from dividend are certain rather than future capital gains, therefore they predict future capital gains to be risky propositions.

ASSUMPTIONS OF GORDON MODEL

Gordon Model is based on the following assumptions.

No Debt: The model assumes that the company is an all equity company, with no proposition of debt in the capital structure.

No External Financing: The model assumes that all investment of the company is financed by retained earnings and no external financing is required.

Constant IRR: The model assumes a constant internal rate of return (IRR) ignoring diminishing marginal efficiency of the investment.

Constant cost of Capital: The model is based on the assumption of a constant capital implying that business risk of all the investments is to be the same.

Perpetual Earnings: Gordon's model believes in the theory of perpetual earnings for the company.

AGENCY THEORY

The agency theory was advanced by Jesen and Meckling (1976). He explained that managers do not always run the firm to maximized returns to the shareholders. The agency theory re-echoes the conflict of interest that traditionally arises from separation of ownership from control. This creates agency problem. Managers will not always adopt a dividend policy that is value-maximizing for shareholders but would choose a dividend policy that maximizes their own private benefits. Making dividend payout reduces the free cash flows available to the managers which would thus ensure that managers maximize shareholders wealth rather than using the funds for their private benefits (De Angelo, H. and De Angelo, l. 2006). In the process of attracting new equity, firms subject themselves to the monitoring and disciplining of these markets.

Agency theory states that managers of firms are likely to engage in non value maximizing (NVM) behavior. Jesen and Meckling (1976) theorized that the value of a firm would be decreased by the agency cost incurred due to non value maximizing managers, however, if managers personal wealth were linked to the price of the firms common equity, these agency cost could be reduced thus, managerial ownership of equity (insider holding) could serve as an agency-cost reducing mechanism, increasing the value of the firm.

TAX PREFERENCE THEORY

Litzenberger & Ramaswamy (1979) put forward a theory which stated that investors prefer lower payout companies for avoidance of current taxation. This argument is based on the assumption that dividend are taxed at higher rates compared to capital gains hence the preference. Dividend are taxed in the year they are received while capital gains if any are taxed when stock is sold. Using the time value of money concept, dividend paid at present has higher effects on capital cost than capital gains taxed in future. This theory reintegrates that dividend policy is relevant and influences the value of shares since shareholders prefer earnings retention to current dividend.

B. CONCEPTUAL FRAMEWORK

This section presents the basic concept relating to financial performance and dividend policy. They include the concept of dividend, the concept of dividend policy and the concept of firm's financial performance.

THE CONCEPT OF DIVIDEND

Dividend are compensatory distribution to equity shareholders for both time and investment risk undertaken, such distribution are usually net of tax and obligatory payments under debt capital and they represent a depletion of cash assets of a company (Ross et al, 2002).

Dividend are distribution out of a company's earnings after theobligation of all income holders have been met. The most common form of dividend payment is in cash. Dividend payment can also take the form of stock dividend or bonus or scrip issues (Pandey, 2003).

Dividend payment are made by organizations to its shareholders from earnings generated in current or previous period. Shareholders earn income from two sources, the capital gain due to appreciation of share and dividend yield. Dividend yield as calculated by dividing the current dividend by the price of a share.

Earnings distributed to shareholders are called dividend (Pandey, 2003) profits made by a corporation can either be re-invested or distributed as dividend to stockholders.

CONCEPTS OF DIVIDEND POLICY

Dividend policy refers to the explicit or implicit decision of the board of directors regarding the amount of residual earnings (past and present) that should be distributed to the shareholders of the company Foong, et al, (2007).

Dividend policy is the set of guidelines and regulations a company uses to decide how much of its earning it will pay out to shareholders. There are three main approaches to dividend policy; residual, stability and a hybrid of the two (Foong et al,. 2007). Dividend policy has been analyzed for many decades but no universally accepted explanation for companies observed dividend behavior has been established (Samuel and Edward, 2011). It has long been a puzzle in corporate finance. Dividend policy is the pivotal policy around which other financial policies rotate (Alii et al., 1993).

CONCEPT OF A FIRM'S FINANCIAL PERFORMANCE

Firm's financial performance can be viewed as how well a firm enhances its shareholders wealth and the capacity of a firm to generate earnings from the capital invested by shareholders (Samuel and Edward, 2011). The aspect of interest in financial performance for a long time has been perceived only through its ability to obtain profits. But this has change over time. Today, the concept of financial performance has different meaning depending on the users of financial information. A company can be categorized as having a high level of financial performance if it can satisfy the interests of all her stakeholders; managers are interested in their welfare and to obtain profits because their work is appreciated accordingly; owners want to maximize their wealth by increasing the company's market value (this objective can only be based on profit); current and potential shareholders perceive performance as the company ability to distribute dividends for capital investment, given the risks they take; commercial partners look at the solvent and stability of the company; credit institutions want to be sure that the company has the necessary capacity to repay loans on time; employees want a stable job and to obtain high material benefits, the state seeks a company to be efficient, to pay its taxes, to help in the creation of new jobs.

Financial performance is a subjective measure of how well a firm can use its assets from its primary mode of business to generate higher revenues. Evaluating the financial performance of a business allows decision makers to judge the results of business strategies and activities in objective monetary terms. (Brealy, Myers & Maarcus, 2007).

C. EMPIRICAL REVIEW

The main body of the literature focuses on studying the relation between dividend payout and firms' financial performance. The study evaluates dividend policy, by trying to determine the effect of a firm's financial performance on its dividend policy. Majority of these studies agreed to the fact that dividend policy is significantly related to firms' financial performance. While a few studies show that dividend policy is insignificantly related to firms' financial performance.

Uwuigbe (2012) investigated the relationship between the dividend policy and financial performance among listed firms in Nigeria. The study also looked as the relationship between profitability, ownership structure, size of firms and the dividend payouts. The annual reports for the period 2006-2010 were utilized as the main source of data collection for the 50 sampled firms. The regression analysis method was employed as a statistical technique for analyzing the data collected. They found that there is a significant positive relationship between the profitability of firms and the dividend payout of the sampled firms in Nigeria. The study also revealed that ownership structure and firm's size has a significant impact on the dividend payout of firms too. The study recommended that future research be carried out to investigate how ownership structure and dividend policy will be affected by changes in tax policy. The implication is that larger firms that are more profitable tend to improve more on their dividend policies, thereby attracting more investors.

Mesut and Yusuf (2014) examined the relationship between dividend policy and financial performance of the companies operating in Istanbul Stock Exchange (IST). The study used data of 172 companies outside of financial sector for the period of 2008-2011. The variable for the study included; Return on Assets (ROA), Return on Equity (ROE), Tobin's q (Q) and dividend per share (DPS). In the study, firms were divided into two groups: the ones that make regularly payments of dividends and the ones that don't make regular dividend payment. The test were conducted in order to understand whether there is a difference between accounting and market based financial performances of these two groups or not. Data analyses made use of multiple regressions, T test methods as well as descriptive statistic. The results of analysis showed that dividend payments had influence on companies' performance. Furthermore, there was a positive and statistically meaningful relationship between dividend per share (DPS) within groups and market based performance indicator. While, there was a statistically meaningless relationship between accounting based performance indicators ROA and ROE and dividend per share. The study found out that there is a significant positive relationship between the performance of firms and the dividend payout of the sampled firms in Istanbul Stock Exchange (IST). The study indicated that market performance of firms is positively influenced by increase in the dividend per share of firms. Accordingly, the study recommended that further investigation be done on the influence of dividend distribution polices of firms on their performance by making an industrial differentiation. From the above study, it can be deduced that the dividend per share of firms leads to an increase in the market performance of firms.

Mohammed (2007) examined whether dividend policy influenced firm performance in Ghana. The analyses were performed using data derived from the financial statements of listed firms on the Ghana Stock Exchange (GSE) during the eight-year period (1997-2004). The variables for the study include; Return on Assets (ROA), Return on Equity (ROE), Dividend payout (DPO), growth, leverage and size. Ordinary least model was used to estimate the regression equation. In order to operationalise dividend policy, the study coded: "1" representing the company that has a policy to pay dividend; while "0" to represent the company that has a policy not to pay dividend, and growth in sales. The study revealed that bigger firms on the GSE performed with respect to return on assets. The results also revealed negative relationship between return on assets and dividend payout ratio, and leverage. The study showed that firm performance is positively influenced by dividend policy. This means that a firm whose dividends are high and are paid in time attract more investors, hence leading to an improved firm performance.

Ajanthan (2013) investigated the relationship between dividend payout and firm profitability among listed hotels and restaurant companies in the Colombo Stock Exchange (CSE). The study covered a period of 8 years from 2006 to 2012. The variables for the study included; Dividend payout (DPO), Return on Assets (ROA) and Return on Equity (ROE). Regression and correlation analysis were carried out to establish the relationship between dividend payout and firm profitability. The findings indicated that dividend payout was a crucial factor affecting firm performance. It concluded that their relationship was also strong and positive. It recommended that managers should pay attention and devote adequate time in designing a dividend policy that will enhance firm profitability and therefore shareholder value. This study therefore showed that dividend policy was relevant.

Ajanthan (2013) investigated the relationship between liquidity and profitability of trading companies in Sri Lanka. The study covered 8 listed companies in Sri Lanka over a period of 5 years from 2008 to 2012. The variables for the study included; Return on Assets (ROA), Return of Equity (ROE), current ratio, Quick ratio and Liquidity ratios. Correlation and regression analysis respectively were employed to examine the nature and extent of the relationship between the variables. Findings suggested that significant relationship exist between liquidity and profitability among the listed trading companies in Sri Lanka. The study recommended that trading companies should strike a balance between liquidity and profitability so as to meet regulations.

Samuel and Edward, (2011) examined the relationship between dividend policy and performance of banks in Ghana. The variables used for the study included; Dividend payout

(DPO), risk and firm size. The study used panel data constructed from the financial statements of 16 commercial banks in Ghana for a period of 5 years, from 1999-2003. From the results of the study, dividend payout had a positive relationship with firm performance. The result further showed that banks that pay dividend increase their performance. The study recommended that future studies be investigated on the effect of dividend policy on the performance of other financial institutions like insurance companies. From the above study, it implies that banks that pay dividend enhance their performance relative to banks that do not.

Ahmed and Javid (2009) investigated the relationship between dividend policy and firm performance among listed firms in Pakistan. The study covered a period of nine years from 2002 to 2012 and variables that were used included; net profit margin, total asset and revenue. Regression analysis was carried out to establish the relationship between payout and firm performance. The study found out that the relationship between dividend policy and firm performance was also strong and positive. Based on the findings of the study, the research revealed that dividend policy is relevant. The study recommended that managers should devote adequate time in designing dividend policies that will enhance firm performance and therefore shareholder value. The implication from the above is that dividend payout is the major factor of firm performance.

Zakaria (2012) investigated the relationship between dividend policy ratios and share price volatility during the period of five years on some construction and material companies in Malaysia. The variables from the study include; return on investment (ROI) and return on equity (ROE), dividend payout (DPO), earnings per share (EPS), and price to earnings ratio (P/E) and price to book value ratio (PB). Correlation and multiple regression analysis were used for analysis. The results revealed that dividend policy ratios has a great impact on all firm performance ratios except return on investment (ROI) and return on equity (ROE). Furthermore, EPS, P/E and PB were significantly correlated with ROA 5 percent level of significant. At the same time P/E was significantly correlated with ROE at 5 percent level of significance. Finally EPS and PB were significantly correlated with ROE at 1 percent level of significance. From the above, the study found out that there is a significant positive relationship between dividend policy and firm performance. The study also recommended that further investigation be done on the effect of firm performance on dividend policy of financial institutions. It can be deduced from the above that an increase in the financial well being of a firm tend to positively affect the dividend policy of firm.

Osegbu (2014) Analyse the extent of relationship between dividend payment and corporate performance in the Nigerian banking industries between 1990 and 2010 using regression model, the results showed that there is no significant relationship between dividend policy and performance, hence insignificant relationship occur between dividend policy and other four variables (free cash flow, financial leverage, business risk and tax paid on dividend).

Komrattanapenya and suntrauk (2013) Examined the factors that affect the dividend payout of all firms listed in the stock exchange of Thailand (SET) during year 2006 to 2010 using the tobit regression analysis they found that profitability and business risk are insignificantly related to dividend payout.

D. CONCLUSION

In view the findings from majority of the studies one may be provoked to conclude that there is a significant positive relationship between dividend policy and financial performance. However, some studies still show a negative relationship. Dividend policy has continued to be one of the most challenging and controversial issue in corporate finance and financial economics. Managers are often confronted with the “dividend puzzle”, which is the problem of reconciling observed dividend behavior with economic incentives.

III. RECOMMENDATION

The study recommends that further investigation should be carried out so as to find out the clear cut relationship between dividend policy and financial performance. This is necessary since previous studies have not been able to reach a consensus.

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