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Corporate Ownership And Dividend Policy: Agency Theory Perspectives

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***Abstract:** The aim of the paper is to examine how dividend policy reduces the conflict of interest between the principal and the agent i.e. shareholders and the managers. The paper reviewed and evaluates the sources of conflict and the mechanism of mitigating against the agency problem. The study is based on review of previous studies to come up with a comprehensive conclusion as far as agency problems are concerned. It is found that dividend is an effective mechanism set up to take care of agency problem, so the shareholders will push for the payments of dividend when the firm has free cash flow in order to monitor the activities of the managers. Also, the board of directors is an effective device to control the agency problem only if it can prevent individual top managers, such as chief executive directors, from engaging in opportunistic behavior. It is recommended that shareholders should always be on alerts once there is free cash flow to the dividend to avoid allowing managers in pursuing their interests or investing in the non-profitable projects.*

***Keywords:** Dividend, Agency Cost, Agency Conflict, Corporate Ownership, Free Cash Flow*

I. INTRODUCTION

The dividend is said to be the return made to shareholders for their investment in a company. While dividend policy is the procedure adopted by the company of either paying the dividend or retaining the earnings for reinvestment in the company. Ownership concentration is measured as the percentage of total company shares held by the controlling shareholders. Shareholder voting has a significant effect on corporate decisions that relies on distribution of stock among the shareholders. Larger shareholders has significant power and control over key decisions like dividends' decisions and payout ratios (Gugler, 2003). Easterbrook (1984) argues that dividends play a role in controlling equity agency problems, by smoothing primary capital market supervising firms' activities and performance, (Farinha, 2003). Since there is a conflict of interest between the principal and the agent, dividend will serve as an instrument that mitigates the conflict. However, it is tremendously important to study ownership structure of companies in emerging markets in understanding dividend policy associated to the agency problems in these markets.

In theory, most financial managers would agree with the goal of owner wealth maximization. In practice, however, managers are also concerned with their personal wealth, job security, and fringe benefits. Such anxieties may make managers reluctant or unwilling to take more than moderate risk if they perceive that taking too much risk might endanger their jobs or reduce their personal wealth. The result is a less-than-maximum return and a potential loss of wealth for the owners, (Gitman, 2012).

Agency theory suggests that outside shareholders prefer dividends over retained earnings, because managers might misuse cash retained within the firm in order to invest in negative NPV projects. Meanwhile, this is some of the situation that brought about a conflict between managers/owners and shareholders or between majority and minority shareholders. This is a good reason that mitigates the conflict that ascends between the outside shareholders and inside shareholders i.e. principal-principal conflicts, see, e.g. (Easterbrook, 1984; Jensen, 1986). This preference for dividends may be even stronger in emerging markets with weak investor protection, if shareholders perceive a greater risk of expropriation by insiders in such countries, this signify that once the investors foresee that there will be risk they will push managers to declare dividend. (Mitton, 2004). This shows there is a relationship between risk and dividend payment.

Furthermore, agency theory assumes that conflicts of interest occur between corporate insiders and outsiders; hence managers are expected to act for their personal interest, which may not always be beneficial for shareholders. Such conflicts lead to agency costs. Agency cost models forecast that dividends' payment can alleviate information asymmetry problem. Therefore, the free cash flow hypothesis is fixed in conflicts of interest between managers and shareholders in the presence of informational and self-centered behavior. Based on this background, firms prefer to increase their dividends and distribute the free cash flow to reduce agency conflicts. Consequently, markets react positively to this type of information. Against this background the study is aimed at reviewing how dividend payment might reduce agency conflict in a firm.

II. OWNERSHIP STRUCTURE AND DIVIDEND POLICY

Dividend is the means that induce shareholders to have interacted in raising capital for running corporations which necessitate them to bear risk in their investment. Similarly, the management of corporations makes up a dividend policy to share dividend among investors for the investment they made in the firm. Dividend policy makes a significant impact on valuation of firm as it must keep a state of balance between growth and payout policies of the firm. However, Jensen and Meckling (1976) posits that the agency relationship is usually established in a circumstance where the owners engage managers to carry out their responsibilities. Agency theory asserts that paying dividends reduces the cash available at the discretion of managers to invest in unprofitable projects, (Jensen, 1986). Agency cost usually arises due to the conflicting interest between investors and the managers.

On the other hand, Bird-in-the-hand theory suggests that investors choose less risky dividends to potential capital gains,(Bhattacharya, 1979). Signaling theory asserts that a firm's announcement of dividend changes provides a signal of its future prospects (Miller & Rock, 1985). Tax clientele effects suggest that investors select a firm with a specific dividend policy because of different tax treatments (Bajaj & Anand, 1990). Life cycle theory of dividends asserts that a firm's optimal dividend policy is based on its stage in the firm life cycle (Bulan & Narayanan, 2009). Firms with growth opportunities wish to retain all their profits to fund investment opportunities, thus avoiding expensive external financing, but mature firms with little or no growth potential prefer to distribute their free cash flows to their shareholders as dividends. Catering theory of dividends advances that firms pay dividends as a response to investors' increasing demand for dividends and reduce such payments when investors prefer non-payer stocks (Baker & Wurgler, 2004). Inflation and dividend payments theory contends that managers pursue an optimal dividend policy where they pay a desired level of real income to their investors, (Baker & Imad, 2017).

III. SOURCES OF AGENCY CONFLICT

One of the most generally reviewed statements for why firms pay dividends is the agency cost theory, which derives from the problems involved with the separation of management (the agent) and ownership (the principal) and the differences in managerial and shareholder priorities, also known as the principal–agent conflict, (Jensen & Meckling, 1976). This theory argues that cash dividends can be used as a tool to mitigate agency problems in a company by reducing free cash flow and compelling management to enter the capital market for financing, hereafter leading to encourage monitoring by the market forces, (Easterbrook, 1984; Jensen, 1986). According to this theory, due to the separation between the functions of decision and those of control, the organization includes persons characterized by the heterogeneity of their expectations and goals. In this context, agency theory highlights conflicts of interest arising between the major players while emphasizing the impact of these conflicts on dividend policy.

There are various ways or sources on which conflict arises between managers and shareholders. Based on the context of this paper the following will be considered:

- ✓ Corporate charter provisions
- ✓ Board structure
- ✓ Ownership structure.

Jensen (1986) suggested that dividend payment could create conflicts among the managers and shareholders because managers are more willing to retain resources instead of paying dividends. Managers are interested to follow the growth strategies for their firms because the growth of a firm will give them more power to control these resources. On the other hand, shareholders prefer dividends to retained earnings, because of risk and uncertainties. If profits are not paid to the shareholders in form of dividend, the managers might change their intentions towards the benefits of the management, or they can engage the resources into unprofitable projects. Consequently, the interest conflict arises among them, which can be solved through dividend payout policy. Therefore, Rozeff, (1982) called dividend payment as a device to reduce agency costs. Stouraitis and Wu, (2004) found that the dividend payout policy can be used to manage the overinvestment problems of the firm and observed that the conflicting interests between the managers and shareholders about the dividend policy vary according to the growth opportunities. From the Agency perspectives, it may be easier for firms with concentrated outside shareholdings to more effectively discipline management. Jensen (1986) suggests that agency conflicts are more likely to occur in firms with low-growth opportunities. This signify that if the managers observed the growth opportunities of a firm are low, they will divert the fund to invest in projects that will be beneficial to them.

A related argument by Jensen (1986) is that agency conflict over dividend payment is particularly severe when firms generate substantial free cash flows. In firms with low cash reserves, the opportunity for expropriation is limited and payment of dividends may financially strain the firm; accordingly, investors' expectation of higher dividends is unlikely, (Jebaraj, Mat, & Abdul Wahab, 2016).

The other opinion is that block investors have enough strength to compel companies to pay dividend to reduce agency conflict as well as having powerful seat in the board room to influence management decision to protect their investment. Block-holder owners can be putting pressure on managers to report favourable financial performance which leads to the enhancement of the stock price of their investments, unlike small shareholders whom have no power to control the managers, in the work of Shleifer and Vishny, (1997) cited in (Tahani & Aymen, 2017).

IV. MECHANISM TO MITIGATE AGENCY PROBLEM

The following are some of the mechanisms put in place to mitigate agency problems in an organization, by Jensen & Meckling (1976).

- ✓ Increase the ownership of the managers in the firm.
- ✓ To reduce agency cost is to force the firm to use leverage or debt financing (Rozeff 1982, Easterbrook 1984, Jensen 1986). Agency theory proposes that financial leverage may serve as a substitute mechanism for dividends because it helps to control agency costs by reducing the cash at the disposal of insiders through regular interest payments (Easterbrook, 1984; Jensen, 1986).
- ✓ Dividend payment can be used as an internal mechanism to reduce agency cost. The agency model of dividend maintains that dividend help addresses agency problems by aligning managers' interests with those of investors. This is because dividends distribute cash at the discretion of managers and force managers to enter the market for new capital more frequently (Easterbrook, 1984).

In the presence of other monitoring mechanisms such as large institutional block holders, dividends are likely to play a lesser role in resolving agency costs (Easterbrook, 1984). However, it is possible that institutions may influence higher dividend payouts by a company, to enhance managerial monitoring by external capital markets, especially if they believe their own direct monitoring efforts to be insufficient or too costly (Farinha, 2003). The expected sign for this coefficient may be either positive or negative.

Managerial share ownership aligns the interests of managers with those of shareholders, as managers are less likely to engage in actions which are not in the interest of shareholders. In addition, Easterbrook (1984) emphasized that in the presence of other monitoring mechanisms, such as a large block holder, dividends are likely to play a lesser role in resolving agency costs (Vo & Nguyen, 2014).

From an agency perspective, it may be easier for firms with concentrated outside shareholdings to more effectively discipline management. The presence of large-block shareholders may be viewed as an alternate governance mechanism to dividends. Large shareholders may have sufficient clout, through their voting power, board representation, and access to management, to mitigate the agency costs of free cash flow. Institutional investors may have greater access to and are better positioned to persuade management. This may especially be the case for financial firms, since their business lines are more closely associated with the money management businesses of their institutional owners. Among institutional investors, hedge funds may serve as highly effective monitors given their presumably more activist perspective. Agency theory predicts that the presence of large-block shareholders mitigates the need to pay dividends. Given information asymmetries, the presence of large-block shareholders may also be viewed as a substitute signal to the dividend that the firm has favorable investment prospects (Zeckhauser & Pound, 1990). This signaling explanation also predicts a negative association between large shareholdings and dividends. On the other hand, effective monitoring of managers by large shareholders is costly and creates free-rider benefits. There may be insufficient incentives for large, controlling shareholders to provide the necessary monitoring and discipline, since they incur the costs of these actions, but share the benefits with other shareholders (Easterbrook, 1984). It may be more beneficial for large shareholders to invest passively and allow dividends and the threat of hostile takeovers to serve as governance devices. Furthermore, institutional investors may desire dividends for non-agency related reasons. They may face statutory obligations to pay operating expenses out of current income. Institutional investors also are not as tax-disadvantaged with regard to dividend income as most individual investors, (Haye, 2014).

An agency problem results when managers, as agents for owners, place personal goals ahead of corporate goals. Market forces, in the firm of shareholder activism and the threat of takeover, tend to prevent or minimize agency problems. Firms incur agency costs to monitor managers' actions and provide incentives for them to act in the best interests of owners. Stock options and performance plans are examples of such agency costs.

V. REVIEW OF AGENCY COSTS

To minimize agency problems and contribute to the maximization of owners' wealth, stockholders incur agency costs. These are the costs of monitoring management behavior, ensuring against dishonest acts of management, and giving managers the financial incentive to maximize share price, (Gitman, 2012). The most popular, powerful, and expensive approach is to structure management compensation to correspond with share price maximization. The objective is to give managers incentives to act in the best interests of the owners. In addition, the resulting compensation packages allow firms to compete for and hire the best managers available. The two key types of compensation plans are incentive plans and performance plans (Gitman, 2012). Incentive plans tend to tie management compensation to share price (Gitman, 2012). The most popular incentive plan is the granting of stock options to management. These options allow managers to purchase stock at the market price set at the time of the grant. If the market price rises, managers will be rewarded by being able to resell the shares at the higher market price. Many firms also offer performance plans, which tie management compensation to measures such as earnings per share (EPS), growth in EPS. Performance shares, shares of stock given to management as a result of meeting the stated performance goals, are often used in these plans. Another form of performance-based compensation is cash bonuses, cash payments tied to the achievement of certain performance goals. Jensen's (1986) classic paper on agency costs argues that, in the absence of attractive investment opportunities, firms can alleviate conflicts between corporate insiders and external stockholders by distributing excess cash flows to shareholders, this is cited by Hwang, Kim, Park, and Soo (2013).

Jensen and Meckling (1976) argued that agency relationship takes place when the principals engage the agents to perform some of their duties on their behalf. Agency cost arises because of conflicting interests of the managers and owners. Short, Zhang, and Keasey, (2002) argue that dividend policy performs crucial role in reducing agency costs which have arisen from the conflicting interests of both the parties. According to Rozeff (1982) dividend payment is a device to reduce agency cost.

However, Jensen and Meckling (1976) establish that if management serve their own interests and not the interest of outside shareholders, then agency costs could arise. These will result because shareholders foresee that managers can increase their own wealth at their expense by the excessive use of incentives or by dodging. Based on Jensen and Meckling (1976) situation, owner-managers may find it optimal to incur monitoring and bonding costs to reduce potential agency costs. These agency costs take a number of forms including monitoring costs and excessive risk aversion by managers who have a significant portion of their own wealth tied up with the wealth of the firm. Excessive attitude may serve the interests of the firm's creditors but not the shareholders. Accordingly, Rozeff (1982) recommends that in the absence of taxes, firms can easily have optimal dividend policy due to the existence of agency costs. The study argues that dividend payout ratios could be hardened by a tradeoff between the flotation costs of raising external finance and the benefit of reduced agency costs, realised when the firm increases its dividend payout ratio. Easterbrook (1984) suggests that dividend payments may serve to reduce agency costs. Management can change the risk of the firm by changing both the profile of its real investment projects and the relative balance of debt and equity. By maintaining a constant payment of dividends it avoids a build up in the balance of equity funds and simultaneously forces the firm to seek external finance. The raising of external finance will cause the contributors of capital to review the firms performance and the activities and this can eases the burden on existing shareholders. Similarly, shareholders will also benefit from the adjustment of leverage ratios which will accompany the raising of external finance. This argument also provides a potential explanation of why companies pay dividends and raise external finance at the same time.

VI. DIVIDEND POLICY AND AGENCY THEORY

According to agency theory, payment of dividend is considered as a substitute to direct monitoring of firms by large shareholders aimed at reducing over-investment problems (Easterbrook, 1984; Jensen, 1986). In line with this, prior studies Chai, (2010) and Jeon, Lee, and Moffett, (2011), argued that the substantial presence of foreign investors forces firms to distribute out more cash in the form of dividend payments. Thus, the foreign investors may serve as effective monitors but due to their inability to directly monitor the firm, dividend is then used as a monitoring device.

Fama and Jensen (1983) commended that free cash flow helps mitigate the agency conflict between management and shareholders. This shows management action may not always be in the interest of the shareholder. Therefore, cash flow is important in determining the level of cash dividend paid by the firms. Similarly, Olatundun, (2003) states that free cash flow measure directly the liquidity position of firms and the liquidity serves as determinant factor contributing to dividend payment since management may manipulate earnings. This is important because it allows a company to pursue opportunities that enhances shareholders value. It is therefore better to pay this cash as dividend if the firms have excess in order to avoid discretionary activities of management and to reduce the agency conflict between management and shareholders (Tijjani & Sani, 2016). It is also posits that agency theory may help firms utilize their resources for the benefit of politically connected shareholders and insiders, rather than for general shareholders (You & Du, 2012).

Furthermore, agency theory asserts that corporate insiders have incentives to divert a firm's resources to activities that benefit themselves but not the outside shareholders (Jensen, 1986). Higher cash dividends can reduce a firm's free cash flow under the insider's discretion and can force managers to seek external sources of funds to finance expansion plans, which expose them to market scrutiny. A question arises as to how a firm's directors can be induced to pay higher dividends when their natural inclination is to retain surplus cash. The outcome model of dividend policies argues that minority shareholders can use their power to force companies to pay dividends, (Firth, Gao, Shen, & Zhang, 2016).

VII. FREE CASH FLOW AND AGENCY THEORY

The seminal work on the free cash flow hypothesis (Jensen, 1986). Jensen (1986) argues that agency problems between insiders' and minority shareholders increase as the level of free cash flow increases. According to agency cost theory the agency problem arises between the principal owner (shareholders) and agent (manager) when the manager takes the action for their self-interest without considering to benefits shareholders. Free cash flow is one of the tools managers use to promote their personal interests, and the problem of reining it in is of equal interest to academics, regulatory bodies and companies, (Kadioglu & Yilmaz, 2017). The excess amount of free cash flow available to the manager increases the agency cost as they are free to use that financial reserves to pursue their personal interest. In this affection, the payment of dividend to the shareholders reduces the free cash flow available to managers and the agency problem between them (Easterbrook, 1984; Jensen & Meckling, 1976; Rozeff, 1982). Therefore, a positive relationship can be expected between the free cash flow available for the company and the dividend payout ratio, (Labhane & Mahakud, 2016).

The percentage of shares owned by different types of shareholders may not be the sole determinant of the dividend-agency relationship; the free cash flow may also be significant. Jensen (1986) defined free cash flow as the cash flow required more than the funds for all projects with a positive net present value (NPV). He demonstrated that as the free cash flow increases, it raises the agency conflict between managerial interests and outside shareholders, leading to a decrease in the performance of the company, this shows that there is negative relationship between free cash flow and the firms' performance. While shareholders desire for their managers to maximize the value of their shares, the managers may have a different interest and prefer to derive benefits for themselves. Jensen (1986) free cash flow hypothesis has been supported by many subsequent studies (Al-Shubiri, Taleb, & Al-Zoued, 2012; Denis & Osobov, 2008; Firth et al., 2016; Patra, Poshakwale, & Ow-Yong, 2012). La Porta, Lopez-De-Silanes, Shleifer, & Vishny, (2000) added that when a firm has a free cash flow, its managers will engage in wasteful practices, even when the protection for inventors improves. A number of studies have suggested that firms with a greater "free cash flow" need to pay more dividends to reduce the agency costs of the free cash flow (Batool & Javid, 2014; La Porta et al., 2000; Roy, 2015; Wen, Lilian, Zaiats, & Zhang, 2017).

VIII. LEVERAGE AND AGENCY THEORY

The use of debt impacts agency cost in several ways. First, the use of debt reduces the free cash flow available to managers (Jensen, 1986, Stulz, 1990), as promised interest payments to debt holders decrease free cash flow available for investment. This decrease in free cash flow also helps in restraining overinvestment problem (D'Mello & Miranda, 2010; Harvey, Lins, & Roper, 2004). By issuing debt, the managers of firm are obliged to make periodic payments of interests and principal. These periodic payments reduce amount of free cash flow available for use by managers and hence reduces agency conflict between owner and managers. The use of debt also increases monitoring of managers' activities. As creditors have incentive to monitor the performance of the enterprise (Jensen and Meckling 1976), to ensure the payment of interest and principal. Banks, which are the major source of financing ( ), play very important role in optimizing the monitoring of managers. Large debt holders also have contractual right to monitor activities of manager. This monitoring by creditors also helps owners in monitoring managers and reduces cost of monitoring managers by owners.

VIII. THE BASIC ARGUMENT OF AGENCY AND OWNERSHIP CONFLICTS

The basic assumption behind M&M's perfect capital market is that there is no point of conflict between shareholders and managers. Practically, there is a distinction between management and owners. This shows that managers are not the perfect agent of the owners (shareholders). This is because management interests are essentially the same as that of owners' interest, and they might commit action for private gains rather than for the benefit of owners, like overriding undue perquisites or over-investing in administratively gratifying but unbeneficial activities. As a result, shareholders must bear agency costs associated with monitoring managers' actions. This is known as agency costs; agency costs are an implicit cost associated with potential conflicts of interest between corporate managers and stockholders. In order to mitigate agency problems, dividends might be served as a device that aligns these interests.

Another potential source of conflicts may be prejudiced by dividend policy is the conflict of interest between bondholders and stockholders. Generally, it is perceived that shareholders are treated as the agent of the funds contributed by bondholders. In such a situation, dividend increase or excess return to the owners might be considered as shareholders confiscating wealth from bondholders (Jensen and Meckling, 1976). In a frequent-cited article, Easterbrook (1984) stated that dividends could easily be used to trim down the free cash flow available for managers for manipulation. In addition to this, dividend payout affects the value of the firms and ultimately obliged managers to approach the capital market for external financing.

Moreover, based on Easterbrook's findings, Jensen (1986) challenged that free (excess) cash flow provides an opportunity for the managers to use these funds for self-benefited project even if it harms the shareholders' best interests. Moreover, he argued that managers enjoy incentives in enlarging the firm's size even beyond the most favourable size to intensify the wealth under their own control and besides to add to their recompense, which is often related to firm size, (Gaver & Gaver, 1993; Ullah, Fida, & Khan, 2012). On the other hand, the free cash flow hypothesis states interrelation between investment decision and dividend policy. Empirics argued that high dividend payout reduces the "overinvestment" problem, which will positively impact the firm's market value, ceteris paribus (Lang & Litzenberger, 1989).

Therefore, corporate dividend policy can play a crucial role in aligning the interests of managers with those of shareholders. Managers distribute dividends to commit not to use firms' free cash flows in private benefits and to eliminate the overinvestment problem (Gugler & Yurtoglu, 2003; Jensen, 1986; Lang & Litzenberger, 1989). Furthermore, paying large dividends forces managers to seek external finance for new projects, which impose further monitoring by the capital market (Easterbrook, 1984).

In the presence of high ownership concentrations, that sufficiently monitor manager's actions, dividends may not be an appropriate device to mitigate the agency problems (Bartram, Brown, How, & Verhoeven, 2012; Jansson &

Larsson-Olaison, 2010). However, this evidence is contradicted by the earlier studies of Fluck (1999) cited in the work of Faccio, Lang, & Young, (2001) which show that firms with large outside shareholders pay more dividends.

Leverage is another mechanism that may align managers' interests to those of shareholders and hence could be viewed as a substitute for dividends e.g., (Al-ghazali, 2014; Jensen, 1986; Margaritis & Psillaki, 2010). Thus, the use of debt to commit managers and reduce agency cost According to agency theory, the higher debt ratio decreases agency cost of equity by aligning the interests of managers and shareholders.

IX. CONCLUSION

This paper investigates the informational content of dividends in the frame work of the principal-agent conflict model developed by Berle and Means and extended by Jensen. If managers are overinvesting, an increase in the dividend will reduce the overinvestment and increase the market value of the firm. Similarly, a dividend decreases signals that more negative-net-present-value projects will be undertaken. For value-maximizing firms the level of investment is theorized to be independent of dividends.

Similarly, the study found that effective monitoring of managers by large shareholders is costly and creates free-rider benefits. There may be insufficient incentives for large, controlling shareholders to provide the necessary monitoring and discipline, since they incur the costs of these actions, but share the benefits with other shareholders (Easterbrook, 1984).

It is also found that dividend is an effective mechanism put in place to take care of agency problem, so the shareholders will push for the payments of dividend when the firm has free cash flow in order to monitor the activities of the managers.

It is also found that low growth firms give more room for managers to diverts firms' resources in a period where the company has free cash flows. This shows once a firm doesn't have opportunity for growth the managers will have benefits to pursue their own personal objectives.

A board of directors is an effective device to control the agency problem only if it can prevent individual top managers, such as chief executive directors, from engaging in opportunistic behavior (Fama and Jensen, 1983). Existing literature also addresses the fact that factors, such as the size and types of the directors, may influence the efficiency of a board in limiting the agency problem in a corporation.

The existing research views family ownership as a structure that helps to reduce the agency problem, because the interests of family members are likely to align with those of the firm they own (for example family ties, efficient monitoring and communication among family members, long-term objective with firms).

The key objective of corporate governance systems is to reduce the conflict of interests between managers and shareholders or between dominant shareholders and minority shareholders. The strengthening of the systems is ideally expected to reduce agency costs and, in turn, to enhance firm performance.

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