A Comprehensive Review of Dividend Policy: Theoretical Perspectives, Empirical Evidence, and Future Directions

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Abstract - Dividend policy is a central issue in corporate finance and is vested with enormous implications for firm valuation, investor preference, and market behaviour. In this paper, a detailed review of the literature on dividend policy is undertaken in respect of its important theoretical underpinnings, empirical findings, and emerging trends. The basic theories include the Dividend Irrelevance Theory, the Bird-in-the-Hand Theory, the Tax Preference Theory, and the more modern theories of signaling, agency costs, and behavioral finance. The recent developments involving the impact of ESG factors, i.e., Environmental, Social, and Governance, and technological change on dividend policy, are also covered. Some gaps in the literature are identified, and suggestions for further research are made.

Keywords: Dividend Policy, Dividend Irrelevance Theory, Signaling Theory, Agency Costs, Behavioral Finance

I. INTRODUCTION

Dividend policy is a phenomenon that has been approached from different perspectives for a relatively long time. It covers ways according to which a company distributes profits to the shareholders. Thus, the goal of this paper is to distinguish the theory arguments, empirical evidence, and new trends in the field of dividend policy, shifted to show a range of key theories and current developments in order to throw more light on dividend policy and point to future research developments.

II. THEORETICAL FOUNDATIONS

Dividend Irrelevance Theory:

Modigliani and Miller (1961): The theory assumes that assuming no taxation or transactions cost exists in a perfect market, the dividend policy of a firm does not affect the value of that firm. Investors can create their choices of dividend policy by selling shares of their firms, which essentially derived the irrelevance of the dividend policy in determining the firm's valuation.

Miller and Modigliani (1961): Contributed to the further development of this theory through an analysis of the impact that personal taxation has on investor preference for dividends versus capital gains.

Bird-in-the-Hand Theory

Gordon (1963): Dividends are desirable for investors, and future capital gains are uncertain because of less perceived risk. Increase the valuation for the firm paying higher dividends could be because less risk is involved with dividends.

Lintner (1962): Lintner provided the Lintner model, which indicated that the firm decides its desired payment rate and alters the dividends slowly in response to variations in earnings.

Tax Preference Theory

Brennan (1970): Part of the thought process that Investors prefer Capital gains rather than Dividends as a result of Capital gains tax treatment. Since there exists tax aversion to Capital gains, firms retain earnings rather than give out dividends;

Signalling Theory

Bhattacharya (1979): That company's hopping dividend changes convey some information about the firm's future expected earnings. Increased dividends signaling probable cash inflows increases market value and stock prices.

Miller and Rock (1985): Further developed the signaling theory to include what is known as asymmetric information, whereby dividends are signals to the capital market as to the current financial health of the firm. Agency Costs Theory:

Jensen and Meckling, 1976: Demonstrated how dividends cut the agency costs between managers and shareholders by reducing free cash flows that are available to misappropriating managers.

Rozeff (1982): Extended this idea, stating that in the presence of larger distribution of dividend, managers would be left with lesser amounts of free cash flow to consume, and therefore their non-value maximizing behavior would be curtailed.

III. BEHAVIORAL FINANCE PERSPECTIVES

Shefrin and Statman, 1984: Propagated an idea on investor preference to dividends. Was based on psychological considerations like aversion to loss and mental accounting.

Baker and Wurgler, 2004: Investigated how investor sentiment influences the dividend policy by showing firms adjust their dividend policies according to market conditions and investor preferences. Empirical studies call for:

Determinants of Dividend Policy:

Profitability: Most of the empirical studies point out the positive relationship between the profitability of a firm and its dividend payments. High profitability provides a firm with the required cash flow to pay out dividends. Lintner (1956) has shown that companies producing a more significant amount of earnings do distribute more dividends. Other developments by Fama and French (2001) showed the existence of a direct relationship of the two variables, that is, profitable companies are most likely to pay dividends. DeAngelo, DeAngelo and Stulz (2006) confirm this by stating that profitability is a very determinant of the dividend payout, particularly strong for firms where earnings are considered stable.

Firm Size: This is another factor by which large firm sizes are more stable and easily accessible to the capital market; hence, making payout likelihood higher. For instance, research studies indicate that firm size correlates positively with dividend payments (Fama and French 2001; DeAngelo et al. 2006). Aivazian, Booth, and Cleary (2003) add to this that the emerging market firms are of high financial stability and relatively low risk, which probably further justifies the announcement of dividends to the shareholders.

Growth Opportunities: The companies with very good growth opportunities usually retain earnings to finance their upcoming ventures and with the motive of not paying dividend. Rozeff: "high-growth firms generally have low dividend payout ratios." Denis and Osobov added that in their findings, they took the sample of different countries to ascertain the growth opportunities in their dividend policies and concluded that there is a negative relation between growth opportunities and dividend payout.

Dividend Policy Effects:

Many research studies in the light of dividend policy with respect to firm valuation have been based on mixed results. Bhattacharya (1979) showed evidence that an increase in dividends is a good signal for high future earnings, thereby improving the price of the stock. On the other hand, DeAngelo, DeAngelo, and Stulz (2006) insist that changes in dividends do not have consistent effects on changes in firm value since they take into account to a great extent the conditions of the market and the expectations of the investors. Finally, Fama and French (2001) show that dividends do not simply affect the firm value; their impacts depend on the firm size and profitability.

Investor Preferences: The dividend policy influences the investor's behavior and preferences. High dividend out payments attract the income-oriented investors, whereas low division out payments attract growth-oriented investors. Allen, Bernardo, and Welch (2000) had conducted a study on the dividend policy vis-à-vis tax clienteles and found that firms adjust the dividend payouts in order to attract evidenced diferentes of clients. Baker and Wurgler (2004) expanded the dimensions of investor sentiment on dividend decisions by saying that a company can adjust payout towards the change in investor's preference.

Behavioral Insights: Shefrin and Statman in 1984 discussed that investors' craving for dividends is affected by the features of psychological factors such as loss aversion and mental accounting. In addition, the behavioral effects of a dividend announcement on investor sentiment and stock prices were pursued through other more recent research work by Baker et al. in 2008. Evidence from the examination proved that alterations in dividend policy could have a very strong influence on investor behavior as well as market reaction.

International Perspectives:

Cross-Country Variations: There are major cross-country differences in the dividend policies mainly because of the differences in tax regimes, market structure, and efficiency of investor protection laws. La Porta et al. (2000) find that the pay-out ratio is significantly higher in countries that have better investor protection and more favorable tax treatment. Duchin, Matsusaka, and Ozbas (2010) investigate international dividend practices, showing that firms in countries with relatively weaker investor protection tend to pay lower dividends.

Dividend Policy: Research regarding dividend policy practices conducted under emerging markets has established that economic uncertainty, market maturity, and regulatory environment impact dividend practices. Chen, Cheung, and Stulz (2010) explained that many companies in these markets implement different dividend behavior compared to companies operating in developed markets. According to Aivazian, Booth, and Cleary (2003), factors such as economic volatility and the maturity of markets also influence dividend policies of firms in emerging markets.

IV. RECENT TRENDS

ESG in dividend policies is the integration that makes it a new trend towards sustainability. Eccles et al. (2014) discovered that companies which integrate ESG criteria in their dividend policy show improved reputation and loyalty of investors. Further in the research of Grewal and Serafeim, 2020, to investigate ESG performs impact on dividend payout, it indicates that high ESG-practice companies will pay out dividends with higher likeliness and also be able to attract long-term investors.

Technological advancements: FinTech and digital platforms have been revolutionizing the universe of dividend policies. The study by Gomber et al. (2018) on the impact of FinTech on corporate finance showed that investments into developing blockchain and smart contract technologies could enhance the level of transparency and efficiency in dividend payouts. Yermack (2017), in a paper on dividend distribution with blockchain, argued that blockchain could lower the transaction costs associated with dividend distribution and that it enhances shareholder participation.

Behavioural Factors:

Investor Sentiment: Contemporary research that is being done regarding investor sentiment currently establishes that with changes in market conditions, firms could easily adjust their dividend policies due to changes in investor preferences. According to Baker and Wurgler, 2004, dividend decisions are affected by investor sentiment because firms change their payout policies on the basis of sentiment in the market. Pang and Zhang, 2020, further study how dividend policy is affected by investor sentiment and find out that alteration at the whim of sentiment drives the stock price and firm valuation.

Behavioral Biases: Behavioral finance research examines the influences of behavioral biases, such as loss aversion and mental accounting, on dividend policies. Shefrin and Statman (1984) proved that investor demand for dividends is influenced more by psychological factors than by financial ones. The study was further extended to examine the effect of behavioral biases on the dividend decisions and market reactions by Baker and Powell in 2012.

V. LITERATURE GAPS

Dynamic Nature of Dividend Policy: More research is warranted on how firms adjust dividend policy over time in light of economic condition, firm performance, and market dynamics. In this regard, longitudinal study is suggested in order to provide the details of such adjustments.

Impact of Technological Advancements: Another strand of the emerging literature relates to the impact of fintech, digital platforms, and their uses on the dividend policies. Further research is needed to document how results about dividend decisions shall be different and change with technological innovations like the blockchain or smart contracts.

Behavioral Factors: Although behavioral finance offers the reader many insights into the behavior of investors and dividend policy, much research is still called for how various psychological biases influence dividend decisions and market reactions. It will go a long way in developing dividend policies tailored toward the needs of investors.

ESG Integration: The long-term impact of ESG consideration in the dividend policies is not very clear. One further research direction can be how ESG considerations impact firm performance, investor satisfaction, and market valuation.

Longitudinal Analysis: Longitudinal research should be focused on whether dividend policies have changed inside the firm, market performance, and economic cycles. Such research might provide a broader view of the elements that drive changes in dividend policy.

The Impact of Technology: Investigate how technological advancement, particularly innovation related to FinTech and digital platforms, has changed the dividend policies and relations with shareholders. So this may include research on how blockchain and smart contracts impact dividend payments and transparency.

Behavioral Insights: The inclusion of behavioral finance in order to see how psychological biases such as loss aversion and mental accounting have an impact on dividend policy decisions and the behavior of investors would thus lead to the realization of this fact, leading to the realization of increasingly effective dividend policies in line with investor preferences.

ESG Integration: Examine the long-term implications of integrating ESG factors into dividend policies pertaining to fostering firm performance, investor satisfaction, and market valuation. Future research may investigate the impact that ESG considerations have on dividend payout decisions and, more broadly, on firm reputation and investor loyalty.

VI. BI. CONCLUSION

The dividend policy remains an area of paramount importance in the discipline of corporate finance, that area which has an effect on firm valuation, investor behavior, and even market efficiency. This review attempts to argue through some prominent theories of dividend decisions: the Dividend

Irrelevance Theory, Bird-in-the-Hand Theory, and Tax Preference Theory, in order to understand their impact on firm value and investor preference.

The review also covered the signaling theory, which puts forth that dividend changes can convey information about a firm's future performance, and the agency costs theory, which explains the role of dividends in reducing conflicts between managers and shareholders. Behavioral finance perspectives further flesh out our understanding by examining the ways in which dividend policies are influenced by psychological factors and investor sentiment.

Recent trends, such as ESG integration and technological change, are changing the face of dividend policy: more and more firms start considering ESG factors in their dividend decisions, which gives the broad emphasis on sustainability; the innovations in FinTech and blockchain make dividend distribution easier and more transparent.

These studies represent a huge amount of research; still, gaps remain. Further research in the future needs to take into account the dynamic behavior of dividend policies in changing economic environments, the effects of technological advances on paying dividends practices, and the embedding of ESG into dividend policy practices. Ongoing research in these directions will be important for generating a more complete understanding of dividend policy and for facilitating effective corporate finance practices.

The paper, therefore, adds to the existing debate on dividend policy by putting some of the key theories in perspective with the recent developments and thus provides a foundation for further exploration and analysis in this dynamic field.

VII. REFERENCE

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