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Edisi 6

Theoretical review: The Dividend Policy

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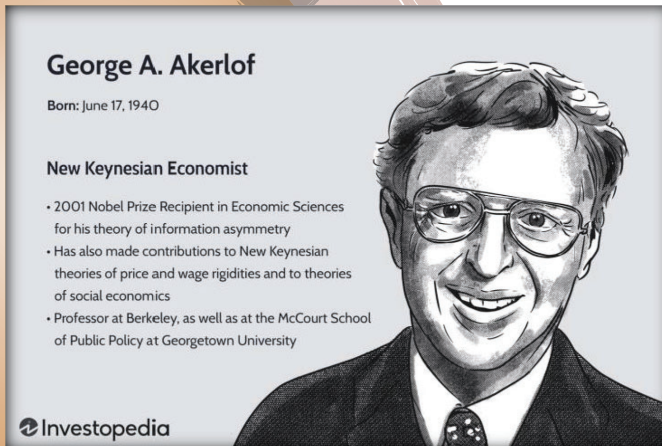
The theoretical review explains the underlying rationale of dividend policy. The dividend policy theory is well-known by the work of Miller and Modigliani (1961) on irrelevance theory. They demonstrated that dividend policy was irrelevant to the market value of a company under restricted assumptions including rational investor and perfect capital market. Consequently, this attracted many other researchers to challenge the theory as well as to extend the model such as tax-preference theory, bird-in-the-hand theory, clientele hypothesis, and many more. However, for this paper, the theoretical review comprises of two most important fundamental principles for the dividend policy developed by different scholars and they are information asymmetries and behavioral factors.

Information asymmetries

The market imperfection of asymmetric information is the basis for a few remarkable theories to explain corporate dividend policy. Asymmetry information indicates that managers have private knowledge of the company's future performance. In this paper, the information asymmetry is presented in three distinct propositions that include signaling models, agency cost, and the free cash flow hypothesis.

(i) Signaling Model

Akerlof (1970) was the first economist to analyze this paradox rigorously and his model illustrated pooling equilibrium in the used car market. The equilibrium demonstrated that the cost of information asymmetries is clear when there is no signaling activity. Spence (1973) applied Akerlof's model in signaling equilibrium in which a job seeker signals his/her quality to a prospective employer. Although the scenario is developed using the employment market, the model became the prototype for financial models of signaling. Bhattacharyya's (1979) signaling model suggested that higher dividend payout indicated the signal of positive information by the manager's expectation of the company's performance and vice versa. Bhattacharyya affirmed that the use of dividends as a signal is a quality message than the other alternatives (Bhattacharyya, 1980).



(ii) Agency Cost

Agency theory attempts to explain corporate capital structure that results in costs associated with the separation of ownership and control. Agency costs are lower in high managerial ownership stakes because of better alignment of shareholders and manager goals (Jensen and Meckling, 1976). The agency problems arise related to information asymmetry. This is when the managers fail to accept positive net present value projects and are involved in excessive perquisite consumption. Therefore, the distribution of profit into dividends is believed to be able to reduce agency costs through increasing monitoring by capital markets. Large dividend payment reduces funds available for perquisite consumption and investment opportunities. Easterbrook (1984) proposed that the free cash flow is distributed as dividends to shareholders in order to force managers to approach the capital market to acquire funding needs for new projects. For that reason, it is believed to be able to reduce the cost of monitoring the managers as they need to be disciplined to attract the market. Rozeff (1982) and Easterbrook (1984) study had supported the theory that dividend is a partial solution to agency problem.

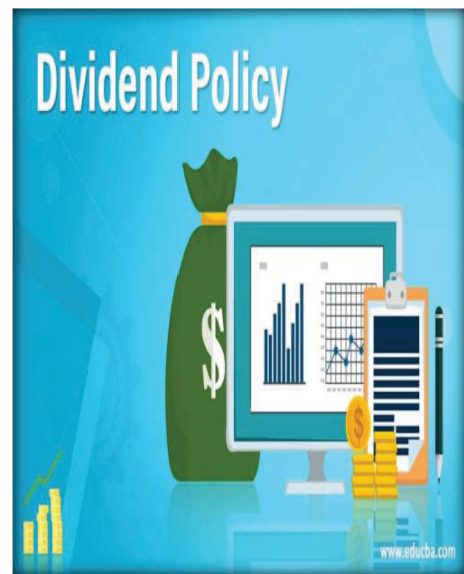
(iii) The Free Cash Flow Hypothesis

It is evident that, the free cash flow hypothesis underlying the framework that dividend is used by shareholders as a mechanism to avoid overinvestment by managers. Jensen (1986) stated that managers and shareholders have conflicts of interest regarding funds in excess of financing finance projects. The priority of funds is invested in a positive net present value project (NPV) and the remaining balance is likely to be distributed as dividends. Thus, this is not in favor of managers because this will decrease the free cash flow to be invested in marginal NPV projects. The shareholders on the other hand claim that managers may lead to excessive perquisite consumption and therefore shareholders favor the cash flow to be distributed as dividends.

Behavioural factors

Behavioural factors are determined by the reaction of rational behaviour. Therefore, it is believed that the dividend paid is a safeguarding of the managerial and owner relationship. Frankfurter and Lane (1992) divided the purposes of dividend payment into two rationales which are partially as a tradition and as a method to dispel investor concern. Managers are likely to pay dividends if they realize investors seek it. Dividend payments should increase the organization's stability by serving as a ritualistic reminder of the managerial and owner relationship (Ho and Robinson, 1992).

In conclusion, dividend policy theories highlight the significance of information asymmetries and behavioral factors in shaping a company's decision on how to distribute profits to its shareholders. The information signaling theory suggests that firms use dividends as signals of their financial health and future prospects. By paying consistent dividends, a company can convey confidence to investors, mitigating information asymmetry and attracting more investment. On the other hand, behavioral theory posits that investors have different preferences for current income versus future capital gains, leading to varying reactions to dividend changes. Some investors have a psychological preference for regular dividend income, while others are more focused on potential capital appreciation. Companies must consider these behavioral factors when determining their dividend policies to attract a diverse investor base and maintain market confidence. In essence, dividend policy theories emphasize the intricate interplay between information asymmetry and investor behavior in shaping a firm's dividend decisions.



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