

## **THE NEXUS BETWEEN CAPITAL STRUCTURE AND DIVIDEND POLICY: LITERATURE REVIEW AND CONTEMPORARY GAPS**

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### **Abstract**

*This paper reports on a systematic literature review that focusing on the firms major two corporate finance decisions about the nexus between the optimal capital structure and dividend policy. By the review of extensive literature review search from the different search engine database, we identified 45 articles that address the issues in this context. Since the optimal level of both the capital structure and the dividend policy is a major challenge for the financial managers which ultimately affects the financial value of both firms and its shareholders. Therefore it has been proved that firms reached its optimal level when its marginal benefit equal to its marginal cost or firm should declare dividend only when having no deficit of internal funds and should finance its business operation firstly either through retain earning secondly through debt and finally can issue the shares. Further in this context the gaps of research areas were highlighted in the conclusion section those needs further research work in the future.*

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*Keywords: Capital Structure, Dividend Policy, Firm Value, Shareholders.*

### **INTRODUCTION**

*Different issues and behavior regarding the firms both optimal dividend and capital structure policies addressed by the different theories of capital structure therefore is discussed in this paper that makes this study more interesting.*

### **THE TRADE-OFF THEORY (TOT)**

*The capital structure according to the main motive of the trade-off theory is to describe the methods through which firms can partially be financed with the debt and equity in which this theory states the tax shield benefit while financing with debt by the firms but there are also the costs of the financial distress and agency cost with the debt that in the conditions firm will suffer.*

*Capital structure is considered one of important decision usually done by the companies and technically determines the careful balance of both equity and debt that being used by the businesses to finance its assets, for daily operations and future growth. Thus, the ideal capital design involves an adequate degree of debt to expand the ultimate return of investors without causing unnecessary risk and the ideal balance between boosting the prosperity and value of the organization and limiting its cost of capital (Ngo, Duong, Nguyen, & Nguyen, 2020).*

*Since in Malaysia the dividend payout is affected if the firms capital structure is reliant most on debt but in certain conditions it pays-out positively higher dividend due to the easy access to the external source of finance which in result enabling firms to be meager depend on retentions. But on the other hand the dividend policy of most sectors i.e Auto Textile, Pharma don't rely on the debt (Martellini, Milhau, & Tarelli, 2018) & (Yusof, 2016)*

### **PECKING ORDER THEORY (POT)**

*Pecking order theory suggest the choice of financing in which firms better to go with internal financing through retained earnings and the part of net income that is reinvested is called retained earning if incase means of this financing is unavailable than a company may itself finance through external sources of debt than equity. The external sources of financing for the firms are ie equity, preferred share, debentures and term loan etc. But there is possibility of retain earning disadvantage if the firm reinvest in the business. Where as pecking order provide important signals to the investors that how the company is performing.*

*Different theories of capital structure are directly linked with the dividend policy that according the internal source of of capital decreases due to the degree of financing equity spending. Hence if the dividend paid by the firm and as a resultant the need about external financiag arises by issuing shares because the necessity of spending cash is related with the dividend paying which imparting that the dividend*

policy of firm caused to the capital shortage of companies (Pinto & Rastogi, 2019). According the most of researchers literature, the firm debt burden simultaneously at the time of business risk affect the profitability of firm this is because if the firms sales are stuck and the revenue is not generated which ultimately disabling the companies to pay the dividends (Al-Najjar, 2017).

Generally a company dividend policy states the sum of dividends paid to the equityholder with the investors proportion they have invested and specially this happens when the company earn profit at that time decision being done either to retain this profit may disburse the amount to the shareholders through the cash dividends. However the decision of disbursement of dividend and retention of residual earning approved by the board directors for the shareholders keeping in view the different factors and this policy may have effect on the firm value because policy must serve the interest of both firm and shareholders this mean to the future growth perspectives of company and its investment projects which are upcoming or running (Barros, Verga Matos, & Miranda Sarmiento, 2020).

Firms usually are making three main decision related to corporate finance which are the investment, financing and dividend policy decision. Since the dividend policy decision determine for the sum of profit will be distributed to the shareholders and how much to be reinvested but in literature there are differences on the dividend policy theories. According seminal work of (Lintner 1956) and (Modigliani and Miller 1961), that there is no impact of dividend policy on the shareprice or firm value and making this irrelevance for the firms on the other hand the agency theory defend to the relevance of dividends for the firm value.

If it is made a optimum dividend policy it has than a positive affect on the firm's share value as according (Baker, 2016) in dividend policy earning is a key determinant. Since the shareholders want to maximize their wealth this not necessary through the company may pay the dividend rather the company retain the amount for reinvestment purposes in the such project having positive Net present value. However to pay the dividend the firm must needs to have the adequate reserve in their banks accounts, payment of cash dividend hence required the use of firm's funds and has a impact of decreasing the cash balance, total assets and in general the net worth of the company (Kimani, 2016).

### **SIGNALING THEORY**

Deciding for the firm the choice to the issuance of debt and equity might be as signaling indicator because the firms decision to go with debt shows both the investors confidence and the confidence of company to make sufficient cashflow to pay the principal and interest due to this it shows the signal of the firm better position of expected cash flows. But contrary to this the issuance of equity is considered as bad news because this signals lack of confidence.

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Laurence Booth (2017) holds the dividends irrelevance argument that the firm dividend payout doesn't add value to firms share price and this irrelevance theory of dividend proposes that the company is affected by the dividend since better the money to be reinvested in the firm because in the real world market the financial structure gets importance taking the example of United States (US) the firm dividend policy usually affects the information, transaction agency costs and taxes which is an engendering signal to the shareholders wealth and the firm value as well since this irrelevance dividend argument holds by the Miller and Modigliani's in the perfect market.

The firm doesn't pay the dividend as per the no dividend policy to the shareholders. Therefore whatever profit is earned will be reinvested again into the business for the firm's future growth. Since it has been experienced the companies which don't pay the dividend are continuously rising and expanding therefore in such companies investors rather like to invest with expectation to the increasing stock value. It is worth to be noted that the stock price appreciation is precious than dividend payout to the investors (Susi & Maria 2020).

Readers of this review paper will let to know firstly the both firm optimum capital structure and dividend policy which leads to the value and wealth of the both firm and shareholders either by the share price escalation or dividend payout and along with firm such a combination of debt and equity which may not create financial distress or debt burden which ultimately can affect the profitability of company which restricts the firm dividend payout ultimately and secondly this review relates to the firm post optimum dividend policy challenges and future research gaps which need more focus. Therefore a nexus review of the capital structure and dividend policy literature within these limits will reveal a comprehensive overview of what exists, and which aspects are inadequate.

After combining previous researchers findings on capital structure and dividend policy it would be worthwhile to know for the companies that how to be benefited from these two corporate finance decisions and avoid pitfalls.

Our research has been guided by the following research questions:

RQ1: Does the optimal capital structure determine the optimal dividend policy?

RQ2: Does the optimal dividend policy determine the financial value for both firm and its shareholders?

RQ3: What are the post optimal dividend policy future research gaps which need more attention?

The paper is organized as follows. Section 2 presents the research method applied. Section 3 presents the data extraction/ analysis and discussion with the

*synthesizing of key findings to the questions. Finally, Section 4 provides some concluding remarks and implications.*

## **RESEARCH METHOD**

*For getting a general idea on the valuable available literature, the system literature is considered as better move forward relating to the one particular area of research that this makes more easy to find the gaps in the latest research for further future research needed (B. Kitchenham, 2009). This study have utilized the suggestions of (Kitchenham, 2016) to the implementation of a systematic review of literature. Therefore keeping in view these suggestions the repoting process of this paper have been divided into three main parts: (1) planning, (2) implementation, and (3) reporting. In the planning phase the clear procedure for search of systematic literature have been defined:*

*Literature review is focused to the search of specific questions answers, the differnt search strings (words tried for searching), relevance of articles were checked keeping inview the tittles of the published papers. During exclusion we eliminated the duplicacy and carefully, the quality of reviewing papers were checked. While reviewing each research paper we examined heading , methodology, number of citations author, year and the impotant findings and recommendations for further research. Finally having reviewed different suitable papers carefully to ensure their affiliation to the research questions for the data extration.*

## **LITERATURE REVIEW CONDUCTED HAVING FOLLOWING RSEARCH QUESTIONS FOCUS RESEARCH QUESTIONS:**

- *Does the optimal capital structure determine the optimal dividend policy?*
- *Does the optimal dividend policy determine the financial value for both firm and its shaheholders?*
- *What are the post optimal dividend policy future research gaps which need more attention?*

## **SEARCH STRINGS AND DIGITAL LIBRARIES**

*The relevant literature was searched through the five main scientific sources of data bases: based on Science Direct (SD), Google scholar (GS). IEEE Xplore (IEEE), ACM Digital Library (ACM) and SpringerLink (SL). Published review of literature addressing the issues of both optimal capital structure and dividend policy was considered from 2016 to 2021.*

*These search terms were used: “optimal capital structure”, “ optimal dividend policy”. And the unrelated papers were excluded that did n’t deal with the issues of these two financial decisions in the corporate finance about the benefits and drawbacks of optimal dividend policy and capital structure. The terms capital structure , dividend policy and optimal was used while considering the research questions.*

*Fourty five (45) publications were retrived during the search process those*

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number of retrived papers are shown from different data base each in table 1 were included. Retrived any paper that found more than one from search engnes, we considered it once.

**Table 1  
RETRIVED PAPERS FROM EACH DATA BASE**

IEE	ACM	SD	SL	GS	Total
0	0	25	0	20	45

**EXCLUSION CRITERIA AND SELECTION:**

In order to shortlisting the rsearch papers the following exclusion criteria's (CR) were used:

CR1: Those all the papers were not published already in peer reviewed journal, conference and reports or workshop were removed. CR2: Only the English written publication have been included. CR3: we considered those publication published in meanwhile the time from year 2016 to 2021. CR4: we excluded all the paper that didn't address the firm issues of both capital structure and dividend policy.

After applying the exclusion criteria the Table 2 includes the total number of papers each year obtained through the different databases.

**TABLE 2 TOTAL NUMBER OF INCLUDED PAPERS PER YEAR:**

2016	2017	2018	2019	2020	2021	Total
6	6	5	5	5	4	31

**TABLE 3 THE INCLUDED PAPERS IN THE LITERATURE REVIEW:**

ID	Title	Digital liabrary	Year
1	<i>Capital Structure Decisions and the Optimal Design of Corporate Market Debt Programs (Martellini et al., 2018)</i>	GS	2018
	<b>THE RELATIONSHIP BETWEEN CAPITAL STRUCTURE AND DIVIDEND (MURAGE, 2016)</b>	GS	2016
	<i>How Capital Structure influences the Dividend Policy? (Saif ul Rahman, 2017)</i>	GS	2017
	<i>Impact of Capital Structure and Dividend Policy on Firm Value (Rehman, 2016)</i>	GS	2016

	<b>THE IMPACT OF CAPITAL STRUCTURE AND DIVIDEND POLICY ON FIRM PERFORMANCE (Zahid, 2018)</b>	GS	2018
	<b>THE RELATIONSHIP BETWEEN CAPITAL STRUCTURE AND DIVIDEND POLICY (Elmurodov, 2020)</b>	GS	2020
	<i>Dividend Policies On Capital Structure And Shareholders' Value (William Kiprotich Andieme, 2019)</i>	GS	2019
	<i>A meta-study of the determinants of corporate capital structure (Markus Hang, 2017)</i>	SD	2017
	<i>Determinants of dividend policy: evidence from an emerging and developing market (N. Jayantha Dewasiri, 2018)</i>	SD	2018
	<i>Sectoral Analysis of Factors Influencing Dividend Policy: Case of an Emerging Financial Market (Geetanjali Pinto, 2019)</i>	SD	2019
	<i>The effects of ownership structure on dividend policy (Ngo et al., 2020).</i>	SD	2020
	<i>Capital structure decisions and the optimal design of corporate market debt programs (Martellini, Milhau, &amp; Tarelli, 2018)</i>	SD	2018
	<i>Sectoral Analysis of Factors Influencing Dividend Policy: Case of an Emerging Financial Market (Pinto &amp; Rastogi, 2019)</i>	SD	2019
	<i>Corporate Dividend Decisions and Dividend Smoothing: New Evidence from an Empirical Study of Turkish Firms (Al-Najjar, 2017)</i>	SD	2017
	<i>What firm's characteristics drive</i>	SD	2020

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	<i>the dividend policy? A mixed-method study on the Euronext stock exchange (Barros et al., 2020).</i>		
	<i>"How Moroccan managers view dividend policy" (Baker, 2016)</i>	SD	2016
	<b>THE RELATIONSHIP BETWEEN CAPITAL STRUCTURE AND DIVIDEND PAY OUT RATIO OF FIRMS LISTED AT THE NAIROBI SECURITIES EXCHANGE (Kimani, 2016)</b>	GS	2016
	<i>"Procedures for performing systematic reviews (Kitchenham, 2016)</i>	GS	2016
	<i>Dividend policy: A selective review of results from around the world (Laurence Both, (2017)</i>	GS	2017
	<i>Does having a semimandatory dividend policy enhance investor confidence? Research on dividend-financing behavior (Wenyun, Zhang, &amp; Hu*, 2020)</i>	GS	2020
	<i>What firm's characteristics drive the dividend policy? A mixed-method study on the Euronext stock exchange (Barros et al., 2020)</i>	SD	2020
	<i>Optimal dividend and risk control policies in the presence of a fixed transaction cost (Peng Li 2021)</i>	SD	2021
	<i>Optimal risk exposure and dividend payout policies under model uncertainty (YangFenga, 2021)</i>	SD	2021
	<i>Family firms' dividend policies: Evidence from a Japanese tax reform (AkitadaKasahara, 2021)</i>	SD	2021

	<i>Dividend optimisation: A behaviouristic approach (Leonie ViolettaBrinker, 2021)</i>	SD	2021
	<i>Passing the dividend baton: The impact of dividend policy on new CEOs' initial compensation (JieChen, 2019)</i>	SD	2019
	<i>Insider ownership and dividend policy in an imputation tax environment (Balasingham, 2019)</i>	SD	2019
	<i>Optimal dividend payment strategies with debt constraint in a hybrid regime-switching jump-diffusion model (SenrenTan, 2018)</i>	SD	2018
	<i>Corporate liquidity and dividend policy under uncertainty (NicosKoussis, 2017)</i>	SD	2017
	<i>Ownership structure and its effect on dividend policy in the Mexican contextEstructura de propiedad y su efecto en la política de dividendos en el contexto mexicano (Reyna, October-December 2017)</i>	GS	2017
	<i>Market Performance, Dividend Policy and Financial stability (Elmirzaev, 2016)</i>	GS	2016

**DATA EXTRACTION/ANALYSIS AND DISCUSSION:**

Selected SLR questions were answered through extracting the data from our selected published review of literature. Therefore firstly an answer for the **research question (RQ1)** is given that is does the optimal capital structure determine the optimal dividend policy?

Andiema, Atieno, and 7 (2016) reported in his research that debt and equity/internal source are the both combination of Capital structure that the firm descide to go with to tackle its business operation. The firm detrimine different economic factors for example market conditions interest/ the cost of debt and business risk, tex and future growth rate while determining the combination of both debt and equity that will have impact on the dividend policy also (Huang, 2006).

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*With reference to the static theory of trade-off proposed by (Myers, 1984), the firm find the optimal capital structure where the marginal benefit equal to the marginal cost this mean tax advantage on borrowing is balanced with the cost of financial distress and further this theory tells the firm can only go with the combination of debt and equity to reach its optimal level that will cause value to the firms ultimately and contrary to this an other pecking order theory in align to capital structure depicted the firm should prefer internal source of fund like retain earning but in the absence of the secondly the firm may choose the debt and finally the equity that will affect the firm dividend policy also (Chen, 2016).*

*According to Rozeff (1982) the firms those decide to disburse the proportionate of dividend to its common stock holder are free but the factors those gets the limitations on its decision are legal requirements, debt covenants and the availability of cash resources. He further suggested the firm having more reliant on external financing should adopt the lower pay out policy to increase the stockholders value.*

*In the recent studies from most of chine listed companies are holding the part of shareholder income from the earning per share as retain earning and part of income is paid so called the semi mandatory behavior of dividend financing but in the most of time firm go with external financing enabling to pay the cash dividend (Wenyun et al., 2020) in their study they proposed future research that the intrinsic mechanism and impact of dividend-financing behavior should be further studied.*

*Firms theories of capital structure are directly concern to its dividend policy this mean when firms uses a cash dividend it will diminish the funds got through the financing of equity and retain earnings and as result firm will be forced to again needs of external sources of (Litzenberger, 1979).*

**Research Question (RQ2) :** *Does the optimal dividend policy determine the financial value for both firm and its shareholders?*

*Existing literature most of time helps to give answers to those questions regarding the firms capital structure and dividend policy which is interconnected but to be more specific we are focused on those questions either are not investigated or if investigated then are not properly documentd in one report and try to investigating the relationship between capital structure and dividend policy in differnd context to the purpose of more clear understanding of firm dividend policies strategic decision*

*Khan, Ahsan, and Malik (2016) The dividend should be paid out keeping inview its impact on stockholder's value through the optimum dividend policy, is one that increase the firm's stock market value. Therefore to pay the dividend, the such firms would be having adequate cash in their accounts of banks to manage the dividend payment. It would be better for the firms to plan the cash budget that will*

indicate the appropriate time to the payment of cash dividend by avoiding to put in the danger of the firms liquidity position because this decreases the cash balance of the company and will ultimately affect the total net worth of its assets and if this happens then to fill this gap by the borrowing funds due to the cash dividend payment (Pandey, 2008)

Rahman, Sindhu, Khadim, and Malik (2017) according to their study it has been reported that any increasing proportionate of dividends from the net profit has depressing impact on the prices of stock (Poterba, 1984). Therefore it raises the questions for the financial managers that what percentage to retain or pay like dividends through which companies can increase their value.

According to Rozeff (1982) that firms should pay the dividend in the case as having no internal shortage of fund needed for investment this mean manager dividend policy is dependent in term of their financial performance and profitability (Barros, Verga Matos, Miranda Sarmiento, & Rino Vieira, 2021).

### **CONCLUSION AND IMPLICATIONS:**

In this study the review of previous literature regarding the firm optimal capital structure in connection to its dividend policy have been used. We have identified systematic literature review which particularly addressing these two corporate finance decisions by the firm's managers. This research keeps those literatures from the year 2016 to 2021. **The key findings of the first questions** are identified according to the view of different authors published work that the firm can find the optimal capital structure where the marginal benefit equal to the marginal cost this means tax advantage on borrowing is balanced with the cost of financial distress therefore in relation to this according (Andiema et al., 2016) and trade off theory that debt and equity/internal source are the both combination of capital structure that the firm decides to go with to tackle its business operation to reach its optimal level and resultant value for the firm. The firm determines different economic factors for example market conditions interest/ the cost of debt and business risk, tax and future growth rate while determining the combination of both debt and equity that will have impact on the dividend policy also.

According to the pecking order theory in alignment to capital structure depicted the firm should prefer internal source of fund like retain earnings but in the absence of this secondly the firm may choose the debt and finally the equity that will affect the firm dividend policy also (Chen, 2016) & (Wenyun et al., 2020)

The key findings about the second research question are regarding optimal dividend policy and the financial value for both firm and its shareholders:

Khan et al. (2016) The dividend should be paid out keeping in view its impact on stockholder's value through the optimum dividend policy, is one that increases the firm's stock market value. Therefore to pay the dividend, such firms would be

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having adequate cash in their accounts of banks to manage the dividend payment. It would be better for the firms to plan the cash budget that will indicate the appropriate time to the payment of cash dividend by avoiding to put in the danger of the firms liquidity position because this decreases the cash balance of the company and will ultimately affect the total net worth of its assets and if this happens then to fill this gap by the borrowing funds due to the cash dividend payment (Pandey, 2008).

According to Rozeff (1982) that firms should pay the dividend in the case as having no internal shortage of fund needed for investment this mean manager dividend policy is dependent interm of their financial performance and profitability (Barros et al., 2021).

### **POST OPTIMAL DIVIDEND POLICY FUTURE RESEARCH GAPS:**

The new future research after the post optimal dividend policy regarding " what are tex benfits of low dividend payouts should be further investegated inlight of different authors literature available on this topic and second research question that why investors favors a high dividend payouts. It is necessary for managment of different firms to understand the different behavior of stockholders regarding the dividend policy.

Impact of taxes on the dividebd policy must be addressed in the future research keeping inview the tax profile of major stockholders and secondly the further the research from the sell side analyst on the dividend policy stability is yet a gap which would be filled by the future research (Reference\_Research paper 1, 2019 victor Barros) .



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