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A Conceptual Review Paper: Revisiting the Non-linear Relationship Between Dividend and Firm Value in Shariah and Non-Shariah Compliant Firms

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ABSTRACT

In the modern corporate world, dividend policy is a widely discussed topic. Early academic literature mainly focused on the linear relationship between dividends and firm value. However, a non-linear (J-shaped) relationship was later discovered in major economies, indicating that firm value may have a more complex connection to dividends. This study reviews existing literature on the non-linear relationship between dividends and company value, suggesting that this relationship might also exist between Shariah-compliant and non-Shariah-compliant firms. The low leverage characteristic of Shariah-compliant firms may contribute to this potential relationship. An extensive search through Google Scholar and Scopus revealed that few empirical studies have examined this non-linear relationship. Notably, no analysis has yet investigated the non-linear relationship between dividends and firm value specifically among Shariah-compliant firms. This article provides a conceptual overview of how and why such a relationship may exist. The review highlights the need for further research, offering insights that could help policymakers and firms make informed decisions to enhance firm performance.

1. Introduction

Research into the relationship between dividend policy and company value has occupied academics, practitioners, and investors for many decades. This complicated relationship is characterized by multidimensional levels and is subject to the influences of economic theories, market dynamics, and corporate decision-making processes. This study examines the key theoretical frameworks, empirical evidence, and practical implications of dividends and their impact on firm valuation, assessing their impact on both Shariah-compliant and non-Shariah-compliant firms. The discourse on the importance of dividends in an idealized frictionless capital market received a decisive impetus with the introductory work of Miller and Modigliani in 1961. In this seminal work, Franco Modigliani and Merton Miller argued that dividend policy is irrelevant in a frictionless capital market. According to MM's thesis of irrelevance, investors are supposedly able to generate their preferred cash flows by selling shares or reinvesting dividends. Notwithstanding this, MM hypothesized the "information content of dividends." This theoretical construct states that dividend announcements provide important information about a company's future prospects and consequently influence the valuation of shares.

Following this foundational research, further theoretical frameworks have been established to support the positive relationship between dividends and firm valuation while refuting the claim of irrelevance of the MM theorem. One notable theoretical perspective relevant to this interaction is the agency theory proposed by Jensen and Meckling in 1976. This theory states that the decision-making of managers who have little or no equity may not be optimally aligned with the financial interests of shareholders. Such misalignment leads to agency costs that require monitoring of managers' behavior. The postulate is that without distributing surpluses to shareholders, managers may misuse these surpluses for their personal benefit or divert resources to ventures with negative net present value. Consequently, outside shareholders prefer dividends to retained earnings because higher dividend payouts supposedly improve firm valuation by reducing the potential for appropriation by management [1], [2].

In addition to the agency cost and free cash flow theory of Jensen and Meckling (1976), the bird-in-hand theory offers important insights into the discourse on dividend relevance [3]. This theory states that in times of economic unpredictability, investors show a preference for immediate dividends (the so-called “bird-in-hand”) over potentially future capital gains (the “two-in-the-bush”). The latter category, which relates to a company's future prospects, is associated with higher risk than current dividends. As a result, investors tend to place a higher value on firms that consistently pay dividends, leading to a higher valuation of such firms [4], [5]. In addition, signalling theory is another important theoretical framework that underpins the importance of dividends. In the corporate world, an information gap arises when one entity has more knowledge than another. In the context of corporate governance, firms generally have better insight into their immediate and expected performance than external stakeholders. Therefore, corporate executives strategically use dividends to convey messages to the financial market about the company's current and future performance [6]. In addition, Lintner (1956) pointed out the discomfort managers experience in effectively communicating the distribution of profits over an extended period of time [7]. Bhattacharya (1979) further elaborated on how dividends serve as an indicator of a firm’s financial health, which is reflected in dividend payments that anticipate future firm performance [8]. Theoretically, a higher dividend correlates with a higher firm valuation.

Prior to the empirical revelation in 2018 by Kim et al. (2018), the relationship between dividend payout and company valuation was often seen as a simple, consistent relationship [9]. However, as part of their research, it became clear that firms that pay out the highest dividends generally achieve a firm valuation that is higher than that of all alternative company categories. Conversely, firms that do not pay dividends appear to have a higher valuation than their counterparts that only pay minimal dividends. This tendency shows a remarkable degree of stability over a long-time frame, especially over the period from 1962 to 2010. Conventional dividend theories, including dividend catering, free cash flow, and dividend customer hypotheses, struggle to explain the observed J-shaped correlation. This phenomenon cannot simply be attributed to mispricing factors. The empirical data show that there is no consensus on whether the observed pattern is due to the dividend payouts themselves or is instead influenced by unobservable characteristics of the firms in question.

The question, then, is whether the j-shaped cross-sectional association also applies to different classifications of businesses, including those that are Shariah-compliant as opposed to their non-Shariah-compliant counterparts. It is worth noting that Shariah-compliant firms are governed by Islamic doctrines that categorically prohibit involvement in certain financial ventures, particularly interest-based transactions, gambling, and alcohol-related activities [10]. Consequently, the dividend policy in these firms is characterized by ethical principles that emphasize the importance of fairness, transparency, and social responsibility. Shariah-compliant firms often tend to favor the reinvestment of profits in productive assets rather than distributing dividends to shareholders; in contrast to firms that adhere to Shariah principles, firms that do not are characterized by the absence of religious restrictions. The formulation of their dividend policy is usually influenced primarily by traditional financial metrics, primarily the desire to increase shareholder value and meet investor expectations. These firms are likely to employ a range of dividend methods, which may include standard payouts, special dividends, or share buybacks.

The study seeks to better understand the non-linear dynamics between dividend policy and firm valuation, thereby providing insights that can help firm fine-tune their dividend methodology to increase shareholder value. In addition, the results can help in the development of advanced financial frameworks and investment tactics. Despite the existing literature that sheds light on various dimensions of dividend policy, there are still some gaps that require further investigation. For example, while there are studies on the dividend policies of Shariah-compliant and non-Shariah-compliant firms, there are relatively few that directly compare the respective behaviors. This scenario shows a distinct lack of comprehensive cross-sectional analyses that address the non-monotonic relationship that exists in both categories of firms. Moreover, it is well established that dividends do not always move linearly with company valuation. However, the exact determinants that drive this non-monotonicity are not yet fully understood. Identifying the underlying factors, such as company size, profitability ratios, and growth prospects, that cause either J-shaped or U-shaped correlations between dividends and company value remains fertile ground for academic research. This non-monotonic interplay may also exhibit fluctuations depending on different economic conditions, legal frameworks, and cultural paradigms. Therefore, examining the interplay of these contextual variables on the dividend policies of Shariah-compliant and non-Shariah-compliant firms could yield important insights. In conclusion, addressing these identified shortcomings could significantly improve our understanding of the dynamics driving the relationship between dividends and firm value, especially in the dichotomy of Shariah-compliant and non-Shariah-compliant firms.

The differences between Shariah and non-Shariah-compliant dividends were empirically substantial, as explained in the previous section. In this section, we have developed an argument as to why dividend policy differs between Shariah and non-Shariah-compliant firms and why the non-linear relationship between dividend and firm value might exist. We have also discussed why the non-linear relationship may lead to different findings, especially when a comparison is made between Shariah and non-Shariah-compliant firms.

One of the many reasons why Shariah-compliant and non-Shariah-compliant firms differ in their dividend policies is the rules that these firms abide by. In addition to regulatory rules, Shariah-compliant firms must also follow standard business procedures prescribed by Shariah law [11]. Shariah law can be defined as Islamic law derived from the divine revelation (Al-Quran) and the practices of Prophet Muhammad P.b.u.h (Al-Hadith) [12]. Farooq and Tbeur (2013) mentioned that Shariah-compliant firms must have low accounts receivable, low debt-to-equity ratio, and low holdings of cash and interest-bearing securities [11]. It has been empirically shown that these three characteristics influence dividend payout. For example, it has been found that debt is a key determinant of dividend policy [13]. Higgins shows that firms with a high level of debt pay out significantly lower dividends.

Rozeff (1982) found that there is a correlation in which firms with a high debt-equity ratio tend to pay a lower dividend [2]. Furthermore, this high leverage correlates with a reduction in dividend payout [14], [15]. From the above theoretical perspectives, it could be argued that financial constraints are of considerable importance in the formulation of dividend policy. In conjunction with maintaining a minimum debt-to-equity ratio, a salient feature of Shariah-compliant firms is the reduction of accounts receivable balances. Prior empirical research suggests that a high level of accounts receivable not only reduces available liquidity but also increases the potential incentives for tunnelling within the firm [16], [17].

The difference between the determinants of dividends in Shariah-compliant firms compared to those in non-Shariah-compliant firms can also be attributed to the so-called clientele effect. Farooq and Tbeur (2013) explain that a notable segment of the investor clientele of Shariah-compliant firms consists of Shariah-aware investors [11]. These investors tend to invest their financial resources in Shariah-compliant investments, predominantly through vehicles such as mutual funds and a variety of institutional investment opportunities [11]. Institutional investors are believed to provide a relatively better governance framework to firms that are categorized as Shariah-compliant compared to those that are not due to their structured monitoring capabilities [18]. As a result, firms that are characterized by superior governance and are therefore classified as Shariah-compliant may exhibit a greater propensity to pay dividends when contrasted with their counterparts that exhibit a weaker governance structure and are classified as non-Shariah-compliant. This variance implies that the underlying determinants of dividend payout policy are different.

Based on the above arguments, there is a clear differentiator between the determinants of Shariah-compliant and non-Shariah-compliant dividends. In the study by Kim et al. (2018), they found that the existing theoretical arguments, such as dividend catering, free cash flow, and the dividend customer hypothesis, were unable to explain the non-linear (J-shaped) cross-sectional relationship between dividends and firm value [9]. They further argued that such relationships may exist due to unobservable firm characteristics that were not tested in the study. In our study, it was specifically suggested that one of the potential unobservable firm characteristics that may lead to a non-linear or J-shaped relationship between dividend and firm value is Shariah-compliant firm characteristics. As noted, Shariah-compliant firms are characterized by low leverage in contrast to non-Shariah-compliant firms. Consequently, Shariah-compliant firms should have proportionally less debt or indebtedness to Islamic banks. According to information-based theories, financial intermediation provides banks with a unique information production and monitoring service in an information-asymmetric capital market [19]. These theories state that an imperfect capital market recognizes the value of bank monitoring and uses bank debt as a signal of firm value. Since bank debt can be used as a signal of firm value, the presence of high bank debt in non-Shariah compliant firms may lead to better firm value compared to non-Shariah compliant firms, especially when no dividends are paid. In the case of low dividend payouts, we argue that Shariah-compliant firms may be better valued than their non-Shariah-compliant counterparts. This is primarily because firms with low dividend payouts are not only relatively more indebted than their non-Shariah-compliant counterparts but also because both firm types are required to pay a dividend. As a result, non-Shariah-compliant firms should have relatively low cash reserves to pay cash dividends due to bank and debt obligations. In addition, Allen and Gottesman (2006) found that bank debt contains clauses that limit dividend payouts, which may further limit the availability of cash to pay dividends [20]. For firms with medium and higher dividend payouts, our arguments can be related to existing theories such as agency theory, signalling theory, and bird-in-hand theory, which states that higher dividends should lead to better firm valuation.

1.1. Empirical Evidence on Dividend Policies of Shariah and non-Shariah-compliant firms

The dividend policy of Shariah-compliant firms is empirically different from that of non-Shariah-compliant firms, as found in previous studies [10], [11], [21]. For example, Farooq and Tbeur (2013) found in their study on the MENA region that Shariah-compliant firms not only pay a higher dividend payout ratio but are also more likely to pay dividends [11]. The reasons for this lie in the characteristics of Shariah-compliant firms, which have low leverage, low accounts receivable, and low cash flow. Guizani (2017) found that Shariah-compliant firms pay 10.33 percentage points more dividends than the non-Shariah-compliant firms [21]. A study also found that Shariah-compliant firms in Indonesia are less likely to pay dividends than their non-Shariah-compliant counterparts [22]. Bakri and Yong (2023) found in their study that the dividend policy of Shariah-compliant firms differs from that of non-Shariah-compliant firms not only when using the linear approach but also when using the quadratic approach, especially the quantile method [10]. Significant differences between the different studies found when comparing the dividend policies of Shariah-compliant and non-Shariah-compliant firms could potentially lead to different results for different firm value associations. Therefore, we hypothesized why the relationship between dividend and firm value might be different for Shariah and non-Shariah-compliant firms and why the potential non-linear relationship might exist.

2. Method

This review manuscript attempts to examine the impact of dividend policy on firm valuation through an examination of existing theoretical frameworks and empirical data from different countries. The methodology used for the research involved an extensive search of databases such as Google Scholar and Scopus [23]. Despite the intense discourse on dividend policy in corporate finance, relevant academic articles were abundantly available. In addition, a number of related references contributed to the literature search. However, financial blogs were systematically excluded due to their potential unreliability and inherent bias.

2.1. Proposed Method

The methodology presented in Fig. 1 illustrates the systematic approach used to identify keywords, recognize related studies, assess the relevancy of the article, and articulate findings into the academic papers relevant to the study of dividends in the context of dividend and firm valuation. This conceptual review draws exclusively on empirical evidence from 2010 and beyond to utilize more recent empirical studies. All empirical data prior to this time marker is omitted from the tabular presentation.

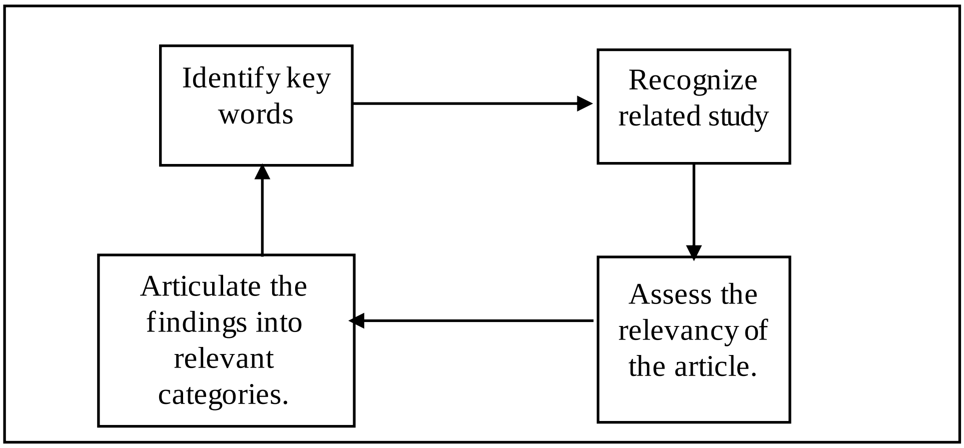

Fig.1. The Proposed Method

3. Results and Discussion

Table 1. Empirical evidence summary on the relationship between dividend and firm value.

Findings	Google Scholar	Scopus
Positive	Rizqia and Sumiati (2013). Morovvati and Pourali (2015), Anton (2016), Triani and Tarmidi (2019), Akhmadi and Robiyanto (2020), Santoso et al. (2020), Bakri (2021b), Margono and Gantino (2021), Agung et al. (2021), Hasanuddin (2021), Kapons et al. (2023).	Kapons et al. (2023).
Negative	Lumapow & Lumapow (2017), Sondakh (2019), Adiputra and Hermawan (2020), Bakri (2021a).	Bakri (2021a).
No association / No significant association	Sinaga (2016), Rehman (2016), Sukmawardini and Ardiansari (2018), Munawar (2019), Sutomo and Budiharjo (2019), Husain and Sunardi (2020), Saputri and Bahri (2021). Winoto and Rudiawarni (2024),	Winoto & Rudiawarni (2024),
Non-monotonic/Non-linear association	Kim et al. (2018).	Kim et al. (2018).

Note: Some of the empirical evidence is subsets to the other database. Thus, some of the lists may be redundant [9], [24], [25], [26], [27], [28], [29], [30], [31], [32], [33], [34], [35], [36], [37], [38], [39], [40], [41], [42], [43], [44], [45], [46].

Table 1 summarizes the empirical evidence on the relationship between dividends and firm value from two academic search engines, Google Scholar and Scopus. For both search engines, we limit our academic search to articles from 2010 to the present study (2024). The key terms we use to identify the relevant articles include "dividend and firm value," "the relationship between dividend and firm value," "non-linear relationship between dividend and firm value," "U-shaped relationship between dividend and firm value," "inverted U-shaped relationship between dividend and firm value," and "J-shaped relationship between dividend and firm value." Based on the above key terms, we were able to extract eleven (11) relevant articles from Google Scholar and one (1) from the Scopus index database, showing a positive relationship between dividends and firm value. On the other hand, we found only four (4) relevant articles showing a negative relationship between dividend and company value and one (1) from Scopus. An increase in the total number of articles revealed no significant relationship between dividend and firm value compared to the negative association. A total of eight (8) articles were found in the Google Scholar search engine and one (1) article in the Scopus database. Finally, for the non-monotonic or non-linear relationship between dividend and firm value, we found only one (1) relevant article in both Google Scholar and the Scopus database. In addition, we also discovered a non-linear relationship between the dividend and the price-earnings ratio, which can also be related to firm value since the earnings ratio is part of the calculation of firm value. The article by Jitmaneeroj (2017) is searchable via Google Scholar as well as via the Scopus database [47]. To summarize, few empirical studies have been conducted to test the non-linear relationship between dividends and firm value. The existing empirical evidence from the Scopus database examining the linear relationship between dividends and firm value is very limited in recent studies. The reason for the small number of studies in the Scopus database may be due to the longevity of the study. The study of dividends and firm value has contributed to more than five decades of theoretical development and empirical studies since the introduction of Miller and Modigliani (1961) [48]. Although there is still more to be discovered, the results seem to be relatively similar (positive, negative, or no relationship). However, Kim et al. (2018) found a non-linear relationship between dividends and firm value that cannot be explained by existing theories, reflecting the lack of studies and gaps that need to be further explored [9]. In addition, the nature of dividend policies of Shariah and non-Shariah-compliant firms, which differ greatly, as highlighted in the previous section, may lead to novel or unique results.

4. Conclusion

Dividends are an important factor in investors' considerations regarding the valuation and perception of firms. The prevailing theoretical framework, exemplified by the theory of dividend irrelevance, assumes that there is no correlation between dividends and the valuation of firms. Investor behavior is highly variable and characterized by heterogeneity. Relevance theory, on the other hand, assumes that there is a correlation between dividends and company valuation. However, the existing empirical evidence mostly focuses on the linear relationship and overlooks the complexity and different ways of analyzing this relationship. A notable discovery in this relationship was the discovery of the non-linear relationship between dividends and firm value. However, the study is not able to adequately explain this relationship using existing dividend theory, and it could be caused by unobservable firm characteristics.

Specifically, in this study, we argue that one of the possible unobservable firm characteristics that led to the non-linear relationship between dividend and firm value is the difference between Shariah-compliant and non-Shariah-compliant firm characteristics. We hypothesize that the non-linear relationship is more pronounced for non-Shariah-compliant firms than for Shariah-compliant firms due to a number of characteristics (e.g., low leverage). In this conceptual study, we explore the potential gaps by identifying and analyzing the existing research in this area. Our results show that existing empirical studies not only focus on the linear relationship between dividend and firm value but also few empirical studies use non-linear approaches to unravel the mystery. In particular, a study comparing Shariah-compliant and non-Shariah-compliant firms is very minimal in this area of non-linear relationship. As with many other studies, there are some limitations to this study. Since this study is a conceptual review, the discovery is limited to the empirical review of the literature, and there is no empirical evidence to support the arguments. For future research, we suggest a non-linear approach (i.e., u-test, quantile analysis, and threshold analysis) to investigate the potential non-linear relationship that might be more pronounced in non-Sharia-compliant firms.

The complicated, non-linear relationship between dividends and company valuation underlines the need to take investor confidence into account. Firms should be aware that their dividend strategies can have a significant impact on investor behavior and market dynamics. A nuanced understanding of these complex relationships can better inform strategic dividend policy considerations. In summary, confidence is of paramount importance, and the interaction between dividends and investor confidence strongly influences the multi-layered relationship between dividends and company valuation.

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