

# Determinants of dividend policy of public listed companies in Malaysia

Yusniliyana Yusof

*Department of Finance, Faculty of Economics and Management Sciences,  
International Islamic University Malaysia, Jalan Gombak, Malaysia*

Suhaida Ismail

*Department of Accounting, Faculty of Economics and Management Sciences,  
International Islamic University Malaysia, Selangor, Malaysia, and*

## Abstract

**Purpose** – This study aims to investigate the determinants of the dividend policy of public listed companies in Malaysia. The factors examined in this study include earnings, cash flows, free cash flows, debt level, growth, investment, size, largest shareholders, risk and lagged dividend.

**Design/methodology/approach** – Data were obtained from the relevant databases and annual reports of the sampled companies. The study examines a total of 147 listed companies. In analyzing the data, the study used fixed and random effects, pooled least squares model, robust standard errors on fixed effects and random-effects models.

**Findings** – The results revealed the five factors that are earnings, debt, size, investment and largest shareholder have a significant influence on dividend policy, with earnings, firm size and investment revealed to have a positive significant effect, while debt and large shareholders have a negative significant effect.

**Practical implications** – The findings from this study are useful to the board of directors and management team of companies in deciding an appropriate dividend policy for the company. The results are also useful to shareholders in making investment decisions.

**Originality/value** – The study extends empirical evidence on dividend policy determinants which are currently reported to be inconclusive. In addition, the study fills the lacuna in the existing literature by focusing on the issue of dividend policy determinants in the context of an emerging economy, namely, Malaysia.

**Keywords** Malaysia, Determinants, Listed companies, Emerging market, Dividend policy

**Paper type** Research paper



## Introduction

Dividend decision is a fundamental corporate finance issue due to its significant impact on investment and financing decisions. If a firm decides not to pay or pays fewer dividends, the firm will have more internal earnings, thus reducing its reliance on external earnings. On the other hand, if a firm pays high dividends, it will result in less internal earnings, thus increasing firm's dependence on debt or other external financing. This implies that the decision to raise funds is directly associated with dividend policy. Subsequently, as dividend policy influences the capital structure of a firm, it will also have an impact on the investment decision and cost of capital of the company (Lee *et al.*, 2010).

Given the importance of dividend policy, an optimal dividend decision is crucial. In addition to rival theoretical stances on dividend policy, prior studies have reported that dividend decision could be affected by various factors, including earnings, firm size, investment opportunities, lagged dividend and cash flows. Over the years, academic research has systematically examined the factors influencing dividend payment policy. Despite the abundance of research on this issue, the evidence reported remains inconclusive. Furthermore, the studies were mostly carried out in the context of developed countries (Charitou, 2000; Al-Malkawi, 2007; Ramli, 2010; Imran, 2011; Appannan and Sim, 2011; Hashemi and Zadeh, 2012).

Malaysia is a developing country, yet its capital market is more developed than many other emerging markets. Malaysia's capital market comprises conventional and Islamic capital markets. Continuous government support and the implementation of the Capital Market Master Plan from 2000 to 2010 have helped the capital market grow from a market size of RM 717.5 billion (US\$239 billion) in 2000 to RM 2.0 trillion (US\$667 billion) in 2010 (Security Malaysia, 2013). Between 2000 and 2010, Malaysia's equity market grew by 11.1 per cent each year, making it the fifth fastest-growing market in Asia (Security Malaysia, 2013). Malaysia's market capitalization has tripled in the past 10 years and is expected to double in the next 10 years. In achieving the vision of Malaysia to become a high-income country by 2020, the capital market is expected to further increase to RM 5.8 trillion (US\$1.93 trillion) with an equity market of RM 2.4 trillion (US\$800 billion) by 2020 (Security Malaysia, 2013).

The rapid growth of Malaysia's capital market, the unresolved issue of dividend policy and the paucity of research in the area from emerging economies have inspired the present study. In particular, this study aims at investigating the influencing determinants of dividend policy of listed companies in a developing country, i.e. Malaysia. The study contributes to the literature not only in terms of extending existing empirical evidence on determinants of dividend policy by using recent years' data but also fills in the gap in the literature on the dividend policy issue by focusing on listed companies from an emerging economy (i.e. Malaysia), which is currently scarce. The findings from this study are useful to the board of directors of companies in deciding an appropriate dividend policy and to the shareholders in making investment decisions.

The remaining paper is structured as follows: the following section discusses the theoretical framework of the study, reviews relevant literature on determinants of dividend policy and outlines the research hypotheses. This is followed by the research methodology and findings. The paper concludes with a discussion of its implications, identification of its limitations and suggestions for future research.

### Literature review and hypotheses development

Dividend refers to the distribution of the portion of profit to the shareholders as a form of reward in fulfilling the wealth maximization objective of the shareholders. Dividend policy is "the practice that management follows in making dividend payout decisions or, in other words, the size and pattern of cash distributions over time to shareholders" (Lease *et al.*, 2000, p. 29). It is well-acknowledged that there are contentious issues surrounding dividend policy such as the optimal portion of earnings to be distributed as dividend, the conflicting priority of using earnings either for payment to shareholders or for investment in expected profitable projects and the suitable form of dividend

payment. Ultimately, as an effort in resolving the identified issues, understanding the influential factors of dividend policy is essential.

The study by Lintner (1956) is among the earliest studies on dividend policy which lead to the development of the Lintner model. The empirical study was carried out on American companies and revealed that current profitability and the previous year's dividend (lagged dividend) are the significant factors in determining changes in current dividend. This is due to the belief that the shareholders favor a reasonably stable rate of dividend. Pruitt and Gitman (1991) studied the interactions between the investment, financing and dividend decisions of major firms in the USA. The study found that the dividend decision of the firms was driven by profits and the previous year's dividends instead of the investment and financing actions of the firms, which therefore supported the findings of Lintner (1956).

Since then, there have been a growing number of studies examining other factors determining dividend policy. Based on the signaling theory, dividend announcements convey some information about firm performance that would cause shareholders to react to the announcement (Miller and Modigliani, 1961). In particular, the ability of firms to pay dividend signals a firm's profitability. Furthermore, the higher the amount of dividend payment, the greater the profitability of the company (Bhattacharya, 1979; Ho, 2003). Announcement on dividend payment also signals the stability of a firm's future cash flows (i.e. liquidity) (Kale and Noe, 1990). Charitou (2000) investigated the impact of cash flows on dividend payment of companies in Japan. The study found a positive relationship between earning measures and dividend changes (firms with losses will face dividend reduction). Similarly, a positive relationship was also revealed for cash flow level and dividend payment. This finding is supported by Al-Malkawi (2007); Kowalewski *et al.* (2007); Anil and Kapoor (2008); Juma'h and Pacheco (2008); Ahmed and Javid (2009); Ramli (2010); Mehrani *et al.* (2011); Al-Shabibi and Ramesh (2011) and Hashemi and Zadeh (2012). In contrast, Gill *et al.* (2010) found a significant negative effect of earnings on dividend policy, while Anil and Kapoor (2005) and Appannan and Sim (2011) discovered an insignificant effect of earnings on dividend policy.

Agency cost theory, which emphasizes on ways to mitigate costs due to the principal–agent problems, suggests that dividend payment is a possible mechanism for reducing the agency costs related to factors such as free cash flows, debt financing, firm's growth, investment opportunities, firm size, large shareholders and risks (Jensen and Meckling, 1976; Rozeff, 1982; Jensen, 1986; Utami and Inanga, 2011). In other words, these factors potentially impact on the dividend policy of a company. A study by Chen and Dhiensiri (2009) examined the factors influencing dividends for firms listed on the New Zealand Stock Exchange and discovered that free cash flow has a significant positive association with dividend payment. However, a significant negative relationship was reported by Imran (2011) and Utami and Inanga (2011). Studies by Al-Kuwari (2010); Al-Shubiri (2011) and Mehrani *et al.* (2011) found no significant relationship between free cash flow and dividend policy.

In relation to debt financing, firms with high debt need more cash to settle debt obligations, which subsequently reduces funds available to shareholders, and therefore leads to lower dividend payment. Al-Malkawi (2007), who examined the determinants of corporate dividend policy of listed companies in Jordan, discovered a significant negative effect of debt financing on dividend policy. Similar evidence was reported by

Kowalewski *et al.* (2007); Ramli (2010) and Al-Shubiri (2011). In contrast, other studies discovered a significant positive association between debt financing and dividend policy (Chang and Rhee, 1990; Appannan and Sim, 2011; Gill *et al.*, 2010), which implies that the higher the debt financing of a company, the greater the dividend payment. At the same time, studies by Ahmed and Javid (2009); Al-Kuwari (2010); Gill *et al.* (2010); Foroghi *et al.* (2011); Mehrani *et al.*, 2011 and Al-Shabibi and Ramesh (2011) revealed insignificant effect of debt on dividend policy.

Growth and investment as determinants of dividend policy is in line with the agency cost theory, whereby firms with no growth or fewer investment opportunities have greater exposure to agency costs, which are related to free cash flows. In reducing the agency costs, these firms will pay higher dividends to the shareholders as compared to firms with high growth and greater investment opportunities (Jensen, 1986). The significant negative effects of growth and investment on dividend payment were evidenced in prior studies such as Rozeff (1982); Chang and Rhee (1990); Jensen *et al.* (1992); Ahmed and Javid (2009); Al-Kuwari (2010) and Subramaniam and Devi (2011). There are also studies which reported a positive impact of growth opportunities and investment on dividend policy (Al-Malkawi, 2007; Foroghi *et al.*, 2011; Al-Shubiri, 2011; Imran, 2011).

Prior studies have also evidenced that firm size could influence dividend payment. Based on the agency cost theory, the wide spread of ownership in larger firms decreases the shareholders' ability to monitor the internal and external financing activities of the firm, which leads to greater information asymmetry, thereby increasing agency costs. Dividend payment is an approach to mitigate the problem. In other words, larger firms tend to pay higher dividends than smaller firms. The positive relationship between firm size and dividend payment is evidenced in a number of previous studies such as Kowalewski *et al.* (2007) Juma'h and Pacheco (2008); Ramli (2010); Mehrani *et al.* (2011) and Hashemi and Zadeh (2012). At the same time, the negative effect of firm size on dividend policy was also reported in several prior studies (Ahmed and Javid, 2009 and Huda and Farah, 2011). There are also studies that claimed an insignificant effect of firm size on dividend policy (Chen and Dhiensiri, 2009; Appannan and Sim, 2011).

Agency cost theory also provides justification for the possible effect of large shareholders on dividend payment. In essence, large shareholders play a greater role in monitoring management as compared to small shareholders, as they have greater voting power to influence a firm's decision. As a result, conflict between the two groups of shareholders may arise due to the influence by large shareholders for the firm to adopt a particular dividend policy, which comes at the expense of minority shareholders (Truong and Heaney, 2007). Dividend payment is therefore a possible remedy to mitigate agency conflict, whereby firms with a greater portion of large shareholders tend to pay higher dividends than firms without large shareholders (Rozeff, 1982; Ramli, 2010). This significant positive relationship was reported in studies by Truong and Heaney (2007); Ahmed and Javid (2009) and Ramli (2010). However, Faccio *et al.* (2001) found a significant contradictory effect.

In terms of firm risk, high dependence on external financing reflects higher volatility of a firm's cash flow, which subsequently increases firm risk. In minimizing the firm's risk due to external financing, a firm will pay lower dividends (Rozeff, 1982). This is consistent with the findings of Kowalewski *et al.* (2007), Juma'h and Pacheco (2008); Ramli (2010) and Al-Shubiri (2011), who found a negative association between firm risk

and dividend policy. On the other hand, Al-Shabibi and Ramesh (2011) reported a positive effect of firm risk on dividend policy.

In the context of Malaysia, although there were several studies that examined the factors affecting dividend policy, the reported findings were mixed and the data used were not recent (Shamsuddin, 2001; Ramli, 2010; Subramaniam and Devi, 2011). In addition, few past studies on dividend policy of Malaysian companies focused on specific sectors. For instance, studies by Anil and Kapoor (2008) and Appannan and Sim (2011) covered companies mainly from the consumer product sector. The present study extends the existing literature on determinants of corporate dividend policy from a developing economy (i.e. Malaysia) using more recent data and is broader in scope to cover all sectors.

Based on the theoretical framework of the Lintner model, signaling theory, agency cost theory and evidences of prior studies, despite their mixed findings, the following hypotheses stated in alternative form were developed for determining the factors influencing dividend policy of listed companies in Malaysia:

- H1.* There is a positive effect of the earnings on the dividend policy of firms.
- H2.* There is a positive effect of cash flow on the dividend policy of firms.
- H3.* There is a positive effect of free cash flow on the dividend policy of firms.
- H4.* There is a negative effect of debt on the dividend policy of firms.
- H5.* There is a positive effect of growth opportunities on the dividend policy of firms.
- H6.* There is a negative effect of investment opportunities on the dividend policy of firms.
- H7.* There is a positive effect of firm size on the dividend policy of firms.
- H8.* There is a positive effect of largest shareholder on the dividend policy of firms.
- H9.* There is a negative effect of firm risk on the dividend policy of firms.
- H10.* There is a positive effect of lagged dividend on the dividend policy of firms.

## Methodology

### *Sample selection and data collection*

The present study samples the top 200 firms listed on the Main Market of Bursa Malaysia based on market capitalization as of 31 December 2010. The study period covers the 2006 to 2010 period. The main justification for selecting large firms is that there is greater tendency that these firms pay dividends to their shareholders. A similar selection basis based on top market capitalization has also been used by several prior studies (Pandey, 2003; Abeysekera, 2008; Mkhize and Msweli, 2011; Salin and Rahman, 2010). In addition, out of the 200 companies in the initial sampling, 53 companies were excluded due to several reasons, such as the firms have not been listed on Bursa Malaysia continuously from 2006 to 2010, the companies have not been paying dividends during the study period and the exclusion of financial and real estate investment trust firms. As a result, 147 companies were included this study.

*Data analysis*

The data were analyzed using EViews version 6.0 software. In particular, regression analysis was carried out using fixed and random effects and pooled least squares model. The preliminary analyses of correlation and robust standard errors of fixed effects and random effect show that the data are free from multicollinearity and heteroskedasticity problems.

The independent variables for the present study include earnings, lagged dividend, cash flows, free cash flows, debt, size, firm's growth, investment opportunities, firm risk and largest shareholder, while dividend policy is the dependent variable. **Table I** shows the proxy or measurement for each of the variables.

The model of the study is as follows:

$$D_{it} = \beta_0 + \beta_1 E_{it} + \beta_2 D_{i(t-1)} + \beta_3 CF_{it} + \beta_4 FCF_{it} + \beta_5 DEBT_{it} + \beta_6 GR_{it} \\ + \beta_7 INV_{it} + \beta_8 SIZE_{it} + \beta_9 LARGE_{it} + \beta_{10} RISK_{it} u_{it}$$

Where,

<i>E</i>	= Earnings
<i>D</i>	= Dividend
<i>D<sub>(t-1)</sub></i>	= Lagged dividend
<i>CF</i>	= Cash flows
<i>FCF</i>	= Free cash flows
<i>DEBT</i>	= Debt
<i>SIZE</i>	= Size
<i>GR</i>	= Growth
<i>INV</i>	= Investment opportunity
<i>RISK</i>	= Risk
<i>LARGE</i>	= Large shareholders

$\beta_0, \beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6, \beta_7, \beta_8, \beta_9$  and  $\beta_{10}$  are the coefficients of the regression model.

Variables	Represent by	Proxy variables
Dividend	<i>D</i>	Dividend per share
Earnings	<i>E</i>	Earnings per share
Lagged dividend	<i>D<sub>(t-1)</sub></i>	Dividend per share
Cash flows	<i>CF</i>	Cash flow per share (operations)
Free cash flow	<i>FCF</i>	(Operating CF-capital expenditure) in share basis
Debt	<i>DEBT</i>	Total liabilities/total assets
Size	<i>SIZE</i>	Log of total assets
Growth	<i>GR</i>	Sales growth
Investment opportunity	<i>INV</i>	Retained earnings/total assets
Risk	<i>RISK</i>	Beta of single year of weekly returns
Largest shareholder	<i>LARGE</i>	Percentage shares owned by largest shareholder

**Table I.**  
Variables and proxy  
variables

## Findings and discussions

### *Descriptive statistics*

**Table II** depicts the mean values and standard deviations for each variable used in this present study.

As shown in **Table II**, the average dividend paid and average earnings per share of the firm are RM 0.15 and RM 0.39, respectively. While, the average cash flows per share of the companies is RM 0.45, and the average free cash flow per share is RM 0.21. The mean value for size is 9.27 in the form of the natural logarithm of the total assets, which represents average total assets of the companies are approximately RM 1.862 million. The average growth level of the companies, which is measured based on the increase in sales, is 23 per cent. The average risk of the companies is 1.04, which implies that firm risk is higher than the market risk by 0.04. As for the largest shareholder, the mean value shows that the percentage shares owned by the largest shareholder are approximately 35 per cent.

### *Regression results*

The results of the regression analysis of pooled ordinary least squares, random-effects and fixed-effects models on factors that affect dividend policy are shown in **Table III**.

The Hausman test indicates that the fixed-effects model is more appropriate for this study. Similarly, as shown in **Table III**, the fixed-effects model is the best model to explain the determinants of dividend policy, as it has the highest adjusted  $R^2$  value of 89 per cent. This implies that the ten factors examined in this study explain almost 90 per cent of the factors affecting dividend policy. Of the ten factors, earnings, debt, size, investment and largest shareholder have a significant influence on dividend policy, with earnings, firm size and investment exercising a positive significant effect on dividend policy at a level of 1 per cent, while debt and large shareholders assert a negative significant effect at 5 and 10 per cent significance levels, respectively. Hence,  $H1$  (earnings),  $H4$  (debt),  $H7$  (size) and  $H8$  (larger shareholder) are supported, while  $H2$  (cash flows),  $H3$  (free cash flows),  $H5$  (growth),  $H6$  (investment),  $H9$  (firm's risk) and  $H10$  (lagged divided) are rejected.

The positive significant result of earnings on dividend policy implies that the increase in company profits leads to payment of higher dividend to shareholders, which is in support of the signaling theory, whereby higher dividends are paid to shareholders when earnings increase, signaling good firm performance. When the companies are

**Table II.**  
Descriptive statistics  
of variables for  
determinants of  
dividend policy

Variables	Mean	SD
Dividend	RM 0.15	0.27
Earnings	RM 0.39	0.42
Cash flows	RM 0.45	0.64
Free cash flow	RM 0.21	0.54
Debt	RM 0.42	0.25
Size	9.27	0.55
Growth	23%	1.07
Investment opportunity	27%	0.33
Risk	1.04	0.71
Largest shareholder	35%	0.19

Model	Pooled ordinary least squares				Random effect (robust model) Regression coefficient	<i>t</i> -statistics
	Regressors	Regression coefficient	model	<i>t</i> -statistics		
Constant	0.12	1.19		-0.87	-2.45*	0.03
$E_{it}$	0.16	9.24*	0.05	2.56*	0.10	4.00*
$D_{it(1)}$	0.57	21.91*	0.008	0.06	0.75	12.91*
$CF_{it}$	0.01	0.89	0.003	0.14	0.018	0.62
$FCF_{it}$	0.02	1.21	0.001	0.28	0.02	1.03
$DEBT_{it}$	0.03	1.34	-0.03	-1.97**	0.02	0.82
$SIZE_{it}$	-0.02	-1.61***	0.10	3.01*	-0.008	-2.26**
$GR_{it}$	-0.002	-0.45	0.001	0.57	0.003	1.46
$INV_{it}$	0.03	1.62***	0.04	4.27*	0.01	1.88***
$RISK_{it}$	-0.02	-2.12**	-0.002	-0.93	-0.002	-0.26
$LARGE_{it}$	0.109	3.48*	0.15	1.83***	0.09	3.65*
Adjusted $R^2$		0.67	0.89		0.77	
<i>F</i> -statistics ( <i>P</i> -value)		152.69 (0.00)	30.80 (0.00)		193.37 (0.00)	
Durbin-Watson		2.16	2.45		2.25	

Notes: \*, \*\*, \*\*\* indicate the significance level at 1, 5 and 10%, respectively

**Table III.**  
Regression results  
for factors that affect  
dividend policy

performing well, they are able to offer greater reward to the shareholders in terms of higher dividend payment. The result is also consistent with the findings reported by prior studies such as Charitou (2000); Kowalewski *et al.* (2007); Al-Malkawi (2007); Juma'h and Pacheco (2008); Ahmed and Javid (2009); Ahmed and Javid (2009); Al-Kuwari (2010); Gill *et al.* (2010); Ramli (2010); Mehrani *et al.* (2011); Al-Shabibi and Ramesh (2011); Al-Shubiri (2011) and Imran (2011), who claimed that higher profitability firms pay larger dividends to their shareholders. On the other hand, the result contradicts the findings of Anil and Kapoor (2005), Appannan and Sim (2011) and Gill *et al.* (2010), who found that firm earnings have a negative or insignificant effect on dividend policy.

Firm size and large shareholders were found to have a positive significant influence on dividend policy. In line with agency cost theory, the larger the firm and the greater the percentage shares owned by large shareholders, the higher the dividend payment to shareholders. This is because larger firms have the potential to generate greater earning to enable higher dividend payment to the shareholders. Having a greater proportion of shares owned by large shareholders implies greater control over the management, which in a way pressures the management to ensure the shareholders' wealth is maximized by way of distributing higher dividends. The findings are consistent with Jensen and Meckling (1976); Al-Malkawi (2007); Kowalewski *et al.* (2007); Al-Kuwari (2010); Ramli (2010); Al-Shubiri (2011); Foroghi *et al.* (2011); Huda and Farah (2011); Mehrani *et al.* (2011) and Hashemi and Zadeh (2012). The result, however, contradicts the findings of Ahmed and Javid (2009); Appannan and Sim (2011) and Chen and Dhiensiri (2009).

Debt level is also a factor significantly affecting dividend policy. The result indicates that higher levels of debt lead to lower dividend payments to shareholders. This is because companies with huge debt have a greater obligation to the creditors in terms of debt repayment and interest charged. As the firms' main priority is to the creditors, the amount to be distributed to shareholders as dividends is subjected to the balance available after settling the debt obligations, which therefore leads to lower dividend payments. Similar findings were discovered by Al-Malkawi (2007); Kowalewski *et al.* (2007); Ramli (2010) and Al-Shubiri (2011). The paper also found that investment opportunity has a positive significant effect on dividend policy, which means that firms with higher investment opportunities pay higher dividends to their shareholders. Al-Malkawi (2007); Juma'h and Pacheco (2008) and Foroghi *et al.* (2011) reported consistent findings. However, the result is contrary to the findings of Ahmed and Javid (2009) and Subramaniam and Devi (2011). The result may be due to the possibility that firms with high investment opportunities have access to other external financing options and do not depend on internal earnings to finance future investment.

### **Implications, limitations and suggestions for future research**

The present study examined the factors that affect dividend policy of public listed firms in Malaysia. Using the top 200 companies listed on the Main Board of Bursa Malaysia, the study found that earnings, debt, investment opportunity, size and large shareholders significantly influence dividend policy. In particular, the results indicate that firms with higher earnings are larger in size, have a greater percentage of shares owned by large shareholder, enjoy higher investment opportunities and low debt and tend to pay higher dividends to shareholders.

The study offers useful input to the board of directors for formulating and revising dividend policy by taking into consideration the factors that have been evidenced to exercise significant influence on dividend payment. In particular, if the board of directors is considering increasing the dividend payment to shareholders, the factors of earnings, debt, investment opportunity, size and large shareholders need to be given careful attention. This is important, as the dividend policy is a crucial factor in retaining existing investors as well as attracting new investors. In addition, as high dividend payments attract investors, the management team needs to strive for higher earnings, greater investment opportunity, larger firm size and lower debt levels to satisfy the shareholders' goal of wealth maximization in the form of higher dividends.

As dividend payment is a form of reward or return to shareholders, the results of this present study also provide insights to the existing and potential shareholders in making investment decisions. Specifically, shareholders may want to invest in large companies with higher earnings and low debt and that have greater proportion of investment by large shareholders if they expect to receive higher dividends from their investment.

This study is not without its limitations. First, the present study focuses solely on Malaysian listed companies with greater market capitalization. For greater generalizability of the findings and to better reflect dividend determinants of companies in Malaysia, future research may want to include other listed companies in Malaysia. Second, the present study was based on secondary data. The use of questionnaires or qualitative studies such as interviews may provide richer data on factors that affect the dividend policy of companies. Alternatively, a combination of quantitative and qualitative methods may produce more comprehensive results. Third, in relation to large shareholders, future research may want to examine the effect of various types of ownership such as insider, financial institution or state-owned on dividend policy, as the present study determined the largest shareholder based on percentage of shares owned. Despite its limitations, this study contributes to the existing literature regarding the important issue of factors affecting dividend policy of companies in Malaysia.

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### **Further reading**

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### **Corresponding author**

Suhaiza Ismail can be contacted at: [suhaiza@jiuum.edu.my](mailto:suhaiza@jiuum.edu.my)

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