

# **Dividend Stability When Firms Distribute All Profits in Dividends\***

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## **Abstract**

We examine stability of dividend policy in a unique environment where (1) firms distribute almost 100% of their profits in dividends, (2) firms are highly levered mainly through bank loans, (3) firms are owned by a small number of investors who have controlling interests, (4) and there is variability in cash dividend payments. These factors suggest a diminished role of dividend stability in Oman. Our results show that the speed of adjustment differs substantially between financial and non-financial firms. Specifically we find that non-financial firms adopt a policy of smoothing dividends while financial firms have unstable dividend policies. This instability of dividends do not support the predictions suggested by the agency theory and the variability of dividend payments in Oman.

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## 1. Introduction

Dividend policy remains to be one of the most controversial and puzzling issues in corporate finance. Miller and Modigliani (1961) (M&M) laid the theoretical foundation of dividend policy research. They asserted that in perfect markets, dividend policy has no impact on firms' value. In doing so, they assumed that the firm's investment is fixed so all positive net present value projects will be financed regardless of dividend policy. Higher dividend payout ratios lead to a lower retained earnings and capital gains, and vice versa, leaving shareholders wealth unaffected. Contrary to this theory, Lintner (1965) demonstrated that US companies follow an adaptive process in their dividend policies by smoothing their payouts. Specifically, Lintner documents that firms maintain target dividend payout ratio and adjust their dividend policy to this target. He also documents that firms pursue a stable dividend policy and gradually increase dividends given the target payout ratio. Brav et al. (2005) provided further support to dividend stability. They find that maintaining the dividend level is a priority on par with investment decisions for US firms. More recent empirical papers have also supported dividend stability (Roy and Cheung (1985), Kato and Lowenstein (1995), Lafer (1996), Dewenter and Warther (1998), Aivazian et al. (2003b), among others).

The majority of these studies are conducted using U.S. data. One natural question is whether these stable dividend policies are peculiar to the U.S. or they are also prominent in countries where the tax regime and/or institutional and economical characteristics are significantly different.

The purpose of this paper is to investigate stability of dividends of firms listed in the Muscat Securities Market in the year 1989 to 2004. There are several important economic and institutional features that make Oman a unique and interesting environment to examine the stability of dividend policy. First and foremost, Omani firms distribute almost 100% of their profits in dividends. This is very different from the western countries which known to distribute a moderate dividends. Since profits usually change from time to time, this may reduce the stability of dividends in Oman.

Second, Omani companies rely heavily on bank financing (Al-Yahyaee et al. (2008)). Banks usually asks for a filing of financial information in a standardized form. They also conduct regular visits to the sites so they become familiar with the company. Banks also require firms to pay the loan through monthly mortgage type installments. These practices are expected to reduce the moral hazard problem as well as in the agency costs. In this vein, Aivazian et al. (2003b) argue that dividend stability should be less important in bank centric countries like Oman. Dewenter and Warther (1998) also suggest that dividend stability may not be important for companies that rely on bank debt. Hence, the reliance of Omani firms on bank debt financing implies that dividend stability may not be important for Omani firms.

Moreover, Omani companies are owned by a small number of investors who have controlling interests. This concentration of ownership structure should reduce the agency cost between managers and shareholders. If the concentration of ownership leads to less information asymmetry between managers and shareholders, dividend stability should be less important compared to countries where companies are owned by a diverse group of investors. Both of these arguments suggest a diminished role for dividend stability in Oman.

Third, a feature of Omani listed firms is the variability in cash dividend payments. The majority of Omani firms change their dividends almost every year (Al-Yahyaee et al. (2006)). This contrasts with the practices observed in the U.S. and

other developed countries where most stocks experience relatively few changes in their dividends. In fact, Aharony and Swary (1980) find that about 87% of all firms had no change in quarterly dividend payments in the U.S. In the samples of Eades et al. (1985), and Bajaj and Vijh (1990), more than 80% of announcements involve no change in dividends. More recently, Hallock and Mashayekhi (2003) find that 80% of firms do not change their dividends in the U.S. during the period 1970-2000.

Fourth, the study will be conducted in a unique environment where there are no taxes on dividends and capital gains. Tax differentials are a major part of the dividend puzzle.<sup>1</sup> Fifth, most previous research excludes non-dividend paying firms which may create a selection bias (Kim and Maddala (1992), Deshmukh (2003), among others). We take account of the selection problem by including non-dividend paying firms. Sixth, there are some studies that report differences between stability of dividend policy of financial and non-financial firms (Naceur, Goaid, and Belanes (2005)). We examine this issue for Oman. Finally, there is no study that examines stability of dividend policy in Oman and given its unique characteristics, such a study is warranted.

Our research provides a number of interesting results on stability of dividend policy. First, we find that financial firms have unstable dividend policies. Second, we find that non-financial firms adopt a policy of smoothing dividends. This instability of dividends do not support the predictions suggested by the agency theory and the variability of dividend payments in Oman.

Hence, our results show that the speed of adjustment differs substantially between financial and non-financial firms. These findings show that there are differences in dividend policies between the Omani companies and those in developed markets. Consequently, potential investors in the Omani market should be aware about these differences in making their investment decisions.

The remainder of the paper proceeds as follows. Section 2 describes the Lintner Model. Section 3 describes the institutional aspects of the Omani stock market. Section 4 describes the data and presents summary statistics for the payment of dividends, and reports some descriptive statistics for the sample. In section 5 we examine the stability of dividends using the Lintner model. Section 6 concludes the paper.

## 2. The Lintner Model

In a frequently cited study, Lintner (1956) develops a quantitative model to test for the stability of dividend policy where he hypothesizes the following relationship between dividends and earnings:

$$D^*_t = rE_t, \quad (1)$$

where  $D^*_t$  is the target level of dividends for any year  $t$ ,  $r$  is the target payout ratio, and  $E_t$  is the firm's net earnings in year  $t$ . In addition, Lintner (1956) also predicts that a firm will only partially adjust to the target dividend level in any given year, so the change in dividend payments from year  $t-1$  to year  $t$  is given by:

$$D_t - D_{t-1} = \alpha + c(D^*_t - D_{t-1}) + u_t \quad (2)$$

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<sup>1</sup> See Aivazian et al. (2003a) for a discussion on the role of bank debt in reducing the agency cost. Fleming, Heaney, and McCosker (2005) also provide a discussion of the benefits of debt financing in alleviating the agency problem.

where  $\alpha$  is the intercept term,  $c$  is the speed of adjustment coefficient,  $u$  is the error term,  $D^*_t$  is the target dividend payment in period  $t$ ,  $D_t$  is the actual dividend payment in period  $t$  and  $D_{t-1}$  is the actual dividend payments in period  $t-1$ .

Substituting  $rE_t$  for the target dividend payment ( $D^*_t$ ) in equation (2), we arrive at the following model,

$$D_t - D_{t-1} = \alpha + \beta_1 E_t + \beta_2 D_{t-1} + u_t \quad (3)$$

where  $\beta_1 = cr$  and  $\beta_2 = -c$ .

The constant term ( $\alpha$ ) is expected to have a positive sign “to reflect the greater reluctance to reduce than to raise dividends” Lintner (1956, p. 107). The speed of adjustment coefficient ( $c$ ) reflects that stability of dividends and measures the speed of adjustment toward the target payout ratio ( $r$ ) in response to earnings changes. The value  $c$  reflects the dividend smoothing behaviour of firms to changes in the level of earnings. A higher value of  $c$  indicates less dividend smoothing and vice versa. Thus, a conservative firm will have a lower adjustment rate, while a less conservative firm will have a higher adjustment rate.

As shown by Lintner, equation (3) can be rewritten as:

$$D_t = \alpha + crE_t + (1 - c)D_{(t-1)} + u_t \quad (4)$$

This model implies that firms set their dividends in accordance with current level of earnings, and that changes in dividends do not correspond exactly with the changes in earnings.

To test whether dividend policy in Oman is stable, we follow Fama and Babiak (1968) and use earnings per share (EPS) and dividends per share (DPS) rather than total earnings as follows:

$$DPS_t = \alpha + \beta_1 DPS_{t-1} + \beta_2 EPS_t + u_t \quad (5)$$

where  $DPS_t$  is the dividend per share for period  $t$ ,  $EPS_t$  is the earning per share for period  $t$ , and  $u$  is the error term. Fama and Babiak argue that per share data are more appropriate for this test than the aggregate data used by Lintner. Indeed, almost all studies conducted since Lintner’s study employ per share data rather than aggregate data. This model has been used by many scholars to examine the stability of dividends such as Brittan (1964, 1966), Fama and Babiak (1968), Fama (1974), Dewnter and Warther (1998), Adaoglu (2000), Aivazian et al. (2003a), Omet (2004), Naceur et al. (2005), among others.

Lintner’s model has been used by many studies in different countries including Chateau (1979) in Canada, Shevlin (1982) in Australia, McDonald et al. (1975) in France, Leither and Zimmermann (1993) in West Germany, UK, France, and Switzerland, Ariff and Johnson (1994) in Singapore, Lasfer (1996) in UK, Dewenter and Warther (1998) in Japan and US, Adaoglu (2000) in Turkey, Pandey (2003) in Malaysia, Stacescu (2004) in Switzerland, Naceur et al. (2005) in Tunisia, and Al-Malkawi (2005) for Jordan. Benartzi et al. (1997, p. 1032) conclude that “...Lintner’s behavioral model of dividends remains the best description of the dividend setting process available”.

### 3. Oman Stock Market: Institutional Aspects

#### 3.1. Trading Rules and Practices

Trading in the MSM was computerized in 1997. MSM is a pure auction market where trades are facilitated through brokerage firms. It is very different from the NYSE in that there are no specialists or market makers. Trading in the market is conducted by stockbrokers, who can not trade on their own account, which means that

they have no role in setting cum- and ex-day prices. Orders are initiated from brokerage firms via computer terminals in their offices or on the exchange floor. Brokerage firms match buy and sell orders. Investors intending to buy or sell stocks execute their transactions through these brokerage firms that charge them a commission or transaction fees. The minimum fee that can be charged by a brokerage firm is 0.4% and the maximum is 0.75% (0.015% of the fee is revenue for the MSM).

As Oman is a petroleum producing country, taxes play a minor role in generating income for the economy. As a result, shareholders are not subject to any taxes on dividends. Likewise, there are no taxes on capital gains. The only taxes are the 12% flat tax rate on corporate income. This makes Oman taxing system one of the simplest in the world.

### **3.2. Dividends**

Firms listed at the MSM distribute dividends in two forms namely, cash dividends and stock dividends. Paying dividends in one form or another is not compulsory. If the board of directors proposes to distribute dividends, the details must be published in the daily newspapers. The proposed dividend is subject to the final approval of shareholders at the Annual General Meeting (AGM). Generally, most dividend propositions are accepted at the AGM as the board of directors usually represents the majority of the share capital. The date when the AGM is held is the record date. Investors whose names are recorded as stockholders on this date are entitled to receive the declared dividend. The following date is the ex-dividend date. Firms usually pay dividends once a year. Some firms complement their cash dividends with stock dividends.

## **4. Data**

The data for this study are obtained from “Share-Holding Guide of MSM Listed Companies” published by the MSM. As the data were available in hard copy only, the first task was to input the data into a computer database. The data set comprise all publicly traded firms listed at the MSM. In the sample, firms come from all four sectors that comprise the MSM namely, financial and banking sector, service sector, industry sector, and insurance sector. We split this sample into financial and non-financial firms. Financial firms include banks, insurance, leasing, and investment holdings while non-financial firms include industrial and service firms such as poultry, fisheries, agriculture, oil, and manufacturing firms.

The number of firms included in the study changes from one year to another, with a range from 14 to 37 for financial firms and a range from 32 to 107 for non-financial firms. This results in a data set of an unbalanced panel containing 413 firm-year observations for financial firms and 1,057 firm-year observations for non-financial firms. The fact that we are using panel data gives “more informative data, more variability, less collinearity among the variables, more degrees of freedom and more efficiency” (Baltagi (2001, p.6)).

These data are time series cross-sectional variables which are collected over the entire life of the MSM from 1989 to 2004. We check the accuracy of the data by comparing the figures from the MSM Guide with the data from the firm’s financial statements available on the internet, where possible.

The empirical literature on stability dividend policy has largely ignored firms that do not pay dividends. If value-maximizing firms choose not to pay dividends, a

sample that contains only dividend paying firms will be subject to a selection bias. An econometric analysis of such a sample will yield biased and inconsistent estimates. To address this selection bias, we use both dividend-paying and non-dividend paying firms. In this vein, Kim and Maddala (1992) demonstrate that it is important to allow for zero observations on dividends in the estimation of models of dividend behaviour. Likewise, Deshmukh (2003, p. 353) states “If firms find it optimal to not pay dividends, then their exclusion from any empirical analysis may create a selection bias in the sample, resulting in biased and inconsistent estimates of the underlying parameters”.<sup>2</sup>

#### **4.1. Estimation Model**

We examine the stability of dividend behaviour in Oman using the Lintner model. Since there are some firms in Oman that do not pay dividends, this creates a censoring problem which needs to be addressed in estimating the Lintner model. In this case, previous research suggested the use of the Tobit model (Anderson (1986), Kim and Maddala (1992), and Huang (2001a, 2001b)). We use a Tobit model to test the stability of dividends in Oman.<sup>3</sup>

#### **4.2. Payment of Dividends**

Omani firms tend to attract investors by distributing large dividends. Most of the profitable Omani firms distribute dividends as a means of rewarding investors for holding their securities. Stock repurchase is a rare phenomena in Oman, however some firms supplement their cash dividends distributions with stock dividends.<sup>4</sup>

In Oman, most profitable companies distribute 100% of their profits as cash dividends. This led the CMA to issue a circular (number 12/2003) arguing that firms should retain some of their earnings for “rainy days”. This circular also requires firms to have a clear policy of dividends and to disclose it in their financial reports. With this regard, the circular states that

*“...studies have shown that the majority of Omani public joint stock companies currently operate with a dividend cover of 100% of its available profits assigned to dividends...We are all required to set out a clear cut dividend policy with a view to the long term expansion of the company by striking the right mix to meet both good housekeeping practice (retention of some earnings appropriate to the economic conditions) and the understandable desire of shareholders for immediate returns. CMA calls upon public joint stock companies to adopt prudent policies in cash dividends and to disclose the same in the annual report of the board of directors attached to the financial statements.”*

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<sup>2</sup> For further information on this issue, see Anderson (1986) and Kim and Maddala (1992).

<sup>3</sup> As a robustness check, we also use a random effects tobit regression. The tobit and random effects tobit results are very similar for financial firms. For non-financial firms, the random effects tobit regression shows a more rapid speed of adjustment than the tobit. Still, the results indicate that the lagged dividend per share is more important than the current earnings per share in determining the current dividend per share.

<sup>4</sup> It is possible for Omani companies to buy back their shares provided that they submit an application to the CMA where they have to list the reasons for buying back their shares.

**Table 1. Dividend Payout Ratio for All, Financial, and Non-Financial Firms over the Period 1989-2004.**

The table presents the mean and the standard deviation for firms listed at the MSM for each year from 1989-2004. Furthermore, the table also shows the mean and standard deviation for financial and non-financial firms during the same period. In panel A, we present the results for all firms including both dividend paying and non-paying firms. In panel B, we report the results for dividend paying firms.

**Panel A: All Firms**

Year	All		Financials		Non-Financials	
	Mean	StDev	Mean	StDev	Mean	StDev
1989	42%	44%	47%	30%	40%	48%
1990	66%	205%	94%	279%	36%	42%
1991	43%	43%	49%	47%	39%	41%
1992	47%	82%	32%	39%	55%	96%
1993	134%	701%	46%	35%	171%	837%
1994	52%	85%	45%	34%	56%	98%
1995	41%	55%	49%	49%	39%	58%
1996	39%	75%	37%	35%	40%	87%
1997	32%	46%	19%	30%	37%	51%
1998	29%	177%	20%	31%	32%	206%
1999	29%	162%	25%	59%	30%	186%
2000	63%	400%	24%	49%	76%	466%
2001	35%	181%	15%	30%	42%	209%
2002	49%	249%	33%	52%	54%	289%
2003	34%	142%	60%	142%	25%	141%
2004	57%	262%	58%	139%	56%	295%
Overall period	46%	182%	41%	67%	48%	197%
Observations	1514		437		1077	

**Panel B: Dividend Paying Firms**

Year	All		Financials		Non-Financials	
	Mean	StDev	Mean	StDev	Mean	StDev
1989	70%	35%	60%	19%	76%	41%
1990	117%	263%	149%	343%	72%	30%
1991	71%	33%	80%	32%	66%	33%
1992	86%	94%	72%	18%	91%	111%
1993	225%	902%	65%	20%	312%	1121%
1994	90%	95%	62%	22%	106%	115%
1995	76%	54%	70%	44%	80%	60%
1996	73%	90%	58%	26%	81%	110%
1997	63%	48%	43%	32%	70%	51%
1998	159%	394%	55%	25%	281%	571%
1999	185%	378%	96%	81%	258%	504%
2000	256%	787%	70%	62%	371%	991%
2001	130%	333%	49%	37%	166%	396%
2002	122%	385%	55%	58%	166%	492%

2003	86%	218%	123%	187%	69%	232%
2004	151%	412%	138%	189%	157%	481%
Overall period	122%	283%	78%	75%	151%	334%
Observations	806		261		545	

As with other Arab countries, Omani investors seem to prefer to receive periodic income in the form of dividends (Bolbol and Omran (2004)). For the entire sample, Panel A of Table 1 shows that the average payout ratio is around 46%. When the zero dividend observations are removed, the average payout ratio increases considerably to 122% (Panel B). This is much higher than the payout ratio reported by Fazzari, Hubbard, and Petersen (1988), Kaplan and Zingales (1997), and Aivazian et al. (2006) samples of US firms. It is also higher than 23.3% reported by Chen and Dhiensiri (2005) for New Zealand. Note that the payout ratio for non-financial firms is higher than that for financial firms. The standard deviation of the payout ratio exhibits a similar pattern.

## 5. Empirical Results

We estimate the Lintner model for both financial and non-financial firms. For both, we find the lagged DPS and EPS are statistically significant with a positive sign. The constant term for both financial and non-financial firms is negative and significant indicating that Omani firms are not reluctant to cut dividends.<sup>5</sup> The major results obtained from the analysis are that the speed of adjustment differs substantially between financial and non-financial firms. While we find that non-financial firms adopt a policy of smoothing dividends, this is not the case for financial firms. In fact, we find that financial firms do not have a stable dividend policy.<sup>6</sup> We evaluate the explanatory power of the model via the Wald test and we find that for both financial and non-financial firms the chi-square is significant at the one percent level. We next review the Lintner model for financial and non-financial firms in more detail.

### 5.1. Non-Financial Firms

The results presented in Table 3 show that both the coefficients on lagged DPS and EPS are statistically significant with a positive sign. But the generally higher coefficient and the associated *t*-statistic of the lagged DPS imply the greater importance of past dividend in deciding the dividend payment. These results are consistent with Lintner and suggest that the lagged DPS and EPS are important factors that affect the decision to pay dividends. The coefficient on the constant is also statistically significant with a negative sign. This indicates that Omani firms are not reluctant to cut dividends, inconsistent with Lintner (1956).

<sup>5</sup> The negative constant reported in this paper is consistent with the results documented by Kim and Maddala (1992), Huang (2001a, 2001b), and Al-Malkawi (2005) who utilize Tobit regression to estimate the Lintner model.

<sup>6</sup> Aivazian et al. (2006) show that the type of corporate debt plays an important role in determining the firms' dividend policy. In particular, they find that firms with access to public debt market are more likely to pay dividends and subsequently to follow a smoothing dividend policy than firms that rely on bank debt.

The objective of using the Lintner model in this paper is to examine whether Omani firms follow stable dividend policies. Consequently, we are interested in the speed of adjustment. The speed of adjustment reflects how quickly the firms adjust dividends towards the target ratio; the higher the speed of adjustment, the less the smoothness, and the less stability in dividends. In our case, the speed of adjustment is 0.2535 which indicates that Omani *non-financial firms* do smooth their dividends. This is close to the value of 0.30 obtained by Lintner for the US. Recently, Brav et al. (2005) find that the mean speed of adjustment for US companies with valid Compustat data is 0.67, 0.4, and 0.33 for the 1950-1964, 1965-1983, and 1984-2002 periods, respectively. Our estimate is lower than that for the first period and close to those reported for the other two periods in Brav et al. Likewise, our speed of adjustment is similar to the 0.25 documented by Goergen, Renneboog, and Correia da Silva (2004) for Germany. However, it is lower than the 0.66 reported by Stacescu (2004) for Switzerland. For emerging markets, our speed of adjustment is much lower than the 0.71 obtained by Pandey and Bhat (2004) for India. It is also considerably lower than the 0.52 documented by Omet (2004) for Jordan and the 1.00 reported by Adaoglu (2000) for Turkey.

**Table 3. Lintner Model Estimates for Non-Financial Firms**

We estimate Tobit regression for all non-financial firms listed at the MSM over the period 1989-2004. The dependent variable is the dividend per share. The explanatory variables are the lagged DPS and the current EPS. The table shows the variable, their coefficients, and their corresponding *t*-statistics.

Variable	Coefficient	T-Statistic
C	-0.4121***	-13.1435
DPS <sub>1</sub>	0.7465***	14.6388
EPS	0.1767***	6.4442
No of Observations		969
Log Likelihood		-579.9871
Wald Test [ $\chi^2$ (2)] <sup>a</sup>		238.0600
P-value		0.0000

\*, \*\*, and \*\*\* represents significance at the 10, 5, 1 percent levels, respectively.

<sup>a</sup> The number in parenthesis is the degrees of freedom.

Another variable of interest is whether Omani non-financial firms have a target payout ratio or not. Lintner (1956) hypothesizes that firms set a long-term target payout ratio and move gradually towards the target. We calculate the target payout ratio and find that Omani non-financial firms have a target payout ratio of 0.6970.<sup>7</sup> This value is higher than the 0.50 reported by Lintner for the US. It is also higher than the 0.459 documented by Fama and Blahnik (1968).

**5.2. Financial Firms**

We re-estimate the Lintner model on our sample of financial firms. The results are reported in Table 4. Similar to the results obtained for non-financial firms, we find that the coefficient on the lagged DPS and ESP are statistically significant with a positive sign. The coefficient on the constant is also significant and negative

<sup>7</sup> We calculate the target payout ratio as (the coefficient on EPS divided by the speed of adjustment).

indicating that financial firms are not reluctant to cut dividends. However, the speed of adjustment is much higher for financial firms with a value of 0.9412. This indicates that Omani *financial firms* do not smooth their dividends. Rather, they change their dividends frequently. In short, Omani financial firms do not follow a stable dividend policy. With regard to the target payout ratio, it is around 0.5668. This finding indicates that financial firms do have a target dividend payout ratio that they move quickly towards.

In sum, there is a major difference concerning the stability of dividends between financial and non-financial firms. Financial firms do not follow a stable dividend policy while non-financial firms smooth their dividends. Regarding the reluctance to cut dividends, both financial and non-financial firms are not reluctant to cut dividends.

#### **Table 4. Lintner Model Estimates for Financial Firms**

We estimate Tobit regression for all financial firms listed at the MSM over the period 1989-2004. The dependent variable is the dividend per share. The explanatory variables are the lagged DPS and the current EPS. The table shows the variable, their coefficients, and their corresponding *t*-statistics.

Variable	Coefficient	T-Statistic
C	-0.1457***	-7.3644
DPS <sub>-1</sub>	0.0588***	2.7855
EPS	0.5335***	46.8658
Observations		377
Log Likelihood		-142.8506
Wald Test [ $\chi^2$ (2)] <sup>a</sup>		509.3700
P-value		0.0000

\*, \*\*, and \*\*\* represents significance at the 10, 5, 1 percent levels, respectively.

<sup>a</sup> The number in parenthesis is the degrees of freedom.

## **6. Conclusion**

We investigate stability of dividend policy in a unique environment where firms distribute almost 100% of their profits in dividends and firms are highly levered. We use a panel data on a sample of Omani firms and take account of the zero observations using Tobit models.

We find that the speed of adjustment differs substantially between financial and non-financial firms. In particular, we find that financial firms adopt a policy of smoothing dividends. On the other hand, our results show that financial firms do not have stable dividend policies. This instability of dividends do not support the predictions suggested by the agency theory and the variability of dividend payments in Oman.

The findings of this study show that there are differences in dividend policies between the Omani companies and those in developed markets. Potential investors in the Omani market should be aware about these differences in making their investment decisions. This study also highlight the need for further research in order to examine whether these results have any effect on the information signaling power of the dividend announcements of Omani firms.

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