

Dividend Policy in the Perspective of Agency Theory: The Role of Earnings Management, IOS, and Solvency

Muhammad Azzam Firdaus Hemawan^{1*}

Universitas Pembangunan Nasional Veteran Jawa Timur, Surabaya, Indonesia

[*21012010206@student.upnjatim.ac.id](mailto:21012010206@student.upnjatim.ac.id)

Abstract. This study aims to explore the role of Agency Theory in explaining dividend policy by considering internal firm factors such as earnings management, investment opportunity set (IOS), and solvency. Agency Theory explains that agency conflicts between managers and shareholders may generate agency costs, which can be mitigated through dividend policy. This study employs a literature review approach by analyzing academic articles published in both national and international. The findings indicate that dividend policy serves as an important mechanism to reduce agency conflicts by limiting free cash flow in the hands of managers while also providing positive signals to shareholders. The literature highlights that earnings management has a complex relationship with dividend policy; on the one hand, it may distort the basis for dividend distribution, but dividends can also constrain earnings manipulation. IOS generally reduces dividend payouts as firms prefer to retain earnings for investment, although in certain contexts dividends are also used as a signaling tool for growth prospects. Meanwhile, solvency shows varying effects depending on financial conditions and industry characteristics. Overall, this study confirms that dividend policy is not a stand-alone decision but rather the outcome of the interaction between Agency Theory, internal firm factors, and governance mechanisms. The study contributes theoretically by reinforcing the conceptual understanding of dividends as a governance instrument, and provides practical implications for managers, investors, and regulators in formulating effective financial strategies.

Keywords: Agency Theory, Earnings Management, Investment Opportunity Set (IOS), Solvency

I. Introduction

Agency Theory is one of the fundamental theories in finance that explains the contractual relationship between the capital owner (principal) and the manager (agent). Jensen & Meckling (1976) introduced this framework by emphasizing that the separation of ownership and control creates potential conflicts of interest. Owners seek to maximize firm value and returns, while managers often have preferences for short-term goals or personal interests, such as bonuses, reputation, or workplace comfort. This conflict is exacerbated by information asymmetry, a condition in which managers have greater access to internal information than shareholders (Mursyidin, 2023).

In modern financial literature, agency conflicts give rise to agency costs, namely costs incurred from efforts to mitigate, monitor, or as a direct consequence of agents' opportunistic behavior. Eisenhardt (1989) classified agency costs into three categories: monitoring costs (incurred by owners), bonding costs (incurred by managers to assure owners), and residual loss (losses resulting from managerial decisions not fully aligned with owners' interests). Recent studies affirm that agency costs remain a critical issue in corporate governance. For example, Lailiyah & Abadi (2021) found that high agency costs are associated with variations in financial policies, including dividend payment decisions, in Indonesian manufacturing firms.

Agency Theory also highlights the role of corporate governance in mitigating conflicts of interest. Mechanisms such as independent boards of directors, audit committees, and ownership structures have been shown to constrain managers' opportunistic behavior. Anggraini et al. (2023), for instance, found that audit committee expertise can strengthen the relationship between earnings management and dividend policy, thereby reducing agency costs arising from the manipulation of accounting information. This finding underscores the importance of effective internal controls in how firms manage principal-agent conflicts.

Within this framework, dividend policy is considered an important mechanism to reduce agency conflicts. By distributing dividends, firms directly limit the cash at managers' disposal, thereby reducing the likelihood of overinvestment or the misuse of funds for personal purposes. Dividend policy also serves as a form of managerial commitment to maintaining investor trust and reducing information asymmetry between agents and principals (Trinh et al., 2022).

However, dividend decisions are not solely influenced by agency conflicts but also by various internal firm factors. Earnings management may distort earnings perception, which serves as the basis for dividend distribution (Ben Amar et al., 2018). The investment opportunity set (IOS) reflects the firm's funding needs for growth, which can suppress dividend payouts (Salim & Widodoatmojo, 2023). Meanwhile, solvency relates to the firm's long-term obligations, which also constrain its flexibility in paying dividends (Prayogo et al., 2021). Therefore, this study seeks to conceptually examine how Agency Theory can explain the relationship between these factors and dividend policy, with the aim of enriching the financial literature

while providing practical insights for managers and investors in formulating more effective financial strategies.

II. Literature Review

Agency Theory and Dividend Policy

Agency Theory emphasizes the existence of conflicts of interest between shareholders and managers due to differing objectives and asymmetric information (Jensen & Meckling, 1976). In the context of dividend policy, the theory explains that dividend payments serve to reduce the free cash flow controlled by management, thereby limiting the likelihood of investing in projects that are unprofitable or merely beneficial to the agent. A recent study by Trinh et al. (2022) shows that dividend policy remains an important mechanism in reducing agency costs in firms operating in emerging markets. Another study by Makadao & Saerang (2021) also found that the dividend payout ratio is often used as a tool to maintain investor trust while simultaneously mitigating principal-agent conflicts.

Earnings Management and Dividend Policy

Earnings management is one of the opportunistic behaviors described in Agency Theory, where managers manipulate financial statements to achieve specific objectives. Its relationship with dividend policy has been examined in various studies, but the results remain mixed. Ben Amar et al. (2018) found that earnings management has a positive effect on dividend policy in non-financial firms in France. Similar results were obtained by Javaid et al. (2024), who showed a positive relationship in more than 20 countries. However, the study by Chandra & Junita (2021) in Indonesia revealed that earnings management does not have a significant effect on dividend policy. These differences highlight a research gap that requires further investigation across different literature and contexts.

Investment Opportunity Set (IOS) and Dividend Policy

IOS reflects the extent to which a firm has future investment opportunities, which can influence dividend decisions. Firms with high IOS tend to retain earnings to finance growth projects, thereby reducing dividend payouts. Studies by Salim & Widoatmojo (2023) and Yani & Maharani (2022) found a negative relationship between IOS and dividend policy in Indonesian companies. However, Desliana Sinukaban et al. (2024) reported different findings, showing that IOS actually has a positive effect on dividends. This inconsistency indicates the presence of other factors, such as corporate governance or firm size, which may moderate the relationship between IOS and dividend policy.

Solvency and Dividend Policy

Solvency describes a firm's ability to meet its long-term obligations. From the perspective of Agency Theory, a high level of debt strengthens creditor monitoring, which may restrict dividend payments. Prayogo et al. (2021) stated that solvency has a negative effect on dividends because highly leveraged firms tend to focus on maintaining their ability to meet obligations. Conversely, Rajali et al. (2025) found that solvency actually has a positive effect on dividend policy in certain firms, as sound solvency enhances investor confidence and enables profit distribution. These differences indicate contextual variations in the relationship between solvency and dividends.

Synthesis of Literature Review

Based on the literature review, it can be concluded that the relationship between Agency Theory, earnings management, IOS, and solvency with dividend policy still yields diverse findings. On the one hand, dividends have been proven to be an effective mechanism for reducing agency conflicts. On the other hand, internal firm factors influence the extent to which dividends are utilized as a governance instrument. The inconsistencies across studies open opportunities for deeper conceptual examination of how these three factors interact within the framework of Agency Theory, particularly in the context of modern corporations.

III. Research Method

This study employs a literature review approach to examine the relationship between Agency Theory and internal firm factors, namely earnings management, investment opportunity set (IOS), and solvency, in influencing dividend policy. This approach was chosen because the topic under study has produced diverse empirical findings, thus requiring a conceptual analysis to strengthen theoretical understanding (Mursyidin, 2023; Prayogo et al., 2021).

The literature sources were drawn from both national and international journal articles indexed in Sinta, Scopus, Web of Science, Emerald Insight, ScienceDirect, and Google Scholar. The selection criteria

included: (1) articles discussing Agency Theory, dividend policy, or related internal factors, (2) articles published in peer-reviewed journals, and (3) articles relevant to the context of corporate finance.

The analysis was conducted through thematic synthesis, grouping the literature based on main themes: the application of Agency Theory in dividend policy, the influence of earnings management on dividends from the perspective of Agency Theory, the relationship between IOS and dividends from the perspective of Agency Theory, and the role of solvency in dividend policy from the perspective of Agency Theory. Using this method, the study aims to provide a comprehensive conceptual synthesis while also opening opportunities for future empirical research.

IV. Results and Discussion

Dividend Policy in Agency Theory

Several recent studies increasingly emphasize the role of dividend policy as an important mechanism within the framework of Agency Theory. Trinh et al. (2022) found that financial reporting quality has a positive relationship with dividend policy, particularly in firms with high free cash flow problems. This indicates that financial transparency can reduce the likelihood of managers engaging in opportunistic behavior while strengthening the role of dividends as a tool to control agency conflicts. Furthermore, Rodrigues et al. (2020) demonstrated that corporate governance mechanisms, such as board effectiveness and ownership structure, have a significant influence on dividends. Firms with strong governance tend to pay higher dividends because investor trust can be maintained without creating conflict risks for managers. A literature review by Mursyidin (2023) also reinforces these findings, highlighting that ownership structure, profitability, debt, and free cash flow are determinants of dividend policy from the perspective of Agency Theory. Overall, these results affirm that dividend policy functions not only as a distribution of profits but also as a governance instrument capable of reducing agency costs through enhanced transparency, cash control, and strengthened ownership structure.

Earnings Management and Dividend Policy in the Perspective of Agency Theory

Several recent studies emphasize that earnings management has a complex relationship with dividend policy within the framework of Agency Theory. Javaid et al. (2024), in a cross-country study (2005–2017), revealed that the higher the practice of earnings management, the greater the dividend payout ratio. However, this relationship can be mitigated by board independence, which serves as a strong corporate governance mechanism. Meanwhile, Hussain & Akbar (2022), using a sample of Chinese firms, showed that dividend payments generally reduce earnings management practices, particularly in financially unconstrained firms, indicating that dividends can limit managers' opportunistic behavior. Lastly, Ben Salah & Jarbouï (2024) found a two-way causal relationship between dividend policy and earnings management in French firms, meaning that not only can earnings management influence dividends, but dividends may also drive earnings management practices. This highlights that both factors can reinforce or trigger each other in managing agency conflicts and shaping market signals or perceptions.

According to Agency Theory, managers have incentives to manipulate earnings reports to support dividend payments, either to signal the firm's performance or to influence investor perceptions. However, when governance mechanisms (such as independent boards) are strong, this effect can be restrained (Javaid et al., 2024). Conversely, dividend distribution can also serve as a "natural control" over earnings management, as evidenced by findings in the Chinese market (Hussain & Akbar, 2022). The study in France (Ben Salah & Jarbouï, 2024) further adds complexity by showing a reciprocal relationship between dividends and earnings management, demonstrating that their interaction may either reinforce or counteract one another in the context of controlling agency conflicts.

Investment Opportunity Set (IOS) and Dividend Policy in the Perspective of Agency Theory

Several recent studies highlight the role of IOS as a determinant of dividend policy within the framework of Agency Theory. Zulfatul Ifadah & Setyo Witiastuti (2021) found that IOS has a significant negative effect on dividend policy in Indonesian manufacturing firms, indicating that companies with high investment opportunities tend to retain earnings to finance growth rather than distribute them as dividends. Furthermore, Hapsari & Aprilia (2023) showed that the dividend payout ratio (DPR) acts as a mediator between IOS and firm value, meaning that the relationship between investment opportunities and firm performance is influenced by dividend decisions. Lastly, in a systematic review, Raza et al. (2020) found that IOS is one of the key factors that consistently affect dividend policy across various studies, reinforcing the relevance of IOS in dividend policy dynamics.

According to Agency Theory, firms with many investment opportunities (high IOS) tend to retain earnings to fund growth projects, thereby reducing dividend payments (Zulfatul Ifadah & Setyo Witiastuti,

2021). However, how dividends are managed—whether distributed or retained—has an impact on firm value itself, with DPR serving as a link between IOS and firm performance (Hapsari & Aprilia, 2023). In addition, broad literature reviews show that the relationship between IOS and dividend policy is not merely theoretical but has been tested in many empirical and conceptual studies, thereby reinforcing Agency Theory as a strong analytical framework (Raza et al., 2020).

Solvency and Dividend Policy in the Perspective of Agency Theory

Several recent studies highlight how solvency (a firm's ability to meet long-term obligations) plays an important role in dividend policy through the lens of Agency Theory. Rajali et al. (2025) reported that solvency (measured using DER) has a significant effect on dividend policy in the mining sector, with financially healthier firms tending to distribute larger dividends due to investor confidence in financial stability. Meanwhile, Rumintan & Herninta (2024) concluded that in the primary consumer goods industry, solvency (DER) does not show a significant effect on the dividend payout ratio (DPR), although DPR variance can be explained by other factors such as liquidity and profitability. In addition, Sirait et al. (2025) stated that although solvency alone does not have a significant effect on dividend policy in IDX-listed property companies, collectively—together with firm size and profitability—solvency contributes significantly to explaining variations in dividend policy.

Within the framework of Agency Theory, solvency influences dividend policy because it relates to the firm's ability to balance long-term obligations with profit distribution. Some studies show that firms with sound solvency are more flexible in paying dividends, reflecting investor confidence (Rajali et al., 2025). However, its impact is not always direct, as other factors such as liquidity, profitability, or market structure may offset the effect of solvency (Rumintan & Herninta, 2024). In other cases, solvency contributes within models that include other variables, even though it is not significant on its own (Sirait et al., 2025).

V. Conclusion

This study explains that dividend policy is one of the key mechanisms within the framework of Agency Theory to reduce agency conflicts by limiting free cash flow under managerial control and serving as a positive signal to shareholders. The literature review findings indicate that the influence of internal firm factors on dividend policy is neither singular nor consistent. Earnings management has been shown to have a complex relationship with dividend policy; on the one hand, earnings manipulation can distort the basis for dividend distribution, yet dividends can also act as a natural control to restrict managers' opportunistic behavior. The investment opportunity set (IOS) generally suppresses dividend distribution because firms with high investment opportunities prefer to retain earnings for expansion, although under certain conditions, dividends are still used as a signal of growth prospects. Meanwhile, solvency shows mixed results: firms with sound solvency tend to pay higher dividends due to increased investor confidence, but in certain sectors or contexts, high solvency actually constrains dividend distribution to safeguard long-term obligations.

Overall, these findings reinforce that dividend policy does not stand alone but is the outcome of the interaction between Agency Theory, internal firm factors, and governance mechanisms. The conceptual contribution of this study is to broaden the understanding that dividends play a dual role—not only as a profit distribution tool but also as a governance instrument to reduce agency costs. From a practical perspective, this research highlights the importance of strong corporate governance in ensuring that dividend policy can function optimally as a control mechanism. This implies that managers need to balance short-term interests in dividend distribution with the firm's long-term needs, such as investment funding and debt obligations. For investors, the findings can serve as a reference for assessing a firm's health and governance quality through its dividend policy patterns. On the other hand, for regulators and policymakers, the results underline the importance of strengthening transparency and financial reporting practices so that dividend policy truly reflects the company's fundamentals. Furthermore, this study opens opportunities for future research, for instance through cross-country or cross-industry empirical approaches to address past inconsistencies, or through meta-analysis methods that can provide a more comprehensive overview of the relationship between Agency Theory, internal factors, and dividend policy.

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