

The various types of dividend policies used by companies



Dividend policy has drawn due attention from various researchers. One of the most famous studies in this respect is Miller and Modigliani hypothesis (1961), which asserted that the cash dividend policy is not important because it has no effect on the company's value, and as such it does not affect the company owners' wealth. This is due to the fact that companies follow a Residual Dividend Policy which is based on reinvestment of corporate profits in the available investment opportunities (Van Horne 1983; Arnold 2008) with positive net present value and distribution the surplus cash as a cash dividend to shareholders.

The above hypothesis aroused a lot of controversy on the part of researchers. However, the most important study that opposed it is that of Partington (1985) which claims that the companies do not follow – in practice – the residual dividend approach as the dividend decisions taken independently from the investment policy. Right now, controversies continue among researchers based on the subject without arriving at any decisive results

This chapter will study the public dividend policy to shareholders, which is considered to be one of the most important financial decisions, in view of its direct relationship to shareholders and financing decisions and investment in the company. The chapter will also cover the alternatives to be addressed consisting of general dividend policy and theories that linked the cash dividend policy with the company market value, and therefore the company owners' wealth in addition to the share dividend policy and buying back policy, besides the cash dividend policy and its relationship with the investment policy

<https://assignbuster.com/the-various-types-of-dividend-policies-used-by-companies/>

2-2 General Dividend Policy

The Company Board suggests distribute dividend to shareholders in an annual meeting (Watson and Head 2004). The main interest is to suggest acceptance and secure fair dividend for shareholders consistent with the rate of dividend decided by the company management. Therefore, in preparing dividend distribution, the managers do not look only for current year profit, but they, instead, will look for the future earnings expected, and hence for the ability of the company to maintain a stable rate of dividend taking into consideration the systematic growth of this ratio. On their part, the investors are aware of this truth, and they look for a profit increase in a positive vision expecting throughout a stability of the future dividend. When the company achieves high profits for a particular year and do not expect the same level of profit for next years, they will make normal dividend and give additional dividend so as not to disappoint the investors hopes in the future. The profits are then divided into two dividends, a normal and an incremental dividend, to make notification to investors that this type of dividend is unexpected and would not continue in the future (Levy and Sarnat 1994).

There are several alternatives for the profits dividend. The company may either distribute the profits in the form of regular cash dividends, or it may distribute profits in the form of shares dividends to shareholders. However, the above two types may be distributed at the same time. Besides that, shareholders can also obtain profits when the company tends to repurchase its shares, and considers the regular cash dividend as something quite common (Broyles 2003).

The percentage of the profits distributed by the company is typically governed by several considerations. In addition to the law which prohibits the distribution of profits unless the company achieves a profit after deducting reserves, the contracts of the bonds, in case the company issues these bonds, often prevents companies from increasing the proportion of cash dividend on a certain level to secure the rights of bondholders (Watson and Head 2004).

Thus, the general dividend policy may well be looked upon on the basis of differentiating between the cash dividends and the shares dividend through capitalization of profits, or through buying back the company's shares. This is due to the fact that the investment policy is fixed. The company will thus detain profits to finance capital spending on growth and expansion or debt repayment, or extinguish the bonds if any, and distribute the remaining cash as a cash dividend, and also to finance any deficit in capital spending by issuing new shares or through outside borrowing. The company could detain the necessary funds to finance capital expenditure and re-buy part of the shares issued and distribute the remaining as a cash dividend.

These alternatives will not affect the company's value, and therefore the wealth of shareholders, if the company is operating in a market characterized by ideal, efficiency and depth (Merton and Modigliani 1961; Black and Scholes 1974; Peter 1996). In case such characteristics are absent of the market, one can expect arguments about the impact of dividend policy, particularly cash, on the value of the company, and therefore the wealth of shareholders. The second group (Gordon 1959; Blume 1980; Dyl and Weigand 1998; Koch and Shenoy 1999) believes that increasing the <https://assignbuster.com/the-various-types-of-dividend-policies-used-by-companies/>

percentage of cash dividends would increase the company's value, thus increasing the shareholders' wealth, while the third group (Litzenberger and Ramaswamy 1979; Blume 1980; Litzenberger and Ramaswamy 1982; Ang and Peterson 1985) believes that increasing the percentage of cash dividend will lead to a decline in the value of the company, thereby reducing the wealth of shareholders. These groups together with their theories will be discussed when dealing with the policy of cash dividend.

The profits will be transferred to return earnings account, which is used for purposes determined by the board and the approval of the General Assembly of the company. This account is usually used to maintain a stable dividend amount of cash dividends (a systematically dividend policy). During the years where the company cannot meet the amount of normal dividend, they will tend to the return earnings account to insure any deficit. The General Assembly of the company has full authority to use this account for normal or abnormal cash dividend in whole or in part. It could also be used for company repurchase share, or for capitalization this account and distribution of share dividends to shareholders. On their part, shareholders can obtain their profits through a set of policies that can be combined in a single year, but it often takes one of the following alternatives(Watson and Head 2004):

A cash dividend policy

Shares dividend policy

Buying back shares policy

2-3 Cash Dividend Policy

The impact of cash dividend policy on current prices of the company shares is considered to be very important, not only for policy makers, but also for investors, portfolio managers, and economists interested in the performance of capital markets (Watson and Head 2004). The questions to be raised here are: Can managers maximize the wealth of the owners of the company through a particular dividend policy? (Lumby and Jones 1999) Are the companies with high dividend sold with premium? Should the shares of companies that retain their profits or distribute a percentage of its profits, be sold as well in a lesser price? The fact is that these questions were, and still are, the subjects of many applied studies. Until now, there seems no consensus on the answers to these questions. The reason is the presence of other relevant factors that affect the market value of the shares that enable us to measure the impact of dividend policy on profits alone. This means that researchers did not so far prepare both proper and adequate tests and studies to distinguish between different hypotheses.

The arguments among researchers about the dividend policy focus on that part of the cash dividend to be distributed to shareholders and its impact on the company's value and therefore the wealth of the owners of the company. Miller and Modigliani (1961) see that the cash dividend does not affect the value of the company, as the company's value will not be affected by how earned profits are divided; but rather affected by the ability to achieve profits. Thus, there is no point in thinking of how to divide profits between dividends and return earnings, while thinking must be directed towards

maximizing these profits through the optimal investment policy as the way by which the cookie is divided will not lead to increase its size.

In the opinion of others (see, Olson and McCann 1994; Lipson, Maquieira et al. 1998), the manner in which profits are divided between dividends and return earnings affects the company's value through an increase or decrease in the demand for the company shares, as the investors with high incomes usually prefer companies without cash dividend if the value of taxes on cash dividend exceeds the taxes on capital gains, while investors typically prefer companies that cash high dividends if they do not pay taxes or who were in low category of taxes. Also, investors in growing companies may not ask the company to distribute high cash dividends and accept, instead, low cash dividends. This is because the internal return rate in these companies is usually greater than the costs of obtaining funds from sources other than return earnings, and thus maximize the wealth of shareholders through the detention of all or most of the profits and use them to finance projects which have positive present value. Investors in non-growing companies, on their part, look for high dividends (see, Walter 1963). From the foregoing discussion, it is viewed by many scholars that the harmony between cash dividend policy with investor wishes will affect the market value, due to any increase or decrease for the company shares emanating from this harmony or compatibility, which will be reflected on the price of its shares.

The decision of cash dividend policy, particularly its cash portion, is one of the challenges facing company managers, because the distribution decision defines the funds to be given company's shareholders, and therefore the

funds to remain for managers in the company to reinvest (Lumby and Jones 1999).

The cash dividend policy can be considered as an action plan for the company to be followed when the company needs to make a decision regarding cash dividends, so that this plan could provide several options from which the company can choose to reach the desired goal. Such a plan is laid taking into account the following two main goals: Maximizing the wealth of shareholders and meeting the company needs to finance its investments.

There are several factors affecting the decision to choose the most appropriate alternative among the alternatives available in the action plan. These factors are: legal, contractual, internal shareholders and market considerations. These factors reduce the available alternatives for the company in order to achieve its aims through a cash dividend policy practice. The available alternatives include the company's range of cash dividend policies the company could follow (Gitman 1997; Brigham and Houston 2004) . These include:

Fixed dividend policy rate

Regularly dividend policy

Regularly low fixed dividend with special or added dividend

Remaining cash dividend policy.

These policies will be discussed in detail as follows:

Fixed Dividend Policy Rate

This percentage is determined by apportionment of dividends on profits earned. The percentage distribution of 80% of the net profits derived mean that the company will distribute 80% of its profits and reserves 20% of retained earnings. Since corporate annual profits are not fixed, adopting this policy will lead to a fluctuation in the amount of dividends because the stability of the dividends rate from non fixed profit leads to a difference in the amount of the annual dividends, which is the main criticisms of this policy. Since the fluctuation of the quantity of dividends is one of the benchmarks that measure the risks of the company and because the non fluctuation of the profits is usually seen as something positive for current and future performance of the company, the prices of company shares that follow such a policy may be adversely affected by this policy.

Regular Dividend Policy

The company, according to this policy, pays fixed rates as a dividend each year. For example, they may pay \$0. 2 per share each year, which will be fixed next years. This policy gives a positive indicator about the company because of the stability of the quantity of dividends, leading to reduce the risks of uncertainty. The companies that follow such a policy tend to increase the dividends rate whenever they feel that the increase in profits is steady and continuing in the future.

Low regular fixed policy with special or added dividend

Some companies follow a policy of systematic low dividend with additional dividends when the company's profits are unstable and highly volatile so

that the company's profits are high in a given year but low in another, which makes it difficult for it to follow a regularly high-level profits distribution policy be able to maintain it. The company, therefore, seeks to pay low dividends characterized by being consistent and continuous and then pay other additional and unusual dividends in the years where it can secure high profits. The company thus has been able to achieve consistency and continuity in the level of profitability, which are indicators of great importance on the part of investors, who consider this as something necessary for building confidence with the company.

Remaining cash dividend policy

The optimal cash dividend rate for any company is best determined by the differentiation between a numbers of factors (Brigham, L. et al. 1999)

Shareholders preference for cash dividend or capital gains.

Investment opportunities available for the company.

Optimal structure mix for the company's capital (money sources).

External financing costs

The last three factors combined affect the remaining dividend policy which is based on distributing cash dividends which exceeds the company's to finance all company investment opportunities that have positive present value.

The company should make the following three steps when applying the remaining cash dividends policy (Brigham and Houston 2004)

<https://assignbuster.com/the-various-types-of-dividend-policies-used-by-companies/>

Identifying all the available investment opportunities which have positive present value and in which the company wishes to invest.

Determining the optimal structure mix of capital that achieves the lowest cost.

Using the profits to finance new projects with positive present value because of their low cost in comparison with new share issues in case they represent the best combination of capital.

Based on this concept, and as long as the money needed by the company to reach the optimal mix of the capital structure is the equity funds , and not money borrowed, and as long as the need for funds exceeds the company's achieved profits and return earnings, the company will not make any dividends distribution for shareholders (Van Horne 1983). But in case the funds needed are less than the return earnings, the company will take its cash needs and distribute the exceeded money as a cash dividend for shareholders.

Besides that, if the optimal capital structure mix does not make it incumbent upon the company for financing or allowing to borrow without leading to the level of damage risks of the company, the company then may distribute profits to shareholders because of lack of need and also because these profits are considered as surplus (Arnold 2008).

2-3-1 Factors affecting cash dividend policy

A combination of factors affect the cash dividend policy and put pressure on the management when a dividends proposal is submitted to the General

Assembly to be taken as a justification of reference for the Assembly when ratifying or adjusting this proposed. These most important of these factors are arguably (see, Damodaran 1997; Gitman 1997; Brigham, L. et al. 1999; Brigham and Houston 2004) the following: legal, contractual, internal, growth and the expected expansion, shareholders' preferences for cash dividend or capital gains and capital market considerations. These factors are explained here in some details:

Legal restrictions

Cash dividends should not exceed the total of retained earnings plus net profits for the current year. This is known as the Impairment of Capital Rule. If the company's net profits equal to \$500 thousand and it the retained earnings of \$ 2 millions, then it should not distribute profits more than \$ 2. 5 million; but if there is retained loss within equity amounting to \$200 thousands, then it should not distribute more than \$300 thousands.

Contractual restrictions

Usually borrowing contracts restrict the amount of profits allowing the company to distribute to shareholders to ensure the rights of the lenders. When the company issues borrowing bonds, the contracts usually include both permissions and restrictions from the date of bonds issuance till bonds date off. The bonds contract often will not allow the company to distribute cash dividends only if they exceed the amount earned in a certain amount. The contract might also prevent the company from increasing the percentage distribution of normal profits or may determine the profits that could be distributed by the company's net profits for distribution. The

company accepts such conditions on themselves to reduce the risks of
<https://assignbuster.com/the-various-types-of-dividend-policies-used-by-companies/>

borrowing from the viewpoint of the lender, thus reducing borrowing costs. There are also restrictions on cash dividends imposed upon issuance of the preferable shares of the company. In this respect, it is natural to restrict the distribution of any dividends to ordinary shareholders unless they pay all preferable share profits.

Internal constraints

The company's ability to pay cash dividends is affected by the quantity of liquid funds available, not by profits and return earnings only. Although the company could resort to borrowing for financing the cash dividend or issuing new shares to finance the dividend process, the companies often do not do that because of high costs for this decision. The company can use it in urgent cases to stabilize the amount of dividends, since the fluctuation of the value of dividends may convey a cost that could be higher than the distribution finance costs. Thus, the company's ability for cash dividends or desire to distribution is often constrained by liquid funds available.

Company expected growth and expansion

The volume of capital expenditure required for financing expansion and growth significantly affects cash dividend policy adopted by the company. If the company is in continuous expansion and development, using modern technology, they will need all the funds available to finance operations. On the other hand, the companies that have reached the stage of maturity are more able to distribute cash dividends than companies in growth.

Shareholders preference for cash dividends or capital gains

One of the management functions is to maximize the company owners' wealth therefore we should take into account the owners' interests when preparing the cash dividend policy. The company's ability to distribute cash profits and desire to do so are often constrained by several important factors affecting the interests of company owners (Brigham, L. et al. 1999):

Tax status of the company's owners:

If most of the company's owners are affluent are in high tax brackets, the company will resort to a dividends policy whereby it can reduce the impact of taxes on the shareholders profits.

Investment opportunities available for company owners

If shareholders can obtain returns for re-investing their profits exceeding the company's returns, the company must distribute a greater proportion of profits to enable shareholders to maximize their wealth by reinvesting these profits. But if the company's returns are more than shareholders' returns, then the company must transfer the maximum part of their profit to return earnings for reinvestment in order to maximize the shareholders wealth.

The steady control of former shareholders

If the company tends to distribute all, or most, of profits achieved over the years, it will find itself forced to issue new shares to finance the expansion and development projects. This would first lead to mitigate and minimize the control of the company's former owners of the company; and then the profits

to be gained would be reduced because of the increasing number of company owners due to the issuance of new shares. This situation could be remedied through the allocation of shares, by allowing old shareholders to subscribe for new shares, each according to his/her contribution and giving them priority in this respect. The company could also resort to another alternative, i. e. to reduce the proportion of cash dividends if they want to retain full control over old shareholders and show no inclination towards increasing the number of shareholders.

Stable and clear dividend policy

Investors give special importance to the stable and clear dividends policy. Also, they give special importance for the continuity of these dividends because they believe that the stability, increase, and continuity of dividends would surely lead to reduce risks from the standpoint of investors. Therefore, investors tend to discount returns of companies whose policies of distribution are characterized by stability, increase and continuity at a discount rate less than other companies. This means that they highly evaluate these companies; in other words, they ask for a less rate of returns, thereby reducing the company's capital cost.

Profit information content

Investors are interested in the informational content of the profits. Through these profits, they can read the management forecasts for company future profits. As the managers have more precise information about the company investors, on their part, will give special attention to the informational content of the profits.

<https://assignbuster.com/the-various-types-of-dividend-policies-used-by-companies/>

2-3-2 Theoretical Framework for Dividend policy and its impact on market value

We can clarify the theoretical framework for the relationship between the dividend policies (cash, shares and repurchase) and market value of the company through the Irrelevant Theory was brought by M & M in 1961. They suggested that there was no relationship between the dividend policy and market value. Many researchers have supported this theory, but also others have suspicion about it. The advocates' researchers believe that companies should follow residuals dividend policy while the opponents' researchers' divided into two divisions, the first believes that there is a positive relationship between the dividend policy and the company market value, others said that this relationship is negative.

The relationship between the dividend policy and the company market value is also affected by other dimensions which create a number of other theories, where we find that the uncertainty created a bird in the hand theory, the presence of taxes helped to find a Tax Effect Theory, either shareholders loyalty has created a Clientele Effect Theory, Management try to send some information through the dividend policy covered by Signaling Effect Theory, while the separation of management and owners (shareholders) has created Agency cost Theory. Therefore, we can draw the theoretical framework for the study through the following form:

Theoretical Framework (figure 2-1)

Share Dividend

Positive Relationship

Negative Relationship

Irrelevant

Market Value

Relationship

Dividend Policy

Irrelevant Theory

Relevant

Residual Dividend Policy

Bird in the Hand Theory

Tax Effect Theory

Clientele Effect Theory

Signaling Effect Theory

Agency Cost Theory

Cash Dividend

Share Repurchasing

2-3-2-1 Irrelevance Proposition

There is a belief among many finance and economics specialists that cash dividends policy is not important because it is not relevant and does not

<https://assignbuster.com/the-various-types-of-dividend-policies-used-by-companies/>

affect the owners' wealth. The source of this belief is a study conducted by Miller and Modigliani (1961). This study concluded that the dividends policy has no effect on the company's value, so the managers will not be able to maximize the owners' wealth through a dividends policy.

The irrelevance proposition concept for dividends policy on the owners' wealth stems from the fundamental idea that companies which distribute continuous high cash dividends to shareholders and secure a little bit higher share prices (Archer, Choate et al. 1983; Lumby and Jones 1999). As a result, the investor's capital gains are very limited in this company as he would receive the same returns received by other investors holding another company's shares with low dividends while its prices become high because of the return earnings, and so he obtains high capital gains which compensates the limited cash dividends. In both cases, the shareholder's wealth is the profits obtained by cash dividend plus capital gains realized from rising share prices. In case there are no taxes or whether taxes on capital gains are equal, the investor will not be affected, whether the company has established cash dividends or kept the profit in return earnings and the investor has obtain capital gains when selling his shares as a result of the rise of the company's shares by cash undistributed profits with no change in the other effective factors.

This theory is based on the following assumptions (Merton and Modigliani 1961):

There are no taxes, or the taxes rate on cash dividends and taxes rate on capital gains are equal.

<https://assignbuster.com/the-various-types-of-dividend-policies-used-by-companies/>

There is no transactions cost for the process of selling or buying shares so that, if the investor needs cash, he will be able to sell his shares without losing any commissions and fees instead of cash dividends.

The investor is absolutely rational in his decisions.

There are no agency costs. This means that the company managers that distribute low cash dividends do not use the company profits to achieve personal goals that may harm the company (Jensen 1986).

The company operates under a full and efficient market, which means that the information is available and accessible to all at the same time without any costs, and the stock prices reflect information and are absolutely influenced by it at the moment provided.

There is no information gap, including that the company operates under a full and efficient market. The future outlook on the performance of the company is homogeneous among all investors, as so do information and expectations among managers and investors.

According to irrelevance proposition, the dividend policy affects only the level of external financing required to finance future projects with positive net present value. This means that each dollar distributed to shareholders represents a capital loss of a dollar. According to this hypothesis, the only constraint to the company's market value is the company's investment policy, not the company's dividends policy followed. This is because the investment policy is responsible for future profits (Miller and Modigliani 1961). Accordingly, the company's decision on the distribution of cash or

non-profit distribution would not affect the market value of the company and therefore would not affect the owners' wealth. This hypothesis recommends that managers should give greater importance to the investment policy and let the dividends policy follow the investment policy, which is known the Residual Dividend Approach.

The advocates of the irrelevance proposition hypothesis (Black and Scholes 1974; Miller and Scholes 1978; Merton and Myron 1982; Merton 1986; Peter 1996) adopt the idea that the investor can build his own cash dividends policy regardless of the company's dividends policy. This is known as "Homemade Dividend"(Merton and Modigliani 1961) where the investors can obtain income through selling part of his shares equal to the value of cash profits that could have been distributed by the company, if the company does not have cash dividends and the investor himself wishes to receive cash dividends to meet his consumer needs. He may wish also to reinvest cash dividends distributed by the company in case the investor shows no desire for cash dividends. By following this method, the investor will not be affected by the company's dividends policy, and therefore would not be compelled to abandon the stocks of companies followed by a dividends policy which is not consistent with his wishes.

One of the criticisms against the irrelevance proposition hypothesis is that it cannot be practically acceptable. The theory of building a dividends policy for each investor based on efficient market, with no transaction costs for buying and selling (Dempsey and Laber 1992), is not practical. In addition, the investor will pay taxes on cash dividends or capital gains, making the adoption of a specific dividends policy for each investor something costly.

<https://assignbuster.com/the-various-types-of-dividend-policies-used-by-companies/>

Besides, the investment in companies whose cash dividends policy is consistent with the investors needs is less expensive than building a special dividends policy. The hypothesis has been built on the basis that the investor is quite rational when taking his decisions. The psychological tests have proved, however, that human beings are not rational one hundred percent with regard to decision-making. Shefrin and Statman (1984) in their study said that investors have an unreasonable preference regarding the profit dividends; this is not consistent with the irrelevance proposition hypothesis. The irrelevance proposition hypothesis is also criticised for assuming equality between the cash dividends and capital gains, while cash dividend is a cash in hand without any uncertainty risk, and the capital gains is cash in the future with a lot of risks. So, how can they be equal?

The irrelevance proposition hypothesis has been built on a set of assumptions and data that have already been indicated. It is understood here that any change in these assumptions and data would naturally lead to a change in the basic hypothesis and therefore to a change in the results. Accordingly, and in practical terms, the financial markets in general do not agree with these assumptions.