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# ***1 Introduction to Dividends***

## **1.1 What is Dividend**

The term dividend usually refers to cash distributions of earnings to shareholders, more specifically, to those shareholders who are registered on a particular record date. However, in practice, ‘any direct payment by the corporation to the shareholders may be considered part of dividend policy’ (Ross, S. A., Westerfield, R. W. and Jaffe, J. 1996: 482).

## **1.2 Different Forms of Dividends**

Dividends come in many forms. But the most common type of dividend payment is in the form of *cash dividend*. Cash dividend can be classed in two categories: *regular cash dividend* and *extra cash dividend*.

*Share repurchase* is considered an alternative to cash dividend. Firms repurchase their stock either by buying on the secondary market or by a tender offer and usually keep these repurchased shares for further resold when firms need cash.

A firm can distribute its earnings to shareholders in the form of *stock dividend*. This dividend does not pay any cash out but just increase the number of shares outstanding of shareholders and therefore reducing the value of each share.

Similar to stock dividend, *stock split* is another kind of non-cash dividends which is very much like a stock dividend. However, there is a technical distinction between them: ‘a stock dividend is shown in the accounts as a transfer from retained earnings to equity capital, whereas a split is shown as a reduction in the par value of each share’ (Brealey, R. D. & Myers, S. C. 1996: 419).

The rare form of dividend is *concession*, which distribute shareholders physical products. Obviously it is just a means of attracting small shareholders who can benefit from it personally.

## ***2 The Importance of Dividend Decision***

Firms consider the dividend decision as quite important for it not only determines what funds distribute to investors but also how many funds are retained for further investment. Dividend decision can also provide stakeholders the information about the firm's current performance and future prospect.

Traditionally, dividend decisions have been treated as financial decisions because cash paid as dividend is not available for firm's desired investment. However, the dividend decision is more than a financial decision. It affects firm's investment decisions as well. A firm's dividend decision is often mixed up with its overall financial and investment decisions, although to a certain extent we should isolate them.

The pure theory of dividend decision indicates that under certain circumstances, it makes no difference whatever it does. However, the circumstance required to support this theory is highly restrictive and unlikely to be applied in practice. Indeed, all discussions regarding dividend decision are appeared to be controversial and there always have many reasons to support as well as against a particular dividend policy.

## ***3 What Factors Determine Dividend Policy?***

### **3.1 Key Factors for Making Dividend decision**

Differ to the perfect and efficient capital market MM assumed in their proposition (Brealey, R. A., Myers, S. C. & Marcus, A. J. 2001: 467), the real-world contains much imperfections, inefficiencies and whether shareholders are entirely rational. The key factors that should be considered by senior management of a listed firm in making decision on the annual size of dividend are various and diverse. We view these factors in two aspects: clientele aspect and firm aspect as follow.

#### **3.1.1 Clientele Aspect**

The investor preference for one dividend decision over another dividend decision is called a clientele effect (Kaen, F. R. 1995: 547). Shareholders are the owners of the

firm and their desires largely affect the dividend decision of a firm. The natures they ask for more or less dividends will be considered by firm's management in deciding dividend policy.

#### Desire for Current Income

It has been argued that many investors desire current income rather than distant dividends, because the discounted value of near dividends is obviously high than the present value of future dividends. Moreover, some investors are living on the income of dividends and consequently they require high payout ratio of dividends.

#### Resolution to Uncertainty

Another factor is the uncertainty of future. Investors are substantially need for current dividends because the uncertainty surrounding dividends in the distant future. A high payout ratio possibly benefit investors for it resolves uncertainty. This is predominant in recession time.

#### Taxation Issues

Investors' preferences are influenced by taxation issues as well. Individuals in high tax brackets are likely to prefer a low dividend policy. While firms can exclude high percentage of tax from their dividends income but cannot in capital, and therefore pursue high dividend. On the other hand, pension funds pay no taxes on both dividends and capital gain, thus a moderate dividend decision will be fine for them.

#### Reduction of Agency Costs

When a firm has diffuse ownership, it is often the case that conflicts of interest will arise up between different shareholders and managers. Moreover, managers may seek for some selfish goals at the expense of shareholders. To reduce management's ability of devouring firm's resources and disperse the agency costs, investors will prefer high dividend payment.

#### Economic Cycle and Characteristics of the Firm

However, investors would prefer low dividend instead. In boom period or for a promising business, investors are likely to keep the earnings in firms to reinvest for further growth and expansion.

### **3.1.2 Firm Aspect**

#### Further Investment Decision

It is often the case that a firm has a attractive project and the success of the project may depend on where the money is coming from. Although in modern capital markets there are many resource for financing a investment, using the money from firm earnings perhaps is better than other financing in increasing shareholders' wealth. Some firms thus prefer to pay low dividends and retain earnings for future expansion. However, when there is absent of attractive projects, firms will tend to pay high cash dividend rather than investing funds at less than the shareholders could earn elsewhere.

#### Information to the Market

More often than not, the dividends are seen as information released by management to the market about firm's current performance and future prospect. By making increasing cash dividend payment, management makes an implicit promise to continue these payment and confidence in firm's future earnings. Contrary, a decreasing cash dividend usually implies that management is pessimistic about firm's further growth. How to deliver a right message to investors is a key factor to be considered in making dividend policy.

#### Taxation

Taxation is affect management in deciding dividend decision greatly. Dividend will be double taxed during the transfer from firms to investors. That is, one time taxed as corporate income in firm's hand and another time taxed as private income in investors' hand. Meanwhile, there is less tax rate on long-run capital old and capital gains are realised. Furthermore, taxes on dividends have to be paid immediately, while taxes on capital gain can be deferred until shares are sold and capital gain realised. This encourages management to defer cash dividend to a long-run capital gain.

#### Firm's Capital Structure

A well-structured capital can give strong support to firm's operation. The optimal capital structure of a firm should cover both its long-term and short-term needs of capital, and take into account the trade-off between interest tax shields and the costs of financial distress. To optimise firm's capital structure, management will seek to replace some debt by retained earnings or vice versa. It is another factor that management should be considered in deciding dividend policy.

#### Legal Constraint

Another constraint factor on managers' freedom of making dividend decision is imposed by the legal system. Although shareholders are the main risk bearers for the firm, other stakeholders, such as debtors and creditors stand the risk as well. To prevent excessive payout of profit to shareholders only, firms are restricted legally when it makes decision on dividend payout.

### **3.2 How Dividend Decision be Determined in Real World**

In fact, it is rare in real world that dividend decision is determined by only one or two factors. Instead, management evaluates most of the key factors mentioned above or even more, and try to balance them simultaneously to make a sensible dividend decision. Generally, the outcomes of the dividend decisions are complied with Lintner's 'stylised facts' (Brealey, R. A., Myers, S. C. & Marcus, A. J. 2001: 464) which summarised four 'stylised facts' about dividend decision as follow: -

- Firms have long-run target dividend payout ratios.
- Managers focus more on dividend changes than on absolute levels.
- Dividend changes follow shifts in long-run, sustainable levels of earnings.
- Managers are reluctant to make dividend changes that might have to be reversed.

By the overall evaluation of those factors, three kinds of dividend decisions can be determined in real world. We will examine these decisions respectively in following section.

#### **3.2.1 High Payout of Dividend**

There are some suggestions for a firm to determine high payout of dividend:

For those firms in traditional industries where the market are saturated and their market shares are stable, it is often the case that there are no more opportunities for firms' further growth and expansion. Firms thus have no magnificent investment decision and there also have no requirement in restructuring capital.

For those firms in a mature market and maintain stable growth, management need an established high payout of dividend record to provide positive and confident information to the market.

For those firms whose considerable shares holden by tax-free funds (such as pension funds) or other firms. These shareholders will naturally require high payout of dividend.

Or for those firms that clientele effect is predominant above other factors, management is likely to make a high payout decision.

#### Example From Philip Morris Companies

Philip Morris Companies is a good example for high payout of dividend. As the world's largest producer and marketer of consumer packaged goods, Philip Morris Companies has a total operating revenues of US \$ 89.9 billion in Year 2001 and US \$ 8.56 billion in its net earnings (Philip Morris annual report 2001. [http://www.philipmorris.com/investors/annual\\_reports.asp](http://www.philipmorris.com/investors/annual_reports.asp))

The firm has several typical characteristics we mentioned above: firm is in traditional industries where the market are saturated and their market shares are stable, there are no more opportunities for firm's significant growth and expansion; As a mature company and grow stably, it attracts those moderate tax-free funds to invest in firm's shares; and there is a surplus of unneeded cash in hand. Philip Morris Companies therefore makes a high payout of dividend to its shareholders for a long period (Refer to Figure 1).

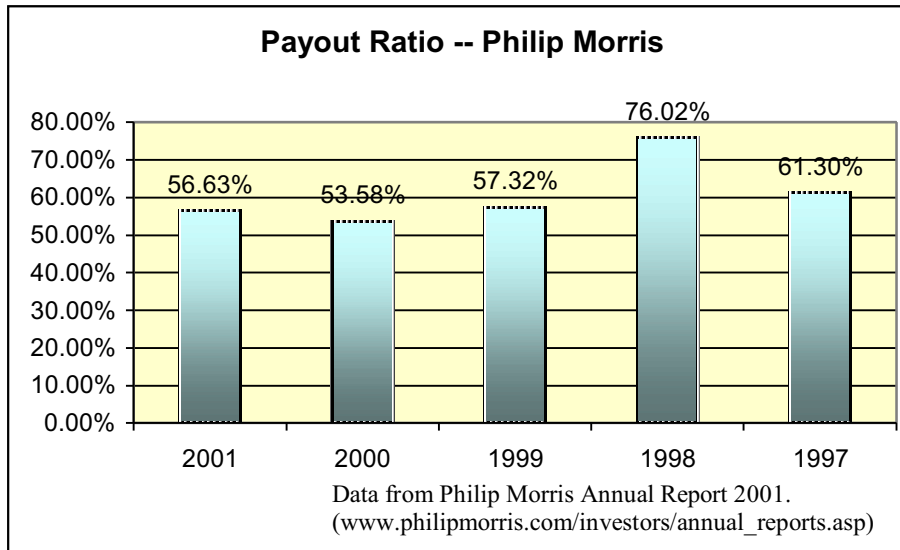


Figure 1. Payout Ratio – Philip Morris

### 3.2.2 Moderate Payout of Dividend

There have many reasons for firms to determine moderate payout of dividend decision. The factors to be taken into account include:

The management wish to maintain a smooth dividend policy to provide strong and confident information to market about firm's excellent current performance and magnificent future prospect. Or the managers know that in a world of informational asymmetries an erratic dividend policy may complicate investor relations when sending the wrong message to them.

Firm has well diversified businesses, and these businesses can provide enough profit from mature markets as well as splendid growth and expansion opportunities from promising industries. Firm has good investment decisions but has no more pressure in cash supplement and capital restructuring.

The investors of the firm respect firm's moderate operation and stable growth, and thus require both short-run cash dividend and long-run capital gain. This requirement also reflects the balance of tax issues between short-run and long-run.



There have less clientele effects than normal against firm's dividend policy: such as an excellent management team in the firm decreases investors' worry about agency costs; or tax is much high on cash dividend than on long-term capital gain in the market etc.

#### Example From General Electric

General Electric perhaps is the most successful company in the world. Its businesses cross from aircraft engines, appliances, industrial systems, and medical systems to capital business. With annual revenues of US \$ 52.68 billion, General Electric becomes the 8<sup>th</sup> biggest company in the world (Fortune Global 500. <http://www.fortune.com/lists.G500/index.html>)

General Electric has a diversified business and an excellent management team. Its capital structure is well organised and there have sufficient cash surplus for desired project investment and dividend distribution. There have good relationship between firm and its investors thus not more clientele effect affect firm's dividend policy. Under this circumstance, General Electric implements a moderate payout of dividend as shown in Figure 2.

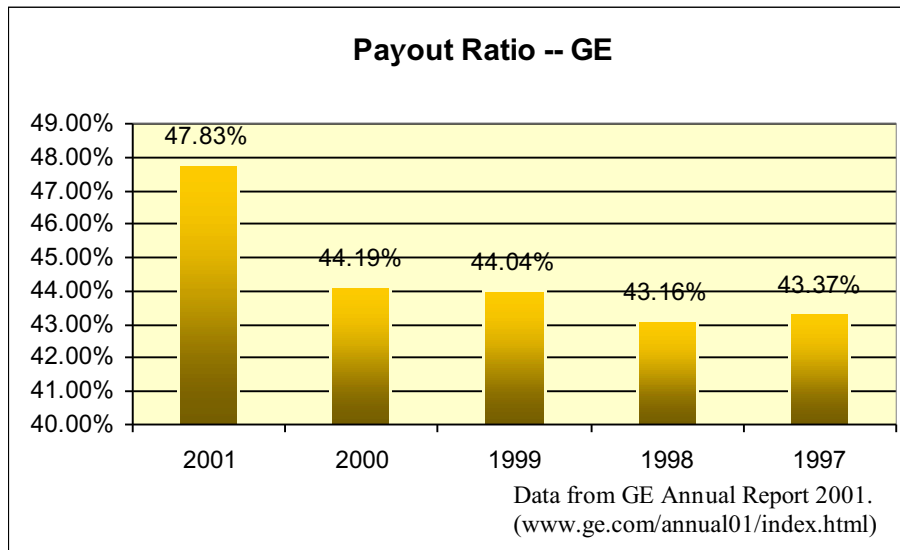


Figure 2. Payout Ratio – General Electric

### **3.2.3 Low Payout of Dividend**

Either a financial difficult firm or a rapidly growing firm may adopt low payout of dividend. But there still have many other factors for firms' low payout policy.

Firms with positive net present value projects are suggested to pay fewer dividends, especially if shareholders agree with management's opinion about investment opportunities. Most of those firms are high-tech or new established enterprises which face expanding markets and need to pour capital investment in short-term in order to build better market position for long-term.

When the management is optimistic about the firm's future and wish to retain earning for survival in coming distress or economy recession, the managers of the firm then would prefer to retract from a high payout policy and adopt a conservative low payout of dividend.

#### **Example From Intel**

Intel is a famous high technology firm in IT industry. It is in the most promising industry and grows incredibly fast. We can view its situation and identify how it determines its dividend policy.

Intel faces the rapidly growing market and need to make capital investment continuously in establishing its market position in the long term. The management has consistent investment strategy and this strategy is also shared by Intel's investors. On the other side, shareholders trust in firm's future prospect and prefer long-run capital gain rather than current cash dividend. For those reasons, the management of Intel adopts the policy of low payout of dividend (Refer to Figure 3).

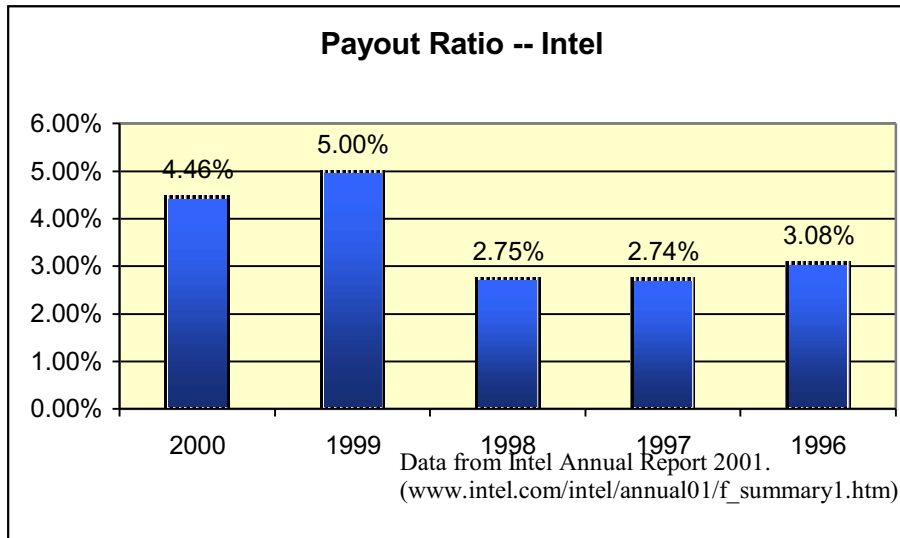


Figure 3. Payout Ratio – Intel

#### 4 Conclusion

There have many factors that should be taken into account by the senior management in making a decision on the size of annual dividend to its shareholders. The key factors considered by management can be categorised into two groups – clientele aspect and firm aspect. The clientele aspect includes desire for current income, resolution to uncertainty, taxation issues, reduction of agency costs, and economic cycle and characteristics of the firm. While firm aspect contains further investment decision, information to the market, taxation, firm's capital structure and Legal Constraint.

In real world that dividend decision is determined through a range of processes. Management evaluates most of the key factors, and try to balance them simultaneously to make a sensible dividend decision which generally comply with Lintner's 'stylised facts'. Whatever the decision is made, it cannot satisfy all the firm's shareholders.

The decisions on the size of the annual dividend are various. They range form high payout of dividend to low payout of dividend. Generally, the dividend decisions can be classed in three categories: high payout, moderate payout and low payout.

Although we assume there has an optimal dividend payout ratio existed, in practice there has no formula for calculating the optimal ratio. Whether the dividend payout ratio is right or not can be examined by the reaction from the market.

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