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Compiled by Nila Firdausi Nuzula, PhD
Faculty of Administrative Science, Universitas Brawijaya

Dividend policy

Corporations may decide to pay cash dividends to their shareholders despite the tax consequences of the payment, and the fact that the funds could be used back into the company for financing the investments. Therefore, why do companies distribute dividends? What are the motives? What are the advantages for the companies? What about stock dividends and splits? This chapter answers these questions.

Definition

According to Drake and Fabozzi (2010), 'a dividend is the cash, stock, or any type of property a corporation distribute to its shareholders'. Dividend seems to be viewed by both the directors and the shareholders as the equivalent of an interest payment that would be made to a lender, a compensation for the shareholder's delaying consumption (McLaney, 2009). Following the definition, a company can pay dividends in the form of cash, stock, or other types of assets to the shareholders. It implies that the board of directors has a choice to declare the payment of a dividend at any time, without any obligation to it. This is contrarily different from interest payments on debt securities, in which the company has an obligation to pay them regularly. If a company does not pay a dividend, there is not violation of a contract.

Declaration of dividend payment includes who has the right to the distribution, amount of the distribution, the date on which the distribution is paid, and the date of record. Date of declaration is important for the shareholders and determines who is going to receive the dividends, since the shares are traded frequently and dividend payments take some time to make it real. Therefore, financial practitioners define four important dates around the dividend payment (Drake and Fabozzi, 2010: 134).

1. The declaration date, which is the date the board declares the distribution.
2. The ex-dividend date, which is the date that determines which investors receive the dividend, any investor who owns the stock the day before the ex-date receives the forthcoming dividend. Any investor who buy the stock on the ex-date does not receive the dividend.
3. The date of record, which is specified by the board of directors as the date that determines who receive the dividend.
4. The payment date, which is the day the distribution is made.

A share is valued on the basis of future cash flows expected to arise from it. If the possibility of the occurrences takeover, liquidation, or share repurchase is less, then the possible cash flow that could be expected being arose from a share is dividend payment. Therefore, the anticipated dividens are usually the only determinant of share prices. From this premise, usually scholars determine shareholders' welfare by calculating how much the company would pay dividends from holding the shares.

Dividend payment is interesting for financial studies especially for the ones who believe that the decision is a vital one for shareholder wealth effect. The study follows *Traditional View* and believes

that shareholders value a dividend more highly than the equivalent amount retained in the business (McLaney, 2009). Other theory is Modigliani and Miller (MM Theory). According to the theory:

1. Dividend should be paid only where the business cannot use the available funds at least as effectively as shareholder can on their own amount, that is, invest in all projects with a positive NPV when discounted at the shareholders' opportunity cost of capital.
2. Only funds remaining after investing should be paid as dividend, therefore, dividend is residual.
3. Share price is the PV of future dividends, therefore, shareholders' wealth will be indifferent as to how the PV is made up (size of each year's dividend). If paying less this year leads to more in later years such that PV (and share price) is increased, shareholders' wealth will be enhanced.
4. Individual shareholders can adjust the business's dividend payments to meet their own needs. If no (or low dividend) and they need funds, they can sell some shares to generate a cash inflow from the shares. If they prefer not to receive a dividend from the business, they can buy more shares with the cash from a dividend and, thereby, leave the investment intact (McLaney, 2009).

According to Drake and Fabozzi (2010), the proportion of earnings paid out in the form of dividends varies by company and industry. Corporate boards usually set the dividend policy such that dividends per share grow at a relatively contant rate.

Dividend policies

There are several basic ways of describing a corporation's dividend policy: 1) No dividends, 2) Constant growth in dividends per share, 3) constant payout ratio, 4) low regular dividends with periodic extra dividends. The first category is usually held by younger, faster growing companies. Companies that usually decided to pay dividend constantly growth are large, mature companies that have predictable earnings growth. Dividends tend to be lower in industries that have many profitable opportunities to invest their earnings. But, as a company matures and finds fewer profitable investment opportunities, it generally pays out a greater portion of its earnings in dividends.

Many companies are reluctant to cut dividends because the share price usually falls when a reduction of dividends is announced. The investors tend to penalize companies that cut dividends. Therefore, corporations tend to only raise their regular quarterly dividend when they are sure they can keep it increased in the future.

Types of dividend payment

Mostly, companies pay dividends in the form of cash. '*Cash dividends are payments made directly to shareholders in proportion to the shares they own*' (Drake and Fabozzi, 2010). Therefore, if a company decides to pay cash dividends, it covers all outstanding shares of a class of stock.

Calculating ratios of dividend payment

The amount of dividends cash paid for each share can be calculated using this following formula.

$$Dividend\ Per\ Share = \frac{Cash\ dividends}{Number\ of\ shares\ outstanding}$$

Another calculation of cash dividend payment is Dividend Payout Ratio (DPR). It is calculated by applying the percentage of earnings paid out in dividends. In other words, the ratio is used to answer the question: what is the ratio of cash dividend paid to total earnings available to shareholders. The formula for DPR is as follows.

$$Dividend\ Payout\ Ratio = \frac{Cash\ dividends}{Earnings\ available\ to\ shareholders}$$

This last equation can be rewrote by dividing both the numerator and the denominator by the number of common shares outstanding. Applying the method, the following formula is the result.

$$Dividend\ Payout\ Ratio = \frac{Dividend\ per\ share}{Earnings\ per\ share}$$

The DPR is also the complement of the retention ratio, or the plowback ratio. It refers to the proportion of earnings retained by the company, or amounts of retained earnings that is reinvested back into the company.

$$Retention\ Ratio = 1 - \frac{Cash\ Dividends}{Earnings\ available\ to\ shareholders}$$

$$Retention\ Ratio = \frac{Earnings\ available\ to\ shareholders}{Earnings\ available\ to\ shareholders} - \frac{Cash\ dividends}{Earnings\ available\ to\ shareholders}$$

$$Retention\ Ratio = \frac{Earnings\ available\ to\ shareholders - Cash\ Dividends}{Earnings\ available\ to\ shareholders}$$

Example:

For FY 2010, Coccone Stores reported the financial performance.

Earnings available to common shares	13,400	billion
Dividend paid	3,746	billion
Number of common shares outstanding	3,810	billion

Dividend per share is $\frac{3{,}746 \text{ billion}}{3{,}810 \text{ billion}}$ or \$0.9832 per share

Dividend payout ratio is $\frac{3{,}746 \text{ billion}}{13{,}400 \text{ billion}}$ or 27.96%

Or

Earnings per share is $\frac{13{,}400 \text{ billion}}{3{,}810 \text{ billion}}$ or \$3.5171

Dividend payout ratio is $\frac{\$0.9832}{\$3.5171}$ or 27.96%

Another type of dividend payment is distributing additional shares of stock, or some types of property owned by the corporation however, this kind of dividend is rare. The additional shares of stock can be distributed to shareholders in two ways: paying a stock dividend and splitting the stock (Drake and Fabozzi, 2010: 137).

The company may state the distribution of stock dividend by a percentage of existing shareholdings. However, different from cash dividend, if a company pays a stock dividend, the company is not transferring any amount of money to the shareholders. The assets of the firm is the same, and each shareholder's proportionate share of ownership remains the same (Drake and Fabozzi, 2010). Analogically, the company cuts its equity pie into more slices and at the same time cuts each shareholder's portion of the equity into more slices.

Stock dividend is the issuance of stock to stockholders. A stock dividend may be declared when the cash position of the firm is inadequate and/or when the firm wishes to prompt more trading of its stock by reducing its market price.

Stock dividends increase the shares held, but the proportion of the company each stockholder owns remains the same. In other words, if a stockholder has a 2 percent interest in the company before a stock dividend, he or she will continue to have a 2 percent interest after the stock dividend.

Contoh.

Tuan Harris memiliki 200 saham Newland Corporation. Saat ini terdapat 10.000 saham Newland yang beredar di pasar. Dengan demikian Tuan Harris memiliki 2% interest perusahaan tersebut. Jika perusahaan mengeluarkan stock dividend sebanyak 10%, maka Tuan Harris akan memiliki 220 saham dari 11.000 lembar saham yang beredar. Di sini, proporsi kepemilikan saham Tuan Harris tetap sama yaitu 220/11.000 atau 2%.

Another form of stock dividend is stock split. A stock split divides the number of existing shares into more shares. For example, in a 2:1 split, or two for one, each shareholder gets two shares for every one owned. If an investor owns 1,000 shares and the stock is split 2:1, the investor will owns 2,000 shares after the split. Similar to other shareholders, the investor holds twice as many shares. The portion of the investor's overnship in the company's equity is remained. If the investor held 1% of the company's equity before the split, he still owns 1% after the split.

Contoh.

Smith corporation memiliki 1.000 saham beredar dengan harga per lembar $20. Dengan demikian, total par value adalah $20.000. Jika perusahaan kemudian mengumumkan adanya stock split 4-untuk-1 maka setelah split policy dilakukan jumlah outstanding stock adalah 4.000 lembar pada harga nominal $5 per lembar. Total par value tetap sama, yaitu $20.000. Secara teoritis, harga pasar per lembar saham akan turun pula sebesar seperempat harga saham sebelum pengumuman split.

Contrarily, there is a reverse stock split. A company may announce 1:2 reverse stock split that reduces the number of shares of stock, by which a shareholder receives half of the number of shares held before the reverse stock split.

Why a company pays stock dividend?

One reason is to provide information to the market. Distributing stock dividend informs good news to the shareholders, without paying cash. According to Drake and Fabozzi (2010:138), it does not make any sense if a company decides to pay cash dividend while the shareholders denote that the company

has an attractive investment opportunity and needs funds for funding it. Paying stock dividends includes less costs for recordkeeping, printing, and distribution. However, it is arguable since the costs are very little, how it could provide a good signal for investors? Do investors really trust it?

Second reason to pay stock dividend is to reduce the price of the stock. If the price of a stock is high relative to most other stocks, investors may pay higher costs in each transaction related to the stock, including broker's commission. By slicing the equity pie into more pieces, the price of the stock should decline. For example, if an investor owns 1,000 shares, each worth $50 per share, total investment is $50,000. If the company pays the investor a 5% stock dividend, the invesstor owns 1,050 shares after the dividend payment. Then, the price of the stock should decline, from $50/share to ($50,000/1,050 shares) or $47,62/share. Please remember that stock split only needs a memorandum entry. In brief, if companies want to reduce the share price, they tend to declare a stock split. If companies want to communicate news, they often declare a stock dividend. A reverse stock split may also be used to reduce the number of shareholders, and take the company private.

The differences between a stock dividend and a stock split are as follows:

1. With a stock dividend, retained earnings are reduced and there is a pro rata distribution of shares to stockholders. A stock split increases the shares outstanding but does not lower retained earnings.
2. The par value of stock remains the same with a stock dividend but is proportionally reduced in a stock split

The similarities between a stock dividend and a stock split are

1. Cash is not paid
2. Shares outstanding increase
3. Stockholders' equity remains the same

Theories related to dividend payment

There is no general agreement whether dividends should or should not be paid. The followings are theories related to dividend payment (Drake & Fabozzi, 2010).

1. *The dividend irrelevance theory*. The payment of dividends does not affect the value of the company since the investment decision is independent of the financing decision → Modigliani & Miller (MM)
2. *The bird in hand theory*. Investors prefer a certain dividend stream to an uncertain price appreciation → Myron Gordon & John Lintner
3. *The tax preference or differential theory*. Due to the way in which dividends are taxed, investors should prefer the retention of funds to the payment of dividens.
4. *The signaling explanation*. Dividends provide a way of the management to inform investors about the company's future prospects.
5. *The agency explanation*. They payment of dividend forces the company to seek more external financing, which subjects the company to the scrutiny of investors.
6. *Dividend residual theory*. Dividends will be paid if there is extra revenues and no profitable investment opportunities.

Example for tax preference theory.

An investor must pay 40% tax for his dividend income and 28% tax for capital gain. Currently, he has two options to invest in Equity I and Equity II, that has similar level of risk, as follows. If he intends to invest only in 1 year, provide recommendation which equity he has to choose.

	Equity A	Equity B
Growth (g)	10%	5%
Dividend yield	5%	10%
Market price	$10	$10

Equity		Dividend yield	Capital gain	Total Return
A	Before tax return	5%	10%	15%
	Tax	2%	2.8%	4.8%
	After tax return	3%	7.2%	10.2%
B	Before tax return	10%	5.0%	15%
	Tax	4%	1.4%	5.4%
	After tax return	6%	3.6%	9.6%

Example for dividend residual.

If perceived optimal capital structure is including 40% Debt and 60% Equity, and if there is earnings available for common stockholder $6,000,000.

If a profitable investment opportunity needs initial investment $8,000,000:

Debt	40%	x	$8,000,000.00	=	$3,200,000.00	
Equity	60%	x	$8,000,000.00	=	$4,800,000.00	Retained earnings

Earnings available for common stock holder	$6,000,000.00
Retained earnings	$4,800,000.00
Dividend payment	$1,200,000.00

- If there is a profitable investment opportunity that needs $10,000,000, then common stockholder would not receive dividends.
- If the amount of funds needed to finance a profitable investment opportunity is less than $10,000,000, then common stockholder would receive dividends.

Example for Stock Dividend.

Commonstock

Nominal	$1,000.00	
Outstanding	4,000	sheets
Market price	$1,500.00	

If the company decides to distribute 1 stock dividend for each 10 sheets ownership, then the additional outstanding stock (as the result of stock dividend policy) is 400 sheets. In other words, stock dividend policy provides 10% additional stocks distribution.

Capitalization of common stock	
Before distribution of stock dividend	$4,000,000.00
After distribution	$4,400,000.00

If earnings that will be distributed as dividend $4,000,000.00

Dividend per share $\frac{\$4,000,000.00}{4,000}$

or $1,000.00

After the distribution of stock dividend

Number of current outstanding stock 4,400 sheet

Dividend per share $\frac{\$4,000,000.00}{4,400}$

or $909.09

The amount of dividend in $dollar for each shareholder:
For each 10 sheets owned by one shareholder, he/she will receive 1 another sheet. Therefore, the number of stocks owned is 11 sheets. If DPS per share is $909.09; the amount of dividend will be paid by the company to each shareholder is $909,09 x 11 sheets = $10,000.

Effect of dividends on share price

Relationship between share prices and dividend policy, whether higher or lower dividend levels create higher or lower returns, is inconclusive. A famous research by Fama & French in 1988, however showed that in the US, the relationship was existed. They sounded that since the increases in dividends are treated by the market as a higher expectation, this leads to enhance share prices because investors reassed the value of the company.

1. If a company increases its dividends or pays a dividend for the first time, this is viewed as good news. Therefore, the share price increases.
2. If a company decreases its dividend or omits it completely, this is viewed as bad news. Therefore, the share price declines (Drake & Fabozzi, 2010).

Signaling (informational content of dividends)

Capital market takes account of dividend announcements as information for assessing share prices. Many studies support the idea that the change in dividend payment provides information about the level of profitability in the years following the change (McLaney, 2009). In other word, the increase in dividend payment is perceived by investors as an indicator that the company would attain accounting profits in each of the two years after the amount of dividend payment changed.

Factors that affect dividend policy

It is broadly assumed that the level of dividends paid by a company is determined by the amount of cash available. However, the relationship between the level of liquidity and a company's dividend policy is not merely direct. Students that want to examine the relationship should take account other variables that provide intermediary effect on the relationship. Some of variables are presented here.

1. *Corporate tax*. It is assumed that changes in tax rules would make dividends less costly to business, therefore it leads to increase dividend (McLaney, 2009).
2. *Cash flow and investment opportunities*. It is assumed that dividends tend to be lower when there are more investment opportunities for the businesses, as the MM principles would suggest (McLaney, 2009).
3. *The existence of agency problems*. Agency problems and costs would arise where shareholders and directors have different objectives. If the senior managers are also shareholders, agency problems would be reduced because the managers receive dividends as well (McLaney, 2009).

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