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SCIENTIFIC REVIEW

## Identification and Evaluation of Factors of Dividend Policy

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**ABSTRACT** – *Dividend policy determines the ratio between the earnings distributed to shareholders and the earnings retained in the company. Even though retained earnings are one of the most important funding sources used for financing corporate growth, the accrued dividends represent stakeholders' cash flows. Should the cash be reinvested in business operations or should it be paid out to investors in equity? The decision might seem simple, but it provokes a surprising number of controversies. Despite thorough theoretical and empirical analyses aimed to explain their omnipresence, dividends remain one of the biggest puzzles in corporate finances.*

*This paper starts by determining the term of dividend and stating the types of dividends. This is followed by a discussion on dividend policy and optimal dividend policy and an analysis of factors that managers should have in mind when forming dividend policy. Considerable attention is given to the leading dividend theories which try to answer the question about the role of dividends in maximizing the value of a corporation, as well as to practical instructions offered to managers in an attempt to achieve this goal. Other related issues are also discussed, such as dividend reinvestment plans, stock dividends, and share repurchase. Finally, two surveys are presented. The aim of conducting the surveys was to determine the attitudes of managers on dividend policy and to identify factors which the managers viewed as decisive when establishing a concrete dividend policy.*

**KEY WORDS:** *dividend, types of dividends, optimal dividend policy, share price, dividend theories, stock dividends, share repurchase, surveys*

### Introduction

It is often emphasized in literature that the three main groups of decisions companies make, more important than all others, are decisions about the choice of investment alternatives and allocating capital to investment projects, decisions on the way of their financing which, among other things, involves finding the optimal capital structure, and decisions about dividends.

The dividend decision, determined by the company's dividend policy, affects the amount of paid out earnings of the company compared to the amount of earnings that the company retains and reinvests. When the company changes its payment of dividends, it can change one of these remaining policies. By reducing the amount of distributed dividend, the company can retain more funds for investment and avoid procuring funds from external

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funding sources. Also, the company can finance capital expenditures mostly by incurring debt, which frees up cash for dividends.

The central principle of financial management is that managers make decisions that lead to the maximal wealth of shareholders, which is reflected in the share price of the company. The decision to pay out dividends compared to retaining earnings is often confusing because it includes many opposing forces. Both professionals and corporate managers continue to disagree on whether the value of a company is independent of its dividend policy. The challenge faced by the board of directors and the management is to balance these forces in order to maximize the contribution of their dividend policy to increasing the shareholders' wealth.

## **Definitions and types of dividends**

Dividends are the payments that the corporations make to their owners, shareholders. Dividends have a tendency to be seen both by the management of the company and by the shareholders who receive them as an equivalent to interest payments to creditors who approved loans, as a compensation to shareholders for delaying consumption, etc.

Dividends are often vividly described as rewards to shareholders in the form of distribution of profits from the previous or current year and as an important determinant of the share price (McLaney, 1997). Some investors use the dividend yield as a risk measure and as investment screen, investing in shares with a high dividend yield (Damodaran, 1999). Dividends represent the only regular channel for transferring corporate assets to shareholders. In that context, it can be stated that dividends represent proportional distribution of corporate assets to shareholders within the framework of the current and accumulated net earnings.

Corporations usually pay dividends in cash and thus the dividend refers to the money paid from the earnings (Ross, Westerfield, Jordan, 2006). Also, corporations periodically pay dividends in shares and some forms of assets. For example, the U.S. whiskey producers, in addition to regular dividends, also distributed extra dividends in the forms of their products to their shareholders. All dividends, with the exception of stock dividends, reduce the total equity of the corporation.

Since the dividends are paid out from the net earnings, dividend per share is usually lower than earnings per share. However, the shareholders do not receive only the yield based on dividends. To them it is important that the company is doing well and that the market price of its share is rising, because that is the way they generate yield on a different basis, as a difference in share price. That other source of income for a shareholder is called capital gain. However, one should keep in mind that when investors sell their shares, they are paid by other investors and not by the corporation. Except when the corporation is repurchasing its own shares (which is a form of dividend payout), only the corporation's money paid to investors is the payment of dividend.

As we have mentioned already, dividends are usually paid in cash. Regular cash dividends are paid on a quarterly basis, but a small number of companies declare them on a monthly, semiannual and annual basis. The term "regular" indicates only that the company



expects to be able to maintain payments in the future. If the company does not want to give that kind of promise, it usually declares both regular and extra dividend. Investors understand that extra dividend might not be repeated. Another type of dividend is liquidating dividend, which refers to any kind of dividend not based on the earnings. Liquidating dividends imply returning the investment to shareholders, not the earnings. For example, liquidating dividends can be a consequence of selling the entire company or only one of its parts and distributing assets. Finally, the term special dividend is mostly reserved for payments that are not likely to be repeated.

The amount of dividend can be shown as: (a) dividend per share – the sum of monetary units per share, (b) dividend yield – the rate compared to the share market price, and (c) dividend payout ratio – paid dividends (in monetary units) compared to the net profit.

Dividend payout ratio usually refers to the percentage of net profit paid to shareholders in cash. This indicator is calculated by dividing the total amount of paid dividends (in monetary units) by net profit, and it is also often seen as the indicator of the generosity of the company's dividend policy or the lack of one (Gallagher, Andrew, 1997).

Dividend payout ratio of 30%, for example, tells us that the corporation pays out dividends. However, caution is advised. By focusing on the presented earnings and the dividend payout ratio, we ignore the key for the payout of dividends. That key is cash. When a company makes profit, that usually results in money that flows into in the company. However, profit and cash flows do not necessarily happen at the same time. The Table 1 illustrates these time differences.

*Table 1. Selected financial data for the corporation X for the current year*

Sales (all on credit payment due in next year)	KM 2.000.000
Total expenses	<u>800.000</u>
Net profit	<u>1.200.000</u>
Cash received this year	KM 0

Table 1 shows that the corporation X showed earnings in the amount of 1.200.000 KM this year, but that it did not receive any cash. The corporation would not be able to pay out dividends, except by using the money from previous earnings.

If the corporation thinks that a certain dividend payout is crucial for preserving its value, it can even choose to incur debt to obtain cash needed to pay out dividends. It sometimes happens that corporations incur debt to obtain cash for dividend payout when it is expected that the dividend payout is of vital importance for regular shareholders.

## **Dividend policy**

Dividend policy is an important theme in corporate financing since dividends represent a large cash expense for many corporations. At first sight it can seem obvious that a company always wants to return as much as possible to their shareholders by paying out dividends. However, it can seem equally obvious that a company can always invest money for its shareholders instead of paying it out. That is the reason why dividend policy is needed. That



is the area in which the shareholders are very much interested, but at the same time it is the area used by the corporate management to preserve the interests of the company by taking account of the possible connection between dividends and the company's market value.

Dividend policy refers to the payment policy used by the management when determining the amount and patterns of distribution to shareholders over a period of time (Baker, Powell, 2005). It is considered that dividend policy includes three questions (Brigham, Houston, 2004): (a) Which part of the earnings should be distributed? (b) Should the distribution be in the form of cash dividends or share repurchase? and (c) Should the company maintain a steady, stable growth rate of dividends?

We can safely say that the central question of dividend policy is whether the available earnings will earn more money for the shareholders if the company stays in business with the aim of financing growth, or if the earnings are distributed to them as a cash dividend or share repurchase. Dividends are important because the timing and the sum of expected dividend payments of the company determines the value of its share. What is less clear is whether or not the time patterns of dividends (more now compared to more later) are a contentious question. This is the question of dividend policy and it is not easy to give a definitive answer to it.

It should be kept in mind that a direct dividend payout benefits the shareholders, but that it also influences the ability of the company to retain the earnings in order to use the possibility of growth. Dividend policy provides guidelines for balancing the opposed forces that surround the decision whether or not to pay out a dividend or retain the earnings.

Even though the total income of the company, after taxes, belongs to its shareholders, the corporations usually distribute only one part as cash dividends, if they are able to do so, and they reinvest the remaining income in the additional assets. When a company retains the earnings, such earnings appear as retained earnings in the equity section in the balance sheet. We would like to also add here that the retained earnings as a source of funds has a few advantages, the most important of which are the following (Bradley, 1978): (a) a cheap source, (b) does not have the right to vote, (c) does not impose restrictive regulations on the management, (d) the company has an unlimited use of funds, (e) the issuer does not pay a fixed yield, as would be the case with bond issue, and (f) collateral is not needed.

Furthermore, when deciding about the amount of money that should be distributed to shareholders, financial managers have to have in mind that the company's goal is to maximize value for shareholders. Consequently, the target dividend payout ratio should to a large extent be based on whether investors prefer dividends compared to the capital gain.

This preference can be considered in relation to the model of the valuation of ordinary shares which assumes that dividends per share will grow by a constant growth rate in every period never expecting it to change. The constant growth model is also known as Gordon Growth Model, named after the financial economist Gordon who developed it and made it widely known. According to this model, the price of an ordinary share is determined in the following way:  $P_0 = D_1 / (k_s - g)$ . It is obvious that the price of an ordinary share according to the given formula depends on three factors: (a) the expected dividend in the following period,  $D_1$ , (b) requested rates of return,  $k_s$  (c) rates of growth of the company's dividends,  $g$ . Along with other constant factors, if the company decides to increase the cash dividend,  $D_1$ , the share price of the company should increase. Still, by increasing its dividend, the company



reduces its growth rate ( $g$ ), which tends to lower the price of the company's share. The reduction of the growth rate happens because retaining a smaller amount of earnings reduces the available cash for obtaining additional assets. Since the increase in the asset base is crucial for the growth of the company, having a reduced amount of retained earnings reduces the expected growth rate,  $g$ , and lowers the price of the share,  $P_0$ . Therefore, changes in dividends result in opposing the forces which can increase or reduce the value of the ordinary share of the company. We can draw a conclusion that the optimal dividend policy establishes balance between the current dividends and the future growth which maximizes the price of the ordinary share of the company (Brigham, 1991).

We will also mention that companies need a strategic policy for dividend payouts because market participants (current and potential shareholders) mostly do not like surprises. Unregulated dividend policy means that those shareholders who liked the previous dividend cannot be sure whether they will like the next one. This insecurity can lead to the fall of the price of company's shares. When shareholders do not get what they expect, they often express their dissatisfaction by selling their shares. One well planned policy applied to the corporation and its business strategy can prevent unpleasant surprises for market participants and protect the share price.

### **Factors affecting dividend policy**

There are several factors which affect dividend policy, the most important of which are the following: (a) legal rules, (b) liquidity position, (c) the need to pay off debt, (d) restrictions in debt contract, (e) rate of expansion of assets, (f) profit rate, (g) stability of earnings, (h) access to capital markets, (i) control, and (j) tax position of shareholders. Details about these factors will be presented in the following section.

One of the factors that determine the extent to which the company will pay out dividends instead of retaining earnings are legal rules. This rules state that dividends must be paid out from the earnings (profit) – whether from current earnings or from the earnings from previous years, which is shown on the balance sheet in “retained earnings”.

State laws emphasize three rules; (a) the net profit rule, (b) capital impairment rule and (c) insolvency rule. The net profit rule states that dividends can be paid out from past and current earnings. Capital impairment rule protects the creditors by forbidding dividend payout from the capital. Dividend payout from capital would mean distributing the investment in the company, not the earnings, and such dividend is called liquidating dividend. The insolvency rule states that corporations cannot pay out dividends as long as they are insolvent, i.e. as long as their liabilities exceed the value of their assets. Dividend payout under such circumstances would mean giving the funds to the shareholders which rightfully belong to the creditors.

One of the factors affecting dividend policy of companies is its liquidity position. Profits that are kept in retained earnings, which appears on the right side of the balance sheet, are usually invested in the assets needed for work. Retained earnings from past years are already invested in facilities and equipment, supplies and other assets, meaning that they are not being retained as cash. Therefore, even if the company has record earnings it may not be able to pay out cash dividend due to its liquidity position. Growing companies, of course,



even those very profitable ones, usually have an urgent need for funds. In such situation, the company can choose not to pay out cash dividends.

The need to pay off debt also determines the company's dividend policy. When the company sells its debt as a way of financing expansion or using it as a replacement for other forms of financing, it faces two alternatives. It can return the debt on the maturity day by replacing it with another form of securities. However, the decision to retire a debt will mostly require retaining the earnings.

Dividend policy is also affected by restriction in debt contract. Debt contracts, especially when a long-term debt is involved, frequently restrict the ability of the company to pay cash dividends. Such restrictions, designed to protect the position of a lender, usually state that (a) future dividends can be paid out only if the earnings were made after signing the loan contract (i.e. they cannot be paid out from past retained earnings) and that (b) dividends cannot be paid out when the net working capital (working capital minus short-term liabilities) or the indicator of current liquidity (working capital, cash being one of its parts, divided by short-term liabilities) are below a certain level.

Company's dividend policy also depends on the rate of expansion of assets. The bigger the need for assets, the bigger the possibility that the company will retain earnings rather than paying them out. If the company wants to obtain assets from external sources, a natural source for that lies in current shareholders who already know the company. But, if the earnings are paid out as dividends and are subjected to a high tax rate of personal income tax, only part of them will be available for reinvestment.

Profit rate also affects dividend policy. The expected rate of return on assets determines the relative attractiveness of paying out earnings to shareholders in the form of dividends (who will use them elsewhere) or of using them in this (current) company.

Stability of earnings is also one of the factors which affects dividend policy. The company that has relatively stable earnings is often able to make a rough assessment of its future earnings. It is therefore more likely that such company will pay out a larger percentage of its earnings than the company with variable earnings. An unstable company is not sure whether the earnings they hope for will be achieved in the years to come and it is more likely that they will retain a part of current earnings. It will be easier to maintain a lower dividend if earnings decrease in the future.

Access to capital markets also determines dividend policy. Understandably, an easier access to capital markets and a wider range of alternative sources of financing make the pursuit of dividend policy easier. Possible restrictions face the management with a serious dilemma: whether to give up on profitable projects and jeopardize the future cash flow and future gain or to reduce or completely give up on dividends and face the effects of unfavorable information signaling. It should be mentioned that large, affirmed companies with the record profitability and stability of earnings have an easy access to capital markets and other forms of external financing. On the other hand, potential investors see small or new companies as more risky. Their ability to increase capital or debt funds from capital market is limited and they have to retain more earnings for financing their business operations. Affirmed companies will therefore probably have a higher rate of dividend payment than new or small companies.



One of the important variables that affect dividend policy is the effect of alternative sources of financing on the control situation in a company. If the company practices the policy of larger dividend payouts, it is to be expected that it will reach for external sources of financing, either because it needs additional capital for new investment or to finance dividends themselves. The consequence of this activity can be control dilution in the situations when shareholders from the control group do not subscribe a sufficient number of new shares. Relying on internal financing with the aim of maintaining control reduces the dividend payout.

And finally, the tax position of shareholders greatly affects the desire for dividends. In relation to that, it should be mentioned that there can sometimes be a conflict of interests in large corporations between shareholders in high tax grades and those in low tax grades. The former can prefer low dividend payout and high rate of retaining earnings hoping for the appreciation of the company's equity. The latter can prefer a relatively high dividend payout. Dividend policy in such companies can be a compromise between a low and high payout – medium payout ratio. If one group comes to dominate the company and sets, for example, the low payment policy, the shareholders who want an income will probably sell their shares with time and find higher yielding shares. In that way, to a certain extent at least, the company's dividend policy is determined by the type of shareholders that company has – and the other way around. This is called the clientele effect on dividend policy.

### Leading dividend theories

As we have already asserted, corporations take a large number of various factors into account when deciding about the character of their dividend policy. Financial experts are trying to combine these factors into dividend theories about the way in which dividend policy affects the company's value. Leading dividend theories, which help the pursuit of dividend policy, are the following: (a) residual theory of dividends, (b) stable dividend theory, (c) dividend clientele theory, (d) signaling dividend theory, (e) “bird in the hand” theory, (f) tax preference theory, and (g) dividend irrelevance theory.

*Residual theory of dividends* is widely known. This theory is based on a hypothesis that the amount of dividends should not be the company's focus. Instead, the primary subject of discussion should be the determining of the amount of retained earnings for investing within a company. Since dividends come from the “residue”, or leftover earnings, the theory is called residual theory. According to this theory, corporate companies follow four steps when deciding on the rate of dividend payout (Brigham, 1991): (a) determine the optimal capital budget, (b) determine the amount of equity needed for financing that budget, (c) to the extent possible, use the retained earnings to supply the equity, and (d) pay out dividends only if the available earnings are higher than needed to support the optimal capital budget.

If the company strictly follows the residual dividend policy, then the dividends paid out in any year can be expressed in the following way (Brigham, Houston, 2004):

$$\begin{aligned} \text{Dividends} &= \text{Net income} - \text{Retained earnings required to help finance new investments} \\ &= \text{Net income} - [(\text{Target equity ratio})(\text{Total capital budget})]. \end{aligned}$$



Determining the amount of dividends, according to the theory of residual dividends, will be shown by using one example. Let us assume that the corporation Y needs 10 million KM for financing its eligible projects of capital budgeting (Table 2).

*Table 2. The application of the residual theory of dividends on the example of corporation Y*

Investment needed for new projects	10.000.000 KM
Optimal capital structure	30% Debt – 70% Equity
Needed equity funds	$70\% \times 10.000.000 \text{ KM} = 7.000.000 \text{ KM}$
Available earnings	12.000.000 KM
Residual earnings	$12.000.000 \text{ KM} - 7.000.000 \text{ KM} = 5.000.000 \text{ KM}$
Amount for dividend payout	5.000.000 KM

The corporation Y has earnings in the amount of 12 million KM. It needs equity funds in the amount of 70 percent out of 10 million KM or 7 million KM, so that what is left is leftover earnings in the amount of 5 million KM for dividends.

If available earnings were 20 million KM instead of 12 million KM, then the dividend payout would be 13 million KM (20 million KM – 7 million KM). However, if the available earnings were 6 million KM instead of 12 million KM, then dividends would not be paid out. As a matter of fact, additional financing by equity in the amount of 1 million KM should be increased by issuing new ordinary shares.

Theory of residual dividends focuses on the optimal using of earnings generated from the perspective of the company. This dividend theory, therefore, ignores the shareholders' preference concerning the regularity and the amount of dividend payout. If the company applies the theory of residual dividends, when the earnings are high and the eligible projects of capital budgeting are small and few, dividends will be high. In contrast, when the earnings are high and there are many big eligible projects waiting to be financed, dividends cannot be paid out if the theory of residual dividends is applied. Dividend payouts would not be regular and the amounts would not be predictable.

*Stable dividend theory* is the theory which requires the payout of the same amount of dividends per share in a series of consecutive accounting periods. As we have already asserted, the essence of the residual approach is that dividends are paid out only after all other profitable investment opportunities have been used up. Naturally, a strictly residual approach can lead to a very unstable dividend policy. If the investment opportunities are rather high in one period, dividend will be either low or zero. Conversely, dividend can be high in the following period if it is considered that investment opportunities are not promising. The company can choose between at least two types of dividend policies. First, each quarterly dividend can be a fixed part of the earnings in that quarter. In this case, dividends will vary during the entire year. This is a cyclical dividend policy. Second, each quarterly dividend can be a fixed part of annual earnings, which implies that all dividend payouts will be equal. This is a stable dividend policy. Corporate officers generally agree that stable dividend policy is in the interest of the company and its shareholders and the stable dividend policy will thus be more frequent.





Most companies that pay dividends try to follow the policy of stable dividend per share for four reasons (Baker, Powell, 2005): (a) many managers think that stable dollar dividend policy leads to higher share prices, (b) shareholders frequently rely on dividends to provide a stable source of income to supplement their current consumption, (c) stable dividend policy gives less chance of transmitting false information content, and (d) legal listing of shares requires dividend stability in many countries.

We will also mention that instead of absolute stability, both corporations and shareholders rather opt for the policy of relative stability which assumes gradual changes in dividend payouts (generally in the ascending line) in relation to the trend line of net income, while trying to avoid short-term net income fluctuations of the amount of dividends. Choices of this kind are primarily motivated by the fact that dividend stability attracts investors and it is therefore believed that this kind of policy leads to the increase in the market price of shares.

*Dividend clientele theory* is based on the attitude that investors find certain companies attractive in part due to their dividend policy. Dividend policy should therefore reflect the clientele effect as well. For example, young investors might want the value of their portfolios to grow from capital gains and not from dividends so they search for companies that retain earnings instead of paying out dividends. In relation to that, it should be mentioned that share prices have a tendency to increase when the earnings are retained and the resulting capital gains are not taxable until the shares are sold.

If there really is a clientele effect, it means that at least some percentage of the company's shareholders acquired shares because they like the company's dividend policy. If the company is inconsistent in its dividend policy, many shareholders will sell shares, because they do not know whether the level of dividends will suit their preferences or not. The lack of popularity of shares would have a negative effect on share price and thus the cost of capital as well. Even if a certain company was rather consistent in its dividend policy, but then initiated a big change, some of its investors who particularly liked the previous dividend policy (that may be the case with all shareholders) would probably want to switch to shares of the company with dividend policy that they find more acceptable. Even though it might be the case that new clientele finds the dividend policy attractive, the friction caused by one group of investors selling to a new group of investors would have a negative effect on shareholders.

*Signaling dividend theory* is based on the premise that the management of the company knows more about its future financial prospects than shareholders. According to this theory, if a company declares a dividend higher than the one predicted by the market, this will be interpreted as a signal that future financial prospects are brighter than expected. Investors assume that the management would not have raised the dividend if they did not think that they could maintain it. As a result of this signal of good future prospects, investors buy more shares, causing the share price to increase. In contrast, if the company lowers its dividend, the market sees this as a signal that the management expects bad earnings and does not think they can maintain the current dividend. If raising the dividend should act as a signal, it seems reasonable to ask ourselves why the management does not only issue a declaration. Surely a declaration would be much less ambiguous than the increase of dividend. Maybe managements think that actions speak louder than words (McLaney, 1997).



The “bird in the hand” theory claims that shareholders prefer to receive dividends instead of the earnings being reinvested in the company on their behalf. According to this theory, the value of the company will be maximized by a high dividend payout ratio because investors think that current dividends are less risky than potential capital gains. Even though investors should expect to benefit from retaining and reinvesting earnings in their company since the future share prices will increase, there is uncertainty about whether that benefit will actually be realized. In other words, “a bird in the hand is worth two in the bush” (Gallagher, Andrew, 1997).

*Tax preference theory* states that, since capital gains are subject to lower tax burden than dividends, investors prefer to own the retained earnings of the company than to be paid dividends. Hence, increasing the dividends, according to this theory, would result in the fall of share price and the growth of requested rate of return on equity.

There are three tax-related reasons that support the opinion that investors would prefer low dividend payouts to high dividend payouts. Those reasons are the following (Brigham, Houston, 2004): (a) Long-term capital gains are generally taxed at a rate of 20 percent, whereas the income from dividends is taxed at effective rates that can reach as much as 38,6 percent. (b) Income taxes are not paid as long as shares are not sold. Due to the effect of time value, a dollar of paid taxes in the future has a lower actual cost than a dollar paid today. (c) If the shares are owned by someone until that person's death, there is no tax on all capital gains – beneficiaries who receive the shares can use the value of shares on the day of death as their purchase value and thus completely avoid capital gains tax.

*Dividend irrelevance theory* considers that a company's dividend policy does not have an effect on the company's value or on its cost of capital. According to this theory, there is no optimal dividend policy. One dividend policy is as good as any other. The notion that dividends are irrelevant originates from the pioneer work of M. Miller and F. Modigliani (M&M) entitled *Dividend Policy, Growth, and the Valuation of Shares*, published in 1961. In that work, M&M claim that the value of a company is determined only by its earnings power and its business risk. In other words, M&M claim that the value of the company depends only on the earnings produced by its assets and not on whether those earnings are distributed in dividends or retained. It should be kept in mind that M&M put their analysis in the context of contemporary capital market with rational investors. The key assumptions of this ideal version of capital market are the following: (a) no flotation, transaction, and agency costs, (b) no taxes, (c) equal and free access to information – investors are symmetrically informed, (d) rationality of investors, and (e) investors cannot influence the price of securities. Therefore, under very restrictive assumptions, M&M provide a generally accepted argument for dividend irrelevance. The theory by Miller and Modigliani and the messages to corporate practitioners about the importance of dividend payouts are completely clear and as it seems, correct in the context of set limitations.

What we cannot afford to miss is that the problem with most of the existing dividend theories is that they neglect the consideration of the potentially complex interactions between different elements. Another problem is that every theory usually assumes the “one size fits all” approach when testing in order to generalize findings. Hence, dividend decisions, like investment decisions and financing decisions, require a compromise (Damodaran, 1999).



However, unlike with the latter decisions, it seems that little agreement exists on where to find the compromises that are supposed to lead us to the “right” dividend policy.

Having all of this in mind, we can conclude that dividend policy clearly represents a dynamic process with a number of interconnected affects that make the existence of a general model that would lead to the optimal dividend policy for any occasion practically impossible. This fact forces us to make a difficult conclusion that dividend decisions represent an area where the ability to make good judgment calls still plays a big part.

### **Guidelines for establishing dividend policy**

The aim of dividend policy is to maximize its contribution to increasing the shareholders' wealth. The task that the board of directors and the management face is the decision about who can make the better use of money – the company or its owners. Practical instructions available to companies which try to achieve this aim are reflected in the following (Baker, Powell, 2005):

- The company should consider its investment opportunities and avoid further reductions on profitable projects in order to pay out dividends. The point of the analysis is to determine whether the company's opportunities are better than the ones available to investors. If the expected return from the available discretionary projects exceeds the opportunity cost of capital, the company should have a lower dividend payout. If it cannot put the retained earnings to good purpose, the company should distribute more to its shareholders. A higher target payment is not an acknowledgment of failure.
- Companies should rely heavily on retained earnings as the source of equity. Companies should avoid issuing new equity unless it is needed for financing profitable investments. The sale of new shares includes the costs of flotation costs and a negative market reaction to such sale.
- If the company is paying out dividends, it should consider paying them on a regular basis from the available cash flow. Consistency, where possible, is important because a large number of investors depend on dividends. When a company establishes dividends, it has an implicit responsibility to maintain them through a regular business cycle. Incurring debt in order to maintain a regular dividend can be accepted if it is within reasonable bounds and if the management expects the earnings to increase.
- Companies should avoid reducing or omitting dividends unless the current dividend level is unsustainable in the long run. One of rare aspects of dividend policy, on which a widespread agreement exists, is that the management should not accidentally reduce a once established dividend rate.

### **Dividend reinvestment plans**

Many corporations offer a dividend reinvestment plan based on which the shareholders reinvest their dividends instead of receiving them in cash. Dividend reinvested plans are popular because they provide shareholders with an opportunity to buy additional shares



without creating provision costs that accompany regular purchases that shareholders make through a stockbroker. To companies, dividend reinvestment plans represent a way to increase the rate of retaining earnings without voting and declaring the lowering of dividend payouts.

Dividend reinvestment plans have various characteristics. There are plans of reinvesting in the existing and new shares. Plans also differ according to investment limits, according to determining the price of reinvestment and according to the way of managing dividend reinvestment plans (Orsag, 2003).

### **Stock dividends**

In addition to cash dividends, the distribution of value to shareholders can be done by distributing dividends in the form of shares (*stock dividends*). Stock dividends are not real dividends because they are not paid in cash. The effect of stock dividends is the increase in the number of shares owned by every shareholder. Since there are more outstanding shares, each share is simply worth less.

Stock dividends are usually expressed in percentages. To take an example, a 20 percent stock dividend means that the shareholder gets one new share for every five shares s/he currently owns (increase by 20 percent). Since every shareholder gets a 20 percent increase in shares, the total number of outstanding shares is increased by 20 percent. As we will see, every share is worth around 20 percent less at one point.

A typical financial manager is aware of the many complexities of the real world and thus the decision on stock dividends is not treated lightly in practice. Usually, in addition to using the distribution of stock dividends to retain earnings in the company, distribution of stock dividends can also be an indicator of higher future profit. The reason for that is the fact that earnings would have to be retained only if it is possible to invest them profitably. If, however, the profitability of the company does not increase, dilution of earnings will occur. Therefore, the management that proposes the issuing of stock dividends should be committed to achieving a higher profitability.

A stock dividend is very similar to stock splits. Specifically, the process of stock splitting, as well as the process of distributing stock dividends, leads to the actual increase of the number of shares (in inverse proportion to the reduction of their nominal value) while the fixed capital remains unchanged. Even though at first sight it might seem that the effects of the two actions are the same or similar, it has to be emphasized that there is a significant difference between them from a financial and accounting point of view. In support of the process of stock splitting, it is stated that the market price of shares falls at a slower rate than the proportion in which their splitting was done (Petty, Keown, Scott, Martin, 1993).

### **Repurchase of own shares**

As an alternative to cash dividend payouts, corporations can choose to pay the earnings to the owners by repurchasing ordinary shares outstanding. When repurchasing shares, the company exchanges the assets for some part of its outstanding shares. Ordinary shares acquired by the company issuer become treasury shares. Such shares have no voting rights,



are not included in the calculation of earnings per share and do not meet the requirements for dividend payout. Even though the primary source of funds used for financing the repurchase is the available amount of funds, companies sometimes use debt and other sources. There are two main types of the repurchase of shares: (a) the situation in which the company has money available for distribution to its shareholders and it distributes that money by repurchasing shares and not by paying cash dividends, and (b) the situation in which the company concludes that its capital structure is overburdened by equity and it sells its debt and uses the funds to repurchase its shares.

There are certain benefits as well as weaknesses to the repurchase of own shares. The advantages of the repurchase of own shares can be summed up in the following (Brigham, 1991):

- Announcement of repurchase is often seen by investors as a positive signal because repurchase is often motivated by the management's conviction that the shares of the company are underrated.
- Shareholders have a choice when the company is repurchasing shares – to sell them or not to sell them. However, shareholders have to accept the dividend payout and pay the tax. Therefore, those shareholders who need cash can sell some of their shares, whereas those who do not need additional cash can simply keep their shares. From a tax point of view, both types of shareholders get what they want.
- The third advantage is that repurchase can remove a large block of shares looming over the market and keeping the share price low.
- Dividends are “sticky” in the short run which is the reason why the management is hesitant to increase the dividend if the increase cannot be maintained in the future – managerial aversion towards the reduction of cash dividends. Therefore, if the surplus of cash flow is seen as being only temporary, the management can prefer to choose a distribution in the form of share repurchase and not to declare an increased cash dividend which cannot be maintained.
- Repurchase can be used for making big changes in the structure of capital.

Weaknesses of the repurchase of own shares include the following (Brigham, 1991):

- Shareholders may not be indifferent between dividends and capital gains, and the price of shares can benefit more from cash dividends than from repurchase. Cash dividends are mostly reliable, repurchases are not. Furthermore, if many companies announced regular, reliable repurchase programs, improper accumulation of taxes could become a threat.
- Shareholders who are selling their shares cannot be completely aware of all the implications of the repurchase or they cannot have all relevant information about the present and future activities of the corporation. However, companies mostly announce repurchase programs before they engage in them in order to avoid potential lawsuits by shareholders.
- Corporation can pay a high price for repurchased shares at the expense of the remaining shareholders. If its shares are not used for active trade and if the corporation wants to acquire a relatively large amount of its shares, then the



offered price can be above its equilibrium level, and then start declining after the corporation suspends its repurchase operations.

## Survey results

Since there are certain reasons for and against dividend payouts and since there is a lack of consensus about the effects of dividends on value, it is necessary to determine the factors which managers take into account the most when making the dividend decision. Baker, Farrelly and Edelman conducted a survey among managers in 1985 about their attitudes on dividend policy and showed their level of agreement with a series of statements. Their findings are summarized in Table 3 (Baker, Farrelly, Edelman, 1985).

*Table 3. Management beliefs about dividend policy*

Statements of management beliefs	Agree	No opinion	Disagree
1. A firm's dividend payout ratio affects the price of the share.	61%	33%	6%
2. Dividend payouts provide a signaling device of future prospects.	52%	41%	7%
3. The market uses dividend announcements as information for assessing firm value.	43%	51%	6%
4. Investors have different perceptions of the relative riskiness of dividends and retained earnings.	56%	42%	2%
5. Investors are basically indifferent with regard to returns from dividends and capital gains.	6%	30%	64%
6. A shareholders are attracted to firms that have dividend policies appropriate to the stockholder's tax environment.	44%	49%	7%
7. Management should be responsive to its shareholders' regarding dividends.	41%	49%	10%

This research clearly shows that, whether they are right or wrong, managers think that their dividend payout ratio affects the company's value and act as a signal of future prospects. They also work under the assumption that investors choose companies with dividend policies that suit their wishes and that the management should respond to their needs.

We will also show the findings of the research conducted in big companies in Split-Dalmatia County which is also related to the attitudes of managers on dividend policy. The findings of that research are presented in Table 4 (Vidučić, 2004).



Table 4. Attitudes of managers on dividend policy in large companies of Split-Dalmatia County

Attitudes on dividends	Rating grade
Shareholders should be informed about the changes in dividend policy	1
It is necessary to define the target rate of dividend payout	2
When assessing securities, investors use information about dividends	3
Payment of dividends is a signal of the company's success	4

This research showed that financial managers think that shareholders should be informed about the changes in dividend policy. Furthermore, they think that it is necessary to determine an optimal dividend payout ratio. According to managers' attitudes, this indicator ranges from 20 to 70%. Likewise, managers think that investors use information about dividends to assess the value of shares and that the payout of dividends is a signal of company's success. It can be assumed that the clientele effect also plays an important role, while the tax effect can be described as marginal. This is understandable if we keep in mind the fact that individuals do not pay tax on dividends, whereas tax on dividends and capital gains of the corporate sector is taxable at the same rate.

## Conclusion

All corporate companies have to face the problem of finding a suitable dividend policy which can be summarized in simple terms as deciding which part of the earnings to retain in a company for the purpose of reinvesting and which part of the earnings to distribute to shareholders through dividends. The main problem is the need for finding the optimal dividend policy which would maximize the market value of a company.

We can safely state that dividend policy is one of the most controversial areas of financial management. A number of reasons can be found for the payout of high dividends and an equal number against dividend payout. Legal rules are important because they provide a framework for the formulation of dividend policy. However, within its boundaries, financial and economic sector have the biggest influence on dividend policy. Financial experts are trying to combine these factors into dividend theories about the impact of dividend policy on the price of an ordinary share. On the one hand, some argue that because of the tax advantages related to the reception of dividends, in relation to price appreciation, some companies should reduce or even stop dividend payouts and consider alternative ways of returning money to shareholders. On the other hand, many claim that increasing the dividend acts as a positive financial signal and that there are investors who prefer dividends, regardless of tax disadvantages. Finally, there is a school of thought which claims that dividend policy does not affect the value of an ordinary share. In short, there is some truth in all of these points of view and it is possible to reach a consensus on the points on which they agree. The reality is that dividend policy requires a compromise between additional tax liability which can be created for some investors and potential signaling and benefits from free cash flows. In some cases, a company can decide not to increase or not to start paying dividends because its shareholders are in high tax grades and are particularly averse towards dividends. In other cases, increase in dividends may occur.



A key question, does the dividend policy affect the owner's wealth and if it does, does the dividend payout increase it or not, does not have a single answer. Various theories of dividend policy have to be considered in order to formulate a concrete dividend policy out of their recommendations. Therefore, decision to pay or not to pay dividends as well as decision on their high depends on the specificity of each company and is in no way simple. The "magic formula" does not exist. The optimal or ideal dividend policy is unusually complicated and is in the final analysis determined to a large extent by the management's ability to make the right call.

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## Identifikacija i evaluacija faktora politike dividendi

**REZIME** – Politikom dividendi se određuje omjer između zarade distribuirane dioničarima i zadržane u firmi. Iako su zadržane zarade jedan od najvažnijih izvora sredstava koji se koristi u finansiranju korporativnog rasta, obračunate dividende predstavljaju tokove gotovine za dioničare. Treba li gotovinu reinvestirati u poslovanje ili je treba isplatiti investitorima u dionički kapital?





Odluka se može činiti jednostavnom, ali izaziva iznenađujuću količinu kontroverze. Uprkos iscrpnim teorijskim i empirijskim analizama da se objasni njihovo sveprožimajuće prisustvo, dividende su i dalje jedna od najvećih zagonetki u korporativnim finansijama.

U ovom radu se najprije određuje pojam dividende i navode oblici dividendi. Nakon toga se raspravlja o politici dividendi i optimalnoj dividendnoj politici, te analiziraju faktori koje menadžeri trebaju imati u vidu kod oblikovanja politike dividendi. Znatna pažnja se posvećuje vodećim dividendnim teorijama, koje nastoje da daju odgovor na pitanje kakva je uloga dividendi u maksimiranju vrijednosti korporacije, te praktičnim uputstvima koja stoje na raspolaganju menadžerima u pokušaju da postignu ovaj cilj. Takođe, raspravlja se i o drugim povezanim pitanjima, kao što su planovi reinvestiranja dividendi, dividende u obliku dionica i otkup dionica. Konačno, predstavljaju se i nalazi dva anketna istraživanja čiji je cilj bio utvrđivanje stavova menadžera o politici dividendi, odnosno identifikuju se faktori koji su u najvećoj mjeri opredjeljivali menadžere pri uspostavljanju konkretne dividendne politike.

**KLJUČNE RIJEČI:** *dividenda, oblici dividendi, optimalna politika dividendi, cijena dionice, dividendne teorije, dividende u obliku dionica, otkup dionica, anketna istraživanja*

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