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PERCEPTIONS ABOUT DIVIDEND POLICY : A NEW ZEALAND SURVEY

A. Introduction

Dividend policy - its rationale and consequence - has long been a matter of controversy among finance academics. Their research efforts have yielded limited guidance to finance executives responsible for implementing dividend decisions. A number of empirical investigations have, according to Hess (1987), failed to provide clear action prescriptions for financial management.

Past research efforts have been directed at studying dividend phenomena in a number of capital markets. For example in the Australian market the relationship between dividends and the value of the firm has been studied by Ball, Brown, Finn & Officer (1979) to describe the per se effect. Brown, Finn & Hancock (1977) have studied how information contained in dividend changes impact on price (information effect).

Other research on dividends has focussed on clientele (tax) effects (e.g. Elton & Gruber, 1970) and how managers decide on changes in dividend policy. The latter, pioneered by Lintner (1956), found that dividend policy is a function of past dividends and current earnings.

Despite considerable research, it has been claimed by Weston & Brigham (1987, p. 637) that academics cannot tell corporate decision makers how dividend policy affects stock prices and capital costs. Dividend policy continues to be a puzzle and no clear understanding of the role of dividends in investing has emerged (Black, 1976). It is not clear whether companies might better serve their shareholders by reinvesting all profits (Berg, 1984). As observed by Baker and Farrelly (1985), dividend policy research has produced inconclusive findings. "In some areas, the results reflect sensitivity of minor specification changes in the testing methodology while in others, the sophistication of the statistical analysis is inadequate for the task at hand." (Baker & Farrelly, 1985, p. 2).

The lack of clear guidance about aspects of dividend policy has stimulated this research paper that switches the focus of research away from financial and accounting data to the views of financial managers on dividend policy from a behavioural perspective. Other research has followed this approach providing insight into the dividend perceptions and actions of U.S. finance managers in companies with a record of dividend achievement (Baker & Farrelly, 1985). That research revealed, among other things, that:

(i) Managers behave as though dividend policy is relevant and impacts on share value.

(ii) Managers smooth dividend payments in the face of earnings variations.

(iii) Managers believe that dividends provide a signal to investors about the firm.

B. Research Objective and Sample

The objective of this study was to survey and report the opinions of selected corporate finance managers responsible for dividend policy decisions in New Zealand companies which are dividend achievers, that is, companies with an unbroken record of increased dividends for the 5 year* period 1981 - 1985. Opinions were sought on the critical issues in dividend policy (Finnerty, 1986, Ch.13) such as reasons for dividends, factors determining dividend policy, perceptions about dividend information content, and the effects of external events on dividends.

The study only references dividend achievers and therefore precludes the results from being generalised to all dividend paying companies. However, dividend achievers represent a cross section of companies in terms of industry grouping.

The focus of the study on dividend achievers and dividend policy behaviour from a management perspective provides an opportunity to generate further findings illuminative of dividend policy behaviour and represents one of the few attempts** to examine this area from the finance manager's perspective. By focussing on dividend achievers the study references companies which have an established record of dividend payments and which are assumed to have clearer views on active dividend policy.

The research method employed is based on an opinion survey of finance managers actively involved in determining dividend policy. The study surveyed those 60 publicly listed New Zealand companies found to have a dividend achievement record as defined.

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* At the time of the survey our corporate data files did not extend to the 1970's and therefore our achievement period was limited to 5 years.

** see Baker, Farrelly and Edelman (1985) and Partington (1985) for such attempts.

The questionnaire, based on Baker & Farrelly's (1985) instrument, consisted of two parts. Part 1 consisted of 12 closed-end statements about the importance of various factors used in determining the firm's dividend policy [See Table 1 for list]. Part 2 contained 16 questions focussing on the issues cited previously as well as the emerging issue of dividend imputation. The responses to these questions are grouped under the following headings in section C of the paper.

(i) Factors determining dividend policy.

(ii) Information content of dividends.

(iii) Reasons for paying dividends.

(iv) Dividend payout targets.

(v) Importance of industry norms, and

(vi) Effect of imputation system on dividend policy.

The questionnaire was pre-tested for validity with several finance executives and their suggestions for improvement incorporated.

A letter of introduction and the questionnaire were sent to the chief financial officer of the sample companies in November 1986. A total of 32 completed questionnaires was received (53% response rate). Responses were anonymous. The responses are shown in Tables 1 and 2 and questions in Part 2 of the survey are dealt with under the headings above.

An analysis of the respondents' industry revealed the following profile: Investment (15.6%), Engineering and Construction (18.7%), Retail (15.6%), Manufacturing - Textiles, Rubber, Medical, Electrical, Chemical - (28.2%), Food and Agriculture (9.3%) and Services - Insurance, Media, Printing, Transport - (12.6%).

An examination of the sample showed that 100% of respondents relied on their annual or quarterly reports to communicate dividend policy to their shareholders. Other communications were made through letters or press releases (20% of sample) and by presentations to analysts (40% of the sample).

C. The Results and Discussion

(i) Factors determining dividend policy

Part I of the questionnaire asked respondents to indicate the importance of each of the 12 listed factors (see Table 1) in determining the company's dividend policy. A Likert five-point scale, 0 (no importance) to 4 (maximum importance), was employed. The distribution of responses is shown in Table 1. The response distributions were analysed using Kendall's coefficient of concordance. The concordance statistic (see Table 1) was highly significant, implying significant agreement between respondents about the order of ranking. To test the significance of differences within the overall ranking, pair-wise comparisons were made using the Wilcoxon matched - pairs signed - ranks test. Significance levels for the differences between adjacently ranked factors are shown in Table 1.

Table 1 ranks the 12 factors by their mean responses. The most highly ranked factor in determining dividend policy was the sustainability of dividend payout with a mean level of importance of 3.12. (The Baker and Farrelly 1985 study also reported this factor as the highest ranked).

Responses to other questions in the survey supported the high 8f ranking of the sustainability factor. For example, when asked whether they believed that most of their shareholders preferred a reasonably stable dividend, the majority of respondents (90.6%) responded affirmatively. When asked to list the action they would adopt in the event of a temporary decline (e.g. 6 - 12 months) in earnings, a large percentage of respondents (68.8%) preferred to continue at the old level of dividend payment, while the remainder would either continue with targeted rate of dividend growth (15.6%) or would give a smaller than customary increase in dividend payment (15.6%).

The importance of the sustainability factor was also supported by responses to a question on sharemarket reaction to dividend growth. A number of respondents (71.9%) believed that the sharemarket placed a premium on the gradual growth in their dividends. Therefore the past 8f behaviour of dividend achievers to increase dividends seems consistent with the importance given to the sustainability of dividend payout in dividend policy. Baker and Farrelly (1985) found that four-fifths of their sample believed that the sharemarket placed a premium on a gradual growth in their dividends.

The next three highest ranked factors in Table 1 were current earnings 3.09, the anticipated earnings 2.96 and pattern of past dividends 2.77. These factors also accord with the variables included in the behavioural model of dividend policy of Lintner (1956) which suggested that dividends depend partly on current earnings and partly on dividends for the previous year.

TABLE 1

RANKING OF FACTORS

Rank	Factor	(RANK: 4=Maximum 0=No Importance) Levels 4 - 3	2	1 - 0	N.Z. Mean [Std.Dev.]	Significance of Difference Between Adjacent Ranks [Wilcoxon]
		Response Percentage				
1	Sustainability of dividend payout	87.1	6.5	6.5	3.12 [0.59]	z = -3.82 p < .01
2	Level of current earnings	87.1	12.9	0	3.09 [0.59]	z = -3.72 p < .01
3	Anticipated level of future after-tax profits	77.5	22.6	0	2.96 [0.65]	z = -3.54 p < .01
4	Pattern of past dividends	67.7	29	3.2	2.77 [0.71]	z = -3.62 p < .01
5	Obligation to meet stated dividend objectives	45.2	35.5	19.4	2.38 [1.14]	z = -3.60 p < .01
6	Maintaining a target capital structure	32.2	35.5	32.2	1.90 [1.07]	z = -2.37 p < .01
7	Shareholders tax characteristics	25.90	35.5	38.8	1.74 [1.18]	z = -2.05 p > .01
8	Anticipated state of economy	16.1	32.3	51.7	1.61 [0.91]	z = -3.66 p < .01
9	Cash availability	25.80	25.8	48.4	1.61 [1.14]	z = -3.01 p < .01
10	Cost of raising external funds	12.90	38.7	48.4	1.35 [1.05]	z = -2.43 p < .01
11	Availability of profitable investment opportunities	22.6	16.1	61.3	1.35 [1.11]	z = -2.75 p < .01
12	Conforming to industry norm	12.90	29	58.1	1.25 [1.12]	-

Kendall Coefficient of Concordance	Degrees of Freedom	Probability	Sample Size
W = 0.42 (seen note Appendix 1)	df = 11	p < .001	N = 32

The Baker and Farrelly (1985) study ranked the factor, a pattern of past dividends, ahead of level of current earnings. This ranking difference may be explained by the response to the question on dividend payout which asked respondents about their likely action in case of temporary decline in earnings. Only 31.2% of the New Zealand respondents would give a smaller than customary increase or continue the targeted rate of dividend growth compared to 50.5% of the sample in the Baker and Farrelly (1985) study. None of the New Zealand respondents indicated that they would cut dividends in the event of a temporary decline in earnings.

As previously observed, 90.6% of the New Zealand sample thought that shareholders preferred a reasonably stable dividend rate, suggesting that managers try and smooth their dividend payments over time. The smoothing of dividends is also supported by the response reported above that none of the New Zealand managers would cut dividends in the case of a temporary decline in earnings. This desire to smooth the dividend payments may also explain the prominence of the sustainability of the dividend payout factor.

A separate question asked respondents to list three factors they considered important in determining their company's dividend policy. The three factors cited most frequently were the firm's current earnings (43.5%) dividend stability (37.6%) and future earnings potential (18.2%). The level of current earnings was considered the most important factor by over a third of the respondents (36.7%). Combined with the results in Table 1 these responses indicate that dividend achievers endeavour, as previously observed, to smooth dividend payments to secure a stable dividend policy.

For this sample of dividend achievers, it would appear that dividend policy objectives favour stability and regularity of distributions and, additionally there appears to be an aversion to cut dividends. Given the low rankings of the two factors, cash availability and the availability of profitable investment opportunities, it would appear that dividends are likely not to be residually determined by a large number of the sample.

(ii) Information content of dividends

Studies have investigated how information contained in dividend changes impact on share price. Asquith and Mullins (1986) have shown a substantial impact on stock prices of initiating a policy of paying cash dividends where no prior dividends existed. An unfavourable reaction might result from increased costs associated with paying dividends. A favourable reaction might result from a dividend policy that communicated information to shareholders and provided incentives to institutional investors who might prefer returns in the form of dividends rather than capital gains. Therefore, the initiation of a dividend policy might induce a change in the type of shareholders investing in the company.

In general, research on the significance of dividend changes has found that the stock market reacts favourably to announcements of dividend increases and adversely to announcements of dividend decreases (Baker & Farrelly, 1985, p.10). This supports the view that dividends convey valuable information to shareholders who interpret dividend changes as signals of managers' views about expected earnings. (Finnerty, 1986, Ch12)

These conclusions have some support in this study which showed that respondents considered the sustainability of dividend payout as the most important factor determining the dividend decision and there was a reluctance to cut dividends where current earnings could not support dividends. The reluctance to alter dividends, supports the implicit notion that respondents believe that dividends convey information about expectations of future performance.

To cast further light on the effects of dividend announcements, respondents were specifically asked whether they believed that a <u>change</u> in the rate of dividends served as a message about the future prospects of the firm. Just over a half of the respondents (56.3%) answered affirmatively. In contrast 91.1% of the managers in the Baker and Farrelly (1985) study thought that dividend changes conveyed information about prospects. There appear to be some New Zealand respondents who believe that investors do not attach much significance to <u>changes</u> in dividend rates, perhaps giving an indication that perceptions about the future are best conveyed through alternative signalling modes, or that assessments of earnings prospects cannot be reflected in dividend changes, given the current tax legislation and sharemarket conditions in New Zealand. When asked whether their firm disclosed the reasons for dividend policy change to shareholders, 56.7% answered negatively.

(iii) Reasons for paying dividends

The survey asked respondents to list the three most important reasons why their company paid dividends. Reward for shareholders' investment was most frequently placed as the first reason at 60.5%.

Almost all had mentioned this reason as important which may suggest that dividend policy is determined on the basis of some perception of how dividends affect shareholders' returns. Other frequently cited reasons for paying dividends were to meet shareholders' expectations (15.6%), to maintain share price in the market (12.8%) and to meet market expectations (11.0%).

TABLE 2

REASONS FOR PAYING DIVIDENDS
(Question 13)

Reasons*	% Respondents
Reward for shareholders' investment	60.5%
Meet shareholders expectations	15.6%
Maintain share price in the market	12.8%
Meet market expectations	11.0%

The finding that respondents are concerned with shareholders' return aligns with the view that most reasons for dividend payments are based on the belief that dividend policy is a determinant of shareholders' total return. When asked if their companies were responsive to shareholders' dividend preferences, 72% of respondents answered affirmatively, lending support to the early observations of Lintner (1956) that managers believe shareholders are entitled to a fair share of earnings.

Survey respondents seem sensitive to their shareholder demands, and though N.Z. shareholders may be indifferent to whether their return

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* It is noteworthy to compare these reasons with a ranking of motives for paying dividends by Partington (1985). His highly ranked motives (top 4) were: (1) to meet shareholder requirements for income, (2) to maintain shareholder loyalty, (3) to support or increase the company's share price, and (4) to indicate to shareholders management's view of the firm's future profitability.

comes from capital gains or dividends, respondents apparently believe that the information content of dividends is important to meet market expectations and to maintain confidence in the market. Partington (1985) also found that Australian managers perceive dividend payments as a means of maintaining confidence in financial markets.

A specific question on the relationship between dividends and market share price was included in the survey. Fifty-eight percent of respondents believed that dividends influenced the market value of their ordinary shares supporting the notion that dividends enhance share price. However, 78.1% believed that the diversion of funds from investments to increase cash dividends would not raise share price. The matter of explaining share price increase resulting from increased dividend remains elusive, especially where increased dividends entail both an increased payout ratio and an increase in the dollars of dividend paid.

(iv) Dividend payout targets

One of the objectives of the survey was to determine whether New Zealand dividend achievers had a target dividend payout ratio. It was found that only half of respondents had a target and only 38.3% of them would formally communicate the payout ratio to their shareholders. This can be compared with the Baker and Farrelly (1985) study, where 73.5% of respondents had a target payout ratio (34.1% revealed such information to their shareholders) and the Partington (1984) study of Australian companies which found that 59% of respondents had set a target payout ratio.

The question of whether or not the firm had a target dividend payout ratio was put to see if dividends were treated a residual. If firms followed the residual theory, then dividends would be erratic. There was neither support nor rejection of this treatment since the responses to this question were equally divided on the issue. The dividends of companies without a target payout ratio (50% of the sample) might be expected to be erratic and to be paid when suitable profitable investments were exhausted. This result does not strongly support the results in Table I where it was indicated that 87.1% of the sample believed that sustainability of the dividend payout was the most important factor determining dividend policy. Table 1 showed also that maintaining a target capital structure, the cost of raising external funds, and the availability of profitable investment opportunities were of less importance. The outcome on this question could be the result of erroneous interpretation of the meaning of "dividend payout ratio" or could be explained by the fact that respondents, although not adopting a target payout ratio, behave as if they did so by adhering to a stable dividend record which would imply that a target payout objective was somehow in place.

(v) Importance of industry norms

Does a company's industry influence dividend policy? Four-fifths (81%) of the sample answered negatively. This result was consistent with the results in Table I where the factor "Desire to conform to industry dividend practice", was ranked last in importance. This is in contrast to the Baker and Farrelly (1985) study which indicated that a company's industry might influence its dividend payout ratio - one third of their respondents indicated that they conformed to industry norms. The difference between the New Zealand and the USA result may be due to differences in economy size, corporate regulation, government policies, and the wider information (USA) sources about corporate behaviour and their performance standards.

(vi) Effect of imputation system on dividend policy

The prospect of a tax imputation system* for dividends in New Zealand prompted a question on what were perceived to be its likely effects on company dividend policy

A quarter of the sample had no view on the matter while 18.8% thought that their dividend payout would be revised upwards. Two fifths (40.6%) thought that there would be no change in their dividend policy. A small percentage (6.3%) thought that the dividend reinvestment plan might lose its attractiveness, while a further 6.3% thought that there would be a reduction in bonus issues.

The fact that 25% had not formulated any views and that 40.6% thought that there would be no effect on their policies indicates that the proposed imputation system and its consequences may not have received close attention by a large number of respondents.

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* A shareholder will obtain a tax credit on dividends received from a company whose profits have already been subject to a tax liability - for many shareholders this will mean tax-free dividends.

D. Summary

The findings of this study provide an insight into the behaviour of New Zealand dividend achievers. The decision on dividend payment incorporates the belief that dividends are part of a reward package to shareholders. Respondents' dividend actions appear to reflect shareholders' preferences; dividend policy does not appear to be a subordinate variable in the investment decision process. A number of responses to questions indicate that respondents behave as though dividend policy is relevant and has an influence on share values.

The determinants of dividend payments for the sample have similarity to the behavioural models described in early dividend literature. The level of dividends is determined by respondents' concern to sustain dividends. Dividend payouts are not significantly changed by temporary fluctuations in earnings. Evidence exists that some of the sample endeavour to achieve a stable dividend regime and reference past dividend record, current and prospective earnings. This behaviour appears to be influenced by their belief that shareholders prefer a reasonably stable dividend record and that the market responds to a record of gradual growth in dividends. The dividend record may also be influenced by the belief of some respondents who see dividends providing a signal to shareholders about the prospects of the firm.

These summaries have some parallels in the actual dividend policies of publicly traded companies in USA. Finnerty (1986, Ch 13) cites that US companies exhibit a predilection toward paying at least some minimum level of dividend on a regular basis, a desire to maintain a stable dividend rate and to make orderly changes in the dividend rate, and a strong aversion to cutting the dividend rate.

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APPENDIX 1

Note - Kendall Coefficient of Concordance

To test agreement between the respondents, the Kendall co-efficient of concordance test was used.

Assuming transitivity of data, the Likert scale responses (0 to 4), were translated to ranked responses, (1 to 12).

The Friedman two-way analysis of variance by ranking test was used to get the X^2. Then the Kendall co-efficient of concordance (w) was calculated using the formulae:

$W = X^2/K(N-1)$ Where:

K = number of judges in the sample.
N = number of variables ranked.

This methodology has been used by Partington (1985). Although the results of the current research appear satisfactory there is a reservation about the validity of the assumption of transitivity of the Likert scale responses to rank scale responses in cases where the ranked scale is much larger than the Likert scale. When converting the Likert Scale to rank scale a large number of ties occur. The W value will need to be adjusted for ties. The effect of the adjustment is to increase the value of W thus leading to the conclusion of greater agreement between the respondents. The larger the value of W the more the agreement among the respondents about the ranking of the variables.

Our concern is that the methodology used has an inbuilt bias towards the conclusion of greater agreement between the respondents, especially so where the number of variables is large.