Dividend Policy

by Sophia

WHAT'S COVERED

In this lesson, you will learn about the advantages and disadvantages of issuing stock dividends, cash dividends, or no dividends at all. Specifically, this lesson will cover:

1. Accounting Considerations

Accounting for dividends depends on their payment method (cash or stock). On the **declaration day**, the firm's Board of Directors announces the issuance of stock dividends or payment of cash dividends. Cash dividends are payments taken directly from the firm's income. This is formally accounted for by marking the amount down as a liability for the firm. The amount is placed in a separate dividends payable account.

The accounting equation for this is simply:

FORMULA TO KNOW

Retained Earnings

$$\text{Retained Earnings} = \text{Net Income} - \text{Dividends}$$

Retained earnings is represented on the balance sheet within stockholders' equity. It consists of the net income earned over a period of time minus any dividends that have been paid out.

On the date of payment, when dividend checks are mailed out to stockholders, the dividends payable account is debited and the firm's cash account is credited.

Stock dividends are parsed out as additional stocks to shareholders on record. Unlike cash dividends, this does not come out of the firm's income. The firm is able to both maintain their cash and give dividends to investors. Here, the firm's net assets remain the same.

TERMS TO KNOW

Declaration Date

The day the Board of Directors announces its intention to pay a dividend.

Retained Earnings

The portion of net income that is retained by the corporation rather than distributed to its owners as dividends.

2. Investor Preferences

The role of investor preferences for dividends and the value of a firm are pieces of the dividend puzzle, which is the subject of much academic debate. Investor preferences are first split between choosing dividend payments now, or future **capital gains** in lieu of dividends.

Further elements of the dividend policy also include:

- High versus low payout
- Stable versus irregular dividends
- Frequency of payment

Cash dividends provide liquidity, but the bonus share will bring capital gains to the shareholders. The investor's preference between the current cash dividend and the future capital gain has been viewed in kind.
Many people hold the opinion that the future gains are more risky than the current dividends, as the "Bird-in-the-hand Theory" suggests. This view is supported by both the Walter and Gordon models, which find that investors prefer those firms which pay regular dividends, and such dividends affect the market price of the share. Gordon's dividend discount model states that shareholders discount the future capital gains at a higher rate than the firm's earnings, thereby evaluating a higher value of the share. In short, when the retention rate increases, they require a higher discounting rate.

In contrast, others, like the Dividend Irrelevance Theory, argue that the investors are indifferent between dividend payments and the future capital gains. Therefore, the content of a firm's dividend policy has no real effect on the value of the firm.

Investor preferences play an uncertain role in the "dividend puzzle," which refers to the phenomenon of companies that pay dividends being rewarded by investors with higher valuations, even though according to many economists, it should not matter to investors whether or not a firm pays dividends. There are a number of factors, such as psychology, taxes, and information asymmetries tied into this puzzle, which further complicate the matter.

TERM TO KNOW

Capital Gains

Profit that results from a disposition of a capital asset, such as stock, bond, or real estate due to arbitrage.

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3. Stock Dividends vs. Cash Dividends

If a firm decides to parcel out dividends to shareholders, they have a choice in the form of payment: cash or stock.

- **Cash dividends** are paid out in some sort of currency. It can either happen through an electronic transfer of funds or by virtue of a check. Cash dividends provide investors with a regular stream of income.
- **Stock dividends** do not provide liquidity to the investors; however, they do ensure capital gains to the stockholders.

BIG IDEA

When choosing between cash or stock dividends, the trade-off is between liquidity in the short term or income from capital gains in the long term.

Costs of taxes can also play a role in choosing between cash or stock dividends. Cash dividends are immediately taxable under most countries' tax codes as income, while stock dividends are not taxable until sold for capital gains (if stock was the only choice for receiving dividends). This can be seen as a huge benefit of stock dividends, particularly for investors of a high-income tax bracket.

A further benefit of the stock dividend is its perceived flexibility. Shareholders have the choice of either keeping their shares in hopes of high capital gains, or selling some of the new shares for cash, which is somewhat like receiving a cash dividend.

If the payment of stock dividends involves the issuing of new shares, it increases the total number of shares while lowering the price of each share without changing the market capitalization of the shares held. It has the same effect as a stock split; the total value of the firm is not affected. If the payment involves the issuing of new shares, it increases the total number of shares while lowering the price of each share without changing the market capitalization, or total value, of the shares held. As such, receiving stock dividends does not increase a shareholder's stake in the firm; by contrast, a shareholder receiving cash dividends could use that income to reinvest in the firm and increase their stake.

For the firm, dividend policy directly relates to the capital structure of the firm, so choosing between stock dividends and cash dividends is an important consideration. A firm that is still in its stages of growth will most likely prefer to retain its earnings and put them toward firm development, instead of sending them to their shareholders. The firm could also choose to appease investors with stock dividends, which would still allow it to retain its earnings. Conversely, a firm that is already quite stable with low growth is much more likely to choose payment of dividends in cash. The needs and cash flow of the firm are necessary points of consideration in choosing a dividend policy.

TERMS TO KNOW

Cash Dividends

Payments by the company to shareholders paid out in currency, usually via electronic funds transfer or a printed paper check

Stock Dividends

Payments paid out in the form of additional stock shares of either the issuing corporation or another corporation.

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4. Signaling

A decision pertaining to the allocation of dividends can have an impact on the formulation of other firms' dividend policies. This is referred to as **signaling**, a term that is derived through economics. The concept is the idea that one firm conveys information to third party firms through its actions.

An **information asymmetry** exists if firm managers know more about the firm and its future prospects than investors.

When investors have incomplete information about the firm (perhaps due to opaque accounting practices), they will look for other information in actions like the firm's dividend policy.

> EXAMPLE When managers lack confidence in the firm's ability to generate cash flows in the future, they may keep dividends constant, or possibly even reduce the amount of dividends paid out. Conversely, managers that have access to information that indicates very good future prospects for the firm (e.g., a full order book) are more likely to increase dividends.

Investors can use this knowledge about managers' behavior to inform their decision to buy or sell the firm's stock, bidding the price up in the case of a positive dividend surprise, or selling it down when dividends do not meet expectations. This, in turn, may influence the dividend decision, as managers know that stockholders closely watch dividend announcements, looking for good or bad news. As managers tend to avoid sending a negative signal to the market about the future prospects of their firm, this also tends to lead to a dividend policy of a steady, gradually increasing payment.

TERMS TO KNOW

Signaling

Action taken by one agent to indirectly convey information to another agent.

Information Asymmetry

The study of decisions in transactions where one party has more or better information than the other.

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5. Clientele Effect

The **clientele effect** refers to the concept that the type of investor that is enticed by a particular security will impact the price of the security when those policies change. These investors are referred to as dividend clientele.

Some would instead prefer the regular income from dividends over capital gains. Of those who prefer dividends over capital gains, there are further subsets of **clientele**; for instance, investors might prefer a stock that pays a high dividend, while another subset might look for a balance between dividend payout and reinvestment in the company.

> EXAMPLE Retirees are more likely to prefer high dividend payouts over capital gains since this provides them with cash income. Therefore, if a company discontinued paying dividends, the clientele effect may cause retiree shareholders to sell the stock in favor of other income-generating investments.

Clientele may choose to sell their stock if a firm changes its dividend policy, and deviates considerably from its preferences. On the other hand, the firm may attract a new clientele group if its new dividend policy appeals to the group's dividend preferences. These changes in demographics related to a stock's ownership, due to a change of dividend policy, are examples of the clientele effect.

This theory is related to the dividend irrelevance theory presented by Modigliani and Miller, which states that, under a particular assumption, an investor's required return and the value of the firm are unrelated to the firm's dividend policy. After all, clientele can just choose to sell off their holdings if they dislike a firm's policy change, and the firm may simultaneously attract a new subset of clientele who like the policy change. Therefore, the stock value is unaffected. This is true as long as the "market" for dividend policy is in equilibrium, where demand for such a policy meets the supply.

The clientele effect's real-world implication is that what matters is not the content of the dividend policy, but rather the stability of the policy. While investors can always choose to sell shares of firms with undesirable dividend policy, and buy shares of firms with attractive dividend policy, there are brokerage costs and tax considerations associated with this. As a result, an investor may stick with a stock that has a sub-optimal dividend policy because the cost of switching investments outweighs the benefit the investor would receive by investing in a stock with a better dividend policy.

Despite the fact that this is typically used in reference to a dividend or a coupon payment, the clientele effect can also be applicable to debt, taxes, as well as other management decisions.

TERMS TO KNOW

Clientele Effect
The theory that changes in a firm's dividend policy will cause loss of some clientele who will choose to sell their stock, and attract new clientele who will buy stock based on dividend preferences.

Clientele
The body or class of people who frequent an establishment or purchase a service, especially when considered as forming a more-or-less homogeneous group of clients in terms of values or habits.

SUMMARY

In this lesson, you learned in greater detail about the factors that companies must consider when determining dividend policy. First, there are **accounting considerations** associated with cash or stock dividends. Second, **investor preferences** must be considered when deciding whether and how to issue dividends, although the relationship between dividend policy and investor behavior is not always clear. You also learned about the advantages and disadvantages of **stock dividends vs. cash dividends** and why each may be preferred by different investors.

Besides being sensitive to the preferences of their investors, companies must be sensitive to the messages sent to other market participants by their dividend decisions. This is known as **signaling**. Finally, you learned about the **clientele effect**, or the notion that a change in a firm's dividend policy may cause a shift in the type of investor attracted to the stock, based on their different dividend preferences. As you can see, dividend policy is a complex and important aspect of financial management.

Best of luck in your learning!

TERMS TO KNOW

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