Chapter 16
Payout Policy

Multiple Choice Questions

1. Firms can pay out cash to their shareholders in the following ways:
(I) Dividends
(II) Share repurchases
(III) Interest payments
A) I only
B) II only
C) III only
D) I and II only
Answer: D Type: Easy Page: 415

2. Dividends are decided by:
(I) The managers of a firm
(II) The government
(III) The board of directors
A) I only
B) II only
C) III only
D) I and II only
Answer: C Type: Easy Page: 416

3. Which of the following dividends is never in the form of cash?
(I) Regular dividend
(II) Special dividend
(III) Stock dividend
(IV) Liquidating dividend
A) I only
B) II only
C) III only
D) I, II, and IV only
Answer: C Type: Easy Page: 417

4. Firms can repurchase shares in the following ways:
(I) Open market repurchase
(II) Through a tender offer
(III) Through a Dutch auction process
(IV) Through direct negotiation with a major shareholder
A) I only
B) II only
C) III only
D) I, II, III, and IV
Answer: D Type: Medium Page: 417

5. The par value of the outstanding shares is defined as:
A) Retained earnings
B) Legal capital
C) Book value of equity
D) None of the above
Answer: B Type: Medium Page: 417

6. Which of these dates occurs last in time (when arranged in the chronological order)?
A) Payment date
B) Ex-dividend date
C) Record date
D) Dividend declaration date
Answer: A Type: Easy Page: 417

7. Which of the following lists events in the chronological order from earliest to latest?
A) Record date, declaration date, ex-dividend date
B) Declaration date, record date, ex-dividend date
C) Declaration date, ex-dividend date, record date
D) None of the above
Answer: C Type: Medium Page: 417

8. The procedure where the firm states a series of prices at which it is prepared to repurchase stock. Shareholders submit offers indicting how many shares they wish to sell at each price. The firm then calculates the lowest price at which it is able to buy the desired number of shares. This procedure is known as:
A) Open market transaction
B) Dutch auction
C) Green mail
D) None of the above
Answer: C Type: Medium Page: 417

9. The most important difference between stock repurchases and cash dividends is that they
(I) Benefit different groups
(II) Have different effects on corporate cash flow
(III) May have different tax consequences
A) I only
B) II only
C) III only
D) I, II, and III
Answer: B Type: Difficult Page: 417

10. Greenmail refers to the practice of a company purchasing its stock from:
A) Small shareholders who are unhappy with performance of the firm
B) A hostile shareholder who threatens to take over the firm
C) Large shareholders who are unhappy with performance of the firm
D) None of the above
Answer: B Type: Medium Page: 417

11. Which of the following is not true?
A) Firms have long-run target dividend payout ratios
B) Dividend changes follows shifts in long-term, sustainable earnings
C) Managers are reluctant to make dividend changes that might have to be reversed
D) All of the above
Answer: D Type: Medium Page: 418

12. Generally, firms resort to repurchase of stock because:
(I) Firms have accumulated large amount of excess cash
(II) Firms want to change their capital structure
(III) Firms want to substitute it for regular dividends
A) I only
B) II only
C) I and II only
D) III only
Answer: C Type: Medium Page: 418

13. Generally, the announcement of an increase in dividends is interpreted by the investors as:
A) Bad news and the stock price drops
B) Good news and the stock price increases
C) A non-event and does not affect the stock price
Answer: B Type: Easy Page: 420

14. Generally, a reduction in dividend is interpreted by investors as:
A) Bad news and the stock price drops
B) Good news and the stock price increases
C) A non-event and does not affect the stock prices
Answer: A Type: Easy Page: 420

15. One key assumption of the Miller and Modigliani dividend irrelevance argument is that:
A) Future stock prices are certain
B) There are no capital gains taxes
C) All investments are risk-free
D) New shares are sold at a fair price
Answer: D Type: Medium Page: 422

16. The indifference proposition regarding dividend policy:
A) Assumes that tax rates increase at the same rate as inflation
B) Assumes that investors are indifferent about the timing of dividend payments
C) States that investors are indifferent between stock dividends and cash dividends
D) States that investors are indifferent between stock repurchase and cash dividends
Answer: B Type: Medium Page: 422

17. One key assumption of the Miller and Modigliani dividend irrelevance is that:
A) Future stock prices are certain
B) There are no capital gains taxes
C) Capital markets are efficient
D) All investments are risk-free
Answer: C Type: Medium Page: 422

18. The dividend-irrelevance proposition of Miller and Modigliani depends on the following relationship between investment policy and dividend policy.
A) The level of investment does not influence or matter to the dividend decision
B) Once the dividend policy is set the investment decision can be made as desired
C) The investment policy is set before the dividend decision and not changed by dividend policy
D) None of the above
Answer: C Type: Medium Page: 425

19. Company X has 100 shares outstanding. It earns $1,000 per year and expects to pay all of it as dividends. If the firm expects to maintain this dividend forever, calculate the stock price today. (the required rate of return is 10%)
A) $110
B) $ 90
C) $100
D) None of the above
Answer: C Type: Easy Page: 425
Response: Dividends = 1000/100 =$10 ; P = 10/0.1 =$100

20. Company X has 100 shares outstanding. It earns $1,000 per year and expects to pay all of it as dividends. If the firm expects to maintain this dividend forever, calculate the stock price after the dividend payment. (The required rate of return is 10%)
A) $110
B) $ 90
C) $100
D) None of the above
Answer: B Type: Easy Page: 425
Response: Dividends = 1000/100 =$10 ; P = 10/0.1 =$100;
Price after dividend payment = $90

21. Company X has 100 shares outstanding. It earns $1,000 per year and expects repurchase its shares in the open market instead of paying dividends. Calculate the number of shares outstanding at the end of year-1, if the required rate of return is 10%.
A) 110
B) 90
C) 100
D) None of the above
Answer: B Type: Medium Page: 426
Response: Share price before repurchase = [1000/100]/ 0.1 = 100
Instead of paying dividends they can repurchase 10 shares

22. One possible reason that shareholders often insist on higher dividends is:
A) They agree with Miller and Modigliani
B) Tax consideration
C) The stock market is efficient
D) They do not trust managers to spend retained earnings wisely
Answer: D Type: Medium Page: 427

23. The rightist position is that the market will reward firms that:
A) Have high dividend yield.
B) Have low dividend yield
C) Are well managed, regardless of dividend yield
D) None of the above
Answer: A Type: Medium Page: 427

24. According to behavioral finance investors prefer dividends because:
A) investors prefer the discipline that comes from spending only the dividends
B) of the tax consideration
C) stock market is efficient
D) all of the above
Answer: A Type: Medium Page: 428

25. If investors do not like dividends because of the additional taxes that they have to pay, how would you expect stock prices to behave on the ex-dividend date?
A) Fall by more than the amount of the dividend
B) Fall exactly by the amount of the dividend
C) Fall by less than the amount of the dividend
D) Cannot be predicted
Answer: C Type: Medium Page: 430

26. If both dividends and capital gains are taxed at the same ordinary income tax rate, the effect of tax is different because:
A) Capital gains are actually taxed, while dividends are taxed on paper only
B) Dividends are taxed when distributed while capital gains are deferred until the stock is sold
C) Both dividends and capital gains are taxed every year
D) Both A and C
Answer: B Type: Medium Page: 430

27. If dividends are taxed more heavily than capital gains, the investors:
A) Should b e willing to pay more for stocks with low dividend yields
B) Should be willing to pay more for high dividend yields
C) Should be willing to pay the same for stocks regardless of the dividend yields
D) Cannot be predicted as stock prices fluctuate randomly
Answer: A Type: Medium Page: 430

28. If investors have a marginal tax rate of 20% and a firm has announced a dividend of $5;
A) The price of stock should decrease by $4 on the ex-dividend date
B) The price of the stock should decrease by $5 on the ex-dividend date
C) The price of the stock should increase by $5 on the ex-dividend date
D) The price of the stock should increase by $4 on the ex-dividend date
Answer: A Type: Medium Page: 430

29. Two corporations A and B have exactly the same risk and both have a current stock price of $100. Corporation A pays no dividend and will have a price of $120 one year from now. Corporation B pays dividends and will have price of $113 one year from now after paying the dividend. The corporations pay no taxes and investors pay no taxes on capital gains but pay a tax of 30% income tax on dividends. What is the value of the dividend that investors expect corporation B to pay one year from today?
A) $7
B) $13
C) $10
D) None of the above
Answer: C Type: Medium Page: 430
Response: Dividend = (120-113)/ 0.7 = $10

30. Which of the following investors have the strongest tax reason to prefer dividends over capital gains?
A) Pension funds
B) Financial institutions
C) Individuals
D) Corporations
Answer: D Type: Medium Page: 432

31. If the corporate tax rate is 35%, what is the maximum effective tax rate on dividends received by another corporation?
A) 35%
B) 30%
C) 10.5%
D) None of the above
Answer: C Type: Medium Page: 433
Response: 70% of dividends received by another corporation is tax-exempt. Tax rate = (0.3)*(0.35) = 0.105 = 10.5%

32. According to middle-of-the-roaders, a firm's value is not affected by its dividend policy because:
A) of the clientele effect
B) of the tax loopholes available to wealthy stockholders
C) well-managed companies prefer to signal their worth by paying high dividends
D) All of the above
Answer: D Type: Difficult Page: 434

33. A firm in Australia earns a pretax profit of $A10 per share. It pays a corporate tax of $3 per share (30% tax rate) in taxes. The firm pays the remaining $A7 in dividends to a shareholder in 30% tax bracket. What is the amount of tax paid by the shareholder under the imputation tax system?
A) $A2.10
B) Zero
C) $3.00
D) None of the above
Answer: B Type: Medium Page: 435

34. A firm in Australia earns a pretax profit of $A10 per share. It pays a corporate tax of $3 per share (30% tax rate) in taxes. The firm pays the remaining $A7 in dividends to a shareholder in 40% tax bracket. What is the amount of tax paid by the shareholder under the imputation tax system?
A) $A1.00
B) Zero
C) $4.00
D) None of the above
Answer: A Type: Medium Page: 435

True/False Questions

T F 35. If a dividend is unlikely to be repeated in the future, it is usually called a "special" or "extra" dividend.
Answer: True Type: Easy Page: 417

T F 36. Because greenmail involves the repurchase of stock at a price higher than the market price, all shareholders benefit.
Answer: False Type: Medium Page: 417

T F 37. Many companies have automatic dividend reinvestment plans (DRIPs).
Answer: True Type: Medium Page: 417

T F 38. An alternative to paying cash dividends is to repurchase stock.
Answer: True Type: Easy Page: 417

T F 39. Dividend payments are used to change the capital structure by replacing equity with debt.
Answer: False Type: Difficult Page: 418

T F 40. Firms have long-run target dividend payout ratios.
Answer: True Type: Medium Page: 418

T F 41. Managers are reluctant to make dividend changes that might have to be reversed.
Answer: True Type: Medium Page: 419

T F 42. Miller and Modigliani's argument for dividend irrelevance assumes an efficient market.
Answer: True Type: Medium Page: 423

T F 43. Australia follows the imputation tax system.
Answer: True Type: Easy Page: 434

Essay Questions

44. Briefly discuss different ways in which a firm can pay dividends to its shareholders.
Type: Easy Page: 417
Answer:
Firms pay a regular cash dividend each quarter. Occasionally, firms pay extra or special dividends. Frequently firms also declare stock dividends. That is, shareholders receive additional shares of stock instead of cash. Many times firms might repurchase their own stock. This is in lieu of paying dividends. "Greenmail" is another form of share repurchase.

45. Briefly explain the information content of share repurchase.
Type: Medium Page: 420
Answer:
Share repurchases are generally a rare event. When a firm announces a repurchase program it is not making a long-term commitment. Firms repurchase shares when they accumulated cash that they are not able to invest profitably. Share repurchase may indicate under priced stock. Share repurchase may also be used to signal management's confidence in the future of the firm.

46. State Miller and Modigliani's proposition on dividend irrelevance.
Type: Difficult Page: 423
Answer:
Miller and Modigliani state that in a world without taxes, transaction costs or other market imperfections, dividend policy followed is irrelevant to the value of the firm.

47. Rightists argue that increasing a firm's dividend will increase its value. State some key points in their assertion.
Type: Difficult Page: 427
Answer:
Investors prefer cash to capital gains as cash dividends are certain and capital gains are uncertain; many investors prefer cash as they need it for living expenses; investors see the information converged by dividend payments as indicative of a firm's good performance.

48. Briefly describe the leftists' point of view on dividends and taxes.
Type: Medium Page: 429
Answer:
If the dividends are taxed at a higher rate than capital gains, firms should pay the lowest cash dividends. By shifting their distribution policy, corporations can transform dividends into capital gains. Leftists generally favor low dividend payout.

49. Briefly explain how current tax laws favor capital gains?
Type: Medium Page: 432
Answer:
Tax rate on capital gains tax rate is 20%, while for taxable income it is much higher. Tax laws favor capital gains in another way. Taxes on dividends have to be paid immediately. But, taxes on capital gains can be deferred until the shares are sold and capital gains realized. The longer the shareholders wait, less the present value of capital gains liability.

50. Briefly describe the middle-of-the-roaders position.
Type: Easy Page: 433
Answer:
Middle-of-the-roaders hold that a firm's value is not affected by its dividend policy.

51. Briefly explain how shareholders' returns are taxed twice in the United States?
Type: Easy Page: 434
Answer:
Shareholders' returns are taxed at the corporate level as corporate tax, and at the shareholders level as either income tax or capital gains tax.

52. Briefly describe the "imputation tax system."
Type: Medium Page: 434
Answer:
In the imputation tax system, shareholders are taxed on dividends, but they receive a tax deduction, which is equal to their share of the corporate tax that the company has paid. This is followed in Australia.

53. Briefly explain how the shareholders are taxed twice in the U.S.A. using an example.
Answer:

Operating Income	\$100
Corporate tax rate 30%	30
After -tax income (paid out as dividends)	70
Income tax paid by the investor at 15%	10.5
Income to shareholders	59.5

54. Briefly explain how the imputation tax system works in Australia using an example.

Answer:

Operating Income	$100
Corporate tax rate 30%	30
After -tax income (paid out as dividends)	70
Grossed-up dividend	100
Income tax paid by the investor at 15%	15
Tax credit for corporate payment	-
Tax due from shareholder	-
Income to shareholders	85