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DIVIDEND POLICY AS AN ELEMENT OF THE COMPANY'S STRATEGY

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Purpose: This article presents the principles of payout of dividends and dividend advances in capital companies and their significance in investor relations, as well as the basic theoretical assumptions regarding the dividend policy in an enterprise. Moreover, it describes positive and negative aspects of various dividend payout strategies.
Design/methodology/approach: The article is entirely based on literature and legal acts. It presents the theoretical approach to the topic.
Findings: The theories of dividends involve fundamentally contradictory assumptions, which may be useful for business managers only when external factors are taken into account. Even if there is no direct relationship between the dividend policy and investors' preferences and, consequently, the company's share price, adopting a specific dividend payout strategy seems to be a necessity. Determining a strategy will also allow shareholders to decide whether to keep the company shares or to sell those shares to investors interested in the strategy of the company.
Originality/value: The review of the theories of dividends may be used by other researchers or investors.

Keywords: dividend policy, enterprise strategies, dividend in capital companies.

Category of the paper: Literature review.

1. Introduction

The profit generated by an enterprise belongs to its owners – partners in a limited liability company and shareholders in a joint-stock company. These entities should not accumulate profit if it is not possible to invest it in order to increase profitability to a level higher than the one which the shareholders will achieve themselves by investing in alternative projects outside the enterprise. Therefore the decision on the distribution of profit should be made taking into account the effectiveness of investments made within the enterprise and the investors' expectations regarding the dividend.

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2. The principles of payout of dividends and dividend advances in capital companies

Dividend is a part of net profit (after taxation) of a capital company to be paid to one partner or shareholder or to be distributed among partners or shareholders. Its amount is calculated on the basis of the company's annual financial result. The amount of dividend and the payout date are determined during the AGM in the case of a joint-stock company or a general meeting of shareholders in the case of a limited liability company. Both in a limited liability company as well as a joint-stock company, the profit payable to individual partners / shareholders depends on the shares or stock owned. However, the articles of association or memorandum of association may set out a different distribution of profit. Since there is no obligation to pay the contributions in their entirety before the joint-stock company is registered (Clause 309, § 3, 2000) and the dates and amount of payments for shares are determined in the memorandum or during the general meeting (Clause 330, § 1, 2000), it should be emphasised that the distribution of profit is made only in relation to the purchased shares. Both a partner to a limited liability company (Clause 191, § 1, 2000) and a shareholder of a joint-stock company (Clause 347, § 1, 2000) have the right to participate in the profit indicated in the annual financial statement (which, in joint-stock companies, has to be validated by a statutory auditor) and allocated for distribution by a shareholders' resolution made in a meeting (in case of a joint-stock company, by a resolution taken during the AGM). The amounts to be distributed among shareholders may not exceed the profit for the last financial year, increased by amounts transferred to the reserve capital in previous years and reduced by the loss incurred as well as by amounts transferred to reserve funds established in compliance with the legal regulations or the company's memorandum, which may not be used as a source of dividends (Clause 192, 2000).

On 1st March 2018, new regulations regarding the payout of dividends came into force. From the point of view of accounting, changes to the payout of dividends in limited liability companies are particularly important. The shareholder agreement may authorise the shareholders to select the date on which the list of shareholders entitled to the dividend for a given financial year is determined during a meeting. The day of the dividend payout is set within two months from the date on which the resolution on profit distribution is made (Clause 193, § 2 and 3, 2000). The amendment to the Commercial Companies Code indicates that if the resolution regarding the dividend does not specify the dividend day, i.e. the date on which shareholders entitled to dividends are indicated, then the day when a resolution regarding the distribution of profit is made becomes the dividend day. If, on the other hand, the date of the dividend payout is not specified by shareholders, then the payout should take place immediately after the dividend day (prawo-dla-ksiegowych.pl). If this deadline is exceeded, the company is required to calculate tax revenue for the period when it uses the money belonging to the shareholders (money.pl). In a joint-stock company, it is the Articles of Association which may

authorise the shareholders to determine the dividend day during the AGM. The dividend day may not be determined later than two months from the date when the resolution on the distribution of profit is taken. In case of a public company, the dividend day and the date on which the dividend is paid should be specified on the day the resolution is made or within a period of three months (Clause 348, § 2 and 3, 2000). Preferred shares may give the shareholder the right to a dividend which is greater than the dividend for common shares holders by no more than a half (Clause 353, § 1, 2000).

A capital company may also pay an advance against the future dividend. Advance payouts are made primarily in limited liability companies, although they are also formally allowed in joint-stock companies. Public companies also use advance dividend payouts as part of the dividend policy and as incentives for potential investors. In order for an advance payout against the anticipated dividend for a given financial year to be made, all of the following conditions must be met (Clause 194 and 195, 2000):

- the Articles of Association must authorise the board of directors to pay the shareholders an advance against the anticipated dividend for a financial year,
- the company must have sufficient funds to pay advances against dividends,
- the financial statement for the previous financial year must be approved and indicate the incurred profit,
- the company has to generate a profit from the end of the previous financial year until the day the resolution on the payout of advances against future dividends is taken by the management board.

However, the advances cannot be higher than a half of the profit generated since the end of the last financial year, increased by unpaid profit from previous financial years and reduced by losses from previous years and by the amounts of mandatory capital reserves established in compliance with the legal regulations or the Articles of Association (Clause 195, § 1, 2000). The amendment to the Commercial Companies Code of 1st March 2019 regulates the settlement of advances paid against dividends. According to clause 195 § 11 of the Commercial Companies Code, which was added by means of Clause 18 point 5 of the Act of 9th November 2018 amending certain acts in order to introduce simplifications in tax and economic law for entrepreneurs (Journal of Laws of 2018, item 2244), if the advance payout against the dividend was made to shareholders in a given financial year and a limited liability company incurred a loss or generated a profit lower than the advances paid, the shareholders should return the advances paid to them in full in the case a loss is incurred or return the amount exceeding the profit attributable to them in a given financial year – in the case when the generated profit is smaller than the advances against dividends.

3. Theoretical assumptions of the dividend policy

According to M. Sierpińska, dividend is the price which a company pays to its investor for the entrusted capital and is therefore treated as the cost of using the capital (Sierpińska, 1999). When making a decision on the choice of a specific dividend policy, the fact that the net profit of the company is actually owned by its partners or shareholders should be taken into account. Considering this aspect, the management board of an enterprise should not retain profit if it is unable to reinvest it with a return expected by shareholders. And shareholders' expectations involve obtaining a higher profitability than the one shareholders would achieve themselves by investing funds obtained from a dividend into alternative projects outside the enterprise. This is illustrated by the following general formula: ROA is greater than REC, where ROA is the profitability indicator of company assets and REC is the retained earning cost. The cost of undistributed profits results from the principle of the cost of lost profits. Thus, using the undistributed profits, the company must earn at least as much as the investors themselves could earn on alternative investments with a comparable risk (Brigham, 2005).

When considering the distribution of all or part of the profit as a dividend, first of all it should be defined what the current level of equity in the enterprise is in relation to the dividend's optimal amount and structure and whether the dividend should be complemented in order to achieve adequate profitability (Bień, 2011). It should also be estimated whether the real amount of equity has decreased due to inflation rate. This will facilitate answering the question whether the profit may be allocated for development purposes of the enterprise and be paid to its partners / shareholders and in what amount, also taking into account the possibility of making further effective investments as well as the availability of external capitals.

Taking into account the fact that both a limited liability company as well as a joint-stock company are legal entities, profit is the sole property of the company itself. In principle, the management of each company is obliged to act in the interest of the company and on the basis of the company's articles of association, which has a significant impact on the decision to pay dividends. Such payout cannot be contrary to the company's statutory objectives. Taking into account such formal and legal terms, the management is not entitled to take a decision on payout of dividends without the explicit instruction of shareholders.

There are many different theories aiming to determine the ideal dividend policy, of which two opposing approaches can be distinguished: relevance of dividend and irrelevance of dividend (Figure 1). Representatives of the first approach, including, among other, James E. Walter and Myron J. Gordon, believe that the regular payout of dividends is less risky than waiting for future capital gains, due to the fact that investors prefer those companies which regularly pay dividends, as it increases their market value.

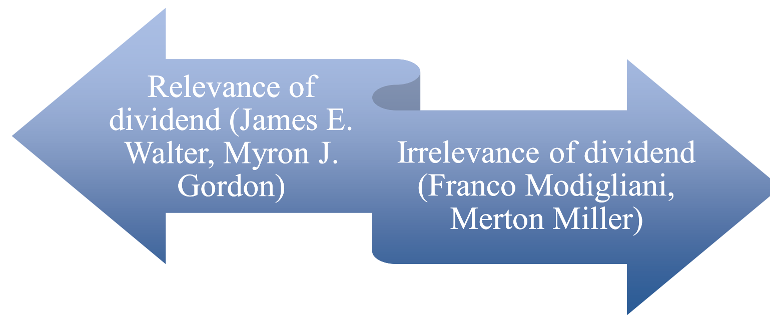

Figure 1. Opposing approaches to dividend policy. Note. Adapted from: governica.com (28.05.2019).

The Walter's model emphasises the importance of paying dividends, as it has an impact on the value of shares. This model is based on the following assumptions (governica.com, 28.05.2019):

- retained profit is the only source of financing investment in an enterprise,
- the cost of capital and the rate of ROI are constant; the risk is estimated at the same level even in case of new investments,
- the company operates indefinitely.

Analysing the above mentioned assumptions, it can be noticed that they are unrealistic – financing the enterprise's activity only with retained profit, or even a fixed value of the capital cost and the rate of ROI, while investment conditions are subject to constant changes. In the Walter model, the policy of paying dividends in companies is determined by the occurrence of sufficiently favourable circumstances to invest the retained profit.

The Gordon's model (dividend discount model) is a variant of the discounted cash flow model. It assumes that an enterprise regularly pays dividends, which increase by a constant coefficient ***g***, which is estimated using one of the three methods (Grzywacz, 2013):

1. A growth rate method. It is based on the assumption that if the profit growth rate and dividend growth rate have been relatively stable and this trend is expected to continue, the past (historical) growth rate can be used to estimate the future expected growth rate.
2. A growth of undistributed profit method. This method involves the use of a dependency - $\boldsymbol{g = b \cdot r}$, where ***b*** means part of the profits that the company will retain and ***r*** means the expected future income from shares. Most often, however, it is assumed that ***r*** = return on equity.
3. Analysts' forecasts.

The criticism of the Gordon model points out the unrealistic assumption of the steady growth of an enterprise and a too high sensitivity of the share value to the assumed growth rate.

The main supporters of the second approach - the theory of irrelevance of dividend – are M.H. Miller and F. Modigliani (Miller and Modigliani, 1961). This theory was developed in 1961 and it claims that for investors, the source from which they derive income is irrelevant and thus it can be both a dividend as well as an increase in the share price. The theory of irrelevance of dividend assumes that even if a dividend is not paid, investors can themselves create its cash equivalent by selling shares of such value as they would receive from dividends

(Jabłoński and Prymon, 2017). The concept of F. Modigliani and M. Miller assumes the perfection of the market, which in consequence means that:

- enterprises may issue new shares at any time without incurring the costs of the issue,
- dividends are not taxed, so they do not differ from profits from the increase in share prices,
- there are no transaction costs,
- universal and excellent information is available.

Based on the above assumptions, Modigliani and Miller came to a conclusion that the dividend policy has no impact on the wealth of investors. In their theory, the authors suggested that if a company retains its profit and does not pay a dividend, shareholders can generate it themselves by selling shares in the secondary market. However, if the entire profit is paid as a dividend, then investors can use the obtained funds to purchase additional shares of the company. This theory may arouse much controversy, for instance because it assumes perfect market conditions that do not actually exist.

In response to the theory of irrelevance of dividend, two other theories were developed, which assumed the imperfection of the market. These include the bird-in-hand theory and the tax preference theory. The creators of the former - one of the leading theories of dividend policy – are M.J. Gordon and J. Lintner. Their theory includes the following assumptions:

- the dividend received by an investor is more certain than the capital gains which will be generated through the reinvestment of retained profits; the paid dividend cannot therefore be taken away from investors and the profits to be used for financing further investments may be at least partially lost as a result of wrong managerial decisions (Jabłoński and Prymon, 2017),
- by selling shares, shareholders deprive themselves of any potential profits in the form of a dividend paid by the company,
- it may occur that a dividend income is taxed at a different tax rate than the capital gains generated from the sale of shares.

M.J. Gordon and J. Lintner argued that the cost of the company's equity increases when the payout of dividends is limited because investors are less confident about receiving capital gains to be generated through retained profits than about dividend payouts (Gordon, 1963 and Lintner, 1962).

The tax preference theory, developed by R.H. Litzenberger and K. Ramaswamy, claims that due to differences in taxation, investors prefer if the company retains the generated profit. For this reason, they are willing to pay more for the shares of companies paying relatively small dividends and retaining most of the profit left after the payout, while they are less willing to invest in shares of companies paying high dividends. The authors developed the theory based on the American market before 1986 and proved that tax rates may affect investors' preferences. During the period when they came to those conclusions, the maximum rate for capital gains in the US was 20%, while the dividend tax rate was 50% (Brigham, 2005).

4. Dividend payout strategies followed by enterprises

The most commonly used dividend payout strategies in enterprises include:
- a fixed dividend amount,
- fixed dividend payout rate,
- surplus (residual) dividend policy,
- target dividend payout rate (Lintner model),
- 100% dividend payout ratio,
- 0% dividend payout ratio.

The main idea of the fixed dividend amount per share is to provide shareholders with a stable income. There is a belief among managers that by avoiding the reduction of the dividend, a positive signal to the potential shareholders indicating the good financial condition of the company is sent (Sierpińska, 1999). The lack of dividend reduction is well perceived, especially by those shareholders who satisfy their consumption needs with income from dividends. A certain variant of the fixed dividend policy involves indexing the dividend payout by the inflation rate, the rationale for which is the need to preserve the real and not the nominal value of payments. This type of policy has some drawbacks as well, as it may lead to a periodic departure from the optimal capital structure, the need to issue new shares, a decrease of profit per share or postponement of some investment projects. However, as practice shows, these side effects are still better perceived in developed countries than the reduction of the amount of the dividend paid out (Brealey and Myers, 1999).

Enterprises may pay a fixed percentage of the profit generated in a given financial year as a dividend. Since the amount of profit generated in individual years may vary, the policy of a fixed dividend payment rate may mean a different dividend per share. An important advantage of such a policy is that shareholders benefit from increased profits, while in periods of reduced profits, they feel less uncertain about the future level of payouts and the decrease of dividends (Sierpińska, 1999).

The surplus (residual) dividend policy involves equalising dividend payouts with net profit less retained earnings which are necessary to finance the optimal capital budget. The amount of the said payment is specified by means of determining the desired capital structure and capital requirements related to new investments (Sierpińska, 1999). The basis for this kind of dividend policy is the preference of investors to retain and reinvest profits, which results from the belief that the rate of return on reinvested profits exceeds the average rate of return which investors could achieve as well as other investments with comparable risk. Companies which follow this dividend policy do not define any target payout ratios, as they depend on the amount of earned profit and investment plans (Brigham, 2005). The principle of this policy is not to lower the annual dividend and/or to maintain a policy of stable dividend growth rate. The first reason for following this principle is the fact that a changing payout policy leads to greater

uncertainty and thus to a higher cost of retained earnings and a lower share price than in case of a stable dividend. The second reason is related to the fact that some shareholders use their dividend income to finance current consumption. If the company reduced the dividend payout, shareholders would certainly have to incur additional costs related to the possible sale of shares (Sierpińska, 1999).

The Lintner Model (Target Dividend Payout Rate), which originated from a series of interviews conducted by John Lintner with business executives in the mid-fifties on the subject of dividend payment policy, is based on the following assumptions (Marsh and Merton, 1987):

1. Companies determine long-term dividend payment ratios.
2. Managers focus more on dividend changes than on its absolute value.
3. Only certain long-term changes in the company's profits are the reason why managers are willing to adjust the dividend level, which means that managers, smooth over issues' so that the temporary changes in the level of profits do not affect the payment of dividends.
4. Managers are reluctant to adjust the level of the dividend, especially if in the future they were supposed to revoke their decision on increasing the dividend.

The Lintner model relies on a relationship between the net profit generated by the company and the level of paid out dividends. Therefore, if managers are reluctant to approve the adjustment of the level of the dividends paid, each decision to increase the part of the profit paid to shareholders indicates that the management expects an increase in the level of dividends.

The 100% dividend payout policy relies on an assumption that the entire generated net profit is paid out as a dividend, in accordance with the shareholders' preferences. On the other hand, the 0% dividend payout rate policy involves retaining the entire profit generated in a given period in the company. Such a policy is mostly adopted in companies for which the only way to make investments is to use their own capital to finance them (Sierpińska, 1999). As compared to the 100% dividend payout rate policy, implementation of such a strategy is quite an extreme solution. However, it can be justified if the company achieves the ROI rate higher than the cost of capital.

5. Summary

There are many factors which determine the company's dividend policy. These include microeconomic factors such as: investment plans, generated net profits, debt and liquidity levels, company capital structure, as well as macroeconomic factors, including the tax system and legal regulations, inflation, concluded contracts and shareholders' expectations and market factors, such as the capital market condition or the general economic situation. The presented theories of dividends involve fundamentally contradictory assumptions, which may be useful for business managers only when external factors are taken into account.

Dividend payout may be perceived as the way for companies to communicate with investors and inform them about how the management feels about the company’s condition – an unexpectedly large increase in the paid dividend may indicate optimism of the management board, while its reduction may show the pessimistic attitude of the managerial staff to the current financial situation in the company. On the other hand, if the expected ROI is higher than the cost of equity when taking risk into account, companies should reinvest as much profit as possible, which must mean a partial or total resignation from dividend payouts. Nevertheless, if the ROI rate is unsatisfactory or negative, companies should pay out as much profit as possible in the form of a dividend, so that the shareholders themselves can invest the received funds into alternative projects outside the company.

However, the adoption of a specific dividend policy by the management does not always translate into the company's share price. Even if there is no direct relationship between the dividend policy and investors' preferences and, consequently, the company's share price, adopting a specific dividend payout strategy seems to be a necessity. Determining a strategy which the management considers the most appropriate will also allow shareholders to decide whether to keep the company shares or to sell those shares to investors interested in the strategy of the company.

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