Chapter 13
Dividend Policy

■ Learning Goals

1. Understand cash dividend payment procedures, the tax treatment of dividends, and the role of dividend reinvestment plans.
2. Describe the residual theory of dividends and the key arguments with regard to dividend irrelevance and relevance.
3. Discuss the key factors involved in establishing a dividend policy.
4. Review and evaluate the three basic types of dividend policies.
5. Evaluate stock dividends from accounting, shareholder, and company points of view.
6. Explain stock splits and stock repurchases and the firm's motivation for undertaking each of them.

■ True/False

1. Holders of record are stockholders whose names are recorded on the date of record.

   Answer: TRUE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Relevant Dividend Dates

2. Purchasers of a stock selling ex-dividend receive the current dividend.

   Answer: FALSE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Relevant Dividend Dates

3. Date of record (dividends) is the actual date on which the company will mail the dividend payment to the holders of record.

   Answer: FALSE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Relevant Dividend Dates

4. The payment date is five days after the date of record, on which the company will mail the dividend to the holders of record.

   Answer: FALSE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Relevant Dividend Dates

5. The ex-dividend period begins four business days prior to the payment date during which a stock will be sold without paying the current dividend.

   Answer: FALSE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Relevant Dividend Dates

6. The payment of cash dividends to corporate stockholders is decided by the firm's chief financial officer.

   Answer: FALSE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Dividend Payment Procedures

7. Dividend reinvestment plans (DRPs) enable stockholders to use dividends received on the firm's stock to acquire additional shares or fractional shares at little or no transaction (brokerage) cost.

   Answer: TRUE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Dividend Reinvestment Plans

8. Because retained earnings are a form of internal financing, the dividend decision can significantly affect the firm's external financing requirements.

   Answer: TRUE
   Level of Difficulty: 2
   Learning Goal: 1
   Topic: Dividend Policy and Financing Policy

9. Ignoring general market fluctuations, the stock's price would be expected to drop by the amount of the declared dividend on the ex-dividend date.

   Answer: TRUE
   Level of Difficulty: 2
   Learning Goal: 1
   Topic: Relevant Dividend Dates

10. The dividend decisions can significantly affect the firm's share price and external financing requirements.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Dividend Policy and Financing Policy

11. According to Modigliani and Miller, a firm's value is determined solely by the earning power and risk of its assets and that the manner in which it splits its earnings stream between dividends and internally retained funds does not affect this value.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Dividend Irrelevance Arguments

12. Due to clientele effect, Modigliani and Miller argue that the shareholders get what they expect and, thus, the value of the firm's stock is unaffected by dividend policy.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Dividend Irrelevance Arguments

13. The residual theory of dividends tends to suggest that the required return of investors is not influenced by the firm's dividend policy and, thus, dividend policy is irrelevant.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Residual Theory of Dividends

14. The clientele effect is the argument that a firm attracts shareholders whose preferences with respect to the payment and stability of dividends corresponds to the payment pattern and stability of the firm itself.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Clientele Effects

15. According to the bird-in-the-hand argument, current dividend payments reduce investor uncertainty and result in a higher value for the firm's stock.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Bird-in-the-Hand Argument

16. The residual theory of dividends implies that if the firm can not earn a return (IRR) from investment of its earnings that is in excess of cost (WMCC), it should distribute the earnings by paying dividends to stockholders.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Residual Theory of Dividends

17. In the dividend relevance arguments, current dividend payments are believed to reduce investor's uncertainty, thereby—all else being equal—placing a higher value on the firm's stock.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Dividend Relevance Arguments

18. While an earnings requirement limiting the amount of dividends paid is sometimes imposed, the firm is not prohibited from paying more in dividends than its current earnings.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Internal Constraints on Dividend Payments

19. Generally, legal constraints prohibit the payment of cash dividends until a certain level of earnings has been achieved or limit the amount of dividends paid to a certain dollar amount or percentage of earnings.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Internal Constraints on Dividend Payments

20. Since lenders are generally reluctant to make loans to a firm to pay dividends, the firm's ability to pay cash dividends is generally constrained by the amount of excess cash available.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Contractual Constraints on Dividend Payments

21. In establishing a dividend policy, a firm should retain funds for investment in projects yielding higher returns than the owners could obtain from external investments of equal risk.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Shareholder Wealth Considerations

22. If a firm pays out a higher percentage of earnings, new equity capital will have to be raised with common stock, which will result in higher control and earnings for the existing owners.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Shareholder Wealth Considerations

23. Regular dividend policy is a dividend policy based on the payment of a certain percentage of earnings to owners in each dividend period.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Regular Dividend Policy

24. A constant-payout-ratio dividend policy is a dividend policy based on the payment to existing owners of a dividend in the form of stock as a certain percentage of the firm's total number of stocks outstanding in each dividend period.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Constant-Payout-Ratio Dividend Policy

25. The regular dividend policy provides the owners with generally positive information, indicating that the firm is okay and thereby minimizing their uncertainty.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: Regular Dividend Policy

26. Since regularly paying a fixed or increasing dividend eliminates uncertainty about the frequency and magnitude of dividends, it increases the owners' wealth.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 4
    Topic: Regular Dividend Policy

27. The payment of a stock dividend is a shifting of funds between capital accounts rather than a use of funds.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 5
    Topic: Stock Dividends

28. In case of stock dividend, the shareholder's proportion of ownership in the firm remains the same, and as long as the firm's earnings remain unchanged, so does his or her share of total earnings.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 5
    Topic: Stock Dividends

29. If the firm's earnings remain constant and total cash dividends do not increase, a stock dividend results in a lower per-share market value for the firm's stock.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 5
    Topic: Stock Dividends

30. The shareholder receiving a stock dividend receives a share of common stock of equal value to their existing shares of common stock.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 5
    Topic: Stock Dividends

31. After the stock dividend is paid, the per share value of the stockholder's stock will remain the same as the value before the stock dividend and, thus, the market value of his or her total holdings in the firm will remain unchanged.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 5
    Topic: Stock Dividends

32. If the stock dividend is paid so that cash can be retained to satisfy past-due bills, a decline in market value may result.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 5
    Topic: Stock Dividends

33. The stock repurchase can be viewed as a cash dividend.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 6
    Topic: Stock Repurchases

34. A stock split commonly increases the number of shares outstanding and the stock's per share par value.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Stock Splits

35. In a 2-for-1 stock split, the number of shares outstanding decreases by fifty percent and the stock's per-share par value will double.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Stock Splits

36. Reverse stock splits are initiated when a stock is selling at too low a price to appear respectable.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Stock Splits

37. The "treasury stock" is an accounting entry on the firm's balance sheet to designate the firm's total investment in government securities.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 6
    Topic: Treasury Stock

38. The repurchase of common stock results in a type of reverse dilution, since the earnings per share and the market price of stock are increased by reducing the number of shares outstanding.

Answer: TRUE
Level of Difficulty: 3
Learning Goal: 6
Topic: Stock Repurchases

39. Generally as long as earnings remain constant, the repurchase of shares reduces the number of outstanding shares, raising the earnings per share and therefore the market price per share.

Answer: TRUE
Level of Difficulty: 3
Learning Goal: 6
Topic: Stock Repurchases

40. Dividends provide information about the firm's current and future performance.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 1
Topic: Dividend Fundamentals

41. Dividends provide information about the firm's current performance but little or no information about the firm's future performance.

Answer: FALSE
Level of Difficulty: 3
Learning Goal: 1
Topic: Dividend Fundamentals

42. The dividend payment date is set by the firm's board of directors and represents the actual date on which the firm mails the dividend payment to the holders of record.

Answer: TRUE
Level of Difficulty: 3
Learning Goal: 1
Topic: Dividend Payment Date

43. The dividend payment date is set by the firm's chief executive officer and represents the actual date on which the firm mails the dividend payment to the holders of record.

Answer: FALSE
Level of Difficulty: 3
Learning Goal: 1
Topic: Dividend Payment Date

44. By purchasing shares through a firm's dividend reinvestment plan (or DRIP), shareholders typically can acquire shares at about 5 percent below the prevailing market price.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 1
Topic: Dividend Reinvestment Plans

45. By purchasing shares through a firm's dividend reinvestment plan (or DRIP), shareholders typically can acquire shares at about 25 percent below the prevailing market price.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 1
Topic: Dividend Reinvestment Plans

46. The Jobs Growth Tax Relief Reconciliation Act of 2003 significantly changed the tax treatment of corporate dividends for most taxpayers by dropping the tax rate to the rate applicable on capital gains, which is a maximum rate of 15 percent.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 1
Topic: Tax Treatment of Dividends

47. The Jobs Growth Tax Relief Reconciliation Act of 2003 significantly changed the tax treatment of corporate dividends for most taxpayers by dropping the tax rate to the rate applicable on capital gains, which is a maximum rate of 25 percent.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 1
Topic: Tax Treatment of Dividends

48. The residual theory of dividends, as espoused by Modigliani and Miller, suggests that dividends represent an earnings residual rather than an active decision variable that affects firm value; this means that a firm's decision to pay dividends or not will not have any impact on a firm's share price.

Answer: TRUE
Level of Difficulty: 4
Learning Goal: 2
Topic: Dividend Irrelevance Arguments

49. The representative theory of dividends, as espoused by Modigliani and Miller, suggests that dividends represent a significant, active decision variable that affects firm value; this means that a firm's decision to pay dividends can have a significant impact on a firm's share price.

Answer: FALSE
Level of Difficulty: 4
Learning Goal: 2
Topic: Dividend Irrelevance Arguments

50. The bird-in-the-hand argument espousing the importance of dividends or dividend relevance suggests that investors view a current (certain) dividend as less risky than future (uncertain) dividends or capital gains; this suggests that whether a firm pays a dividend or not can have a significant impact on share price.

Answer: TRUE
Level of Difficulty: 3
Learning Goal: 2
Topic: Bird-in-the-Hand Argument

51. The bird-in-the-hand argument espousing the importance of dividends or dividend relevance suggests that investors view a current (certain) dividend as less risky than future (uncertain) dividends or capital gains; nevertheless, proponents of this theory argue that this will have no significant impact on share price.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Bird-in-the-Hand Argument

52. In most states, legal capital is measured either by the par value of common stock; other states, however, define legal capital to include not only the par value of the stock, but also any paid in capital in excess of par.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Legal Capital

53. In most states, legal capital is measured not only by the par value and paid in capital of the stock, but also by any accumulated retained earnings.

    Answer: FALSE
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Legal Capital

54. If a firm has overdue liabilities or is legally insolvent or bankrupt, most states prohibit its payment of cash dividends.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Legal Constraints on Dividend Payments

55. The level of dividends a firm expects to pay is often directly related to how rapidly it expects to grow as well as the level of asset investments required.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Growth Constraints on Dividend Payments

56. The level of dividends a firm expects to pay is generally unrelated to how rapidly it expects to grow as well as the level of asset investments required.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Growth Constraints on Dividend Payments

57. Because dividends are taxed at the same rate as capital gains under the 2003 Tax Act, a firm's strategy of paying low or no dividends primarily offers tax advantages to wealthy stockholders through tax deferral rather than as a result of a lower tax rate on current income.

Answer: TRUE
Level of Difficulty: 3
Learning Goal: 3
Topic: Shareholder Wealth Constraints on Dividend Payments

58. In general, the market rewards firms that adopt a constant dividend payout policy rather than a fixed or increasing level of dividends through higher share prices.

Answer: FALSE
Level of Difficulty: 3
Learning Goal: 3
Topic: Market Constraints on Dividend Payments

59. In general, the market rewards firms that adopt a fixed or increasing level of dividends rather than a fixed dividend payout policy through higher share prices.

Answer: TRUE
Level of Difficulty: 3
Learning Goal: 3
Topic: Market Constraints on Dividend Payments

60. A shareholder receiving a stock dividend typically receives nothing of value.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 5
Topic: Stock Dividends

■ Multiple Choice Questions

1. At a firm's quarterly dividend meeting held April 9, the directors declared a $0.50 per share cash dividend for the holders of record on Monday, May 1. The firm's stock will sell ex-dividends on

(a) April 9.
(b) May 5.
(c) April 25.
(d) April 27.

Answer: D
Level of Difficulty: 1
Learning Goal: 1
Topic: Relevant Dividend Dates

2. Stockholders dislike dividends that
   (a) are fixed.
   (b) fluctuate with earnings.
   (c) are continuous.
   (d) increase.

   Answer: B
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Dividend Fundamentals

3. The payment of cash dividends to corporate stockholders is decided by the
   (a) management.
   (b) stockholders.
   (c) SEC.
   (d) board of directors.

   Answer: D
   Level of Difficulty: 2
   Learning Goal: 1
   Topic: Dividend Payment Procedures

4. Paying a stock dividend __________ the retained earnings account.
   (a) decreases
   (b) has no effect on
   (c) increases
   (d) reorganizes

   Answer: A
   Level of Difficulty: 2
   Learning Goal: 1
   Topic: Stock Dividends

5. A dividend reinvestment plan __________ on the security.
   (a) decreases the return
   (b) has no effect on the return
   (c) increases the return
   (d) has an undetermined effect

   Answer: C
   Level of Difficulty: 2
   Learning Goal: 1
   Topic: Dividend Reinvestment Plans

6. A dividend reinvestment plan enables stockholders to
   (a) reinvest the dividends in money market instruments which are risk free.
   (b) reinvest all dividends in the firm with no accompanying increase in equity.
   (c) acquire additional dividends through redemption of stock.
   (d) acquire shares at little or no transaction costs.

   Answer: D
   Level of Difficulty: 2
   Learning Goal: 1
   Topic: Dividend Reinvestment Plans

7. The residual theory of dividends suggests that dividends are _________ to the value of the firm.
   (a) residual
   (b) relevant
   (c) irrelevant
   (d) integral

   Answer: C
   Level of Difficulty: 2
   Learning Goal: 2
   Topic: Residual Theory of Dividends

8. The information content of dividends refers to
   (a) nonpayment of dividends by corporations.
   (b) dividend changes as indicators of a firm's future.
   (c) a stable and continuous dividend.
   (d) a dividend paid as a percent of current earnings.

   Answer: B
   Level of Difficulty: 2
   Learning Goal: 2
   Topic: Informational Content of Dividends

9. According to the residual theory of dividends, if the firm's equity need exceeds the amount of retained earnings, the firm would
   (a) borrow to pay the cash dividend.
   (b) sell additional stock to pay the cash dividend.
   (c) pay no cash dividends.
   (d) not need to consider its dividend policy.

   Answer: C
   Level of Difficulty: 3
   Learning Goal: 2
   Topic: Residual Theory of Dividends

10. According to the residual theory of dividends, if the firm's equity need is less than the amount of retained earnings, the firm would
    (a) borrow to pay the cash dividend.
    (b) declare a dividend equal to the remaining balance.
    (c) pay no cash dividends.
    (d) not need to consider its dividend policy.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Residual Theory of Dividends

11. Dividend policy is a form of
    (a) capital budgeting policy.
    (b) financing policy.
    (c) working capital policy.
    (d) dividend reinvestment policy.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Dividend Policy and Financing Policy

12. The clientele effect refers to
    (a) the relevance of dividend policy on share value.
    (b) the firm's ability to attract stockholders whose dividend preferences are similar to the firm's dividend policy.
    (c) the informational content of dividends.
    (d) the "bird-in-the-hand" argument.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Clientele Effect

13. Modigliani and Miller suggest that the value of the firm is not affected by the firm's dividend policy, due to
    (a) the relevance of dividends.
    (b) the clientele effect.
    (c) the informational content.
    (d) the optimal capital structure.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 2
    Topic: Dividend Irrelevance Arguments

14. Modigliani and Miller, recognizing that dividends do somehow affect stock prices, suggest that positive effects of dividend increases are attributable
(a) directly to the dividend policy.
(b) directly to the optimal capital structure.
(c) not to the informational content but to the consistency in the payment of dividends.
(d) not to the dividend itself but to the informational content of the dividends with respect to future earnings.

Answer: D
Level of Difficulty: 3
Learning Goal: 2
Topic: Informational Content of Dividends

15. Modigliani and Miller argue that when the firm has no acceptable investment opportunities, it should
(a) close its doors.
(b) distribute the unneeded funds to the owners.
(c) lower its cost of capital.
(d) retain the funds until an acceptable project arises.

Answer: B
Level of Difficulty: 3
Learning Goal: 2
Topic: Residual Theory of Dividends

16. Gordon's "bird-in-the-hand" argument suggests that
(a) dividends are irrelevant.
(b) firms should have a 100 percent payout policy.
(c) shareholders are generally risk averse and attach less risk to current dividends.
(d) the market value of the firm is unaffected by dividend policy.

Answer: C
Level of Difficulty: 3
Learning Goal: 2
Topic: Bird-in-the-Hand Theory

17. Proponents of the dividend irrelevance theory argue that, all else being equal, an investor's required return and the value of the firm are unaffected by dividend policy, for all of the following reasons, EXCEPT
(a) the firm's value is determined solely by the earning power and risk of its assets.
(b) investor's are generally risk averse and attach less risk to current as opposed to future dividends or capital gains.
(c) if dividends do affect value, they do so solely because of their information content, which signals managements' earnings expectations.
(d) a clientele effect exists which causes a firm's shareholders to receive the dividends that they expect.

Answer: B
Level of Difficulty: 4
Learning Goal: 2
Topic: Dividend Irrelevance Arguments

18. In general, with regard to dividend payments, the contractual constraints imposed by loan agreements can include all of the following EXCEPT
    (a) prohibit the payment of cash dividends until a certain level of earnings has been achieved.
    (b) limit the percentage of earnings that can be paid out in dividends.
    (c) limit the actual dollar amount of dividends that can be paid out.
    (d) require the payment of a common stock dividend.

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Contractual Constraints on Dividend Payments

19. Firms are usually prohibited by state law from distributing
    (a) retained earnings as dividends.
    (b) paid-in capital as dividends.
    (c) dividends in a year the firm has a net loss.
    (d) assets as dividends.

    Answer: B
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Legal Constraints on Dividend Payments

20. The factors involved in setting a dividend policy include all of the following EXCEPT
    (a) restrictive covenants in a bond indenture.
    (b) growth prospects.
    (c) the legal prohibition on paying dividends which exceed current earnings.
    (d) capital impairment restrictions.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Constraints on Dividend Payments

21. The factors involved in setting a dividend policy include all of the following EXCEPT
    (a) operating constraints.
    (b) legal constraints.
    (c) contractual constraints.
    (d) internal constraints.

    Answer: A
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Constraints on Dividend Payments

22. A firm has the following stockholders' equity balances:

Common stock at par	$400,000
Paid-in capital in excess of par	1,200,000
Retained earnings	2,000,000

In states where the firm's legal capital is defined as the par value of its common stock, the maximum cash dividend the firm could pay is
(a) $3,600,000.
(b) $400,000.
(c) $3,200,000.
(d) $1,600,000.

Answer: C
Level of Difficulty: 3
Learning Goal: 3
Topic: Legal Constraints on Dividend Payments

23. An excess earnings accumulation tax is levied when
(a) shareholders receive dividends which exceed the firm's earnings.
(b) firms do not pay dividends in order to delay the owner's tax liability.
(c) firms do not pay dividends to reinvest in the firm.
(d) earnings exceed dividends.

Answer: B
Level of Difficulty: 3
Learning Goal: 3
Topic: Legal Constraints on Dividend Payments

24. A firm that has a large percentage of _________ investors may pay out a lower percentage of its earnings as dividends.
(a) wealthy
(b) pension fund
(c) middle-income
(d) business

Answer: A
Level of Difficulty: 3
Learning Goal: 3
Topic: Shareholder Wealth Constraints on Dividend Payments

25. Among owner considerations in the establishment of dividend policy, any of the following may enter into the decision EXCEPT
    (a) the tax status of the owners.
    (b) the owners' investment opportunities.
    (c) the potential dilution of ownership.
    (d) restrictive constraints on the preferred stock.

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Shareholder Wealth Constraints on Dividend Payments

26. The dividend policy must be formulated considering two basic objectives, namely
    (a) delaying the tax liability of the stockholder and information content.
    (b) maximizing shareholder wealth and delaying the tax liability of the stockholder.
    (c) maximizing shareholder wealth and providing for sufficient financing.
    (d) maintaining liquidity and minimizing the weighted average cost of capital.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Shareholder Wealth Constraints on Dividend Payments

27. The capital impairment restrictions are established to
    (a) reduce dividends equal to or below the current earnings level.
    (b) constrain the firm to paying dividends which do not require additional borrowing.
    (c) protect the shareholder.
    (d) provide a sufficient base to protect creditors' claims.

    Answer: D
    Level of Difficulty: 4
    Learning Goal: 3
    Topic: Legal Constraints on Dividend Payments

28. A firm has current after-tax earnings of $1,000,000 and has declared a cash dividend of $400,000. The firm's dividend payout ratio is
    (a) 2.5 percent.
    (b) 2.0 percent.
    (c) 4.0 percent.
    (d) 40 percent.

    Answer: D
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Dividend Payout Ratio

29. The most commonly used dividend policies are all of the following EXCEPT
    (a) constant-payout-ratio.
    (b) regular.
    (c) in-kind.
    (d) low-regular-and-extra.

    Answer: C
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Types of Dividend Policies

30. The problem with a constant-payout-ratio dividend policy from the shareholder's perspective is that
    (a) it bores the shareholders.
    (b) if the firm's earnings drop, so does the dividend payment.
    (c) even when earnings are low, the company must pay a fixed dividend.
    (d) there is no informational content.

    Answer: B
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: Constant-Payout-Ratio Dividend Policy

31. The problem with the regular dividend policy from the firm's perspective is that
    (a) it bores the shareholders.
    (b) if the firm's earnings drop, so does the dividend payment.
    (c) even when earnings are low, the company must pay a fixed dividend.
    (d) it increases the shareholders' uncertainty.

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: Regular Dividend Policy

32. When a firm pays a stated dollar dividend and adjusts the payment as earnings increase, its dividend policy can be called
    (a) a low-regular-and-extra dividend policy.
    (b) a regular dividend policy.
    (c) a target dividend-payout ratio policy.
    (d) a constant-payout-ratio dividend policy.

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: Regular Dividend Policy

33. The advantage of using the low-regular-and-extra dividend policy is that
    (a) the firm avoids giving the shareholders false hopes.
    (b) if the firm's earnings drop, so does the dividend payment.
    (c) the extra dividend may become a regular event.
    (d) cyclical shifts in earnings may be avoided.

    Answer: A
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: Low-Regular-and-Extra Dividend Policy

34. At a firm's quarterly dividend meeting held on December 5, the directors declared a $1.50 per share cash dividend to be paid to the holders of record on Monday, January 1. Before the dividend was declared, the firm's accumulated retained earnings balance and cash balance were $1,280,000 and $30,000 respectively. The firm has 10,000 shares of common stock outstanding. On January 2, the cash, dividends payable, and retained earnings accounts had balances of
    (a) $15,000, $0, and $1,265,000, respectively.
    (b) $30,000, $15,000, and $1,280,000, respectively.
    (c) $30,000, $0, and $1,265,000, respectively.
    (d) $15,000, $0, and $1,280,000, respectively.

    Answer: A
    Level of Difficulty: 3
    Learning Goal: 4
    Topic: Accounting for Dividends

35. A firm has had the following earnings history over the last five years:

Year	**Earnings per Share**
2003	$2.50
2002	2.00
2001	1.75
2000	1.25
1999	–1.00

    If the firm's dividend policy is based on a $0.50 payout per share, increasing by $0.05 per share whenever earnings exceed $1.50 per share, the annual dividends for 2000 and 2003 were
    (a) $1.25 and $2.50, respectively.
    (b) $0.50 and $0.50, respectively.
    (c) $0 and $0.50, respectively.
    (d) $0.50 and $0.55, respectively.

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 4
    Topic: Low-Regular-and-Extra Dividend Policy

36. A firm has had the following earnings history over the last five years:

Year	Earnings per Share
2003	$2.50
2002	2.00
2001	1.75
2000	1.25
1999	–1.00

If the firm's dividend policy was based on a constant payout ratio of 50 percent for all of the years with earnings over $1.50 per share and a zero payout otherwise, the annual dividends for 1999 and 2003 were

(a) $0.50 and $1.25, respectively.
(b) $0 and $2.00, respectively.
(c) $0 and $1.25, respectively.
(d) $0 and $0.88, respectively.

Answer: C
Level of Difficulty: 3
Learning Goal: 4
Topic: Constant-Dividend-Payout-Ratio Dividend Policy

37. A firm has had the following earnings history over the last five years:

Year	Earnings per Share
2003	$2.50
2002	2.00
2001	1.75
2000	1.25
1999	–1.00

If the firm's dividend policy was to pay $0.25 per share each period except when earnings exceed $1.50, when an extra dividend equal to 50 percent of the earnings above $1.50 would be paid, the annual dividends for 2000 and 2003 were

(a) $0.25 and $1.25, respectively.
(b) $0.25 and $0.75, respectively.
(c) $0 and $0.25, respectively.
(d) $0.25 and $0.25, respectively.

Answer: B
Level of Difficulty: 3
Learning Goal: 4
Topic: Low-Regular-and-Extra Dividend Policy

38. The shareholder receiving a stock dividend receives
    (a) a share of common stock of equal value to their existing shares of common stock.
    (b) cash.
    (c) additional shares of common stock and cash.
    (d) nothing of value.

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 5
    Topic: Stock Dividends

39. Stock dividends are _________ costly to issue than cash dividends.
    (a) less
    (b) equally
    (c) more
    (d) occasionally less

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 5
    Topic: Stock Dividends

40. Mr. R. owns 20,000 shares of ABC Corporation stock. The company is planning to issue a stock dividend. Before the dividend Mr. R. owned 10 percent of the outstanding stock, which had a market value of $200,000, or $10 per share. Upon receiving the 10 percent stock dividend the value of his shares is
    (a) $220,000.
    (b) $210,000.
    (c) $200,000.
    (d) greater, but cannot be determined.

    Answer: C
    Level of Difficulty: 4
    Learning Goal: 5
    Topic: Stock Dividends

41. A _________ has an effect on the firm's share price similar to that of a _________.
    (a) stock repurchase; stock split
    (b) stock dividend; stock split
    (c) cash dividend; stock dividend
    (d) cash dividend; stock split

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 6
    Topic: Stock Dividends and Stock Splits

42. The purpose of a stock split is to
 (a) affect the firm's capital structure.
 (b) decrease the dividend.
 (c) enhance the trading activity of the stock by lowering the market price.
 (d) increase the market price of the stock.

 Answer: C
 Level of Difficulty: 3
 Learning Goal: 6
 Topic: Stock Splits

43. A stock split has _________ effect on the firm's capital structure.
 (a) little
 (b) no
 (c) a measurable
 (d) a detrimental

 Answer: B
 Level of Difficulty: 3
 Learning Goal: 6
 Topic: Stock Splits

44. The purpose of a reverse stock split is to
 (a) issue additional shares.
 (b) increase the dividend.
 (c) increase the price of stock.
 (d) reduce trading activity.

 Answer: C
 Level of Difficulty: 3
 Learning Goal: 6
 Topic: Stock Splits

45. The accounting in a stock split will transfer funds
 (a) from the Common Stock and Paid in Capital accounts to the Retained Earnings account.
 (b) from the Retained Earnings account to the Paid in Capital account.
 (c) from the Paid in Capital account to the Retained Earnings account.
 (d) from the Retained Earnings account to the Preferred Stock account.
 (e) None of the above.

 Answer: E
 Level of Difficulty: 3
 Learning Goal: 6
 Topic: Stock Splits

46. Stock repurchases are made for all of the following reasons EXCEPT
    (a) to obtain shares to be used in acquisition.
    (b) to retire outstanding issues.
    (c) to have shares available for stock option plans.
    (d) to decrease the book value of equity.

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 6
    Topic: Stock Repurchases

47. When common stock is repurchased and retired, the underlying motive is to
    (a) delay taxes.
    (b) boost the stock's dividends.
    (c) distribute the excess cash to the owners.
    (d) reduce the retained earnings balance.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 6
    Topic: Stock Repurchases

48. The repurchase of stock _________ the earnings per share and _________ the market price of stock.
    (a) increases; increases
    (b) decreases; decreases
    (c) increases; decreases
    (d) decreases; increases

    Answer: A
    Level of Difficulty: 3
    Learning Goal: 6
    Topic: Stock Repurchases

49. Stock repurchases may be made for all of the following reasons EXCEPT
    (a) to enhance shareholder value by reducing the number of shares outstanding and thereby raising earnings per share.
    (b) to help discourage an unfriendly takeover by reducing the number of publicly traded shares.
    (c) to make shares available for stock option plans.
    (d) to make shares available for stock dividends.

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 6
    Topic: Stock Repurchases

50. When purchasing outstanding shares of common stock a firm can utilize all of the following methods EXCEPT
   (a) purchase on the open market at market prices.
   (b) with a tender offer at varying prices.
   (c) with a tender offer at a specified price.
   (d) by purchasing a large block on a negotiated basis.

   Answer: B
   Level of Difficulty: 3
   Learning Goal: 6
   Topic: Stock Repurchases

51. The purpose of a stock split is to
   (a) issue additional shares.
   (b) increase the dividend.
   (c) reduce the price of stock.
   (d) reduce trading activity.

   Answer: C
   Level of Difficulty: 3
   Learning Goal: 6
   Topic: Stock Splits

52. The net effect of a stock repurchase is
   (a) similar to the payment of a stock dividend.
   (b) similar to a cash dividend.
   (c) similar to a stock split.
   (d) similar to a reverse stock split.

   Answer: B
   Level of Difficulty: 4
   Learning Goal: 6
   Topic: Stock Repurchases

53. Enhancement of shareholder value through stock repurchase is achieved by
   (a) reducing the number of shares outstanding and thereby raising earnings per share.
   (b) sending a positive signal to investors in the marketplace that management believes that the stock is undervalued.
   (c) providing a temporary floor for the stock price, which may have been declining.
   (d) all of the above.

   Answer: D
   Level of Difficulty: 4
   Learning Goal: 6
   Topic: Stock Repurchases

54. At the quarterly meeting of Tangshan Mining Corporation, held on September 10th, the directors declared a $1.00 per share dividend for the firm's 100,000 shares of common stock outstanding. The net effect of declaring and paying this dividend would be to
    (a) decrease total assets by $100,000 and increase stockholders equity by $100,000.
    (b) decrease total assets by $100,000 and decrease stockholders equity by $100,000.
    (c) increase total assets by $100,000 and increase stockholders equity by $100,000.
    (d) increase total assets by $100,000 and decrease stockholders equity by $100,000.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Account for Dividend Payments

55. Under the Jobs and Growth Tax Relief Reconciliation Act of 2003, the maximum rate of taxation on dividends received by shareholders was set at
    (a) 18%.
    (b) 20%.
    (c) 25%.
    (d) none of the above.

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Tax Rate on Dividend Income

56. As a result of the Jobs and Growth Tax Relief Reconciliation Act of 2003, early studies showed that the percentage of firms paying quarterly dividends
    (a) increased.
    (b) decreased.
    (c) did not change.
    (d) none of the above.

    Answer: A
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Tax Rate on Dividend Income

57. Tangshan Mining has common stock at par of $200,000, paid in capital in excess of par of $400,000, and retained earnings of $280,000. In states where the firm's legal capital is defined as the par value of common stock, the firm could pay out _________ in cash dividends without impairing its capital.
    (a) $200,000.
    (b) $480,000.
    (c) $600,000.
    (d) $880,000.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 1
    Topic: Legal Constraints on Dividend Payments

58. Tangshan Mining has common stock at par of $200,000, paid in capital in excess of par of $400,000, and retained earnings of $280,000. In states where the firm's legal capital is defined as the total of par value and paid-in-capital of common stock, the firm could pay out _________ in cash dividends without impairing its capital.
(a) $280,000.
(b) $400,000.
(c) $480,000.
(d) $600,000.

Answer: A
Level of Difficulty: 3
Learning Goal: 1
Topic: Legal Constraints on Dividend Payments

59. Shareholder wealth considerations in the payment of dividends include all of the following except
(a) the tax status of the firm's owners.
(b) the criminal status of the firm's owners.
(c) the investment opportunities of the firm's owners.
(d) the potential dilution of ownership on behalf of the firm's owners.

Answer: B
Level of Difficulty: 2
Learning Goal: 1
Topic: Shareholder Wealth Constraints on Dividend Payments

60. Which type of dividend payment policy has the disadvantage that if the firm's earnings drop or if a loss occurs in a given period, dividends may be low or nonexistent?
(a) Constant-payout-ratio policy.
(b) Regular dividend policy.
(c) Low-regular-and-extra dividend policy.
(d) none of the above.

Answer: A
Level of Difficulty: 2
Learning Goal: 4
Topic: Constant-Payout-Ratio Dividend Policy

61. Which type of dividend payment policy has the advantage that if the firm's earnings drop, dividends will still be maintained at a relatively constant level?
(a) Constant-payout-ratio policy.
(b) Regular dividend policy.
(c) Low-regular-and-extra dividend policy.
(d) none of the above.

Answer: B
Level of Difficulty: 2
Learning Goal: 4
Topic: Regular Dividend Policy

62. The great advantage of a _________ is that this policy avoids giving shareholders false hopes.
    (a) constant-payout-ratio policy
    (b) regular dividend policy
    (c) low-regular-and-extra dividend policy
    (d) none of the above.

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: Low-Regular-and-Extra Dividend Policy

63. Tangshan Mining has 100,000 shares outstanding and just declared a 20 percent stock dividend. Before the announcement, the firm's shares were trading at $50.00 per share. After the stock dividend, the firm's shares should trade at _________ per share.
    (a) $40.00
    (b) $41.66
    (c) $46.33
    (d) remain unchanged

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 5
    Topic: Stock Dividend

64. Tangshan Mining has 100,000 shares outstanding and just declared a 2-for-1 stock split. Before the announcement, the firm's shares were trading at $50.00 per share. After the stock dividend, the firm's shares should trade at _________ per share.
    (a) $100.00
    (b) $25.00
    (c) $50.00
    (d) none of the above.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 6
    Topic: Stock Split

65. Tangshan Mining has 100,000 shares outstanding and just declared a 3-for-2 stock split. Before the announcement, the firm's shares were trading at $50.00 per share. After the stock dividend, the firm's shares should trade at _________ per share.
    (a) $33.33
    (b) $50.00
    (c) $75.00
    (d) none of the above.

    Answer: A
    Level of Difficulty: 3
    Learning Goal: 6
    Topic: Stock Split

■ Essay Questions

1. A firm has had the indicated earnings per share over the last three years:

Year	EPS
2003	$3.00
2002	2.00
2001	1.00

(a) If the firm's dividend policy was based on a constant payout ratio of 50 percent, determine the annual dividend for each year.

(b) If the firm's dividend policy was based on a fixed dollar payout policy of 50 cents per share plus an extra dividend equal to 75 percent of earnings per share above $1.00, determine the annual dividend for each year.

Answers:

(a)

Year	EPS	Dividend per Share
2003	$3.00	$1.50
2002	2.00	1.00
2001	1.00	0.50

(b)

Year	EPS	Dividend per Share
2003	$3.00	$2.00
2002	2.00	1.25
2001	1.00	0.50

Level of Difficulty: 2
Learning Goal: 4
Topic: Alternative Types of Dividends Policies

2. Caswell-Cassey Pharmaceutical has a stockholders' equity account as shown below. The firm's common stock currently sells for $20 per share.

Preferred stock	$500,000
Common stock (2,000,000 shares @ $1 par)	2,000,000
Paid-in-capital in excess of par	10,000,000
Retained earnings	11,600,000
Total stockholders' equity	$24,100,000

(a) What is the maximum dividend per share Caswell-Casey can pay? (Assume capital includes all paid-in capital.)

(b) Recast the partial balance sheet (the stockholders' equity accounts) to show independently

(1) a 2 for 1 stock split of the common stock.

(2) a cash dividend of $1.50 per share.

(3) a stock dividend of 5 percent on the common stock.

(c) At what price would you expect the Caswell-Cassey stock to sell after
  (1) the stock split?
  (2) the stock dividend?

Answers:

(a) The maximum dividend per share the firm can pay is:
$11,600,000/2,000,000 shares = $5.80/share

(b)

Preferred stock	$500,000	$500,000	$500,000
Common stock	2,000,000*	2,000,000	2,100,000**
Paid-in-capital	10,000,000	10,000,000	11,900,000
Retained earnings	11,600,000	8,600,000	9,600,000
Total S.E.	$24,100,000	$21,100,000	$24,100,000

*(4,000,000 shares at $0.50 par)
**(2,100,000 shares at $1 par)

(c) (1) $10/share
(2) $19.05; 2,000,000 shares × $20/share = $40,000,000 market value
2,100,000 shares × ? /share = $40,000,000 market value

Level of Difficulty: 4
Learning Goal: 6
Topic: (a) Legal Constraints on Dividend Payments; (b) Cash Dividends, Stock Dividends, and Stock Splits; (c) Stock Dividends and Stock Splits

3. Tangshan Mining Company has released the following information.

Earnings available to common stockholders	$5,000,000
Number of shares of common stock outstanding	1,000,000
Market price per share	$50
Retained earnings	11,600,000

(a) What are Tangshan Mining's current earnings per share?
(b) What is Tangshan Mining's current P/E ratio?
(c) Tangshan Mining wants to use half of its earnings either to pay shareholders dividends or to repurchase shares for inclusion in the firm's employee stock ownership plan. If the firm pays a cash dividend, what will be the dividend per share received by existing shareholders?
(d) Instead of paying the cash dividend, what if the firm uses half of its earnings to pay $55 per share to repurchase the shares, what will be the firm's new EPS? What should be the firm's new share price?
(e) Compare the impact of a stock dividend and stock repurchase on shareholder wealth.

Answers:

(a) EPS = \$5,000,000/1,000,000 = \$5.00 per share

(b) P/E Ratio = \$50.00/\$5.00 = 10

(c) Dividends/Share = \$2,500,000/1,000,000 = \$2.50/share

(d) If the firm paid \$55 to repurchase stock, it could repurchase approximately 45,455 shares (\$2,500,000 ÷ \$55 per share). As a result, the firm would now have 954,545 shares outstanding (1,000,000 shares – 45,455 shares). As a result, EPS would rise from \$5.00 per share to approximately \$5.24 per share (\$5,000,000 ÷ 954,545 shares). If we assume the stock still sells at 10 times earnings, the new market price could be estimated by multiplying the new EPS by the PE ratio. The new price would thus be \$52.40 per share, again of approximately \$2.40 in share price. Note that this amount would have been precisely \$2.50 cents per share if not due to rounding.

(e) The net effect of a stock dividend and a stock repurchase is the same. In this example, in both cases, shareholders would have received a net gain of approximately \$2.50 per share.

Level of Difficulty: 4
Learning Goal: 6
Topic: Cash Dividends, Stock Dividends, and Share Repurchases