

WHAT FACTORS MOTIVATE THE CORPORATE DIVIDEND DECISION?

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ABSTRACT

What motivates a corporation to issue cash dividends? What specific financial factors lead management to make a decision as to the creation or amendment of their firm's dividend policy? What factors are common among firms issuing a dividend to their shareholders, and do these factors share a commonality across sector boundaries? This study attempts to identify the impact of certain financial variables on the dividend decision/policy of a corporation by analyzing the financial data of over 10,000 publicly traded firms found through the Multexinvestor.com database using Ordinary Least Squares (OLS) Regression. The study tests the effects of financial variables (deemed appropriate by the finance literature) on dividend policy (as measured by the firm's payout ratio) for a sample of firms screened from the Multexinvestor.com database. By analyzing these selected financial factors on a large sample of firms, this study will also identify those financial variables that have proven historically significant in explaining the dividend decision. The study results add to the body of dividend policy literature by either supporting or rejecting the theories advanced in the literature.

INTRODUCTION

The financial world has yet to develop a model indicative of the process by which corporations create an effective dividend policy. In conjunction with this, there still remains controversy over the value of dividends themselves to both the firm and the investor. Many studies are divided in their findings, as some researchers have taken a "normative" approach to answering questions concerning dividend decisions, while others have taken a "behavioral" approach, looking directly to management for answers on the factors that enter into their decision-making process. Simply put, dividend policy is the determination of which portion of cash earnings should be retained in the firm for reinvestment and which funds are paid out to investors from either current or accumulated retained earnings, but the complexities of this payout have continued to mystify the financial community.

LITERATURE REVIEW

WHY PAY DIVIDENDS?

Factors such as the impact of dividends on stockholder wealth, the role of dividends in stock valuation, and the stockholders' expectations of future cash flows from dividends still provoke controversy among finance scholars as to the value of issuing a dividend for both the investor and the corporation. Robert Parks, author of The Witch Doctor of Wall Street (1996), refutes the need to issue dividends by suggesting the following:

The maximum potential growth of earnings occurs, other things being equal, when (a) all revenues covering depreciation are reinvested to replace depreciating capital and (b) all earnings are invested, or plowed back, into new and expanded assets. In that extreme case, assuming perfect markets and no change in perceived risk or required return, the moneys plowed back into assets would show up dollar-for-dollar in a rise in the price of the stock. Assuming also no tax differences, the investor could look upon dividend receipts at the end of the year as being..an equivalent rise in the market price of the stock by the end of the year. He could treat market appreciation the same as the receipt of dividend income. (228-229)

The Modigliani-Miller (MM) Dividend Irrelevancy Theorem is the basis for the theory indicating that investors are financially unaffected by a firm's decision to reinvest earnings or distribute them as dividends to investors. The capital gains would be equivalent to dividends in a perfect market without tax considerations or attached transaction costs. The MM Theory states that shareholder wealth will remain unaffected by dividend policy in that without tax as a consideration, investors place equal weight in receiving returns as dividends or capital gains as long as the firm's investment policy is not affected by dividend policy (Shapiro 539).

Negative aspects associated with paying out profits to shareholders include the potential tax costs associated with dividends, agency costs, and the lost opportunity to reinvest these corporate earnings to further the firm's growth. William Droms (1990) also suggests that investors might benefit more from reinvested earnings as can be seen in the residual dividend policy theory (217). Furthermore, corporations often face limitations in the framing of their dividend policy imposed by legal constraints, such as the capital impairment rule, stating that firms cannot issue cash dividends from capital assets, and the insolvency rule, which forbids dividends be paid during periods of insolvency (Weston 659). By paying a dividend, a firm also risks having to use more expensive external financing methods if earnings are not sufficient to cover both dividends and investment opportunities, which results in a high opportunity cost for the firm (Shapiro 549).

Why then do corporations offer dividends in light of their supposed irrelevance in a perfect market and their negative characteristics? Although investors may be in theory mathematically indifferent to dividend policy, dividends themselves have proven very relevant in the eyes of investors for behavioral reasons (Shapiro 542). As most investors are risk-averse, a predictable return through dividends is often preferred to the uncertain return of capital gains resulting from reinvested earnings, despite the fact that either option would lead to the same end result in the absence of taxes and expected transaction costs (Shapiro 541). Dividends also lend more easily to "regret aversion" than capital gains in the eyes of investors as investors are more likely to prefer spending income received via dividends rather than from sale-induced capital gains (Shapiro 542). The imperfections of the market, including taxes and agency costs, also cause dividend policy to become highly relevant in the case of stockholder wealth (Shapiro 541,549). In conjunction with agency costs, the free cash flow hypothesis states that a dividend increase is a positive signal to investors as it reduces the amount of free cash flow available for unauthorized use by management (Ross 519). Dickens (2002) also suggests, "The factors explaining dividends should be important because the intrinsic model holds that a stock's price is the present value of its future dividends."

DO DIVIDENDS SIGNAL FUTURE SUCCESS?

Positive factors further encouraging corporations to issue dividends include the psychological perceptions of investors. The favorable behavioral reactions of stockholders to the positive signal dividends convey as well as the economic rationale for a reliable dividend policy suggest the

underlying value of dividends. Although management's choice to either raise or lower a current dividend may not greatly affect the current value of the firm, these changes can have a marked effect on the market price of the stock and the opinions of both investors and company stakeholders.

Dividends serve as an indicator of the firm's present and future performance and potential risk level by lending credibility to management claims, and as such may help determine the market price of the stock. Stability in dividend policy is often necessary to eliminate uncertainty and the potential poor market valuation by investors associated with unpredictable dividend payments, and a decrease in dividends often results in a negative market response as seen by a reduction in the price of the stock. The level of the decline in stock price is, however, often dependent upon the reason behind the dividend cut, be it poor earnings or future growth potential (Shapiro 537). Therefore, dividend payout percentages are often raised only after a permanent increase in earnings is expected with the firm, which results in a lag between earnings and payout ratios. The dividend-signaling hypothesis is in line with the smoothed residual dividend policy.

Other economic rationale behind a stable dividend includes the idea that dividends limit both the amount of expensive external financing that is needed by the firm and the associated flotation costs and investor concerns which can result. Stable dividend policy further limits the transaction costs paid by the investor when a variable dividend may result in selling or buying of shares to compensate for the deviation from needed current income (Shapiro 535). Shapiro also suggests that high dividends provide benefit to investors as when firms must resort to external financing methods, the unbiased opinion of the lender provides stockholders with a good indication of the firm's standing and future potential (Shapiro 549).

In theory, management should work to maximize stockholder value, and dividends often work to accomplish this goal provided that firms do not issue dividends to the point where they reject investment projects with positive NPVs, thereby altering their investment policy. Dividends then often have a significant benefit to the corporation. Droms (1990) states that normally a corporation's prosperity and earnings growth lead to an increase in dividends, and thereby increase the value of the stock and allow for capital gains (Droms 216).

THE CLIENTELE EFFECT AND RECENT TAX LAW CHANGES

A firm must consider other preferences of their investors when determining dividend policy—would investors prefer to receive a profit through capital gains or a payout of cash dividends (Parks 230)? A 1974 study conducted by Black and Scholes cited a significant factor affecting dividend policy to be the tax repercussions, known as “clientele influence.” Tax rates relating to the stockholders' tax brackets affect investor desires for dividends. Investors in higher tax brackets have often preferred that earnings be retained in the firm to avoid paying heavy taxes, while investors in lower brackets prefer to receive returns in the form of dividends (Weston 661, Shapiro 546). This effect seems to be changing, however, in light of the May 2003 tax law changes that have altered the tax rate on dividends. As the maximum tax rate on dividends through 2008 is now 15% and equivalent to the tax on capital gains, the appeal of dividends should widen across tax brackets (Yang and Chang), though capital gains still have a slight advantage in that they allow taxpayers to defer taxes until a later date. According to Sivy, this tax change has, however, already boosted the availability of dividend-paying stocks, as people are no longer seeking tax benefits from capital gains; investors are able to receive “..better returns

with greater predictability and lower risk” by investing in dividend paying stocks (*Dividends Rule!*).

DIVIDEND THEORIES

The literature currently advances three main theories purporting to explain the methodology of dividend policy, each of which centers on the idea of remitting residual earnings to investors:

- **Pure Residual Dividend Policy** – states that when the corporation’s return on equity capital is greater than the rate of return the investor could obtain by reinvesting those dividends in another investment of equivalent risk, the investor would rather the corporation act on his behalf and reinvest the earnings rather than issue a dividend; the firm can determine which option is better suited to benefiting the investor by first identifying the firm’s optimal capital budget, thereby noting the level of equity capital required, and then maintaining the amount of earnings required to finance the equity capital in the capital budget and allowing “residual” funds (earnings not utilized in internal investment) after the mandated reinvestment to be issued as a dividend (Droms 218). Therefore, dividends are a function of earnings fluctuations, and this method allows for significant fluctuations in dividends with changes in earnings and corporate investment opportunities. In effect, all residual earnings are paid out which causes the dividend payout ratio to fluctuate. This policy also results in a dividend that varies from year to year, and when equity investment is greater than earnings, equity financing must be initiated to create a residual (Droms, 1990).
- **Smoothed Residual Dividend Policy** – suggests that dividend fluctuations are kept to a minimum. Dividend policy changes tend to lag behind earnings fluctuations according to Shapiro, as “Dividends are set equal to the long-run residual between forecasted earnings and investment requirements. Dividend changes, in turn, are made only when this long-run residual is expected to change; earnings fluctuations believed to be temporary are ignored in setting dividend payments. The clear preference is for a stable, but increasing, dividend per share” (Shapiro 532-533). As such, the dividend payout ratio fluctuates significantly with this payment method, and dividends have the potential to exceed the residual if earnings are unexpectedly low.
- **Constant Payout Residual Dividend Policy** – suggests maintaining a constant dividend payout ratio, which causes dividends to fluctuate with earnings.
- **Small Quarterly Dividend with Annual Bonus** - suggests a small periodic dividend and a yearly “bonus” dividend offered to investors if earnings exceed expectations. Companies that experience wide earnings and investment fluctuations often use this policy. This option benefits both management, as they have cash flexibility, as well as the investor as they are guaranteed a small yearly dividend.

DIVIDENDS STILL A PUZZLE

However little is known about the dividend decision-making process, these decisions do not seem to be made lightly. All of the aforementioned factors (tax preferences, external financing costs, signaling, agency and transaction costs), as well as inflation, liquidity position, stability of earnings, control, and the personal preferences of management have been suggested to play a role in management’s dividend decision.

PURPOSE

Although dividend policy remains a subject of controversy for many finance scholars, the belief that dividends play a significant role has been illustrated by the many empirical studies and behavioral surveys that have been conducted on dividends. A deeper understanding as to the motivation behind dividends would provide opportunity to better value stock, as most current

stock valuation models include dividends as a key element. Although the aforementioned literature suggests that dividends provide additional worth to a firm in the eyes of investors, it is unclear what financial factors management uses to support their reasoning behind initiating a dividend policy. This study investigates possible factors that could influence the dividend decision for a large sample of dividend paying firms. The dividend payout ratio, being the dependent variable, will be examined for correlation with the following factors selected from the literature: return on equity, sales growth, beta, current ratio, debt to total assets, insider ownership, institutional ownership, capital spending, and EPS growth.

RELATED STUDIES

Lintner's (1956) creation of a mathematical model indicative of dividend policy, which is today continually reconfirmed by other research findings, was a key step in dividend policy research. Lintner's study suggested that a main factor considered in adjusting dividend policy was the change in the payout ratio in a direction away from the target payout. Baker, Veit, and Powell (2001) determined that management places substantial importance on the choice of dividend policy for their firm, and firms often review their policies annually. Baker and Powell (1999) also noted that there were limited statistical differences between differing industries in regards to managerial ideas on dividend effectiveness, thereby suggesting that dividend policy is a market-wide concern faced in similar fashions.

Baker, Veit, and Powell (2001) surveyed management of both financial and non-financial NASDAQ firms to determine the influential factors on dividend policy. Of the twenty-two factors evaluated, highly relevant factors in dividend policy decisions of both financial and non-financial firms included the past pattern of dividends, earnings stability, and current and predicted future earnings levels, though significant differences exist between the degree of importance that non-financial and financial firms' management place on several factors, including legal constraints, capital structure maintenance, and the degree of financial leverage. Baker, Veit, and Powell's (2001) results also suggested that managers' dividend decisions are in tandem with the model created by Lintner. Management's ideology on dividends seems to include a belief that despite academic reasoning as provided by the Modigliani-Miller (MM) Dividend Irrelevancy Theorem (1961), the dividend decision can impact firm value via a change in stock price, thereby creating or reducing shareholder wealth; therefore this subject warrants attention.

The importance of the pattern of dividends can be seen through Dickens, Casey, and Newman's (2002) assessment that, as shown by bank dividend policy, the historical stability of dividend payments can communicate substantial information about a firm. Dickens, Casey, and Newman (2002) found that dividends convey value-related information about a firm that earnings and other financial variables failed to communicate; one instance in which this is true is in the case where earnings patterns are highly irregular while dividends are smooth, dividends can better portray profitability potential than earnings.

Previous studies have indicated a positive correlation between expected returns and dividend yield, though these numbers do not move in similar proportion, while other studies have suggested no such correlation (Ross 476). One of the major suggested influences on dividend policy is a corporation's desired growth rate. Shapiro states, "...a rapidly growing firm, with an abundance of positive net present value projects, will usually retain a larger share of its operating

cash flow than will a firm with few investment opportunities. As a result, rapidly growing firms will have lower dividend payout rates” (550).

Aivazian, Booth, and Cleary (2003) have concluded that both return on equity and profitability positively correlate with the size of the dividend payout ratio. Their study also concluded that corporations with high debt ratios often had lower dividend payments, and firm size also positively correlated with dividend payout. Moh'd, Perry, and Rimbey (1995) also concluded that dividend payout related positively with firm size. Holder, Langrehr, and Hexter (1998) suggest that corporations who placed their business focus on a single business line had lower payout ratios than less focused firms.

Other suggested determinants of dividend policy have been the corporation's level of liquidity, access to capital, cash flow, depreciation methods, current inflation level, and level of debt. Myers and Bacon (forthcoming) determined that the higher the PE of a firm, the lower its risk and the higher its payout ratio. Supporting management feelings regarding the issuance of dividends include the desire to maintain access to equity capital to fund continued capital expenditures and firm growth through flow of cash to stockholders. Myers and Bacon (forthcoming) find that dividend cash flow provides a positive signal to stockholders and increases the reputation of the firm. Mick and Bacon (2003) found that past dividend patterns as well as current and expected earnings levels are empirically relevant in explaining the dividend decision, with future earnings being the most influential variable. Another key element in this question is the level of stability associated with a corporation's projected earnings. Droms illustrates this by stating, “A high level of earnings stability reduces the corporation's business risk and allows a higher dividend payout than could be paid if earnings were highly erratic” (217).

Dempsey, Laber, and Rozeff (1993) determined that certain regularities exist between firms of various industries, though these similarities seem to result from firm-specific factors rather than industry-wide characteristics. Lintner (1953) offers that dividend policies have effects on the industry beyond the obvious impact on investment acceptance and opportunity, internal funds accessibility, and earnings stability. Lintner suggests a competitive motivation behind dividends that goes beyond firm-specific factors. As stated by Lintner, “Companies probably most generally follow the ‘lead’ of other companies in the same industry, but on occasion may be concerned with maintaining some sort of conformance to other companies whose securities are, investment-wise, close substitutes for the company's own securities, even though the other companies are in entirely different industries.” This is later to be stated as the industry-related dividend leadership hypothesis.

Baker and Powell's (1999) study indicates that 90 percent of management places substantial value in dividends as they are believed to affect the firm's overall value, and they find that the Modigliani-Miller proposition holds little weight in the real world. Signaling proved a key motivation behind dividend policy, and their suggestion that dividends are a means to curb the controversy resulting between the firm and its investors (as dividends help to monitor management performance) was supported as dividends proved to reduce agency costs by forcing the firm to seek external financing and thereby be subject to critical public evaluation. As stated by Moh'd, Perry, and Rimbey (1995) in their study on the effects of dividends on agency costs, “Distribution of resources in cash-dividend form compels managers to find outside capital, thereby encouraging them to lower agency expenses as they are exposed to the capital market. In

this environment, the maximum level of dividend payout minimizes the agency cost structure as compared to the cost of generating required funds.”

Research indicates that the percentage of insider ownership versus institutional ownership also affect dividend decisions. Dickens, Casey, and Newman examined the impact of ownership on the banking industry and found that inside ownership correlated negatively with payout ratio, thereby indicating that agency costs were less with largely insider-owned firms. Moh’d, Perry, and Rimbey (1995) concluded that when the institutional ownership of a firm increases, the dividend payout also increases.

Baker and Powell (1999) state that the use of dividend announcements as a way to evaluate stock price has been determined applicable empirically, though other evidence suggests that dividends announcements could potentially indicate growth as well as a lack of investment opportunities. The tax preference explanation, although not supported confidently by empirical evidence, states that stocks offering low dividends appeal more to investors in higher income brackets. Research findings also indicated that market preference leans towards stable dividend growth rather than a stable payout ratio.

SAMPLE SELECTION AND CHARACTERISTICS

To study the determinants of dividend policy, we tested the selected variables’ effects on the dividend decision for a large sample of publicly traded firms. We created the samples of firms using the power-screening tool from Multex Investor. MultexInvestor.com is the website of Market Guide, Inc., which provides quarterly, fundamental financial information on over 10,000 publicly traded companies that trade on the NASDAQ, AMEX, NYSE, and OTC exchanges (www.MultexInvestor.com). We observed the data for all firms in the selected sample at the end of the second quarter of 2004. The query of Multex Investor produced a sample of 542 companies. Firms were screened by each variable to generate the largest sample possible.

METHODOLOGY

To analyze those characteristics of a company that appear to affect the dividend decision, this study employs Ordinary Least Squares (OLS) Regression on the study sample. The Multexinvestor.com Database provides financial data on approximately 10,000 publicly traded firms. Independent variables and hypotheses supported by the literature appear in Table 1.

TABLE 1. VARIABLES AND HYPOTHESES

FACTOR	VARIABLES	DEFINITIONS	HYPOTHESIZED SIGN
DIVIDEND DECISION	DIVIDEND PAYOUT RATIO	DIVIDEND/EPS	DEPENDENT VARIABLE
PROFITABILITY	RETURN ON EQUITY	NET INCOME/EQUITY	NEGATIVE
GROWTH	SALES GROWTH	5 Year compounded annual growth rate of Sales Per Share over last 5 years	NEGATIVE
RISK	BETA	Slope of the 60 month regression line of the	NEGATIVE

		stock relative to the percentage price change of the S&P 500	
LIQUIDITY	CURRENT RATIO	CURRENT ASSETS/ CURRENT LIABILITIES	NEGATIVE
FINANCIAL LEVERAGE	DEBT TO TOTAL ASSETS	TOTAL DEBT / TOTAL ASSETS	NEGATIVE
CONTROL	INSIDER OWNERSHIP	% SHARES OWNED BY INSIDERS	NEGATIVE
INSTITUTIONAL INFLUENCE	INSTITUTIONAL OWNERSHIP	% SHARE OWNED BY INSTITUTIONS	POSITIVE
EXPANSION	CAPITAL SPENDING	GROWTH IN CAPITAL SPENDING	NEGATIVE
PROFITABILITY GROWTH	5 YEAR GROWTH IN EPS	5 YEAR EPS GROWTH	POSITIVE

QUANTITATIVE TESTS AND RESULTS

TABLE 2: REGRESSION RESULTS

FACTOR	VARIABLES	BETA COEFFICIENT	HYPOTHEZIZED SIGN
DIVIDEND DECISION	DIVIDEND PAYOUT RATIO	NA	DEPENDENT VARIABLE
PROFITABILITY	RETURN ON EQUITY	-.0024***	NEGATIVE
GROWTH	SALES GROWTH	-.0054***	NEGATIVE
RISK	BETA	-.0071**	NEGATIVE
LIQUIDITY	CURRENT RATIO	-.0030***	NEGATIVE
FINANCIAL LEVERAGE	DEBT TO TOTAL ASSETS	+.0089***	NEGATIVE
CONTROL	INSIDER OWNERSHIP	-.0227**	NEGATIVE
INSTITUTIONAL INFLUENCE	INSTITUTIONAL OWNERSHIP	-.0044***	POSITIVE
EXPANSION	CAPITAL SPENDING	-.0937***	NEGATIVE
PROFITABILITY GROWTH	5 YEAR GROWTH IN EPS	+.0042***	POSITIVE
R square	.383		
F statistic	21.78***		
N	542		

*** Significant at the 1% level
 ** Significant at the 5% level
 * Significant at the 10% level

The multivariate regression analysis indicates that the following variables relate negatively to the dividend payout ratio as hypothesized and are also significant at the 1% level: profitability (return on equity), growth (sales growth), risk (beta), liquidity (current ratio), control (insider ownership), and expansion (growth in capital spending). Profitability growth (five-year growth in EPS) related positively to dividend payout as hypothesized and was significant at the 1% level. Financial leverage (debt to total assets) produced an unanticipated, significant positive relationship with the payout ratio, while institutional influence (institutional ownership) related positively, not negatively as hypothesized, with dividend payout and was significant. Of the nine independent variables tested, seven produced the anticipated relationship with the dividend decision and were mostly significant at the 1% level. Two of the nine variables produce contrary signs with dividend payout and were significant. The F statistic shows that the multivariate regression model produced significant explanatory power and the r^2 indicates that the 38% of the variability in the dividend payout ratio is explained by the independent variables tested.

CONCLUSION

This study empirically examined the data for a sample of 542 firms taken from the Multex Investor Database to assess the impact of selected financial variables on the dividend decision using OLS Regression. The study used the firm's dividend payout ratio as the dependent variable to represent the dividend decision. Independent variables tested include: return on equity, sales growth, beta, current ratio, debt to total assets, percent of insider ownership, percent of institutional ownership, expansion, and the estimated five-year growth rate for earnings per share. As hypothesized by the literature (residual theory), sales growth and expansion related negatively to the dividend payout ratio. Likewise, insider ownership produced the anticipated negative relationship with dividend payout. Contrary to the literature, institutional ownership varied negatively with dividend payout. The positive relationship observed between the debt to total assets ratio and the dividend payout ratio produced anomalous results.

As expected, results suggest that the higher the firm's risk, the lower is its payout ratio. Since a greater insider ownership results in a lower dividend, the findings suggest that possibly management in the firms examined has an incentive to reduce dividends in order to increase the expected value of their stock options received as executive compensation. The importance of dividend cash flow as a signaling device to stockholders is also evident in the sample, since the firm is willing to increase debt to fund increasing dividends. The firms in the sample behave as anticipated by the literature since increasing dividends reduces liquidity, and the higher the return on equity, the greater the firm's retained earnings for reinvestment or the lower is the dividend payout. And finally, a higher EPS growth allows a greater capacity for the firm to increase dividends. Overall, results support several of the dividend theories in the literature.

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