Corporate Finance, Module 15, “Payout Policy”

Corporate finance module 15: Readings for Tenth Edition

(The attached PDF file has better formatting.)

Updated: October 13, 2010

The page numbers here are for the *tenth* edition of Brealey and Myers. You may also use the seventh, eighth, or ninth editions of this text. The page numbers for earlier editions are in separate postings. The substantive changes in the textbook are slight among these editions, but the final exam problems are based on the tenth edition.

{The Brealey and Myers textbook is excellent. We say to read certain sections and to skip others. This does not mean that certain sections are better; it means that the homework assignments and exam problems are based on the sections that you must read for this course. Some of the skipped sections are fascinating, but they are not tested.}

The terms *dividend policy* and *payout policy* are both used in corporate finance. Both terms are used in the online postings, practice problems, and final exam questions. The tenth edition of the Brealey and Myers textbook uses the term payout policy.

Read the introduction on page 391. As Brealey and Myers say, the central question is “How does payout policy affect firm value?”

Read section 16.1, “Choice of Payout Policy,” on pages 391-392. This is an introduction.

Read section 16.2, “How firms pay dividends and repurchase stock,” on pages 392-394. These are facts about dividends; even if you know how stocks are traded, the section on stock repurchase plans contains much new information. Know the sequence in Figure 16.2 on page 393 and the terms for each date.

Skip section 16.3, “How Do Companies Decide on Payouts,” on pages 394-395. We don’t need Lintner’s model for the financial theory in this textbook. The model is reasonable, but it is not used elsewhere in this course.

Read section 16.4, “The Information in Dividends and Stock Repurchases,” on pages 395-397. You can skip the J. P. Morgan side-bar on page 397; it is a nice story, but it is not tested on the final exam. Many common dividend practices are hard to explain, and financial analysts presume that dividends send information to investors, not just money. There are more efficient ways of getting money to investors, but dividends may be a good source of information.

Read section 16.5, “The Payout Controversy,” on pages 397-402, focusing on the sub-section “Dividend Policy Is Irrelevant in Perfect Capital Markets” on pages 398-399. The illustration on page 399 is helpful for understanding the theory and answering final exam questions. Understanding this irrelevance theorem is important; the irrelevance theorem for capital structure is similar, so make sure you grasp the concept.

Skip section 16.6, “The Rightists,” on pages 402-405; skip section 16.7, “Taxes and the Radical Left,” on pages 405-409; and skip section 16.8, “the Middle-of-the-Roaders,” on pages 409-410. Brealey and Myers are middle-of-the-roaders. But financial analysts differ so much in their views of dividends that Brealey and Myers present the full range of current opinion. If you trade common stocks, you may want to read these sections to better judge how dividends affect your stock values, but these sections are not tested on the final exam.

Read the summary on page 411, stopping at the line: “… to run a tighter ship”; skip the rest of the summary.

Dividend payouts highlight some unsolved problems. We have a hundred years of dividend payments by thousands of firms. But we still can’t explain what is happening, and we have widely divergent perspectives (left, right, and middle). This is not like a statistics course, where everything is mathematically proved; it is not like a social science class where it is hard to find hard data. Here we have data as hard as we would like, but we still can’t figure out why firms pay the dividends that they do. This is what make corporate finance so fascinating – and so promising for the student you can interpret the real world.

Review problems 1, 2, and 3 on page 412; problems 5 and 6 on page 413.

Problem 7 on page 413 is particularly relevant to actuaries, since insurance companies and pension funds have different tax rates (for dividends) than other firms. The tax rate on capital gains is now 15% for personal taxpayers and 35% for corporate taxpayers. Insurers have a proration provision that increases taxes on corporate dividends. The tax laws are complex, and they are not tested on this course.

Review problem 9 on page 414. Would you expect life insurers and property-casualty insurers to pay out a high or low percentage of their earnings? Insurers (and especially life insurers) are a declining industry in the U.S. (though not in other parts of the world).

Review problem 10 on page 414 and problems 15, 17, 18, and 20 on page 415.