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In search of a residual dividend policy

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Abstract

We survey 309 sample firms exhibiting behavior consistent with a residual dividend policy and their matched counterparts to learn how they set their dividend policies. The findings reveal that the sample firms are more likely than their counterparts to maintain a long-term dividend payout ratio, use long-run earnings forecasts in setting the dividend, and be unconcerned about the cost of raising external funds. Yet, firms behaving as though they follow a residual dividend policy generally do not profess to follow the policy. At best, the sample firms follow a "modified" residual policy in which they carefully manage their payout ratio and dividend trend. Although it may not be an explicit goal of such a dividend policy, consistently low free cash flow typically results.

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1. Background and purpose

In establishing a dividend policy for their firm, managers can select among several major types. With a "pure" *residual dividend policy*, the firm's dividend decision is a direct consequence of its investment policy[1]. The firm follows the net present value (NPV) rule and distributes only the excess cash. Excess

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[1] Preinreich (1932) was the first to suggest that dividend policy is a residual decision.

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cash refers to a firm's internally generated cash flow less all desirable capital expenditures. Under a pure residual policy, the firm avoids retaining internally generated cash flow unless a project earns more than the required rate of return, that is, the project has a positive NPV. Alternatively, with a *managed dividend policy*, the firm attempts to achieve a specific pattern of dividend payments. A third option is a hybrid policy, which we call a "modified" *residual dividend policy* because it shares characteristics of both a residual and managed dividend policy.

Rigidly following a residual dividend policy would inherently lead to highly variable and sometimes zero dividend payments. Such a policy would make predicting future dividends difficult and would be sensible only if investors are indifferent to fluctuating dividends. Most firms are unlikely to follow a "pure" residual dividend policy because of investors' clear preference for dividend predictability.

Managers following a "modified" residual model might attempt to smooth their firm's dividends in relation to expected cash available over time instead of using the excess cash balance as a guide to the payout in any 1 year. Managers can accomplish this objective of having stable, dependable dividends by taking three steps. First, they can estimate their firm's earnings (or cash flows) and investment opportunities over an appropriate time horizon, such as 5 years or so. Next, managers can use this forecasted information to find the average residual model payout ratio and dollars of dividends during the planning period. Finally, they can set a target payout ratio based on the average projected data. Thus, the residual policy can help a firm establish its long-run target payout ratios.

Although discussion of a residual dividend policy is common in the finance literature, little research exists on the prevalence of this policy in practice or the characteristics of firms following such a policy. Our motivation for conducting this study is to help fill this void in the empirical literature. The unique value added by our study is that we are the first to evaluate the phenomenon and to provide comprehensive managerial views on this topic.

The purpose of the study is twofold: (1) to identify firms during the 1990s characterized by a low standardized free cash flow, managerial behavior most consistent with a residual dividend policy, and (2) to learn the views of managers of these firms and their matched counterparts about how they set their dividend policies. Because we expect to find few firms that rigidly follow a "pure" residual dividend policy on a yearly basis, our focus is on firms that use a residual policy to set long-run target payout ratios as described above.

Our findings add to the existing literature on dividend policy by providing current evidence on the residual approach to paying dividends. The few available studies on residual dividend policy provide only indirect evidence obtained from cross-sectional comparisons of firm characteristics. Such indirect evidence cannot reveal the motivations behind such a policy. Unlike most previous research, the current study uses survey methods to obtain direct evidence of attitudes about a residual dividend policy.

Our results help to resolve the question of whether firms view themselves as following a "pure" residual dividend policy. Simply put, our evidence shows that such a policy does not appear to be part of the landscape for firms. Even managers of firms that "behave" mostly like pure residual firms do not profess to be following such a policy. Our evidence also confirms that managerial attitudes toward certain aspects of dividend policy such as the determinants of dividend policy remain largely unchanged. A possible implication of this evidence is that the voluminous research published on dividends over the years has done little to alter managerial perceptions about dividend policy.