

University of Bahrain
College of Business Administration
MBA Programme

**Determinants of Stock Dividend Distribution
Decisions:
Financial Characteristics and Informational
Impacts**

By:
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September 1999

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Declaration

I declare that this work is the result of my own investigation and that it has not already been accepted in substance for any degree, nor is it being currently submitted for any degree.

Signed:



Date: 14.9.1999

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The Thesis defence committee considers the Thesis titled:

“Determinants of Stock Dividends Distribution Decisions: Financial Characteristics and Informational Impacts”

Submitted by Aziza A. Rahim Kamal to the department of Management and Marketing and accepted for the Post-Graduate Diploma in Business Administration.

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**THIS REPORT IS PRESENTED TO
DR. JASIM ABDULLA
AS A PARTIAL FULFILMENT OF
Post-Graduate Diploma Project
MGT 540 (Finance)**

ABSTRACT

This study is an attempt to investigate into manager's motivations for issuing stock dividends from the Financial and Informational perspective.

The research is divided into two sections:

The first section investigates the management's motivations related to financial determinants. The most common reasons to issue stock dividends from the financial perspective is as follows: the desire to conserve cash in order to finance future expansions or to avoid cash dividends due to cash flow problems, signal optimistic managerial expectations about the future and move stock price into a better trading price range.

The second section studies informational impacts of distributing stock dividends. Stock dividends are attention-triggering events there fore managers issue them to signal favourable information about firm value. Although stock dividends may be costly, extensive literature has reported that they are associated with a significant increase in stockholders wealth when issued by undervalued firms.

Related articles have been reviewed in order to develop a thorough understanding of the topics discussed

ACKNOWLEDGEMENT

I am taking this opportunity to express my profound gratitude and sincere thanks to Dr. Jasim Abdulla for providing me with all sorts of valuable advise in the field of Financial Management.

Also I would like to extend my thanks and appreciation to all the people who contributed to the accomplishment of this study.

TABLE OF CONTENTS

NO.	PARTICULARS	PAGE NO.
1	Introduction	1
	1.1 Purpose of the research	2
	1.2 Problem	2
	1.3 Scope of the research	3
	1.4 Research Limitation	3
	1.5 Organization of the research	4
	CHAPTER TWO	
	Financial Determinants to Distribute Stock Dividends	
2	Literature Review :	5
	2.1 Introduction	5
	2.2 Theoretical background	5
	Part One	
	2.2.1 Cash dividend policy	8
	2.2.1.1 Definition	8
	2.2.1.2 A residual dividend policy	8
	2.2.1.2.1 Criticism	8
	2.2.1.3 An independent dividend policy	9
	2.2.1.4 Simultaneous dividend policy	10
	2.2.2 Restatement of the 'M & M dividend irrelevance' argument	11
	2.2.2.1 The Bird in the Hand Theory	12
	2.2.2.1.2 Criticism of The Bird in the Hand Theory	13
	2.2.2.2 The Agency Cost Theory	14
	2.2.2.3 Rozeff's Theory	15
	2.2.2.4 Regret Theory	17
	2.2.2.4.1 Criticism	18
	2.2.2.5 Dividend and picking order	20
	2.2.2.5.1 Criticism	22
	Part two	
	Section one	
	2.2.3 Motives behind stock dividend distribution	23
	Part two	
	Section two	
	2.2.4 Stock dividends from the accounting perspective	27
	2.2.4.1 Legal issues	29
	2.2.5 Summary	31

NO.	PARTICULARS	PAGE NO.
3	Chapre Three The Stock Dividend Effect: Information or Price Impact. Literature Review :	33
	3.1 Introduction	33
	3.2 Theoretical Background	34
	3.2.1 Information asymmetry and stock dividend	34
	3.2.2 Millers restatement of the M & M proposition	35
	3.2.3 Dividends signalling properties	38
	3.2.4 Retained earnings hypothesis	41
	3.2.5 Theoretical development and accounting rules	44
	3.2.6 Summary	48
4	References	49

CHAPTER ONE

1. INTRODUCTION :-

At first glance, stock splits and stock dividends appear to be purely cosmetic changes to a firm's capital structure. Shareholders receive additional shares in proportion to their existing holdings, without additional cash outlays. In surveys, managers cite a desire to move a firm's stock price into a preferred trading range and to improve a stock's liquidity as important motives for issuing stock splits and stock dividends.

Stock dividend distributions in Bahrain can be traced to the year 1988 when the National Company for Exports and Imports declared such a dividend. Ever since, stock dividend has been issued by firms in the Bahrain Stock Exchange. Such practice has been taking place in other countries in the G.C.C, mainly in Kuwait, Saudi Arabia and United Arab Emirates. Definitely more stock dividend distributions are coming. Why?

This question could be answered by investigating about one of the following topics:-

- 1) Determinants to distribute stock dividends found from the annual report of the issuing firms.

- 2) Investor's reactions towards issuing stock dividends.
- 3) Managers motivation
- 4) Stock dividends effect on stock value after announcement.

1.1 Purpose of the Research :-

There is an accumulating body of evidence in the behavioural and business literatures that in some situations individuals have little self-insight as to those factors which actually do influence their decisions. **Eisemann and Moses** (1978) and **Baker and Gallagher** (1980) tried to relate actual managerial behaviour to some potential determinants of stock split and stock dividend decisions.

The principal aim of this research is to investigate the financial characteristics, which motivate management to issue stock dividend and the informational impact of such a distribution.

1.2 Problem :-

Despite the popularity of stock dividends in many countries, both the accounting treatment and corporate status tend to view stock dividend distributions as paper

transaction of limited substance. If this is the case, then why so many corporations continue a policy of stock dividend distribution.

1.3 Scope of the Research :-

The research consists of two studies, which are as follows:

1. Financial Determinants to distribute stock dividends.
2. The Stock Dividend Effect: Information or Price Impact.

Researches and articles have been reviewed in order to develop a thorough understanding of the topic and to seek information about the latest findings in this field. Articles which are directly related to the topic of the research have been chosen. Unfortunately not many researches could be found due to the recency of the topic..

1.4 Research Limitations :-

The main limitation for conducting this research is the lack of literature in the area of stock dividends distribution. Motivations behind stock dividends have not been fully explored. Also there is risk inherent in conducting a study like this.

Whenever proxies for motivation or behaviour are developed, the risk of that the proxies chosen do not adequately represent the phenomenon is present.

Articles published before the year 1980 were not possible to find, therefore some of the theories included in the research were cited in books or articles for other authors.

1.5 Organization of the research :-

The remainder of the paper is organized as follows: The relevant literature on dividend policy is reviewed in the following two chapters. Chapter 2 provides the theories and the literature related to financial determinants and managerial motivations to issue stock dividends. This chapter is divided into two parts. Part one reviews the literature related to cash dividends as a background for the main subject discussed. Part two presents motives behind stock dividend distribution in section one. Section two discusses stock dividends from the accounting and legal perspective. Chapter three provides the literature related to informational impacts of stock dividends, signalling and information asymmetry theories. The final section explains the research limitations.

CHAPTER TWO

Financial Determinants to Distribute Stock Dividends

2. Literature Review :-

2.1 Introduction :-

Stock dividend represents a distribution of additional shares to common stock holders without receiving any consideration from the stockholders. Stock dividend does not transfer assets from the corporation to the stockholders. It has no effect on the corporation assets. Also it has no effect on total stockholders equity and no effect on the percentage of the company owned by each individual stockholder. Then why such dividends are declared and distributed?

2.2 Theoretical Background:-

Stock splits and stock dividends are not costless undertakings. **Sosnick** (1961) addressed this issue in his article “ Stock Dividends are Lemons, not Melons”. His analysis can be summarised in the following points.

His argument has two parts. **First**, ordinary stock dividend carry effects that are unfavourable to the common stockholders. These effects can be summarized by saying that stock dividend :-

(A) Reduce the surplus available for future cash dividends.

(B) Require adjustment of previously reported data.

(C) Cause the corporation substantial expense such as: (1) Use of officers' time, (2) Handling of fractional shares, (3) Issuing of certificates, (4) Revision of the stockholders ledger, (5) Mailing costs, (6) Miscellaneous supplies, (7) Increased franchise taxes, (8) Charter amendment, (9) Stock issue tax, (10) Listing fees.

(D) Considerably increase the recipients transaction costs by incurring up to four kinds of expense: (1) Nuisance value, (2) Increased transfer taxes, (3) Increased broker's commissions, (4) More odd lot differentials.

Second, under certain circumstances, such dividends may also carry effects that are favourable to the recipients. These are primarily (A) An increase in cash dividends and (B) A gain in convenience and value from finer division of the units of ownership. But these effects, when relevant, could often better be accomplished by other means - not notably by a stock dividend.

Elgers and Murray (1985) surveyed corporate managers regarding the factors that influence their stock distribution decisions. Actual managerial behaviour was examined and it was found that the desire to signal optimistic expectations might have been a factor prompting managements to issue small stock

distributions. It was also found that small firms with low stock prices tended to issue small stock dividends. The results also indicated that a poor cash position was not a factor in the decision.

The results of the analysis of large distributions suggested that reducing the per share price is a primary motivator. The findings also indicate that a desire to signal optimistic expectations may be a motivator.

To develop a thorough understanding of the motivations for issuing stock dividends this literature review is divided in two parts. Part one reviews the literature related to cash dividends as a background for the main subject discussed. Part two presents motives behind stock dividend distribution in section one. Section two discusses stock dividends from the accounting and legal perspective.

Part One

2.2.1 Cash Dividend Policy :-

2.2.1.1 Definition:-

Brealey (1981) defined dividend policy as the trade off between retaining earnings on the one hand, and paying out cash and issuing new shares on the other.

Dividend payments are one element of the financial interaction decisions system. Firms can adopt one of three major types of dividend policy which are :-

2.2.1.2 A residual dividend policy :-

Adopters of this type consider their investment and financing activities as more important than their dividend decisions (**Abdulla** 1991). In other words it means that the level of dividend payments depends upon values selected for the investment and financing variables. If there is a surplus of funds dividends will be increased, or if insufficient funds are available dividends will be cut.

2.2.1.2.1 Criticism :-

The only problem with the residual theory is that it does not give recognition to how stockholders feel about receiving dividends. If the stockholders only

concern is with achieving the highest return on their investment either in the form of retained earnings remaining in the business or as current dividends paid out then there is no issue. But if stockholders have a preference for current funds, for example, over retained earnings, then the theory is incomplete. The issue is not only whether reinvestment of retained earnings or dividends provides the highest return but also how stockholders react to the two alternatives. While some researchers maintain that stockholders are indifferent to the division of funds between retained earnings and dividends (holding investment opportunities constant), others disagree. Though there is no conclusive proof one way or the other, the judgement of most researchers is that investors do have some preference between dividends and retained earnings (**Block and Hirt 1989**).

2.2.1.3 An independent dividend policy :-

In which the size of the dividend payment selected and either investment or financing or both are adjusted. This dividend policy emphasises the importance of the stability of dividend payment.

2.2.1.4 Simultaneous dividend policy :-

Where the dividend decision is neither totally residual nor totally independent. Dividend decisions are taken with reference to some exogenous factors, but consideration is also given to investment and/or financing decisions.

Thus we have three opposing points to view. There is a conservative group, which believes that an increase in dividend pay out increases firm value. There is a radical group, which believes that an increase in payout reduces value. Also there is the in between party which claims that dividend policy makes no difference.

Assuming perfect markets, **Miller and Modigliani** in 1961, suggested that only investment policy determines the value of the firm and that investment policy should therefore be given first priority, or the value of the firm is unaffected by dividend policy in a world without taxes or transactions costs. Within this framework the choice between an independent, simultaneous, or residual dividend policy is of no consequence. In 1977 **Ross** suggested that **M & M** dividend irrelevancy proposition implies the assumption that the investors know the return stream of the firm and its effect on the value of the firm. What is valued in the market place is the perceived stream of returns for the firm. This means that there is a possibility that changes in the capital structure or dividend payout may change the market perception. (**Copland and Western** 1988).

Also there is evidence that when dividends and capital gains are differentially taxed, stock returns on ex-dividend days reflect the differential tax payment on the distributed dividends. **Sarig and Tolkowsky** (1996) examined whether stock returns on ex-dividend days in the Tel Aviv Stock Exchange (TASE) reflect the differential taxation of dividends and capital gains. TASE data offer significant advantages over data used by other studies. It is characterized by less frictional trading, no bid-ask spreads, prices quoted in hundredths of Israeli shekels, and by uniform tax rates on dividends and capital gains for only three types of investors. They found that stock prices on the TASE on ex-dividend days exhibit significant abnormal returns. Surprisingly, they found no evidence of short-term trading around ex-dividend days to exploit these profit opportunities.

2.2.2 Restatement of the 'M&M dividend irrelevance' argument:-

Hess (1992 : p,445) provides a persuasive restatement of the '**M&M** dividend irrelevance' argument in his research based on the Bird in the Hand Theory. But first let's look at what he stated in his research:-

"In 1961 **Merton Miller and Franco Modigliani** published a theoretical paper on the subject of "Dividend Policy, Growth and the Valuation of Shares". The central argument of the paper, now well-known as the '**M&M** dividend

irrelevance 'Proposition', says that in a world without taxes, transactions costs, other market 'imperfections,' a company's dividend policy should have no effect on its market value. Only investment policy determines the value of the firm and that investment policy should therefore be given first priority. An assumption crucial to the argument is the independence of a company's investment policy from its dividend policy : that is the "irrelevance " argument holds only if the company's investment decisions are not influenced by management's insistence on maintaining or raising the company's dividend".

2.2.2.1 The Bird in the Hand Theory :-

This notion holds that, because stock prices are highly variable, dividends represent a more reliable form of return than capital gains. And the greater certainty associated with dividends leads investors to place a higher value on dividends than on an equivalent amount of uncertain and riskier capital gains.

In a more sophisticated and analytical version of the 'bird in the hand' argument, In 1959 **Myron Gordon** argued that investors will discount the expected stream of future dividends at a lower rate than expected capital gains. This proposition was formalised into the 'Gordon Valuation Model' which places premium prices on stocks offering higher dividend growth. (**Hess** 1992).

2.2.2.1.2 Criticism of the bird in the hand theory :-

Hess concluded that 'The bird in the hand theory' is, at bottom, an argument about investment policy, not dividends. What it's really saying is that companies paying lower dividends tend to have riskier investments, or that there is greater uncertainty about how those investment decisions will be made in the future. And for these reasons - and not the lower dividends - the market discounts the earnings of low dividend companies more heavily. In other words, Investors discount future earnings according to the perceived operating and financial risk of the company regardless of whether those earnings will be retained or distributed.

Hamid, Prakash, and Anderson (1994) examined the theoretical relationship between systematic risk as measured by the beta of the security and growth in dividends or earnings. They offer a simple procedure that shows this positive relationship between growth as defined in terms of growth in dividend and/or earnings and beta and offers empirical evidence to support the relationship. They found that the relationship between systematic risk and growth defined as growth in earnings and dividends is positive.

Michael Rozeff (1992) attempts to take the theory beyond the Miller-Modigliani dividend 'irrelevance' argument by offering positive rationales for the corporate practice of paying dividends. Rozeff's study provides some suggestive evidence

that the separation of ownership from control in the large public corporation creates a demand for dividends by stockholders. He also presents a model, based on a measure of stockholder dispersion as well as the risk and capital requirements of the firm, which does a reasonably good job of explaining actual corporate dividend payout ratios.

But first let us explain the agency theory on which he has based his argument on.

2.2.2.2 The Agency Cost Theory :-

In an article published in 1976, entitled "Theory of the Firm; Managerial Behaviour, Agency Costs, and Ownership Structure," **Jensen and Meckling** argued that the separation of ownership and control may explain much corporate behaviour that does not appear 'rational' under the assumptions of perfect markets. More precisely, they argued that 'agency costs' result from the potential conflict of interest between 'agents' (managers) and 'principals' (stockholders/owners). That is 'agency costs' arise whenever owner-managers sell off portions of their stock holdings to 'outside' security holders who have no voice in management. The measure of these 'agency costs' is the difference

between the market value of the company when 100% owned by management, and its value when less than 100% owner managed.

They demonstrated that corporate managers take actions designed to minimize the implicit costs associated with the separation of ownership and control. These actions include the external auditing of the company's accounts and activities, the establishment of supervisory and control functions by boards of directors, the acceptance of covenants in lending agreements which contractually limit management's decision making powers and the structuring of incentive compensations contracts to bring the interests of managers and outside equity holders into closer harmony. These 'bonding' 'monitoring', and 'auditing' functions help to control management behaviour, thus reducing the potential conflict between managers and security holders. (**Rozeff** 1992).

2.2.2.3 Rozeff's theory :-

His argument is that dividend payments serve a function similar to the 'bonding' and 'monitoring' devices described above. In the process of providing additional information to investors about the actions and intentions of management, dividends reduce the 'agency cost' associated with outside ownership.

His theory suggests that companies' dividend payout ratios are influenced primarily by three considerations: the transactions cost of external finance, the

agency costs of outside ownership, and the financing constraints created by higher operating and financing leverage. The first and third are both arguments for restricting the dividend payout, and both rest on the assumption that raising new securities is far from a costless activity for corporations. These two closely related concerns are balanced by the positive role of higher dividends in mitigating the agency problem - the implicit loss in value caused by the separation of ownership from control.

In order to test his predictions, He compiled a sample of 1,000 companies representing 64 industries. In support of this theory of how companies choose (whether consciously or implicitly) their dividend payout ratios, his study furnishes empirical evidence consistent with the three previously mentioned considerations in his theory. He concluded that dividend payout ratios are not 'randomly distributed' among companies. There is a predictable pattern of dividend behaviour. This pattern could reflect decisions by managers that are 'rational', that is they conserve stockholders wealth.

Rozeff noted that Miller and Modigliani proposition can not explain how a company actually settles on a dividend policy. This will be accomplished only by concentrating our attention on those market 'imperfections', which much of the literature has ignored.

2.2.2.4 Regret theory :-

In 1979 **Khahnemann and Tversjt** introduced Regret Theory as follows:

“Regret is felt if one can readily imagine having taken an action that would have led to a more desirable outcome. This interpretation explains the close link between the experience of regret and the availability of choice: actions taken under duress generate little regret. The reluctance to violate standard procedures and to act innovatively can also be an effective defence against subsequent regret because it is easy to imagine doing the conventional thing and more difficult to imagine doing the unconventional one”. Cited in **Gosh** (1993: p, 563) .

Regret Theory implies that when individuals choose an action from several possible strategies, all with uncertain outcomes, they experience regret (pride) if the outcome from the action chosen turns out to be inferior (superior) to the outcomes from the foregone strategies. Assuming regret to be an attribute of managers, He demonstrated that the decisions to

1. Simultaneously pay dividends and raise venture capital from the market; and
2. Borrow to continue cash dividend payments when earnings are inadequate to support them,

are consistent with managers' eagerness to avoid regret or feel pride in decision making under uncertainty.

An implication to Regret Theory is that regret or pride is felt only when the chosen action represents a deviation from the conventional or standard practice.

2.2.2.4.1 Criticism :-

In 1982 **Bell** postulated that depending on the outcome of his choice the decision maker feels not only a sense of regret but also a sense of pride or euphoria. **Thaler** in 1980 pointed out that regret is acute when an individual must assume responsibility for the final outcome. An action which is taken under duress or which represents the standard and conventional course causes little regret, even if it fails to produce the best outcome among the available decision options. (**Gosh** 1992).

Furthermore **Ghosh** explored the implications of Regret Theory for corporate dividend policy. Specifically, he focused on the predictions of the model for the behaviour to managers when they are confronted with a decision involving the interaction of the firm's investment and dividend policies.

His paper analyzed the findings from a recent survey of over two hundred and fifty practicing top financial managers of large companies in the New England and New York states. The survey indicates that,

(1) When managers decide on a choice between paying higher dividends or conserving funds for uncertain investment opportunities, they prefer higher dividend payments.

(2) In a choice between cutting dividends or supporting dividends with funds borrowed at high cost and risk, managers tend to prefer the second alternative.

These findings are consistent with the implications of Regret Theory. A decision to retain earnings for investment purposes entails responsibility on the part of management with potential loss of utility due to regret should the investment fail. Maintaining the payout at the existing level, on the other hand, is the standard practice that produces little regret. Regret-aversion may thus lead to external financing of risky investments. Moreover, taxes on dividends and the loss of shareholders' wealth associated with external financing of projects may be interpreted as the premium management pays to avoid decision-regret.

2.2.2.5 Dividends and Picking Order:-

The dividend policy has been related to the firms capital structure in the article "The capital structure puzzle", by **Myers** (1984). Myers contrasted tow ways of thinking about capital structure:-

1) A static trade-off framework, in which the firm is viewed as setting a target debt-to-value ratio and gradually moving towards it in much the same way that a firm adjusts dividends to move towards a target payout ratio.

2) An old-fashioned pecking order framework which can be summarised in the following points:-

A) Firms prefer internal finance.

B) They adapt their target dividend pay out ratios to their investment opportunities, although dividends are sticky and target payout ratios are only gradually adjusted to shifts in the extent of valuable investment opportunities.

C) Sticky dividend policies plus unpredictable fluctuations in profitability and investment opportunities, mean that internally-generated cash flow may be more or less than investment outlays. If it is less the firm first draws down its cash balance or marketable securities portfolio.

D) If external finance is required, firms issue the safest security first. That is they start with debt. then possibly hybrid securities such as convertible bonds, then perhaps equity as a last resort. In this story, there is no well-defined target debt-equity mix because there are two kinds of equity, internal and external, one at the top of the pecking order and one at the bottom. Each firm's observed debt ratio reflects its cumulative requirement for external finance.

Myers summarised the firm's financing behaviour in the following points in which he refers to, as the dividend policy:-

- 1) Firms have good reasons to avoid having to finance real investment by issuing common stock or other risky securities. They do not want to run the risk of falling into the dilemma of either passing by positive-NPV projects or issuing stock at a price they think is too low.

- 2) They set target dividend pay out ratios so that normal rates of equity investment can be met by internally generated funds.

- 3) The firm may also plan to cover part of normal investment outlays with new borrowing, but it tries to restrain itself enough to keep the debt safe, that is, reasonably close to default-risk free. It restrains itself for two reasons : first to

avoid any material cost of financial distress; and second, to maintain financial slack in the form of reserve borrowing power.

4) Since target dividend pay out ratios are sticky, and investment opportunities fluctuate relatively to internal cash flow, the firm will from time to time exhaust its ability to issue safe debt. When this happens the firm turns to less risky securities first.

2.2.2.5.1 Criticism :-

Myers modified pecking order theory depends on sticky dividends but does not explain why they are sticky. Also it does not explain why and when firms issue common equity. The modified pecking order theory recognises both asymmetric information and cost of financial distress. Thus the firm faces two increasing costs as it goes down the picking order stages, it might face more cost of financial distress and more possibilities of refusing positive-NPV projects because the firm is unwilling to issue common stock or other risky securities. The firm might choose to reduce these future costs by issuing stock now, even if new equity is not needed immediately to finance real investment because financial slack is valuable and the firm may issue stock to acquire it.

Part two

Section one

2.2.3 Motives behind stock dividend distribution :-

There have been several studies exploring the motivations of managers in issuing stock dividends and stock splits. **Abdulla** (1990) investigated the factors which motivate managements to make stock distributions in Kuwait. He hypothesised that managements of Kuwaits' companies are distributing stock dividends in order to reduce the stock price to an optimal range. Also he hypothesised that managements distribute stock dividends during a period of declining ratios of cash dividends and during the distribution year the distributing firms enjoy a higher earning growth rate per share than other firms. Finally he hypothesised that management might use a stock dividend distribution as a signalling device for conveying an optimistic view about the company's future. The period selected for this examination was limited to 1984 through 1988. All firms listed in the Kuwait stock exchange subject to data availability were included in the sample. Abdulla concluded that management of Kuwaiti companies are not distributing stock dividends in order to reduce the stock price to an optimal range. He also found that firms are using stock dividends as a substitute for the reduction in their cash dividend distribution and that there is little evidence to believe that distributing firms enjoy a higher earning growth rate per share than the other firms during the distribution year. His final conclusion

was that there is no direct evidence that management is using stock dividend distribution as a signalling device for conveying an optimistic view about the companies future.

Esmann and Moses (1978) investigated corporate managers' motivations for issuing stock dividends. Their findings were based on answers to a detailed questionnaire sent in 1975 to chief financial officers of two groups of New York stock Exchange firms, one distributed stock dividends and the other did not. The questionnaire was divided into two parts. The first part consisted of 17 closed-end questions and the second consisted of several open-end questions.

The researchers concluded that management's motivation behind stock dividend distribution was as follows:- To increase number of shareholders in the firm, to make the stock more attractive to investors, to conserve cash, replacing cash dividends with stock dividends would increase shareholders after tax receipts, in order to maintain historical practice because stock dividend paying group felt that terminating an existing policy of paying these dividends would hurt the stock price, the research did not confirm the idea that stock dividends enable management to express their confidence in the firm and the non distributing firm considered cost as a strong motivator for not distributing stock dividends. The research consisted of more interesting conclusions which were not directly related to this study therefore they have not been included in this literature review.

Kimmell and Marquette (1991) paper presents empirical evidence supporting the hypothesis that managers use different stock dividend under different conditions. Also they hypothesised that the distribution size is related to the economic condition of the firm. In order to test their hypothesis that managers use different stock dividends in a rational and systematic manner for different reasons they have developed proxies for the stock dividend motivation most frequently mentioned in the literature. The proxies are presented in detail in the following five points:-

1. **Cash Conservation**, a commonly cited reason for using stock distribution is the desire to conserve cash. A stock distribution may be used as a substitute for cash dividends for several reasons like the company having cash flow problems and can not pay the cash dividend or it has expansion plans. The stock dividend distribution was expected to be small since additional shares of stock will make the firm pay additional cash dividends in future periods.
2. **Historical practice**. Once stock dividends are issued management fears that discontinuation may cause negative shareholder reaction.

3. **Reduce price, increase the number of shares.** This is one of the most widely accepted of all management motivations for issuing stock dividend distribution.
4. **Increase cash dividends inconspicuously.** This motive assumes that management wishes to increase the cash dividend payout to existing stockholders without attracting unwanted attention from competitors or government. Rather than increase the per share dividend , the company increases the number of shares without decreasing the cash dividend proportionally.
5. **Facilitate future capital financing.** Lowering the market price may facilitate future sales of stock in two ways. First, it may lead to an increase in ownership dispersion, generating increased interest in the firm. This, in turn, may ease the future sale of new shares. Second, a reduced price means that more investors will be financially able to acquire the new shares. But large distributions may lead to later demands on cash, which a company would not welcome as it entered into an expansionary period.

Kimmel and Marquette (1991) concluded that managers plan stock distributions with several alternative objectives in mind and they found a systematic relationship between stock distribution size and corporate financial condition.

Part two

Section two

2.2.4 Stock dividends from the accounting perspective :-

To understand the effects of stock dividend on the firm one should compare it with cash dividends. a cash dividend transfers assets from the corporation to the stock holders. It reduces the corporation assets and its stockholder's equity. But stock dividend does not transfer assets from the corporation to the stockholders. It has no effect on assets and no effect on total stockholders equity. However, a stock dividend does have an effect on the components of stockholders equity. To record a stock dividend accountants must transfer some of the retained earning balance to contributed capital accounts (**Larson** 1990).

Accounts treat stock dividend in two different ways according to its size. "If a corporation declares a small stock dividend, accounting principles require that the corporation capitalise an amount of retained earnings that equals the market value of the shares to be distributed. This rule is based on the idea that a small stock dividend is likely to have only a small impact on the price of the stock. In applying this rule, a small stock dividend is defined as one that amounts to 25% or less of the previously outstanding shares. The rule makers concluded that some stockholders might incorrectly believe that earnings are distributed in a

small stock dividend. Thus, the amount of retained earnings capitalised and made unavailable for future dividends should equal the market value of the shares to be distributed.

On the other hand, a stock dividend that exceeds 25% of the outstanding shares normally has a pronounced impact on the stock's market price and is not apt to be perceived as a distribution of earnings. Therefore, in recording a stock dividend that is over 25%, it is necessary to capitalise retained earnings only to the extent required by law. In most cases, this means that you ignore the market value of the shares. Instead, you debit Retained Earnings and credit the stock account for the par value or stated value of the shares issued".

Brealey and Myers (1991) characterize the difference between a stock dividend and a stock split in the following terms:

A stock dividend is very much like a stock split. Both increase the number of shares, and both reduce value per share, other things equal. Neither makes anybody better off. The distinction between the two is a technical one. A stock dividend is shown in the accounts as a transfer from retained earnings to equity capital, whereas a split is shown as a reduction in the par value of each share.

The technical accounting rules go further and establish three categories of stock distributions for accounting purposes (AICPA (American Institute of Certified

Public Accountants) (1953), Ch.7B, par.10;SEC (Securities and Exchange Commission) (1972)), both state that for:

- i) Stock Split . The par value of all shares is reduced. No accounting transfers are made.
- ii) Large Stock Dividend. The par value of the newly issued shares is transferred from either retained earnings or from capital surplus, or from a combination of both.
- iii) Small Stock Dividend. The market value of the newly issued shares must be transferred from retained earnings.

2.2.4.1 Legal Issues :-

In the 1950's texts on Corporate Policy, and stockholding were still arguing that stock dividends were evidence of excess capital. for many years stock dividends were income subject to Federal Income Tax in the United States. The Committee on Accounting Procedures and the New York Stock Exchange (NYSE) believed that small dividends contained value while large dividends did not. The N Y S E still classifies stock dividends as splits (large distributions greater than 25%) and they consider distributions less than 25% to be stock dividends regardless of the accounting treatment employed. The supplement to the Model Business Corporation Act (1988) considers stock dividends to be

solely paper transaction and the accounting treatment of stock dividends to be fictional.

Baker and Gallagher (1980) investigated reasons corporate managers give for issuing stock splits instead of stock dividends. As mentioned previously, stock dividends for more than 25% are treated like stock splits. That is in theory, a stock split is merely an arithmetic exercise. They result in a reduction of the par value and a consequent increase in the number of shares proportionate to the split. All other capital accounts remain unchanged. The researchers concluded that while in general the reasons for issuing stock dividends and splits are quite different, the findings suggest that both stock dividends and splits are perceived as increasing the number of shareholders.

The large retained earnings reduction for stock dividends can limit the issuing firm's ability to pay cash dividends in the future. **Rankine and Stice** (1997) show that to avoid this relatively large market value transfer from retained earnings, almost half the firms declaring 20% stock dividends use a loophole in the accounting rules to classify these distributions as large and be treated as stock splits.

2.2.5 Summary :-

The amount of research conducted in the field of stock dividends is limited but it constructs sufficient bases for conducting a research based on the previously mentioned studies. To construct a thorough understanding of managements motivations for stock dividends distribution all the motivations mentioned in the previously presented researches were scanned in order to come up with maximum number of motivations. Th following is a summary of the motivations studied in this research as one group with no reference to its origin and they are as follows:-

- 1) Cash conservation.
- 2) Maintain a historical practice.
- 3) Signal optimistic managerial expectations about the future.
- 4) Move stock price into a better trading price range.
- 5) Increase the total market value of the firms stock.
- 6) To substitute cash dividends.
- 7) To avoid costs of raising external fund.
- 8) To finance profitable opportunities for reinvestment from retained earning.

Three motivations were found suitable to stand for accounting measures which, explain managers behaviour. These motivations were selected based upon previous studies as well as on the availability of an empirical surrogate and data. These motivations are NO 1,3 and 4 from the previous list.

Chapter Three

The Stock Dividend Effect: Information or Price Impact.

3. Literature Review:-

3.1 Introduction :-

In the past, the question of the effect of dividends on stock prices has been a controversial one. Until quite recently, in fact, the academic finance profession collectively had come up with no convincing rationale for corporate dividend payments. There were only two positions on the dividend question that were seriously defended by financial economists (1) dividends are 'irrelevant' (that is, investors care only about their total returns, and the level of total stockholder returns is unaffected by managements decisions to payout part of that return in the form of dividends); and (2) Higher dividends actually lead to lower stock prices because of taxable investors pay higher taxes on dividends than on capital gains. This was before the Tax Reform Act of 1986 in the U.S.

3.2 Theoretical Background :-

3.2.1 Information Asymmetry and stock dividend :-

The relationship between corporate dividend policy and stock prices was unclear until the formation of the "dividend irrelevance" proposition by Miller and Modigliani in (1961). They stated that in perfect markets the only important determinants of a company's market value are the expected level and risk of its cash flows. A company's dividend policy affects only the amount of outside financing required to fund new investments, which means a dollar paid out in dividends is a dollar of capital gains foregone.

Miller and Modigliani in 1958 assumed either explicitly or implicitly that:

- 1-Capital markets are frictionless.
- 2- Individuals can borrow and lend at the risk-free rate.
- 3- There are no cost to bankruptcy.
- 4- Firms issue tow types of claims: risk-free debt and (risky) equity.
- 5- All firms are assumed to be in the same risk class.
- 6- Corporate taxes are the only form of government levy (i.e., there are no wealth taxes on corporations and no personal taxes).
- 7- All cash flow streams are perpetuities (i.e., no growth).

- 8- Corporate insiders and outsiders have the same information (i.e., no signalling opportunities).
- 9- Managers always maximise shareholders ' wealth (i.e., no agency costs).
- (**Copland** 1988).

3.2.2 Miller's restatement of the M and M proposition:-

Miller (1986) stated in his article ' Behavioural rationality in finance: The case of dividends' That:

In the shorter run, management can be presumed to know more than outside investors about the current prospects of the firm. Under these conditions, dividend decisions can take on an additional strategic dimension that, on balance, tends to inhibit changes in policy.

Miller concluded that the rationality based market equilibrium models of dividends are alive like other economic models and they will continue to be a major issue to study and individual dividend policy decisions depends on the corporate conditions.

Of course, there has never been any doubt that large announced dividend increases are generally accompanied by increases in stock price, and that dividend cuts can send prices down. But the interpretation of this phenomenon has been that such changes in dividend policy convey information to the market

only about the firm's future earnings power. The positive market response to announcements of higher dividends says nothing about a preference by investors for dividends over capital gains, and this 'information effect' has accordingly been interpreted as being consistent with the dividend 'irrelevance' proposition.

Finance scholars recently proposed a positive economic rationale for corporate dividends by elaborating the role of dividends in providing information. They observe that management often has significant inside information about its company's prospects that it cannot (or chooses not to) convey to investors; and the possibility of this information 'gap' between management and stockholders causes stock prices to be lower than they otherwise would under conditions of perfect certainty. Corporate dividends, may be management's most cost-effective means of overcoming the investor uncertainty resulting from this potential 'informational asymmetry'. In periodically and predictably raising the dividend, management effectively binds itself to make a series of future payments to stockholders; and this commitment, which is costly in terms of management's future flexibility provides investors with the assurance that management is not sitting on some important piece of negative information.

The fact that almost all successful companies pay dividends would suggest, at least to a 'positive' economist, that dividends must have some value for

investors that they don't get through capital gains. Before we speak about information asymmetry and its relation to stock dividends lets talk about information asymmetry and its relation to management's earnings forecasts

Coller and Yohn (1997) examined bid-ask spreads around management forecasts of quarterly earnings to investigate whether the decision to issue a management earnings forecast is related to information asymmetry in the market for the firm's stock and whether the forecasts reduce the information asymmetry. Theoretical models of the bid-ask spread hold that a portion of the bid-ask arises because of asymmetric information and that specialists widen spreads when they perceive greater information asymmetry. The findings suggested that management forecasts are effective in reducing information asymmetry in the market for the firm's stock.

In another interesting research which is related to information asymmetry and trading volume **Abdelsalam and Satin** 1991 examined The Effect of Published Corporate Financial Reports on Stock Trading Volume in Saudi Arabia. This paper studied the trading volume for 28 corporations in 1985 and 20 in 1986.

The researchers found that the release of annual corporate financial reports seems to have little effect on share trading volume in the Saudi Stock market. Possible explanations for this non-reaction vary from the thinness of the Saudi market, a possible lagged reaction to news, the country's economic reliance on

oil, and the heavy government influence on corporations. The fact that some firms are subsidised or partially owned by the Government ought to reduce both individual investor reaction and total market reaction to earnings news. The investors in subsidised firms are not as concerned with their profits; the government as a shareholder has more interest in aiding its own economy than in receiving dividends.

Lobo and Tung (1997) hypothesised that trading volume at the time of earnings announcements is higher when the level of predisclosure information asymmetry is greater. They found that trading volume reaction to quarterly earnings announcements is positively related to predisclosure information asymmetry and to the price reaction to the earnings announcements after controlling for the effect of each other. **Brooks** (1996) concluded that earnings announcements reduce the information asymmetries between informed traders and liquidity traders to such an extent that liquidity traders postpone trades until after these anticipated announcements.

3.2.3 Dividend's signaling properties :-

Management may possess important information about the company that the market doesn't share. Investors recognise this information disparity and revise their estimate of a company's value in response to management's announced decisions.

In 'How Investors Interpret Changes in Corporate Financial Policy', **Paul Healy and Krishna Palepu** (1988) attempt to explain why investors react in fairly consistent ways to announcements of three kinds of corporate policy changes (1) dividend initiations, (2) common stock offerings, and (3) stock splits. They found that both dividend initiations and stock splits are followed by several years of sustained increases in earnings, thus explaining the market's initially positive reaction. Announcements of stock offerings, by contrast, foretell a period of significantly higher operating risk and share price volatility, thus justifying the generally negative market response.

In another research by **Smith** (1986) concluded that, The academic evidence on market responses to announcements of new securities sales, stock repurchases, dividend changes, and changes in capital spending is broadly consistent with the signalling hypothesis. As shown in the research, announcements of security purchases, dividend increases, and increases in capital spending are greeted systematically by increases in stock prices. The market responds negatively, as a rule, to announcements of security sales, dividend reductions, and decreases in new investment .

Woolridge (1983) proposed an alternative hypothesis. He argued that the signal sent to the market by a dividend cut is a positive one. If a company has

many profitable opportunities but little available cash, the value of that company's shares may be increased by reducing current dividends and increasing investment. Also if the company has a limited number of investment opportunities shareholders are better served if the excess cash is paid out to them in the form of higher dividends. This is exactly the opposite of what has been predicted by the traditional dividend information hypothesis.

Woolridge explored his alternative dividend information hypothesis and presented empirical data on companies cutting their dividends. In one of his researches he studied companies distributing stock dividends instead of cash dividends. He completed this study in 1983. In it he identified and analysed 50 cases where companies distributed stock dividends instead of cash dividends. Most of these decisions were as a response to earning problems. Only in 8 cases the reduction in cash dividends and substituting it by stock dividends were for financing future growth. He concluded that stock dividends provide a positive signal to the market which helps to offset some of the negative news conveyed to the market by a cut in cash dividends. Also Woolridge said in his research "the economic theory postulates that the value of information conveyed through a signalling mechanism is directly related to the cost of providing the signal. Stock dividends impose costs on the firm, in the form of registration and handling costs. And stock dividends, accordingly may be viewed by the market as a stronger signal about the firm's prospective performance and investment

opportunities than simply a direct statement by management to the financial community.

If the stock dividend is a signal that manager's private information about current and future earnings is more favourable than the prevailing market expectation, the announcement reaction should be correlated with current and subsequent period earnings growth.

3.2.4 Retained Earnings Hypothesis :-

Self imposed reductions in retained earnings and/or capital surplus can be interpreted as a signal of management's favourable private information (**Healy and Palepu** 1988). In the stock dividend/stock split literature, this particular signalling interpretation of stock dividends has become known as the retained earnings hypothesis (**Woolridge** 1983).

Rankin and Stice(1997) concluded that for stock distributions of the same size, consistent with the retained earnings hypothesis, those accounted for as stock dividends are interpreted by the market as more positive signals than are those accounted for as stock splits. Prior research has underestimated this difference because of inaccurate categorisation rules relying on distribution size or CRSP (Centre for Research in Security Prices) classification. In fact, prior empirical studies purportedly comparing stock dividends and stock splits are

best interpreted as comparisons of small stock distributions to large distributions.

In this research we see that 2-for-1 distributions accounted for as stock dividends are associated with a 2.70% abnormal return in the five-day announcement period, significantly greater than the 0.93% abnormal return for the 2-for-1 distributions accounted for as stock splits. The magnitude of the announcement reaction for stock dividends is shown to be positively related to future earnings growth, whereas the announcement reaction for stock splits is unrelated to future earnings growth.

By voluntarily reducing the existing pool of distributable funds, managers of undervalued firms can signal their confidence that such a reduction will not negatively impact the firms ability to make future cash distributions. In this setting, the accounting choice it self, rather than any information content in the accounting numbers , is the vehicle for conveying information. Furthermore **Peterson, Millar and Rimby** (1996) investigated the question of whether the choice of accounting method is viewed as a management signal to the capital market. They found that more positive information is signalled if the stock distribution accounting choice reduces distributable equity

Also **Philips, Baker and Edelman** (1997) investigated the behaviour of returns to shareholders of NYSE and AMEX firms that publicly announced the

discontinuance of regular stock dividends. The results showed that the average abnormal returns for the firms stocks are negative but not statistically significant on the event date. Partitioning the sample by stock-related characteristics showed that for small firms with low stock prices and low institutional ownership, management's decision to drop regular stock dividends conveyed a significantly negative signal, which, in turn, caused stock prices to decline. Firms that dropped a stock payment and simultaneously initiated or increased cash dividends experienced a significant increase in shareholder wealth. However, firms that dropped the stock dividend policy and did not begin a cash dividend policy experienced a sharp decline in shareholder wealth.

As for stock splits **Szewczyk and Tsetsekos** (1993) tested the proposition that split announcements are informative signals that play a greater information role for widely held firms. They presented evidence for an inverse relationship between managerial ownership and the magnitude of stock split-induced abnormal returns. After controlling for industry and firm size, they found that splitting firms have lower managerial ownership, on average, than nonsplitting firms. But they did not discuss the effect of stock splits on the price of the securities.

3.2.5 Theoretical Development and Accounting Rules :-

Managers possess information that is relevant to firm valuation but unavailable to stockholders and potential investors. This information may be communicated through financial reports but not reflected in share prices if:

- (1) Managerial incentives differ from those of shareholders.
- (2) Flexibility permitted under generally accepted accounting principles, allows managers to distort reported results.
- (3) Shareholders and potential investors find it costly to assess the degree of distortion (**Healy and Papelepu** 1988).

Managers of undervalued firms can credibly signal their favourable private information by undertaking corporate financing policies that would be costly for firms with a pessimistic outlook about future cash flows to imitate.

As previously mentioned under current accounting rules, 20% stock dividends must be accounted for by transferring the market value of the new shares from retained earnings, a far larger transfer than required for 25% stock dividends. Because of constraints on future cash dividend payments imposed by bond covenants and state incorporation codes, a 20% stock dividend can be

interpreted by the capital market as a positive signal of management's private information about firm valuation.

The empirical implication is that the declaration of a 20 percent stock dividend, with the associated large reduction in retained earnings, should be interpreted as a more positive signal than the declaration of a 25 percent stock dividend. The voluntary retained earnings reduction should be an even better signal in states with restrictive incorporation laws regarding retained earnings and the pay of cash dividends.

The finance literature describes a variety of factors associated with a firm price per share that have been put forward as the cost of signalling in conjunction with a stock dividend or split. Regardless of the validity of these factors, it seems reasonable to assume that they do not differ significantly between 20% or 25% stock dividends. The primary difference between these two groups is the retained earnings impact dictated by the accounting rules.

To examine these assumptions **Rankine and Stice** (1997) concluded that Firms declaring 20% stock dividends Generate significantly higher announcement returns than firms declaring 25% stock dividends. This result is not driven by concurrent increases in cash dividends, by firm size, or by factors which might influence the market's evaluation of the probability of the declaration of a stock dividend.

Consistent with the notion that it is the retained earnings transfer that is the signal, firms using par value to account for a 20% stock dividend exhibit smaller announcement returns than those using market value. Evidence that it is the constraining nature of the retained earnings transfer that provides the signal is provided by the result that the market reaction to 20% stock dividends accounted for at market value is higher for firms incorporated in states with more restrictive incorporation codes. These same firms exhibit superior cash dividend growth in the five years following the declaration.

Although accounting regulators may have originally designed stock dividend rules with other objectives in mind, this research provides evidence that these rules give managers the opportunity to signal their private information by selecting the size and accounting treatment, of stock dividend. This paper provides evidence on the role of accounting method choice in mitigating information asymmetries between managers and the capital market. From an information perspective, accounting methods may be viewed as a mechanism for communicating with investors that supplements corporate disclosure policies. Within this context, accounting method choice can be viewed as one of the tools available to managers for reducing the costs associated with information asymmetries.

With in the same context **Jeblom** (1989) analysed if the announcements of stock dividends and stock splits in themselves convey positive information, and whether this information is interpreted independently of other simultaneously published new information. The study is based on stocks listed on the Stockholm Stock Exchange, where the problem of simultaneous announcements is markedly present: the stock dividend/stock split announcements and proxy statement disclosures are usually simultaneous.

Excess returns were found to be related to variables of informational content of the EPS announcement, dividend proposal and stock split/stock dividend decision. The results indicate that the unexpected EPS change as well as the stock dividends/ stock split announcement are the most important reasons for significant price reactions following the announcement.

3.2.6 Summary :-

Even though stock splits and stock dividends do not directly affect a firm's cash flows, and extensive literature has reported that they are associated with a significant increase in stockholder wealth, a widely-cited explanation for this positive market reaction is that stock distributions signal management's favourable information about firm value. For stock splits and stock dividends to be credible signals, they must be more costly for firms without favourable information. Stock dividends and splits may be costly because (a) Transactions costs and brokerage commissions are inversely related to share price. (b) Firms have a 'desired trading range' determined by the constraints that a high share price may reduce liquidity while a low share price may increase per share transactions costs or reduce prestige , and (c) Stock dividends and splits are attention - triggering events by undervalued firms but potential reputation loss prevents imitation by overvalued firms . In addition, it has been suggested that stock dividends may be costly because they require an accounting reduction in retained earnings.

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