

# The Influences of Value-Based Management on Dividend Policy

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**Abstract:** The value-based management (VBM) is a new kind of management techniques that has been put forward in management field in the west. It stresses the core position of enterprise value in the principle of enterprise management and aims at promoting the value of the entire enterprise. However the traditional dividend policy of listed companies is more concerned about the stockholder's interest. Therefore, in order to realize the goal of financial management—maximizing the enterprise value, it is necessary to analyze the influences of Value-based management on dividend policy. So that managements can eliminate the disadvantages of the traditional dividend policy, which aims at maximizing the shareholder's wealth, when we hope to maximize the enterprise value and promote the long-term development of the enterprise. [The Journal of American Science. 2006;2(4):35-39].

**Keywords:** Dividend policy, Enterprise value, Sustainable development, Value-based management

## 1. Introduction

Value-based management appeared in U.S.A. in the eighties of the 20th century, and the thought of value management has been pursued in western enterprises since the 1990s. The value-based management has already become a kind of new enterprise management mode in the west, a lot of famous companies such as Microsoft, Intel, coca-cola, Siemens have made very great success since implementing this mode. The new enterprise management mode has stressed the key position in the business administration idea of enterprise's value. It bases on the promotion of enterprise's whole value and emphasizes the unity of external market value and inherent economic worth of enterprises. So the theory of enterprise's value management has become the extension and developing of the enterprise's management theory. Since the value management is a new proposition, it provides very wide space for scholars both at domestic and international to investigate.

In addition, the arrival of the globalization of economic, liberalization of trade, the information networking, the fierce market competition, the quicker technology creation and the faster changes of customer's demand have made the business face more and more challenges and impacts. Because of the wide application of a large amount of high technology, the management mode and the management idea will inevitably change and all these will lead the enterprises to transform from traditional production management to value management.

On the other hand, at present there are more and more nonstandard behavior in the dividend policy of China, such as so little cash dividend or no dividend in many companies, the random and discontinuity of the dividend policy. The motive of paying dividend all against the scientific finance and the investment views, which is urgently for us to overcome these shortcomings with scientific, systematic and practical study results, and what's more, it offers the opportunity to research dividend policy based on the value management. The main purpose of the study on the dividend policy based the value management is to make the enterprise take the maximum of enterprise value as the goal and make the policy more scientific, systematic and practical with the theory, method and principle of the value management.

## 2. The blemishes in the traditional dividend policy

There are some blemishes existing in the making and the process of carrying out the traditional policy:

### 2.1 The traditional dividend policy is not devoted to the maximization of enterprise value

The traditional dividend policy is not devoted to the maximum of enterprise value, but to the maximum of the profit or shareholder's wealth. The main blemish of taking the maximum of profit as the final goal of dividend policy is that it only considers the interests of enterprise's operator to emphasize the amount of profit of enterprise to reach most top in a certain period, but it did not go to consider the enterprise itself. When pursue the maximum of profit unilaterally, it may cause

the acts and efforts for expediency of enterprises and is unfavorable to enterprise's long-term development. While, when we regard the maximum of shareholder's wealth as the goal, the weak point is that the maximum of shareholder wealth is related to the maximum of the market value of the stock, but in fact, the factor influencing the change of the stock price, not merely include enterprise's business performance, but also include investor's psychology expectation and economic policy, political situation etc. All these make it lose standard and objective Dimensions. In this kind of case, when make the policy; we will only often consider the income of shareholder but no consideration for the future of enterprise. In addition, the traditional dividend distribution policy can't systematically have contact with the behavior that creates value. That is another reason to not realize maximum of enterprise value. In another word, when we make the policy, we only think of the matters, such as how to distribute dividend, which means of payment to choose, which kind of distribution policy to use, etc., but do not think of the relationship of the behavior of the value creation. That's to say we don't take the principle of the value management into the dividend policy.

## **2.2 There is no consideration about the sustainable development of enterprises in traditional dividend policy**

First, it doesn't take "maximizes the enterprise value" as the final goals when establish firm's dividend policy. Just as we have stated, while set down the policy, firms only pursue the short-term interests such as the maximum of profit and shareholder's wealth, and neglect the long-term income and the effect to the sustainable development of enterprise. To a great extent, we cannot say it is stable and relative independent as a policy. Secondly, it lacks the whole, overall and long-term planning while establish the dividend policy. That is without thinking of the factor of enterprise value, it only pays attention to carrying on unilateral, short-term planning. All these are unfavorable to the long-term development of enterprises, and also can't realize the sustainable development of enterprises.

## **2.3 The traditional dividend policy is out of joint with the overall business decisions of enterprises**

The traditional dividend policy often ignores the close relationship among the dividend policy and investment decisions and financing decisions. It makes dividend policy is out of joint with the business decisions. So the business activities may not accordance with the promoting enterprises value. In addition, we often don't take consider of which kind of effect the dividend policy will bring to the stock market

and how it can influence the long-term development of the companies. In fact, cutting down dividend can make a response as negative signal at the stock market, which might make the company's stock price drops.

## **3 Characteristics of dividend policy based on value management**

### **3.1 Regarding maximum of enterprise value as the final goal**

Dividend policy based on value management can realize the final goal of maximizing enterprise value. While making the distribution policy of the dividend, emphasizing on the goal of maximizing the enterprise value, we will overcome the defect in the policy of maximizing the shareholder's wealth with the profit. It pursues the balanced and effective cash flow in a long time period and promotes enterprise's value. The essence is to make enterprise more adaptable to future changes of environments and realize value creation and the sustainable increasing. As value creation is a starting point of value management, so the main characteristic of dividend policy based on value management is to pay attention to creating firm's value and increasing it to realize the maximum of enterprise value, and promote enterprise's long-term development when consider the dividend policy.

### **3.2 Focus on the enterprise's long-term sustainable development**

Dividend policy based on value management focus on enterprise's long-term sustainable development, but does not pay attention to enterprise's short-term state excessively. For example, in order to realize stable long-term maximizing of the enterprise value, sometimes we have to sacrifice temporary interests and take the temporary stock price drops easy. Because on long terms, so long as enterprises have developed, the stock price will drop in a short time, but will rise eventually. If enterprises only emphasize the short-term spurt of the stock prices, and ignore the ups and downs later on, the temporary rise will be managed improperly by wrong management, the scale atrophy and low benefit. So the dividend policy will conform to enterprise's goal in the long-term, the short-term contradiction is common. So, our every dividend decision, every dividend policy does not demand to make enterprise's stock price highest, but to make enterprise value maximum, and we only need to do is to realize the long-term financial goal. In addition, we should make the dividend policy of in terms of not only the stock price or the income determinants but also the overall situation of enterprise. In order to create enterprise's value, we must improve the profitability and strengthen the development ability in the future, in

other words, we must strengthen the sustainable development ability, since enterprises with perfect prospects have the most powerful developmental potentiality of creating value. Dividend policy that regards the idea of value management and sustainable development as guidelines with overall perspective and long-term characteristic could realize enterprise's long-term sustainable development.

### **3.3 Coordinate with company's management decision**

Dividend policy based on value management can coordinate with every sub-decision and help to realize the overall management decision of enterprise. The function of the dividend policy, fundamentally speaking, is to serve the overall management decision and offer the essential condition for decision making, and what's more, it can coordinate with other investment and financing decision to accelerate the decision making. The adjustment of enterprise's investment decision will impact future profits, while the dividend policy will also be affected by the future business performance and financial situation. When the expectation is good and is thought to be keeping continuously in the future, the enterprise will adopt more positive dividend policy, and vice versa. So it's important to make the policy cooperate with enterprise's investment decision. Some factors, such as the arrangement and adjustment of decision of financing will influence the dividend policy, the ability of financing outside the company will inevitably influence the proportion of retained earnings, the state of development of enterprises will also influence on the financing channels, all these will be reflected by the undistributed profit, then influence enterprise's dividend policy. So we should make dividend policy coordinate with every sub-decision, which is the only way to realize the business decision and analyze the strategy that can create biggest value for enterprise. Enterprises must analyze from many angles about enterprise's reality and predict while carrying on the dividend policy, and then select a best scheme that can meet the demand of not only the development but also investors. So, enterprises should not study the dividend distribution with the financial angle only, we also have to consider the whole enterprise to make enterprise's dividend policy concert with enterprise's business decision.

### **3.4 Optimize the capital structure**

The dividend policy based on value management can realize the optimization of capital structure. The way granting dividend directly influences enterprise's capital structure, and a good dividend policy contributes to improving the structure of the capital and makes it reasonable. If the total debt ratio of company

is too high, we should reserve more dividend or increase the capital stock to improve the capital structure, strengthen its leverage, reduce the financial risk; On the contrary, we should distribute the cash dividend, increase debt and improve financial leverage interests. On the basis of necessary fund for the good capital project, we should arrange the reasonable sum of the surplus and debt according to the best capital structure.

## **4. The influence of the value management to the dividend policy**

In practice, we can introduce the value management to the process of the policy making of dividend distribution to make it scientific, reasonable and perspective. According to the traditional dividend distribution policy, the advantages of the one based on value management is that it take the rule of maximizing and increasing the enterprise value.

Linking the distribution policy of the dividend to the profit or the EVA can make it consistent with the target of creating value and contribute to realize it. The core of this management system is to set up the management system of dividend distribution based on value, and we could analyzes and make point according to business unit using EVA and profit state which can be distributed. One business unit must have clear value creating decision, and should be sure of the index that is closely linked to with value drivers. We must know that which business unit inside enterprises can create value? Which business unit limits enterprise value creating ability? We should regard it as strip and sell target. Which business unit has the ability of getting cash flows? Which business unit is always consuming enterprise's cash flows? In another words, when business unit's  $EVA > 0$ , it means value creating; otherwise is value damage.

There are four kinds of dividend distribution state. Now let's state them respectively:

### **4.1 Business units can create value and have surplus profit**

This is the best situation. In this case, we could promote the business with the surplus undistributed profit, such as increasing the inside investment, purchase other similar or related business. If there is no such project whose expected payback exceeds capital cost to investment, we should distribute the dividend, in another word, return retained earnings to the owner —The shareholder of the company who can choose the investment of value creating. There are some method of distributing the retained earnings, such as special cash dividend paying and stock buy-back. The stock buy-back is an effective way for tax avoidance. Improving capital structure, reducing the agent cost and

combining with the market effect is all the method to increase enterprise value.

#### **4.2 Business units can create value but short of distributed profit**

In this case, when distributed profit is in short, we must reduce or cancel the distribution of the dividend to the shareholders. In addition, because the strategic operating unit at this moment can create value for company, we should send new equity capital and issue new stock to increase capital. As to these new equity capitals, business unit can increase funds in debt to keep the optimum capital structure.

#### **4.3 Business units damage value but have surplus profit**

We should make it stable before the distributed profit was used up as soon as possible. Part of the surplus profit can be made to improve the Paying rate of dividend and return to shareholders in the form of cash dividend, the others should be used in the rebuilding of business as quickly as possible. The goal is to make the payback of the investment exceed the capital cost. If present capital structure is not optimum or minimum level, we could adjust the capital structure of business unit to reduce average capital cost. One of the considerable tactics is selling the business unit to the one who can manage it better.

#### **4.4 Business units damage value and short of distributed profit**

It is the worst state. Manager should immediately pay attention to the condition and take action to cancel the dividend distribution. If the business unit can't be quickly and thoroughly rebuilt, we should sell it as quickly as we can. Deciding to rebuild thoroughly, we should sell some assets which can increase cashes immediately and keep the scale of business to the state that can survive in a short time. The final purpose is to keep the retained business become one that can create value for the enterprise. If it 's hopeless to carry on quick and successful conversion, we should sell it immediately before it influence the long-term existence of company's other parts.

After we get which kind of state the company is in, we could make the dividend distribution policy and company's total management tactics for the concrete company and concrete business unit. In this way , we can make the best dividend distribution policy that take the core of value, regard the maximum of enterprise value as the goal and take enterprise's sustainable development as prerequisite.

### **5. Conclusion**

Today, as the economy globalizes day by day, the management mode- value management is accepted by

enterprises gradually. Operating objective, management idea, decision standard and management style are changing fundamentally, so we have stepped into the era that take value as the foundation and maximum of enterprise value as the goal. The core of the value management is value and the main content is the process of the creating, increasing, realizing and assigning of the value. Value management has put forward the clear task and defines the key goal of management activity: Maximum of enterprise value. Through the activity of creating value, we increase the cash flows of the company and prompt the whole value of enterprises constantly, thus realize the maximum of enterprise value. In order to realize the maximum of enterprise value, it's necessary to minimize the risk that enterprises face, maximize the cash flows and the ability of continuing operating. The realization of the goal of maximum of enterprise value depends on the effective and scientific financial policy, including company's financial investment and distribution policy. The dividend policy substantially pursue the relationship between dividend and retaining profit, and it is the important decision about the equity distributing and fund operation of the company. Through dividend policy, managers arrange the net profit between the reinvestment and distributing to shareholders, and it's the way to offer enough fund for the further development and enlarged reproduction.

We should make it be advantageous to both the long-term development and the cash flow need of owners. In the modern society, in order to make company's value to the maximum extent, we must strengthen value management to get the maximized income. So, while making the dividend policy, it's helpful to introduce the value management method and idea. It contributes to regarding value creating as the prerequisite. According to this, we can design an overall, long-term and instructive dividend policy that is based on value management and can promote the long-term sustainable development of enterprises.

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