

# Distributing excess cash: the role of specially designated dividends

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## Abstract

Investors can receive cash distributions from corporations through share repurchases, regular cash dividends, and specially designated dividends (SDDs). Understanding why firms choose one method over another to distribute excess cash has important implications for investors. We find that the primary motive for repurchasing shares is to take advantage of perceived market undervaluation of the firm's shares. Having strong earnings and cash flows provide an impetus for both regular dividends increases and SDDs, but investors should view any increase in yield resulting from SDDs as temporary. They should interpret SDDs as conveying positive information about current excess performance, not long-run performance. © 2005 Academy of Financial Services. All rights reserved.

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## 1. Introduction

On July 20, 2004, Microsoft Corp., which had amassed nearly \$60 billion in cash, announced that it would return about \$32 billion in a one-time dividend of \$3 for every share held by investors.<sup>1</sup> The software giant had been under mounting pressure from Wall Street to put its growing pool of cash to better use than simply earning interest. In explaining the

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plan, John G. Connors, Microsoft's chief financial officer, said the company was trying to navigate through the demands of several types of investor groups. Some investors wanted higher regular dividends; others wanted a large cash payout; while still others wanted a more aggressive stock buyback program. Although this event is unique because of its size and most technology companies offer no dividends, the practice of paying large specials has increased in recent years.<sup>2</sup>

Should individual investors be concerned with whether firms distribute excess cash through regular dividends, share repurchases, and specials? Are these methods perfect substitutes of each other? If not, what message, if any, does a firm send about the firm's future when it chooses one distribution method over another? For example, is issuance of special dividends a testimony to good performance of the present or an indication of superior performance of the future? Answers to these questions have implications for investment decisions of individuals. Knowledgeable investors should be aware of why corporate managers decide to use one method of distribution over another. In this study, we conduct a survey of firms involved in distributing excess cash to seek their input on the circumstances that might favor one method of disbursement over another. Specifically, our purpose is to discover the rationale for distributing cash through specials versus the more common practices of increasing regular dividends and repurchasing stock.

A dividend may be "special" for various reasons, but the intention is often to differentiate this special payment from the normal dividend stream and avoid disrupting the pattern of normal dividends declared by a company. A common view is that special dividends are distributions to investors of large, non-recurring cash inflows, as opposed to regular cash dividends, which firms tend to fund with recurring earnings. Thus, specials allow managers to make temporary increases in cash payouts without necessarily committing to continue the higher distribution in future years. In this study, we define a specially designated dividend (SDD) as a cash dividend labeled by management as "extra," "special," or "year-end." In theory, management should use labeling to differentiate SDDs from regular (unlabeled) dividends.

As previously discussed, managers face three major ways of distributing excess cash to shareholders: initiate or increase regular dividends, repurchase shares, and pay SDDs.<sup>3</sup> Corporate managers and directors presumably select the distribution method that increases the value of the firm. Although some firms use all of these distribution methods, they often do so at different times. According to Crutchley, Hudson, Jensen, and Marshall (2003), the method selected is likely to depend on the firm's expected future earnings and cash flows as well as prior share price performance. Jagannathan, Stephens, and Weisback (2000) note that the flexibility inherent in repurchase programs is another reason firms use repurchases instead of using regular dividends. That is, stock repurchases offer firms another means of distributing their "lumpy," non-recurring cash flows. Similar logic could also apply to paying large, infrequent SDDs.<sup>4</sup> Thus, under certain circumstances firms may substitute repurchases or SDDs for regular dividends when they have excess cash flows.

If managers anticipate above average earnings and cash flows that appear sustainable, they are more likely to initiate or increase regular dividends rather than repurchase shares or pay SDDs. Brickley (1983) finds that firms tend to declare both regular dividend increases and SDDs after experiencing good earnings over the previous year. The firms declaring regular

dividend increases have significantly larger earnings changes in the year after the dividend increase than do the firms declaring SDDs. The dividend performance following a regular dividend increase also dominates that following an SDD. Jagannathan et al. (2000) report that firms pay regular dividends with higher “permanent” operating cash flows, but use higher “temporary,” non-operating cash flows for repurchases. They also find that repurchasing firms have more volatile earnings than dividend-paying firms do. Gombola and Liu (1999) conclude that SDD announcements convey favorable information about transitory, not permanent, earnings. Lie (2000) finds that excess funds are largely non-recurring for SDD and self-tender offer firms and recurring for regular dividend increase firms. Similarly, Crutchley et al. (2003) find that firms announce SDDs after temporary increases in operating performance, but these unexpected earnings decline significantly in the years following the special dividend.

If firms experience poor stock price performance, they are more likely to repurchase shares than to initiate or increase regular dividends or pay a SDD. Ikenberry, Lakonishok, and Vermaelen (1995) report evidence consistent with the possibility of market undervaluation at the time firms announce a repurchase. Stephens and Weisback (1998) find a negative relationship between share repurchase and prior stock price performance, suggesting that firms increase stock repurchases depending on the perceived degree of stock undervaluation. Thus, firms may be reluctant to repurchase shares after a period of increased stock prices. They also find a positive relationship between repurchases and the levels of cash flow, suggesting that firms actively adjust their buyback behavior to their cash position. Jagannathan et al. (2000) find evidence that firms repurchase stock following poor stock market performance and increase dividends following good performance. In contrast, Crutchley et al. (2003) document that those firms paying SDDs earn significant positive excess returns the year before the SDD announcement. Thus, an implication of the decision to distribute excess cash to shareholders using a SDD rather than a stock repurchase is that managers believe the current share price is not undervalued.

In this study, we follow a different path to understanding why companies pay SDDs instead of using alternative methods of distributing excess cash. Unlike previous research on SDDs, we survey senior executives of United States incorporated firms that paid special dividends to obtain direct evidence about their views. Other studies generally provide only indirect evidence about the motivations behind using one distribution method versus another, whereas we provide direct evidence from managers.

The study is important for at least two reasons. First, the paper adds to the body of research by being the first to examine SDDs using survey research methodology. Our study follows a long practice in finance of surveying managers about dividend policy.<sup>5</sup> As with other approaches used to investigate managerial behavior, survey research has its strengths and weaknesses. Although surveys of managers do not replace other empirical approaches, they complement them and yield additional insights. As Bruner (2002, p. 50) notes, “The task must be to look for patterns of confirmation across approaches and studies much like one sees an image in a mosaic of stones.”

Second, the study enhances our understanding of corporate payout policy in the United States. Specifically, we offer additional insights into the role of SDDs as a means of distributing excess cash compared with regular dividends and share repurchases. In most

instances, our results reinforce and complement previous research, while a few others are surprising. As one of the few studies, except Lie (2000), investigating the three methods of distributing excess funds, it sheds additional light on how managers view these methods.

In this study, we have three main objectives: (1) to identify why firms choose to pay SDDs; (2) to discover why firms choose to use regular (unlabeled) dividends or repurchase shares as a means of distributing temporary excess cash instead of paying SDDs; and (3) to learn how managers view various statements about SDDs derived from prior empirical research. Although our study is partially exploratory in nature, we have a priori expectations about some responses from the survey participants.

We address three major research questions in this study. First, why do firms choose to pay SDDs? While there are many possible reasons, we expect that the major motive for paying SDDs is to distribute cash resulting from a temporary increase in earnings or cash flows. That is, managers view any increase in earnings or cash flows as short-lived, not permanent. Crutchley et al. (2003) show that unlike regular dividend increases and share repurchases, SDD announcements indicate current excess performance rather than expected improvements in long-run performance. Thus, firms generally announce SDDs after periods of temporary increases in operating performance and positive stock performance. Our findings support this expectation by showing that having strong earnings or cash flows is the most important impetus for paying a SDD.

Second, why do firms choose to use regular (unlabeled) dividends or repurchase shares as a means of distributing temporary excess cash instead of paying a SDD? The literature contains various explanations for paying dividends such as signaling, tax-preference, and agency costs, but previous research does not attempt to differentiate between the motives for paying regular dividends versus SDDs with *temporary excess cash*. Conventional wisdom suggests that management increases the regular dividend only when it is confident that the firm can maintain the new dividend over time, but distributes temporary cash in the form of a SDD or share repurchase. Thus, we make no predictions about the motives for initiating or increasing regular dividends with temporary excess cash. Our results show that two responses tied as the top-ranked motive—having strong earnings or cash flows and serving as part of standard dividend policy. A third reason for paying regular dividends with temporary excess cash is to exert a positive influence on stock price, which appears to be a signaling motive.

We expect firms to distribute temporary excess cash to shareholders through share repurchases instead of paying a SDD when managers believe the current share price is undervalued. This finding would be consistent with Crutchley et al. (2003) and survey data by Baker, Powell, and Veit (2003b). We also anticipate that managers buy back shares with excess cash instead of paying a SDD because share repurchase results in higher accounting measures such as earnings per share (EPS) than do SDDs. Baker et al. report that the third most common reason for open market repurchases is to increase EPS. The findings from the current survey support our expectations.

Third, how do managers view various statements about SDDs derived from empirical research? In general, we expect the responses to be consistent with previous research findings. Overall, the mean responses to statements in this study are generally consistent with the findings found in the dividend literature. For example, respondents express a high level

of agreement with the statement that firms tend to repurchase shares instead of using SDDs when managers believe their firm's current stock is under priced. Respondents also agree that the stock market generally views an announcement of an unexpected SDD as conveying positive information about a firm's short-term earnings. Our findings do not necessarily suggest that respondents are familiar with the research studies upon which the statements are based.

Our results have several implications for investors. Perhaps the most important implication is that paying SDDs generally reflects only a temporary increase in excess cash. Although some firms pay SDDs frequently, this practice is not the norm. Thus, announcements of SDDs signal only temporary increases in cash flows levels, not permanent increases. Our finding reinforce an implication made by Crutchley et al. (2003, p. 131), that "on average, investors cannot expect the performance that precedes a special dividend to continue following the announcement." Having strong earnings and cash flows also provide an impetus for regular dividend increases, but paying regular dividends is part of a firm's standard dividend policy. The primary motives for repurchasing shares are to take advantage of perceived market undervaluation of the firm's shares and to improve performance measures, especially. Thus, investors can often expect a stock repurchase to signal management's perception that the market is currently underpricing the firm's shares.

The remainder of this paper has the following organization. Section 2 discusses the literature relating to methods of distributing excess cash, especially SDDs. Section 3 presents the research design including a discussion of the survey instrument, sample, and limitations of the study. Section 4 presents the results. Section 5 provides a summary and our conclusions.

## 2. Literature review

In this section, we discuss relevant literature about methods of distributing excess cash. Previous research generally documents a significant, positive stock price reaction to the announcement of increases in regular dividends, share repurchases, and SDDs and investigates the rationale for such behavior.<sup>6,7</sup> The magnitude of the price reaction tends to differ depending on the type and size of distribution. For example, Brickley (1983) finds that regular dividend increases result in more positive market reaction than do SDDs of similar relative size. Chhachhi and Davidson (1997) report a larger market reaction for tender-offer stock repurchases than SDDs even after controlling for their larger relative size and preferential capital gains tax rate. Because the literature in this area is voluminous, we focus our discussion on SDDs.<sup>8</sup>

Several explanations exist for the positive announcement effects surrounding SDDs, but three major contenders involve information signaling, free cash flow, and wealth transfers. Of these theories, the signaling hypothesis is the leading explanation for abnormal returns on the announcement of SDDs because it has the most empirical support. The evidence favoring the free cash flow and wealth transfer hypotheses is scant. We begin our discussion by reviewing each explanation and then discuss the historical trend in paying SDDs.

According to the signaling hypothesis, cash disbursements, such as through SDDs, signal

favorable information about the firm's future earnings and cash flows. Studies by Brickley (1983), Jayaraman and Shastri (1988), Howe, He, and Kao (1992), Shih (1992), Mitra (1997), Chhachhi and Davidson (1997), Gombola and Liu (1999), and Crutchley et al. (2003) support this hypothesis by showing that the announcements of SDDs result in an upward revaluation of stock prices. DeAngelo et al. (2000) find that while recent years' special dividends generally convey good news to investors, any such signaling content is typically small.

For example, Brickley (1983) examines common stock returns surrounding infrequent and hence unanticipated SDDs and compares them to those surrounding regular dividend increases. The results support the notion that management uses the labeling of dividend increases to convey information to the market about a firm's future prospects, but regular dividend increases convey more positive information than do SDDs. Thus, Brickley's evidence indicates that investors treat SDDs as hedged managerial signals about future profitability in that SDDs have weaker stock market reactions than do regular dividend increases of comparable size. This evidence supports the information-signaling hypothesis.

The free cash flow (excess funds) hypothesis, developed by Jensen (1986) and extended by Lang and Litzenberger (1989), asserts that disbursements may mitigate agency problems between managers and shareholders. Specifically, a cash disbursement reduces funds available to managers and prevents them from investing in negative net present value (NPV) projects. Thus, firms with greater agency problems of free cash flows should have a greater price reaction to a dividend increase. Such firms should be those with poor investment opportunities and lower Tobin's  $q$  ratios.

Howe et al. (1992) test whether the market interprets SDDs as a means to distribute free cash flow to shareholders. The results show that the market's reaction to SDDs is about the same for both high- $q$  and low- $q$  firms. Thus, their evidence does not support the free cash flow hypothesis. Instead, the information-signaling motive appears to be the driving force underlying these returns. Similarly, the results in the Gombola and Liu (1999) study do not support the free cash flow hypothesis but strongly support the signaling hypothesis. Lie (2000) interprets his findings to suggest that large incremental disbursements in the form of large special dividends effectively curb over-investment, while the evidence for small incremental disbursements is inconclusive.

The third explanation of the price reaction involves a wealth transfer effect from bondholders to stockholders as the dividend payment undermines the assets protecting the bondholders. Jayaraman and Shastri (1988) test the wealth transfer hypothesis by analyzing the behavior of stock and bond prices on dates surrounding their announcements. They find that the positive price reaction for stocks is significant and substantially larger than the small and insignificant negative price reaction for bonds. These results do not support the wealth transfer hypothesis but are consistent with the information-signaling hypothesis. Similarly, the results contained in Gombola and Liu (1999) do not support the notion of wealth transfer from bondholders to stockholders but provide direct evidence supporting the signaling hypothesis.

DeAngelo et al. (2000) examine the evolution of SDDs paid by NYSE firms over 1926 through 1994. Their evidence shows that NYSE firms once commonly paid SDDs but now they rarely distribute cash in this manner. In the past, firms generally paid specials almost as

predictably as they paid regular dividends. Despite the overall decline in specials, firms actually increased the use of very large specials in recent years. Finally, firms did not replace SDDs with stock repurchases. They attribute the decline of small SDDs to their predictability, which made them close substitutes for regular dividends.

### 3. Research design

The three subsections that follow describe the survey instrument used to collect data, information about the sample, and limitations of the study.

#### 3.1. Survey instrument

We developed our original set of questions based on an extensive review of the relevant dividend literature, especially related to SDDs. During February 2003, we pre-tested preliminary versions of our survey among a small group of finance faculty members and MBA students. Based on their feedback, we eliminated several questions to shorten the survey and changed the wording on others to improve clarity. The final version of the one-page survey consists of six questions and 14 statements. The Appendix contains a copy of the survey.

The survey consists of two sections. The first section contains six questions (hereafter referred to by Q#). The first two questions (Q1 and Q2) concern background information about the respondents' involvement in determining their firm's dividend policy and their current position or title. The next four questions (Q3–Q6) ask about the methods firms use to distribute temporary excess cash to shareholders and their motives for doing so. Because all of these questions are open-ended except Q3, they require classifying the responses.

The next section contains 14 statements (hereafter referred to by S#). In this section, we ask closed-end questions to lessen the subjectivity involved with classifying responses. These questions ask respondents to indicate their level of agreement or disagreement with statements about SDDs derived from empirical evidence. The respondents use a five-point, equal-interval scale where:  $-2$  = strongly disagree,  $-1$  = disagree,  $0$  = no opinion,  $+1$  = agree, and  $+2$  = strongly agree. For these statements, we use one-sample  $t$  tests to determine whether the level of disagreement or agreement differs significantly from zero, which represents a "no opinion" response.

#### 3.2. Sample

We use data from the Center for Research in Security Prices (CRSP) to identify firms incorporated in the United States and listed on the NASDAQ, AMEX, and NYSE that paid at least one SDD during 1994 through 2001. We limit the period of investigation to improve the chances that survey respondents are knowledgeable about their firm's dividend policy. We consider only securities with CRSP distribution codes 10 or 11 (ordinary common shares for securities that have not been further defined). Thus, we exclude other security types such as American Depositary Receipts (ADRs), closed-end funds, and real estate investment trusts (REITs). We classify a cash distribution as a SDD if it carries distribution code 1262 or 1272,

the code numbers used by CRSP to identify dividends labeled year-end, final, extra, or special. We initially identify 667 SDDs (479 NASDAQ, 97 AMEX, and 91 NYSE). After adjusting the sample for multiple SDDs by the same company, mergers, and business failures, the final sample consists of 343 separate companies (250 NASDAQ, 42 AMEX, and 51 NYSE) paying at least one SDD during 1994 through 2001. We obtained mailing addresses from COMPUSTAT and the name of a senior executive for each firm from Hoover's Online.

We mailed a personalized cover letter requesting participation in this study, along with a stamped, self-addressed return envelope and the survey instrument, to a top executive of each firm on March 3, 2003 for NYSE and AMEX firms and on March 5, 2003 for NASDAQ firms. We received 42 usable responses. We sent a second mailing to non-respondents on April 9, 2003 to increase the response rate and thereby reduce potential non-response bias, but received only three usable responses. The cover letter requested that if the recipients did not actively participate in determining their firm's dividend policy that they should give the survey to someone in their company who was involved. The survey contained a code number to identify the respondents and to avoid including duplicate responses in the analysis.

Of the 343 surveys, the post office returned 21 as undeliverable. In addition, 25 firms either returned the survey blank or contacted us to express their unwillingness to participate. Our final sample consists of 45 usable surveys (39 NASDAQ, four AMEX, and two NYSE), representing 14.0% of the 322 delivered surveys. This response rate is similar to that reported in other recent academic studies in finance involving senior executives.<sup>9</sup> The specialized nature of the subject matter and the increasing demands placed on senior executives may help explain the response rate.

### *3.3. Limitations*

Our study has several potential limitations. First, the small number of responses does not permit partitioning the data by type of listing and hence precludes conducting statistical tests to determine whether differences exist by this characteristic. Another limitation is the possibility of non-response bias. This is true despite taking the normal precautions to reduce this bias including guaranteeing confidentiality and using multiple mailings. To test for non-response bias, we use an approach similar to that suggested by Moore and Reichert (1983), which compares characteristics of responding firms to those of non-responding firms.<sup>10</sup> If the characteristics of the two groups were similar, this would lessen the concern about potential non-response bias. As Table 1 shows, interpretation of the *t* tests for differences in means suggests that the respondents closely correspond with the non-respondents on the following characteristics: total assets, sales, price to book ratio, dividend payout, and dividend yield. None of the differences in means was significant at the 5% level.<sup>11</sup>

Accepting that non-response bias may be small, concerns may still exist about the survey data. For example, the respondents may not have answered truthfully or carefully. Given that we guaranteed confidentiality to respondents, we believe that the former problem is minimal. Senior executives are unlikely to complete this survey if their intent is to be untruthful. Despite our efforts to design and pretest the questions, respondents might not properly understand some questions. Other questions might not elicit the appropriate information.

Table 1  
Firm characteristics: responding vs. non-responding firms

Firm characteristics	Responding firms	Non-responding firms	<i>t</i> value
Total assets (in millions)	1,997.4 ( <i>n</i> = 19)	2,202.8 ( <i>n</i> = 147)	−0.06
Net sales (in millions)	1,377.7 ( <i>n</i> = 19)	385.9 ( <i>n</i> = 147)	1.95
Price to book ratio	1.56 ( <i>n</i> = 19)	3.12 ( <i>n</i> = 146)	−0.35
Dividend yield	42.58 ( <i>n</i> = 19)	40.37 ( <i>n</i> = 146)	0.04
Dividend payout	2.97 ( <i>n</i> = 20)	9.46 ( <i>n</i> = 151)	−0.39

This table reports certain firm characteristics (total assets, net sales, price to book ratio, dividend payout, and dividend yield) for year-end 2002 for both the responding and non-responding firms. The first column lists the firm characteristics. The second and third columns report the value of the firm characteristic for the responding and non-responding firms, respectively, with the number of firms in parentheses next to the value. The fourth column reports the *t* value.

Finally, our study addresses key issues involving SDDs, but the survey is not exhaustive. We can do little to change this situation without conducting a follow-up survey, which is impractical at this time. We limit the scope and hence the length of our survey to increase the response rate. The decision to focus on several important areas involving SDDs entails a tradeoff between comprehensiveness and the response rate. As the length and complexity of practitioner surveys increase, the response rate generally declines, which increases the potential for non-response bias. In our view, justification exists for the tradeoff in this situation. Having said this, we believe that these data are representative and provide additional insights about SDDs.

#### 4. Survey results

In reporting the survey results, we begin by providing some background data about the respondents. We then examine the responses to our three research questions and relate empirical predictions, where appropriate, to the responses received. In responding to the survey, some respondents did not answer each question.

##### 4.1. Background information

To help provide context for interpreting the responses, we sought information about the respondents' involvement in formulating their firm's dividend policy (Q1) and the positions they hold in their firms (Q2). Of the 45 respondents, 43 (95.6%) said that they are actively involved in determining their firm's dividend policy.<sup>12</sup> Based on 44 responses, the two most common positions or titles of respondents are chief financial officer (52.3%) followed by president/chairperson (40.9%). The only other positions reported are chief executive officer (4.5%) and treasurer (2.3%). Thus, virtually all respondents represent senior executives who are involved in determining their firm's dividend policy.

Although not included in the survey, we also examine the frequency of paying SDDs during 1994 through 2001. The majority of firms (62.2%) paid only a single SDD. For these

Table 2  
Reasons for paying SDDs

Reason	Response ( $n = 45$ )	Rank
Have strong earnings or cash flows	40.0%	1
Increase (temporarily) the yield to shareholders	33.3	2
Lack investment opportunities	6.7	3
Distinguish from an increase in a regular dividend	4.4	4 tied
Meet dividend competition from peers	4.4	4 tied
Serve as part of standard dividend policy	4.4	4 tied
Other (e.g., mergers)	6.7	5

This table reports the most important reasons firms choose to pay a SDD during the period 1994–2001. Each respondent could list up to two reasons. Percentages may not add to 100 because of rounding.

firms, SDDs appear to be a one-time payment rather than a sustained increase in cash payment. For other firms, the payment of SDDs occurs more frequently with 24.5% issuing two or three SDDs and the remaining 13.3% paying between four and nine SDDs during the sample period.<sup>13</sup>

#### 4.2. *Reasons for paying SDDs*

Our first research question concerns why firms choose to pay SDDs. Although all 45 firms paid at least one SDD during 1994 through 2001, only 30 respondents gave at least one reason for doing so. Because respondents could list up to two reasons, the total number of responses is 45. Table 2 presents the reasons for paying SDDs. Two reasons constitute almost three-quarters of the responses. Firms distribute excess cash as SDDs because (1) they experience strong earnings or cash flows (40.0%) and (2) they want to increase the yield to shareholders (33.3%), at least temporarily. This finding is consistent with evidence reported by Brickley (1983) and Crutchley et al. (2003) that firms have unexpectedly high earnings during the year of the SDD announcement. Ranking a distant third is a lack of investment opportunities (6.7%). Thus, the decision to issue a special dividend for some firms reduces the potential for managers to squander excess cash on negative NPV projects. Overall, the top ranked responses are consistent with our expectations involving the rationale for using SDDs to distribute temporary excess cash.

#### 4.3. *Reasons for using other distribution methods*

Our second research question focuses on why firms choose to use regular (unlabeled) dividends or repurchase shares as a means of distributing temporary excess cash instead of paying SDDs. Of the 45 respondents, 21 initiated or increased dividends and 32 repurchased shares to distribute temporary excess cash to shareholders in lieu of issuing SDDs. Each respondent could list up to two reasons for both initiating or increasing regular dividends and repurchasing shares.

Panel A of Table 3 presents the reasons for paying regular dividends with temporary excess cash. Although multiple reasons exist, the two top-ranked motives are having strong

Table 3

Reasons for initiating or paying dividends and repurchasing shares instead of using SDDs to disburse excess cash

Reason	Response	Rank
A. Initiating or paying dividends	( <i>n</i> = 31)	
Have strong earnings or cash flows	25.8%	1 tied
Serve as part of standard dividend policy	25.8	1 tied
Exert a positive influence on stock price	12.9	2
Meet the desires of shareholders	6.5	3 tied
Meet dividend competition with peers	6.5	3 tied
Other (e.g., increase yield to shareholders, signal the strength of the company)	19.3	
B. Repurchase shares	( <i>n</i> = 52)	
Perceive shares as undervalued (bolster the share price and make stock more attractive to investors)	34.6%	1
Improve performance measures (e.g., EPS and ROE)	28.8	2
Have strong earnings or cash flows	11.5	3
Provide shares for other uses (e.g., benefit plans, stock splits, and stock options)	5.8	4
Other (e.g., provide liquidity to shareholders, signal confidence in the stock)	19.2	

This table reports the most important reasons firms choose to initiate or pay a regular (unlabeled) dividend and repurchase shares instead of using a SDD during the period 1994–2001. Each respondent could list up to two reasons. No single response in the “other” category constitutes as much as five percent of the responses. Percentages may not add to 100 because of rounding.

earnings or cash flows and serving as a part of standard dividend policy, each with 25.8% of the total responses. Thus, the highest ranked reason for paying both regular dividends and SDDs is the same. This finding is not surprising because Crutchley et al. (2003) document that the firms paying regular dividends and SDDs have unexpectedly high earnings the year of the announcement. The next highest ranked motive is the belief that paying regular dividends exerts a positive influence on stock price. Overall, the motives for paying regular dividends are consistent with those provided in recent surveys by Baker and Powell (2000) and Baker, Veit, and Powell (2001).

Panel B of Table 3 contains the responses involving the rationale for repurchasing shares with temporary excess cash instead of paying SDDs. The major reasons given by respondents are consistent with our expectations. More than a third (34.6%) of the respondents reports that the most important reason to buy back stock with temporary excess cash is to correct perceived undervaluation. This finding is not surprising given the substantial evidence on the relationship between share repurchases and market undervaluation such as Ikenberry, Lakonishok, and Vermaelen (1995). This motive supports the market undervaluation version of the signaling hypothesis. That is, managers may be signaling their disagreement with how the market is pricing existing public information.

The second most important reason for repurchasing, with 28.8% of the responses, is to improve accounting measures of firm performance such as earnings per share (EPS). From a traditional finance perspective, earnings dilution should not be relevant because only cash flows should matter. Yet, managers, stock analysts, and investment bankers often contend

Table 4  
Level of agreement/disagreement to statements about disbursements of excess cash

S#	Statement	n	Disagree		No opinion	Agree		Mean (SD)	t value
			-2	& -1		+1	+2		
1	The stock market generally views frequent and successive SDDs as regular dividends	42	30.9%		28.6%	40.5%	0.071 (1.177)	0.393	
2A	The stock market generally views an announcement of an unexpected SDD as: A. Conveying positive information about a firm's short-term (current) earnings.	40	12.5%		15.0%	72.5%	0.775 (0.891)	5.500***	
2B	B. Conveying positive information about a firm's long-term (future) earnings prospects.	40	30.0%		35.0%	35.0%	-0.025 (0.947)	-0.167	
2C	C. Conveying less positive information about a firm's future prospects (earnings and dividends) than does a regular dividend increase of comparable size.	41	26.8%		29.3%	43.9%	0.244 (1.090)	1.432	
2D	D. Causing wealth transfers from bondholders to stockholders as the dividend payment reduces the assets protecting the bondholders.	40	35.0%		47.5%	17.5%	-0.325 (0.944)	-2.177**	
3	Stock prices generally react positively to unexpected announcements of SDDs of all sizes.	42	21.4%		35.7%	42.9%	0.262 (0.939)	1.808*	
4	Stock prices generally react positively to unexpected announcements of large SDDs only.	42	31.0%		45.2%	23.8%	-0.024 (0.841)	-0.184	
5	Stock price reactions are negatively related to how frequently a firm declares SDDs.	42	45.2%		47.6%	7.1%	-0.452 (0.739)	-3.966***	
6	Firms tend to use SDDs, instead of initiating or increasing regular dividends, when managers believe their firm's current earnings performance level does not appear sustainable.	42	40.5%		19.0%	40.5%	0.000 (1.126)	0.000	
7	Firms tend to repurchase shares, instead of using SDDs, when managers believe their firm's current stock is under priced.	42	0.0%		7.1%	92.9%	1.310 (0.604)	14.042***	

(Continued)

Table 4  
Continued

S#	Statement	n	Disagree -2 & -1	No opinion 0	Agree +1 & +2	Mean (SD)	t value
8	Firms paying regular dividends are more likely to issue SDDs than to repurchase shares.	41	48.8%	43.9%	7.3%	-0.512 (0.779)	-4.213***
9	Firms not paying dividends are more likely to repurchase shares than to issue SDDs.	42	4.8%	40.5%	54.8%	0.667 (0.816)	5.292***
10	SDDs reduce management's potential for inappropriately using excess cash (for example, over-investing).	40	27.5%	42.5%	30.0%	0.025 (0.947)	0.167
11	Fewer firms tend to use SDDs as their institutional stock ownership increases.	42	16.7%	61.9%	21.4%	0.024 (0.680)	0.227

\*, \*\*, \*\*\* indicates statistical significance at the 0.10, 0.05, and 0.01 level, respectively.

This table shows the level of agreement or disagreement the respondents have with specific statements about SDDs in general. Respondents answered each statement based on a five-point scale where: -2 = strongly disagree, -1 = disagree, 0 = no opinion, +1 = agree, and +2 = strongly agree. The t value shows whether the mean responses differ significantly from 0 (no opinion). Percentages may not add to 100 because of rounding.

that reported earnings do matter. For example, Microsoft announced at the urging of analysts that it would resume buying back its stock to counteract potential dilution of its shares (*The Wall Street Journal*, August 8, 2000, p. B6). Grullon and Ikenberry (2000) contend that the “EPS bump” argument has a fundamental flaw because it assumes that disposing of idle cash by repurchasing stock also leads to a rise in a firm’s productivity. This is not necessarily true because repurchasing shares can affect a firm’s ability to generate future earnings.

#### 4.4. Views about SDDs

Our final research question concerns how managers view various statements about SDDs derived from prior empirical research. Hence, we expect respondents to agree, on average, with S1, S2A, S2C, S3, S5, S6, S7, S10, and S11, but to disagree, on average, with statements S2B, S2D, and S4. We have no a priori expectations about their responses to S8 and S9. Based on our *t* tests, half of the 14 statements (S2A, S2D, S3, S5, S7, S8, and S9) differ significantly from “no opinion” at the 0.10 level or better. Of these seven responses, all are in the predicted direction except S5. The majority of respondents agree with only three statements (S2A, S7, and S9).

Of the 14 statements, the most respondents (92.9%) agree that firms tend to repurchase shares, instead of using SDDs, when managers believe their firm’s current stock is under priced (S7). In fact, no one disagreed with this statement. Evidence exists to support the view that firms are undervalued at the time they announce a repurchase (Ikenberry et al., 1995; Stephens & Weisback, 1998). The strong level of support for S7 is also consistent with results shown in Panel B of Table 3.

The statement with the second highest level of agreement (72.5%) is that the stock market generally views an announcement of an unexpected SDD as conveying positive information about a firm’s short-term (current) earnings (S2A). In an early study, Brickley (1983) concludes that contrary to a commonly held belief, SDDs appear to convey positive information about future earnings beyond that related to the current period. Later research by Gombola and Liu (1999), Lie (2000), and Crutchley et al. (2003), however, documents that firms pay SDDs when earnings receive a temporary positive shock. Our results support the latter finding, namely, firms announce SDDs after periods of a short-term increase in operating performance.

The majority of respondents (54.8%) agree that firms not paying dividends are more likely to repurchase shares than to issue SDDs (S9). Respondents generally disagree (48.8%) that firms paying regular dividends are more likely to issue SDDs than to repurchase shares (S8). DeAngelo et al. (2000) provide evidence indicating that firms with the highest prior frequency of special dividends have the lowest subsequent incidence of repurchases. They also find little evidence of a connection between the disappearance of specials and the emergence of repurchases as an important payout vehicle. These results appear contrary to the views expressed by respondents involving S8. We make no predictions about how the respondents are likely to view S8 and S9.

On average, respondents disagree with the statement that stock price reactions are negatively related to how frequently a firm declares SDDs (S5). This finding is surprising and contrary to our expectation. Evidence by Jayaraman and Shastri (1988) supports this negative relationship. They attribute the negative relationship between excess returns around the announcement of SDDs and the frequency of announcements to the fact that firms announcing SDDs more frequently declare smaller ones. This explanation is consistent with the result

reported by Brickley (1983) of the positive relationship between the size of the SDD and returns. As Jayaraman and Shastri (1988) note, this result suggests that investors anticipate the announcements of SDDs by firms frequently declaring such dividends. In turn, an implication of this finding is that frequent declarations of SDDs convey less information than do infrequent declarations. A study by Mitra (1997) finds that the abnormal returns are significantly higher for the initial announcement relative to the last announcement. This result suggests that the last of a recurring series of SDD announcements convey less information than the first, presumably because of greater market anticipation.

Respondents generally do not believe that SDDs cause wealth transfers from bondholders to stockholders (S2D) as the dividend payment reduces the assets protecting the bonds. That is, respondents in our sample do not attribute stockholders' positive announcement returns to transfer of wealth from bondholders. This result is consistent with the findings of Jayaraman and Shastri (1988), Gombola, and Liu (1999) that the wealth transfer hypothesis cannot explain the positive abnormal returns associated with SDDs.

Respondents agree that stock prices generally react positively to unexpected announcements of SDDs of all sizes (S3). This view is consistent with several studies. For example, Jayaraman and Shastri (1988) find that the market considers SDDs as positive signals. Their evidence also supports the view that repeated announcements of SDDs, which typically involve smaller declarations, convey less information than do infrequent SDD announcements, which typically involve larger declarations. Brickley (1983) also shows that the relative size of the SDD is important in explaining excess returns. DeAngelo et al. (2000) posit that only SDDs involving large distributions have survived through time as they, as opposed to small SDDs, are capable of sending positive signals to the market. Their results show that over 1962 through 1995 the stock market tends to react favorably to the declaration of a SDD. The market reaction, however, is typically modest in size and shows no systematic relationship to the size or magnitude of the change from one positive special dividend payment to another. Thus, our result disagrees with the conclusion of DeAngelo et al. that only large SDDs convey good news to investors.

All the responses for the remaining seven statements (S1, S2B, S2C, S4, S6, S10, and S11) are in the predicted direction but are not statistically significant from "no opinion" at normal levels. Respondents tend to express greater diversity of opinion on these statements than on the previous seven statements.

DeAngelo et al. (2000) provide evidence that the stock market generally views frequent and successive SDDs as regular dividends (S1). They contend that when firms pay SDDs so predictably, the special versus regular labeling loses much of any meaningful distinction. Under such conditions, investors view specials and regulars as reasonably close substitutes. Our results show that respondents generally agree with this view, but their reaction is not statistically significant.

Respondents appear highly uncertain about whether the stock market generally views an announcement of an unexpected SDD as conveying positive information about a firm's long-term (future) earnings prospects (S2B). This response differs markedly from the high level of agreement expressed about SDDs conveying positive information about a firm's short-term (current) earnings (S2A). Gombola and Liu (1999) report, based on revisions of analysts' forecasts surrounding SDD announcements, that special dividends may convey information about future earnings. Based on additional analysis, they conclude that the signaling effect

of SDDs is evident only for current-year earnings, but not for following-year earnings or five-year earnings growth. Thus, favorable information conveyed by SDD announcements reflects transitory, not permanent, earnings. Evidence by Crutchley et al. (2003) supports the view that SDDs indicate current excess performance rather than expected improvement in long-run performance.

Respondents generally agree that the stock market generally views an announcement of an unexpected SDD as conveying less positive information about a firm's future prospects (earnings and dividends) than does a regular dividend increase of comparable size (S2C), but the average response does not differ significantly from "no opinion." Evidence by Brickley (1983) supports the view that the market perceives that a regular (unlabeled) dividend increase conveys more positive information than an SDD of similar magnitude.

Respondents, on average, disagree with the statement that stock prices generally react positively to unexpected announcements of large SDDs only (S4). In our discussion of S3, we note that the stock price reactions to SDD announcements are typically positive and do not consist solely of large SDDs.

Respondents express highly divergent views as to whether firms tend to use SDDs, instead of initiating or increasing regular dividends, when managers believe their firm's current earnings performance level does not appear sustainable (S6). The results show that both 40.5% agree and disagree with the statement, while the remaining 19.0% have no opinion. Empirical evidence by Gombola and Liu (1999), Lie (2000), and Crutchley et al. (2003) support the notion that increased earnings related to SDDs are transitory, not permanent.

The notion that SDDs reduce management's potential for inappropriately using excess cash (S10) relates to the free cash flow theory. By distributing free cash flow to shareholders, instead of investing in lower return projects, managers should be able to increase shareholder wealth. In addition, such distributions should result in lowering managerial perquisites and potentially improve earnings over the longer term. Lie (2000) finds that the large incremental disbursements related to excess funds for larger, but not small, SDDs mitigate the agency problem associated with excess funds. Evidence by Howe et al. (1992) and Gombola and Liu (1999) suggests that agency cost reduction does not appear to be an important motive for paying SDDs. Thus, the results of the latter studies do not support the free cash flow theory.

Of the 14 statements, the one with the highest percentage of "no opinion" responses (61.9%) is whether fewer firms tend to use SDDs as their institutional stock ownership increases (S11). The average response is positive, but not statistically significant at normal levels. DeAngelo et al. (2000) find a significant negative relation between the level of institutional ownership and the probability that a firm continues to pay SDDs. They contend that if institutional investors have a higher degree of financial sophistication than do retail investors, they should more easily infer the lack of a substantive difference between regular dividends and specials paid with greater frequency. Thus, higher levels of institutional ownership should encourage firms to stop paying SDDs.

## **5. Summary and conclusions**

Investors can receive disbursement of excess cash from corporations in several ways. In this study, we survey top managers of United States incorporated firms that announced at least one SDD during the period 1994 through 2001 to obtain their views about various

reasons and issues involving the distribution of excess cash. Based on the survey evidence, our results show that a substantial proportion of the respondents use multiple methods—regular dividend increases, share repurchases, and paying special dividends—to distribute excess cash. Firms tend to pay SDDs when they experience strong earnings and cash flows and want to increase the yield to shareholders. Having strong earnings and cash flows provides an impetus for regular dividend increases, but paying such dividends is also part of firm's standard dividend policy. The main motives for repurchasing shares are to take advantage of perceived market undervaluation of the firm's shares and to improve performance measures such as EPS. The latter motive suggests that achieving an "EPS bump" is an important benefit of stock buybacks.

These findings suggest that individual investors should not view the three cash distributions methods as perfect substitutes. Although some reasons for using each method overlap, distinct differences exist among the methods. Knowing why corporate managers select a specific distribution method should help investors avoid incorrectly interpreting the intentions of managers. For example, investors should not expect companies paying a large, one-time SDD such as Microsoft, MGM, and Blockbuster did in 2004 to repeat this practice any time soon. However, some companies that pay small SDDs often repeat this practice on a regular basis.

Taken as a whole, a major implication of this study is that the results lend support to the signaling explanation for the disbursement of excess funds, but not the free cash flow or wealth transfer explanations. Respondents believe that SDDs generally convey positive information about a firm's short-term (current) earnings and stock prices generally react positively to unexpected announcements of SDDs. The positive market response does not come by transferring wealth from bondholders to stockholders. Respondents appear uncertain about whether SDDs provide an important vehicle for managers to signal stockholders about future firm profitability. Evidence suggests, however, that SDD announcements indicate current excess performance rather than expected improvement in long-run performance. In addition, an overwhelming percentage of respondents hold the opinion that firms tend to repurchase shares, instead of using SDDs, when managers believe that underpricing of their firm's current stock exists. This response supports the undervaluation version of the signaling explanation for stock repurchases.

Perhaps the most surprising finding is that respondents do not perceive a negative relationship between the frequency that a firm declares SDDs and the market reaction to these announcements. Firms declaring SDDs more often typically make small special payments, which results in a modest stock price reaction. The market tends to respond more positively to large, non-recurring specials. Hence, the views of respondents tend to differ markedly from the results of several empirical studies documenting a negative relationship between the frequency of SDDs and the stock price reaction.

Although various impediments such as the number of respondents precluded extending our analysis, the results provide additional insights into the rationale for using different methods to distribute excess cash. Nonetheless, fertile ground exists for future researchers to study incremental disbursements of excess funds. For example, researchers could examine whether the motives for issuing SDDs and the views managers express about them differ based on the frequency of announcement and hence the size of SDDs. Frequent special dividends tend to be smaller than infrequent ones. The motives for small versus large special dividends could differ. Hence, researchers should control for the size of the cash disbursement as they further explore the rationale for paying SDDs.

Appendix

**Specially Designated Dividends Survey**

A **specially designated dividend** (SDD) is a cash dividend labeled by management as “extra”, “special” or “year-end” and differs from a regular (unlabeled) dividend.

**I. BACKGROUND INFORMATION**

**Directions:** Answer the questions as they apply to **you** and **your firm** by placing a check (✓) in the box, where appropriate.

1. Are **you** actively involved in determining your firm’s dividend policy?  Yes  No
2. What is **your** current position or title? \_\_\_\_\_
3. Has **your firm** used any of the following methods to distribute **temporary excess cash** to shareholders during the past 10 years? **Check all applicable.**
  - A. Pay a specially designated dividend
  - B. Initiate or increase regular dividends
  - C. Repurchase shares
  - D. Other methods (specify) \_\_\_\_\_
4. If you checked **3A**, why did your firm choose to pay a specially designated dividend? **List the two most important reasons.**
  - A. \_\_\_\_\_
  - B. \_\_\_\_\_
5. If you checked **3B**, why did your firm choose to initiate or increase dividends with *temporary excess cash* instead of paying a specially designated dividend? **List the two most important reasons.**
  - A. \_\_\_\_\_
  - B. \_\_\_\_\_
6. If you checked **3C**, why did your firm choose to repurchase shares with *temporary excess cash* instead of paying a specially designated dividend? **List the two most important reasons.**
  - A. \_\_\_\_\_
  - B. \_\_\_\_\_

**II. OTHER ISSUES ABOUT SPECIALLY DESIGNATED DIVIDENDS (SDDs)**

**Directions:** Circle the number matching your level of agreement with each statement about SDDs *in general*.

Statement	Level of Agreement					Circle One	
	Strongly Disagree -2	Disagree -1	No Opinion 0	Agree +1	Strongly Agree +2	Disagree	Agree
1. The stock market generally views frequent and successive <b>SDDs</b> as regular dividends.	-2	-1	0	+1	+2	-2	-1 0 +1 +2
2. The stock market generally views an announcement of an unexpected <b>SDD</b> as:							
A. Conveying positive information about a firm’s short-term (current) earnings.	-2	-1	0	+1	+2	-2	-1 0 +1 +2
B. Conveying positive information about a firm’s long-term (future) earnings prospects.	-2	-1	0	+1	+2	-2	-1 0 +1 +2
C. Conveying <b>less</b> positive information about a firm’s future prospects (earnings and dividends) than does a regular dividend increase of comparable size.	-2	-1	0	+1	+2	-2	-1 0 +1 +2
D. Causing wealth transfers from bondholders to stockholders as the dividend payment reduces the assets protecting the bondholders.	-2	-1	0	+1	+2	-2	-1 0 +1 +2
3. Stock prices generally react <i>positively</i> to unexpected announcements of <b>SDDs of all sizes</b> .	-2	-1	0	+1	+2	-2	-1 0 +1 +2
4. Stock prices generally react <i>positively</i> to unexpected announcements of <b>large SDDs only</b> .	-2	-1	0	+1	+2	-2	-1 0 +1 +2
5. Stock price reactions are <i>negatively</i> related to how frequently a firm declares <b>SDDs</b> .	-2	-1	0	+1	+2	-2	-1 0 +1 +2
6. Firms tend to use <b>SDDs</b> , instead of initiating or increasing regular dividends, when managers believe their firm’s current earnings performance level does not appear sustainable.	-2	-1	0	+1	+2	-2	-1 0 +1 +2
7. Firms tend to repurchase shares, instead of using <b>SDDs</b> , when managers believe their firm’s current stock is under priced.	-2	-1	0	+1	+2	-2	-1 0 +1 +2
8. Firms paying regular dividends are more likely to issue <b>SDDs</b> than to repurchase shares.	-2	-1	0	+1	+2	-2	-1 0 +1 +2
9. Firms not paying dividends are more likely to repurchase shares than to issue <b>SDDs</b> .	-2	-1	0	+1	+2	-2	-1 0 +1 +2
10. <b>SDDs</b> reduce management’s potential for inappropriately using excess cash (e.g. over-investing).	-2	-1	0	+1	+2	-2	-1 0 +1 +2
11. <b>Fewer</b> firms tend to use <b>SDDs</b> as their institutional stock ownership increases.	-2	-1	0	+1	+2	-2	-1 0 +1 +2

To receive a summary of the findings, simply enclose business card or write e-mail address: \_\_\_\_\_

**Please check to see that you answered each question. Thank you for your help.**

Company Code \_\_\_\_\_

## Notes

1. See Krim (2004) for a discussion of Microsoft's announcement to pay a special dividend to investors. Microsoft plans to disburse the one-time cash dividend on December 2, 2004 to shareholders of record on November 17, 2004.
2. In a study of NYSE firms for 1926–1995, DeAngelo, DeAngelo, and Skinner (2000) find that despite a dramatic overall decline in specials, the incidence of very large specials increased in recent years.
3. Lie (2000) shows that firms using all three methods tend to have funds in excess of industry norms before the events.
4. Regular dividend increases and SDDs are both dividend decisions representing cash disbursements to shareholders with identical tax consequences. Firms may use share repurchases in lieu of cash dividends to minimize stockholder taxes. This tax-motivated substitution of share repurchases for dividends results from the favorable tax treatment given to share repurchases over cash dividends under U.S. tax law. That is, investors who choose to sell to the firm incur capital gains taxes. Non-selling shareholders pay no immediate tax bill, but receive a pro-rata increase in their ownership in the firm. Evidence by Chhachhi and Davisdon (1997), as well as Grullon and Michaely (2002), lends support to the tax-motivated substitution for dividends explanation.
5. For surveys on regular dividends, see Baker, Farrelly, and Edelman (1985), Baker and Powell (1999), Baker and Powell (2000), and Baker, Veit, and Powell (2001); and for surveys on stock repurchase programs, see Baker, Gallagher, and Morgan (1980), Wansley, Lane, and Sarkar (1989), Tsetsekos, Kaufman, and Gitman (1991), and Baker, Powell, and Veit (2003b).
6. For a comprehensive review of dividend signaling, see Allen and Michaely (1995).
7. Denis (1990) reports evidence indicating that announcements of defensive repurchases are associated with an average negative impact on the share price of the target firm. In contrast, special dividend payments generally increase the wealth of target firm shareholders.
8. For a review of the literature on regular dividends and stock repurchases, see Lease et al. (2000), Bierman (2001), Frankfurter, Wood, and Wansley (2003), and Copeland, Weston, and Shastri (2005).
9. For example, Graham and Harvey (2001) achieve a response rate of almost 9% from financial executives in a survey about the cost of capital, capital budgeting, and capital structure. Trahan and Gitman (1995) obtain a 12% response rate in a survey mailed to 700 chief financial officers.
10. We could not test for non-response bias by comparing the responses for the firms that returned the survey on time (first mailing) to those that did not (second mailing) because of the number of usable responses to the first mailing ( $n = 42$ ) versus the second mailing ( $n = 3$ ).
11. Deleting firms whose data were unavailable on COMPUSTAT reduced the sample sizes for the  $t$  tests.

12. Excluding respondents who are not actively involved in dividend policy decisions has little effect on the results.
13. We do not partition and analyze the data by frequency of paying SDDs because of the small sample size.

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