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DIVIDEND POLICY

Dividend policy – Dividend policy decisions – Dividend theories – Modigliani Miller‟s Approach – Walter‟s Approach – Determinants of dividend of dividend policy.

MEANING OF DIVIDEND

DIVIDEND: (லாபத்தில் கிடைக்கும் பாகம்)

Dividend refers to that part of the profits of a company which is distributed amongst its shareholders. get its shareholders. The return that a shareholder gets from the company, out of its profits, on his shareholdings. It is the reward of the shareholders for investments made by them in the shares of the company. The investors are interested in earning the maximum return on their investments and to maximise their wealth. A company, on the other hand, needs to provide funds to finance its long-term growth.

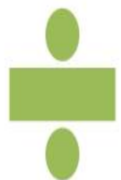
"A distribution to shareholder of profits or reserves available for this purpose".

"a sum of money paid regularly (typically annually) by a company to its shareholders out of its profits (or reserves)."

"A company's dividend is **decided by its board of directors** and it requires the shareholders' approval. However, it is not obligatory for a company to pay dividend. Dividend is usually a part of the profit that the company shares with its shareholders."

According to **ICAI,** " Dividend is the distribution to the shareholder the of a company from the reserves and profits".

Total Dividend Paid Per Year



Price Per Share

Dividend Yield

Dividend

- Cash Dividend
- Scrip Dividend
- Bond Dividend
- Stock Dividend
- Property Dividend
- Liquidating Dividend

1. Cash Dividends

Cash Dividend refers to the dividend that is distributed to the shareholders from the earnings of a firm in the form of cash. Then, it is the choice of the shareholders, either to reinvest the money or to break out. Cash Dividends are taxable.

2. Stock Dividends

Stock Dividend refers to the dividend that is distributed to the shareholders from the earnings in the form of additionally fully paid shares. In stock dividends, firm's cash is conserved. Also, these dividends are not taxable until the shares are sold.

3. Property Dividend

Property Dividend refers to the dividends that are paid to the shareholders of the firm in the form of some property. For Example, Firm shipping the products made by it to the shareholders. Property dividend is the alternative to cash and stock dividend. These dividends are taxable at the fair market value of the property.

4. Liquidating Dividend

Liquidating Dividend refers to the dividends that are paid to the shareholders by the firm at the time of partial or fully bankruptcy or while ceasing business operations. Usually, the shareholder is paid from the firm's capital base as per the number of shares the owe. This type of dividend is non-taxable.

5. Scrip Dividend

Scrip Dividend refers to the dividends that are given to the shareholders by the firm in the form of promissory notes or certificates in which the firm promises to pay the shareholders a decided amount after a particular time period. The firm issues scrip dividends due to the shortage of liquidity. This type of dividend is also an alternative to cash and stock dividends.

DIVIDEND POLICY:

A policy which determines the amount of earnings to be distributed to the shareholders and the amount to be retained in the company as retained earnings, it called dividend policy.

The policy that a firm uses to decide, how much portion of the firm's net earnings or profit after tax must be paid to the shareholders in the form of dividends to keep them happy is known as **Dividend Policy**.

Dividend policy refers to the policy concerning **quantum of profits to be distributed as dividend**. The concept of dividend policy implies that companies through their **Board of Directors evolve a pattern of dividend payment** which has a bearing of future action.

- If a company pays out as dividend most of what it earns, *then for business requirements and further expansion it will have to depend upon outside resources such as issue of debt or new shares.*
- Dividend policy of a firm, thus affects both the **long-term financing and the wealth of shareholders.**
- As a result, the firm's decision to pay dividends must be reached in such a manner so as **to equitably apportion the distributed profits and retained earnings**

Types of Dividend Policy:

Dividend is a right of shareholders to participate in the profits and surplus of the company for their investment in the share capital of the company, they should receive fair amount of the profits. The company should, therefore, distribute a reasonable amount as dividends (which should include a normal rate of interest plus a return for the risks assumed) to its members and retain the rest for its growth and survival.

- **The various types of dividend policies are discussed as follows:**

(a) Regular Dividend Policy:

Payment of dividend at the usual rate is termed as regular dividend. The investors such as retired persons, widows and other economically weaker persons prefer to get regular dividends.

A regular dividend policy offers the following advantages:

(a) It establishes a profitable record of the company.

(b) It creates confidence amongst the shareholders.

(c) It aids in long-term financing and renders financing easier.

(d) It stabilises the market value of shares.

(e) The ordinary shareholders view dividends as a source of funds to meet their day-to-day living expenses.

(f) If profits are not distributed regularly and are retained, the shareholders may have to pay a higher rate of tax in the year when accumulated profits are distributed.

However, it must be remembered that regular dividends can be maintained only by companies of long standing and stable earnings, A company should establish the regular dividend at a lower rate as compared to the average earnings of the company.

(b) Stable Dividend Policy:

The term 'stability of dividends' means consistency or lack of variability in the stream of dividend payments. In more precise terms, it means payment of certain minimum amount of dividend regularly.

A stable dividend policy may be established in any of the following three forms:

(i) Constant dividend per share:

Some companies follow a policy of paying fixed dividend per share irrespective of the level of earnings year after year. Such firms, usually, create a 'Reserve for Dividend Equalisation' to enable them pay the fixed dividend even in the year when the earnings are not sufficient or when there are losses. A policy of constant dividend per share is most suitable to concerns whose earnings are expected to remain stable over a number of years.

(ii) Constant payout ratio:

Constant pay-out ratio means payment of a fixed percentage of net earnings as dividends every year. The amount of dividend in such a policy fluctuates in direct proportion to the earnings of the company. The policy of constant pay-out is preferred by the firms because it is related to their ability to pay dividends. Figure given below shows the behaviour of dividends when such a policy is followed.

(iii) Stable rupee dividend plus extra dividend:

Some companies follow a policy of paying constant low dividend per share plus an extra dividend in the years of high profits. Such a policy is most suitable to the firm having fluctuating earnings from year to year.

Dividend Theories

- **Relevance Theories**
  (i.e. which consider dividend decision to be relevant as it affects the value of the firm)
  - Walter's Model
  - Gordon's Model
- **Irrelevance Theories**
  (i.e. which consider dividend decision to be irrelevant as it does not affects the value of the firm)
  - Modigliani and Miller's Model
  - Traditional Approach

Some of the major different theories of dividend in financial management are as follows: 1. Walter's model 2. Gordon's model 3. Modigliani and Miller's hypothesis.

On the relationship between dividend and the value of the firm different theories have been advanced.

They are as follows:

1. Walter's model
2. Gordon's model
3. Modigliani and Miller's hypothesis

1.Walter's model:

Professor James E. Walterargues that the choice of dividend **policies almost always affects the value of the enterprise.**

His model shows clearly the importance of the relationship between the firm's internal rate of return (r) and its cost of capital (k) in determining the dividend policy that will maximise the wealth of shareholders.

- According to Prof. Walter**, If r>k i.e. if the firm earns a higher rate of return on its investment than the required rate of return, the firm should retain the earnings.** Such firms are termed as growth firm's and the optimum pay-out would be zero which would maximize value of shares.
- In case of declining firms which do not have profitable investments i.e. where **r<k, the shareholder would stand to gain if the firm distributes it earnings.** For such firms, the optimum payout would be 100% and the firms should distribute the entire earnings as dividend.
- In case of normal firms **where r=k the dividend policy will not affect the market value of shares as the shareholders will get the same return from the firm as expected by them.** For such firms, there is no optimum dividend payout and value of firm would not change with the change in dividend rate

Walter's model is based on the following assumptions:

1. The firm finances all investment through retained earnings; that is debt or new equity is not issued;
2. The firm's internal rate of return (r), and its cost of capital (k) are constant;
3. All earnings are either distributed as dividend or reinvested internally immediately.
4. Beginning earnings and dividends never change. The values of the earnings pershare (E), and the divided per share (D) may be changed in the model to determine results, but any given values of E and D are assumed to remain constant forever in determining a given value.
5. The firm has a very long or infinite life.

Earnings and dividends do not change while determining the value.

The investments of the firm are financed through retained earnings only and the firm does not use external sources of funds.

Walter's formula to determine the market price per share (P) is as follows:

$$P = \frac{D + ke(E - D)/ke}{ke}$$

Where P = Market price per share

D = Dividend per share

r = internal rate of return

E = earnings per share

k_e = Cost of equity capital.

Criticism:

Walter's model is quite useful to show the effects of dividend policy on an all equity firm under different assumptions about the rate of return. However, the simplified nature of the model can lead to conclusions which are net true in general, though true for Walter's model.

The criticisms on the model are as follows:

1. Walter's model of share valuation mixes dividend policy with investment policy of the firm.
2. The model assumes that **the investment opportunities of the firm are financed by retained earnings only and no external financing debt or equity is used for the purpose**
2. Walter's model is based on the assumption t**hat r is constant. In fact decreases as more investment occurs.** This reflects the assumption that the most profitable investments are made first and then the poorer investments are made.

   The firm should step at a point where r = k. This is clearly an erroneous policy and fall to optimise the wealth of the owners.
3. A firm's cost of capital or discount rate**, K, does not remain constant; it changes directly with the firm's risk. T**hus, the present value of the firm's income moves inversely with the cost of capital. By assuming that the discount rate, K is constant, Walter's model abstracts from the effect of risk on the value of the firm.

2. Gordon's Model:

One very popular model explicitly relating the market value of the firm to dividend policy is developed by Myron Gordon.

Assumptions:

Gordon's model is based on the following assumptions.

1. The firm is an all Equity firm
2. No external financing is available
3. The internal rate of return (r) of the firm is constant.
4. The appropriate discount rate (K) of the firm remains constant.
5. The firm and its stream of earnings are perpetual
6. The corporate taxes do not exist.
7. The retention ratio (b), once decided upon, is constant. Thus, the growth rate (g) = br is constant forever.
8. K > br = g if this condition is not fulfilled, we cannot get a meaningful value for the share.

According to Gordon's dividend capitalisation model, the market value of a share (Pq) is equal to the present value of an infinite stream of dividends to be received by the share. Thus:

The above equation explicitly shows the relationship of current earnings (E,), dividend policy, (b), internal profitability (r) and the all-equity firm's cost of capital (k), in the determination of the value of the share (P_0).

3. Modigliani and Miller's hypothesis:

Modigliani and Miller have expressed in the most comprehensive manner in support of theory of irrelevance. They maintain that dividend policy has no effect on market prices of shares and the value of firm is determined by earning capacity of the firm or its investment policy. As observed by M.M, "Under conditions of perfect capital markets, rational investors, absence of tax discrimination between dividend income and capital appreciation, given the firm's investment policy, its dividend policy may have no influence on the market price of shares". Even, the splitting of earnings between retentions and dividends does not affect value of firm.

Under M – M assumptions, r will be equal to the discount rate and identical for all shares. As a result, the price of each share must adjust so that the rate of return, which is composed of the rate of dividends and capital gains, on every share will be equal to the discount rate and be identical for all shares.

Assumptions of MM Hypothesis

(1) There are perfect capital markets.

(2) Investors behave rationally.

(3) Information about company is available to all without any cost.

(4) There are no floatation and transaction costs.

(5) The firm has a rigid investment policy.

(6) No investor is large enough to effect the market price of shares.

(7) There are either no taxes or there are no differences in tax rates applicable to dividends and capital gains.

8. Risk of uncertainty does not exist. That is, investors are able to forecast future prices and dividends with certainty and one discount rate is appropriate for all securities and all time periods. Thus, $r = K = K_t$ for all t.

$$P_0 = \frac{D_1 + P_1}{1 + K_e}$$

where

P_O = Market price per share at beginning of period.

D_1 = Dividend to be received at end of period.

P_1 = Market price per share at end of period.

K_e = Cost of equity capital.

The value of P_1 can be derived by above equation as under.

Thus, the rate of return for a share held for one year may be calculated as follows:

Where P^ is the market or purchase price per share at time 0, P, is the market price per share at time 1 and D is dividend per share at time 1. As hypothesised by M – M, r should be equal for all shares. If it is not so, the low-return yielding shares will be sold by investors who will purchase the high-return yielding shares.

This process will tend to reduce the price of the low-return shares and to increase the prices of the high-return shares. This switching will continue until the differentials in rates of return are eliminated. This discount rate will also be equal for all firms under the M-M assumption since there are no risk differences.

From the above M-M fundamental principle we can derive their valuation model as follows:

Multiplying both sides of equation by the number of shares outstanding (n), we obtain the value of the firm if no new financing exists.

If the firm sells m number of new shares at time 1 at a price of P^, the value of the firm at time 0 will be

The above equation of M – M valuation allows for the issuance of new shares, unlike Walter's and Gordon's models. Consequently, a firm can pay dividends and raise funds to undertake the optimum investment policy. Thus, dividend and investment policies are not confounded in M – M model, like waiter's and Gordon's models.

Criticism:

Because of the unrealistic nature of the assumption, M-M's hypothesis lacks practical relevance in the real world situation. Thus, it is being criticised on the following grounds.

1. The assumption that taxes do not exist is far from reality.
2. M-M argue that the internal and external financing are equivalent. This cannot be true if the costs of floating new issues exist.
3. According to M-M's hypothesis the wealth of a shareholder will be same whether the firm pays dividends or not. But, because of the transactions costs and inconvenience associated with the sale of shares to realise capital gains, shareholders prefer dividends to capital gains.
4. Even under the condition of certainty it is not correct to assume that the discount rate (k) should be same whether firm uses the external or internal financing.

If investors have desire to diversify their port folios, the discount rate for external and internal financing will be different.

5. M-M argues that, even if the assumption of perfect certainty is dropped and uncertainty is considered, dividend policy continues to be irrelevant. But according to number of writers, dividends are relevant under conditions of uncertainty.

Determinants of Dividend Policy

The payment of dividend involves some legal as well as financial considerations. It is difficult to determine a general dividend policy which can be followed by different firms at different times because dividend decision has to be taken considering the special circumstances of an individual case.

The following are important factors which determine dividend policy of a firm:

1. Legal Restrictions:

Legal Provisions relating to dividends as laid down in section, 205, 205A, 206 and 207 of companies Act, 1956 are significant because they lay down a framework within which dividend policy is formulated. These provisions require that dividend can be paid only out of current profit or past profits after providing for depreciation. The companies (Transfer of Profits to Reserves) Rules, 1975 require a company providing more than 10% dividend to transfer certain percentage of current year's profit to Reserves

When Dividend Proposed

Amount to be transferred to Reserves most not be less than

- Exceeds 10% but not 12.5% of paid up capital
- 2.5% of current year profit
- Exceeds 12.5% but not 15% of paid up capital
- 5% of current year profit
- Exceeds 15% but not 20% of paid up capital
- 7.5% of current year profits
- Exceeds 20% of paid up capital
- 10% of current year profits.

3. Nature of Industry:

Nature of Industry to which company is engaged also considerably affects dividend policy. **Certain industries have comparatively steady and stable demand irrespective of prevailing economic conditions. For example, people used to drink liquor both in boom as well as in recession.** Such firms expect regular earnings and hence follow consistent dividend policy. On the other hand, if earnings are uncertain, as in the case of luxury goods conservative policy should be followed. Such firms should retain a substantial part of their current earnings during boom period in order to provide funds to pay adequate dividends in the recession periods. Thus, industries with steady demand of their products can follow a higher dividend payout ratio while cyclical industries should follow a lower payout ratio.

4. Age of Company & 5. Future Financial Requirements:

- **4. Age of Company:** It also influences dividend decision of company. A nearly established concern has to limit payment of dividend and retain substantial part of earnings for financing its future growth while older companies which have established sufficient reserves can afford to pay liberal dividends.
- **5. Future Financial Requirements:** If a *company has highly profitable investment opportunities it can convince the shareholders of need for limitation of dividend to increase future earnings and stabilise its financial position*. But when profitable investment appointments do not exist then company may not be justified in retaining substantial part of its current earnings. Thus, a concern having few internal investment opportunities should follow high payout ratio as compared to one having more profitable investment opportunities.

6. Liquid Resources: &
7. Requirements of Institutional Investors:

- **6. Liquid Resources:** The dividend policy of a firm is also influenced by availability of liquid resources. Although, a firm may have sufficient available profit to declare dividends, yet it may not be desirable to pay dividend if it does not have sufficient liquid resources. Hence **liquidity position of company is an important consideration in paying dividends. If company does not have liquid resources, it is better to declare *stock dividend* i.e. issue of bonus shares to existing shareholders.**
- **7. Requirements of Institutional Investors:** Dividend policy of a company can **be affected by requirements of institutional investors such as financial institutions, banks, insurance corporations** etc. These investors usually favour a policy of regular payment of cash dividends and stipulate there own terms with regard to payment of dividend on equity shares.

8. Stability of Dividends

Stability of dividend refers to payment of dividend regularly and shareholders generally, prefer payment of such regular dividends. Some companies follow a policy of constant dividend per share while others follow a policy of constant payout ratio and while there are some other who follow a policy of constant low dividend per share plus an extra dividend in years of high profits. A policy of constant dividend per share is most suitable to concerns whose earnings are expected to remain stable over a number of years or those who have built up sufficient reserves to pay dividends in years of low profits. The policy of constant payout ratio i.e. paying a fixed percentage of net earnings every year may be supported by firm because it is related to firms ability to pay dividends. **The policy of constant low dividend per share plus some extra dividend in years of high profits is suitable to firms having fluctuating earnings from year to year.**

9. Magnitude and Trend of Earnings:

The amount and trend of earnings is an important aspect of dividend policy. It is rather the starting point of the dividend policy. **As dividends can be paid only out of present or past's years profits, earnings of a company fix the upper limits on dividends. The dividends should nearly be paid out of current years earnings only as retained earnings of the previous years become more or less a part of permanent investment in the business to earn current profits.** The past trend of the company's earnings should also be kept in consideration while making dividend decision.

10. Control objectives:

When a company pays high dividends out of its earnings, it may result in dilution of both control and earnings for existing shareholders. As in case of high dividend pay out ratio the retained earnings are insignificant and company will have to issue new shares to raise funds to finance its future requirements. The control of the existing shareholders will be diluted if they cannot buy additional shares issued by the company. **Similarly issue of new shares shall cause increase in number of equity shares and ultimately cause a lower earnings per share and their price in the market.** Thus under these circumstances to maintain control of the existing shareholders, it may be desirable to declare lower dividends and retain earnings to finance the firm's future requirements.