DIVIDEND POLICY

MEANING

Dividend refers to the business concerns net profits distributed among the shareholders. It may also be termed as the part of the profit of a business concern, which is distributed among its shareholders.
According to the **Institute of Chartered Accountant of India**, dividend is defined as "a distribution to shareholders out of profits or reserves available for this purpose".

TYPES OF DIVIDEND/FORM OF DIVIDEND

1. **Cash Dividend:** If the dividend is paid in the form of cash to the shareholders, it is called cash dividend. It is paid periodically out the of the business concerns EAIT (Earnings after interest and tax). Cash dividends are common and popular types followed by majority of the business concerns.
2. **Debenture dividend:** In this form of dividend, the company may issue debentures in lieu of dividends to its shareholders. Such debentures carry interest at a prescribed rate and are also payable after the prescribed expiry period.
3. **Stock Dividend/Bonus share:** When the liquidity position of the company is not good and the company is unable to pay cash dividend, it can issue shares to the shareholders from accumulated past profits.
4. **Script Dividend**: The company may issue promissory note payable after few months or it may issue convertible dividend warrants redeemable in few years. Such dividend is known as scrip dividend.
5. **Property Dividends:** This form of dividend is unusual and may be paid in the form of inventory or securities of subsidiary companies.
6. **Composite dividend**: When a part of dividend is paid in cash and balance is settled in any asset form, this is known as composite dividend policy.

DIVIDEND POLICY

The market value of shares of a company is greatly affected by its policy regarding distribution of profits/surplus between pay-out (dividend) and plough-back (retained earnings). Dividend policy determines the allocation of earnings payable to shareholders and earnings to be retained.

Dividend policies can be of following types

1. **Constant Percentage of Earnings:** a company may distribute dividends to its shareholders on the basis of a definite percentage of earnings. In this kind of policy, the shareholders are benefited if the earnings are increasing every year. But shareholders may not prefer this policy in case of declining earnings.
2. **Constant dividend rate:** A certain percentage of paid up capital may be adopted as dividend policy. The merit of this policy is that the shareholders are fully assured as to how much dividend they are going to get.
3. **Conservative Dividend Policy:** Conservative dividend policy is one where the management distributes only a few portion of profit as dividend in spite of excessive profits earned. Under this policy major part of profit is retained and shareholders are paid minimum divided. This policy is suitable for those companies which need extra funds for improvement and development programs.
4. **Liberal Dividend Policy:** When the management distributes major part of profit as dividend and retains very less amount, it is called liberal dividend policy. Only that part of profit is retained which is urgently required.

5. **Sound or Stable dividend policy:** This policy attaches equal importance to company's future requirements and shareholder's current expectations and tries to balance both reasonably. Normally the amount of dividend and retained earnings are more or less same. This policy is a middle path and is helpful in maintaining the reputation of the company.

Essentials of a Sound Dividend Policy

1. **Stability/regularity** in the dividend distribution
2. **Gradual rise in dividend rate** as per increase in profit.
3. **Moderate start:** start at low rate in the beginning.
4. **Distribution of Dividend should be done normally in Cash**
5. **Other factors**

Advantages of Sound dividend policy

1. Shareholders satisfaction.
2. Confidence among Shareholders.
3. The relative stability in the market price of shares.
4. Helpful in long term planning.
5. Stability in national income.

Factors Affecting Dividend Policy

The dividend policy comprises all aspects of dividend payments such as stability of dividend rate, time of payment, methods of payment, forms of payments etc. while formulating dividend policy covering all these aspects, one has to carefully study not only the company's requirement but also the interest of shareholders. Some other economic factors must also be considered. Thus factors affecting dividend policy may be put into three categories

1. Ownership factors
2. Company oriented factors
3. Other factors

1. **Ownership factors**
   - **i.** Current income requirements of the shareholders
   - **ii.** Alternative uses of funds by shareholders
   - **iii.** Tax Consideration of shareholders
2. **Company oriented factors**
   - **i.** Legal or contractual constraints
   - **ii.** Liquidity, credit standing and working capital requirement
   - **iii.** Need for expansion and diversification
   - **iv.** Business Cycle
   - **v.** Dividend policies and shareholder's relationship
   - **vi.** Availability of external capital
   - **vii.** Inflation
3. **Other Factors**
   - **i.** Nature of Business
   - **ii.** Attitude and Objection of Management
   - **iii.** Composition of Shareholding
   - **iv.** Restriction by the financial institution
   - **v.** Age of the company
   - **vi.** Corporate tax policy
   - **vii.** Public opinion.

   (Students must refer the book for a detailed explanation of these points)

THEORIES OF DIVIDEND

Experts like James E Walter, Myron J. Gordon, Ezra Soloman, and Gitman hold that dividend decision plays a very important role in the value of the firm.

WALTERS MODEL

According to Walter, the choice of the dividend policy almost always affects the value of the company. According to him, the dividend policy of the companies must be framed by keeping in mind the availability of new investment opportunities.

If the company has abundant profitable investment opportunities, no cash dividends should he paid because retained earnings will be a source of fund for such investment. On the other hand, if there are no profitable investment opportunities available, hundred per cent of earning should be distributed as dividend. For the situation between these two extremes, dividend payment will be between zero and hundred.

Walters model is based on the following assumptions

1. All investments are financed through retained earnings.
2. The company's internal rate of return (r) and cost of capital (k) is constant.
3. All earnings are either reinvested internally or distributed as dividend
4. There is no change in key factors like EPS and DPS
5. The company has a very long and perpetual life.
6. The market value of share is affected by present value of future dividends.
7. Retained earnings in the business affect the expected future dividend and this in turn affect the market value of share.

Formula given by Walter is as under

$$P = \frac{D + \frac{r}{k}(E - D)}{k}$$

Where,

D = Dividend Per Share
r = Internal Rate of Rate
k = Cost of Capital
E = Earnings Per Share

Walter identified three kinds of firm

1. **Growth Firms: (R>K):**The firms having R>K may be referred to as growth firms. These firms have investment opportunities and they can earn a return which is more than what shareholders could earn on their own. So optimum payout ratio for growth firm is 0%.
2. **Normal Firms (R = K):** If R is equal to K the firm is known as a normal firm. These firms do not have unlimited profitable investment opportunities and they can earn a rate of return which is equal to that of shareholders. In this case dividend policy will not have any

influence on the price per share. So there is nothing like optimum. payout ratio for a normal firm. All the payout ratios are optimum.

3. **Declining Firms (R<K):** If the company has no profitable investment opportunities and the company earns a return which is less than, what the shareholders can earn on their investments, it is known as declining firm. Here it should not make any sense to retain the earnings. So entire earnings optimum payout ratio for declining firms is 100%.
   So according to Walter, the optimum payout ratio is either 0% (when R>K) or 100% (when R<K)

Growth Firm	**R > K**	Entire earning should be retained (Zero payout)	P increases with decrease in payout ratio. So, P will be maximum when dividend is zero
Normal Firms	**R = K**	Indifferent	Indifferent
Declining Firms	**R < K**	Entire earning should be distributed (100% payout)	P decreases with increase in payout ratio. So, P will be minimum when dividend is hundred percent

Criticism of Walter Model

1. It assumes that all investments are financed through retained earnings. Thus it ignores the benefit of optimum capital structure.
2. It assumes r is constant but in practice r generally declines when more and more investment is taken
3. Assumption of k is constant also may not hold good in practice
4. It ignores the fact that market price of share is affected by many other factors the dividend is only one of them.

GORDONS MODEL

M.J. Gordon also holds that dividend is relevant to the value of the company and dividend policy certainly affects the value of the company i.e. marker price of shares. According to Gordon, the market value of share is equal to the present value of future stream of dividends.

Assumptions of Gordons model

1. Only retained earnings are used to finance investment opportunities.
2. The firm is an all equity firm. No external financing is available.
3. The company's internal rate of return (r) and cost of capital (k) is constant.
4. The company has very long and perpetual life.
5. Corporate tax does not exist.
6. The retention ratio once decided is taken as constant. Thus growth rate g = br is also constant.
7. cost of capital (k) is greater than growth rate (g = br)

$$P = \frac{E(1-b)}{k-br}$$

Where,
E = Earning Per Share
b = retention ratio
k = Cost of Capital
br = growth rate

Growth Firm	**R > K**	The company should retain more and pay less dividend	P increases with increase in retention ratio
Normal Firms	**R = K**	Indifferent	Indifferent
Declining Firms	**R < K**	The company should be retained less and pay high dividend	P decreases with increase in retention ratio

Criticisms of Gordon Model

1. Gordon model assumes that there is no debt and equity finance used by the firm. It is not applicable to present day business.
2. K and r cannot be constant in the real practice.
3. According to Gordon's model, there are no tax paid by the firm. It is not practically applicable.

MODIGLIANI AND MILLERS IRRELEVENCE THEORY

According to MM, under a perfect market condition, the dividend policy of the company is irrelevant and it does not affect the value of the firm. According to the theory, the value of a firm depends solely on its earnings power resulting from the investment policy

"Under conditions of perfect market, 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".

When a firm pays its earnings as dividends, it will have to approach market for procuring funds to meet a given investment programme. Acquisition of additional capital will dilute the firms share capital which will result in drop in share values. Thus, what the stockholders gain in cash dividends they lose in decreased share values. The market price before and after payment of dividend would be identical and hence the shareholders would be indifferent between dividend and retention of earnings. This suggests that dividend decision is irrelevant. M-M's argument of irrelevance of dividend remains unchanged whether external funds are obtained by means of share capital or borrowings. This is for the fact that investors are indifferent between debt and equity with respect to leverage and cost of debt is the same as the real cost of equity.
Finally, even under conditions of uncertainty, dividend decision will be of no relevance because of operation of arbitrage. Market value of share of the two firms would be the same if they are identical with respect to business risk, prospective future earnings and investment policies. This is because of rational behaviour of investor who would prefer more wealth to less wealth. Difference in respect of current and future dividend policies cannot influence share values of the two firms.

Assumptions of MM Theory is that

1. Capital markets are perfect: Investors are rational. it means that information is available to all investors easily and freely. Investors are free to buy and sell securities. There is no transaction cost. investors can lend and borrow at the same time.
2. Dividends. Earnings and capital gains are subject to same tax rates.
3. The firm has a fixed investment policy which will remain unchanged in future.
4. No risk is there in forecasting income, dividends and prices.

$$P_0 = \frac{D1+P1}{1+k}$$

$$P_1 = P_0(1+k) - D_1$$

Where
P_0 = Value of share in the beginning or zero period
P_1 = value of share in the end
D_1 = Dividend Per share at the end of the period
k = Cost of capital

Value of the company may be ascertained as under

$$V = \frac{\{(n+\Delta n)P1 - I + E\}}{1+k}$$

n = Number of outstanding shares
I = Total investment
Δn = Additional number of shares
E = earning of the company

Criticism of MM theory

1. The assumption that there are no floatation cost is invalid. In practical life whenever fresh issue is made by a company it has to bear floatation cost.
2. Another assumption that investors are not subject to transaction cost during sale and purchase of securities, is not valid. In actual, they are subject to transaction cost which affects sale and purchase value.
3. Besides equity financing of a new project, a company may have a number of other alternatives which can be used for financing.
4. MM's assumption that taxes do not exist is far from reality. Dividends are not taxed whereas tax is levied on capital gains. So the shareholders may prefer dividend to capital gains.