UNIT 4: DIVIDEND DECISIONS

1. **Define dividend? explain the types of decision?**

Introduction

The term dividend refers to the portion of profit which is distributed among the shareholders of the firm. In other words, dividend is that part of the net earnings of a company that is distributed to its shareholders. It is a payment made to the equity shareholders, for their investment in the company.

The financial manager has to determine the amount of profit to be distributed as dividends and the amount of profit to be retained in the business for financing its long-term growth.

Definition

According to institute of chartered accounting (CA) of India- "A dividend is a distribution to shareholders out of profit or reserves available for this purpose."

Features of dividend

1. Dividends are distributed to equity shareholders.
2. Dividends are variable in nature.
3. Dividends are decided by board of directors.
4. Dividends are optional payment there is no legal obligations.
5. Dividend cannot be paid out of depreciation reserve or any other capital reserves.
6. It can be paid in the form of cash or business shares.

Types of dividends:

- Cash dividend
- Stock dividend or bonus
- Scrip dividend or bond
- Property dividend
- Composite dividend

1. Cash Dividend

A cash dividend is a usual method of paying dividends and the companies which have enough cash balances will declare cash dividends. Payment of cash dividends result in out flows of funds and reduces the company's net worth. The cash account and reserve account of a company will be reduced when the cash dividend or paid. Thus, both the total assets and net worth of the company are reduced when the cash dividend is distributed.

2. Stock dividend

It is also called "bonus shares". Stock dividend means the issue of bonus shares at free of cost to the existing shareholders. If a company does not have liquid resources, then it is better to declare the stock dividends.

For example, if a shareholder owns 100 shares, at the time when a 10% bonus issued, when shareholders will receive 10 additional shares.

3. Scrip dividend

It is also known as "Bond dividend". A script dividend is a promise to pay to the shareholders at a future specific date. In case if a company does not have sufficient funds to pay dividend in cash it may issue a note or bond for the due amount to the shareholders. The objective of Bond dividend is to postpone the immediate payment of cash. A scrip dividend bears interest and it is accepted as a additional security.

4. **Property dividend**

   Property dividends are paid in the form of some assets other than cash. They are distributed under exceptional conditions and it is not popular in India.

5. **Composite dividend**

   When dividend is paid partly in the form of cash and the remaining in the other form, it is called as composite dividend. This is not a new technique for payment of dividend, it is a combination of all the dividend types.

2. **what are the factors influencing the dividend policy of a firm?**

   A number of considerations influence a company in the dividend policy. These considerations are of very practical in nature. The major factors influencing dividend policy of a concern are given below.

1. **Liquidity of funds**

   The liquidity of funds is an important consideration in dividend policy decisions. The liquidity of a firm is determined by the firm's investment and financing decisions. The investment decisions determined the rate of asset expansion and the financing of funds determined the dividend policy. If the cash position is weak, shareholders may be satisfied with stock dividends.

2. **Stability of learnings**

   If earnings are relatively stable, a firm is better able to predict its future earnings. Dividend declaration is a decision to be taken by the management keeping into consideration the stability of earnings.

3. **Past dividend rates**

   If an existing firm, the board of directors, while recommending the rate of dividend will have to keep in mind the rate of dividend declared in the past. In a new concern, the rate of dividend being declared by organizations will have to be honour.

4. **Profit rate**

   The profit rate of a firm is also highly important and it is variable. The internal profit rate of the firm provides a basis of comparing the productivity of retained earnings. The alternative investment opportunities also play an important role in dividend decisions.

5. **Control**

   One of the important variables in dividend decisions is the study of alternative sources of financing on the control situation in the firm. If maintenance of existing control is an important consideration the dividend payout may be lower to financing of retained earnings.

6. **Maintenance of a target dividend**

   The objective of a stable dividend policy will make for low payout, when profits are temporarily high and high payouts when profit are temporarily low, it will affect of dividend policy and growth in profit until the establishment of a new income level is strongly assured.

7. **Nature of ownership**

   Natural ownership of the corporation also affects the dividend decisions. Corporations closely held by a few tax payers in high income are likely to have a lower dividend payout ratio.

8. **Timing of investment opportunities**

   If company is able to forecast it's needs of funds well in advance it can make timely adjustment in investment opportunities.

9. **Effect of trade cycle**

   It is also highly influencing the dividend policy. For example, in the period of inflation, funds generated from depreciation may be insufficient to replace the assets. Consequently, a care on retained earning simply to preserve the earnings power of the firm.

10. **Legal requirements**

    The board of directors to decide on dividends will have to consider the legal requirements under section 205 of the companies act 1956. Prescribes the guidelines in respect of declaration and payment of dividends.

11. **Corporate taxation policy**

    Corporate taxes affect dividends both directly and indirectly. Heavy rates of taxation reduce the profit after tax available for shareholders **for example** in India dividends beyond 10% of paid-up capital are subject to 7.5% by way of dividend tax.

3. **Explain the different types of dividend policy?**

   Dividend policy means that management follows in making dividend payout decisions. In other words, divide policy is the firm’s plan of actions to be followed when dividend decisions are made. It is the decisions about the earnings of the form to pay-out as dividends versus retaining and reinvesting earnings in the firm. There are four types of dividend policy

   - Regular dividend policy
   - stable dividend policy
   - Irregular dividend policy
   - Zero dividend policy

1. **Regular dividend policy**

   In this type of dividend policy, the investors get dividend at usual rate. The investors are generally retired persons are weaker sections of the society who want to get regular income. This type of dividend payment can be maintained only if the company has regular income.

   ❖ **Assumptions/merits of regular dividend policy**
   - It helps in creating confidence among the shareholders.
   - It's stabilizes the market value of shares.
   - It helps in maintaining the goodwill of the company.
   - It helps in giving regular income to the shareholders.

2. **Stable dividend policy**

   Hear, the payment of certain sum of money is regularly paid to the shareholders.

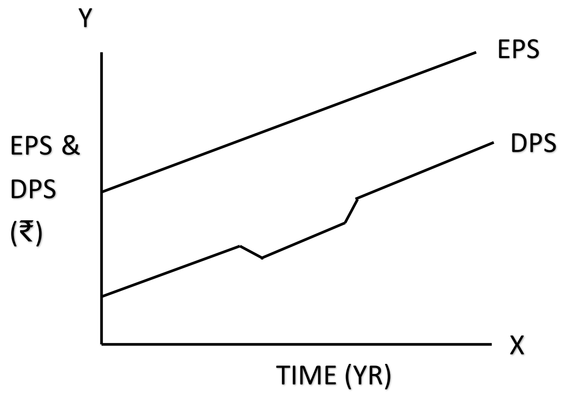
- ❖ **Merits of stable dividend policy**
  - It helps in creating confidence among the shareholders.
  - It's stabilizes the market value of shares.
  - It helps in maintaining the Goodwill of the company.
  - It helps in giving regular income to the shareholders.
- ❖ **Forms of table dividend policy**

There are three different form of dividend policy of stability. They are

- Constant dividend per share
- Constant dividend payout ratio
- Constant dividend per share + extra dividend

a. constant dividend per share

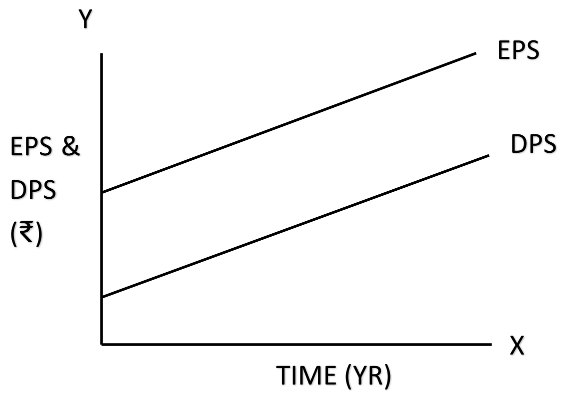
Some companies follow a policy of paying dividend per share irrespective of the level of earnings year after year. Such forms usually create a reserve for dividend capitalization, to enable them pay the fixed dividend even in the year when the earnings or not sufficient. The relationship between earnings per share (EPS) and dividend per share (DPS) under this policy is shown below.



It is easy to follow this policy when the earnings are stable. However, if they earnings pattern of a company shows wide fluctuations, it is difficult to maintain the policy.

b. Constant payout ratio

A certain percentage of net earnings are paid by way of dividends to the shareholders for every year. In such as policy amount of dividend fluctuations in direct proportion with earnings of the company as shown below



c. **Constant dividend per share Plus extra dividend**

Some companies follow a policy of paying constant low dividend per share Plus and extra dividend in the year of high profits. This policy is suitable for the forms having fluctuations earnings from <u>year to year.</u>

3. **Irregular dividend policy**

The companies does not pay the regular dividend to the shareholders. In practice the following are the reasons to pay the irregular dividends.

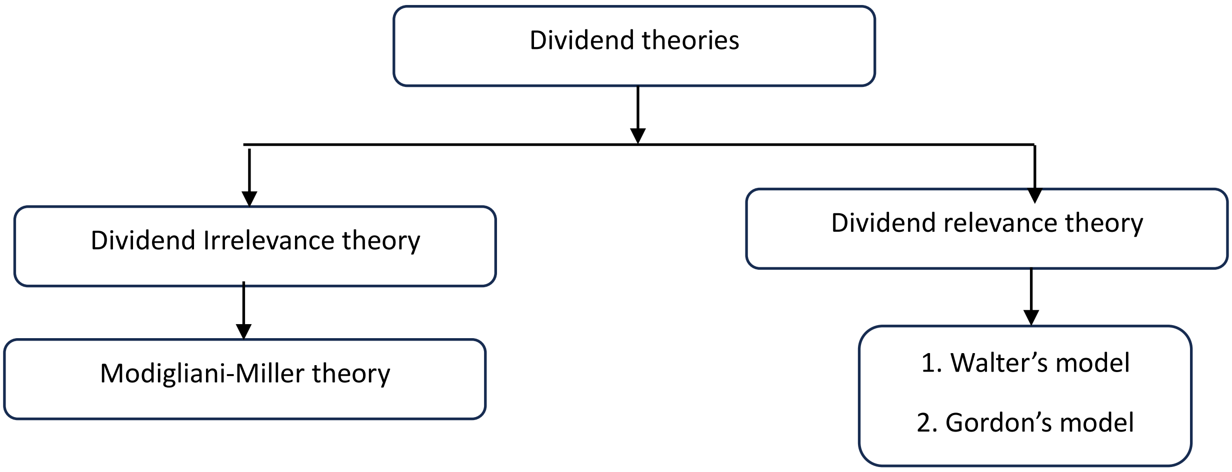
- Due to uncertain earnings of the company
- Due to lack of liquid resources
- The company is not so much successful business
- The company is afraid of giving regular dividend

4. **Zero dividend policy**

The company my follow the policy of paying no dividends permanently because of its unfavorable working capital position, requirements of funds for future expansion and growth

4. **Explain the models of dividend?**

Based on the relationship between dividend and value of the firm, different theories have been in financial management. They are listed below



I. **Dividend irrelevance theory**

1. **Modigliani miller theory**

According to MM dividend policy of a form is irrelevant as it does not affect the wealth of the shareholders. They argue that the value of the firm depends on the firm's earnings which result from its investment policy.

Assumptions

- The form operates in perfect capital market
- No taxes
- The farm has a fixed investment policy
- Risk of uncertainty does not exist

The rate of return for a share held for 1 year may be calculated as

$$\mathbf{r = D + \frac{(p1 + p0)}{p0} = \frac{Dividends + \mathit{Capital\ gains/losses}}{Purchase\ price}}$$

P = market price per share

D = Dividend per share

Criticism

- The assumption the taxes does not exist from reality
- MM argues that that they internal and external financing are equivalent
- According to MM the wealth of a shareholder will be same whether the firm pays dividend or not

II. Dividend relevance theory

1. Walter's model

Professor James E. Walter argues that the choice of divide and policies almost always affect the value of the form. His model shows clearly the importance of the relationship between the forms IRR and it's cost of capital (k) in determining the dividend policy that will maximize the wealth of the shareholders

Assumptions

- The firm has a very long or infinite life
- The firm’s internal rate of return (r) and its cost of capital (k) are constant
- All earnings and dividend never change

<u>Walter formula to determine the market price per share</u>

$$\boldsymbol{p} = \mathbf{D/k + r(E - D)/k/k}$$

$$\mathbf{D/k = The\ pv\ of\ an\ infinite\ stream\ of\ constant\ dividends}$$

$$\mathbf{r(E - D)/k/k = The\ pv\ of\ an\ infinite\ stream\ of\ gain}$$

Criticism

1. Walter's model is based on the assumption that “r” is constant. In fact, decreate and more investment occurs
2. A firm’s cost of capital (k) does not remain constant, it changes directly with the firm’s risk. Thus, the pv of the firm’s income moves inversely with the cost of capital

2. Gordon's model

This model developed by Myron Gordon, explains the relationship between a company's dividend policy and its market value. The model suggest that higher dividend payouts reduce risk for investors and increase the firms market value. It emphasizes that firms value is determined by its the dividend policy, growth rate, and cost of equity

Assumptions

- The IRR is constant
- The corporate taxes are does not exits
- The farm has only equity with no dept
- Fast of equity (k) is higher than the growth rate (g)
- Financing is done only through retained earnings

Statement

According to this model change in dividend will affect the value of the firm. The formula used by Gordon to determine the market price per share given by

$$\mathbf{Po} = \frac{\mathbf{E1[L - b]}}{\mathbf{k - br}}$$

Po= value of share

E1= current earnings

b= Dividend policy

r= internal profitability

k= firm's cost of capital

5. **Explain the retired earnings policy and its advantages**

Retained Earnings Policies:

Retained earnings refer to the portion of a company's net income that is not distributed to shareholders as dividends but is retained in the business for reinvestment or to meet future needs. The decision to retain earnings instead of paying them out as dividends is a critical aspect of financial management, particularly under the domain of dividend policy.

A company's retained earnings policy outlines how much profit will be distributed as dividends and how much will be retained for reinvestment, growth, and other purposes.

Factors Influencing Retained Earnings Policy:

Several factors determine a company's approach to retained earnings:

Profitability:

Companies with higher profits can afford to retain more earnings while also paying dividends.

Growth Opportunities:

Firms with significant growth opportunities are more likely to retain earnings to finance these ventures.

Liquidity:

Adequate cash flow is essential for retaining earnings; otherwise, the company may prioritize dividend payments.

Cost of Capital:

If the cost of raising external funds is high, companies may prefer to retain earnings.

Shareholder Preferences:

Some shareholders, especially those seeking regular income, may prefer higher dividends over retained earnings.

Legal and Regulatory Requirements:

Certain legal authorities may impose restrictions on how much profit can be retained.

Advantages of Retained Earnings Policies:

Self-Financing:

Retained earnings provide an internal source of funding, reducing reliance on external debt or equity.

Flexibility:

Allows the company to allocate funds based on immediate needs without external approval.

Cost-Effective:

Avoids the costs associated with raising external capital, such as interest payments or underwriting fees.

Strengthens Financial Position:

Enhances the company's reserves, improving its ability to weather financial crises.