+Dividend Decision

The Dividend Decision is one of the crucial decisions made by the finance manager relating to the payouts to the shareholders. The payout is the proportion of Earning per Share given to the shareholders in the form of dividends.

The companies can pay either dividend to the shareholders or retain the earnings within the firm. The amount to be disbursed depends on the preference of the shareholders and the investment opportunities prevailing within the firm.

The optimal dividend decision is when the wealth of shareholders increases with the increase in the value of shares of the company. Therefore, the finance department must consider all the decisions viz. Investment, Financing and Dividend while computing the payouts.

If attractive investment opportunities exist within the firm, then the shareholders must be convinced to forego their share of dividend and reinvest in the firm for better future returns. At the same time, the management must ensure that the value of the stock does not get adversely affected due to less or no dividends paid out to the shareholders.

The objective of the financial management is the Maximization of Shareholder's Wealth. Therefore, the finance manager must ensure a win-win situation for both the shareholders and the company.

Factors affecting Dividend Decisions of Firms

There are many factors affecting the decisions relating to dividends to be declared to shareholders.

These are discussed below:

i. Expectation of Investors:

People who invest in the firms have basically done so, with the view of long-term investment in a particular firm to avoid the necessity of shifting from one firm to another. The expectation of the investor has been two fold. They expect to receive income annually and have a stable investment.

Capital Gains:

All investors who are less interested in speculation and more interested in long-term investment do so with a view to making some capital appreciation on their investment. Capital gain is the profit, which results from the sale of any capital investment. If the investor invests in equity stock, the capital gain would be out of the sale of equity stock after holding it for a reasonable period of time.

Current Income:

The investor would like to have some current earnings which are also continuous in nature and it is the price of abstinence from current consumption to more profitable avenues.

The expectation of the shareholder should be considered before taking any appropriate decision regarding dividends. In this sense, the company has to think of both maximization of wealth of the investor as well as its own internal requirements for long-term financing.

ii. Reducing of Uncertainty:

Dividends should be declared in a manner that the investor is confident about the future of his earnings. If he receives dividends annually and the amount is such that it satisfies him then the company is able to gain his confidence because it reduces his uncertainty about future capital gains or appreciation of the company's equity stock.

A current dividend is the present value cash in-flow to the investors. This also helps him to assess the kind of future that his investments will carry for him. The decisions for paying dividend should also considered this point.

iii. Financial Strength:

The payment of dividend which is regular, stable and continuous with a promise of capital appreciation, helps the company in judging its own financial strength and also it receives financial commitments from creditors and financial institutions because they are in a position to gauge the kind of working of the firm through the information they receive regarding the amount of dividend and the market value of their shares.

While all investors would like to maximize their wealth, the company must also see its requirement for expansion programs. The company also has certain limitations or environmental constraints which enable it to pay dividend in a limited form.

Retained Earnings

Retained earnings (RE) is the amount of net income left over for the business after it has paid out dividends to its shareholders. A business generates earnings that can be positive (profits) or negative (losses).

Positive profits give a lot of room to the business owner(s) or the company management to utilize the surplus money earned. Often this profit is paid out to shareholders, but it can also be re-invested back into the company for growth purposes. The money not paid to shareholders counts as retained earnings.

Using Retained Earnings

The following options broadly cover all possibilities on how the surplus money can be utilized:

- The income money can be distributed (fully or partially) among the business owners (shareholders) in the form of dividends.
- It can be invested to expand the existing business operations, like increasing the production capacity of the existing products or hiring more sales representatives.
- It can be invested to launch a new product/variant, like a refrigerator maker foraying into producing air conditioners, or a chocolate cookie manufacturer launching orange- or pineapple-flavored variants.
- The money can be utilized for any possible merger, acquisition, or partnership that leads to improved business prospects.

- It can also be used for share buybacks.
- The earnings can be used to repay any outstanding loan (debt) the business may have.

The first option leads to the earnings money going out of the books and accounts of the business forever because dividend payments are irreversible. However, all the other options retain the earnings money for use within the business, and such investments and funding activities constitute the retained earnings (RE).

By definition, retained earnings are the cumulative net earnings or profits of a company after accounting for dividend payments. It is also called earnings surplus and represents the reserve money, which is available to the company management for reinvesting back into the business. When expressed as a percentage of total earnings, it is also called retention ratio and is equal to (1 - dividend payout ratio).

While the last option of debt repayment also leads to the money going out, it still has an impact on the business accounts, like saving future interest payments, which qualifies it for inclusion in retained earnings.

Retained Earnings vs. Dividend Decision

Which one do you choose? A company that declares dividend or a company that retains the profit???

This is always a tricky question & there are always different views on this topic.

The general perception people have is that by not paying dividends or not increasing the dividend policy the company is doing no good for the investors. This may or may not be true.

The good side about retaining the money is that the company may be investing the money in a fruitful project which may give you better returns a little later. The company may have intentions of launching a new product/service or building a new plant or probably is going in for expansion.

And the bad side?

There a few cases when a company does not benefit from the retained earnings. When does that happen?

- When the management piles up cash far beyond its present or short term needs.
- The next is when the management has been getting a sub standard return on its capital and uses the retained earnings to enlarge the effect.
- Also, when there has been a fraud in the accounting method followed, the retained earnings prove to be of no benefit.
- In some cases the retained earnings may be needed but they are of no use to the investor. In cases where the retained earnings is a necessity but in no way increases the operational efficiency. For example: A large retail mall investing in a central air conditioning system. It requires a large investment but it does result largely in an increase in sales.

Hence, the only way you can take a call on whether dividends are better or retained earnings is by checking the difference in the benefit of both. This analysis & decision is very company specific.

Now, how will you figure out the difference in the benefit of both?

A company retaining its earnings can be checked by looking at its **ROE & ROIC.** If the return gained on the retained earnings is higher than the dividend it would have declared you are obviously at a benefit. When the company declares dividend how do you check your benefit? Find out if the company has any growth & expansion plans. If not, then why? If yes then probably the company did not need more of the retained earnings to implement the growth plans. Check what kind of plans are those and why the company did not need more of the retained earnings to implement the growth plans. Whether it is due to the nature of the industry or is it because of the size of the company.

Hence, don't jump to conclusions regarding a company's dividend policies. Study the company properly, its objectives & its plans.