CHAPTER III

ENTREPRENEURIAL DECISIONS ON THE DIVIDENDS, RETAINED EARNINGS
AND EXTERNAL FINANCE

OBJECT OF THE FINANCIAL PLANNING & MANAGEMENT:

The twin objectives of financial planning and management in a scientific manner are (a) the minimisation of the cost and (b) avoidance of risk. In other words, the rational means of financial control must ensure maximum of returns and at the same time necessary and sufficient level of liquidity for the day to day transactions of the firm. Hence the managerial decisions on the composition of claims involve consideration of two major elements of cost and risk to the firm - which, of course, have related implications of returns and risk for the providers of finance¹. A successful management, particularly in the modern corporate sector has to balance the competing interests of the participants in the concern, the equity holders and the creditors; short-term interest of profit maximisation has to be merged with the long term goal of the growth and expansion, which emerged as the premier aim of the present-day corporate sector, wherein the principal decision makers are neither the capital owners, nor the profit receivers. The diverse interests of the different sections of the corporate sector, naturally involve a simultaneous and synchronised approach.

As Myers and Pogue observe, "the theory of financial management now includes detailed considerations of investment and financing decisions, of dividend policy and most other aspects of corporate finance. But there is a clear tendency to 'isolate' these decisions in order to analyse them. ....Financial management really requires simultaneous considerations of the investment, financing and dividend options facing the firm". Hence, in this chapter, an attempt is made to give a theoretical background to the study of financial management with special reference to the inter-relationships among the variables of retained earnings, dividend payments and the external finance.

**DISPOSITION OF EARNINGS**

The current earnings of any concern with a corporate character have to be apportioned among the principal claimants of equity holders as dividends, and the firm itself as the retentions. This appropriation is done only after meeting the regular claims of tax payment, interest and service charges to the creditors, depreciation reserves to cover the wear and tear and other reserves to meet the incidental contingencies other than the expansion programs of the firm. For the investor, that is, the equity owner, the dividend payment as well as retention of earnings are to his own interests. After all, the

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equity owner does own the firm, to the extent he holds the equity. If he is paid cash dividend out of current earnings, he is immediately benefited; if the dividend is curtailed in favour of retentions, he is sure to reap the ultimate benefits in the form of increased dividends in future and also the capital gains. Thus it is only a conflict between the short term interests and the long term interests of the stockholders that complicates the problem of earnings distribution.

On the part of the company, the question whether to retain or to dispose is not so simple. It has to take into consideration, in addition to the preference of the shareholder, so many other constraints such as growth opportunities and demands of the firm, conditions of the market structure and its own position in the industrial structure, tax rates facing the firm and its shareholders, expectations about the firm's viability in the eyes of the potential investors, responsiveness or otherwise of the capital market and other exogeneous factors that may dislocate its plans from time to time.

With due weight to the above considerations, nonetheless, the finale may be performed by the conventions and practices pertaining to the firm and the industry, especially in the developing countries like India. Practices of cash management in different countries vary considerably, and in certain managerial environments, they have been systematised to a degree close to being a well-developed science. In the
Indian context, however, the traditional rules of thumb and broad generalisations still govern the management of controlling the levels of cash\(^1\). Once the financial decisions are arrived, they become a routine business for a pretty long time and hence the evolution of some norms and conventions in the financial management.

**DIVIDEND BEHAVIOUR IN RELATION TO RETENTIONS**:  

The firms, in actual practice, follow any of the following policies of dividend payment, depending upon the realities facing the firms: regular dividend (a) irrespective of current earnings (b) proportionate to current earnings (c) at minimum rate (d) payable in stock (e) payable partly in stock and partly in cash and (f) very small, erratic or no dividend at all\(^2\).

The explanation of the dividend pay-out ratios of the firm is just the corollary of the explanation of the retention of earnings. What is withheld within the firm implies that the residual is available for the distribution outside; or, in some circumstances, the latter may have to be determined as a priority and leave the former to be the remainder. The inter-relationship between these two variables which comprise the net earnings of the firm, is intertwined closely. Hence, it can be said that the analysis (of why corporations pay

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dividends) is based on the law of mirror images which states that every theory is geometrically symmetrical to some other theory. The theory of optimal retention of earnings is the mirror image of the theory of optimal financial leverage. As a consequence, corporations pay dividends for basically the same reason that they have owners. The essential aspects of dividend payment in relation to the retained earnings and other related aspects of investment and financing have been theorised by several economists as detailed below.

MODIGLIANI & MILLER AND GORDON

The basic assumptions of some of these studies are (a) the existence of a perfect capital market and (b) the firm pursuing a constant growth rate over the period. That is, each of the theory "critically requires the firm to follow constant exponential growth in dividends or earnings, so that corporation managers are not fully free at all times to determine values for these economic variables consistent with optimising current shareholder value". These theories analyse

the optimal investment and financing behaviour under various specifications of the available sources of capital and the degree of uncertainty by which the future is known.

But these two sets of views about the dividend behaviour and its effects on the pattern of investment and financing of the firm lead to different conclusions. One view which is led by Modigliani and Miller, holds that the dividend behaviour is 'irrelevant' to the actual investment decision because of the availability of debt and equity sources of finance in lieu of reinvestment funds. The other view, led by N.J. Gordon and others, asserts that the dividends payments do matter because there is a trade-off relationship between dividends and reinvestment of earnings; and the dividend policy depends upon the rate of return from the new reinvestment which at least must cover the cash dividends to the shareholders. Thus the continuing controversy over the relevance or irrelevance of the dividend decision arises from the two different and somewhat incompatible approaches to the decision making problem. Those who argue for the relevance of dividend policy generally regard the payment of dividends as an alternative to the reinvestment of earnings within the firm; while those who argue for the irrelevance of dividend policy point out that the investment decision need not be controlled by the firm's dividend policy, but may be financed equally well through the issuance of new debt and equity.\(^\text{1}\).

However, in a broad sense, both these approaches, under some constraints, may be considered to approve of the irrelevancy of dividend policy in a perfect financial market. Modigliani - Miller's irrelevance is feasible only if the debt and equity funds are easily available proportionate to the dividends paid out. And the Gordon's hypothesis of 'relevance' becomes also one of 'irrelevance', if the returns from reinvestment are only just sufficient (and nothing more of a net return) to nullify the benefits that accrue from immediate cash dividends. As Mark Rubinstein¹ observes, "in the first approach adopted by Miller and Modigliani, the assets of the firm are held constant and compensating equity financing is used to replace dividends (substitute financing).

In the second approach, (neutral reinvestment), adopted by Gordon, assets are permitted to vary with changes in dividends in such a way that the change in investment is not desired for itself. ......... However, while the former approach explicitly incorporates uncertainty, the second, presumably because of the difficulty of valuing an uncertain income stream has not been so generalised".

Modigliani visualised a sort of "Ratchet function" to exist in the relationship of corporate savings to profits, just like Duesenberry's hypothesis regarding the relationship

of personal consumption to income. He holds the view that the ratio of savings to income is linearly related to the ratio of current income and the highest income of any preceding year, instead of expressing that savings are a direct function of income and perhaps some other variable. But John Lintner has reservations against the Modigliani's application of ratchet hypothesis to the explanation of corporate savings. He rules out any major downward shift or break in the profits function as required by the ratchet theory at the point during the upswing when output reaches its previous peak and capacity is expanded; and he implies substantially higher marginal profit ratios during the expansion phase of the cycle than does the ratchet theory.

Dobrovolski explained that corporate dividends depend upon current and lagged profits after taxes and either net-worth or surplus as shown on the book at the beginning of the then-current year. The requirement of retentions was not considered as a major factor of decision on dividends. Rather, dividend

was considered only as a function of net profits, current and lagged, and net worth. Using the current and laggard profits and net surplus, all undeflated, Modigliani arrived at a multiple correlation of 0.98 with dividend payments of all American Corporations in the years 1921-40; there was also quite a high partial correlation for all the variables. Whereas Dobrovolski correlating retained earnings as a percentage of net worth with current profits as a percentage of net worth for all manufacturing companies, 1924-43, obtained a correlation coefficient of as high as 0.97. But Lintner questions the significance of any correlation involving either net surplus or book value of the net worth.

JOHN LINTNER

Lintner believes that there is a tendency for the dividend behaviour to follow a stable or sticky path.


For him, the rate of dividends the company has been paying always plays a major role and provides the central 'bench-mark' for the problem in management's eyes. "If for instance a company has been paying dividends at the rate of two dollars a share, the question that comes up first - and usually continues to be dominant issue - is "Is there any sufficient reason to change it and if so by how much", not "How much should we pay this quarter (or this year)?", considered do nova. Hence he concludes that the current dividend distributions are primarily determined by last year's dividends and current profits. The net-effect of these factors, in so far as not systematically reflected by current profits and lagged dividends is small and random. So, he concludes that the dividends and hence savings in the entire corporate sector follow, approximately, a stable linear regression on current profits and the previous year's dividend payments.

As to the relationship between retained earnings and dividends, Lintner is very clear that the latter represent 'primary and active decision variable', while the former are largely a 'by-product' or 'residual', of dividend payment. The firm will have its own target of pay-out ratio; till it reaches the target, the firm will be adjusting its actual dividend ratios towards its desired goal. Once it reaches the target, the firm will have a stable dividend policy.

The important factors which influence the choice of desired or targeted pay-out ratio are best catalogued by Lintner himself as follows: "The growth prospects of the industry and more importantly, the growth and earnings prospects of the particular company, the average cyclical movement of investment opportunities, working capital requirements, and internal funds flows, judged by past experience; the relative importance attached by management to longer term capital gains as compared with current dividend income for its stockholders, and management's view of its stockholders' preference between reasonably stable or fluctuating dividend rates and its judgement of the size and importance of any premium the market might
put on stability or stable growth in the dividend rate as such; the normal pay-outs and speeds of adjustment of competitive companies of those whose securities were close substitutes investmentwise; the financial strength of the company, its access to the capital market on favourable term, and company policies with respect to the use of outside debt and new equity issues; and management's confidence in the soundness of earnings figures as reported by its accounting department, and its confidence in its budgets and projections of future sales, profits and so on\(^1\).

The firm will be very reluctant either to reduce or to raise this target payment chosen in the light of above considerations, unless it is feasible to maintain and stabilise any proposed variation. Dobrovolskij also held this view that since the corporations are as a rule reluctant to change their dividend policy, the preceding periods' dividend payments may be taken as a rough measure of current requirements of

dividend. Hence, he added lagged dividends to the explanatory income variable to allow for relatively stable dividend requirements.

Similarly, Modigliani and Miller arrived at the same result of fairly a stable dividend relationship, by regarding dividends as a function of expected profits rather than current profits which are characterised by disturbances and temporary distortions. The only difference in their study is that expectations are adapted in response to current changes in profits, while Lintner recognises implicitly the transitory nature of current profits and allows for adjustment of desired dividends based on current profits.

While the Lintner's model considers current profits, it is as well reasonable to argue that the management tries to pay a fixed fraction of the long-run profits (instead of current profits), which is analogous to Friedman's concept of permanent income in consumption theory. This could be introduced by Marlovian expectational model on profits in the context of partial adjustment on dividends and hence arises the problem of identification of adjustment and expectation coefficients. Feldstein\(^1\) on the other hand, introduced the rate of growth of profits in addition to current profits, in order to approximate the permanent income, a fraction of which is to be paid as dividends.

In an attempt of rigorous analysis, Brittain and Kuh have adopted the cash-flow approach. They have branded net earnings as a misleading concept of measure of income because the capital consumption allowances are varied due to changes in accounting procedures or for legal or fiscal rather than economic reasons. The profits will have a downward bias if the depreciation allowances or development rebate are accelerated or liberalised. Hence they have taken gross cash flow (net earnings plus depreciation) as a better basis for dividend determination, than that of net earnings which is a poor measure of the firm's ability to pay dividends. This cash flow approach has also been attempted in the present study.

Most of the above studies believe that there is a desired level of dividend pay-out, and that the retentions are adjusted towards that. This may be a reflection of financing pattern of the advanced economies with developed capital markets. But it would be reasonable to postulate for a developing economy with not so well-developed capital market that retained earnings may be linked by some behavioural relationship with interest rate, investment needs etc. A satisfactory relationship will indicate that there is a

a desired level of retained earnings and dividend policy is adjusted accordingly. Though H.S. Johri made an earnest attempt to establish the preceding postulation, his empirical evidence did not corroborate and hence he concludes that the study does not "lend any support to the hypothesis of retentions being the prime motivating force in determining the allocation of corporate profits. On the contrary, the results support the existing view regarding the residual character of retained earnings." And the various studies made by K. Krishnamurthy and M.U. Sastry also broadly provide the background evidence to prove the pivotal role of dividend decisions and residual nature of retained earnings.

DIVIDENDS AND EXTERNAL FINANCE:

The demand for external finance, in the form of debt and equity, depends upon the investment horizon of the firm and the availability of savings generated from within. The investment options warrant resort to external funds, if the rate of return from the proposed investment is higher

2. Rajendra Singh Johri, ibid p.53.
than the cost involved in raising the external funds. But the villain of the piece happens to be the dividend decision. If the dividend decisions allow for sufficient internal funds, then the necessity of the external funds does not arise. Hence the dividends determine the level of retained earnings which in turn, depending upon the developmental investment requirements of the firm, influence the size and composition of external finance, that is, how much of debt and how much of equity. As K. Krishnamurthy and V.J. Sastry observe: "Investment expenditure and external finance generally do not influence dividend policies and where such influence is observed in some industries, its impact is weak. Thus dividend decisions are largely autonomous of investment and external financing decisions and therefore retained earnings are residual in character....Given profits, dividends through retained earnings determine investment expenditure and external financing."

Higher dividends may imply larger demand for external finance only if the firm has higher investment target in relation to its own internal funds. In the case of firms which are not growing or have no growth prospects, the need for external finance, of course, becomes irrelevant, given the profit level. And the availability of external finance, in turn, facilitates the firm to 'bolster' dividends in line with

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its targetted pay-out ratios, in times of low profits and expansionary investment programs.

The firm size and its anxiety to avoid the external control as far as possible, have a bearing on its dividend policy and the consequent recourse to external finance. Normally, the small firm, with not-so-much familiarity in the stock market, will lay its first priority on its own internal funds. So, the small firm will have lower dividend ratio than that of larger concerns which have ready access to the capital market. Companies emphasizing internal financing of their investment and expansion projects, either due to their desire not to impair the managerial manoeuvrability by incurring debts or to avoid dilution of control following an increase in the ordinary share capital, or because of the difficulty of access to the investment market, will choose lower target payment ratios (of dividend) than the other companies. We may expect small companies, in particular, to have lower target pay-out ratios. That is, widely differing target pay-out ratios can be justified in terms of the managerial attitude towards internal and external financing of investment, irrespective of the size of the company.

The principles governing the composition of external finance in relation to retained earnings that make up an optimal

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capital structure have been already discussed in detail in the previous chapter. The actual impact of dividends on the equity issues and credit mobilisation will give a clear picture about the linkage between the incoming and the outgoing flow of funds. Higher the dividend payment, higher may be the amount of funds that could be raised by way of equity capital and also debt and vice versa, under normal growth conditions of the firm. Two specific counts on which, the dividends' impact on external finance would be more direct and pronounced are (a) equity prices and (b) liquidity or the risk of illiquidity associated with debt.

SECURITY PRICES

The valuation of shares in practice may follow any of the following guidelines (a) the discounted cash-flow (b) the investment opportunities (c) the stream of dividends and (d) the stream of earnings. But, generally, the potential purchasers of the shares in the market, will go by the past dividend behaviour of the firm and their own expectation about the future dividend payments. They will be prepared to pay a higher price for the shares of a growing firm with better and stable dividend prospects than with higher retentions.

The market value of the security cannot be ignored by the management. The main object of the firm is to maximise the growth rate of total productive assets, subject to a security constraint. The security constraint is nothing but
the valuation ratio that is, the ratio of the market value of the firm to the book value of its equity. The valuation ratio, ultimately depends upon the various factors such as, retention ratio, leverage ratio, the rate of new issues of stock and the profitability of the assets.

In this context, Miller and Modigliani argue that given the investment policy of the firm and a perfect capital market and certainty conditions, the price of firm's shares is invariant with respect to the size of the dividend paid. "The dividend pay-out policy it chooses to follow will affect neither the current price of its shares, nor the total return to its shareholders". Myron Gordon, on the other hand, holds the opposite view. Even in perfect capital markets, the price of a share is bound to be dependent upon the dividend policy followed by the firm, mainly because of the existence of the uncertainty about the future. Hence Gordon states that especially, the more generous is the dividend policy, the higher will be the price of the share. The current prices in the market only indicate the management's earning power and firm's liquidity. The information regarding these aspects and the dividend payments are fully reflected in an efficient capital market. Announcements of changes in dividends would be immediately and unbiasedly reflected in the security's price.

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The allocative efficiency of capital markets depends on the extent to which capital asset prices fully reflect information that affects their value.

**DIFFERENTIAL TAX RATES**

The assumption of perfect capital market is not a reality even in the developed economies. The actual securities market suffer from several imperfections, the most important of which, from the point of view of dividend policy, are the existence of differential taxes on income from dividends and capital gains. Capital gains for individuals are taxed at lower rates and only when they are realised. As a result, the individual investors who are already in high brackets of tax, will prefer generally, returns in the form of capital gains rather than dividends. In sharp contrast to this, the firms may prefer dividend payments to capital gains because a major part of the former is usually exempted from tax.

For eg., in U.S.A. 85% of the corporate dividends are not subject to corporate income tax. In such a condition, the actual dividend decision will take the tax policy into consideration and decide on a course leading to minimum burden.

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on the whole. If the shareholder is indifferent between receiving capital gains and dividends, despite the tax differences, the market price of shares will depend on corporate earnings, irrespective of dividend policy.

But the differential tax rates on dividends and the capital gains on the one hand, and on the dividends and the interest paid on the debt, on the other, do affect the equity prices, to a large extent. The firms have tax relief on the interest amount paid on its debt. In this respect, there is a definite tax advantage of debt over equity and the retained earnings over dividends. So, even when the leverage is associated with risk, it must be considered as a blessing in disguise, from the tax point of view.

The determinants of equity risk also have its impact on the equity price and its transaction terms. The leverage of the firm, the size of operation and the past record of the firm's dividend behaviour are important among them. Firms with larger debt in their capital structure, will face higher risk of default and hence lower valuation of its equity. The equities of the larger firms are likely to fetch a higher price because of the low probability of bankruptcy, wide scope

for diversification and economies of scale and easy marketability of the securities.

The relationship between dividend payments and debt capital, can be discerned from the liquidity and profitability implications of the firm. Ability to pay higher dividends depend upon the liquidity and the profitability positions which in turn are at least partially influenced by the availability of external finance or debt in particular. The liquidity and the profitability, of course, are incompatible with each other. Growth of the firm will be constrained by its degree of liquidity. But the dividend payment, especially at stable and regular rates, involves the existence of comfortable liquid reserves with the firm; only then, the firm can honour its target pay-out ratio, even during fluctuations in current profits. It may be asked whether the firm cannot raise a short term debt to meet the dividend payments. Generally, this is not a financially sound practice. It is normal practice to borrow from the bank in order to pay part of a heavy tax bill, and bank finance for stock-building is perfectly acceptable, but companies are generally reluctant to borrow from their banks to pay dividends to their shareholders, and bankers are generally none-too happy to lend for this purpose. Again, companies make capital issues to finance

investment programs, but not to pay dividends or interest on earlier borrowings.

The profitability of the firm is subject to the availability of external finance when the internal funds are not sufficient. If the firm has a sound support of external sources of long term credit at reasonable rates of interest, given the prospects of investment with attractive marginal efficiency, then the dividend payment would be fairly higher. And the maintenance of higher dividend level will inspire the credit agencies to fund its prospective projects. Thus there is a kind of reinforcement or a sort of feed-back effect between debt and dividend. However, dividend is only one among the determinants of the investment and financial decision-making. The other variables of investment criteria are the interest rate, potentialities, and the expected rate of return, besides the degree of risk associated with the proposed project.

RE-INVESTMENT CONSIDERATIONS:

In the choice of the investment projects, the point to be considered is not only the immediate returns that are likely to be realised, but also the ultimate returns that are expected to accrue from re-investment of cash flow returns from the initial projects up to some common horizon.


while making a choice between alternative projects based on their relative rates of profitability, the projects with longer span of re-investment possibilities (or expansion prospects at least with the help of external finance) stands a better chance. As Ezra Solomon observes, "The valid comparison is not simply between two projects but between two alternative courses of action. The ultimate criterion is the total wealth that the investor can expect from each alternative by the terminal date of the longer-lived project. In order to make a fair comparison, an explicit and common assumption must be made regarding the rate at which funds released by either project can be re-invested up to a terminal date".

For the growth-oriented firms, for which funds are not a constraint, liberal and stable dividend policy is also not a problem. But, it must be noted that the impact of retained earnings on the equity value is very

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much limited. The value of the retained earnings as represented by a growing retained earnings account, may not be reflected in an equal growth in market price. However, market price does grow in relation to a high current or expected rate of dividends. To be more precise, the rates of dividend payments do have a substantial impact on the value of the firm and its pattern of investment and financing in the long run.