Chapter - 2

Conceptual Framework of Dividend

2.1 Introduction:

Dividend decision by any company is an important issue to be determined by the financial management. The dividend policy of firm determines what proportion of earnings is paid to shareholders by way of dividends and what proportion is ploughed back in the firm for reinvestment purpose that is retained earnings. Payment of dividend is desirable because the shareholders invest in the capital of the company with a view to earn higher return and to maximize their wealth. On the contrary, retained earnings are the sources of internal finance for financing future requirement and expansion programmes of the company. Thus, both growth and dividends are desirable. But they are in conflict; a higher dividend means less provision of funds for growth and higher retained earnings means low dividends which majority of shareholders dislike. As both decisions are complementary to each other and no decision can be taken independent of the other, the finance manager has to formulate a guidable dividend policy in such a way as to strike a comparison between dividend payment and retention.
2.2 **Meaning of Dividend:**

The word ‘dividend’ is derived from the Latin word ‘Dividendum’ which means ‘that which is to be divided’. This distribution is made out of the profits remained after deducting all expenses, providing for taxation, and transferring reasonable amount to reserve from the total income of the company.\(^{(1)}\)

The term dividend refers to that part of the profits of a company, which is to be distributed amongst its shareholders. It may, therefore, be defined as the return that shareholders get from the company, out of its profits, on his shareholdings. According to the Institute of Chartered Accountants of India, dividend is, ‘a distribution to shareholders out of profits or reserves available for this purpose.’\(^{(2)}\) A company cannot declare dividend unless there is:

- Sufficient profits
- Board of Directors recommendation
- An acceptance of the shareholders in the annual general meeting.

Thus, the Board of Directors keeping in view the financial requirements of the company and the quantum of reasonable return to shareholders decides how much dividend should be distributed. It is declared in annual general meeting of the company and after approval it is known as ‘declared dividend’.
2.3 **Types of Dividends:**

Dividends can be classified into different categories depending upon the form in which they are paid. The various forms of dividend are as under:

1) **Cash Dividend**

2) **Stock Dividend or Bonus Issue**

3) **Bond Dividend**

4) **Scrip Dividend or Promissory Note**

5) **Property Dividend**

1) **Cash Dividend:** The usual practice is to pay dividends in cash. Payment of dividend in cash results in outflow of funds from the firm. The firm should, therefore, have adequate cash resources at its disposal or provide for such resources so that its liquidity position is not adversely affected on account of distribution of dividends in cash. Generally, shareholders are interested in cash dividend and according to sec. 205(3) of the Companies Act also dividend is payable in cash only.

2) **Stock Dividend:** Stock dividend is next to cash dividend in respect of its popularity. Payment stock dividend is popularly termed as "issue of bonus shares" in India. Issue of bonus shares results in conversion of company's profit into share capital. Bonus shares are therefore, shares allotted by capitalization of reserves or surplus of a corporate enterprise.

(3)
Such shares are issued to the equity shareholders in proportion to their holdings of the equity share capital of the company. When the company pays stock dividend, there is no change in the company’s assets or liabilities or in total market value of the company’s shares. A shareholder does not gain or lose as a result of the new shares, because he retains the same old proportion of total share capital.

However, in India issue of stock dividend is not permitted. Dividend has to be paid in cash. According to SEBI’s guidelines on issue of bonus shares, bonus shares cannot be issued in lieu of can issue bonus shares frequently in addition to cash dividend. (Infosys, Wipro, RIL, etc.)

3) **Scrip Dividend**: It is the dividend given in the form of promissory notes to pay the amount at a specific future date. The promissory note is known as scrip or dividend certificates. When a company is a regular dividend paying company but temporarily its cash position is affected due to locking up of funds, which is likely to be released shortly, this opinion is preferred. Scrip may or may not be interest bearing.

4) **Bond Dividend**: In case the company does not have sufficient funds to pay dividend in cash it may issue bonds for the amount due to the shareholders by way of dividends. It has longer maturity date than Scrip dividend. It always carries interest. Thus, bondholders get regular interest on their bonds besides payment of bond money on the due date. But this practice is not seen in India nor legally allowed.
5) **Property Dividend:** In case of such dividend the company pays dividend in the form of assets other than cash. This may be in form of company’s products. This type of dividend is not popular in India.

### 2.4 Dividend Policy - Meaning:

The term 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 payments, which has a bearing on future action.

As per Weston and Brigham, "Dividend policy determines the division of earnings between payments to shareholders and retained earnings." (4)

Gitman, "The firm’s dividend policy represents a plan of action to be followed whenever the dividend decision must be made." (5)

Dividend policy decision has a significant effect on the credit standings of the firm, its shares prices and its future growth. Dividend policy refers to determining how much earnings are to be distributed and how much earnings is to be retained in the firm. There is a reciprocal relationship between dividend and retained earnings. On the one hand, dividend results cash outflow and consequently reduction in current assets. Larger dividends result in less retained earnings, which are necessary for financing growth and modernization of firm, which may in
turn hamper growth rate in earnings and share price. On the other hand, retention of larger earnings and fewer amounts of funds for dividend payments, which shareholders may re-act strongly causing reduction in, share prices.

While formulating dividend policy, the management will obviously take into account the effect of the decision on the maximization of shareholders’ wealth. In case payment of dividend helps the management in achieving this objective, it would be advisable to pay dividend. In case payment of dividend does not help in achieving this objective, the management would be advised to retain the profits and use them for financing investment programmes. Thus, the dividend decision is largely based on its impact on the value of the firm. However, there are certain schools of thought who give conflicting opinions to this effect. According to MM hypothesis (Miller-Modigliani) that supports that dividends are of irrelevance and has no effect on the valuation of the firm. Contrary to this hypothesis, Walter and Gordon support and suggest that investment policy and dividend policy are interlinked and affects the price of the shares of a firm. Hence, dividend is relevant.
2.5 **Factors affecting Dividend Policy:**

It is a generally accepted principle that the directors of a company have sole right to declare dividend and determine its amount out of company’s earnings. But, in addition to legal restrictions, they have to consider following factors while deciding the dividend policy:

1) **Preference of Shareholders:** The preference of shareholders may influence the dividend policy of the firm. Dividend income provides investors a regular income and builds confidence amongst the investors of the company. However, there are certain shareholders, especially from high tax brackets, like to get the benefit of capital gains in the form of appreciation in the value of share. In such a case, the policy should try to satisfy the dominating group of shareholders.

2) **Current Year’s Earnings:** Earnings of a company fix the upper limit of dividends. A company has to determine the amount of dividend keeping in view the actual earnings of the current year only. Of course, the whole of earnings is not to be distributed by the company, but it is the base of dividend policy.

3) **Past Dividends:** Shareholders do expect that the company would pay not less than dividend pain in the past. Of course, if conditions change, departure has to be made from the past trend of dividends. But
generally directors are hesitant to reduce the previous year’s dividend rate, and if needed, they would maintain the rate by withdrawing from accumulated profits.

4) **Management Control Motive:** The existing shareholders or management’s control motive also influences the dividend policy of a company. If the management wants that the existing shareholders should continue to retain control over the company it would not be wise to raise finance through issues of new shares, for that control is diluted into the hands of new shareholders. Therefore, the firm may rely more on retained earnings. It is likely to have a lesser dividend payout policy.

5) **Liquidity Position:** Dividends entail cash payments. Hence, the liquidity position of the firm has a bearing on its dividend decisions. A firm may have earned handsome profits, but may not have enough cash to pay dividend. This is typically the case of new establishments or highly profitable but rapidly expanding firms, which, thanks to their substantial investment and other commitments do not have adequate liquidity.

6) **Future Financial Requirements:** A company should consider its financial requirements for expansion programmes or increased needs of working capital before taking a dividend decision. Generally, firms, which have substantial investment proposals and consequently...
considerable funding needs, should retain maximum of its earnings and minimum dividend payout ratio.

7) **Access to Capital Market**: If a firm has an easy access to capital market (it can raise fund, whenever it is required, at minimum cost), it can afford to adopt liberal dividend policy. If the firm does not have easy access to capital market, it cannot raise funds externally easily and so it will have to depend more on retained earnings for funds required for its expansion programmes. This consideration also affects the dividend policy of the companies.

8) **Contractual Restrictions**: Sometimes a firm’s dividend policy is restricted by certain specific conditions in loan agreements. When the finance is raised from external sources, creditors may impose various restrictions to exempt themselves from possible insolvency of the firm. The creditors may withdraw their money from the firm if these requirements are violated.

9) **Taxation Policy**: The corporate taxes affect the rate of dividend of the company. High rate of taxation reduces the residual profits available for distribution to shareholders and consequently the rate of dividend is lowered down. Further, in some circumstances, government levies additional dividend tax on distribution of profits beyond a certain limit.
10) **Inflation**: Inflation may also affect the dividend policy of a company. With rising pricing, funds generated by depreciation may fall short in order to replace obsolete equipments. The firms have therefore to rely on retained earnings for this purpose and have to retain greater part of earnings for replacement. As such, the dividend payment ratio tends to be low during the inflation period.

11) **Stability of Earnings**: The stability of earnings has a significant impact on formation of dividend policy. A firm having a stable income over a long period of time will be more liberal in its dividend policy, usually; firms dealing in necessities suffer less from fluctuating income and can adopt stable dividend policy. A firm having fluctuating earnings for example firms dealing in luxurious product would have to be very careful in determining its dividend policy, as it would not be able to adopt a stable dividend policy.

12) **Legal Restrictions**: The Company may have to legally pay all arrear and current interest on loans/debentures, all arrear and current dividend to preference shareholders and charge depreciation on depreciable assets before payment of dividend.
Table No. 2.1 LEGAL FRAMEWORK OF DIVIDEND (6)

<table>
<thead>
<tr>
<th>Section</th>
<th>Legal Requirements</th>
</tr>
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<tbody>
<tr>
<td>205(1) &amp; (2)</td>
<td>A company can pay dividend out of current profit and profit earned in any earlier financial years after charging depreciation as per the requirement of the Companies Act. Depreciation is provided as the rates given in Schedule XIV to the Companies Act. This Schedule gives minimum depreciation rate. But a company can charge higher depreciation. For this purpose it has to charge at least 95% of the original cost of the asset over its useful life.</td>
</tr>
<tr>
<td>205(2A)</td>
<td>As per the Companies (Transfer of Profits to Reserves) Rules, 1975 a company has to transfer the following % of current profits.</td>
</tr>
<tr>
<td>Compulsory transfer to Reserve before payment of dividend</td>
<td>( (a) \text{ Dividend proposed exceeds 10% but not 12.5% of the paid up capital} \quad 2.5% )</td>
</tr>
<tr>
<td></td>
<td>( (b) \text{ Dividend proposed exceeds 12.5% but not 15% of the paid up capital} \quad 5.0% )</td>
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<tr>
<td></td>
<td>( (c) \text{ Dividend proposed exceeds 15% but not 20% of the paid up capital} )</td>
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Can a company transfer higher % to reserves?

Voluntary transfer of higher % of profit to reserves is allowed, when the company declared dividend:

(i) It has to maintain average rate of dividend declared by it over the last three years.

(ii) In case bonus shares are issued and its paid up capital has been increased, a company has to maintain average amount of dividend declared over the last three years.

However, in case the net profit after tax of the company is lower by 20% or more in a year as compared to the average net profits after tax of the two preceding financial years, it is not required to maintain average rate or amount of dividend as stated above. If the company does not declare dividend, then amount proposed to be transferred from reserves should be
<table>
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<th>Section</th>
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<tr>
<td>205(2B)</td>
<td>Compliance with the requirements of Section 80A. Dividend on equity shares cannot be paid unless the company redeems irredeemable preference shares. Presently, it is not permissible to issue irredeemable preference shares.</td>
</tr>
<tr>
<td>205(3)</td>
<td>Dividends should be paid in cash only. However, a company can capitalize profit by way of issue of bonus shares.</td>
</tr>
<tr>
<td>205A(1)</td>
<td>Dividend is declared by the shareholders in the annual general meeting on the basis of the dividend proposed by the Board of Directors. Dividend should be paid within 30* days from the date of declaration. In case a company cannot pay such dividend, it is to be transferred to a special account called Unpaid Dividend Account of Company Ltd/ (Pvt.) Ltd.</td>
</tr>
<tr>
<td>205(3)</td>
<td>In case company wants to pay dividend out of reserves because of inadequacy of profit in any year, it should</td>
</tr>
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follow the Companies (Declaration of Dividend out of Reserves) Rules, 1975. The guidelines are:

(i) *The rate of dividend cannot exceed the average rate of dividend declared in the immediately preceding five years, or 10% of the paid up capital, whichever is less.*

(ii) *Total amount to be drawn from accumulated profit earned in the previous years. The profits so drawn should be utilized first to set off any loss incurred during the financial year before payment of dividend.*

(iii) *The balance of reserves after such transfer shall not fall below 15% of its paid share capital*

Free reserves do not mean capital reserve & revaluation reserves.

205(5) Any money transferred to the Unpaid Dividend Account and remains unpaid or unclaimed for a period of seven years should be transferred to Investor Education and Protection Fund established under section 205C of the
<table>
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<th></th>
<th>Companies Act.</th>
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<tr>
<td>206</td>
<td>Dividend is to be paid to the registered shareholders or to their order or to their bankers.</td>
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<tr>
<td>207</td>
<td>Penalty for failure to distribute dividends within forty-two days where a dividend has been declared by a company but has not been paid, or the warrant in respect thereof, has not been posted, within forty-two days from the date of the declaration, to any shareholders entitled to the payment of the dividend, every director of the company shall, if he is knowingly a party to the default, be punishable with simple imprisonment for a term which may extend to seven days and shall also be liable to fine. Provided that no offence shall be deemed to have been committed within the meaning of the foregoing provision in the act. (7)</td>
</tr>
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*Substituted for 42 days by the Companies (Amendment) Act, 2000 w.e.f. 13-12-2000.*
2.6 Types of Dividend Policies:

The dividend policy should be determined by taking into consideration the above stated factors. A financial manager can recommend any one of the following dividend policies:

1) **Stable Dividend Policy**: Stability of dividend means similarity or no change in dividend payments over the years. In other words, when a company pays dividend at a fixed rate and follows it for future years to come regardless of fluctuations in the level of earnings, it is said to be a stable dividend policy. Thus, stability of dividends refers to regular payment of dividend at a fixed rate. Stable dividend policy increases credibility of the management in the market and shareholders also prefer such stock giving minimum return at regular interval leads to increase in market price of shares. Those companies whose earnings are stable follow this policy. The stability of dividend is described in two different ways viz. (a) constant/fixed dividend per share (b) constant payout ratio.

(a) **Constant amount per share**: In this policy, company pays fixed amount of dividend per share regularly every year irrespective about the earnings of the company. But it does not mean that management has static nature and will adopt the policy for years to come. If the company's levels of earnings are increased gradually
and same level is to be maintained in the future then the dividend per share is been increased respectively. This policy puts equity shares at par with preference shares which yields fixed dividend per share every year. The fact that equity shareholders bear the total risk of the business is forgotten here. Generally, this policy is preferred by those persons and institutions that depend upon the dividend income to meet their living and operating expenses.

(b) **Constant payout ratio:** In this policy, a fixed percentage of net earnings are paid as dividend every year, that is, constant payout ratio. For example, a company adopts a 60 per cent payout, that is, 60 per cent of net earnings of the company will be paid as dividend and 40 per cent of net earnings will be transferred to reserves. No dividend is paid in the year of loss. Companies generally, prefer this policy because it reflects the ability of the company to pay dividends. But it is not preferred by shareholders as the return fluctuates with the amount of earnings.

2) **Policy of No Immediate Dividend:** Generally, management follows a policy of paying no immediate dividend in the beginning of its life, as it requires funds for growth and expansion or they may be experiencing serious financial difficulties and may be unable to pay dividend. In this case, the firm can minimize adverse effects on the stock
price by carefully explaining the reason for the elimination of the dividend. After the, no dividend policy, it is advisable that the company should either issue bonus shares from its reserves or company's shares should be split into shares of small amount so that later on rate of dividend is maintained at a reasonable rate.

3) **Policy of Irregular Dividend:** When the firm does not payout fixed dividend regularly, it is irregular dividend policy. It changes from year to year according to change in earnings level. This policy is based on the management belief that dividends should be paid only when the earnings and liquid position of the firm warrant it. Firms having unstable earnings, particularly engaged in luxury goods, follow this policy.

4) **Policy of Regular Dividend plus Extra Dividend:** This policy would be appropriate for a firm with cyclical earnings and limited opportunities for growth. In a good earnings year, the firm would declare an extra dividend. The designation ‘extra’ is used in connection with the payment to tell the shareholders that this is extra and which might not be continued in future. When the earnings of the company have permanently increased, the extra dividend should be merged with regular normal dividend and thus, rate of normal dividend should be raised.

5) **Policy of Regular Dividend plus Stock Dividend:** In this policy company pays stock dividend in addition to the regular dividend. Thus,
the dividend is split into two parts. This policy is adopted when the company has earned handsome profit and wants to give shareholders a share in the additional profit but wants to retain cash for expansion. It is not advisable to follow this policy for a long time, as the number of shares increases and the earning per shares reduces, which led to decrease in share price.

2.7 Dividend Policy and Share prices:

Dividend decision is one of the three major decisions of financial management. The financial management has to choose between distribution of earnings and retention of earnings. The choice would depend on the effect of the decision on the shareholders wealth. That is, the payment of dividend should be preferred, if it leads to the maximization of shareholders’ wealth. If it is not so, the firm should retain the profit and should not distribute dividend. Financial experts have not been unanimous on this issue.

Since the principle objective of the firm is to maximize the share price, question arises, what is the relationship between dividend policy and market share price? This is one of the most controversial and unresolved questions, where the empirical evidence is often mixed. However, there are opinions regarding the impact of dividends on the
price of share or valuation of firm. One school of thought believes that dividend is irrelevant and does not affect the price of shares. The other school of thought believes that dividend is relevant and affects the prices of shares.

The following dividends models of both these schools of thoughts on the relationship between dividend policy and the price of shares have been discussed below:

1) **Traditional Position**: (8)

According to the traditional position expounded expressively by Graham Benjamin and David L. Dodd, the stock market places considerably more weight on dividends then on retained earnings. According to them:

*the stock market is overwhelmingly in favour of liberal dividends as against niggardly dividends.*

Their view is expressed quantitatively in the following valuation model advanced by them:

\[ P = m (D + E/3) \]

Where, \( P \) = market price of share

\( D \) = dividend per share
E = earnings per share

m = a multiplier

According to this model, in the valuation of shares the weight attached to dividends is equal to four times the weight attached to retained earnings. This is clear from the following version of above equation in which E is replaced by (D + R).

\[ P = m \left[ D + \frac{D+R}{3} \right] \]

The weights provided by Graham and Dodd are based on their subjective judgments not derived from objective, empirical analysis. Notwithstanding the subjectivity of these weights, the major contention of the traditional position is that a liberal payout policy has a favourable impact on stock price.

2) **Walter’s Model of Dividend Relevance:**

James E. Walter has presented a model in 1963, which explains the relevance of dividend for valuation of shares or maximization of wealth. The investment policy of a firm cannot be separated from its dividend policy and both are, according to Walter, interlinked. The choice of an appropriate dividend policy affects the value of an enterprise. The key argument in support of the relevance
The proposition of Walter’s model is the relationship between the return on firm’s investment or its internal risk of return \( (r) \) and its cost of capital or required rate \( (k) \). The firm would have an optimum dividend policy, which will be determined by the relationship of \( r \) and \( k \).

If the return on investments exceeds the cost of capital, the firm should retain the earnings. On the contrary, it should distribute the earnings to the shareholders if the required rate of return exceeds the expected return on the firm’s investment. If a firm has adequate profitable investment opportunities, it will be able to earn more than what the investors expect so that \( r > k \). Such firms are called “growth firms,” which should plough back the entire earnings within the firm. If a firm does not have profitable investment opportunities (where \( r < k \)) the entire earnings should be distributed as dividend. Finally, when \( r = k \) (normal firms), it is a matter of indifference whether earnings are retained or distributed.

Walter’s model is based on the following assumptions. (9)

1) The firm finances all investment through retained earnings; that is debt or new equity is not issued.

2) The firm’s rate of return \( (r) \) and cost of capital \( (k) \) are constant.

3) All earnings are either distributed as dividend or retained internally immediately.
4) There is no change in the earnings per share EPS and dividend per share DPS. They may be changed in the models to determine the results.

5) The firm has a very long or infinite life.

*Share Valuation Formula:* \(^{(10)}\)

Walter put forward the following share valuation formula:

\[
P = \frac{D}{k} + \left[ \frac{r (E-D)/k}{k} \right]
\]

Where, \(P\) = Price per share

\(D\) = Dividend per share

\(E\) = Earnings per share

\((E-D)\) = Retained earnings per share

\(r\) = Rate of return on investments

\(k\) = Cost of capital

The above formula suggests that the market value of share is the sum of

(i) the present value of all dividends \((D/k)\) and

(ii) the present value of all capital gains, which occur when earnings are retained in the firm. \([ r (E-D) / k ] / k \).
The above equation can also be written as:

\[ P = \frac{[D + (E - D) r / k]}{k}. \]

*Limitations:*

Though Walter’s Model of share valuation is quite useful in explaining the effects of dividend policy on value of shares under different circumstances and assumptions, it has the following limitations:

1. It assumes that the firm’s investments are financed exclusively by retained earnings and no external financing is used. It is an unrealistic assumption.

2. It assumes that \( r \) is constant. This is not a realistic assumption because when increased investments are made by the firm, \( r \) also changes. Thus, this model becomes incorporative.

3. It assumes that \( k \) is constant. By assuming \( k \) to be constant, it ignores the effect of risk on the value of firm.

3) **Gordon’s Model of Dividend Relevance:**

Gordon’s Model is based on relevance of dividend concept. According to Myron J. Gordon dividends are relevant and dividend policy affects the value of firm. It is based on the relationship of dividend policy and market value of shares.
The assumptions that he has made are almost the same as those by Walters. They are as follows: \(^{(II)}\)

1) The firm is an all equity firm. It means its capital consists of only equity shares. There is no debt capital.

2) The firm uses only retained earnings for financing its investment programmes. No external financing is used.

3) The internal rate of return of the firm \((r)\) is constant.

4) The cost of capital or the appropriate discount rate \((k)\) of the firm is constant.

5) The firm has perpetual life and its earnings are also perpetual.

6) There are no corporate taxes.

7) The retention ratio \((b)\), once decided upon is constant. \((\text{Retention ratio is the proportion of earnings retained in the business.})\) Thus, the growth rate \(g = br\) is constant.

8) \(k > br\). If this condition is not fulfilled we cannot get a meaningful value for the shares.

The crux of Gordon’s arguments is investors are risk averse and they put a premium on a certain return and discount/penalize
uncertain returns. As investors are rational, they want to avoid risk. The term risk refers to possibility of not getting a return on investment. The payment of current dividends *ipso facto* completely removes any chance of risk. If, however, the firm retains the earnings (that is current dividends are withheld), the investors can expect to get a dividend in future. The future dividend is uncertain, both with respect to the amount as well as the timing. The rational investors can reasonably be expected to prefer current dividend and discount future dividend, that is, they would place less importance on it as compared to current dividend. The investors evaluate the retained earnings as a risky promise. In case the earnings are retained, therefore, the market price of the shares would be adversely affected. \(^{12}\)

When the rate of return is greater than cost of capital \((r > k)\) the share prices increases of such growth firm, if dividend payout ratio decreases to zero. In normal firms, where the rate of return is equal to cost of capital \((r = k)\), the price per share remains unchanged with dividend payout ratio. Even in this situation, the model prefers more dividends and less retention for having higher value of firm and market price of share, whereas in declining firm the rate of return is lesser than the cost of capital \((r < k)\), the price per share increases as the dividend
payout ratio increases. Thus, the conclusions of this model are same as
drawn by Walter. Hence, it suffers the same limitations.

*Share Valuation Formula*: \(^{(13)}\)

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

Where, \(b = \text{Retention ratio}\)

\(r = \text{Rate of return on investment of an all equity firm.}\)

\(br = g = \text{Growth rate of earnings and dividends}\)

\(k = \text{Cost of capital / Rate of return expected by the shareholders}\)

\(P = \text{Price of share}\)

\(E = \text{Earnings per share}\)

\(1-b = \text{Dividend payout ratio}\)

*Gordon’s Model versus Walter’s Model*: \(^{(14)}\)

Gordon’s model contends that dividend policy of the firm is
relevant and the investors put a positive premium on current
incomes/dividends. He argues that dividend policy affects the value of
shares even in a situation in which the return on investment of a firm is
equal to the required/capitalization rate (i.e. \( r = k_e \)). Walter's model is of the view that the investors are indifferent between dividends and retention.

**Dividends and Uncertainty: The Bird in the Hand Argument.**

According to Gordon's model, dividend policy is irrelevant where \( r = k \), when all other assumptions are held valid, but when the simplifying assumptions are modified to conform more closely to reality. Gordon concludes that dividend policy does affect the value of a share even when \( r = k \). This view is based on the assumption that under conditions of uncertainty, investors tend to discount distant dividends (capital gains) at a higher rate than they discount near dividends. Investors, behaving rationally, are risk-averse and, therefore, have a preference for near dividends to future dividends. The logic underlying the dividend effect on the share value can be described as the bird-in-the-hand argument. The bird-in-the-hand argument was put forward, first of all, by Krishman in the following words:

"Of two stocks with identical earnings record, and prospects but the one paying a larger dividend that the other, the former will undoubtedly command a higher price merely because stockholders prefer present to future values. Myopic vision plays a part in the price-making process. Stockholders often act upon the principle that a bird in the hand
is worth two in the bush and for this reason are willing to pay a premium for the stock with the higher dividend rate, just as they discount the one with the lower rate."

Graham and Dodd also hold a similar view when they state:

"The typical investor would most certainly prefer to have his dividend today and let tomorrow take care of itself. No instances are on record in which the withholding of dividends for the sake of future profits has been hailed with such enthusiasm as to advance the price of the stock. The direct opposite has invariably been true. Given two companies in the same general position and with the same earning power, the one paying the larger dividend will always sell at a higher price."

Myron Gordon has expressed the bird-in-the-hand argument more convincingly and in formal terms. According to him uncertainty increases with futurity; that is, the further one looks into future, the more uncertain dividends become. Accordingly, when dividend policy is considered in the context of uncertainty, the appropriate discount rate, k, cannot be assumed to be constant. In fact, it increases with uncertainty and would be willing to pay higher price for the share that pays the greater current dividend, all other things held constant. In other words, the appropriate discount rate would increase with the retention rate. Thus,
distant dividends would be discounted at a higher rate than near dividends.

Incorporating uncertainty into his model, Gordon concludes that dividend policy affects the value of the share. His reformulation of the model justifies the behaviour of investors who value a rupee of dividend income more than a rupee of capital gains income. These investors prefer dividend above capital gains because dividends are easier to predict, are less uncertain and less risky, and are therefore, discounted with a lower discount rate.

4) **John Williams on Dividend Relevance:** (16)

John B. Williams expressed relevance of dividend in the form of some sage advice of an old farmer to his son:

A cow for her milk,

A hen for her eggs,

And a stock by heck,

For her dividends.
An orchard for fruit,

Bees for their honey,

And stocks, besides

For their dividends.

5) **Modigliani and Miller Hypothesis of Dividend Irrelevance:**

Franco Modigliani and Merton H. Miller advocate that, the dividend policy of a firm is irrelevant, as it does not affect the wealth of the shareholders. Thus, dividends are irrelevant i.e. the value of firm is independent of its dividend policy. It depends on the firm’s earnings, which result from its investment policy. When investment decision of a firm is given, the dividend decision is of no significance in determining the value of firm.

The MM hypothesis is based on the following assumptions: (17)

1. There exist perfect capital market and investors are rational.

   Information is available to all free of cost. There is no investor large enough to influence the market price of securities.

2. There is no transactional cost.

3. There is no floatation cost of raising new capital.
4. There exists no taxes or there is no difference in tax rates applicable to dividends and capital gains.

5. The investment policy of the firm is fixed and does not change. So the financing of investment programmes through retained earnings does not change the business risk and there is no change in required rate of return.

The matter of MM hypothesis may be stated as follows: If a company retains earnings instead of giving it out as dividends, shareholders enjoy capital appreciation equal to the amount of earnings retained. If it distributes earnings by way of dividends instead of retaining it, the shareholders enjoy dividends equal in value to the amount by which his capital would have appreciated had the company chosen to retain its earnings. Lastly, because of operation of arbitrage, the dividend decision would be irrelevant even under conditions of uncertainty. The market prices of the shares of two firms, with similar business risk prospective future earnings and investment policies would be the same, irrespective of their payout ratios. This is because of rational behaviour of shareholders. Hence, the division of earnings is irrelevant from the viewpoint of the shareholders.
However, certain thinker affects the validity of this hypothesis. According to them, the MM hypothesis is based on unrealistic assumptions. The approach is criticized on following grounds.

1. MM assumes that capital markets are perfect. This implies that there are no taxes, floatation costs do not exist and there is absence of transaction costs. These assumptions are not valid in actual conditions.

2. Apart from the market imperfection, the validity of the MM hypothesis, insofar as it argues that dividends are irrelevant, is questionable under conditions of uncertainty. MM hold, it would be recalled, that dividend policy is as irrelevant under conditions of uncertainty as it is when perfect certainty is assumed. The MM hypothesis is, however, not valid as investors cannot be indifferent between dividend and retained earnings under conditions of uncertainty. This can be seen in the fact that the investors prefer near and certain dividend more rather than distant and uncertain dividend or bonus stocks in future. Hence, they discount more the stock with distant dividend than the stock with near dividend. Moreover, majority of shareholders being small investors they prefer current income to meet their consumption requirements. Lastly, the payment of dividend conveys to the shareholders
information relating to the profitability of the firm. The significance of this aspect of current dividend payments is expressed by Ezra Solomon in these words:

“In an uncertain world in which verbal statements can be ignored or misinterpreted, dividend action does provide a clear-cut means of making a statement that speaks louder than a thousand words.”

Modigliani and Miller ignores this facts but powerfully expressed by Gordon. Investors prefer dividend to capital gains. So shares with higher current dividends, other things being equal, command higher price in the market.
Reference:


3. Ibid. p-D-443.


5. Ibid. p-494.


13. Chandra Prasanna, ibid, p-577.


17. Rana T. J., ibid, p-428.