Chapter 5
Dividend Policy
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5.0 DIVIDEND POLICY:

The term dividend refers to that part of profits of a company which is distributed by the company among its shareholders. It is the reward of the shareholders for investment made by them in the shares of the company. The investors are interested in earning the maximum return on their investments and to maximize their wealth. A company, on the other hand, needs to provide funds to finance its long-term growth. If a company pays out all of its profits as dividend, most of what it earns, then for business requirements and further expansion it will have to depend upon outside resources such as issue of debt or new shares.

Dividend policy of a firm, thus affects both the long-term financing and wealth of shareholders. As a result, the firm’s decision to pay dividends must be reached in such a manner so as to equitably apportion the distributed profits and retained earnings. Since dividend is a right of shareholders to participate in the profits and surplus of the company for their investment in the share capital of the company, they should receive a fair amount of the profits. The company should, therefore, distribute a reasonable amount of dividends (which should include a normal rate of interest plus a return for
the risks assumed) to its members and retain the rest for its growth and survival.

5.1 THEORIES OF DIVIDENDS; DIVIDEND DECISION AND VALUATION OF FIRMS:

The value of the firm can be maximized if the shareholders' wealth is maximized. There are conflicting views regarding the impact of dividend decision on the valuation of the firm. According to one school of thought, dividend decision does not affect the shareholders' wealth and hence the valuation of the firm. On the other hand, according to the other school of thought, dividend decision materially affects the shareholders' wealth and also the valuation of the firm. We have discussed below the views of the two schools of thought under two groups:

The Irrelevance Concept of Dividend or the Theory of Irrelevance, and
The Relevance Concept of Dividend or the Theory of Relevance.

5.1-1 THE IRRELEVANCE CONCEPT OF DIVIDEND OR THE THEORY OF IRRELEVANCE:

5.1-1-1 RESIDUAL APPROACH:

According to this theory, dividend decision has no effect on the wealth of the shareholders or the prices of the shares, and hence it is irrelevant so far as the valuation of the firm is concerned. This theory regards dividend decision merely as a part of financing decision because the earnings available may be retained in the business for re-investment. But, if the funds are not required in the business they may be distributed as dividends. Thus
the decision to pay dividends or retain the earnings may be taken as the residual decision. This theory assumes that investors do not differentiate between dividends and retentions by the firm. Their basic desire is to earn higher return on their investment. In case the firm has profitable investment opportunities giving a higher rate of return than the cost of retained earnings, the investors would be content with the firm retaining the earnings to finance the same. However, if the firm is not in a position to find profitable investment opportunities, the investors would prefer to receive the earnings in the form of dividends. Thus, a firm should retain the earnings if it has profitable investment opportunities otherwise it should pay them as dividends.

5.1-1-II MODIGLIANI AND MILLER APPROACH (MM MODEL)

Modigliani and Miller have expressed in the most comprehensive manner in support of the theory of irrelevance. They maintain that dividend policy has no effect on the market price of the shares and the value of the firm is determined by the earning capacity of the firm or its investment policy. The splitting of earnings between retentions and dividends, may be in any manner the firm likes, does not affect the value of the firm. As observed by M.M “Under conditions of perfect capital markets, rational investors, absence of tax discrimination between dividend income and capital appreciation, given the firm’s investment policy, its dividend policy may have no influence on the market price of the shares.”

Assumptions of MM Hypothesis
The MM hypothesis of irrelevance of dividends is based on the following assumptions:
- There are perfect capital markets.
- Investors behave rationally.
- Information about the company is available to all without any cost.
- There are no floatation and transaction costs.
- No investor is large enough to affect the market price of shares.
- There are either no taxes or there are no differences in the tax rates applicable to dividends and capital gains.
- The firm has a rigid investment policy.
- There is no risk or uncertainty in regard to the future of the firm. (MM dropped this assumption later).

5.1-1-II-1 The Argument of MM:

The argument given by MM in support of their hypotheses is that whatever increase in the value of the firm results from the payment of dividend, will be exactly off set by the decline in the market price of shares because of external financing and there will be no change in the total wealth of the shareholder. For example, if a company, having investment opportunities, distributes all its earnings among the shareholder’s it will have to raise additional funds from external sources. This will result in the increase in number of shares or payment of interest charges, resulting in fall in the earnings per share in the future. Thus whatever a shareholder gains on account of dividend payment is neutralized completely by the fall in the market price of shares due to decline in expected future earnings per share. To be more specific, the market price of a share in the beginning of a period is equal to the present value of dividends paid at the end of the period plus
the market price of the shares at the end of the period. This can be put in the form of the following formula:

\[ P_o = D_1 + P_1 \]
\[ \frac{1}{1 + K_e} \]

Where

\( P_o \) = Market price per share at the beginning of the period, or prevailing market price of a share

\( D_1 \) = Dividend to be received at the end of the period.

\( P_1 \) = Market price per share at the end of the period.

\( K_e \) = Cost of equity capital or rate of capitalisation.

The value of \( P_1 \) can be derived by the above equation as under:

\[ P_1 = P_o \left[ 1 + K_e \right] - D_1 \]

The MM hypothesis can be explained in another form also presuming that investment required by the firm on account of payment of dividends is financed out of the new issue of equity shares.

In such a case, the number of shares to be issued can be computed with the help of the following equation:

\[ M = \frac{1}{(E-nD_1)} \]
\[ P_1 \]

Further, the value of the firm can be ascertained with the help of the following formula:
nPo = (n+m)P1-(I-E) 
1 + ke

Where,
m = number of shares to be issued.
I = Investment required.
E = Total earnings of the firm during the period.
P1 = Market price per share at the end of the period.
ke = Cost of equity capital
n = number of shares outstanding at the beginning of the period.
D1 = Dividend to be paid at the end of the period.
nPo = Value of the firm

5.1-1-II-1*Criticism of MM Approach:

MM hypothesis has been criticized on account of various unrealistic assumptions as given below.

1) Prefect capital market does not exist in reality
2) information about the company is not available to all the persons.
3) The firms have to incur floatation costs while issuing securities.
4) Taxes do exit and there is normally different tax treatment for dividends and capital gains.
5) The firms do not follow a rigid investment policy.
6) The investors have to pay brokerage, fees, etc. while doing any transaction.
7) Shareholders may prefer current income as compared to further gains.
5.1-2 THE RELEVANCE CONCEPT OF DIVIDEND OR THE THEORY OF RELEVANCE:

The other school of thought on dividend decision holds that the dividend decisions considerably affect the value of the firm. The advocates of this school include Myron Gordon, Jone Linter, James Walter and Richardson. According to them dividends communicate information to the investors about the firms’ profitability and hence dividend decision becomes relevant. Those firms which pay higher dividends, will have greater value as compared to those which do not pay dividends or have a lower dividend pay out ratio. We have examined below two theories representing this notion: (i) Walter’s Approach, and (ii) Gordon’s Approach

5.1-2-I WALTER’S APPROACH:

Prof. Walter’s approach supports the doctrine that dividend decisions are relevant and affect the value of the firm. The relationship between the internal rate of return earned by the firm and its cost of capital is very significant in determining the dividend policy to subserve the ultimate goal of maximizing the wealth of the shareholders. Prog. Walter’s model is based on the relationship between the firm’s (i)return on investment, i.e. \( r \), and (ii) the cost of capital or the required rate of return, i.e. \( k \).

According to Prof. Walter, If \( r < k \) i.e., if the firm earns a higher rate of return on its investment than the required rate of return, the firm should retain the earnings. Such firms are termed as growth firm’s and the optimum
pay-out would be zero in their case. This would maximize the value of share.

In case of declining firms which do not have profitable investments, i.e., when \( r < k \), the shareholders would stand to gain if the firm distributes its earnings. For such firms, the optimum pay-out would be 100%.

In case of normal firms where \( r = k \), the dividend policy will not affect the market value of shares as the shareholders will get the same return from the firm as expected by them. For such firms, there is no optimum dividend pay-out and the value of the firm would not change with the change in dividend rate.

5.1-2-I-1 Assumption of Walter’s Model:
The investments of the firm are financed through retained earnings only and the firm does not use external sources of funds.
The internal rate of return \( \% \) and the cost of capital (\( k \)) of the firm are constant.
Earnings and dividends do not change while determining the value.
The firm has a very long life.

Walter’s Formula for Determining the value of a share
Prof. Walter has given the following formula to ascertain the market price of a share:

\[
P = \frac{D + r (E-D)}{Ke}
\]
or
\[
P = \frac{D}{Ke} + \frac{r(E-D)}{Ke}
\]

Where,
- \(P\) = market price per share
- \(D\) = dividend per share
- \(r\) = internal rate of return
- \(E\) = earnings per share
- \(Ke\) = cost of equity capital

### 5.1-2-I-2 Criticism of Walter’s Model:
Walter’s model has been criticized on account of various assumptions made by Prof. Water in formulating his hypotheses:

The basic assumption that investments are financed through retained earnings only is seldom true in real world. Firms do raise funds by external financing.

The internal rate of return, i.e., \(r\), also does not remain constant. As a matter of fact, with increased investment the rate of return also changes. The assumption that cost of capital (\(k\)) will remain constant also does not hold good. As a firm’s risk pattern does not remain constant, it is not proper to assume that \(k\) will always remain constant.

### 5.1-2-II GORDAN’S APPROACH:
Myron Gordon has also developed a model on the lines of Prof. Walter suggesting that dividends are relevant and the dividend decision of the firm affects its value.
5.1-2-II-1 Assumptions:

His basic valuation model is based on the following assumptions:

- The firm is an all equity firm.
- No external financing is available or used. Retained earnings represent the only source of financing investment programmes,
- The rate of return on the firm's investment \( r \), is constant.
- The retention ratio, \( b \), once decided upon is constant. Thus, the growth rate of the firm \( g = kr \), is also constant.
- The cost of capital for the firm remains constant and it is greater than the growth rate, i.e. \( k > kr \).
- Corporate taxed do not exist.

According to Gordon, the market value of a share is equal to the present value of future stream or dividends. Thus,

\[
P = \frac{D_1}{1+k} + \frac{D_2}{(1+k)^2} + \ldots + \frac{D_t}{(1+k)t} = \sum_{t=1}^{n} \frac{D_t}{(1+k)t}
\]

Gordon’s basis valuation formula can be simplified as under:

\[
P = \frac{E (1-b)}{ke - br}
\]
or, \[ P = \frac{D_0}{ke - g} \]

Where,
- \( P \) = Price
- \( E \) = Earnings per share
- \( b \) = Retention Ratio
- \( ke \) = Cost of equity capital
- \( br = g \) = growth rate in \( r \), i.e. rate of return on investment of an all-equity firm
- \( D \) = Dividend per share

**5.1-2-II-2 Implications:**

The implications of Gordon’s basic valuation model may be summarized as below:

When the rate of return of firm on its investment is greater than the required rate of return, i.e.; when \( r > k \), the price per share increases as the dividend payout ratio decreases. Thus, growth firm should distribute smaller dividends and should retain maximum earnings.

When the rate of return is equal to the required rate of return, i.e., when \( r = k \), the price per share remains unchanged and is not affected by dividend policy. Thus, for a normal firm there is no optimum dividend payout.

When the rate of return is less than the required rate of return, i.e., when \( r < k \), the price per share increases as the dividend payout ratio increases. Thus,
the shareholders of declining firm stand to gain if the firm distributes its earnings. For such firms, the optimum pay out would be 100%.

5.1-3 GORDON'S REVISED MODEL

The basic assumption in Gordon's Basic Valuation Model that cost of capital (k) remains constant for a firm is not true in practice. Thus, Gordon revised his basic model to consider risk and uncertainty. In the revised model, he suggested that even when \( r = k \), dividend policy affects the value of shares on account of uncertainty of future, shareholders discount future dividends at a higher rate than they discount near dividends. That is there is a two fold assumption, viz. (i) investors are risk averse, and (ii) they put a premium on a certain return and discount/penalize uncertain returns. Because the investors are rational and they want to avoid risk, they prefer near dividends than future dividends. This argument is described as bird-in-the hand argument, i.e., the value of a rupee of dividend income is more than the value of rupee of capital gain. In the words of Krishnan, John, E.” of two stocks with identical earnings, record, prospects, but the one paying a larger dividend than the other, the former will undoubtedly command a higher price merely because shareholders prefer present to future values. Myopic vision plays part in the price-making process. Stockholders often act on the principle that a bird in hand is worth than two in the bushes and for this reason are willing to pay a premium for the stock considered in the context of uncertainty, the cost of capital cannot be assumed to be constant and so firm should set a high dividend payout ratio and offer a high dividend yield in order to minimize its cost of capital.
5.2 FACTORS AFFECTING DIVIDEND DECISION:

The payment of dividend involves some legal as well as financial considerations. It is difficult to determine a general dividend policy which can be followed by different times because the dividend decision has to be taken considering the special circumstances of an individual case. The following are the important factors which determine the dividend policy of a firm:

1. Legal Restrictions: Legal provisions relating to dividends as laid down in sections 93, 205, 205A, 206 and 207 of the Companies Act, 1956 are significant because they down a framework within which dividend policy is formulated. These provisions require that dividend can be paid only out of current profits or past profits after providing for depreciation or out of the moneys provided by Government for the payment of dividends in pursuance of a guarantee given by the Government. The Companies (Transfer of Profits to Reserves) Rules, 1975 require a company providing more than ten per cent dividend to transfer certain percentage of the current year’s profits to reserves. Companies Act, further, provides that dividends cannot be paid out of capital, because it will amount to reduction of capital adversely affecting the security of its creditors.

2. Magnitude and Trend of Earnings: The amount and trend of earnings is an important aspect of dividend policy. It is rather the starting point of the dividend policy. As dividends can be paid only out of present or past year’s profits, earnings of a company fix the upper limits on dividends. The dividends should, generally, be paid out of current year’s earnings only as the retained earnings of the previous years become more or less a part of
permanent investment in the business to earn current profits. The past trend of the company's earnings should also be kept in consideration while making the dividend decision.

3. **Desire and Type of Shareholder:** Although, legally, the discretion as to whether to declare dividend or not has been left with the Board of Directors, the directors should give the importance to the desires of shareholders in the declaration of dividends as they are the representatives of shareholders. Desires of shareholders for dividends depend upon their economic status. Investors, such as retired persons, widows and other economically weaker persons view dividends as a source of funds to meet their day-to-day living expenses. To benefit such investors, the companies should pay regular dividends. On the other hand, a wealthy investor in a high income tax bracket may not benefit by high current dividend incomes. Such an investor may be interested in lower current dividends and high capital gains. It is difficult to reconcile these conflicting interests of the different type of shareholders, but a company should adopt its dividend policy after taking into consideration the interests of its various groups of shareholders.

4. **Nature of Industry:** Name of industry to which the company is engaged also considerably affects the dividend policy. Certain industries have a comparatively steady and stable demand irrespective of the prevailing economic conditions. For instance, people used to drink liquor both in boom as well as in recession. Such firms expect regular earnings and hence can follow a consistent dividend policy. On the other hand, if the earnings are uncertain, as in the case of luxury goods, conservative policy should be followed. Such firms should retain a substantial part of their current earnings
during boom period in order to provide funds to pay adequate dividends in the recession periods. Thus, industries with steady demand of their product can follow a higher dividend payout ratio while cyclical industries should follow a lower payout ratio.

5. **Age of the Company**: The age of the company also influences the dividend decision of a company. A newly established concern has to limit payment of dividend and retain substantial part of earnings for financing its future growth and development, while older companies which have established sufficient reserves can afford to pay liberal dividends.

6. **Future Financial Requirement**: It is not only the desires of the shareholders but also future financial requirements of the company that have to be taken into consideration while making a dividend decision. The management of a concern has to reconcile the conflicting interests of shareholders and those of the company’s financial needs. If a company has highly profitable investment opportunities it can convince the shareholders of the need for limitation of dividend to increase the future earnings and stabilize its financial position. But when profitable investment opportunities, do not exist then the company may not be justified in retaining substantial part of its current earnings. Thus, concern having few internal investment opportunities should follow high payout ratio compared to one having more profitable investment opportunities.

7. **Government’s Economic Policy**: The dividend policy of a firm has also to be adjusts to the economic policy of the Government as was the case when the Temporary Restriction on Payment of Dividend Ordinance was in
force. In 1974 and 1975, companies were allowed to pay dividends not more than 33 per cent of their profits or 12 per cent on the paid-up value of the shares, whichever was lower.

8. Taxation Policy: The taxation policy of the Government also affects the dividend decision of a firm. A high or low rate of business taxation affects the net earnings of company (after tax) and thereby its dividend policy. Similarly, a firm’s dividend policy may be dictated by the income-tax status of its shareholders. If the dividend income of shareholders is heavily taxed being in high income bracket, the shareholders may forego cash dividend and prefer bonus shares and capital gains.

9. Inflation: Inflation acts as a constraint in the payment of dividends. Profits as arrived from the profit and loss account on the basis of historical cost have a tendency to be overstated in times of rise in prices due to over valuation of stock-in-trade and writing off depreciation on fixed assets at lower rates.

5.3 Types of Dividend Policies:

Companies may use following dividend policies

**Regular Dividend Policy:** payment of dividend every year or at a regular fixed time interval

**Stable Dividend Policy:** fixed rate or amount of dividend each year

**Irregular Dividend Policy:** payment of dividend at no fixed rate and time interval

**No Dividend policy:** no dividend to any share holder.
5.5 ANALYSIS OF DIVIDEND POLICY

Q. Do you use any dividend policy?

<table>
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<th>Percentage of Companies</th>
<th>Opinion</th>
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<tbody>
<tr>
<td>8</td>
<td>Yes</td>
</tr>
<tr>
<td>92</td>
<td>No</td>
</tr>
</tbody>
</table>

Most of the respondents (92%) have no dividend policy. Companies in Bundelkhand region generally don’t distribute dividends. The reason for this may be the fact that most of the enterprises are Private Ltd. Or Firms hence managed by owners itself.
Q. What type of dividend policy do you use?

<table>
<thead>
<tr>
<th>Type of Dividend Policy</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regular</td>
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<tr>
<td>Irregular</td>
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<tr>
<td>Stable</td>
<td>4</td>
</tr>
<tr>
<td>No Dividend policy</td>
<td>86</td>
</tr>
</tbody>
</table>

Type of Dividend Policy used by Companies