CHAPTER 5 - THE DIVIDEND DECISIONS

5.1 INTRODUCTION

Fund raising, to be used as capital is dealt with, in Financial Decisions. The next function is deployment of funds, for the procurement of assets and resources is considered in Investment activity. Businesses are done to earn profits, and profits are keenly observed by all the stakeholders of the firm. Major stakeholder is the shareholder of the firm, who invests in any firm with the intention of prospering with the firm, in two ways. First, as a recipient of share in profit of the company. This is commonly called as Dividend. And second, the shareholder also expects the appreciation of capital. Hence dividend decisions are of equal importance like Financing as well as investing decisions. The researchers and scholars in the field of corporate finance have studied dividend decisions from different paradigms. Broadly following theories or concepts are associated with the Dividend decisions.

While studying dividend decision related research, through the research articles and text. This researcher has classified the Normative statement on the basis of the relevant theory, concept.

In certain cases, the clear cut classification was not possible, even though the research is pertaining to dividend policy, however it is not exhibiting any relevance with a specific theory or concept is classified as Dividend Decisions.

5.2 THEORIES / CONCEPTS / APPROACHES IN DIVIDEND DECISIONS

The theories, concepts in the domain of Dividend Decisions along with the normative statements are as under
Agency Cost Theory- The personal aspirations are prioritized over objectives of the company and expectations of shareholders. In professional organizations, the distinct categorization between ownership and Control is followed. The shareholder’s are the owners of the firm and the professional managers are (which may include the executive directors of the firm) appointed to run the organization in accordance with, the objectives of the firm. Ideally the objectives of the firm like, wealth maximization or value of the firm should also be the objective of the said employee hired by the owner. Typically, owners are called as principals and the employees are called as the Agents. As ownership and Control differs, the conflict between the agents and principals may take place. The individual goals of the agent, when differs that from the principal, which is explained by the agency cost theory. The short term objectives of the managers may be prioritized against the long term goals of the organization. This may have implication on the composition of the capital of the Firm.

Particularly the following normative statement/s is/ are being considered by the researcher during this study.

DD-1. The Dividend payout is a significantly negative function of percentage of stock held by the Insiders.

Quite a few researchers have opined, that dividend policy continues to be mysterious. Some of the questions are answered in conflicting ways while some questions are not raised at all. Rozef (Michael C Rozeff, 1982). The researcher observed that, increase in dividends relative to earnings lowers agency cost but increases transaction cost of external financing. Sum of these opposing costs determines the optimal dividend payout. Regression technique was used by the researcher. This study advocates that investment policy and dividend policy are co related.
Hence firms establish higher dividend payouts, when insiders hold lower fraction of equity. This supports dividend payments are part of firms optimum monitoring package and serve to reduce agency costs.

**Bird-in-hand Theory:** This theory states that investor’s certainty of dividend over capital appreciation in future. The name of the theory has been taken from the adage; bird in hand is worth two in bush. This theory has been developed by Myron Gordon and John Lintner as a counterpoint to Modigliani-Miller Dividend irrelevance theory. M-M dividend irrelevance theory claims that, investors are indifferent towards, whether returns from holding a stock arise from dividend or capital appreciation. The Bird-in-hand theory states high dividend paying firms are sought by shareholders/investors and such firms command higher price at stock market.

Particularly the following normative statement/s is/are being considered by the researcher during this study.

DD-2. The “bird-in-hand” argument suggests that dividend policy matters because investors value current dividends more highly than uncertain future capital gains.

Will there be any significant change in the value perceived by an investor? When the firm declare dividend or not. This question has been answered by Black and Scholes (Fischer Black and Myron Scholes, 1970). On the basis of time series data, these scholars prove that dividend policy of a corporation has no effect on its stock return. Further they state there is no optimal dividend policy for a firm. This study is not in favor of the investors perception of current dividend rather than futuristic stock price appreciation.
Because of lack of conformity amongst the researchers, some of the scholars tried to reexamine the findings started by earlier researchers, who worked in the field of the dividend decision. One such study has been done by Seneque (P J C Seneque, 1978). This scholar reexamined the Lerner’s model, which strongly supports the dividend relevance aspect. Further it is stated that empirical evidence, not substantiated scientifically, says positive support for dividend policy. This study is not conclusive enough in favor of bird-in-hand theory.

Whether firms should pay dividend or conserve funds? Why payment of dividend is advocated? Such aspects were studied by Bhattacharya (Sudipto Bhattacharya, 1979). This study is not in favor of the assumption that shareholders prefer current dividend than, future capital appreciation, in the form of rise in the market price of stock. The model developed by the researcher does not subscribe to dividend preference as perceived by the shareholders. Hence the research papers and the conclusions of the same are not conclusive enough to advocate the bird-in-hand approach. From the observation of the study made by these researchers, we cannot conclude the predominance of bird-in-hand approach. Which mean shareholders are willing to consider the option of accepting the returns on the stock, by way of capital appreciation.

**CAPM- C A P M (Capital Asset Pricing Model):** The Required rate of return of an asset can be calculated with the help of C A P M model, if the asset is added in the existing portfolio. The model says expected return of a security or a portfolio is equal to risk free rate of return plus the risk premium. If the expected rate of return does not match with the required rate of return, then such investment should not be considered. A model that describes the
relationship between risk and **expected return** and that is used in the pricing of risky securities.

\[ \bar{r}_g = r_f + \beta_a (\bar{r}_m - r_f) \]

Where:
- \( r_f \) = Risk free rate
- \( \beta_a \) = Beta of the security
- \( \bar{r}_m \) = Expected market return

The riskiness depends on the beta of the security. Securities having high Beta are perceived to be risky.

Particularly the following normative statement/s is / are being considered by the researcher during this study.

**DD-3.** The Dividend payout is a significantly negative function of firm's beta coefficient.

While analyzing the dividend decisions, researchers have time and again noted it to be an area of some mystery. When a study was made by Michael S Rozeff (1982), it was noted that Dividend payout is a significantly negative function of firms past and expected future growth rate of sales and a significantly negative function of its beta coefficient. The researcher expects further research in this area.

**Cash Flow** - A revenue or expense stream which causes change in cash account over a period of time. The source of cash flow is in three activities viz, Financing, Investing and operations. Generally cash out flow denoted an expense. Every firm prepares a cash flow statement where in the non cash expenses are added back to net income and business generated by business is calculated. The cash flow is a major indicator of company’s health, more specifically the financial health. At personal level as well as at firm’s level adequate cash level maintains the solvency. All the stake holders as well as business analysts of a firm are in gauge the financial performance of the firm on basis of Cash flow.
Particularly the following normative statement/s is / are being considered by the researcher during this study.

DD-4. Cash flow and taxation are significant determinants of Dividend behavior.

The study of determinants of dividend policy has enthused many researchers. Different perspectives have been tested by many of them. The tax regime and retention of profits has been studied by Callen et al. (Tim Callen, Steven Morling and Jill Pleban, 1992). These researchers have observed that because of certain recent changes, like introduction of Capital Gains Tax, Dividend imputation and taxation of earnings on superannuation fund have increased the incentives to companies to pay dividends than to retain profits. These researchers made a mathematical model on the basis of the panel data. It was noted by these researchers that, real dividend per share have been increased by about 38 per cent from 1985-86 to 1990-91. So Cash flow and taxation are significant determinants of Dividend behavior.

It is evident from the above study that firms prefer to pay dividend when the incentives are more for doing so. A steady stream of cash flow would be essential for company to take the decision about distribution of Profits. Besides taxation policies certainly play important role in devising a dividend policy.

**Clientele Effect**- Clientele effect or Clientele theory speaks about investor’s preferences. With regard to dividend, clientele effect says investors who prefer that company should conserve cash for growth and minimize dividend payout. Other set of investors may prefer that company should pay dividend, instead of conserving cash. If the company adopts a policy of high dividend payouts then such investors would purchase the shares of such company which would result in increase in stock price. Whereas investors who preferred growth of the
company in lieu of dividend payout start selling the shares of the company. So, clientele effect suggests that investors are partial to company’s policies and change in policy may trigger sale or purchase of companies share as per individual investor’s preference.

Particularly the following normative statement/s is / are being considered by the researcher during this study.

DD-5. The Dividend payout is a significantly positive function of firm's number of common stockholders.

DD-6. U S Firms pay dividend out of foreign earning at about three times the rate that they do out of their domestic Earning.

Michael C Rozeff (1982) as referred in CAPM, has studied determinants of dividend policy. In his study he did considered the beta and its effect on the dividend payout. It was candidly observed by him that Dividend payout is a significantly positive function of firm's number of common stockholders.

Distribution of profit earned amongst the shareholders is an absolute prerogative of the company. The classification of profit earned in domestic country and the profit earned in foreign land, and its effect on the declaration of dividend has been studied by Hines (James R Hines Jr., 1991). He stated that American companies have large scale operations in other countries. When other things are equal, U S Corporations pay dividends out of foreign earnings at the rate that is three times higher than their payout rates from the domestic earnings. The reason behind this behavior of the firms is not ascertained by the researcher. The researcher further states that, why firms pay dividend is still not understood. He used panel data from 1984-1989 from COMPUSTST. This study endorses that U S Firms pay
dividend out of foreign earning at about three times the rate that they do out of their domestic Earning.

From the research papers studied, the existence and relevance of clientele effect is noted. This effect states that the shareholders have specific preferences about dividend. The firms do acknowledge this, and accordingly take the decisions about dividend payouts. The reflection of this effect is seen in the firm’s behavior while taking dividend decision.

Dividend Decisions: As mentioned above the normative statements, which cannot be specifically classified in any theory, concept, is considered as Dividend Decisions.

Particularly the following normative statement/s is / are being considered by the researcher during this study.

DD-7. The rate of profit required by the market is a superior measure than income & dividend yield.
DD-8. Before Capital budgeting theory can be made a reliable guide to action, improvement technique , Measuring future revenue is needed.
DD-9. Firms should not pay dividend, when it has to generate cash by selling stock.
DD-10. Why firms pay dividend and simultaneously raise funds in Capital Market?is answered by Finance Theories.
DD-11. Change in taxation Policy causes change in company's Dividend Policy.
DD-12. Pile of evidence, decades of theoretical debate is not capable of solving the dividend puzzle And its impact on Firm Value.
DD-13. The harder we look at the Dividend Picture , the more it seems like a Puzzle , with pieces That Just doesn’t fit together.
DD-14. There is positive correlation between the current Debt and Past Dividend.
DD-15. Economic rational can explain the Dividend phenomenon.
DD-16. Capital Structure and Dividend Policy, of a firm are not correlated.

Gordon and Shapiro (Myron J Gordon and Eli Shapiro, 1956) made a presentation of definition of rate of profit required by market, on a share of market stock. These researchers claim that it is superior to Dividend yield or income yield, as it recognizes that the revenue stream provided by the share can be expected to grow. These researchers opined that, before capital budgeting theory can be made a reliable guide to action, we must improve the techniques of estimating the future revenue on a capital outlay proposal. It was also opined by them that, we must learn about the market Expectations of rate profit. So it is clear from this paper that, The rate of profit required by the Market is a superior measure than income & dividend yield.

When the firms should pay dividend? Generating profits would qualify a firm to pay dividend or Not? Was studied in detail by Myers and Majluf (Stewart C Myers and Nicholas S Majluf, 1984). These Researchers designed a model called issue-invest decision. They proposed that, external financing using Debt is better than issuing equity. They felt that firms can build financial slack by restricting the Dividends when financial requirements are modest. They categorically mentioned that firms should not pay dividend when it has to recoup the cash by selling security or risky assets.

The manager’s behavior contributes significantly in dividend decisions. A detailed study has been Made by Easterbrook (Frank H. Easterbrook, 1984). He has mentioned that, economic literature Has yet to integrate the study of corporate finance. He stated that, dividends keep the firms in capital market, where monitoring of managers is available at a lower cost and may be useful in adjusting The level of risk taken by managers and different classes of investors. Such explanation offers to Explain Why firms pay dividend and simultaneously raise funds in Capital Market? is answered by Finance Theories.
The rationale behind declaration is not fully understood as yet. Why do firms declare dividends? Instead why they do not conserve cash for their expansion? Manos (Ronnay Manos, 2001). He observed that, empirical literature has recorded systematic variations in dividend behavior across Firms, countries and time as well as in type of dividend paid. He said the dividend puzzle is Inconclusive. Despite four decades of theoretical debate and very many attempts to empirically validate various theories the pile of evidence collected is not conclusive to determine the Determinants of dividend policy. Neither it is clarifying the impact of dividend on the value Of the firm.

The dividend has been looked at as a puzzle by the research scholars. Some of them perceived Dividend as a jig-saw puzzles, and tried to fit all the pieces, in place to see the complete picture. The researchers in the domain of corporate finance continued their efforts to find out the ultimate Solution. Kinkki (Seppo Kinkki, 2001). Kinkki also acknowledged that, dividend policies, is the topic Which was analyzed with rigorous model? The theories of dividend and empirical studies do not Provide evidence for one over other. He also noted that conceptions among corporate dividend theories Are different. He concluded by quoting black (1976), The harder we look at dividend picture the more It seems like a puzzle, with pieces that just don’t fit.

Researchers tried to test dividend policy from various angles. The Capital structure and dividend policy Aspect was studied by Tong and Green (Guanqun Tong and Christopher J. Green, 2004). These Researchers considered panel data of Chinese for their study. Their main findings are, significant positive co relation between current leverage and past dividend. The insignificant negative co relation between Growth of investment and past dividends. Positive co relation between debt and dividend was not observed.
Not a single model was developed by the researchers, which could support the majority of Dividend theories. Why firms pay dividend? Has not been answered by the researchers. The Dividend theories are studied by Frankfurter and Wood (George M. Frankfurter and Bob G. Wood, 2005). They noted that, Myers (1990) said, dividend payment is, in reality, an unwritten contract between Shareholders and company management. Managers are reluctant to reduce the payment of dividend Even in the periods of financial distress. No single economic rationale explains the dividend Phemenon. While studying the dividend policy these researchers endorsed the views of Green (1983) and Black (1976) which says, nearly universal policy of paying substantial dividends Is the primary puzzle in the economics of corporate finance. The corporate tradition of paying dividend is sum total of more than three hundred years of evolution of practice of dividend Payment. Further these researchers advocated that, current models of corporate dividend policy By and large ignore behavioral and socioeconomic influences on managerial and shareholder Activities. They feel that unless these aspects are incorporated in future models, dividend Preferences are difficult to explain. Hence it is wrong to believe that, economic rational can Explain the dividend phenomenon.

The rationale behind paying cash dividend and the factors affecting dividend policy has been Studied by Jumah and Pacheco (Ahmad H. Juma'h and Carlos J. Olivares Pacheco, 2008). Like the previous paper, these researchers observed that, in spite of strong financial position some firms do not pay dividend, while some firms pay dividends even though they are facing financial Difficulties. The managerial and behavioral issues are important in firm's dividend policy. It was Noted that, companies paying cash dividends are of larger size, have good liquidity and profitability Ratios as well as these companies spend higher amounts on Research and Development. These Researchers also did not observe any economic rationale behind corporate dividend policy.
Optimal dividend policy and optimal debt policy was studied by Lally (Martin Lally, 2009). This researcher considered the dividend imputation aspect. The present tax regime in India, does not tax the dividend at the hands of investors. However in foreign countries, tax credit is given to shareholder receiving dividend is called dividend imputation. This avoids double taxation. The researcher developed a mathematical model. He noted that, un imputed dividends are not desirable and dividends in the form of share re purchase are neutral as long as they do not induce share issues. So, no economic rational is observed while dividend policy was studied.

In an independent study done by Jagannathan et al. (2011) in the context of Indian Joint stock Companies, noted that the dividend determinants for service sector companies are difficult to ascertain. As public sector banks are governed by Government of India, the extent of dividend would be in line with the provisions of Indian Banking Act. Similarly the Government of India owned firms Government would be having upper hand in deciding the dividend. Hence this study hints that there are no clear cut determinants for dividend policy.

A detailed country specific study was made by Pakistani Researchers. These researchers studied the co relation between Capital Structure and Dividend policy of the firm. Hunjra et al., (Ahmed Imran Hunjra, Muhammad Bilal, Haroon Shafi, Ikram Ullah and Kashif-Ur-Rehman, 2011). They used survey method for collection of data. They targeted ninety company executives, who were responsible for the dividend decisions. Descriptive analysis was used for analysis of data. It was revealed that capital structure decisions were in line with the theoretical literature. However dividend decisions were a concern. They found positive co relation between capital structure decision, dividend policy and performance of the firm. This study does not approve that capital structure and dividend decisions are independent.
**Financial Performance Management**: Performance of the firm is measured and compared with the benchmark, to assess the efficiency. In Financial Performance Management, for assessment and comparison purpose ratios are extensively used. Four broad types of ratios, viz. Liquidity Ratios, Profitability Ratios, Capital Structure (Leverage) Ratios and Activity/Efficiency/Turnover Ratios.

While assessing the financial performance, the relevant benchmark Standards are considered. For different Industries the parameters would differ. While evaluating the Financial Performance Of a firm, the comparison of Historical data is important.

Particularly the following normative statement/s is / are being considered by the researcher during this study.

DD-17. As long as the probability distribution of the firm’s cash flows is fixed and there are no tax effects, The firm’s choice of dividend policy leaves the current market value of the firm unaffected.

DD-18. For Self-Interested Manager Leverage Choices deviate from Optimum leverage, which maximizes the firm’s Value.

The expectation of dividend by the shareholders, and firm’s policy of paying the dividend are in sync the stock prices are unaffected. However if there is some distortion between the firms Dividend policy and share holder’s expectation then it do affect the stock price. This has been revealed by Fischer Black and Myron Scholes(1970). Hence, As long as the probability distribution Of the firm’s cash flows is fixed and there are no tax effects, does not hold true.
The managers self interest and its effect on the dividend policy was critically studied by Researchers. Wang (Hao Wang, 2008). Wang studied S & P 500 firms. On the basis of A mathematical model it was observed that, dividend yields negatively influenced by Leverage ratios as well as managerial entrenchment. It was observed that self interested Leverage choices deviate from optimal leverage that maximizes the firm value. So The Dividend payout is a significantly negative function of firm's past and future growth Rates of sales are in line with the observations of the researcher.

**Signaling Theory:** The basis of this theory is in information asymmetry. Information is not available To all the parties at the same time. This may lead to low valuation of the firm. This theory believes that, that corporate finance decisions are the signals sent by the companies managements to the Outsiders (investors). These signals counter attack the information asymmetry. Certain corporate Finance decisions like declaration of dividend, is perceived as future profitability of the company. Particularly the following normative statement/s is / are being considered by the researcher during this study.

DD-19. The changes in dividend are positively correlated with future changes in profitability And earnings.

DD-20. The Dividend payout is a significantly negative function of firm's past and future growth Rates of sales.

DD-21. Changes in Dividends have information contents about future earnings of the firm.

DD-22. The declaration of Cash or Stock Dividend elicits significantly positive abnormal returns.
5.3 – CHRONOLOGICAL REVIEW OF RESEARCH PAPERS STUDIED

Whether changes in dividend are co related with future changes in profitability and earnings?

Was studied by Gordon and Shapiro (1956). These researchers tried to develop a model estimating

The rate of profit and effect on share price. It was noted that The changes in dividend are

Positively correlated with future changes in profitability and earnings is not true.

The co relation between firm’s revenue growth and its dividend payout by Rozeff (1982).

It was noted by the researcher that, an anticipated growth in revenue, would lead to lower

Dividend Pay our ratio. The reason assigned for the same was, growth entails higher

Investment expenditure. This evidence supports the view that dividend policies are

Influenced by investment policies. It justifies that, The Dividend payout is a significantly negative

Function of firm's past and future growth Rates of sales.

Does dividend predict firm’s future growth? In reality can dividend be signaling the growth in

Earnings? Is the increase in dividend consistent? These and such types of questions are

Pertinent in the minds of Scholars researching the dividend phenomenon. Benartzi et al.,

(Shlomo Benartzi, Roni Michaely and Richard Thalar, 1997). These researchers observed that, firms

That increase the dividend in the year 0 have experienced the increase in earnings in year -1 and 0

But no subsequent unexpected earnings growth. As well the size of dividend does not predict the

Future earnings. Firms cutting dividend in year 0 have experienced the reduction in earnings

In year 0 and -1 but they show significant earnings growth in year 1. for their study these researchers

Used COMPUSTAT data for NYSE listed firms for the years 1979-1991. They clearly conclude by

Stating that there is no evidence in assuming that changes in dividend has information content
About future earnings changes.

The signaling effect was further probed by many researchers. Everyone was curious to know

The link between dividend and future earnings or profitability. On such study was made by

Grullon et al., (Gustavo Grullon, Roni Michaely, Shlomo Benartzi and Richard H Thaler, 2003). Their study is based on the papers of Modigliani(1961), Watts(1973), where these researchers Were looking for some co relation between changes in dividend and future changes in earnings. These papers could not establish any link. Then Nissim and Ziv(2001) found that, there is a positive Correlation between the dividend changes and future earnings changes. These researchers used Matched sample and non linear specification for their study. They found no relationship between Changes in dividend and corresponding changes in earnings. They have arrived at further crossroad They said the motive of dividend and its market reaction should be looked for elsewhere. Hence this Study also is not favoring the notion of, Changes in Dividends have information contents about Future earnings of the firm.

Similar views were noted by Frankfurter and Wood (2005). They noted that, A number of conflicting Theoretical models lacking strong empirical support define current attempts to explain the Puzzling reality of corporate dividend behavior. They concluded by saying that No Dividend model Either separately or jointly is supported invariably. Hence this study is also of the opinion that, Changes in dividend have information contents about future earnings of the firm, is not supported Empirically.

Somewhat similar study was conducted by Pani (Upananda Pani, 2006). It was noted that in some Cases Clientele effect was observed. This researcher used panel data. The sample included six Industries and study was based on the data between 1996-2006 time periods. This study says there is no conclusive evidence saying Changes in dividend have information contents about future Earnings of the firm. As well Pani (2006) noted the dividend paying pattern changes across Industries over the years.
A Study which is not in line with the earlier studies of signaling effect has been done by Purmessur and Boodhoo (Purmessur Rajshree Deeptee and Boodhoo Roshan, 2009). These Researchers claimed that the changes in dividend payout convey information to market About future. It was reiterated that four possible reasons to declare dividend are signalling Effect of Dividend payout, reduction of Agency Problem, Tax preferences of investors and Bird-in-hand approach. This probable reasoning was proposed by Baker and Powell (1999). An effort was made to test the impact of declaration of higher dividend or Declaration of Stock Dividend (Bonus Issue) on the stock return. This study was done by Travlos et al., (Nickolaos Travlos, Lenos Trigeorgis and Nikos Vafeas, 2001). Their study for the firms Based in Cyprus. In line with the researchers expectations, the study revealed a positive Relationship between stock market returns and firms announcing higher dividends or Bonus issues. However the tests were not convincing enough to provide the explanation For dividend policy. Their observations are based on the data collected from 1985-1995. They used single factor market model for their study. They concluded that, The declaration of Cash or Stock Dividend elicits significantly positive abnormal returns.

5.4 FINDINGS AND CONCLUSIONS ABOUT DIVIDEND DECISIONS

This researcher has calculated the mean values for all the theories / concepts on the basis of Acceptance or rejection of the theory / concept.

The mean values of all the theories considered under Dividend Decisions are as given below

<table>
<thead>
<tr>
<th>Theory / Concept</th>
<th>Mean Value</th>
</tr>
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<tbody>
<tr>
<td>Agency Cost Theory</td>
<td>0.004629</td>
</tr>
<tr>
<td>Bird-in-Hand Theory</td>
<td>-0.01389</td>
</tr>
</tbody>
</table>
These results signify that, none of the theory under consideration is fully rejected neither accepted. Because when the theory is fully accepted the mean value would be 1. When the theory is totally rejected then the mean value would be -1, where as 0 denotes a status where the theory is neither accepted nor rejected. 0 signifies a neutral status.

From the above data it is evident that Bird-in-Hand theory and Signaling theory are giving negative mean values, means the results put forth by the researchers who studied these theory are not in line with what the respective are proposing.

The Financial Performance Management is giving 0 mean values. This is because FPM per say is not a theory. And the results are in the form of indication of performance, judged on the basis of ratios. The Agency Cost theory, CAPM, Cash Flow and Clientele theory are yielding positive and non zero values. But they are not near to 1. This denotes that these theories are also not fully accepted by the researchers, who studied these theories.

Hence we can say that these results pertaining to the Dividend Decisions are in line with the hypothesis of this study. And none of the theory / concept studied under the Dividend Decisions is fully accepted or fully rejected.