

UNIT V – DIVIDEND DECISIONS

SHORT ANSWERS:

Q.1. Name the two theories of dividend.

a. The Irrelevance Concept of Dividend or the Theory of Irrelevance: They state that the dividend policy employed by a firm does not affect the value of the firm. They argue that the value of the firm is dependent on the firm's earnings which result from its investment policy, such that when the policy is given the dividend policy is of no consequence. (Modigliani and Miller Approach-MM Model)

b. The Relevance Concept of Dividend or the Theory of Relevance: These are theories whose propagators argue that the dividend policy of a firm affects the value of the firm. There are two main theorists: James E. Walter (Walter's model), Myron Gordon (Gordon's model)

Q.2. Discuss the various forms of dividends.

- ❖ Dividends paid in the ordinary course of business are known as **Profit dividends**, while dividends paid out of capital are known as **Liquidation dividends**.
- ❖ A dividend which is declared between two annual general meeting is called **Interim dividend**, while the dividend which is recommended to the shareholders at the annual general meeting is known as **Final dividend**.
- ❖ Dividends may also be **classified on the basis of medium** in which they are paid:
 - (a) Cash Dividend:** A cash dividend is a usual method of paying dividends. Payment of dividend in cash results in outflow of funds.
 - (b) Scrip or Bond Dividend:** A scrip dividend promises to pay the shareholders at a future specific date. In case a company does not have sufficient funds to pay dividends in cash, it may issue notes or bonds for amounts due to the shareholders
 - (c) Property Dividend:** Property dividends are paid in the form of some assets other than cash. They are distributed under exceptional circumstances and are not popular in India.
 - (d) Stock Dividend:** Stock dividend means the issue of bonus shares to the existing shareholders. Stock dividend amounts to capitalisation of earnings and distribution of profits among the existing shareholders without affecting the cash position of the firm.

Q.3. What are the objectives of dividend policy?

Dividend policy denotes to the decision of the board concerning distribution of residual earnings to its shareholders.

I. Wealth Maximization: The dividend policy should be developed keeping in mind the wealth maximization objective of the firm.

II. Future Prospects: The dividend policy must be devised in such a manner that potential projects may be financed through retained earnings.

III. Stable Rate of Dividend: Variation in the rate of return unfavourably affects the market price of shares. In order to have a stable rate of dividend, a firm should retain a high proportion of earnings so that the firm can keep adequate funds for payment of dividend when it faces loss.

IV. Degree of Control: Issue of new shares or dependence on external financing will decline the degree of control of the existing shareholders. Therefore, a more conservative dividend policy should be followed in order that the interest of existing shareholders is not hindered.

Q.4. Write short note on stable dividend policy.

Stable dividend policy: Here the payment of certain sum of money is regularly paid to the shareholders. It is of three types:

a) Constant dividend per share: Here reserve fund is created to pay fixed amount of dividend in the year when the earning of the company is not enough. It is suitable for the firms having stable earning.

b) Constant pay-out ratio: It means the payment of fixed percentage of earning as dividend every year.

c) Stable rupee dividend + extra dividend: It means the payment of low dividend per share constantly + extra dividend in the year when the company earns high profit.

Q.5. What is 'Scrip Dividend'?

Scrip or Bond Dividend:

A scrip dividend promises to pay the shareholders at a future specific date. In case a company does not have sufficient funds to pay dividends in cash, it may issue notes or bonds for amounts due to the shareholders. The objective of scrip dividend is to postpone the immediate Payment of cash. A scrip dividend bears interest and is accepted as a collateral security.

Q.6. What are the assumptions of MM model?

Assumptions of MM model:

- 1. Capital markets are perfect:** - Investors are rational information is freely available, transaction costs are nil, securities are divisible and no investor can influence the market price of the share.
- 2. There are no taxes:** - No difference between tax rates on dividends and capital gains.
- 3. The firm has a fixed investment policy** which will not change. So, if the retained earnings are reinvested, there will not be any change in the risk of the firm. So, K remains same.
- 4. Floatation cost does not exist.**
- 5. No Risk of Uncertainty:** All investors are certain about the future market prices and the dividends. This means that the same discount rate is applicable for all types of stocks in all time periods.

Q.7. What is relevance theory of dividend?

The Relevance Concept of Dividend or the Theory of Relevance:

These are theories whose propagators argue that the dividend policy of a firm affects the value of the firm. There are two main theorists: James E. Walter (Walter's model), Myron Gordon (Gordon's model)

Q.8. Write a note on criticism of Walter's model.

Criticism of Walter's Model:

Walter's theory is criticized for the following impractical assumptions in the model:

- 1. No External Financing:** Walter's assumption of complete internal financing by the firm through retained earnings is problematic to follow in the actual world. The firms do need external financing for new investments.
- 2. Constant r and k :** It is very unusual to find the internal rate of return and the cost of capital to be constant. The business risks will certainly change with more investments which is not revealed in this assumption.

Though Walter's theory has some improbable assumptions, it follows the notion that the dividend policy of a company has an effect on the market price of its share. It elucidates, the impact in the mathematical terms and finds the value of the share.

ESSAY QUESTIONS:

Q.1. Explain the various factors which influence the dividend decision of a firm.

- 1. Type of Industry:** The nature of industry to which the company is associated has major impact on the dividend policy. Industries where earnings are stable, may use a consistent dividend policy in contrast to the industries where earnings are undefined and uneven.
- 2. Determinants of dividend decisions ownership structure:** A company with a higher promoter holding will prefer a low dividend pay-out as paying out dividends may cause a deterioration in the value of the stock.
- 3. Age of corporation:** Recently established companies will have to retain major part of their incomes for future development and expansion.
- 4. Extent of Share Distribution:** A company with huge number of shareholders may face difficulty to agree them to follow a conservative policy.
- 5. Different Shareholders' Expectations:** Different group of shareholders will have different anticipations. The company needs to clearly understand the different beliefs and formulate an effective dividend policy.
- 6. Leverage:** A company having more leverage in their financial structure and subsequently, frequent interest payments will have to decide for a low dividend pay-out.
- 7. Future financial requirements:** A company having lucrative investment opportunities is reasonable in holding the earnings.
- 8. Business Cycles:** When the company experiences a success, it is sensible to save up and make reserves for dips. Such reserves will help a company declare high dividends even in depressing markets to retain and attract more shareholders.
- 9. Growth:** Companies experiencing higher rate of growths, choose high dividend pay-outs to keep their investors happy.
- 10. Changes in government policies:** There could be change in the dividend policy of a company due to the compulsory changes by the government. Indian government had put temporary restrictions on companies to pay dividends during 1974-75.
- 11. Profitability:** A highly profitable company usually pays higher dividends and a company with less or no profits will embrace a conservative dividend policy.
- 12. Taxation Policy:** The taxes directly decrease the residual earnings after tax available for the shareholders. Indirectly, the dividend distribution is taxable after a certain limit.
- 13. Trends of Profits:** The trend of profits should be properly investigated to find the average earnings of the company. This average number should be then studied in relation to the general economic circumstances. This will aid in choosing a conservative policy if a depression is approaching.

14. **Liquidity:** Liquidity has a direct relation with the dividend policy. If a firm has a strong liquidity and sufficient money for its working capital, it can manage to pay for higher dividends. Conversely, a firm with less liquidity will choose a conservative dividend policy.
15. **Legal Rules:** In any country, there are some legal constraints on the companies for dividend payments. These rules are formed to protect creditors' interest.
16. **Inflation:** Inflationary environments force companies to maintain major part of their earnings and indulge in lower dividends.
17. **Control Objectives:** The firms that has aim to more control in the hands of current shareholders choose a conservative dividend pay-out policy.

Q.2.What are the different types of Dividend Policy?

Dividend policy is the set of guidelines a company uses to decide how much of its earnings it will pay out to shareholders. Some evidence suggests that investors are not concerned with a company's dividend policy since they can sell a portion of their portfolio of equities if they want cash.

There are basically 4 types of dividend policy

1. Regular dividend policy:

In this type of dividend policy, the investors get dividend at usual rate. Here the investors are generally retired persons or weaker section of the society who want to get regular income. This type of dividend payment can be maintained only if the company has regular earning.

Merits of Regular dividend policy:

- ❖ It helps in creating confidence among the shareholders.
- ❖ It stabilizes the market value of shares.
- ❖ It helps in maintaining the goodwill of the company.
- ❖ It helps in giving regular income to the shareholders.

2. Stable dividend policy: Here the payment of certain sum of money is regularly paid to the shareholders. It is of three types:

a) Constant dividend per share: Here reserve fund is created to pay fixed amount of dividend in the year when the earning of the company is not enough. It is suitable for the firms having stable earning.

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3.Irregular dividend: as the name suggests here the company does not pay regular dividend to the shareholders. The company uses this practice due to following reasons

- ❖ Due to uncertain earning of the company.
- ❖ Due to lack of liquid resources.
- ❖ The company sometime afraid of giving regular dividend.
- ❖ Due to not so much successful business.

4.No dividend: the company may use this type of dividend policy due to requirement of funds for the growth of the company or for the working capital requirement.

Q.3.Explain Modigliani and Miller Model or Irrelevance theory of dividend.

According to MM, the dividend policy of a firm is irrelevant, as it does not affect the wealth of shareholders. The model which is based on certain assumptions, side-lined the importance of the dividend policy and its effect thereof on the share price of the firm.

According to the theory the value of a firm depends solely on its earnings power resulting from the investment policy and not influenced by the manner in which its earnings are split between dividends and retained earnings.

Assumptions:

1. **Capital markets are perfect:** - Investors are rational information is freely available, transaction costs are nil, securities are divisible and no investor can influence the market price of the share.
2. **There are no taxes:** - No difference between tax rates on dividends and capital gains.
3. **The firm has a fixed investment policy** which will not change. So, if the retained earnings are reinvested, there will not be any change in the risk of the firm. So, K remains same.
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The substance of MM arguments may be stated as below:

- ❖ If the company retains the earnings instead of giving it out as dividends, the shareholders enjoy capital appreciation, which is equal to the earnings, retained.
- ❖ If the company distributes the earnings by the way of dividends instead of retention, the shareholders enjoy the dividend, which is equal to the amount by which his capital would have been appreciated had the company chosen to retain the earnings.

Hence, the division of earnings between dividends and retained earnings is irrelevant from the point of view of shareholders.

Disapproval of Modigliani Miller's Model:

Modigliani - Miller theory on dividend policy has been criticized on following grounds:

1. **Perfect capital markets do not exist.** Taxes are present in the capital markets.
2. This theory indicates that there is **no difference between internal and external financing**. However, if the flotation costs of new issues are considered, it is incorrect.
3. This theory considers that the **shareholder's wealth is not impacted by the dividends**. Though, there are transaction costs related with the selling of shares to make cash inflows. This makes the investors choose dividends.
4. The assumption of **no uncertainty is unrealistic**.

4.Explain Walter's model of dividend policy?

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 sub serve the ultimate goal of maximising the wealth of the shareholders. Prof. 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 .

- ❖ In the case of growth firm ($r > k$), the market value per share, P , increases as pay-out ratio declines (optimum pay-out ratio is zero).
- ❖ In the case of declining firm ($r < k$), the market value per share, P , increases as pay-out ratio increases (optimum pay-out ratio is 100%).
- ❖ In the case of normal firm ($r = k$), the pay-out ratio has no effect on the market value per share

Assumption of Walter's Model

- (i) The investments of the firm are financed through retained earnings only and the firm does not use external sources of funds.
- (ii) The internal rate of return (r) and the cost of capital (k) of the firm are constant.
- (iii) Earnings and dividends do not change while determining the value.
- (iv) The firm has a very long life.

Criticism of Walter's Model:

Walter's theory is criticized for the following impractical assumptions in the model:

1. No External Financing: Walter's assumption of complete internal financing by the firm through retained earnings is problematic to follow in the actual world. The firms do need external financing for new investments.

2. Constant r and k : It is very unusual to find the internal rate of return and the cost of capital to be constant. The business risks will certainly change with more investments which is not revealed in this assumption.

Though Walter's theory has some improbable assumptions, it follows the notion that the dividend policy of a company has an effect on the market price of its share. It elucidates, the impact in the mathematical terms and finds the value of the share.