UNIT-IV
DIVIDEND DECISIONS

1. What is a Dividend Policy? Explain the different types of dividend policy.

Ans. A dividend policy can be defined as the dividend distribution guidelines provided by the board of directors of a company. It sets the parameter for delivering returns to the equity shareholders, on the capital invested by them in the business.

Types of Dividend Policy:

(i) Stable Dividend Policy: In this policy, the company decides a fixed amount of dividend for the shareholders, which is paid periodically. There is no change in the dividend allowed even if the company incurs loss or generates high profit.

(ii)Regular Dividend Policy: Here, a certain percentage of the company's profit is allowed as dividends to the shareholders. When the gain is high, the shareholders' earnings will also hike and vice-versa. It is one of the most appropriate policy to be adopted for creating goodwill.

(iii)Irregular Dividend Policy: Under this changeable policy, the company may or may not pay dividends to the shareholders. The top management i.e., the board of directors solely take all dividend decisions, as per their priorities.

(iv)No Dividend Policy: Here, the company always retain the profits to fund further projects. Moreover, it has no intention of declaring any dividends to its shareholders. This strategy may seem to be beneficial for business growth but usually discourages the investors aiming for sustainable income.

2. What is a Dividend? Explain the different types of dividend.

Ans. A dividend is nothing but the return declared to the equity shareholders through the distribution of a portion of profits earned by the organization.

Dividends can be classified in various forms. 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 meetings 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 and reduces the company's net worth, though the shareholders get an opportunity to invest the cash in any manner they desire. This is why the ordinary shareholders prefer to receive dividends in cash. But the firm must have adequate liquid resources at its disposal or provide for such resources so that its liquidity position is not adversely affected on account of cash dividends.

(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. 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.

(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. If a company does not have liquid resources it is better to declare stock dividend. Stock dividend amounts to capitalisation of earnings and distribution of profits among the existing shareholders without affecting the cash position of the firm.

3. What is stock dividend/bonus issue of shares? State its objectives. State the circumstances for issue of bonus share/declaration of stock dividend.

Ans. Bonus shares are additional shares given to the current shareholders without any additional cost, based upon the number of shares that a shareholder owns. Stock dividend means the issue of bonus shares to the existing shareholders. If a company does not have liquid resources it is better to declare stock dividend. Stock dividend amounts to capitalisation of earnings and distribution of profits among the existing shareholders without affecting the cash position of the firm.

Objectives of issue of bonus shares:
(i) To award their shareholders,
(ii)To retain profits in business,
(iii)To keep it's a good cash liquidity position,
(iv)To benefit existing shareholders instead of seeking new additional capital,

The following circumstances warrant the issue of bonus shares:

(i) When a company has accumulated huge profits and reserves and it desires to capitalise these profits so as use them on permanent basis in the business.

(ii) When the company is not able to declare higher rate of dividend on its capital, in spite of sufficient profits, due to restrictions imposed by the Government in regard to payment of dividend.

(iii) When higher rate of dividend is not advisable for the reason that the shareholder may expect the same higher rate of dividend in future also.

(iv) When the company cannot declare a cash bonus because of unsatisfactory cash position and its adverse effects on the working capital of the company.

(v) When there is a large difference in the nominal value and market value of the shares of the company.

4. State the advantages and disadvantages of bonus shares/stock dividend.

Ans. Advantages of bonus shares:

From investors point of view:
(i)The investor doesn't need to pay any tax upon receiving the bonus shares.
(ii)It is specifically beneficial for the investors who believe in the long-term story of the company and want to increase their investment in the same.

From Company's point of view:
(i) Bonus issue allows the company to conserve cash for reinvesting back into the business.
(ii)Sometimes, the company may not be in a position to pay any cash, so bonus issue is the only means to satisfy the shareholders' desire for a dividend.

Disadvantages of bonus shares:
From investors point of view:

(i) Not all investors may be interested in receiving the shares as a dividend; some may want liquidity for fulfilling other objectives. When such investors sell their bonus shares for generating liquidity, their stake in the company is reduced.

(ii)The stock dividend doesn't give any extra wealth to the shareholders because share price drops by a proportionate amount to keep the market capital of the company same as before.

From Company's point of view:
(i)Bonus issue increases the number of outstanding shares of the company and this will decrease the future EPS and cash dividend yield. This can have a negative impact on the market's perceived value of the company.

(ii)The company doesn't receive any cash upon issuing bonus shares. So, the company's ability to raise money by follow-on offerings is reduced.

5. Explain the SEBI guidelines on bonus issue of a company.

Ans. SEBI guidelines on bonus issue of a company are as follows:

(i)No bonus shares shall dilute other issues: Issue of bonus shares shall not be made pending conversion of fully convertible debentures or partly convertible debentures unless sufficient number of shares is reserved for allotment to the holders of the said FCDs or PCDs after conversion

(ii) Bonus issue from free reserves: Bonus shares can be issued only out of free reserves built out of genuine revenue profits or share premium collected in cash.

(iii) Revaluation reserves are not eligible: Reserve created by revaluation of assets cannot be capitalized for issue of bonus shares.

(iv)Issue in lieu of dividend: Bonus issue shall not be made in lieu of dividend.

(v) Partly paid up shares not eligible: Partly paid shares, if any, will not be eligible for bonus shares. Such partly paid shares, if any, must be made fully paid before a bonus issue is contemplated.

(vi) No default of payment of interest, etc.: The issuing company shall not have defaulted in the payment of interest or principal in respect of fixed deposits and interest payment on dentures or repayment of principal on redemption of debentures. The company must be certain that it has not defaulted in respect of payment of statutory dues of the employees, such as contribution of provident fund, gratuity, bonus, etc.

(vii)Time within which bonus issue shall be made: A company which announces a bonus issue after the approval of its Board of Directors must implement the proposal within a period of six months from the date of such approval.

(viii)Bonus proposal cannot be withdrawn: A company which has announced its proposal to issue bonus shares, cannot have the option to change its decision.

(ix) Provision in the articles: There must be a suitable provision in the Articles of Association of the company for capitalisation of reserves. If not, the company must pass a special resolution and incorporate a suitable provision in the Articles of Association, before initiating action for a bonus issue.

(x)Increase in authorized capital: Where necessary, before action on a bonus issue is taken, the company shall increase its authorised capital so as to permit the proposed bonus issue.

6. Explain the MM hypothesis of dividend (Irrelevance theory of dividend policy).

Ans. The irrelevance of dividend policy for valuation of the firm has been most comprehensively presented by Modigliani and Miller (MM). They have argued that the market price of a share is affected by the earnings of the firm and is not influenced by the pattern of income distribution. The dividend policy is immaterial and is of no consequence to the value of the firm. What matters, on the other hand, is the investment decisions which determine the earnings of the firm and thus affect the value of the firm. They argue that subject to a number of assumptions, the way a firm splits its earnings between dividends and retained earnings has no effect on the value of the firm.

Assumptions of the MM Approach: The MM approach to irrelevance of dividend is based on the following assumptions:

(i) The capital markets are perfect and the investors behave rationally.

(ii) All informations are freely available to all the investors.

(iii) There is no transaction cost and no time lag.

(iv) Securities are divisible and can be split into any fraction.

(v) There are no taxes and no flotation cost.

(vi) The firm has a defined investment policy and the future profits are known with certainty. The implication is that the investment decisions are unaffected by the dividend decision and operating cash flows are same no matter which dividend policy is adopted.

The Argument of MM

The argument given by MM in support of their hypothesis 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 shareholders. For example, if a company, having investment opportunities, distributes all its earnings among the shareholders, 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 neutralised 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.

Critical Appraisal (Shortcomings):

The MM model may be criticized as follows:

(i) The assumption of perfect capital market is theoretical in nature as the perfect capital market is never found in practice.

(ii) No flotation cost and no time lag assumptions are also unrealistic. In reality, the fact is otherwise and companies have to incur expenses in raising fresh equity capital from the market and that too requires a time gap to fulfil a lot of legal formalities for raising capital, etc.

(iii) Similarly, the assumption of no transaction costs is imaginary. Some brokerage or commission etc. is payable by the investors whenever they decide in future to encash future capital gain arising out of bonus shares. Hence, the investors may prefer current dividend.

(iv) Assumption of no tax is also questionable. There is generally a difference in tax rate applicable to dividend incomes and capital gains in the hands of the shareholders.

(v) MM have assumed that the investment policy of the firm is independent of the financing policy. But, some of the firms may undertake only limited investment projects which can be financed by retained earnings only. Some companies, even if they are willing, may not find conducive conditions to raise capital from the market.

Thus, the MM model is not a practical proposition. The dividend irrelevance argument does not seem to be feasible when the assumptions underlying the MM model are relaxed.

7. Explain the Walter's model of dividend policy.

Ans. 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 share holders. 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.

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 firms and the optimum pay-out would be zero in their case. This would maximise the value of shares.

In case of declining firms which do not have profitable investments, i.e., where **r <k,** the shareholders would stand to gain if the firm distributes its earnings. For such firms, the optimum pay-out would be 100% and the firms should distribute the entire earnings as dividends.

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 payout and the value of the firm would not change with the change in dividend rate.

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.

(ii) Earnings and dividends do not change while determining the value.

(iy The firm has a very long life.

Criticism of Walter's Model

Walter's model has been criticised on account of various assumptions made by Prof. Walter in formulating his hypothesis:

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

(ii)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.

(iii) 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.

8. Explain the Gordon's model of dividend policy.

Ans. 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. His basic valuation model is based on the following assumptions:

(i) The firm is an all equity firm.

(ii) No external financing is available or used. Retained earnings represent the only source of financing investment programmes.

(iii) The rate of return on the firm's investment **r,** is constant.

(iv) The retention ratio, **b**, once decided upon is constant. Thus, the growth rate of the firm **g = br**, is also constant.

(v) The cost of capital for the firm remains constant and it is greater than the growth rate, i.e. **k> br**.

(vi) The firm has perpetual life.

(vii) Corporate taxes do not exist.

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

The implications of Gordon's basic valuation model may be summarised as below:

(i)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.

(ii) 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.

(iii)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%.

Criticism of Gordon's Model

(i)It is assumed that firm's investment opportunities are financed only through the retained earnings and no external financing viz. Debt or equity is raised. Thus, the investment policy or the dividend policy or both can be sub-optimal.

(ii)The Gordon's Model is only applicable to all equity firms. It is assumed that the rate of returns is constant, but, however, it decreases with more and more investments.

(iii)It is assumed that the cost of capital (K) remains constant but, however, it is not realistic in the real life situations, as it ignores the business risk, which has a direct impact on the firm's value.

8. Explain the factors affecting dividend decision.
Or
Explain the determinants of dividend policy.

Ans. The finance manager analyses following factors before dividing the net earnings between dividend and retained earnings:

(i)Earning: Dividends are paid out of current and previous year's earnings. If there are more earnings then company declares high rate of dividend whereas during low earning period the rate of dividend is also low.

(ii) Stability of Earnings: Companies having stable or smooth earnings prefer to give high rate of dividend whereas companies with unstable earnings prefer to give low rate of earnings.

(iii) Cash Flow Position: Paying dividend means outflow of cash. Companies declare high rate of dividend only when they have surplus cash. In situation of shortage of cash companies declare no or very low dividend.

(iv)Growth Opportunities: If a company has a number of investment plans then it should reinvest the earnings of the company. As to invest in investment projects, company has two options: one to raise additional capital or invest its retained earnings. The retained earnings are cheaper source as they do not involve floatation cost and any legal formalities.

(v)Stability of Dividend: Some companies follow a stable dividend policy as it has better impact on shareholder and improves the reputation of company in the share market. The stable dividend policy satisfies the investor. Even big companies and financial institutions prefer to invest in a company with regular and stable dividend policy.

(vi) Tax policy: Taxation policy of the government is an important factor in taking the dividend decision. For instance, if the rate of taxation on payment of dividends by companies is high, then the company may distribute less by way of dividends.

(vii) Stock market reactions: Dividend decisions taken by a company affect the market price of its stock. If a company declares higher dividends, then it is seen positively by investors, and its stock price increases. On the other hand, a fall in dividends would have an adverse effect on the stock price of a company.

(viii) Legal Constraints: Certain provisions of the Companies Act, place restrictions on payouts as dividend. Such provisions must be adhered to, while declaring the dividend.