

## **Unit IV: Dividend Decisions**

### **INTRODUCTION**

Once a company makes a profit, it must decide on what to do with those profits. They could continue to retain the profits within the company, or they could pay out the profits to the owners of the firm in the form of dividends. The dividend policy decision involves two questions:

- 1) What fraction of earnings should be paid out, on average, over time? And,
- 2) What type of dividend policy should the firm follow? I.e. issues such as whether it should maintain steady dividend policy or a policy increasing dividend growth rate etc.

### **DEFINITION: DIVIDEND**

According to the Institute of Chartered Accountants of India, dividend is "a distribution to shareholders out of profits or reserves available for this purpose."

"The term dividend refers to that portion of profit (after tax) which is distributed among the owners / shareholders of the firm".

In other words, dividend is that part of the net earnings of a corporation that is distributed to its stockholders. It is a payment made to the equity shareholders for their investment in the company.

Dividend is a reward to equity shareholders for their investment in the company. It is a basic right of equity shareholders to get dividend from the earnings of a company.

### **DEFINITION: DIVIDEND POLICY**

"Dividend policy determines the ultimate distribution of the firm's earnings between retention (that is reinvestment) and cash dividend payments of shareholders."

"Dividend policy means the practice that management follows in making dividend payout decisions, or in other words, the size and pattern of cash distributions over the time to shareholders."

In other words, dividend policy is the firm's plan of action to be followed when dividend decisions are made. It is the decision about how much of earnings to pay out as dividends versus retaining and reinvesting earnings in the firm.

Dividend policy must be evaluated in light of the objective of the firm namely, to choose a policy that will maximize the value of the firm to its shareholders. The dividend policy of a company reflects how prudent its financial management is. The future prospects, expansion, diversification mergers are effected by dividing policies and for a healthy and buoyant capital market, both dividends and retained earnings are important factors.

As we know in corporation, owners are shareholders but management is done through Board of directors. It is the Board of Directors to decide whether to pay dividend or retain earnings for future projects. It is a matter of conflict between shareholders and directors. Shareholders expect a quick return on their capital. On the other hand, directors have to consider a number of factors in determining divided policy.

Most of the company follows some kind of dividend policy. The usual policy of a company is to retain a position of net earnings and distribute the remaining amount to the shareholders. Many factors have to be evaluated before forming a long term dividend policy.

## **TYPES OF DIVIDENDS:**

Classifications of dividends are based on the form in which they are paid. Following given below are the different types of dividends:

- i. Cash dividend
- ii. Bonus Shares referred to as stock dividend
- iii. Property dividend interim dividend, annual dividend.
- iv. Special- dividend, extra dividend etc.
- v. Regular Cash dividend
- vi. Scrip dividend
- vii. Liquidating dividend
- viii. Property dividend

### **Cash dividend:**

Companies mostly pay dividends in cash. A Company should have enough cash in its bank account when cash dividends are declared. If it does not have enough bank balance, arrangement should be made to borrow funds. When the Company follows a stable dividend policy, it should prepare a cash budget for the coming period to indicate the necessary funds, which would be needed to meet the regular dividend payments of the company. It is relatively difficult to make cash planning in anticipation of dividend needs when an unstable policy is followed.

The cash account and the reserve account of a company will be reduced when the cash dividend is paid. Thus, both the total assets and net worth of the company are reduced when the cash dividend is distributed. The market price of the share drops in most cases by the amount of the cash dividend distributed.

### **Bonus Shares:**

An issue of bonus share is the distribution of shares free of cost to the existing shareholders, In India, bonus shares are issued in addition to the cash dividend and not in lieu of cash dividend. Hence, Companies in India may supplement cash dividend by bonus issues. Issuing bonus shares increases the number of outstanding shares of the company. The bonus shares are distributed proportionately to the existing shareholder. Hence there is no dilution of ownership. The declaration of the bonus shares will increase the paid-up Share Capital and reduce the reserves and surplus (retained earnings) of the company. The total net-worth (paid up capital plus reserves and surplus) is not affected by the bonus issue. Infact, a bonus issue represents a recapitalization of reserves and surplus. It is merely an accounting transfer from reserves and surplus to paid up capital.

The following are **advantages** of the bonus shares to shareholders:

- 1) **Tax benefit:** One of the advantages to shareholders in the receipt of bonus shares is the beneficial treatment of such dividends with regard to income taxes.
- 2) **Indication of higher future profits:** The issue of bonus shares is normally interpreted by shareholders as an indication of higher profitability.

- 3) **Future dividends may increase:** if a Company has been following a policy of paying a fixed amount of dividend per share and continues it after the declaration of the bonus issue, the total cash dividend of the shareholders will increase in the future.
- 4) **Psychological Value:** The declaration of the bonus issue may have a favorable psychological effect on shareholders. The receipt of bonus shares gives them a chance to sell the shares to make capital gains without impairing their principal investment. They also associate it with the prosperity of the company.

**Please note from exam point of view only cash dividend and bonus dividend are important.**

**Special dividend :** In special circumstances Company declares Special dividends. Generally company declares special dividend in case of abnormal profits.

**Extra- dividend:** An extra dividend is an additional non-recurring dividend paid over and above the regular dividends by the company. Companies with fluctuating earnings payout additional dividends when their earnings warrant it, rather than fighting to keep a higher quantity of regular dividends.

**Annual dividend:** When annually company declares and pay dividend is defined as annual dividend.

**Interim dividend:** During the year any time company declares a dividend, it is defined as Interim dividend.

**Regular cash dividends:** They may be paid quarterly, monthly, semiannually or annually.

**Scrip dividends:** These are promises to make the payment of dividend at a future date: Instead of paying the dividend now, the firm elects to pay it at some later date. The 'scrip' issued to stockholders is merely a special form of promissory note or notes payable.

**Liquidating dividends:** These dividends are those which reduce paid-in capital: It is a pro-rata distribution of cash or property to stockholders as part of the dissolution of a business.

**Property dividends:** These dividends are payable in assets of the corporation other than cash. For example, a firm may distribute samples of its own product or shares in another company it owns to its stockholders.

## **THE DIVIDEND DECISION**

### **WHO MAKES DIVIDEND DECISION?**

The company's Board of Directors makes dividend decisions. They are faced with the decision to pay out dividends or to reinvest the cash into new projects.

## **The tradeoff between paying dividends and retaining profits within the company:**

The dividend policy decision is a trade-off between retaining earnings v/s paying out cash dividends.

Dividend policies must always consider two basic objectives:

1. Maximizing owners' wealth
2. Providing sufficient financing

While determining a firm's dividend policy, management must find a balance between current income for stockholders (dividends) and future growth of the company (retained earnings).

In applying a rational framework for dividend policy, a firm must consider the following two issues:

1. How much cash is available for paying dividends to equity investors, after meeting all needs-debt payments, capital expenditures and working capital (i.e. Free Cash Flow to Equity - FCFE)
2. To what extent are good projects available to the firm (i.e. Return on equity - ROE > Required Return)

### **Dividend Decision Matrix**

<b>Factors</b>	<b>FCFE &gt; Dividends</b>	<b>FCFE &lt; Dividends</b>
<b>ROE &gt; Cost of Equity</b>	Good Projects Cash flow surplus No Change	Good Projects Decrease Dividends Invest in Projects
<b>ROE &lt; Cost of Equity</b>	Poor Projects Cash flow surplus Dividends Investment	Poor Projects Cash flow Deficit Decrease Dividends Reduce Investment

**Where, ROE: Return on Equity and FCFE: Free Cash Flow to Equity.**

### **TYPES OF DIVIDEND POLICY**

#### **How do firms view their dividend policies?**

In a classic study, Lintner surveyed a number of managers in the 1950's and asked how they set their dividend policy. Most of the respondents said that there were a target proportion of earnings that determined their policy. One firm's policy might be to pay out 40 % of earnings as dividends whereas another company might have a target of 50 %.

On the basis of interviews with corporate executives, Lintner concluded that firms select target payout ratios to which they gradually adjust actual dividend payments over time. **This would suggest that dividends change with earnings.**

However, dividend policies may vary between various firms as every firm sets its own policy for dividend distribution.

Firms may pursue any one of the following dividend policies:

1. **Generous or liberal dividend policy:** Firms that follow this policy reward shareholders generously by stepping up dividend over the time.
2. **Stable dividend policy:** Firms may follow the policy of: Stable dividend payout ratio: According to this policy, the **percentage of earnings paid out of dividends remains constant.** The dividends will fluctuate with the earnings of the company. Stable rupee (inflation adjusted) dividend policy: As per this policy the rupee level of dividends remains stable.
3. **Low regular dividend plus extra dividend policy:** As per this policy, a low, regular dividend is maintained and when times are good an extra dividend is paid. Extra dividend is the additional dividend optionally paid by the firm if earnings are higher than normal in a given period. Although the regular portion will be predictable, the total dividend will be unpredictable.
4. **Residual dividend policy:** Under this policy, dividends are paid out of earnings not needed to finance new acceptable capital projects. The dividends will fluctuate depending on investment opportunities available to the company.
5. **Multiple dividend increase policy:** Some firms follow the policy of very frequent and small dividend increases. The objective is to give shareholders an illusion of movement and growth.
6. **Uniform cash dividend plus bonus policy:** Under this policy, the minimum rate of dividend per share is paid in cash plus bonus shares are issued out of accumulated reserves. However, bonus shares are not given compulsorily on an annual basis. They may be given over a period of a certain number of years, for example 3-5 years depending on the accumulated reserves of the company that can be utilized for the purpose of issuing bonus.

## **STABLE DIVIDEND POLICY: A POLICY OF DIVIDEND SMOOTHING**

Lintner (1956) had observed that managers tend to value stable dividend policies and corporations tend to smooth dividends relative to earnings. That is, dividends are increased gradually and rarely cut, resulting in a much lower variability of dividends as compared to the variability in earnings.

Most Companies adapt a basic policy of maintaining its internal reserves to ensure stable income far into the future, while at the same time seek to distribute a sufficient amount of earnings to shareholders in accordance with business results. with a decrease in EPS, DPS has decreased and with increase in earnings the dividend per share has increased. However increase in dividends is lagging behind increase in earnings in order to 'smoothen' or 'stabilize' dividend payments over the time.

Firm may adapt any of the following stable dividend policies:

- Stable dividend payout ratio
- Stable dividends per share
- A regular plus extra dividend policy

**Dividend payout Ratio:** it is calculated by dividing the total dividend to equity shareholders by the net income available to them for that period as follows:

$$= \frac{\text{Total dividend paid}}{\text{Net income after tax}}$$

OR

$$= \frac{\text{Annual dividend paid per share}}{\text{EPS}}$$

OR

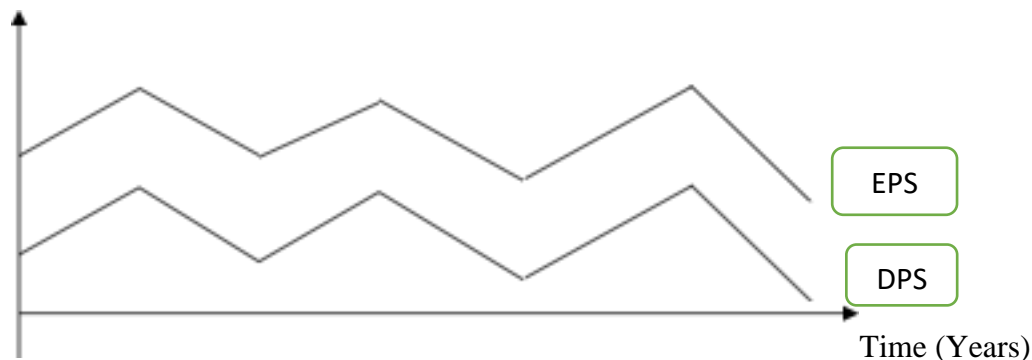
$$= 1 - \text{Retention Ratio}$$

Where retention ratio =  $\frac{\text{Retained Earnings}}{\text{Net income}}$

**Retention Ratio + Dividend payout Ratio = 1** (which means whatever amount is not paid by dividend is retained by the company to reinvest)

### 1. Stable dividend payout ratio

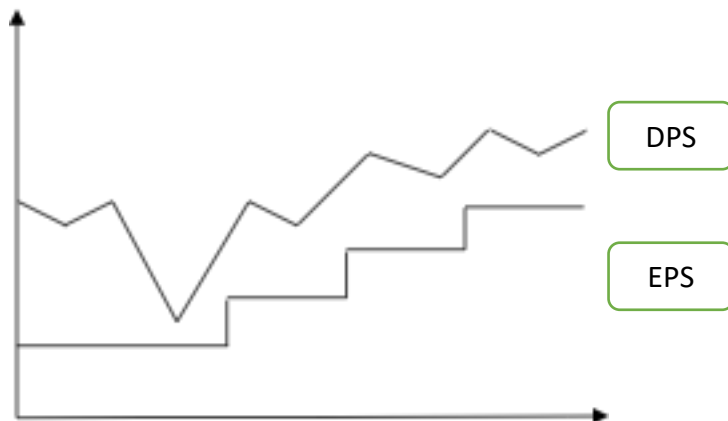
As per this policy the **percentage** of dividends paid out of earnings remains **constant**.



Example: if a company adopts a 30% payout ratio and if EPS is Rs 100, then shareholder having 10 shares will receive Rs.300 as dividend under this policy.

### 2. Stable dividends per share

According to this policy, the firm **pays a certain fixed amount of dividend per share** every year. Annual dividend per share is increased only when the company reaches a new level of earnings and expects to maintain it.



### 3. A regular plus extra dividend policy

According to this policy a certain fixed percentage or a minimum amount of dividend is paid every year, which is referred to as regular dividend. The firm pays 'additional' or 'extra' dividend if earnings are higher than normal in any year.

#### **Rationale for stable dividend policy:**

Most firms adopt a stable dividend policy. If a firm's earnings are temporarily depressed or if it needs a substantial amount of funds for investment, then it might well maintain its regular dividend using borrowed funds to meet its needs, until things returned to normal. The logic or rationale for stable dividend policy is:

- Stockholders like stable dividends--many of them depend on dividend income, and if dividends were cut, this might cause serious hardship to them. A stable dividend policy is desirable for many investors such as retired persons, who take dividends as a source to meet their current living expenses.
- A stable dividend policy would reduce investor uncertainty, and reductions in uncertainty are generally associated with lower capital costs and higher stock prices, other things being equal.
- Institutional investors generally prefer to invest in companies having stable dividend records
- Adoption of stable dividends is advantageous for a company interested in raising funds from external sources as shareholders willingly invest in companies having stable dividends as they have more confidence in such companies.

The **disadvantage** is that such a policy might decrease corporate flexibility. Once a company has adapted a stable dividend policy, any change in such a policy may have adverse effects on the company image and may result in creating serious doubts in the minds of investors about financial standing of the company, which might prove to be very dangerous for the company at a later stage.