Chapter 13 Dividend Policy and Decisions

Every CFO has, therefore, to decide how are the accumulated net earnings of the company to be utilized? The one alternative is to continue to retain them with the company for reinvestment; the other one is distribute them to the share owners as dividends. In most of the cases they have to determine what portion of the net earnings to be retained in the business and what portion to be utilized for dividends.

Marginal Principle of Retained Earnings

Retained earnings of the company can either be used to reinvest in new projects of the company that generate further revenue and assure continuous growth or distributed to stock holders as dividends for the funds provided by them to start the business. Ideally the finance managers should determine what rate of earnings the shareholders would receive from the dividends distributed to them, if that rate is higher than the rate of earnings from reinvestment in company's future projects, then it is clear that available funds can be distributed as dividends. This is termed Marginal Principle of Retained Earnings. Here we have tacitly assumed that the active base for issue of dividends is retained earnings and not the need for dividends.

But if the rate of earnings on reinvestment in the company is higher than what equity holders can earn from dividends in their hands, finance managers have to decide what portion of retained earnings be distributed as dividends so that enough funds are available for reinvestment for further growth of the company. Each potential project to be financed by internally generated funds must provide a higher rate of return than the equity holder could achieve on his/her other investments.

Here we are assuming that dividends are to be paid out only if the business entity cannot make better use of the available retained earnings. The active base for issue of dividends is retained earnings and not the investors' need for dividends.

Stockholders' Preference

However when investors put their funds into company's equity stock, they expect to receive returns, usually more than what they would receive from investment in term loans / deposits. Some want this return immediately and at a reasonable fixed rate and balance wish long term gains usually in the form of appreciation the market value of their shares. Additionally there is a class of investors who want both above. Shareholders' preference along with the need for funds by the company together is considered by CFOs to determine the part of the net earnings to be distributed as dividends.

Companies with high business growth potential retain most of the retained earnings for investment and declare modest dividends. Thus high growth companies enjoy a low payout ratio and those mature companies with slower business growth potential have a high dividend payout ratio.

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Some financial analysts argue that investors are not concerned with a company's dividend policy since they can satisfy their need for current funds as they can sell a portion of their portfolio of equities if they want cash. This evidence is called the "dividend irrelevance theory," and it essentially indicates that an issuance of dividends should have little to no impact on stock price. But each investor cannot be expected to sell a portion of her shares in lieu of dividends as this is very complex alternative to receipt of dividends direct into her bank account.

Other factors that influence dividend decisions are a) the need for informing investors about company's bright prospects - when shareholders receive dividends regularly they are assured about the financial prospects of the company. A high dividend payout ratio suggests that the future of the company as judged by the management is promising and there is no need to look at alternative investment opportunity; b) availability of liquid assets - Retained earnings are not fully reflected by liquid cash in the balance sheet. They are often reflected by inventory and receivables which can be substantial, especially when sales volumes are increasing. As sales and earnings expand rapidly there is bound to be an inventory and receivables build up. It restricts generation of cash flow and it is uneconomic to liquidate these non-cash assets for immediate satisfaction of shareholders; c) access to the Financial Markets - a company with sound financial past record can have an easy access to financial markets and it can arrange funds for dividends through increasing its debt. Declaration of dividend this way ensures stability in dividend payout which in turn has positive impact on the firm's credit standing; and d) Income Tax - Until 1997 dividend income of stockholders was added to their taxable income. Shareholders in the higher tax bracket, at that time, were not in favor of dividend payout. With no dividend obligations, a company could utilize its retained earnings fully for reinvestment and increase in earnings per share. This in turn results in higher market value for its shares. High income tax payers thus had preference for scrips that offered potential to generate capital gains achieved from increase in their value in the stock market. The tax on capital gains was at much lower rate than tax on income.

Today the situation has changed. Shareholders do not have to pay any income tax on dividend income

The Companies Act 2013 requirements

Dividend should be paid out of i) the profit of the company for the financial year; or ii) profits for the previous financial years which have not been transferred to reserves; or iii) out of both. It has to be ensured that the board of directors has arranged to set off entire previous losses and depreciation not provided in previous year or years. Company should pay dividend to preference shareholders before dividend is paid to the equity shareholders of the company.

The Companies Act 2013 allows CFOs to determine what proportion of net earnings has to be retained by them as reserves with the company. Earlier these percentages were defined by the Act. The act further states that after declaration of the dividend the company shall deposit amount of dividend (including interim dividend) in separate account with a scheduled bank.

Earlier Companies Act, 1956, had imposed a burden to transfer certain fixed percentage of profit to reserve before declaration of dividend in any financial year. This percentage had direct

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relation to the percentage of dividend to be declared. However, Companies Act, 2013 introduced a liberal provision in this regard and withdrew the fixed percentage of profits to be transferred to reserves and instead allowed transfer such percentage of profit to reserves of the company as company may consider appropriate.

Market Price of Shares Depends on Earnings and not on Dividends

Two economists Miller and Modigliani have propagated that market value of a company depends on its earning power and whether these earnings are retained in the business for reinvestment or distributed to its shareholders in the form of dividends has no relationship with firm's market value of shares.

The Modigliani–Miller theorem (of Franco Modigliani, Merton Miller) is a theorem on capital structure, arguably forming the basis for modern thinking on capital structure. The basic theorem states that under a certain market price process (the classical random walk), in the absence of taxes, bankruptcy costs, agency costs, and asymmetric information, and in an efficient market, the value of a firm is unaffected by how that firm is financed or how does it employ its retained earnings. Since the value of the firm depends neither on its dividend policy nor its decision to raise capital by issuing stock or selling debt, the Modigliani–Miller theorem is often called the capital structure irrelevance principle. Modigliani and Miller approach further states that the market value of a firm is affected by its future growth prospect apart from the risk involved in the investment. The theory stated that value of the firm is not dependent on the choice of capital structure or financing decision of the firm. If a company has high growth prospect, its market value is on the rise and hence its stock prices would be high. If investors do not see attractive growth prospects in a firm, the market value of that firm would not be that great.

Second very popular model explicitly relating the market value of the firm to dividend policy is developed by Myron Gordon. According to Gordon's dividend capitalization model, the market value of a share (Po) is equal to the present value of an infinite stream of dividends to be received by the shareholders.

Rational Expectations Model

The third school of thought on dividends is based on the premise that what matters is not the actual dividend amount but the difference between what was expected to happen and the actual event. This was enunciated by John F Muth in his paper entitled "Rational Expectations and the Theory of price Movements. It concludes that if dividend declared is higher than the investors' expectations, the share price increases after dividend declaration and *vice versa.*

External factors that affect company's dividend policy include a) State of Economy; b) Capital Markets; c) Legal Constraints and d) Corporate tax structure. While Internal Factors that determine dividend policy include a) Firm's need for funds b) Business Nature; c) Availability of Funds; d) Maturity of Business Unit; e) Availability of Liquid Funds; f) Debt Agreements and g) Company's' Expansion Plans.

Dividends are sometimes also offered in the form stock dividends or stock splits.

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