SOS POLITICAL SCIENCE AND PUBLIC ADMINISTRATION

MBA FA 202

SUBJECT NAME: FUNDAMENTALS OF FINANCIAL MANAGEMENT

UNIT-V **TOPIC NAME: DIVIIDENT POLICY**

Introduction

The important aspect of dividend policy is to determine the amount of earnings to be distributed to shareholders and the amount to be retained in the firm. Retained earnings are the most significant internal sources of financing the growth of the firm. On the other hand, dividends may be considered desirable from the shareholders' point of view as they tend to increase their current return. Dividends, however, constitute the use of the firm's funds. Dividend policy involves the balancing of the shareholders' desire for current dividends and the firms' needs for funds for growth.

Objective of dividend policy

A firms' dividend policy has the effect of dividing its net earnings into two parts: retained earnings and dividends. The retained earnings provide funds to finance the firm's long – term growth. It is the most significant source of financing a firm's investment in practice. Dividends are paid in cash. Thus, the distribution of earnings uses the available cash of the firm. A firm which intends to pay dividends and also needs funds to finance its investment opportunities will have to use external sources of financing, such as the issue of debt or equity.

1.1. Dividends - Classification

The term dividend usually refers to cash paid out of earnings. If a payment is made from sources other than current or accumulated retained earnings, the term distribution, rather than dividend, is used. However, it is acceptable to refer to a distribution of earnings as a dividend and a distribution from capital as a liquidating dividend. More generally, any direct payment by the corporation to the shareholders may be considered a dividend or a part of dividend policy.

Dividends come in several different forms. The basic types of cash dividends are:

- Regular cash dividends

- Extra dividends
- Special dividends
- Liquidating dividends

1.1.1 Cash Dividends

The most common type of dividend is a cash dividend. **Commonly, public companies pay regular cash dividends four times a year. As the name suggests, these are cash payments made directly to shareholders, and they are made in the regular course ofbusiness.** In other words, management sees nothing unusual about the dividend and no reason why it won't be continued.

Sometimes firms will pay a regular cash dividend and an extra cash dividend. By calling part of the payment "extra" management is indicating that the "extra" part may or may not be repeated in the future. **A special dividend is similar, but the name usually indicates that this dividend is viewed as a truly unusual or one-time event and won't be repeated.** Finally, the payment of **a liquidating dividend usually means that some or all of the business has been liquidated, that is, sold off.** However it is labeled**, a cash dividend payment reduces corporate cash and retained earnings, except in the case of a liquidating dividend.**

1.1.2 Bonus Shares (Stock dividend)

An issue of bonus shares is the distribution of shares free of cost to existing shareholders. Bonus shares are issued in addition to the cash dividend and not in lieu of cash dividends. Hence, companies may supplement cash dividend by bonus issues. Issuing bonus shares increase 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**. For example,** if a shareholder owns 100 shares at the time when a 10 per cent (ie., 1:10) bonus issue made, he will receive 10 additional shares. The declaration of the bonus shares will increase the paid-up share capital and reduce the reserve and surplus earnings of the company. The total net worth is not affected by the bonus issue.

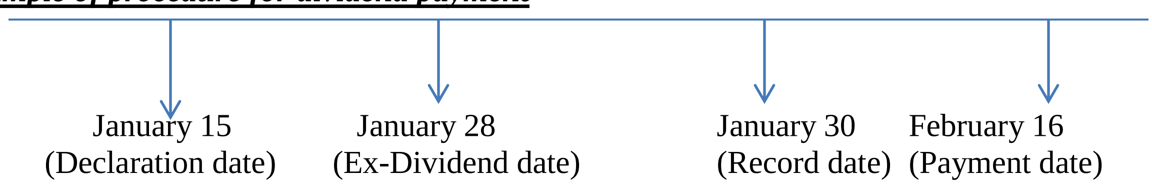
1.1.3 Stock Split

A **stock split** is essentially the same thing as a stock dividend, except that a split is expressed as a ratio instead of a percentage. When a split is declared, each share is split up to create additional shares. **For example, in a three-for-one stock split, each old share is split into three new shares.**

1.1.4 Standard Method of Cash Dividend Payment

The decision to pay a dividend rests in the hands of the board of directors of the corporation. When a dividend has been declared, it becomes a debt of the firm and cannot be rescinded easily. Sometime after it has been declared, a dividend is distributed to all shareholders as of some specific date. Commonly, the amount of the cash dividend is expressed in terms of dollars per share (dividends per share). As we have seen in other chapters, it is also expressed as a percentage of the market price (the dividend yield) or as a percentage of net income or earnings per share (the dividend payout).

Example of procedure for dividend payment



6.2 Establishing Dividend policies and Decisions

How do firms actually determine the level of dividends they will pay at a particular time? As we have seen, there are good reasons for firms to pay **high** dividends and there are good reasons to pay **low** dividends. There are three approaches for establishing dividend policy. These are three types of the dividend policy, such as residual dividend approach, dividend stability and a compromise dividend policy.

6.2.1 Residual Dividend Approach

- Firms with higher dividend payouts will have to sell stock more often. Such sales are not very common and they can be very expensive.

- ❖ Consistent with this, we will assume that the firm wishes to minimize the need to sell new equity. We will also assume that the firm wishes to maintain its current capital structure.
- ❖ If a firm wishes to avoid new equity sales, then it will have to rely on internally generated equity to finance new positive NPV projects. Dividends can only be paid out of what is left over. This leftover is called the *residual,* and such a dividend policy is called a **residual dividend approach**.
- ❖ With a residual dividend policy, the firm's objective is to meet its investment needs and maintain its desired debt-equity ratio before paying dividends.

Illustrate, imagine that a firm has $1,000 in earnings and a debt-equity ratio of 0.50. Notice that, because the debt-equity ratio is 0.50, the firm has 50 cents in debt for every $1.50 in total value. The firm's capital structure is thus debt and equity.

The first step in implementing a residual dividend policy is to determine the amount of funds that can be generated without selling new equity. If the firm reinvests the entire $1,000 and pays no dividend, then equity will increase by $1,000. To keep the debt-equity ratio of 0.50, the firm must borrow an additional $500. The total amount of funds that can be generated without selling new equity is thus $1,000 + 500 = $1,500.

The second step is to decide whether or not a dividend will be paid. To do this, we compare the total amount that can be generated without selling new equity ($1,500 in this case) to planned capital spending.

- ➢ If funds needed exceed funds available, then no dividend will be paid. In addition, the firm will have to sell new equity to raise the needed financing or else postpone some planned capital spending.
- ➢ If funds needed are less than funds generated, then a dividend will be paid. The amount of the dividend will be the residual, that is, that portion of the earnings that is not needed to finance new projects.

For example,

Suppose we have $900 in planning capital spending. To maintain the firm's capital structure, this $900 must be financed by 2⁄3 equity and 1⁄3debt. So, the firm will actually borrow 1⁄3 X $900 = $300. The firm will spend 2⁄3 X $900 = $600 of the $1,000 in equity available. There is a $1,000 - 600 = $400 residual, so the dividend will be $400.

In sum, the firm has after tax earnings of $1,000. Dividends paid are $400. Retained earnings are $600, and new borrowing totals $300. The firm's debt-equity ratio is unchanged at 0.50.

6.2.2 Stability of Dividend

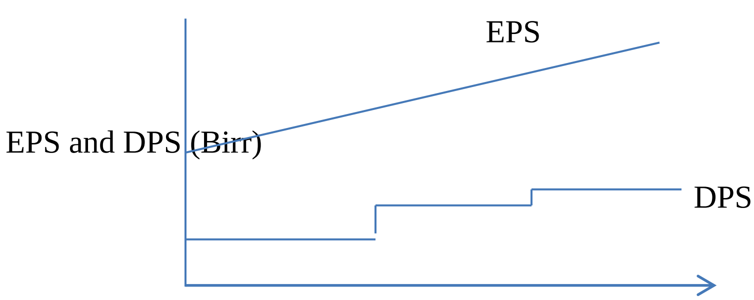
It is considered a desirable policy by the management of most companies in practices. Many surveys have shown that shareholders also seem generally to favor this policy and value stable dividends higher than the fluctuating ones. All other things being the same, ***the stable dividend policy may have a positive impact on the market price of the share.***

It is also meant regularity in paying some dividend annually, even though the amount of the dividend may fluctuate over the years, and may not relate to earnings. There are a number of companies, which have records of paying dividend for a long, unbroken period. More precisely, ***stability of dividend refers to the amounts paid out regularly.*** Three forms of such stability may be distinguished:

a) Constant dividend per share or dividend rate
b) Constant pay out.
c) Constant dividend per share plus extra dividend.

a) Constant dividend per share or dividend rate

The companies announce dividend as per cent of the paid-up capital per share. A company follows the policy of paying a fixed rate on paid-up capital as dividend every year, irrespective of fluctuations in the earnings. This policy does not imply that the dividend per share or dividend rate will never be increased. When the company reaches new levels of earnings and expects to maintain them, the annual dividend per share may be increased. The relationship between earnings per shares and the dividend per share under this policy is shown below figure



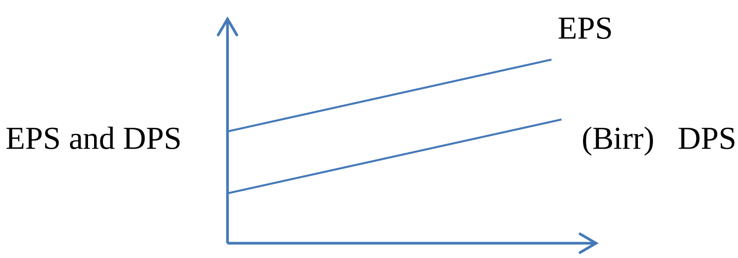
Constant dividend per share policy ***Time (Years)***

A constant dividend per share policy puts ordinary shareholders at par with preferred shareholders irrespective of the firm's investment opportunities or the preference shareholders. Those investors who have dividends as they only sources of their income may prefer the constant dividend policy. They do not accord much importance to the changes in share prices. In the long run, this may help to stabilize the market price of the share.

b) Constant Payout

The ratio of dividend to earnings is known as payout ratio. Some companies may follow a policy of constant payout ratio ie., paying a fixed percentage of net earnings every year. With this policy of the amount of the dividend will fluctuate in direct proportion to earnings. If a company adopts a 40 percent payout ratio, then 40 percent of every Birr of net earnings will be paid out.

For example, if the company earns, 2 Birr per share, the dividend per share will be 0.80 Birr and if it earns 1.5 Birr per share the dividend per share will be 0.60 Birr. The relation between the earnings per share and the dividend per share under the policy is exhibited in the below figure.



Dividend policy of constant payout ratio

This policy is related to a company's ability to pay dividends. If the company incurs losses, no dividend shall be paid regardless of the desires of shareholders. Internal financing with retained earnings is automatic when this policy is followed. At any given payout ratio, the amount of dividends and the additions to retained earnings increase with increasing earnings and decrease with decrease earnings. This policy does not put any pressure on a company's liquidity since dividends are distributed only when the company has profited.

c) Constant dividend per share plus Extra dividend

The smallest amount of dividend per share is fixed to reduce the possibility of every missing a dividend payment. By paying extra dividend in periods of prosperity, an attempt is made to prevent investors from expecting that the dividend represents an increase in the established dividend amount. This type of policy enables a company to pay a constant amount of dividend regularly without a default and allows a great deal of flexibility for supplementing the income of shareholders only when the company earnings are higher than the usual, without committing itself to make a larger payments as part of the future fixed dividend.

6.2.3 A Compromise Dividend Policy

In practice, many firms appear to follow a compromise dividend policy. Such a policy is based on five main goals:

1. Avoid cutting back on positive NPV projects to pay a dividend.
2. Avoid dividend cuts.
3. Avoid the need to sell equity.
4. Maintain a target debt-equity ratio.
5. Maintain a target dividend payout ratio.

These goals are ranked more or less in order of their importance. In our strict residual approach, we assume that the firm maintains a fixed debt-equity ratio. Under the compromise approach, the debt-equity ratio is viewed as a long-range goal. It is allowed to vary in the short run if necessary to avoid a dividend cut or the need to sell new equity.

In addition to having a strong reluctance to cut dividends, financial managers tend to think of dividend payments in terms of a proportion of income, and they also tend to think investors are entitled to a “fair” share of corporate income. This share is the long-run **target payout ratio**, and it is the fraction of the earnings the firm expects to pay as dividends under ordinary circumstances. Again, this ratio is viewed as a long-range goal, so it might vary in the short run if this is necessary. As a result, in the long run, earnings growth is followed by dividend increases, but only with a lag.

6.3 Factors Determination of Dividend Policies

1. **Bond Indentures.** Debt contracts often limit dividend payments to earnings generated after the loan was granted. Also, debt contracts often stipulate that no dividends can be paid unless the current ratio, times-interest earned ratio, and other safety ratios exceed stated minimums.
2. **Preferred stock restrictions.** Typically, common dividends cannot be paid if the company has omitted its preferred dividend. The preferred average must be satisfied before common dividends can be resumed.
3. **Impairment of capital rule.** Dividend payments cannot exceed the balance sheet item "retained earnings." This legal restriction, known as the *impairment of capital rule,* is designed to protect creditors. Without the rule, a company that is in trouble might distribute most of its assets to stockholders and leave its debt holders out in the cold. (*Liquidating dividends* can be paid out of capital, but they must be indicated as such, and they must not reduce capital below the limits stated in debt contracts.)
4. **Availability of cash.** Cash dividends can be paid only with cash. Thus, a shortage of cash in the bank can restrict dividend payments. However, the ability to borrow can offset this factor.
5. **Penalty tax on improperly accumulated earnings.** To prevent wealthy individuals from using corporations to avoid personal taxes, the Tax Code provides for a special surtax on improperly accumulated income. Thus, if the IRS can demonstrate that a firm's dividend payout ratio is being deliberately held down to help its stockholders avoid personal taxes, the firm is subject to heavy penalties. This factor is generally relevant only to privately owned firms.
6. **Number of profitable investment opportunities.** If a firm typically has a large number of profitable investment opportunities, this will tend to produce a low target payout ratio, and vice versa if the firm's profitable investment opportunities are few in number.
7. **Possibility of accelerating or delaying projects.** The ability to accelerate or postpone projects will permit a firm to adhere more closely to a stable dividend policy.
8. **Cost of selling new stock.** If a firm needs to finance a given level of investment, it can obtain equity by retaining earnings or by issuing new common stock. If flotation costs (including any negative signaling effects of a stock offering) are high, k_e will be well above

K_s, making it better to set a low payout ratio and to finance through retention rather than through sales of new common stock. On the other hand, a high dividend payout ratio is more feasible for a firm whose flotation costs are low.

9. **Flotation costs differ among firm** For example, the flotation percentage is generally higher for small firms, so they tend to set low payout ratios.
10. **Ability to substitute debt for equity.** A firm can finance a given level of investment with either debt or equity. As noted above, low stock flotation costs permit a more flexible dividend policy because equity can be raised either by retaining earnings or by selling new stock. A similar situation holds for debt policy: If the firm can adjust its debt ratio without raising costs sharply, it can pay the expected dividend, even if earnings fluctuate, by increasing its debt ratio