

CHAPTER – 2

CONCEPTUAL FRAMEWORK OF DIVIDEND POLICY

- 2.1** Introduction
- 2.2** Meaning of dividend
- 2.3** Kinds of Dividend
- 2.4** Meaning of Dividend Policy
- 2.5** Objective of Dividend Policy
- 2.6** Essential of a sound Dividend policy
- 2.7** Types of Dividend Policy
- 2.8** Factors affecting Dividend Policy
- 2.9** Dividend Policy Theories
- 2.10** Dividend Models
- 2.11** Dividend Payment Procedure
- 2.12** Dividend and a firm's life cycle
- 2.13** Conclusion

2.1 INTRODUCTION:

A major decision of financial management is the dividend decision and the firm has to choose between two things:

- I. Distributing profit to Shareholders
- II. Ploughing them back in to the business.

The profit of the company that remains after meeting all expenses, provision of taxation and depreciation and transferring the reasonable amount to the reserve funds called 'divisible profit' or 'Surplus'. A portion of this surplus is distributed among the shareholders of the company as dividend as the balance is retained or plugging back in the business for meeting future needs of the funds. ⁽¹⁾ How this surplus is to be bifurcated between dividend and retained earnings, depends upon the rational decision of the directors. Payment of dividend is desirable, because the shareholder invest in the capital of the company with the view to earn higher return and to maximize their wealth. On the contrary are the sources of internal finance for financing future development and expansion programmes of the company. If the large portion of the surplus is distributed as dividend among the shareholders then the management has to depend upon external sources like debenture or new issue of shares for financing future capital and working capital needs. Thus, both growth and dividend are desirable. But they are in conflict, a higher dividend amount to less provision of fund for growth and retention of large earnings leaves a little amount of funds for divisible to which shareholder may react strongly. Therefore the finance manager has to formulate a guidable dividend policy in such a way as to strike a compromise between dividend payment and retention.

2.2 MEANING OF DIVIDEND:

The word 'Dividend' is derived from the Latin word 'Dividendum' which means 'that which is to be divided'. This distribution is made out of profits remained after deducting all the expenses, providing for the taxation and transferring a reasonable amount to reserve from the total income of the company.⁽²⁾ such distribution of profit is made as a fixed percentage of paid up capital or fixed amount per share. Thus the dividend is that portion of profit and surplus fund of the company

which has actually been set aside by a valid act of the company for the distribution among its shareholders on record at a fixed date In proportion to their holding to be paid on demand or at fixed time. In other words a dividend may be defined as divisible profits which are distributed among the members of a Company in proportion to their share in a manner as is prescribed by law.

The term dividend refers to that part of the profits of a company, which is to be distributed amongst its shareholders. It may, therefore, be defined as the return that shareholders get from the company, out of its profits, on his shareholdings. According to the Institute of Chartered Accountants of India, dividend is, “a distribution to shareholders out of profits or reserves available for this purpose.” ⁽³⁾A company cannot declare dividend unless there is –

- Sufficient profits in the company
- Recommendation of the Board of Directors
- An Acceptance of the shareholder in the Annual General Meeting

Definition:-

- **Institute Of Chartered Accountant of India:**

“A Dividend is a distribution to a shareholder out of profit or reserve available for this purpose.”

- **Dr. S.N. Maheshwari :**

“The dividend may be defined as the return that a shareholder gets from the Company out of its profit, on his Share holding.”

- **Khan and Jain:**

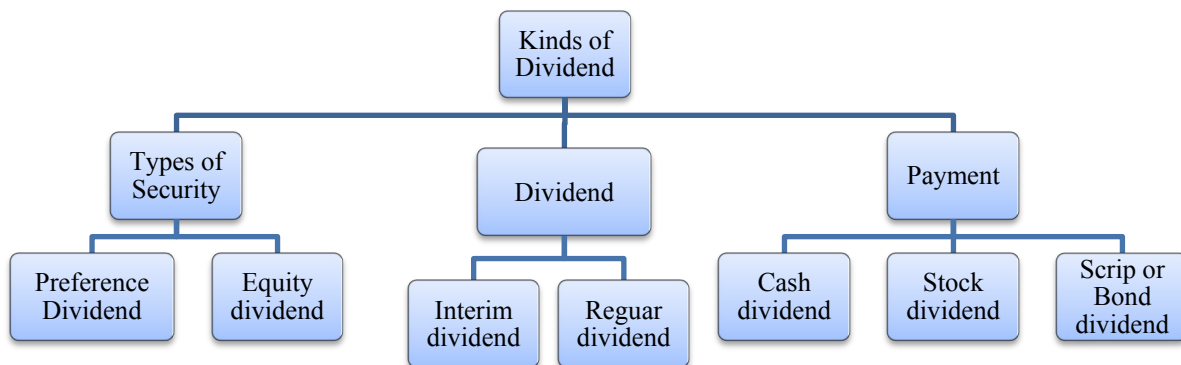
“Dividend refers to that portion of a firm net earning which are paid out to the share holders.”

2.3 KINDS OF DIVIDEND:

Dividend may be to different kinds.

Figure 2.1

Common classification of dividends



A brief description of each of these dividends is made here⁽⁴⁾

2.3.1 Preference dividend :

Preference dividend is paid on preference shares. It is paid at the fixed rate which is mentioned at the time of issue of preference share. This dividend is paid before the payment of equity dividend. The decision to pay or not to pay preference dividend is taken by Board of Director. But, the BOD has no freedom of choice to reduce the rate of preference dividend.

2.3.2 Equity Dividend :

Equity dividend is paid on equity shares at the rate of recommended by the board of directors and approved by the shareholders in annual general meeting. The board of directors have freedom of choice with regard to payment or nonpayment of dividend, the rate of dividend and the medium of dividend i.e. cash dividend and non-cash dividend. Because of the maximum managerial freedom available in the case of equity dividend, most of the discussion on dividend policy relates to equity dividend.

2.3.3 Interim Dividend :

Interim dividend is a dividend which is declared between two annual general meetings. If the profits are good in a firm the board of director may from time to time pay interim dividend to its share holders. However, the director have to consider many important aspects such as cash resources, orders in hand any seasonal element in business otherwise it may capital be considered payment out of capital.

2.3.4 Cash Dividend :

The usual practice is to pay dividend in cash payment of dividend in cash results in outflow of funds from the firm. The firm should, therefore, have adequate cash resources at its disposal or provide for such resources so that its liquidity position is not adversely affected on account of distribution of dividend in cash. For such resources generally, shareholders are interested in cash dividend and according to sec.205 (3) of the companies ACT also dividend is payable in cash only.

2.3.5 Stock Dividend or Bonus Shares:

Sometimes, a company cannot pay dividend in cash due to shortage of liquid funds in spite of large amount of reserve and surplus. Under such circumstance, the company issues new shares to the existing shareholders in lieu of paying dividend in cash. Such shares are known as 'stock dividend' or 'Bonus shares', Thus, stock dividend or bonus shares represent a distribution of share in lieu of or in addition to cash dividend to the existing shareholders as per the guidelines issued by the central government.⁽⁵⁾The issue of bonus shares is the conversion of profits into capital, therefore, it is also called 'capitalization' of profits. This capitalization of profits may take two forms.

- Making the partly paid up shares fully paid up without asking for cash from the shareholders, or
- Issuing or allotting fully paid up shares to the existing shareholders in a definite proportion free of cost.

The issues of bonus shares results in an increase in number of shares and hence increase the paid up capital of the company without involving any monetary

transaction. Such shares are issued to all the existing shareholders in proportion to their holdings of share capital of the company. Thus, bonus shares do not alter the proportional ownership of the company as far as the existing shareholders are concerned. In other words, the owner's equity or net worth remains unaltered.

2.3.6 Scrip or Bond Dividend:

Scrip dividend is the dividend paid by a company to its shareholders in the form of scrip's i.e shares and debentures of another companies or a promissory note. This form of dividend is used by a company when it faces a temporary financial crisis inspite of high earnings. Scrip and bond dividend differ only In respect of time period. In case of scrip dividend, the time period is short term whereas in bond dividends are not in practice in India after the companies Amendments Act, 1960.

2.4 MEANING OF DIVIDEND POLICY:

Dividend policy is a flexible and comprehensive term. In narrow sense dividend policy means the policy followed by the BOD concerning quantum of profit to be distributed as dividend. In broader sense, dividend policy refers the determination of the principles rules and procedure for the planning of distribution dividend after deciding the rate of dividend. The Oxford dictionary defines a policy as "The plan of action accepted by the person or the organization." "A company's dividend policy can be defined as the plan of action adopted by its directors whenever the dividend decision is to be made."

As per Weston and Brigham, "Dividend policy determines the division of earnings between payments to shareholders and retained earning".⁽⁶⁾

Gitman, "The firm's dividend policy represents a plan of action to be followed whenever the dividend decision must be made."⁽⁷⁾

Thus deciding a dividend policy is the most significant decision among three important decisions (Investment, Financing, and Dividend) of the financial management as the dividend policy determines the division of earning between pay out to shareholders and retained earnings. Retained earnings, generally remain in

business and are of much use for financing the replacement of assets and expansion program of the company. On the hand, dividend entails cash outflow and consequently reduction in current assets. Distribution of dividend at high rate results in reduction in current assets⁽⁸⁾ Distribution of dividend at high rate results in reduction of ploughing back of profits and slackness in the rate of development. On the other hand meager distribution of dividend causes dissatisfaction among the shareholders. Therefore it is imperative for the directors to follow an unambiguous and balanced dividend policy.

Definition:

- **R.P.Rustagi, Fundamentals of Financial Management:**

“Dividend policy is basically concerned with deciding whether to pay dividend in cash now or to pay increase dividend at a later stage or distribution of profit in the form of bonus share.

- **Dr. S.N. Maheshwari:**

“The term dividend policy refers to the policy concerning quantum of profit to be distributed as dividend.”

2.5 OBJECTIVE OF DIVIDEND POLICY:

The firms dividend policy represents a plan of action to be follow whenever the dividend decision must be made. The dividend policy must be formulated with two basic objectives in mind maximizing the wealth of the firm’s owners and providing for sufficient financing. These objectives are not mutually exclusive, rather they are interrelated.⁽⁹⁾

2.5.1 Wealth Maximization:

The firm’s dividend policy should be one that supports the general objectives of maximizing the wealth of the firm’s owners or the long run. It must be design not merely to maximize the share price in the coming year but to maximize wealth in the long run, since the firm is assumed to have an infinite life. Of course the theoretically we except that shareholders and prospective investor will recognize the long run

effect of a dividend policy on their ownership and that this recognition will be reflected in the level of future return they forecast.

2.5.2 Providing for sufficient financing :

Making provision for sufficient financing can be considered a secondary objective of dividend policy. Without sufficient financing to implement acceptable project, the wealth maximization process cannot be carried out. The firm must forecast its future funds needs and taken in to account the external availability of fund and certain market consideration, determine both the amount and retained earnings financings needed and the amount of retained earnings available after the minimum dividends have been paid. The important point paid to remember here is that the amount of retained earnings financing available must be forecast on an after dividend basis, since the market can be expected to react adversely to the nonpayment of the cash dividend.

2.6 ESSENTIALS OF A SOUND DIVIDEND POLICY:

Sound dividend policy is a long term policy that aims in maximization of shareholders wealth. While determining such a policy investment opportunity of the firm, its present economic status and investor preferences should be given due weight age. Sound dividend policy remains stable during the prosperous and lean years. Dividend are paid in cash and stock dividend is paid only when the amount of reserves exceed too much⁽¹⁰⁾ Generally a sound dividend policy contains the following elements :

2.6.1 Distribution of dividend in cash :

A dividend policy is good only when dividend is paid in cash. Dividend paid in property, scrip or bond is not considered good. An Indian company Act is also prohibits distribution of dividend other than in cash except issue of bonus share by capitalizing the profits.

2.6.2 Initial Lower Dividend :

In the beginning a company should declare dividend at low rate so that a substantial part of profit is available as a source of internal financing. It will strengthen the financial position of the company. Initially lower dividend is also helpful in development and expansion of the company. Therefore the rate of dividend should be increased gradually as the company prospers.

2.6.3 Gradual Increase in Dividend :

With the increase in price level, the income of the company also increases. The shareholders expect similar increase in their income. Therefore the rate of dividend should increase gradually so that there may not be any discontentment among the shareholders. If there is super profit in any particular year, then extra dividend or interim dividend can be declared.

2.6.4 Stability :

Stability of dividend means that there should not be too much fluctuation in the rate of dividend. During stability, the rate of dividend is increased gradually and slowly. Payment of dividend at very high rate in a year and no dividend in the next year results in high speculation in share of company. Therefore, the payment of Stable and regular dividend is considered better than heavy fluctuation.

2.6.5 Dividend out of Earned Profits :

Dividend should be declared out of earned profits. If there is any loss in the Profit & Loss account, it should be written off and then dividend should be declared out of remaining profits. Moreover all the governmental restrictions on dividend should be compliance.

2.7 TYPES OF DIVIDEND POLICY:

The dividend policy should be determined by taking in to consideration the aforesaid factors. But if a clear cut dividend policy is developed, it is in the interest of both the shareholders and company. A financial manager can recommend any of the following dividend policy.⁽¹¹⁾

2.7.1 Stable Dividend Policy :

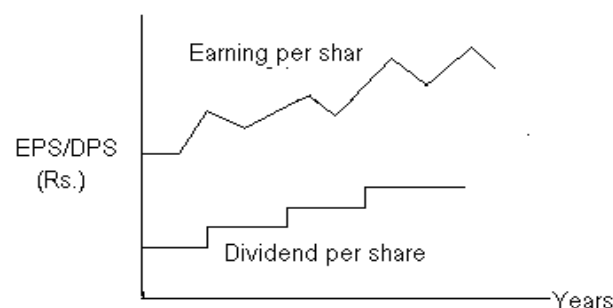
Stability of dividend means similarity or no change in dividend payment over a year. In other words, when a company pays dividend at a fixed rate and follows it for future years to come regardless of fluctuation in the level of earnings, it is said to be a stable dividend policy. Thus stability of dividend refers to regular payment of dividend at a fixed rate. Stable dividend policy increases credibility of the management in the market and shareholders also prefer such stock giving minimum return at regular intervals leads to increase in market price of shares. Those companies whose earnings are stable follow this policy. The stability of dividend is described in two different ways viz.

- a. Constant dividend per share.
- b. Constant payout ratio.

a. Constant dividend per share :

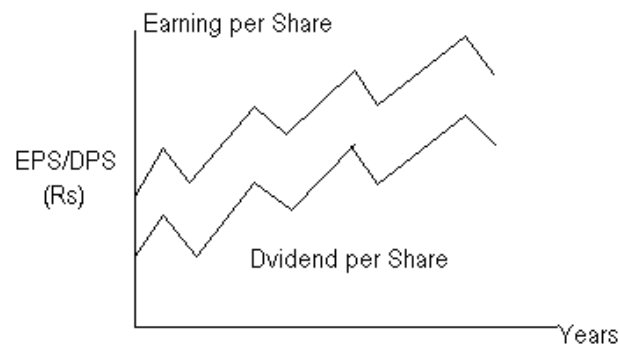
Under this policy, the firm pays a fixed amount per share as dividend to its shareholder. However, the earnings may fluctuate from year to year and so as to firm has to be careful in setting the dividend amount at a reasonable level. The dividend per share is not increased or decreased for a temporary increase or decrease in earnings but only for maintainable increase or decrease.

It is shown in the following figure.



The dividend policy is quite popular and investors also favor this type of policy as it will enable them to plan their investment. Moreover, a steady, regular, and constant dividend per share benefits the firm.

b. Constant Pay-out Ratio :



In this policy, a fixed percentage of net earnings are paid as dividend every year that is constant payout ratio. For example, a company adopts 60% payout that is 60% of net earnings of the company will be paid as dividend and 40% of net earnings will be transferred to reserves. No dividend is paid in the case of loss. Company generally prefers this policy because it reflects the ability of the company to pay the dividend. But it is not preferred by shareholders as the return fluctuates with the amount of earnings.

2.7.2 Policy of Regular Plus Extra Dividend :

A firm may adopt a policy of paying a steady dividend together with paying some extra whenever supported by the earnings of the firms. The extra may be paid in the form of cash, or bonus shares, depending upon the firm's liquidity position. The term extra is used to tell the shareholders that this is extra and may not be maintained in future.

From the view point of the management a constant dividend per share together with an extra dividend when supported by higher earnings will be more flexible. However, the policy of extra dividend if adopted on regular basis, the firm may run the risk of having shareholders treating this extra component as really a part of regular annual dividend. Therefore, it is desirable to preserve the true meaning of the extra dividend.

2.7.3 Policy of regular bonus dividend:

Under this policy, the company pays dividend in the form of its shares instead of cash. Such shares are designated as 'Bonus Shares' which is often used to capitalize company's retained earnings. It does not at all affect the liquidity positions of the company but increases the shareholding of the owners⁽¹²⁾ This policy can be justified in the following circumstances:

- When the company needs cash generated by its earnings to cover its modernization and expansion scheme.
- When the company is deficient in cash despite high earnings.

This policy should be followed temporarily. If it is followed for a long time, the earning per share would decline and the value of share would decline and value of share in the market would adversely be affected. Besides this policy is not favored by those shareholders who have strong preference cash dividend.

2.7.4 Policy to pay Irregular Dividend :

Under the policy of irregular dividend, the amount of dividend to be paid by the company of shareholders fluctuates with the changing level of earnings. The larger the earnings the higher as the dividend and vice versa. The policy is adopted due to (i) uncertainty of meaning; (ii) inefficient operation of business; (iii) Shortage of cash; (iv) Fear of adverse effect of regular dividend policy on the financial position of the company.

Generally this policy is adopted when the companies have fluctuating investment opportunities. A large part of the profit should be retained in the year in which the company has profitable investment proposal whose execution may result in sufficient profit. On the contrary, if in any year the company has limited or no investment opportunities, the management may distribute larger share of earning as dividend.

2.7.5 Policy o no immediate dividend :

When the directors of the company decide to declare no dividend despite large earning, then it is known as policy of no immediate dividend. This policy is usually is pursued in the following circumstances:

- When the company is new which require a huge amounts for fund for development purpose.
- When company's access to capital market is difficult for raising additional funds or availability for additional capital is costlier.
- When shareholders have strong preference for long term capital gains in lieu of cash dividend.

After the expiry of no dividend period the company should either pursue the policy of paying stock dividend from its reserves or company's share should be split into shares of small amount so as to keep dividend per share low and larger amount of dividend to shareholders. Such an action is necessary to keep share prices at reasonable level.

Table 2.1
LEGAL FRAMEWORK OF DIVIDEND⁽¹³⁾

Section	Legal Requirement
205(1)&(2) Depreciation Should be charged before payment of dividend.	A company can pay dividend out of current profits and profit earned in any earlier financial year after charging depreciation as per the requirements of the companies Act. Depreciation is provided as the rates given in schedule XIV to the companies Act. The schedule gives minimum depreciation rates but a company can charge higher depreciation rates. For this purpose it has to charge at least 95% of the original cost of the assets over its useful life.

<p>205 2(A)</p> <p>Compulsory transfer to Reserve before payment of dividend.</p>	<p>As per the companies (Transfer of profit to reserve) Rules 1975 a company has to transfer the following % of current profits.</p> <p>Dividend proposed exceeds 10% but not 12.5% of paid of capital 2.5%</p> <p>Dividend proposed exceeds 12.5% but not 15% of paid of capital 5.0%</p> <p>Dividend proposed exceeds 15% but not 20% of the paid of capital 7.5%</p> <p>Dividend proposed exceeds 20% of the paid of capital 10.0%</p>
	<p>Can a Company transfer higher % to reserves?</p> <p>Voluntary transfer of higher % of profit to reserve is allowed, when the company declare dividend :</p> <ol style="list-style-type: none"> i. It has to maintain average rate of dividend declared by it's over the last three year. ii. In case bonus share are issued and its paid up capital has been increased a company has to maintain average of dividend declared over the last three years. <p>However, in case the net profit after tax of the company is lower by 20% or more in a year as compared to the average net profit after tax of the preceding financial year, it is not required to maintain average rate or amount of dividend as stated above. If the company does not declare dividend, then amount proposed to be transferred from reserve should be lower than the average amount of dividend declare by it over last three immediately preceding financial years.</p>
<p>205 (2B)</p> <p>Compliance with the requirement of section 80A</p>	<p>Dividend on equity share cannot be paid unless the company redeems irredeemable preference share. Presently, it is not permissible to issue irredeemable preference shares.</p>
<p>205(3)</p>	<p>Dividend should be paid in cash only. However, a company can capitalize profit by way of issue of bonus shares.</p>

205 A(1)	Dividend is declared by the shareholders in the annual general meeting on the basis of dividend proposed by the board of directors. Dividend should be paid within 30 days from the date of declaration. In case company cannot pay such dividend, it is to be transferred to special accounts called “unpaid dividend Account Company Ltd/ (Pvt) Ltd.
205(3)	<p>In case company wants to pay dividend out of reserves because of inadequacy of profit in any year, it should follow the companies (Declaration of dividend out of reserves) rules, 1975. The guidelines are</p> <ol style="list-style-type: none"> The rate of dividend cannot exceed the average rate of dividend declared in the immediately preceding five years, or 10% of the paid up capital, whichever is less. Total amount to be drawn from accumulated profit earned in the previous years. The profit so drawn should be utilized first to set off any loss incurred during the financial year before payment of dividend. The balance of reserves after such transfer shall not fall below 15% of its paid share capital. <p>Free reserves do not mean capital reserve & revaluation reserves.</p>
205(5)	Any money transferred to the unpaid dividend account and remains unpaid or unclaimed for a period of seven years should be transferred to Investor Education and Protection Fund established under section 205 C of the companies Act.
206	Dividend is to be paid to the registered shareholders or to their order or to their bankers.

207	Penalty for failure to distribute dividends within forty two days where a dividend has been declared by a company but has not been paid, or the warrant in respect thereof has not been posted, within forty two days from the date of the declaration, to any shareholders entitled to the payment of the company shall, if he is knowingly a party to the default, be punishable with “ simple imprisonment for a term which may extend to seven days and shall also be liable to fine”. Provided that no offence shall be deemed to have been committed within the meaning of the foregoing provision in the act ⁽¹²⁾
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Substitute for 42 days by the companies (Amendment) Act, 2000

2.8 FACTORS AFFECTING DIVIDEND:

It is a generally accepted principle that the directors of a company have sole right to declare dividend and determine its amount out of company's earnings. But, in addition to legal restrictions, they have to consider many factors while deciding the dividend policy. A rational distribution of earnings has been very beautifully described in a legal case. Accordingly, the net earnings that should be distributed among the shareholders depends largely upon the company's needs for accumulated reserves to strengthen its credit, increase its working capital, carrying contemplated projects of expansion or provide contingencies against future hazards.⁽¹⁴⁾ In the light of this statement, the different factors which determine the dividend policy of a company are explained below.

2.8.1 Stability of Earnings:

The nature of business has an important bearing on the dividend policy. Industrial units having stability of earnings may formulate a more consistent dividend policy than those having an uneven flow of incomes because they can predict easily their savings and earnings usually, enterprises dealing in necessities suffer less from oscillating earnings than those dealing in luxuries or fancy goods.

2.8.2 Age of Corporation:

Age of the corporation count much in deciding the dividend policy. A newly established company may require much of its earnings for expansion and plant improvement and may adopt a rigid dividend policy while, on the other hand, an older company can formulate a clear cut and more consistent policy regarding dividend.

2.8.3 Liquidity of Fund:

Availability of cash and sound financial positions is also an important factor in dividend decision. A dividend represents a cash outflow, the greater the funds and the liquidity of the firm the better the ability to pay dividend. The liquidity of the firm depends very much on the investment and financial decisions of the firm which in turn determines the rate of expansion and the manner of financing. If cash position is weak, stock dividend will be distributed and if cash position is good, company can distribute the cash dividend.

2.8.4 Extent of share Distribution:

Nature of ownership also affects the dividend. A closely held company is likely to get the assent of the shareholders for the suspension of dividend or for following a conservative dividend policy. On the other hand, a company having a good number of shareholders widely distributed and forming low or medium income group would face a great difficulty in securing such assent because they will emphasize to distribute higher dividend.

2.8.5 Needs for Additional capital:

Companies retain a part of their profits for strengthening their financial positions. The income may be conserved for meeting the increased requirements of working capital or of future expansion. Small companies usually find difficulties in raising finance for their needs of increased working capital for expansion programmes. They having on other alternative, use their ploughed. Thus, such companies distribute dividend at low rates and retain a big part of profits.

2.8.6 Trade cycles:

Business cycle also exercise influence upon dividend policy. Dividend policy is adjusted to the business oscillations. During the boom prudent management creates

food reserves for contingencies which follow the inflationary period. Higher rates of contingencies which follow the inflationary period. Higher rates of dividend can be used as a tool for marketing the securities in on otherwise depressed market. The financial solvency can be proved and maintained by the companies in dull years if the adequate reserves have been built up.

2.8.7 Government policies:

The earnings capacity of the enterprise is widely affected by the change in fiscal, industrial labour, control and other government policies. Sometimes government restricts the distribution of dividend beyond a certain percentage in a particular industry or in all spheres of business activity as was done in emergency. The dividend policy has to be modified or formulated accordingly in those enterprises.

2.8.8 Taxation Policy:

High taxation reduces the earning of the companies and consequently the rate of dividend is lowered down . Sometimes government levies dividend -tax of distribution of dividend beyond a certain limit . It also affects the capital formation. North India, dividends beyond 10% of paid up capital are subject to dividend tax at 7.5%.

2.8.9 Legal Requirements:

In deciding on the dividend, the directors take the legal requirements too into consideration. In order to protect the interest of creditors an outsider, the companies Act 1956 prescribe certain guidelines in the respect of distribution and the payment of dividend. Moreover a company is required to provide for depreciation on its fixed and tangible assets before declaring dividend on shares. It proposes that dividend should not be distributed out of capital, in any case. Likewise, contractual obligation should also be fulfilled, for example payment of dividend on preference shares on priority over ordinary dividend.

2.8.10 Past Dividend Rates:

While formulating the dividend policy, the directors must keep in mind the dividend paid in past years. The current rate should be around the average past rates.

If it has been abnormally increased the shares will be subjected to speculation. In a new concern the company should consider the dividend policy of the rival organization.

2.8.11 Ability to Borrow:

Well established and large firms have better access to the capital market than the new companies and may borrow funds from the external source if there arises any need. Such companies may have a better dividend payout, whereas smaller firms have to depend on their internal sources and therefore they have to build up good reserves by reducing the dividend payout ratio for meeting any obligation requiring heavy funds.

2.8.12 Policy of Control:

Policy of control is another determining factor is so far as dividend are concerned. If the directors want to have control on company, they would not like to add new shareholder and therefore, declare a dividend at lower rates because by adding new shareholder they feared dilution of control and diversion of policies and the programmers of the existing management so they preferred to meet the needs through retained earnings. If the directors do not bother about the control of affairs they will follow a liberal dividend policy. Thus control is an influencing factor in framing the dividend policy.

2.8.13 Repayments of Loan:

A company having loan indebtedness are vowed to high rate of retention earnings unless one other arrangements are made for the redemption of debt on maturity. It will naturally lower down the rate of dividend. Sometimes the lenders (mostly institutional lenders) put restriction on the dividend distribution still such time their loan is outstanding. Formal loan contracts generally provide a certain standard of liquidity and solvency to be maintained. Management is bound to hour such restriction and to limit the rate of dividend payout.

2.8.14 Time for payment of dividend:

When the dividend should is to be paid is another consideration. Payment of dividend means outflow of cash. It is therefore desirable to distribute dividend at time

when it is least needed by the company because there are peak times as well as lean periods of expenditures. Wise management should plan the payment of dividend in such a manner that there is no cash outflow at a time when the undertaking is already in need of urgent finances.

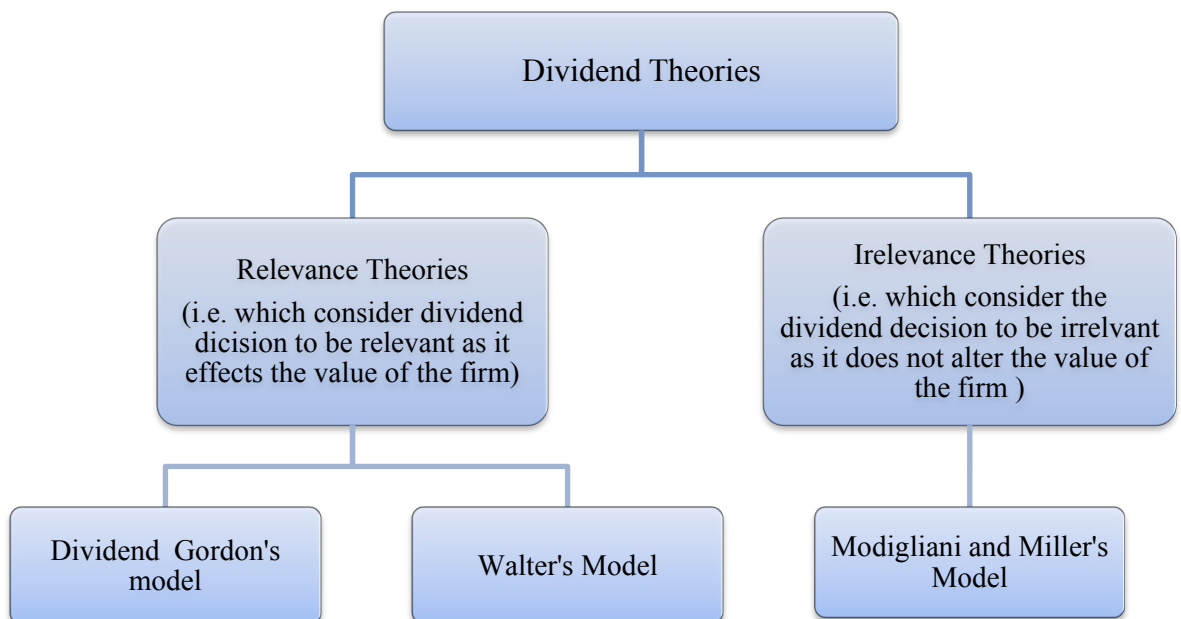
2.8.15 Regularity and stability in Dividend Payment:

Dividend should be paid regularly because each investor is interested in the regular payment of dividend. The management should, inspite of regular payment of dividend, considered that the rate of dividend should be all the most constant. For this purpose sometimes companies maintain dividend equalization fund.

2.9 DIVIDEND POLICY THEORIES:

Over the time various theories of dividend policy have emerged, some of the main theories are as follows. ⁽¹⁵⁾

Figure- 2.2
Dividend Theories



2.9.1 Relevance Theory:

Relating to this theory there are following two models.

i) Dividend Gordon's Model :

It is based on the following important assumption:

- a. Retained earnings represent the only source of financing
- b. Rate of return is constant
- c. Growth rate of the firm is the product of retention ratio and its rate of return
- d. Cost of capital remains constant and is greater than growth rate
- e. The company has perpetual life
- f. Tax does not exit

● Arguments :

“Gordon argues that the investors do have preference for current dividend and there is a direct relationship between the dividend policy and the market value of the share.”⁽¹⁵⁾

-R.P. RUSTAGI

He believes that the investors are basically risk averse and they evaluate the future dividend/ capital gains as risky. Dividends are more predictable than capital gains and also management can controlled dividend but can't dictate the market price of the shares. In short an investor values, current dividend more highly than an expected future capital gains.⁽¹⁶⁾

ii) Walter's Model :

This is also best on relevance theory of dividend policy. It is based on following assumptions.⁽¹⁷⁾

- a. All investment proposal of the firm are to be finance through retained earnings only.
- b. The firm has an infinite life.
- c. All earnings are either distributed as dividend or invested internally immediately.

- d. With additional investment, undertaken, the firm's basic risk does not change.
- e. There is no change in the key variables such as EPS and DPS. It is considered that the investment decision and dividend decision of a firm are interrelated. According to him the market value of a share is the present value of the expected stream of dividend and capital gains.

2.9.2 Irrelevance Theory:

Modigliani and Miller have argued that a firm's dividend policy has no effect on its value or assets i.e. if the rate of dividend declared by a company is less its retained earnings will increase and so also the net worth and vice versa. This theory is based on a number of assumptions the following are the most important. ⁽¹⁸⁾

- a. There are no personal or corporate income taxes.
- b. There are no stock flotation or transaction costs.
- c. Dividend policy has no effect on the firm's cost of equity.
- d. The firm's capital investment policy is independent of its dividend policy.
- e. Investors and managers have the same set of information regarding future opportunities.

- **CLIENTELE EFFECT :**

This effect states that a firm will attract stockholders whose preferences with respect to the payment pattern and stability of dividend match with the firm's payment pattern. So, the clientele of the firm get what they expect, and the value of the firm's shares is unaffected by the dividend policy.

- **ARGUMENTS FOR IRRELEVANCE :**

They argue that the value of the firm is determined by its basic earning power and risk class. Therefore the firm's value more depends on its assets investment policy and not much on how earnings are split between dividend and retained earnings.

2.10 DIVIDEND MODELS:

There are three dividend models of which two are of dividend relevance and the one is for dividend irrelevance.

2.10.1 Walter Models :

Prof. James E. Walter argued that in the long run the share prices reflect only the present value of expected dividends. Retentions influence stock price only through their effect on future dividends.⁽¹⁹⁾ Walter has formulated this and used the dividend to optimize the wealth of equity Shareholders. His formula in determination of expected market price of a share is given below:

$$P = \frac{D + \frac{r(E - D)}{K_e}}{K_e}$$

- Where, P = Market value of equity share
D = Dividend per share paid by the firm
r = Rate of return on investment o the firm
Ke = Cost of Equity Capital
E = EPS of the firm

Assumptions

Walter Model is based on following assumption:

- All the financing is done through retained earnings and external sources of funds like debt of new equity capital are not used. Retained earnings represent the only source of funds.
- With additional investment undertaken the firm's business risk does not change. It implies that firm's IRR and its cost of capital are constant.
- The return on investment remains constant.
- The firm has an infinite life and is going concern.
- All earnings are either distributed as dividend or invested internally immediately.
- There is no change in the key variable such as EPS and DPS.

2.10.2 Gordon Growth Model :

The dividends of most companies are expected to grow and evaluation of value share based on dividend growth is often used in valuation of shares. Dividend valuation model assumes a constant level of growth in dividends in perpetuity. The Gordon Growth Model Is a theoretical model used to value ordinary equity share. The model incorporates the retention of earning and growth of dividend and hence it is called as dividend growth valuation model. The main proposition of the model is that the value of share reflects the value of future dividend accruing to that share.⁽²⁰⁾ Hence, the dividend payment and its growth are relevant in valuation of shares. The model holds that share market price is equal to the sum of share discounted future dividend payments.

$$P_0 = \frac{E_1 (1-b)}{K - b_r}$$

where,

- P_0 = Price per Share at the end of the year
- E_1 = EPS at the end of the year 1
- $1-b$ = Eraction of earnings the firm distributes by way of dividend
- K = Rate of return required by the Shareholders
- b = Retention Ratio
- b_r = Growth rate of earnings and dividend

Assumption:

Gordon Growth Model using dividend capitalization is based on the following assumption:

- The firm is an all equity firm and has no debt.
- External financing is not used in the firm. Retained earnings represent the only source of financing.
- The internal rate of return is the firm's cost of capital 'K'. It remains constant as is taken as the appropriate discount rate.
- Future annual growth rate dividend is expected to be constant.
- Growth rate of the firm is the product of retention ratio and its rate of return.

- Cost of capital is always greater than the growth rate.
- The company has a perpetual life and the streams of earning are perpetual.
- Corporate taxes do not exist

The mode provided by Walter and Gordon Growth Model lead to the following implications:

- If $r > k$ price per share increases as dividend payout ratio decrease.
- If $r < k$ price per share increases as dividend payout ratio Increase.
- If $r > k$ price per share remains unchanged with change in dividend payout ratio.

TYPES OF FIRM		OPTIMUM PAYOUT RATIO
GROWTH FIRM	—————→	NIL
NORMAL	—————→	IRRELEVANT
DECLINING FIRM	—————→	100%

2.10.3 Modigliani and Miller's model :

They have agreed that firm's dividend policy has no effect on its value of assets. According to them the value of the firm is determined by its basic earning power and its risk class.⁽²¹⁾

Modigliani and Miller's Model has given the following formula:

$$P_0 = \frac{P_1 + D_1}{1 + K_e}$$

where,

P_0 = Prevailing market price of a share

K_e = Cost of equity capital

D_1 = Dividend to be received at the end of period one.

P_1 = Market price of a share at the end of the period one.

Assumption:

Modigliani and Miller have built their arguments on a number of assumptions, the most important of which were:

- There are no personal or corporate income taxes.
- There are no stock floatation costs, transaction cost or brokerage fees.
- Dividend policy has no effect on the firm's cost of equity.
- The firm's capital investment policy is independent of its dividend policy.
- Investors and managers have equal and cost less access to information regarding future opportunities.
- All investor can lend or borrow at the same rate of interest.
- No buyer or seller of securities can influence prices.
- Dividend decisions are not used to convey information.
- Perfect capital market exists with free flow of information.
- No tax differential between distributed and undistributed profit as also between dividend and capital gains.
- Investment opportunities and future net income of all companies are known with certainty to all market participants.

2.11 DIVIDEND PAYMENT PROCEDURE:

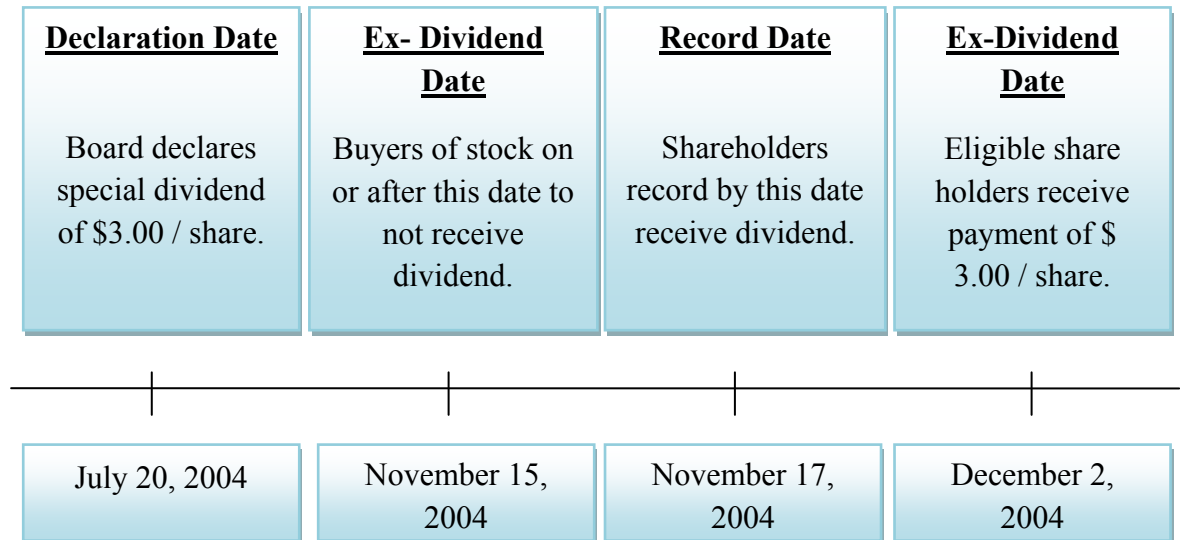
A public company's board of directors determines the amount of the firm's dividend. The board sets the amount per share that will be paid and decide when the payment will occur. The date on which the board authorizes the dividend is the declaration date. After the board declares the dividend, the firm is legally obligated to make the payment.⁽²²⁾

The firm will pay the dividend to all shareholders of record on a specific date, set by the board, called the record date. Because it takes three business days for shares to be registered, only shareholder who purchases the stock at least three days prior to the record date receive the dividend. As a result the date two business days prior to the record date is known as ex-dividend rate; anyone who purchases the stock on or after the ex-dividend date will not receive the dividend.⁽²³⁾ Finally, on the payable

date (or distribution date), which is generally about the month after the record date, the firms mails dividend cheques to the registered shareholders.

Figure 2.3

Important Dates for Microsoft's Special Dividend



2.12 DIVIDEND AND FIRM'S LIFE CYCLE :

The payout policy of firms undergoes systematic changes over their life cycle. New firm or firms that are in the growth stage pay very low or no dividend as during this initial growth period firms retain funds to finance investment. Mature funds that are no longer in growth phase of tern pay high and increasing dividends. Thus , dividend payout keeps increasing as firm grow more mature and finally a stage arises a firm's cash flow exceeds its capital needs, and during this liquidation stage, excess cash is distributed generously in the form of cash dividend to the shareholders.⁽²⁴⁾

Figure 2.4

STAGE OF GROWTH			
Stage I	Stage II	Stage III	Stage IV
Introduction	Rapid Growth	Maturity	Decline
DIVIDEND POLICY			
No Dividend	Low dividend payout policy	Growing or increasing payout policy	Generous dividend payout policy

2.13 CONCLUSION:

The usual practice in a company is to apportion a part of a profit for dividend payment and to retain the other payment and retain to other part of for investment in profitable channels. Determination of ratio between dividend payment and retention of earnings is very important. There are different views in this respect M.M. hypothesis suggested that dividend payment or no dividend payment or has the same impact on the value of the firm. The shareholders are therefore indifferent towards dividend. However in imperfect market condition, where taxes and transaction cost exist, shareholder prefer cash dividend. Residual theory prefer retention of earnings, however smoothened residual theory suggests that retention should preferred only after constant dividend payment. Walter believes that retention dividend ratio influences shareholders wealth. It raised share prices only when return from investment is greater than capitalization rate. Gordon and Ezra Soloman are in the favor of dividend payment as it has a positive impact on share prices. There are certain factors that influence dividend payment, such as shareholders expectation, financial requirement, legal and other constraints etc.

Dividend should be stable. It is normally paid in cash forms. Sometimes, however it is also in form of shares that are known as bonus share.

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