Business Finance

Unit 3

Dividend

The term ‘dividend’ is derived from the Latin word ‘dividendum’ which means ‘that which is to be divided’. Dividend is that part of the profits of the company which is distributed amongst its shareholders. It differs from interest in the sense that it does not arise out of contractual obligations. Dividend implies two things—(i) payment out of profits, and (ii) actual release of some assets. Issue of bonus shares or right shares to the existing members is not considered as dividend because the former does not involve release of any assets and the latter has no relation with the profits of the company. Every trading company has an implied inherent power to distribute its net earnings or profits to the shareholders in the shape of dividends. Power to declare dividends, therefore, need not expressly be given by the Memorandum or Articles of Association. Articles may, however, regulate the manner in which the dividends are to be paid.

Procedure for Declaration of Dividend

A company which intends to declare and pay dividend should adopt the following procedures. Further, in case the company’s shares are listed on the Stock Exchanges, additional requirements relating to Listing Agreements are to be followed.

1. **Recommendation by Board of Directors**

Dividend can be declared only on the recommendation of the Board of Directors of the Company. The shareholders do not have any power to declare any dividend. The Board of Directors after considering and approving the financial statements of the company, determines the rate of dividend to be declared and then recommends the same to the shareholders. For this purpose, a Board Meeting shall be convened to pass the resolution for purposes of

- rate of dividend and the amount of dividend to be paid
- book closure date for dividend
- date of annual general meeting
- Bank with which the account shall be opened for the remittance of dividend.

2. **Approval by the Shareholders**

The dividend recommended by the Board of Directors is declared by a resolution passed at the Annual General Meeting by the shareholders. The declaration of dividend should form part of an ordinary business item to be transacted in the notice of the Annual General Meeting. While approving the rate of dividend at the Annual General Meeting, the shareholders have power to declare a lower rate of dividend than what is recommended by the Board but they have no power to increase the amount or the rate of dividend so recommended. Dividend when declared becomes debt against the company.

Usually, dividend is declared at the annual general meeting. But a company which has not declared dividend at an annual general meeting may do so at a subsequent general meeting.

A company which has declared dividend at a general meeting is not permitted to declare dividend for the second time in that year.

3. Dividend includes Interim Dividend

As per the Companies Act, 2013, dividend includes interim dividend [Section 2(35)]. Interim dividend can be declared by the Board of Directors if they have authority to do so. Further, the provisions on payment of dividend contained in Section 123, 124 and 127 shall apply to interim dividend also.

4. Dividend to be deposited in a Separate Bank Account

The company must deposit the dividend amount (including interim dividend) within 5 days of its declaration in the separate bank account opened for this purpose. The interim dividend will have to be deposited in a bank account within 5 days of the Board Meeting whereas final dividend will have to be deposited within 5 days from the date of Annual General Meeting in which it was approved by the shareholders.

5. Dividend to be paid by cheque or warrant

Section 123(5) of the Companies Act, 2013 provides that the dividend payable in cash may be paid either by cheque or warrant or in any electronic mode to the shareholder entitled to the payment of dividend.

6. Time frame for payment of Dividend

As per Section 127 of the Companies Act, 2013, the dividend is to be paid or the warrants in respect thereof shall be posted within 30 days from the date of declaration of dividend.

7. Transfer of Unpaid Dividend

As per Section 124 of the Act, where a dividend has been declared by a company but has not been paid (or claimed) within 30 days from the date of declaration, the company shall within 7 days from the expiry of the period of 30 days transfer the total amount of dividend which remains unpaid or unclaimed to a special account to be opened by the company in that behalf with any Scheduled Bank which is called "Unpaid Dividend Account. Interest at the rate of 12% p.a. is payable by the company for delay in making the above transfer.

8. Transfer of unpaid or unclaimed dividend to the Investor Education and Protection Fund

Any amount of dividend which remains unpaid or unclaimed for a period of 7 years from the date it became due for payment shall be transferred by the company to the Investor Education and Protection Fund [Section 124(5)]. When making a transfer to the Fund, the company shall furnish to the authority appointed by the Central Government, the details as prescribed in this respect. The said fund shall be utilised for promotion of investor awareness and protection of the interests of investors.

In case of any default in complying with these provisions, the company and every officer of the company who is in default shall be punishable with the fine as prescribed.

Dividend Policy

Dividend policy refers to the pay-out policy that management follows in determining the size and pattern of distribution to shareholders over time. The key stress of the dividend policy of a firm is centred upon the percentage of earning that a firm should pay out. The dividend pay-out ratio is the percentage of earning paid to the shareholders in cash.

There are two sets of approaches on dividend policy:

a. Irrelevance of dividend policy approach
b. Relevance of dividend policy approach

A. Irrelevance of Dividend Policy Approach

1. Residual Approach

Under this theory, dividend decision has no effect on the wealth of the shareholders or the prices of the shares, and hence it is irrelevant so far as the valuation of the firm is concerned. This theory regards dividend decision merely as a part of financing decision because the earnings available may be retained in the business or for re-investment. But if the funds are not needed in the business then it may be distributed as dividend. It means, in each period a firm has to decide whether to retain its earnings or to distribute part or all of them to shareholders as cash dividend. As long as there are investment opportunities, firm will retain the earnings to finance these projects, otherwise will be distributed to shareholders. In the words of J. C. Van Horne, if the dividend policy is strictly a financing decision then the payment of dividends is a passive residual. The passive residual nature, and wide fluctuations make dividend policy irrelevant, and investor become indifferent between dividend pay-out and retention of earnings. On the contrary, investors opt to take dividend if the form's rate of return is below than expectations or below the market level. If the firm's rate of return is more than expected or above market average rate of return, a shareholder will prefer to retain the earnings. Thus, a firm should retain earnings if it has profitable investment opportunities otherwise it should pay them as dividends.

2. Modigliani and Miller Approach (MM-Model)

Modigliani and Miller have also given comprehensive argument for irrelevancy of dividends. They assert that, given the investment decision of the firm, the dividend pay-out ratio 1s a mere detail. It does not affect the wealth of shareholders. MM argued that the value of the firm is determined by the earning power of the firm's assets or its investment policy and that the manner in which the earnings stream is split between dividends and retained earnings does not affect this value. They concluded that, under the conditions of perfect capital market, rational investors, and absence of tax discrimination between dividend income and capital appreciation, may have no influence on the market prices of the share. The MM-Model has following assumptions:

1. There are perfect capital markets, and investors behave rationally,
2. Information is available to all at no cost,
3. No investor is large enough to affect the market price of shares,
4. There are no floatation and transaction costs,
5. There is no tax,
6. The firm has rigid investment policy, and not subject to change,
7. There is no uncertainty in respect of future investment and profit of the firm, thus, every investor is certain about future investments and profits. Hence, discount rate is equal to cost of capital ($r = K_e$).

Crux of MM-Model

This model state that the effect of dividend is neutralized by issue of new securities. In simple words, a payment of dividend increases the market value of share, but on the same time it reduces the balance of funds available to a firm as retained earnings. In order to meet the requirement of future needs of funds, firm will make a fresh issue which result into increase in total number of shares available in the market and reduce the market price of the share. Thus, dividend has no effect on wealth of the

shareholders. MM model suggest that the sum of the discounted value per share after financing and dividends paid 1s equal to the market value per share before the payment of dividends. In other words, the stock's decline in the market price because of external financing offsets exactly the payment of the dividend. Thus, the shareholders are at indifferent point either to get dividend or increase value through retained earnings.

The MM-Model sets the relationship of present value of share in respect of dividend pay-out at the end of financial year, and requirement of additional funds, as shown below:

$$P_0 = \frac{(D_1 + P_1)}{(1 + k_e)}$$

Where,

P_0 = Market price per share at the beginning of the period, or prevailing market price of a share

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

P_1 = Market price at the end of the period

K_e = Cost of equity capital, or rate of capitalization.

From the above equation, the present value of share at the end of the period can be computed as shown below:

$$P_1 = P_0(1 + K_e) - D_1$$

Limitations of MM-Model

MM Model has been criticised due to its unrealistic assumptions. The major limitations of this model are given below:

1. Model assumes that perfect market conditions will prevail. However, perfect market is an 1deal and hypothetical situation only and does not exist in reality.
2. It is hypothesized that there is no corporate tax, under present law, earnings of a company are taxed at the corporate level, irrespective of dividend is paid or not. Corporate income may affect dividend relevance if tax laws are changed.
3. Apart from tax issues, the argument in favour of dividend can be also advanced because a sizable number of investors prefer dividend due to behavioural reasons.
4. MM approach assumes no flotation cost as funds are arranged out of retention money. In case, dividend 1s paid and company issues new shares, flotation cost 1s reality. In such a case company prefer to retain more money to avoid flotation costs.
5. Alike flotation cost, transaction costs, brokerage charges are actually paid by shareholders, thus they prefer quick generation of income in form of dividend.
6. Assumption of fee availability of shares is criticised because of applicability of certain restrictions on investors in respect of purchase of securities beyond a limit.
7. Certainty on expected dividend is a loose preposition because, dividend payout ratio 1s affected by number of factors, internal as well as external to a firm.
8. The management of the firm knows in detail about the firm's operations, its operating profit, and movement in information, but it 1s disseminated selectively, or no uniform information is available to all shareholders, especially, at free cost.

9. Firms do not follow strict investment policy, rather firms go to every extent possible to generate earnings of the firm. A strict investment policy has much serious implications on value of a firm.

B. Relevance of Dividend Policy Approach

Another school of thought supports dividend relevance. They advance argument in favour of dividend relevance. According to this approach, the current dividend payments reduce investors uncertainty, therefore, investors will discount the firm's earnings at a lower rate. Thereby placing a higher value of the firm's stock. On the other hand, if dividend 1s not paid, investors uncertainty will increase, raising the required rate of return and lowering stock value. Where Prof. Walter has established relationship of 't" and 'k' 1.e., discount rate and cost of capital in the relevance of dividend distributed, on the same line, Prof. Gordon suggested that shareholders do have a preference for current dividend. Both approaches are discussed below.

1. Walter's Approach

Prof. Walter's suggested that there is positive relationship between dividend policy and value of the firm. According to this model, the rate of return, i.e.., 'r', and cost of capital 1.e., 'k' plays a significant role in achieving ultimate goal of wealth maximisation of shareholders. The cost of raising funds 1s different for each firm due to risk associated with firm, size, age, and nature of business undertaken by the firm, Therefore, the expected rate of return, and cost of capital may vary in different situations. This approach laid down three situations to decide pay-out ratios as per 'r' and 'k' relationships. These conditions are explained below:

a) If $r < k$, i.e., the firm earns a higher rate of return on its investment than the required rate of return, the firm should retain the earnings as much as possible. These types of firms are **growing firms**. In order to increase wealth of the shareholders, the pay-out ratio may be zero in their case.
b) If $r > k$, i.e., the capacity of the firm to earn return on its own investment is lower than the required rate of return, such firms are **grown up firm** and are on **declining stage**, should pay-out dividend up to maximum extent possible. The rate of dividend may be 100%. It is better for investors to pay higher dividend so they can invest same money in growing firm.
c) In normal situation, $r = k$, where firms rate of return on investment and required rate of return on capital are equal, for such firm there is no optimum dividend pay-out. The value of the firm would not change with the change in dividend rate.

Assumptions in Walter's Model

i. The firm use its own retained earnings to fund new investments, and firm does not use external source of funds.
ii. The internal rate of return 'r' and cost of capital 'k' of the firm are constant.
iii. The firm has an infinite life.
iv. Earnings and dividends do not change while determining the value of the firm. Walter's Model proposes the following formula to compute the market price per share.

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

or,

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

Where,

P = Market price of the equity share
D = Dividend per share
r = Internal rate of return
E = Earnings per share
K_e = Cost of equity capital
$\frac{D}{K_e}$ = Present Value of future dividends
$\frac{r(E-D)/K_e}{K_e}$ = Present value of retained earnings capitalised ar 'r' and discounted 'k'

Limitations of Walter's Model

1. The assumption of funding new project from retained earnings limits the expansion of business. Firms do raise funds from external sources.
2. The internal rate of return varies from each investment yield, years of outflow and inflow, amount of inflows etc., thus constant internal rate of return is an unrealistic assumption.
3. Similarly, cost of capital 'r' is also vary due to various factors, even model in itself produce counter point that if only retained earnings are ploughed back then after completion of each year its cost of capital will reduce, therefore, 'r' will not remain static.
4. Due to change in rate of 'r' and 'k' the earnings will be changed.

2. Gordon's Approach

Prof. Myron J. Gordon developed a model on relevance of dividend in determination value of firm. Prof. Gordon suggested that shareholders do have a preference for current dividends, in fact, there is a direct relationship between the dividend policy of a firm and its market value. Model proposes that investors are generally risk averters and attach less risk to current as opposed to future dividends or capital gains. The argument "bird-in-the-hand" suggests that a firm's dividend policy is relevant since investors prefer some dividends now in order reduce their certainty results into wealth creation.

Assumptions of Gordon's Model

1. The firm has only equity capital in its structure, and no external financing is available or used, retained earnings represents only source of financing investment programmes.
2. Model assumes that cost of capital and rate of return do not change even in case of internal source of financing, i.e., through retained earnings.
3. The firm has perpetual life.
4. The retention ratio, 'b', once decided is constant, the growth rate 'g' is set as function of 'b' and 'r' i.e., rate of return. In other words, g = br.
5. The cost of capital for firm remains constant, is also greater than growth rate, i.e., $k > br$.

The Gordon's Model summarised the following formula in simplified manner as under:

$$P = \frac{E(1 - b)}{K_e - br}$$

or,

$$P = \frac{D}{K_e - g}$$

Where,

P = price of equity share
E = Earnings per share
b = retention ratio
K_e = cost of equity capital
br = g = growth rate of the firm
E(1 - b) = D = dividend per share

Implications of Gordon's model

1. When the 'r' > 'k', or in case of internal rate of return is more than the cost of capital, the price of share increases as the dividend pay-out ratio decreases. Thus, growth firm should distribute smaller dividends and should retain maximum earnings.
2. In case of r = k, or when internal rate of return is equal to cost of capital, the firm is indifferent in payment of dividend or keeping earnings to plough back in business. Thus, this situation applies for a normal firm. The pay-out ratio does not affect price of the share.
3. When the rate of return 1s less than cost of capital, i.e., r < k, the price of share decreases by increase in pay-out ratio. The value of shareholders' wealth can be increased by making payment of dividend at higher rate even at 100%.

The implications of Walter's and Gordon's models are same 1.e., dividend pay-out is closely related with association between 'r" and 'k', i.e., internal rate of return and cost of capital. Since the assumptions of both models are similar, therefore limitations of Walter's Model also applicable on Gordon's model.

Factors Affecting Dividend Policy

1. **External Factors**: External factors are those factors which are uncontrollable, which cannot be influenced by decision. Financial manager has to adopt his policies whenever there is a change in these factors.
    a. **General state of the economy**: The general state of the economy in which the company operates has a great impact on dividend policy. If the economy is passing through boom or prosperity all the businesses will be expanding showing good financial results. Market price of shares rise rapidly. Companies need funds for expansion or diversification and therefore many prefer to retain profits instead of approaching the capital market for funds. During recession, business face problems of contracting sales, mounting inventories, decreasing profits etc. If the recession persists, businesses have to cutdown the production capacities. The market price of shares continues to fall. Companies must make a logical balance between dividends and retentions to stabilise the market price.
    b. **State of the capital market**: The factor is related to a company's access to the capital market. If the capital market is overwhelmingly in favour of equity issue, then the companies may adopt liberal dividend policy. At times when funds are required companies access the capital market instead of generating internal funds through retention.

c. **Legal Restrictions**: Dividend policy is governed by restrictions imposed by certain laws. For example, as per the provisions of the Companies Act, 2013 dividend can be declared only after providing for depreciation and any company providing for more than 10% dividend is required to transfer a certain percent of profits to reserves.
d. **Tax Policy**: According to the provisions of the Income Tax Act, any domestic company distributing dividend has to pay additional tax on distributed profits at a rate of 12.5% (plus surcharge in addition to normal tax rate of 35% (plus surcharge). In the hands of the shareholders, dividend is not a taxable income and the long-term capital gain arising out of sale of shares is taxable at a flat rate of 20%.
e. **Requirements of institutional investors**: Dividend policy of a company is affected by the requirements of institutional investors such as financial institutions, banks, insurance companies, mutual funds etc. These investors usually favour a policy of regular payment of dividends.

2. **Internal Factors:**
   a. **Nature of Business**: Nature of business is an important factor which influences the dividend policy. Any company engaged in the production with steady demand which is not influenced by variations in business cycles can follow a liberal dividend policy. These are the various factors which are controllable by taking Companies with seasonal whereas, or cyclical variations in their demand for product cannot follow liberal dividend policy. They adopt a cautious approach.
   b. **Composition of the shareholders**: Composition of shareholders influence current income requirements of shareholders. If the shareholders belong to low-income brackets or retired persons the expectation for a regular dividend will be more. Which influences the dividend policy.
   c. **Alternative uses of funds**: If the shareholders have alternative uses of the funds they would prefer the company to declare dividends so that they can invest the dividend amounts in the alternative opportunities.
   d. **Future Requirements of the company**: Companies having profitable ventures on hand, or companies having plans for future expansions, diversifications etc prefer to retain earnings by adopting a low dividend payout ratio.
   e. **Control**: If a company adopts a liberal dividend policy, it may have to access the capital market through a fresh issue of shares. This may dilute the control of the existing shareholders, as the proportion of their shareholding decreases with every fresh issue of shares. If the existing shareholders do not like to dilute their control, they would prefer low dividend payout.
   f. **Desire for financial solvency and liquidity**: The dividend policy of a company is influenced by a company's need for liquid funds for meeting working capital requirement. It depends upon the credit standing of a company.

Forms Of Dividend

Stock dividend (Bonus Shares):

Most companies pay cash dividend, but some companies pay stock dividend in addition to cash dividend. This stock dividend is popularly known as bonus share issue. Here, the bonus shares are distributed proportionately to the original shares of the stockholders. Therefore, each shareholder can retain his original proportionate ownership of the company.

Issue of bonus shares does not affect the net worth of the shareholders. Bonus issue represents recapitalisation of the owners' equity portion. It is just a transfer of reserves to paid-up capital. Shareholders future dividends may rise as the number of shares owned by them has increased, because of bonus issue. A shareholder who originally owned 100 shares, now he will be the owner of 150 shares after bonus issue.

Stock Splits:

A method of either increasing or decreasing (by a reverse split) the number of shares of stock outstanding while lowering or raising the market price per share. If a company believes that its share is too high priced and that lowering the market price will enhance trading activity, one equity share is divided into two or more shares.

Stock split has no effect on capital structure it only increases the number of shares and reduces stocks par value. The stock splits are made generally prior to new issue of stock in order to enhance the marketability of the stock and stimulate the market activity.

Stock repurchases (Buy-Back):

Companies repurchase their stock in order to change their capital structure or to increase the returns to the owners. Companies with very good liquid position which-do not have attractive investment opportunities. buy-back their shares. A company can buy-back its stock from the existing shareholders on a proportionate basis through the tender offer, from open market [through (i) back building process or ii) stock exchange and from odd-lot holders.