

**CHAPTER -3**  
**DIVIDEND POLICY-A**  
**THEORY**

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### **3.0 INTRODUCTION**

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

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

On the other hand Management has to satisfy various stakeholders from the profit. Out of the Stakeholders priority is to be given to equity share - holders as they are being the highest risk.

### **3.1 DIVIDEND - DEFINED**

#### **DEFINITION: DIVIDEND**

According to the Institute of Chartered Accountants of India, dividend is "a distribution to shareholders out of profits or reserves available for this purpose."<sup>7</sup>

"The term dividend refers to that portion of profit (after tax) which is distributed among the owners / shareholders of the firm."<sup>8</sup>

"Dividend may be defined as the return that a shareholder gets from the company, out of its profits, on his shareholdings."<sup>9</sup>

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

As per the section 2(22) of the Income Tax Act, 1961, dividend defined as:-

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<sup>7</sup> Guidance Note on Terms used in Financial Statements, ICAI

<sup>8</sup> R.P. Rustagi, Financial Management, Galgotia Publishing Company, 2001, p. 806

<sup>9</sup> Dr. S.N. Maheshwari, Elements of Financial Management, Sultan Chand and Sons, 1999, p. C 71

"Any distribution of accumulated profits whether capitalized or not, if such distribution entails a release of assets or part thereof".

Dividend is a reward to equity shareholders for their investment in the company. It is a basic right of equity shareholders to get dividend from the earnings of a company. Their share should be distributed among the members within the limit of an act and with rational behavior of directors.

The word dividend has not been defined in The Indian Companies Act, 1956. It may be described as a periodical cannot be declared from capital gains under following conditions:

- i) Provision in Articles of Association.
- ii) Capital gain must be realized.

All assets & liabilities must be revalued before distributing this capital gain.

### **3.2 DEFINITION: DIVIDEND POLICY**

"Dividend policy determines the ultimate distribution of the firm's earnings between retention (that is reinvestment) and cash dividend payments of shareholders."<sup>10</sup>

"Dividend policy means the practice that management follows in making dividend payout decisions, or in other words, the size and pattern of cash distributions over the time to shareholders."<sup>11</sup>

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

Dividend policy means policy or guideline followed by the management in declaring of dividend. A dividend policy decides proportion of dividend and retains earnings. Retained earnings are an important source of internal finance for long term growth of the company while dividend reduces the available cash funds of company.

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<sup>10</sup> Moyer Mc Guigan Kretlow, Contemporary Financial Management, Eight edition, Southwestern College Publishing, 2001 p. 516

<sup>11</sup> Ronald C. Lease, Kose John, Avner Kalay. Uri Loewenstein, Oded H. Sarig, Dividend Policy- Its Impact on Firm Value, Harvard Business School Press, Boston, Massachusetts, 2000 p. 29

"As long as the firm has investment project whose returns exceed its cost of capital, it will use retained earnings to finance these projects".<sup>12</sup>

There is a reciprocal relationship between retained earnings and dividend i.e. larger the retained earnings, lesser the dividend and smaller the retained earnings, larger the dividend.

James E. Walter (1963) says "Choice of dividend policy almost effects the value of the enterprise"<sup>13</sup>

"Dividend policy must be evaluated in light of the objective of the firm namely, to choose a policy that will maximize the value of the firm to its shareholders" Financial Management and Policy.<sup>14</sup>

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

Investors must keep an eye on the company's dividend policy for most companies regular boosts in the face of irregular earnings can be a warning signal. So can the refusal of Management to lower dividends when earnings fall or capital requirement rise. Companies with high dividend and rising debt may be borrowing money to pay shareholders. For investors who are seeking stock that will advance on their performance and earnings and earnings per share, lower dividend may mean high returns. (Adopted from the Quality of earnings - Thornton O. Glove 1987)

The dividend policy of a company reflects how prudent its financial management is. The future prospects, expansion, diversification mergers are effected by dividend policies and for a healthy and buoyant capital market, both dividends and retained earnings are important factors.

Most of the company follows some kind of dividend policy. The usual policy of a company is to retain a position of net earnings and distribute the

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<sup>12</sup> Janis C. Vanhorn, 1975 F. Management and Policy Prentice Hall of India P. Ltd. N. Delhi, 1975, Page 264.

<sup>13</sup> James Walter "Dividend Policy its influence on the value of enterprise journals of finance-18th May 1963 P. 280

<sup>14</sup> James C. Vanhorn, Prentice Hall of India, 1975, P. 263.

remaining amount to the shareholders. Many factors have to be evaluated before forming a long term dividend policy.

### **3.3 TYPES OF DIVIDENDS:**

Classifications of dividends are based on the form in which they are paid.

Following given below are the different types of dividends:

- Cash dividend
- Bonus Shares referred to as stock dividend in USA
- Property dividend interim dividend, annual dividend.
- Special- dividend, extra dividend etc.
- Regular Cash dividend
- Scrip dividend
- Liquidating dividend
- Property dividend

#### **3.3.1 Cash dividend:**

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

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

### 3.3.2 Bonus Shares : (OR Stock -dividend in USA)

An issue of bonus share is the distribution of shares free of cost to the existing shareholders, In India, bonus shares are issued in addition to the cash dividend and not in lieu of cash dividend. Hence, Companies in India may supplement cash dividend by bonus issues. Issuing bonus shares increases the number of outstanding shares of the company. The bonus shares are distributed proportionately to the existing shareholder. Hence there is no dilution of ownership.

The declaration of the bonus shares will increase the paid-up Share Capital and reduce the reserves and surplus retained earnings) of the company. The total net-worth (paid up capital plus reserves and surplus) is not affected by the bonus issue. Infact, a bonus issue represents a recapitalization of reserves and surplus. It is merely an accounting transfer from reserves and surplus to paid up capital.

The following are advantages of the bonus shares to shareholders:

- 1) **Tax benefit:** One of the advantages to shareholders in the receipt of bonus shares is the beneficial treatment of such dividends with regard to income taxes.
- 2) **Indication of higher future profits:** The issue of bonus shares is normally interpreted by shareholders as an indication of higher profitability.
- 3) **Future dividends may increase :**  
if a Company has been following a policy of paying a fixed amount of dividend per share and continues it after the declaration of the bonus issue, the total cash dividend of the shareholders will increase in the future.
- 4) **Psychological Value:**  
The declaration of the bonus issue may have a favorable psychological effect on shareholders. The receipt of bonus shares gives them a chance sell the shares to make capital gains without impairing their principal investment. They also associate it with the prosperity of the company.



### **3.3.3 Special dividend :**

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

### **3.3.4 Extra- dividend:**

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

### **3.3.5 Annual dividend:**

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

### **3.3.6 Interim dividend**

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

### **3.3.7 Regular cash dividends:**

Regular cash dividends are those the company expects to maintain every year. They may be paid quarterly, monthly, semiannually or annually.

### **3.3.8 Scrip dividends:**

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

### **3.3.9 Liquidating dividends:**

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

### **3.3.10 Property dividends:**

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

### **3.4 THE DIVIDEND DECISION**

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

The company's Board of Directors makes dividend decisions. They are faced with the decision to pay out dividends or to reinvest the cash into new projects<sup>15</sup>.

The tradeoff between paying dividends and retaining profits within the company

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

Dividend policies must always consider two basic objectives:

- Maximizing owners' wealth
- Providing sufficient financing

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

In applying a rational framework for dividend policy, a firm must consider the following two issues:<sup>16</sup>

**3.4.1** How much cash is available for paying dividends to equity investors, after meeting all needs-debt payments, capital expenditures and working capital (i.e. Free Cash Flow to Equity - FCFE)

**3.4.2** To what extent are good projects available to the firm (i.e. Return on equity - ROE > Required Return)

The potential combinations of FCFE and Project Quality and the generalizations of the dividend policy to be adapted in each situation are presented below:

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<sup>15</sup> Lintner, John. "Distribution of Incomes of Corporations among dividends, Retained Earnings and Taxes" American Economic Review 46, May 1956, p. 97-133

<sup>16</sup> Aswath Damodaran, "A Framework For Analyzing Dividend Policy", Corporate Finance: Theory And Practice, John Wiley and Sons, Inc., 2000, p. 572-598

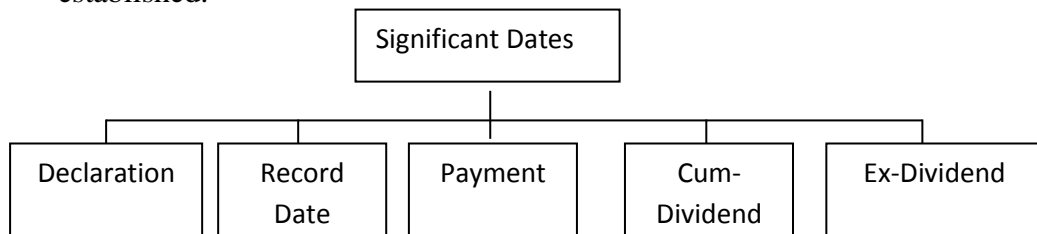
Factors	FCFE > Dividends	FCFE < Dividends
<b>ROE &gt; Cost of Equity</b>	Good Projects Cash flow surplus No Change	Good Projects Decrease Dividends Invest in Projects
<b>ROE &lt; Cost of Equity</b>	Poor Projects Cash flow surplus Increase Dividends Reduce Investment	Poor Projects Cash flow Deficit Decrease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

**Figure 3.1: Dividend Decision Matrix**

### 3.5 DIVIDEND PAYMENT PROCEDURES

The firm's board of directors normally meets quarterly to evaluate financial performance and decide whether, and in what amount, dividends should be paid.

If dividend is to be paid the declaration date, record date etc. have to be established.



**Figure: 3.2 Dividend Payment Dates**

**Declaration date:** This is the day on which the board of directors declares a payment of dividend.

**Date of Record:** This is the day on which all persons whose names are recorded as stockholders will receive the dividend.

**Payment date:** The dividend checks are mailed to shareholders of record.

**Cum Dividend date:** This is the last say on which the buyer who buys the stock is entitled to get the dividend.

**Ex-Dividend date:** Shares become ex dividend on the date seller is entitled to keep the dividend. This is the first date on which the buyer who buys the stock is not entitled to dividend.

### **3.6 DIVIDEND POLICY THEORIES**

Over the time various theories of dividend policy have emerged; some of the main theories are as follows:

#### **3.6.1 The Residual Theory of Dividend Policy**

The residual theory of dividend policy holds that the firm will only pay dividend from residual earnings, that is dividends should be paid only if funds remain after the optimum level of capital expenditures is incurred i.e. all suitable investment opportunities have been financed.

With a residual dividend policy, the primary focus of the firm is on investments and hence dividend policy is a passive decision variable. The value of a firm is a direct function of its investment decisions thus making dividend policy irrelevant.

#### **3.6.2 Dividend Irrelevancy Theory, (Miller & Modigliani, 1961)<sup>17</sup>**

The dividend irrelevancy theory asserts that dividend policy has no effect on either the price of the firm or its cost of capital.

##### **Dividend Irrelevance Arguments**

Dividend policy does not affect share price because the value of the firm is a function of its earning power and the risk of its assets. If dividends do affect value, it is only due to:

- a) **Information effect :** The informational content of dividends relative to management's earnings expectations
- b) **Clientele effect:** A clientele effect exists which allows firms to attract shareholders whose dividend preferences match the firm's historical dividend payout patterns.

A study conducted by Aswath Damodaran<sup>18</sup> found that

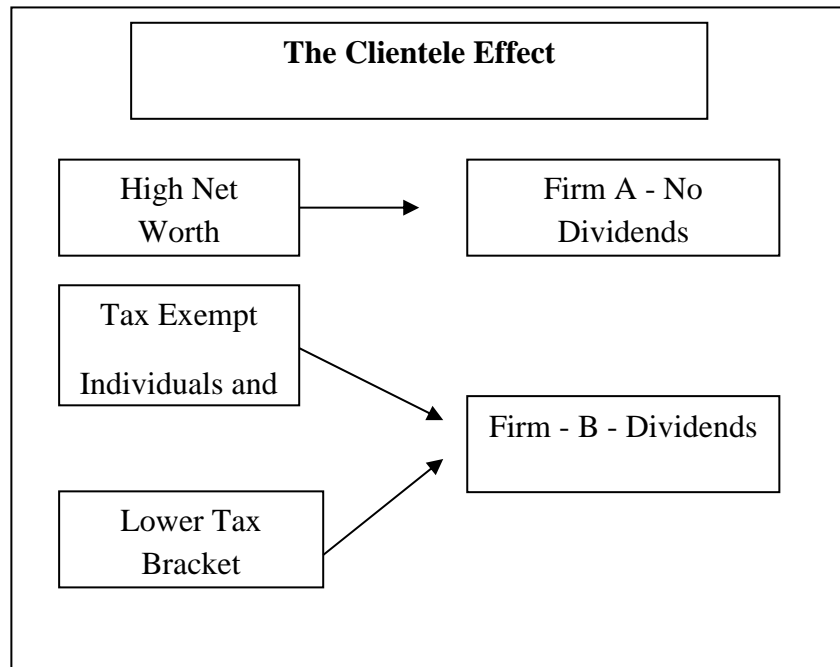
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<sup>17</sup> Miller, Merton H., and Modigliani, Franco. "Dividend Policy, Growth and the Valuation of Shares: Journal of Business 34, No. 4, October 1961, p. 411-433

\*(a) Older investors were more likely to hold high dividend stocks and

\*(b) Poorer investors tended to hold high dividend stocks

Hence, firms with older investors pay higher dividends and firms with wealthier investors pay lower dividends.



**Figure 3.3: The Clientele Effect**

(b) **Signaling effect:** Rise in dividend payment is viewed as a positive signal whereas a reduction in dividend payment is viewed as a negative signal about the future earnings prospects of the company, thus leading to an increase or decreases in share prices of the firm. Managers use dividends as signals to transmit information to the capital market. Theoretical models by Bhattacharya (1979)<sup>19</sup>, Miller and Rock (1985)<sup>20</sup> and John and Williams (1985)<sup>21</sup> and Williams (1988)<sup>22</sup> tell us

<sup>18</sup> Aswath Damodaran, "The Determinants of Dividend Policy", Corporate Finance: Theory and Practice, John Wiley and Sons, Inc., 2000 p. 544-570

<sup>19</sup> Bhattacharya, S. "Imperfect information, Dividend policy, and 'the bird in the hand fallacy,'" Bell Journal of Economics 10, 1979, p. 259-270

<sup>20</sup> Miller, Merton, and Kevin Rock, "Dividend Policy Under Asymmetric Information," Journal of Finance, vol. 40, September 1985, p. 1031-1051

<sup>21</sup> John, Kose, and Williams, Joseph. "Dividends, Dilution and Taxes: A Signaling Equilibrium." Journal of Finance 40, no.4, September 1985, p. 1053-1070

<sup>22</sup> Williams, Joseph. "Efficient Signaling with Dividends, Investment and Stock Repurchases." Journal of Finance 43, no.3, July 1988, p. 737-747

that dividend increases convey good news and dividend decreases convey bad news.

However, this theory is based on the following assumptions:

1. There is an existence of perfect capital markets i.e. No personal or corporate taxes and no transaction costs.
2. The firm's investment policy is independent of its dividend policy.
3. Investors behave rationally and information is freely available to them
4. Risk or uncertainty does not exist.

The above-mentioned assumptions exclude personal and corporate taxes as well as any linkage to capital investment policy as well as other factors that limit its application to real world situations.

### **3.6.3 The Bird in the Hand Theory, (John Lintner 1962 and Myron Gordon, 1963)<sup>23, 24</sup>**

The essence of this theory is not stockholders are risk averse and prefer current dividends due to their lower level of risk as compared to future dividends. Dividend payments reduce investor uncertainty and thereby increase stock value. This theory is based on the logic that ' what is available at present is preferable to what may be available in the future'. Investors would prefer to have a sure dividend now rather than a promised dividend in the future (even if the promised dividend is larger). Hence dividend policy is relevant and does affect the share price of a firm.

### **3.6.4 The Tax Differential Theory, (B. Graham and D.L. Dodd)**

This theory simply concludes that since dividends are taxed at higher rates than capital gains, investors require higher rates of return as dividend yields increase. This theory suggests that a low dividend payout ratio will maximize firm value.

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<sup>23</sup> Gordon Myron J., "Optimal Investment and Financing Policy:", Journal of Finance, May 1963, p. 264-272

<sup>24</sup> Lintner, John, "Dividends Leverage, Stock Prices, and the Supply of Capital of Corporations", Review of Economics and Statistics, August 1962, p. 243-269

### **3.6.5 Percent Payout Theory (Rubner 1966)<sup>25</sup>**

Rubner (1966) argued that shareholders prefer dividends and directors and managers requiring additional finance would have to convince the investors that proposed new investments would increase their wealth. However to increase their job security and status in the eyes of the shareholders companies can adopt 100 per cent payout. However this policy is not followed in practice.

### **3.6.6 Per Cent Retention Theory (Clarkson and Eliot 1969)<sup>26</sup>**

Clarkson and Eliot (1969) argued that given taxation and transaction costs dividends are a luxury that is not afforded by shareholders as well as by companies and hence a firm can follow a policy of 100 per cent retention. Firms can thus avail of new investment opportunities that would be beneficial to shareholders too.

### **3.6.7 Agency Cost Theory (Jenson)<sup>27, 28</sup>**

Since Jenson and Meckling (1976), many studies have provided arguments that link agency costs with the other financial activities of a firm. It has been argued that firms payout dividends in order to reduce agency costs. Dividend payout keeps firms in the capital market, where monitoring of managers is available at lower cost. If a firm has free cash flows (Jensen (1986), it is better off sharing them with stockholders as dividend payout in order to reduce the possibility of these funds being wasted on unprofitable (negative net present value) projects. This modern view of dividend policy emphasizes the valuable role of dividend policy in helping to resolve agency problem and thus in enhancing shareholder value.

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<sup>25</sup> Ravi M Kishore, Dividend Policies and Share Valuation, Taxmann's Financial Management, 2001 p. 1.473, 1.474

<sup>26</sup> Ravi M Kishore, Dividend Policies and Share Valuation, Taxmann's Financial Management, 2001 p. 1.473, 1.474

<sup>27</sup> Jensen Michael. C., and William Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure', Journal of Financial Economics, Vol. 3, 1976, p. 305-60

<sup>28</sup> Jensen, Michael C., "Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers", American Economic Review 76666(2), 198, p6. 323-329

### 3.6.8 A Summary View of Dividend Policy Theories

The dividend policy theories focus on the issue of the relevancy of dividend policy to the value of a firm.

#### **Dividend Irrelevance**

- Dividends do not make any difference (M & M theory)
- If there are no taxes disadvantages associated with dividends.

#### **Dividend Relevance**

- Dividends are relevant and have positive impact on firm value
- If stockholders like dividends, or dividends operate as a signal of future prospects. (Lintner & Gordon)
- Dividends help to resolve agency problem and thus enhancing shareholder value. (Jenson)
- Dividends are not good (Graham and Dodd)
- If dividends have a tax disadvantage and increasing dividends reduce value.

There are therefore, conflicting viewpoints regarding the impact of dividend decision on value of a firm.

## 3.7 **DIVIDEND MODELS**

The various models that support the above-mentioned theories of dividend relevance and irrelevance are as follows:

### 3.7.1 **Modigliani Miller approach**

According to them the price of a share of a firm is determined by its earning potentiality and investment policy and not by the pattern of income distribution. The model given by them is as follows:<sup>29</sup>

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

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 period one

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<sup>29</sup> Dr. S.N. Maheshwari, Elements of Financial Management, Sultan Chand & Sons, New Delhi, 1999, p. C. 74



According to the MM hypothesis, market value of a share before dividend is declared is equal to the present value of dividends paid plus the market value of the share after dividend is declared.

### 3.7.2 Walter's approach<sup>30</sup>

According to Prof. James E. Walter, in the long run, share prices reflect the present value of future+ dividends. According to him investment policy and dividend policy are inter related and the choice of a appropriate dividend policy affects the value of an enterprise. His formula for determination of expected market price of a share is as follows:<sup>31</sup>

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

Where,            P = Market price of equity share  
                       D = Dividend per share  
                       E = Earnings per share  
                       (E-D) = Retained earnings per share  
                       r = Internal rate of return on investment  
                       k = cost of capital

### 3.7.3 Gordon's approach<sup>32</sup>

#### Dividend Yield Basis

The value of a share, like any other financial asset, is the present value of the future cash flows associated with ownership. On this view, the value of the share is calculated as the present value of an infinite stream of dividends.

Myron Gordon's Dividend Growth Model explains how dividend policy of a firm is a basis of establishing share value. Gordon's model uses the dividend capitalization approach for stock valuation. The formula used is as follows:

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

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<sup>30</sup> James Walter, " Dividend Policy : its influence on the Value of The Firm", Journal Of Finance, May 1963, p. 280-290

<sup>31</sup> Ravi M Kishore, Dividend Policies and Share Valuation, Taxmann's Financial

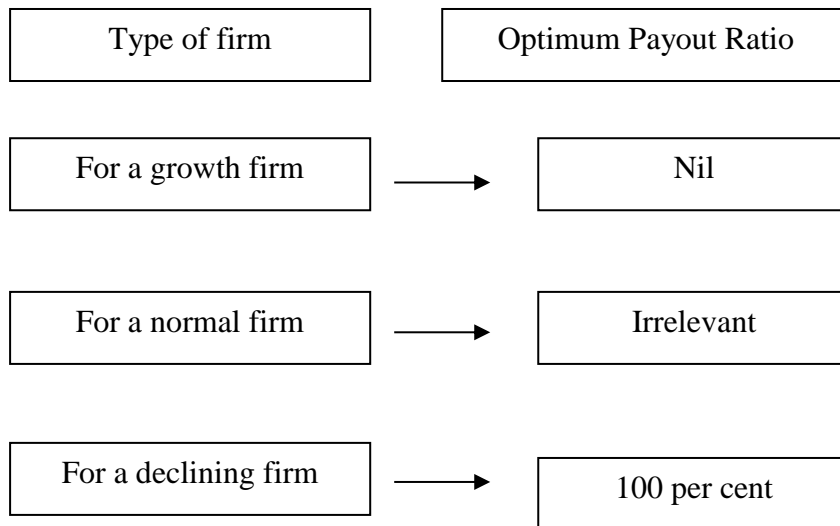
<sup>32</sup> Prasanna Chandra, "Dividend policy and firm value", Financial Management, Theory and practice, Fifth edition, Tata McGraw-Hill Publishing Co., New Delhi, p. 479, 480.

Where,  $P_0$  = price per share at the end of year 0  
 $E_1$  = earnings per share at the end of year 1  
 $(1-b)$  = fraction of earnings the firm distributes by way of dividends  
 $b$  = fraction of earnings the firm ploughs back  
 $k$  = rate of return required by shareholders  
 $r$  = rate of return earned on investments made by the firm  
 $br$  = growth rate of dividend and earnings

The models, provided by Walter and Gordon lead to the following implications:

- If  $r > k$  Price per share increases as dividend payout ratio decreases
- If  $r = k$  Price per share remains unchanged with changes in dividend payout ratio
- If  $r < k$  Price per share increases as dividend payout ratio increases.

**This further implies that:**



**Figure 3.4: Optimum Payout Ratio**

## **3.8 TYPES OF DIVIDEND POLICY**

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

In a classic study, Lintner surveyed a number of managers in the 1950's and asked how they set their dividend policy. Most of the respondents said that there were a target proportion of earnings that determined their policy. One firm's policy might be to pay out 40 % of earnings as dividends whereas another company might have a target of 50 %. On the basis of interviews with corporate executives, Lintner concluded that firms select target payout ratios to which they gradually adjust actual dividend payments over time. This would suggest that dividends change with earnings.

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

Firms may pursue any one of the following dividend policies:

#### **3.8.1 Generous or liberal dividend policy**

Firms that follow this policy reward shareholders generously by stepping up dividend over the time.

#### **3.8.2 Stable dividend policy**

Firms may follow the policy of:

Stable dividend payout ratio: According to this policy, the percentage of earnings paid out of dividends remains constant. The dividends will fluctuate with the earnings of the company.

Stable rupee (inflation adjusted) dividend policy: As per this policy the rupee level of dividends remains stable.

#### **3.8.3 Low regular dividend plus extra dividend policy**

As per this policy, a low, regular dividend is maintained and when times are good an extra dividend is paid. Extra dividend is the additional dividend optionally paid by the firm if earnings are higher than normal in a given period. Although the regular portion will be predictable, the total dividend will be unpredictable.

#### **3.8.4 Residual dividend policy**

Under this policy, dividends are paid out of earnings not needed to finance new acceptable capital projects. The dividends will fluctuate depending on investment opportunities available to the company.

#### **3.8.5 Multiple dividend increase policy**

Some firms follow the policy of very frequent and small dividend increases. The objective is to give shareholders an illusion of movement and growth.

#### **3.8.6 Erratic dividend policy**

Dividends are paid erratically when the management feels it will not strain the resources of the firm. Interests of the shareholders are not taken care of while making the dividend decisions.

It has been observed by various researchers that firms generally prefer to follow a stable or a gradually rising dividend policy.

#### **3.8.7 Uniform cash dividend plus bonus policy**

Under this policy, the minimum rate of dividend per share is paid in cash plus bonus shares are issued out of accumulated reserves. However bonus shares are not given compulsorily on an annual basis. They may be given over a period of a certain number of years, for example 3-5 years depending on the accumulated reserves of the company that can be utilized for the purpose of issuing bonus.

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

Lintner (1956)<sup>33</sup> had observed that managers tend to value stable dividend policies and corporations tend to smooth dividends relative to earnings. That is, dividends are increased gradually and rarely cut, resulting in a much lower variability of dividends as compared to the variability in earnings.

Most Companies adapt a basic policy of maintaining its internal reserves to ensure stable income far into the future, while at the same time seek to distribute a sufficient amount of earnings to shareholders in

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<sup>33</sup> Lintner, John, "Distribution of incomes of corporations among dividends retained earnings and taxes", American Economic Review, 46, May 1956, p. 97-113

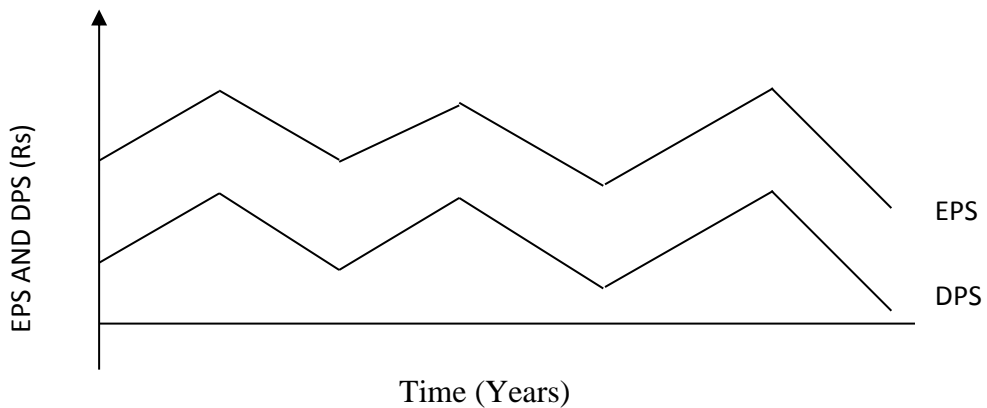
accordance with business results. with a decrease in EPS, DPS has decreased and with increase in earnings the dividend per share has increased .However increase in dividends is lagging behind increase in earnings in order to ‘smoothen’ or ‘stabilize’ dividend payments over the time.

Firm may adapt any of the following stable dividend policies:<sup>34</sup>

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

### 3.9.1 Stable dividend payout ratio

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

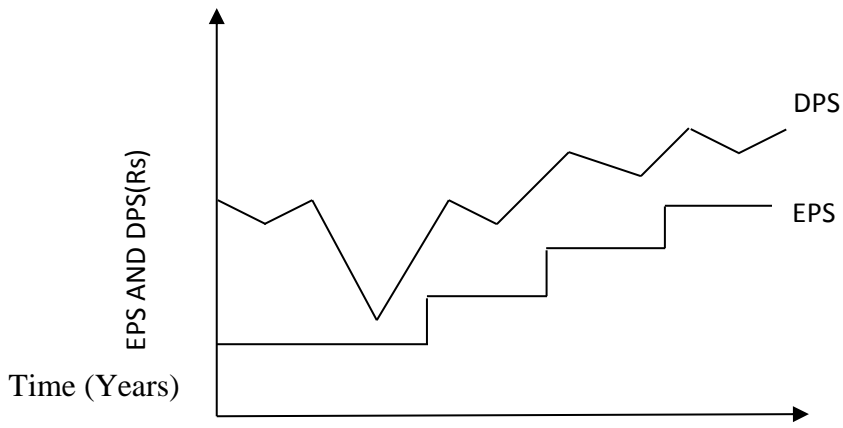


**Figure 3.5: Stable Payout Ratio Policy**

### 3.9.2 Stable dividends per share

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

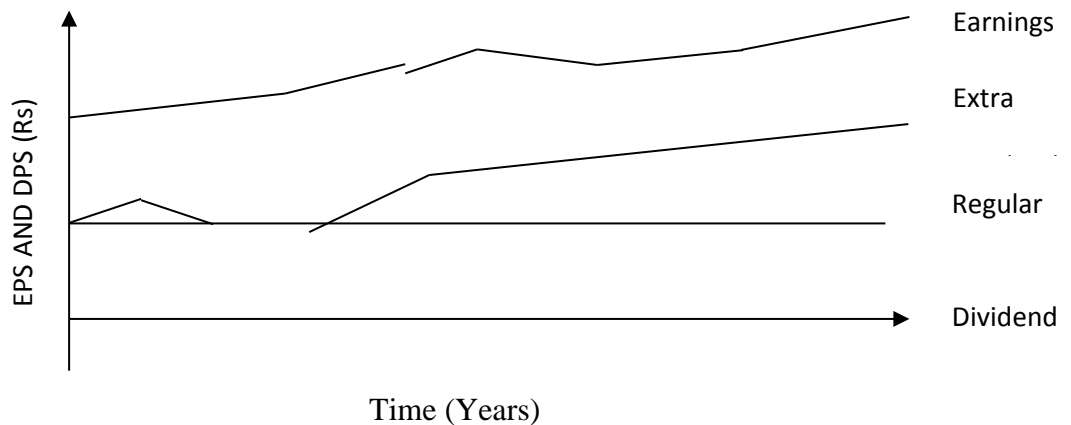
<sup>34</sup> Prasanna Chandra, Financial Management : Theory and Practice, Tata Mc-Graw-Hill Publishing Company Ltd., New Delhi, p 496, 497



**Figure 3.6: Stable Dividend per Share Policy**

**3.9.3 A regular plus extra dividend policy**

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



**Figure 3.7: Regular and Extra Dividend Policy**

**3.9.4 Rationale for stable dividend policy**

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

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

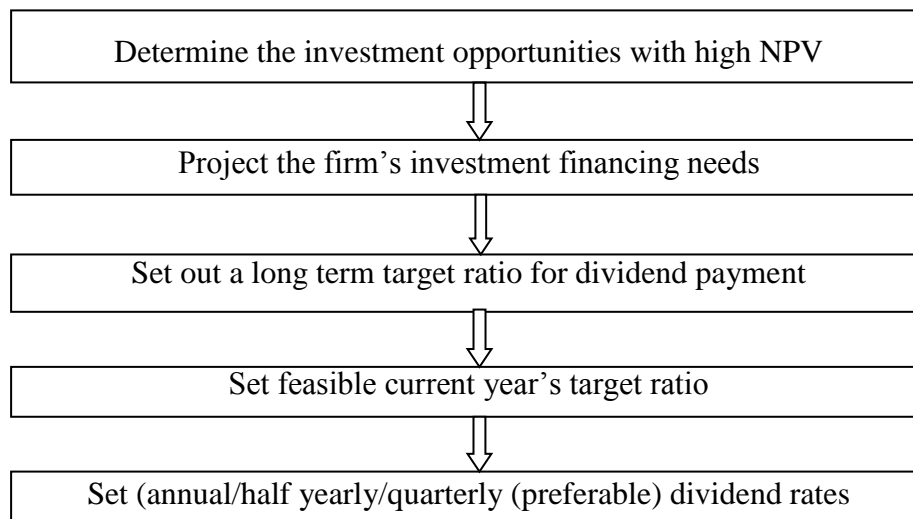
The disadvantage is that such a policy might decrease corporate flexibility. Once a company has adapted a stable dividend policy, any change in such a policy may have adverse effects on the company image and may result in creating serious doubts in the minds of investors about financial standing of the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

### **3.10 STEPS TO BE FOLLOWED IN SETTING DIVIDENDS**

The points considered by the BOD while making the dividend decision has already been discussed earlier in 3.4 The Dividend Decision.

The dividend payment procedure involves determination of a firm's profitable investment opportunities over a reasonable time horizon; projection of the firm's operating cash flows necessary for financing the projects; estimation of the residual funds which can be made available for distribution; finalizing the target payout rates keeping in view industry trends, financial soundness of business, future prospects, borrowing capacity etc. among other factors; and finally setting a feasible payout rate for the current year

The steps to be followed by a firm in setting dividends are briefly listed as follows:



**Figure 3.8: Steps for setting dividends**

### 3.11 DIVIDEND AND A FIRM'S LIFE CYCLE

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

<b>Stage of Growth</b>			
<b>Stage I</b>	<b>Stage II</b>	<b>Stage III</b>	<b>Stage IV</b>
<b>Introduction</b>	<b>Rapid Growth</b>	<b>Maturity</b>	<b>Decline</b>
<b>Dividend Policy</b>			
<b>No Dividend</b>	<b>Low Dividend Payout Policy</b>	<b>Growing or Increasing Payout Policy</b>	<b>Generous Dividend Payout Policy</b>

**Figure3.9: Dividend and a firm's life cycle**



### 3.12 MEASURES OF DIVIDEND POLICY

**Dividend Payout:** measures the percentage of earnings that the company pays in dividends. The Dividend payout ratio of a firm indicates the percentage of earnings that is distributed to the owners in the form of cash; calculated by dividing the firm's cash dividend per share by its earnings per share.

$$\text{Dividend Payout} = \text{Dividends per share} / \text{Earnings per share}$$

**Dividend Yield:** measures the return that an investor can make from dividends alone.

$$\text{Dividend Yield} = \text{Dividends} / \text{Stock Price}$$

**Dividend Cover** : indicates the vulnerability or margin of safety, of dividend payments to a drop in earnings.<sup>35</sup> The dividend cover ratio is used to assess a company's ability to pay dividends to its ordinary shareholders from its distributable earnings.

$$\text{Dividend Cover} = \text{Earnings per Share} / \text{Dividends per share}$$

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<sup>35</sup> Jim Mc Menamin, Financial Management - An Introduction, Oxford University Press, Reprinted - Replica Press Pvt. Ltd., Delhi 110 040, 2000, p. 486

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