UNIT – V DIVIDEND

Meaning:

Dividend is the payment by a company to its shareholders out of its distributable profit. In other words, dividend is paid to the shareholders out of the revenue profits earned by it in the ordinary course of business.

Concept of Dividend:

Dividend represents that part of the profit of a firm which is distributed to the shareholders. The company declares the amount of dividend at its shareholders' meeting. Shareholders will get dividends in proportion to their shareholding in the company. Dividend may be in the form of cash or non-cash, i.e. bonus shares.

TYPES/ FORMS OF DIVIDEND:

The types are: 1. Cash Dividends 2. Stock Dividends 3. Scrip Dividend 4. Bond Dividend 5. Property Dividends.

1. Cash Dividends:

Cash dividends are, by far, the most popular form of dividend. In cash dividends, stockholders receive cheques for the amounts due to them. Cash generated by business earnings is used to pay cash dividends. Sometimes, the firm may issue additional stock to use proceeds so derived to pay cash dividends or bank may be approached for the purpose. Generally, stockholders have strong preference for cash dividends.

2. Stock Dividends/ Bonus Shares:

Stock dividends rank next to cash dividends in respect of their popularity. In this form of dividends, the firm issues additional shares of its own stock to the stockholders in proportion to the number of shares held in lieu of cash dividends. The payment of stock dividends does not affect cash and earning position of the firm nor is ownership of stockholders changed.

The net effect of this would be an increase in number of shares of the current stockholders but there will be no change in their total equity.

With payment of stock dividends the stock-holders have simply more shares of stock to represent the same interest as it was before issuing stock dividends. Stock dividend is also knows as bonus shares.

Reasons for issue of Bonus Shares

Companies have a common tendency to issue bonus shares to their shareholders. Many companies have issued bonus shares once a while, whereas some other companies have issued bonus shares on regular basis. Companies such as Bajaj Auto Ltd., Hindustan Level Ltd. have issued bonus shares on regular basis. Companies prefer issue of bonus shares as against payment of cash dividend for several reasons as follows:

1. When a company issues bonus shares, it utilises a part of profit of company and also rewards the shareholders but without affecting liquidity of company.
2. Since, bonus shares is capital receipt, it is not taxable in hands of issuing company as well as shareholders.
3. Issue of bonus shares increases the goodwill of company in capital market and build confidence among investors and helps raising additional funds in future.
4. Bonus issue helps a company to streamline its capital structure and bring its paid-up capital in line with capital employed in business.
5. It makes available capital to carry on a larger and more profitable business.
6. It enables a company to make use of its profits on a permanent basis and increases creditworthiness of the company.
7. The balance sheet of the company will reveal a more realistic picture of the capital structure and capacity of the company.
8. The investors can easily sell these shares and get immediate cash, if they so desire.
9. The bonus shares are a permanent source of income to the investors.

Advantages of Bonus Shares

(A) For Shareholders:

(1) Immediately Realizable:

Bonus shares can be sold in the market immediately after a shareholder gets it.

(2) Not taxable:

Bonus shares are not taxable.

(3) Increase in future Income:

Shareholders will get dividend on more shares than earlier in future.

(4) Good Image increases the value in market:

Bonus shares create very good image of the company and the shares. Thereby it results into increase in the value of the share in the market.

(B) For Company:

(1) Economical:

It is an inexpensive mode of raising capital by which cash resources of company can be used for some other expansion project.

(2) Wider Marketability:

When bonus shares are issued, market price of share is automatically reduced which increases its wider marketability?

(3) Increase in Credit Worthiness:

Issuing bonus shares mean capitalisation of profits and capitalisation of profits always increases the credit worthiness of the company to borrow funds.

(4) More realistic Balance Sheet:

Balance Sheet of the company will reveal more realistic picture after the issue of bonus shares.

(5) More Capital Availability:

After issuing bonus shares, more capital will be available and hence more capital can be utilised for more expansion works.

(6) Unaltered Liquidity Position:

Liquidity cash position of the company will remain unaltered with the issue of bonus shares because issue of bonus shares does not result into inflow or outflow of cash.

Disadvantages of Issue of Bonus Shares

1. The issue of bonus shares leads to drastic fall in the future rate of dividend as it is only the capital that increases and not the actual resources of the company. The earnings do not usually increase with the issue of bonus shares.
2. The fall in the future rate of dividend results in the fall of the market price of shares considerably, this may cause unhappiness among the shareholders.
3. The reserves of the company after the bonus issue decline and leave lesser security to investors.

SEBI GUIDELINES FOR ISSUE OF BONUS SHARES

The Securities and Exchange Board of India has issued the guidelines for issue of bonus shares. The guidelines for issue of bonus shares can be summarized as follows:

1. These guidelines are applicable to existing listed companies who shall forward a certificate duly signed by the issuer and duly counter signed by its statutory auditor or by company secretary in practice to the effect that the terms and conditions for issue of bonus shares as laid down in these guidelines have been complied with.
2. The bonus shares is made out of free reserves built out of genuine profits or share premium collected in cash.
3. Reserves created by revaluation of fixed asset are not capitalized.
4. The declaration of bonus issue in lieu of dividend is not made.
5. The bonus issue is not made unless the partly paid shares if any existing are made fully paid up.
6. A company which announces its bonus issue after the approval of the board of directors must implement the proposals within the period of six months from the date of such approval and shall not have the option of changing the decision.
7. There should be provision in the Articles of Association of the company for capitalisation of reserves etc., and if not the company shall pass resolution at its general body meeting making provisions in the Articles of Association for capitalization.
8. Consequent to issue of bonus shares if the subscribed and paid up capital exceed the Authorised share capital a resolution shall be passed by the company at its general body meeting for increasing authorized capital.

3. Scrip Dividend:

Scrip dividend means payment of dividend in scrip or promissory notes. Sometimes companies need cash generated by business earnings to meet business requirements or withhold the payment of cash dividend because of temporary shortage of cash.

In such cases the company may issue scrip or notes promising to pay dividend at a future date. The scrip usually bears a definite date of maturity. Sometimes maturity date is not stipulated and its payment is left to the discretion of Board of Directors. Scrip may be interest bearing or non-interest bearing. Such dividends are relatively scarce.

Issue of scrip dividends is justified in the following circumstances:

i. When a company has sufficiently large earnings to distribute dividends but cash position is temporarily tight because bulk of the sale proceeds tied in receivables for time being will be released very shortly, the management may issue certificates to stockholders promising them to pay dividend in near future.

ii. When a company wants to maintain an established dividend record without paying out cash immediately, the management may take recourse to scrip dividend.

iii. When the management believes that stock dividend will not be useful because future earnings of the company will not increase sufficiently to maintain dividend rate on increased shareholding, issue of promissory notes to pay dividends in future would be a wise step.

iv. When the company does not wish to borrow to cover its dividend. The danger lies in their use as a sop to stockholders when business earnings are inadequate to cover dividend payments. Such kind of dividend is not in existence in India.

4. Bond Dividend:

As in scrip dividends, dividends are not paid immediately in bond-dividends; instead company promises to pay dividends at future date and to that effect issues bonds to stockholders in place of cash. The purpose of both bond and scrip dividends is alike, i.e. postponement of dividend payment.

Difference between the two is in respect of date of payment and their effect is the same. Both result in lessening of surplus and in addition to the liability of the firm. The only difference between bond and scrip dividends is that the former carries longer maturity date than the latter.

Thus, while issue of bond-dividend increases long-term obligation of the Company, current liability increases as consequence of issue of scrip dividends. In bond dividends stockholders have stronger claim against the company as compared to scrip dividends.

Bonds used to pay dividends always carry interest. This means that company assumes fixed obligation of interest payments annually on principal amount of bond at the maturity date.

5. Property Dividends:

In property dividends, Company pays dividends in the form of assets other than cash. Generally, assets that are superfluous for the Company are distributed as dividends to stock-holders. Sometime, a Company may use its products to pay dividends. Securities of subsidiaries owned by the Company may also take the form of property dividends. This form of dividend is not vogue in India.

Meaning of Dividend Policy:

The term dividend refers to that part of profits of a company which is distributed by the company among its shareholders. It is the reward of the shareholders for investments made by them in the shares of the company. The investors are interested in earning the maximum return on their investments and to maximise their wealth. A company, on the other hand, needs to provide funds to finance its long-term growth.

If a company pays out as dividend most of what it earns, then for business requirements and further expansion it will have to depend upon outside resources such as issue of debt or new shares. Dividend policy of a firm, thus affects both the long-term financing and the wealth of shareholders.

Determinants of Dividend Policy

The payment of dividend involves some legal as well as financial considerations. It is difficult to determine a general dividend policy which can be followed by different firms at different times because dividend decision has to be taken considering the special circumstances of an individual case. The following are important factors which determine dividend policy of a firm:

1. Legal Restrictions: Legal Provisions relating to dividends as laid down in section, 205, 205A, 206 and 207 of companies Act, 1956 are significant because they lay down a framework within which dividend policy is formulated. These provisions require that dividend can be paid only out of current profit or past profits after providing for depreciation. The companies (Transfer of Profits to Reserves) Rules, 1975 require a company providing more than 10% dividend to transfer certain percentage of current year's profit to Reserves.

Companies Act, further provides that dividend cannot be paid out of capital, because it will amount to reduction of capital adversely affecting the security of creditors.

2. Desire and Type of Shareholders: Although, legally, the direction as to whether to declare dividend or not has been left with BOD, the directors should give importance to desires of shareholders in declaration of dividends as they are representatives of shareholders. Investors such as retired persons, widows, and other economically weaker persons view dividends as source of funds to meet their day-to-day living expenses. To benefit such investors, the companies should pay regular dividends. On other hand, a wealthy investor in a high income tax bracket may not benefit by high current dividend incomes. Such an investor may be interested in lower current dividend and high capital gains.

3. Nature of Industry: Nature of Industry to which company is engaged also considerably affects dividend policy. Certain industries have comparatively steady and stable demand irrespective of prevailing economic conditions. For example, people used to drink liquor both in boom as well as in recession. Such firms expect regular earnings and hence follow consistent dividend policy. On the other hand, if earnings are uncertain, as in the case of luxury goods conservative policy should be followed. Such firms should retain a substantial part of their current earnings during boom period in order to provide funds to pay adequate dividends in the recession periods. Thus, industries with steady demand of their products can follow a higher dividend payout ratio while cyclical industries should follow a lower payout ratio.

4. Age of Company: It also influences dividend decision of company. A nearly established concern has to limit payment of dividend and retain substantial part of earnings for financing its future growth while older companies which have established sufficient reserves can afford to pay liberal dividends.

5. Future Financial Requirements: If a company has highly profitable investment opportunities it can convince the shareholders of need for limitation of dividend to increase future earnings and stabilise its financial position. But when profitable investment appointments do not exist then company may not be justified in retaining substantial part of its current earnings. Thus, a concern having few internal investment opportunities should follow high payout ratio as compared to one having more profitable investment opportunities.

6. Liquid Resources: The dividend policy of a firm is also influenced by availability of liquid resources. Although, a firm may have sufficient available profit to declare dividends, yet it may not be desirable to pay dividend if it does not have sufficient liquid resources. Hence liquidity position of company is an important consideration in paying dividends. If company does not have liquid resources, it is better to declare *stock dividend* i.e. issue of bonus shares to existing shareholders.

7. Requirements of Institutional Investors: Dividend policy of a company can be affected by requirements of institutional investors such as financial institutions, banks, insurance corporations etc. These investors usually favour a policy of regular payment of cash dividends and stipulate there own terms with regard to payment of dividend on equity shares.

8. Stability of Dividends: Stability of dividend refers to payment of dividend regularly and shareholders generally, prefer payment of such regular dividends. Some companies follow a policy of constant dividend per share while others follow a policy of constant payout ratio and while there are some other who follow a policy of constant low dividend per share plus an extra dividend in years of high profits. A policy of constant dividend per share is most suitable to concerns whose earnings are expected to remain stable over a number of years or those who have built up sufficient reserves to pay dividends in years of low profits. The policy of constant payout ratio i.e. paying a fixed percentage of net earnings every year may be supported by firm because it is related to firms ability to pay dividends. The policy of constant low dividend per share plus some extra dividend in years of high profits is suitable to firms having fluctuating earnings from year to year.

9. Magnitude and Trend of Earnings: The amount and trend of earnings is an important aspect of dividend policy. It is rather the starting point of the dividend policy. As dividends can be paid only out of present or past's years profits, earnings of a company fix the upper limits on dividends. The dividends should nearly be paid out of current years earnings only as retained earnings of the previous years become more or less a part of permanent investment in the business to earn current profits. The past trend of the company's earnings should also be kept in consideration while making dividend decision.

10. Control objectives: When a company pays high dividends out of its earnings, it may result in dilution of both control and earnings for existing shareholders. As in case of high dividend pay out ratio the retained earnings are insignificant and company will have to issue new shares to raise funds to finance its future requirements. The control of the existing shareholders will be diluted if they cannot buy additional shares issued by the company. Similarly issue of new shares shall cause increase in number of equity shares and ultimately cause a lower earnings per share and their price in the market. Thus under these circumstances to maintain control of the existing shareholders, it may be desirable to declare lower dividends and retain earnings to finance the firm's future requirements.

The external factors are:

1. General State of Economy:

Level of business activity of a firm and also its earnings is subject to general economic conditions of the country. Uncertainty about future economic and business conditions may lead to the retention of all or part of the profits in the firm so as to build up funds to absorb any shock in future.

Similarly, in the event of depression when level of business activity is very likely to sag, the management may withhold dividend payments to retain large income to preserve its liquidity position at all times. During periods of prosperity the management may not always be liberal in dividend payment although the firm's earning power warrants.

A firm may have array of profitable investment opportunities to seize upon in times of boom. Management may, therefore, be inclined heavily to hold dividends down to retain sizeable share of profits so as to improve growth prospects of the firm.

Furthermore, a wise management would always hold back a larger part of peak earnings to maintain dividend pay-out and also to preserve liquidity during recessions when level of income of the firm drops sharply. Further, the management anticipating inflationary rise in prices in the ensuing years would withhold dividend payments in order to retain larger proportion of income to replace worn-out assets.

2. State of Capital Market:

If capital market condition of the country is comfortable and raising funds from different sources poses no problem, the management may tempt to declare high dividends to maintain confidence of existing stockholders and attract potential ones.

However, when the stock market is in slump and when the investors are aphetic to buy securities, the management must plough back sizeable proportion of its earnings so that the firm gets substantial resources to face any financial turmoil.

Likewise, if term lending financial institutions is supplying funds on prohibitively stiffer terms it may be desirable to rely on internal source of finances and accordingly conservative dividend policy should be pursued.

3. Legal Rules:

The management must formulate the firm's dividend policy within overall legal framework which prescribes rules to regulate pattern and mode of income distribution. Companies (Transfer to Reserves) Rules, 1975 provide that before dividend declaration a percentage of profit as specified below should be transferred to the reserves of the company.

i. Where the dividend proposed exceeds 10 percent but net 12.5 percent of the paid-up capital, the amount to be transferred to the reserves shall not be less than 2.5 percent of the current profits.
ii. Where the dividend proposed exceeds 12.5 percent but net 15 percent, the amount to be transferred to reserves shall not be less than 5 percent of the current profits.
iii. Where the dividend proposed exceeds 15 percent but net 20 percent, amount to be transferred to reserves shall not be less than 7.5.

4. Tax Policy:

Dividend policy is also affected in part by tax policy of the Government. Sometimes, the Government in order to quicken the pace of capital formation provides tax incentives to companies retaining larger share of their earnings. By levying additional tax burden on higher dividend pay-outs also companies can be induced to plough back sizeable earnings.

For instance, the Government decided with effect from 1st April 2001 to reduce dividend tax from 20% to 10%. This will certainly encourage companies to retain more earnings and ruin share capital from near issue market.

5. Contractual Restrictions:

Contractors may put some kind of restriction on the payment of dividends to save their interests during the hard times when the company or market is going through a low phase.

Types of Dividend Policy

The various types of dividend policies are discussed as follows:

(a) Regular Dividend Policy: Payment of dividend at usual rate is termed as regular Dividend. The investors such as retired persons, widows, and other economically weaker persons prefer to get regular dividends. A regular dividend offer following Advantages.

- It establishes profitable record of company.
- It creates confidence among shareholder.
- It stabilises market value of shares
- It aids in long term financing and renders financing easier.
- The ordinary shareholders view dividends as a source of funds to meet their day-to-day living expenses.

Regular dividend can be maintained only by companies of long standing and stable earnings.

(b) Stable Dividend Policy: The term 'Stability of Dividend' means consistency or lack of variability in stream of dividend payments. A stable dividend policy may be established in any of following three forms.

i. ***Constant Dividend Per Share*****:** Some companies follow a policy of paying fixed dividend per share irrespective of level of earnings year after year. Such firms usually create a 'Reserve for Dividend Equalisation' to enable them pay fixed dividend even in year when earnings are not sufficient or when there are losses. A policy of constant dividend per share is most suitable to concerns whose earnings are expected to remain stable over number of years.

ii. ***Constant Pay out ratio*****:** It means payment of fixed percentage of net earnings as dividends every year. The amount of dividend in such a policy fluctuates in direct proportion to earnings of company. The policy of constant pay out is preferred by the firms because it is related to their ability to pay dividends.

iii. ***Stable rupee Dividend plus extra dividend***: Some companies follow a policy of paying constant low dividend per share plus an extra dividend in the years of high profit. Such a policy is most suitable to the firm having fluctuating earnings from year to year.

Advantages of Stable Dividend Policy: A Stable dividend policy is advantageous to both investors and company on account of the following:

(a) It is sign of continued normal operations of company.

(b) It stabilises market value of shares.

(c) It creates confidence among investors.

(d) It improves credit standing and making financing easier.

(e) It meets requirements of institutional investors who prefer companies with stable dividends.

Dangers or disadvantages of Stable dividend policy:

Inspite of many advantages, the stable dividend policy suffers from certain limitations:

1. Once a stable dividend policy is followed by a company, it is not easier to change it.

2. If stable dividends are not paid to shareholders on any account including insufficient profits, the financial standing of company in minds of investors is damaged and they may like to dispose of their holdings. It adversely affects the market price of shares of the company.

3. If companies pays stable dividends inspite of its incapacity it will be suicidal in long run.

(c) Irregular Dividend Policy: Some companies follow irregular dividend payments on account of following:

(a) Uncertainty of Business.

(b) Unsuccessful Business operations

(c) Lack of liquid resources.

(d) Fear of adverse effects of regular dividend on financial standing of company.

(d) No Dividend Policy: A company may follow a policy of paying no dividends presently because of its unfavourable working capital position or on account of requirements of funds for future expansion and growth.

Theories of Dividend:

Some of the major different theories of dividend in financial management are as follows: 1. Walter's model, 2. Gordon's model, 3. Modigliani and Miller's hypothesis.

1. Walter's model:

Professor James E. Walter argues that the choice of dividend policies almost always affects the value of the enterprise. His model shows clearly the importance of the relationship between the firm's internal rate of return (r) and its cost of capital (k) in determining the dividend policy that will maximise the wealth of shareholders.

Walter's model is based on the following assumptions:

1. The firm finances all investment through retained earnings; that is debt or new equity is not issued;
2. The firm's internal rate of return (r), and its cost of capital (k) are constant;
3. All earnings are either distributed as dividend or reinvested internally immediately.
4. The values of the earnings per share (E), and the divided per share (D) may be changed in the model to determine results, but any given values of E and D are assumed to remain constant forever in determining a given value.
5. The firm has a very long or infinite life.

Walter's formula to determine the market price per share (P) is as follows:

P = D/K +r(E-D)/K/K

The above equation clearly reveals that the market price per share is the sum of the present value of two sources of income:

i) The present value of an infinite stream of constant dividends, (D/K) and

ii) The present value of the infinite stream of stream gains.

[r (E-D)/K/K]

Criticism:

Walter's model is quite useful to show the effects of dividend policy on an all equity firm under different assumptions about the rate of return. However, the simplified nature of the model can lead to conclusions which are net true in general, though true for Walter's model.

The criticisms on the model are as follows:

1. Walter's model of share valuation mixes dividend policy with investment policy of the firm. The model assumes that the investment opportunities of the firm are financed by retained earnings only and no external financing debt or equity is used for the purpose when such a situation exists either the firm's investment or its dividend policy or both will be sub-optimum. The wealth of the owners will maximise only when this optimum investment in made.

2. Walter's model is based on the assumption that r is constant. In fact decreases as more investment occurs. This reflects the assumption that the most profitable investments are made first and then the poorer investments are made.

The firm should step at a point where r = k. This is clearly an erroneous policy and fall to optimise the wealth of the owners.

3. A firm's cost of capital or discount rate, K, does not remain constant; it changes directly with the firm's risk. Thus, the present value of the firm's income moves inversely with the cost of capital. By assuming that the discount rate, K is constant, Walter's model abstracts from the effect of risk on the value of the firm.

2. Gordon's Model:

One very popular model explicitly relating the market value of the firm to dividend policy is developed by Myron Gordon.

Assumptions:

Gordon's model is based on the following assumptions.

1. The firm is an all Equity firm
2. No external financing is available
3. The internal rate of return (r) of the firm is constant.
4. The appropriate discount rate (K) of the firm remains constant.

5. The firm and its stream of earnings are perpetual
6. The corporate taxes do not exist.
7. The retention ratio (b), once decided upon, is constant. Thus, the growth rate (g) = br is constant forever.
8. K > br = g if this condition is not fulfilled, we cannot get a meaningful value for the share.

According to Gordon's dividend capitalisation model, the market value of a share (Pq) is equal to the present value of an infinite stream of dividends to be received by the share. Thus:

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

The above equation explicitly shows the relationship of current earnings (E,), dividend policy, (b), internal profitability (r) and the all-equity firm's cost of capital (k), in the determination of the value of the share (P_0).

3. Modigliani and Miller's hypothesis:

According to Modigliani and Miller (M-M), dividend policy of a firm is irrelevant as it does not affect the wealth of the shareholders. They argue that the value of the firm depends on the firm's earnings which result from its investment policy.

Thus, when investment decision of the firm is given, dividend decision the split of earnings between dividends and retained earnings is of no significance in determining the value of the firm. M – M's hypothesis of irrelevance is based on the following assumptions.

1. The firm operates in perfect capital market

2. Taxes do not exist

3. The firm has a fixed investment policy

4. Risk of uncertainty does not exist. That is, investors are able to forecast future prices and dividends with certainty and one discount rate is appropriate for all securities and all time periods. Thus, r = K = K_t for all t.

Under M – M assumptions, r will be equal to the discount rate and identical for all shares. As a result, the price of each share must adjust so that the rate of return, which is composed of the rate of dividends and capital gains, on every share will be equal to the discount rate and be identical for all shares.

Thus, the rate of return for a share held for one year may be calculated as follows:

$$r = \frac{D + (P_1 + P_0)}{P_0} = \frac{\text{Dividends + Capital gains (on loss)}}{\text{Purchase price}}$$

Where P^ is the market or purchase price per share at time 0, P, is the market price per share at time 1 and D is dividend per share at time 1. As hypothesised by M – M, r should be equal for all shares. If it is not so, the low-return yielding shares will be sold by investors who will purchase the high-return yielding shares.

This process will tend to reduce the price of the low-return shares and to increase the prices of the high-return shares. This switching will continue until the differentials in rates of return are eliminated. This discount rate will also be equal for all firms under the M-M assumption since there are no risk differences.

From the above M-M fundamental principle we can derive their valuation model as follows:

$$P_0 = \frac{D_1 + P_1}{(1+r)} \qquad P_0 = \frac{D_1 + P_1}{(1+k)} \qquad r = k$$

Multiplying both sides of equation by the number of shares outstanding (n), we obtain the value of the firm if no new financing exists.

$$V = nP_0 = \frac{N(D_1 + P_1)}{(1+k)}$$

If the firm sells m number of new shares at time 1 at a price of P^, the value of the firm at time 0 will be

$$nP_0 = \frac{ND_1 + (n+m)p_1 - mp_1}{(1+k)}$$

The above equation of M – M valuation allows for the issuance of new shares, unlike Walter’s and Gordon’s models. Consequently, a firm can pay dividends and raise funds to undertake the optimum investment policy. Thus, dividend and investment policies are not confounded in M – M model, like waiter’s and Gordon’s models.

Criticism:

Because of the unrealistic nature of the assumption, M-M’s hypothesis lacks practical relevance in the real world situation. Thus, it is being criticised on the following grounds.

1. The assumption that taxes do not exist is far from reality.

2. M-M argue that the internal and external financing are equivalent. This cannot be true if the costs of floating new issues exist.

3. According to M-M’s hypothesis the wealth of a shareholder will be same whether the firm pays dividends or not. But, because of the transactions costs and inconvenience associated with the sale of shares to realise capital gains, shareholders prefer dividends to capital gains.

4. Even under the condition of certainty it is not correct to assume that the discount rate (k) should be same whether firm uses the external or internal financing.

If investors have desire to diversify their port folios, the discount rate for external and internal financing will be different.

5. M-M argues that, even if the assumption of perfect certainty is dropped and uncertainty is considered, dividend policy continues to be irrelevant. But according to number of writers, dividends are relevant under conditions of uncertainty.

Stock Split

A stock split is a corporate action in which a company divides its existing shares into multiple shares to boost the liquidity of the shares. Although the number of shares outstanding increases by a specific multiple, the total dollar value of the shares remains the same compared to pre-split amounts, because the split does not add any real value. The most common split ratios are 2-for-1 or 3-for-1, which means that the stockholder will have two or three shares, respectively, for every share held earlier.

A stock split is also known as a forward stock split. In the UK, a stock split is referred to as a scrip issue, bonus issue, capitalization issue, or free issue.

Reverse Stock Split

A reverse stock split is the opposite of a forward stock split. A company that issues a reverse stock split decreases the number of its outstanding shares and increases the share price. Like a forward stock split, the market value of the company after a reverse stock split would remain the same. A company that takes this corporate action might do so if its share price had decreased to a level at which it runs the risk of being delisted from an exchange for not meeting the minimum price required to be listed. A company might also reverse split its stock to make it more appealing to investors who may perceive it as more valuable if it had a higher stock price.

DIVIDEND THEORIES/DIVIDEND DECISION MODEL

A firm must decide whether to distribute all profits, retain them, or distribute a portion and retain the balance. Dividend decision is essentially a trade-off between retained earnings and issue of new shares. Dividend decision model helps a firm to make a profitable choice between the two.

Dividend decision consists of two important theories which are based on the relationship between dividend decision and value of the firm.

Relevance Theory of Dividend – Walter`s model, Gordon`s Model
Irrelevance Theory of Dividend – Modigliani and Miller`s Approach

Relevance Theory –

According to this theory, the dividend decision of a firm affects the market value of the firm. It suggests that shareholders prefer current dividend and there is a direct relationship between dividend decision and value of the firm. This theory was supported by two professors James E. Walter and Myron Gordon.

Walter`s Dividend Decision Model –
According to this approach dividend decision is an active variable that influences share price and value of the firm. **James E. Walter** believed that the dividend decision of a firm always affects the market value of the firm.
In determining the significance of dividend decisions Walter related the firm's Internal Rate of return (r) with the firm`s Cost of capital (K).

According to Walter –
If r > K – The firm should retain its earnings.
If r < K – The firm should distribute its earnings so that shareholders can make higher earnings by investing elsewhere.
If r = K – The firm can be indifferent towards earnings retained or distributed
Based on the relationship between a firm`s K and r there may be the following types of firms –

Growth Firms- [r>k] – These firms have ample investment opportunities promising high rate of return in the future. Therefore they should retain earnings to grow more and must not distribute any dividend.
Declining Firms – [r<k] – These firms lack investment opportunity and therefore it should distribute all its earnings so that the investors can invest it elsewhere and earn better return.

Normal firms – [r=k] – In these firms shareholders are indifferent between retention and distribution of earnings as the firm does not have the ability to earn huge profits in near future.

According to this dividend decision model, if a firm has a return on investment greater than its cost of equity capital, then it must prefer high dividend payout ratio in order to maximize its market value.

Assumptions of Walter Model –

1. The firm does not use debt or equity financing.
2. Retained earnings are the exclusive source of financing.
3. The Firm`s (r) and (K) are constant.
4. The Firm either entirely distributes or retains its earnings.
5. There is no change in earning per share and dividend distributed.
6. The firm has a perpetual life.
7. Corporate taxes do not exist.

Determining the Market Value of Shares According to Walter`s Approach

According to Walter Model of Dividend decision **Market Value of Share** is the sum of the market value of two sources of income.

1. **Present Value of all dividends** = **D/Ke** and,
2. **Present Value of all capital gains = [r(E-D)Ke]/Ke**

Therefore,

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

ke= 10%= .10 d= 8*50%= 4, E= 8, r=15%= 0.15Type equation here.

Where

P = Market price per share

D = Dividend Per Share

E = Earnings Per Share

R = Internal rate of Return

Ke = Cost of Capital

Criticism of Walter`s Dividend decision Model

It has been criticised on the following points:

1. It assumes that there is no external financing used by the firm which is not practical.
2. It assumes constant return which cannot be possible.
3. It assumes constant cost of equity capital which is not practical as every business faces uncertainties.

Gordon Dividend Decision Model

Gordon argued for the relevance of dividend decisions to valuation of firm. He believed that investors or shareholders prefer current dividends to future dividends as they are rational and not committed to take risks.
Payment of current dividends completely removes the possibility of risk. This is why when a firm retains its earnings its value receives a setback.

According to him preference for dividend exists even if r = K (Contrary to Walter)
Gordon`s dividend decision model is also known as Dividend Equalization Model

Assumptions of Gorden Model-

1. It is an all equity firm
2. The Firm`s (r) and (K) are constant.
3. The firm has a perpetual life.
4. Corporate taxes do not exist.
5. Retention Ratio once decided remains constant. Thus, growth rate (g = br) is constant.
6. ‘K’ is greater than ‘Br’ which is equal to ‘g’ (K>br=g). It is an essential condition to get a meaningful value of share.

Determining the Market Value of Shares According to Gordon`s Approach

According to Gordon the Market Value of Share (P) of a firm is equal to the Present Value of all the dividends to be received by the shareholders in the future.

$$P_o = \frac{D_1}{(1+k)} + \frac{D_2}{(1+k)} + \frac{D_3}{(1+k)} + \ldots\ldots\ldots\ldots\ldots + \frac{D_n}{(1+k)}$$

Taking into consideration the growth rate (g) of dividends

$$P_o = \frac{E\,(1 - b)}{K_e - br} \quad \text{or} \quad \frac{Ar\,(1 - b)}{K_e - br}$$

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

Here g = br
b = retention ratio
r = internal rate of return
D = E (1-b)
1-b = % of earnings distributed as dividends
A = Investment per share

Criticisms of Gordon`s Model

It has been criticised on the following points:

1. Gordon model assumes that there is no debt and equity finance used by the firm, which is not applicable to present day business.
2. Ke and r cannot be constant in the real practice.

Irrelevance Theory –

Modigliani and Miller's Approach –

According to Modigliani and Miller dividend decision model, under a perfect market condition, dividend decision has no effect on the share price of the company and that there is no relation between the dividend rate and market value of the shares. Therefore dividend decision is irrelevant factor does not affect the value of the firm.

Assumptions

1. There is a perfect capital market.
2. All Investors are rational.
3. Government does not impose any taxes.
4. The firm has fixed investment policy.
5. There are No risk or uncertainty factors.

Determining the Market Value of Shares According to Modigliani and Miller's dividend decision model

1) Calculate the prevailing market price of share –

$$\mathbf{P} = \frac{\mathbf{D1 + P1}}{(\mathbf{1 + Ke})}$$

Where,

P0 = Prevailing market price of a share.

Ke = Cost of equity capital.

D1 = Dividend to be received at the end of period one.

P1 = Market price of the share at the end of period one.

According to this dividend decision model market value of a share can be found out by the following –

2) Compute the value of **P1 (market value of share)** by the following formula =

P 1= P0 (1+Ke) – D1

3) If the company needs to issue fresh shares in order to meet its investment needs. Gordon gave the formula to find out the number of new shares to be issued.

$$\textbf{New Shares to be Issued } (\mathbf{m}) = \frac{\mathbf{I - (E - nD1)}}{\mathrm{P1}}$$

Where**,**

P1 = Price of new issue

I = Amount of investment required

E = Total Earnings/ Total Net Profit of the firm during that period.
nD1 = Total dividend paid during that period.(n= number of outstanding share x dividend per share)

Now the **value of the firm** can be calculated as under:

$$nP0 = \frac{(n + m)P1 - (I - E)}{1 + Ke}$$

n = No. of shares outstanding at the beginning of the period.
m= no of new shares
p1= market price at the end of the year
I = total investment
E = total earnings
Ke= cost of equity

Criticism of Modigliani and Miller's dividend decision model

It has been criticised on the following points:
It does not consider taxes.
It does not consider risks and uncertainty associated with a business.
It does not consider flotation and transaction cost.
Investors do not always behave rationally.