UNIT 18 DIVIDEND DECISIONS

Objectives

The objectives of this unit are:

- to acquaint you with the meaning, types and purpose of dividend
- to highlight the various factors which influence the determination of dividend policy

Structure

18.1 INTRODUCTION

A business organisation always aims at earning profits. The utilisation of profits earned is a significant financial decision. The main issue here is whether the profits should be used by the owner(s) or retained and reinvested in the business itself. This decision does not involve any problem is so far as the sole proprietory business is concerned. In case of a partnership the agreement often provides for the basis of distribution of profits among partners. The decision-making is somewhat complex in the case of joint stock companies.

Since company is an artificial person, the decision regarding utilisation *of* profits rests with a group of people, namely the board of directors. As in any other types of organisation, the disposal of net earnings of a company involves either their retention in the business or their distribution to the owners (i.e., shareholders) in the form of dividend, or both. Yet the decision regarding distribution of disposable earnings to the shareholders is a significant one. The decision may mean a higher income, lower income or no income at all to the shareholders. Besides affecting the mood of the present shareholders, dividend may also influence the mood, behaviour and responses of prospective investors, stock exchanges and financial institutions because of its relationship with the worth of the company, which in turn affects the market value *of* its shares. The decision regarding dividend is taken by the Board *of* Directors and is then recommended to the shareholders for their formal approval in the annual general meeting of the company. Disposal of profits in the form of dividends can become a controversial-issue because of conflicting interests of various parties like the directors, employees, shareholders, debenture holders, lending institutions, etc. Even among the shareholders there may be conflicts as they may belong to different income groups. While some may be interested in regular income, others may be interested in capital appreciation and capital gains. Hence, formulation of dividend policy is a complex decision. It needs careful consideration of various factors. One thing, however, stands out. Instead of an ad hoc approach, it is more desirable to follow a reasonably long-term policy regarding dividends.

18.2 FORMS OF DIVIDEND

Dividend ordinarily is a distribution of profits earned by a joint stock company among its shareholders. Mostly dividends are paid in cash, but there are also other forms such as **Scrip** dividends, **Debenture** dividends, Stock dividends, and, in unusual circumstances, Property dividends. These are briefly described below:

Scrip Dividends

Dividends can be paid only out of profits earned in the particular year or in the past reflected in the company's accumulated reserves. Profits do not necessarily mean-adequate cash to enable payment of cash dividends: In case the company does not have a comfortable cash position it may issue promissory notes payable in a few months. It may also issue convertible dividend warrants redeemable in a few years.

Debenture Dividends

Companies may also issue debentures in lieu of dividends to their shareholders. These debentures bear interest and are payable after a prescribed period. It is just like creating a long-term debt. Such a practice is not common.

Bonus Shares or Stock Dividends

Instead of paying dividends out of accumulated reserves, the latter may be capitalized by issue of bonus shares to the shareholders. Thus, while the funds continue to remain with the company; the shareholders acquire the right and this way their market-able equity increases. They can either retain their bonus shares and thus be entitled to increased total dividend or can sell their bonus shares and realise cash. Ordinarily, bonus shares are not issued in lieu of dividends. They are periodically issued by prosperous companies in addition to usual dividends, Certain guidelines, as laid down by the government, are applicable for issue of bonus shares in India.

Property Dividends

This form of dividend is unusual. Such dividend may be in the form of inventory or securities in lieu of cash payment. A company sometimes may hold shares of other companies, e.g., its subsidiaries that it may like to distribute among its own shareholders, instead of paying dividend in cash. In case the company sells these shares it may have to pay capital gains, which may be subject to taxation. If these shares are transferred to its shareholders, there is no tax liability.

18.3 DIVIDEND POLICY

The objective of corporate management usually is the maximisation of the market value of the enterprise i.e., its wealth. The market value of common stock of a company is influenced by its policy regarding allocation of net earnings into `plough back' and `payout'. While maximising the market value of shares, the dividend policy should be so oriented as to satisfy the interests of the existing shareholders as well as to attract the potential investors. Thus, the aim should be to maximise the present value of future dividends and the appreciation in the market price of shares.

Policy Options

Dividend policy refers to the policy that the management formulates in regard to earnings for distribution as dividend among shareholders. It is not merely concerned with dividends to be paid in one year, but is concerned with the continuous course of action to be followed over a period of several years. Dividend decision involves dealing with several questions, such as:

- Whether dividend should be paid right from the initial year of operation i.e., **regular dividends.**

- Whether equal amount or a fixed percentage of dividend be paid every year, irrespective of the quantum of earnings as in case of preference shares, i.e. **stable, dividends.**

- Whether a fixed percentage of total earnings be paid as dividend which would mean varying amount of dividend per share every year, depending on the quantum of earnings and number of ordinary shares in that year, i.e., a **fixed payout ratio.**

- Whether the dividend be paid in cash or in the form of shares of other companies held by it or by converting (accumulated) retained earnings into bonus shares, i.e., **property dividend or bonus share dividend.**

Dividend Policy Goals

There are several factors, which influence the determination of the dividend policy. As such no two companies may follow exactly similar dividend policies. The dividend policy has to be tailored to the particular circumstances of the company. However, the following aspects have general applicability:

- Dividend policy should be analysed in terms of its effect on the value of the company.

- Investment by the company in new profitable opportunities creates value and when a company foregoes an attractive investment, shareholders incur an opportunity loss.

- Dividend, investment and financing decisions are interdependent and there is often a trade off.

- Dividend decision should not be treated as a short run residual decision because ' variability of annual earnings may cause even a zero dividend in a particular year. This may have serious repercussions for the company and may result in the delisting of its share for the purpose of dealings on any approved stock exchange.

- A workable compromise is to treat dividends as a long-run residual to avoid undesirable variations in payout. This needs financial planning over a fairly long time horizon.

- Whatever dividend policy is adopted by the company, the general principles guiding the dividend policy should, as far as possible, be communicated clearly to investors who may then take their decisions in terms of their own preferences and needs.

- Erratic and frequent changes in dividends should be avoided. Reduction in the rate of dividend is a painful thing for the shareholders to bear. The management will find it hard to convince the shareholders of the desirability of a lower dividend for the sake of preserving their future interests.

18.4 ROLE OF FINANCIAL MANAGER

The disposal of the earnings-retention in business or distribution among shareholders - is an issue of fundamental importance in financial management. The financial manager plays an important role in advising the management i.e., Board of Directors regarding the decision. It is the latter's privilege to take the decision. The retention of profits in business helps the company in mobilising funds for expansion. Economist's, however, believe that the entire earnings of a business should be paid to its owners who should then decide where to reinvest them. That all of them may decide to reinvest the distributed earnings in the same company is another thing.

In case the company has more favourable reinvestment opportunities within it as compared to those offered outside, it would be more profitable for the company to retain earnings than to pay them out as dividends. The shareholders can later be compensated by issue of bonus shares. Let us illustrate this point by taking an example. Suppose the net profit after taxes of a company is Rs. 1 lakh and is totally distributed as dividend to shareholders. The relevant figures would then appear as follows:

1	Amount of dividend to shareholders	Rs. 1,00,000
2	Less income-tax (say at 40%) on personal income	Rs. 40,000
3	Net amount available to shareholders for reinvestment (1 minus 2)	Rs. 60,000
4	Less reinvestment cost say at 10%	Rs. 6,000
		Rs. 54,000

It is clear from the above example that if dividends are not paid, Rs. 1 lakh of income is available to the company for reinvestment in business. In case dividends are paid, it is likely that not more than Rs. 54,000 would be available for reinvestment (in the same or any other business), assuming that the stockholders are willing to reinvest their entire dividend income. If better outside investment opportunities are available to the shareholders, depending upon the environment prevalent in the capital market, they may not appreciate the recommendation (or action) of the Board of Directors for retention of larger amounts in the business, as they might perceive it to their detriment. As such they would be interested in receiving larger dividends. The dividend policy, particularly the timing of the declaration of dividend, influences the market value of a company's shares. The financial manager, therefore, should be well informed about the capital market trends and the tax policies of the government, besides the rationale behind the, investment programme of the company.

18.5 ROLE OF THE BOARD OF DIRECTORS

The Board of Directors has the power to determine whether and at what rate dividend shall he paid to the shareholders. The payment of dividend is not obligatory. Even a majority of shareholders have no right to interfere with the authority of the Board. So long as the Board acts in good faith, acts on the basis of a reasonable policy, and it does not flagrantly abuse its fiduciary responsibility, its decision cannot be challenged and there is no way to force a dividend by direct legal action.

However, there are some restrictions, dictated by law or prudence, on the discretion of the Board of Directors which are as follows.

i) Dividends may be declared out of any unappropriated surplus.

ii) If there is a loss, it should be absorbed first before dividends can be declared.

iii) Dividend declarations which impair the capital strength of a corporation must be discouraged.

iv) Dividend declarations which might lead to insolvency should be discouraged.

v) A due provision for depreciation, depletion, etc. should be made prior to dividend declaration.

vi) Directors can be sued by shareholders, if-they have declared any unlawful dividends or have grossly neglected their interests.

vii) The rights of creditors should be taken care of while taking a decision on dividend.

The corporate management is an elective management. The power of recommending a dividend is delegated by the shareholders to the Board of Directors. The Board declares a dividend in its duly convened meeting by a resolution which sets forth the rate of dividend, the class of stockholders to whom dividend is payable, and the date and mode of dividend payment.

At times the interest of the shareholders may come into conflict with those of the company. The Board is expected to act judiciously in taking decision on dividends. The decision has two dimensions. First, the corporate management must satisfy the shareholders by offering them a fair return on their investment by way of dividends. Second, the management has a commitment to ensure the financial stability of the corporation by withholding dividends (i.e. by not declaring dividends), if it feels this course is necessary in order to enable the company to stand on a firm ground.

The dividend decision thus is a difficult one because of conflicting objectives and also because of lack of specific decision-making techniques. It is not easy to lay down an optimum dividend policy, which would maximise the long-run wealth of the shareholders. However, there is no gain saying that dividend decision involves sound judgement.

There are certain factors that impinge upon the dividend decision and, therefore, should be taken into consideration while deciding a policy in this respect.

18.6 FACTORS AFFECTING DIVIDEND DECISION

It is possible to group the factors affecting dividend policy into two broad categories:

- Ownership considerations
- Firm-oriented considerations

Ownership Considerations: Where ownership is concentrated in few people, there are no problems in identifying ownership interests. However, where ownership is decentralised on a wide spectrum the identification of their interests becomes difficult. Further; the influence of stockholders' interests on dividend decision becomes uncertain because: (a) the status or preferences of stockholders relating to their position, capital gains, current income, etc. cannot be precisely ascertained; (b) a conflict in shareholders' interests may arise. In spite of these difficulties, efforts should be made to ascertain the following interests of shareholders to encourage market acceptance of the stock:

- Current income requirements of stockholders
- Alternative uses of funds in the hands of stockholders
- Tax matters affecting stockholders

Since various groups of shareholders may have different desires and objectives, understandably, investors gravitate to those companies that combine the mix of growth and desired dividends. Since companies generally do not have a singular group of shareholders, the objective of the maximisation of the market value of shares requires that the dividend policy be geared to investors in general.

Firm-oriented Considerations: Ownership interests alone may not determine the dividend policy. A firm's needs are also an important consideration which include the following:

a) Contractual and legal restrictions

b) Liquidity, credit-standing and working capital

c) Needs of funds for immediate or future expansion

d) Availability of external capital

e) Risk of losing control of organisation

f) Relative cost of external funds

g) Business cycles

h) Post dividend policies and stockholder relationships.

The following factors affect the shaping of a dividend policy.

Nature of Business

This is an important determinant of the dividend policy of a company. Companies with unstable earnings adopt dividend policies, which are different from those which have steady earnings. Consumer goods industries usually suffer less from uncertainties of income and, therefore, pay dividends with greater regularity than the capital goods industries. Industries with stable income are in a position to formulate consistent dividend policies. Thus, public utilities may be able to establish a relatively fixed dividend rate. Mining companies, on the other hand, with long gestation period and multiplicity of hazards, may not be able to declare dividends for years. But once they get established, they might afford to make liberal dividend payments. If earnings fluctuate and losses are caused during depression, the continued payment of dividends may become a risky proposition.

A company with `wasting' assets-such as timber, oil or mines-which get depleted over time may well pursue a policy of gradually returning capital to its owners because its resources are going to be exhausted. Such a company may offer dividends, which include, in part, a. return of the owner's investment.

Generally speaking, large and mature companies pay a reasonably good but not a excessive rate of dividend. Excessive dividends may be paid only by `mushroom' companies. A healthy company with an eye on future, follows a somewhat cautious policy and build up reserves. A company which believes in publicity gimmicks may follow a more liberal dividend policy to its future detriment. A firm with a heavy programme of investment in research and development would see to it that adequate reserves are built up for the purpose.

Attitude and Objectives of Management

While some organisations may be niggardly in dividend payments, some others may be liberal. A large number of firms may be found within these two extremes.

Niggardly organisations prefer to conserve cash. Though such an approach may easily meet their future needs for funds, it deprives the stockholders of a legitimate return on their investment. Liberal organisations, on the other hand, feel that stockholders are entitled to an established rate of dividend as long as their financial condition is reasonably sound. Within these two extremes, a number of corporations adopt several variations.

The attitude of the management affects the dividend policies of a corporation in another way. The stockholders who control the management of the company may be interested in `empire-building'. They may consider ploughing back of earnings as the most effective technique for achieving their objectives of building up the corporation is perhaps the largest in the field.

Composition of Shareholding

There may be marked variations in dividend policies on account of the variations in the composition of the shareholding. In the case of a closely held company, the personal objectives of the directors and of a majority of shareholders may govern the decision. Widely held companies have scattered shareholders. Such companies may take the dividend decision with a greater sense of responsibility by adopting a more formal and scientific approach.

The tax burden on business corporations is a determining factor in formulation of their dividend policies. The directors of a closely held company may take into consideration the effect of dividends upon the tax position of their important shareholders. Those in the high-income brackets may be willing to sacrifice additional income in the form of dividends in favour of appreciation in the value of shares and capital gains. However, when the stock is widely held, stockholders are enthusiastic about collecting their dividends regularly, and do not attach much importance to tax considerations.

Thus a company, which is closely held by a few shareholders in the high income-tax brackets, is likely to payout a relatively low dividend. The shareholders in such a company are interested in taking their income in the form of capital gains rather than in the form of dividends, which are subject to higher personal income taxes. On the other hand, the shareholders of a large and widely held company may be interested in high dividend payout.

Investment Opportunities

Many companies retain the earnings to facilitate planned expansion. Companies with low credit ratings may feel that they may not be able to sell their securities for raising necessary finance they would need for future expansion. So, they may adopt a policy for retaining larger portion of earnings.

In the context of opportunities for expansion and growth, it is wise to adopt a conservative dividend policy if the cost of capital involved in external financing is greater than the cost of internally generated funds.

Similarly, if a company has lucrative opportunities for investing its funds and can earn a rate, which is higher than its cost of capital, it may adopt a conservative dividend policy.

Desire for Financial Solvency and Liquidity

Companies may desire to build up reserves by retaining their earnings, which would enable them to weather deficit years or the downswings of a business cycle. They may, therefore, consider it necessary to conserve their cash resources to face future emergencies. Cash credit limits, working capital needs, capital expenditure commitments, repayment of long-term debt, etc. influence the dividend decision. Companies sometimes prune dividends when their liquidity declines.

Regularity

A company may decide about dividends on the basis of its current earnings which according to its thinking may provide the best index of what a company can pay, even though large variations in earnings and consequently in dividends may be observed from year to year. Other companies may consider regularity in payment of dividends as more important than anything else. They may use past profits to pay dividends regularly, irrespective of whether they have enough current profits or not. The past record of a company in payment of dividends regularly builds up the morale of the stockholders who may adopt a helpful attitude towards it in periods of emergency or financial crisis. Regularity in dividends cultivates an investment attitude rather than speculative one towards the shares of the company.

Restrictions by Financial Institutions

Sometimes financial institutions which grant long-term loans to corporations put a clause restricting dividend payment till the loan or a substantial part of it is repaid.

Inflation

Inflation is also a factor, which may affect a firm's dividend decision. In period of inflation, funds generated from depreciation may not be adequate to replace worn out equipment. Under these circumstances, the firm has to depend upon retained earnings as a source of funds to make up for the shortfall. This is of particular relevance if the 'assets have to be replaced in near future. Consequently, the dividend payout ratio will tend to be low.

On account of inflation often the profits of most of the companies are inflated. A higher payout ratio based on overstated profits may eventually lead to the liquidation of the company. You are aware that inflation has become an integral part of the present financial climate: While shareholders may delight in immediate income, they will feel sorry lithe company has to suffer in a few years on account of not retaining sufficient earnings to support future growth or not being able to maintain its position in the market place.

Inflation has another dimension. In an inflationary situation, current income becomes more important and shareholders in general attach more value to current yield than to distant capital appreciation. They would thus expect a higher payout ratio.

Other Factors

Age of the company has some effect on the dividend decision. Established companies often find it easier to distribute higher earnings without causing an adverse effect on the financial position of the company than a comparatively younger corporation which has yet to establish itself.

The demand for capital expenditure, money supply, etc. undergo great oscillations during the different stages of a **business cycle.** As a result, dividend policies may fluctuate from time to time.

In many instances, dividend policies result from **tradition,** ignorance and indifference rather than from considered judgement. An industry or a company may have established some `satisfactory standard' for the payment of dividends; and this standard becomes a convention or custom for that industry or company.

Activity 18.1

Meet an executive in the Accounting and Finance Department of your organisation (or any other commercial or industrial organisation in case you are not working in such an organisation) and discuss with him on matters related to dividend on the following lines:

a) What dividend the company paid last year?

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b) What dividend the company paid over the last 10 years? Did the company skip dividend in any year? Why it had to do so? What is the trend in payment of dividend over this period? Are the dividends constant, increasing or decreasing ? What are the reasons for a particular trend?

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c) What are the main features of and the major influences on the company's policy on dividends?

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18.7 SUMMARY

Dividend is a portion of the profits distributed to shareholders in a company and is usually expressed as a percentage of nominal value of shares. Dividends are often paid in cash, though in theory other forms also exit.

Though the declaration and payment of dividends is a matter, which concerns the Board of Directors, the finance manager plays an important role by advising the Board of Directors regarding the enunciation of a proper dividend policy.

Dividend policy involves the decisions whether to retain earnings in the firm for capital investment and other purposes, or to payout the earnings in the form of cash dividend to shareholders. Many financial managers believe that a stable dividend policy with a certain percentage on capital paid up on shares and with periodic increases is a better course to follow. Besides being psychologically appealing, stable dividend also has an information content in that it indicates to investors the management's expectation on levels of long- run earnings and growth.

Often the company has to strike a balance between its own needs for funds for financing growth opportunities and the needs and expectations of the investors. In view of this, therefore, dividend policy cannot or should not be regarded as a residual policy. While it is true that companies with strong investment opportunities have relatively low dividend payout ratio and vice versa, most financial managers like to follow a stable dividend policy.

There are several factors which impinge upon the dividend decision. The attitude and objectives of management, nature of business, composition of shareholdings, cash position, and future needs for funds are some of the important considerations which have a bearing on the dividend decision.

18.8 KEY WORDS

Capital Gain is a gain, which arises on transfer (or selling) of a capital asset due to appreciation in its market value. Under the Indian Income Tax Act, a capital asset must be held for a minimum of three years in order that it gives rise to a capital gain to its owner.

Bonus Shares are shares, which are issued by. a company free of charge to its existing shareholders in proportion to the shares held by them. Bonus shares are issued when a company wished to increase its capital by using its retained profits (or free reserves) and feels that its existing share capital does not give a true picture of the amount of capital employed in the firm.

Dividend Payout Ratio is the ratio of dividend declared and paid to the total disposable profits.

18.9 SELF-ASSESSMENT QUESTIONS/ EXERCISES

1 What is dividend and why is dividend decision important?

2 "While formulating a dividend policy the management has to reconcile its own needs for funds with the expectations of shareholders". Explain the statement. What policy goals might be considered by management in taking a decision on dividends?

3 Discuss the role of a financial manager in the matter of dividend policy. What alternatives he might consider and what factors should he take into consideration before finalising his views on dividend policy?

4 "Dividend can be paid only out of profits". Explain this statement. Will a company be justified in paying dividend when it has written off accumulated losses of the past?

5 What factors a company would in general consider before it takes a decision on dividends?

18.10 FURTHER READINGS

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