**LESSON – 15**

# DIVIDEND POLICIES

## 15.0 Objective :

The objective of the lesson are to present the

* factors affecting the dividend decision
* types of dividend policies followed by companies
* various forms of dividend.

**STRUCTURE :**

**15.1 Introduction**
**15.2 Determinants of Dividend Policy**
**15.3 Dividend policies of companies**
**15.4 Forms of Dividend**
**15.5 Summary**
**15.6 Key words**
**15.7 Self Assessment questions / exercises**
**15.8 Further Readings**

## 15.1 Introduction

In the previous lesson you have been introduced to the relevance and irrelevance of dividend decision in the determination of the value of a company. Various theories were proposed under a set of assumptions. Given the imperfections prevailing in the real world, a company cannot treat its dividend policy irrelevant. It must carefully analyse the environment in which it is operating and take consideration various factors that have a bearing on its valuation. Realising the importance of dividend policy, this lesson covers the important dimensions of dividend policy, discuss the factors relevant for formulating the dividend policy and policy relating to stock split, bonus issues, stock repurchase, etc.

## 15.1 Determinants of Dividend policy

Dividend policy determines the distribution of earnings available to share holders or dividing earnings per share between dividend payment and retention.

Therefore earnings per share is equal to dividend per share plus retention per share. This break up must be carefully decided keeping in view various factors, which are discussed below:

**15.2.1 External Factors :** External factors are those factors which are uncontrollable, which cannot be influenced by decisions. Financial manager has to adopt his policies whenever there is a change in these factors.

**i) General state of the economy :** The general state of the economy in which the company operates has a great impact on dividend policy. If the economy is passing through boom or prosperity all the businesses will be expanding showing good financial results. Market price of shares rise rapidly. Companies need funds for expansion or diversification and therefore many prefer to retain profits instead of approaching the capital market for funds. During recession, business face problems of contracting sales, mounting inventories, decreasing profits etc. If the recession persists, businesses have to cut down the production. The market price of shares continue to fall. Companies must make a logical balance between dividends and retention of profits to stabilize the market price.

**ii) State of the capital market :** The factor is related to a company's access to the capital market. If the capital market is overwhelmingly in favour of equity issue, then the companies may adopt liberal dividend policy. At times when funds are required companies access the capital market instead of generating internal funds through retention.

**iii) Legal Restrictions :** Dividend policy is governed by restrictions imposed by certain laws. For example, as per the provisions of the Companies Act, 1956 dividend can be declared 1) out of current profits or past profits only after providing for depreciation (2) or out of the money provided by Government for payment of dividends in pursuance of guarantee given by the Government. Any company providing more than 10% dividend is required to transfer a certain percentage of profits to reserves.

**iv) Tax Policy :** According to the provisions of the Income Tax Act, any domestic company distributing dividend has to pay additional tax on distributed profits at a rate of 12.5% (plus surcharge) in addition to normal tax rate of 35% (plus surcharge). In the hands of the shareholders, dividend is not a taxable income and the long term capital gain arising out of sale of shares is taxable at a flat rate of 20%.

**v) Requirements of institutional investors :** Dividend policy of a company is affected by the requirements of institutional investors such as financial institutions, banks, insurance companies, mutual funds etc. These investors usually favour a policy of regular payment of dividends.

### 15.2.2. Internal Factors :

**i) Nature of Business :** Nature of business is an important factor which influences the dividend policy. Any company engaged in the production with steady demand which is not influenced by variations in business cycles can follow a liberal dividend policy. Companies with seasonal or cyclical variations in their demand for product cannot follow liberal dividend policy. They adopt a cautious approach.

**ii) Composition of shareholders :** Composition of shareholders influence current income requirements of shareholders. If the shareholders belong to low income brackets or retired persons the expectation for a regular dividend will be more which influences the dividend policy.

**iii) Alternative uses of funds :** If the shareholders have alternative uses of the funds they would prefer the company to declare dividends so that they can invest the dividend amounts in the alternative opportunities.

**iv) Future Requirements of the company :** Companies having profitable ventures on hand, or companies having plans for future expansions, diversifications etc prefer to retain earnings by adopting a low dividend payout ratio.

**v) Control :** If a company adopts a liberal dividend policy, it may have to access the capital market through a fresh issue of shares. This may dilute the control of the existing shareholders, as the proportion of their shareholding decreases with every fresh issue of shares. If the existing shareholders do not like to dilute their control, they would prefer low dividend payout.

**vi) Desire for financial solvency and liquidity :** The dividend policy of a company is influenced by the need for liquid funds for meeting working capital requirement. It depends upon the credit standing of a company.

### 15.3 Dividend policies of companies :

In the previous section of this lesson we have analysed various factors that influence the dividend policy of a company. In this part we will look into various alternative dividend policies.

**15.3.1 Stable Rupee Dividend :** Payment of a fixed amount per share as dividend is one of the dividend policies followed by companies. This payment is not influenced by the companies earnings. Fluctuation in earnings will have no influence on dividend.

Dividends as percentage of paid-up capital is fixed. If the par value of the equity share is Rs.10 and if the company maintains a stable rupee dividend policy, for example a rate of 30%, the dividend per share would amount to Rs.3. This amount will be maintained even if there are changes in earnings per share (EPS).

This policy is simple and easy to follow when the company's earnings are stable and steady. But, if the earnings fluctuate widely, it is difficult to maintain fixed rupee dividend or fixed rate on paid up capital.

**15.3.2 Relatively stable rupee level of dividends which steadily trends upward** As the shareholders expect a growth in the dividends they receive, companies maintain fixed rupee dividend but shows an upward trend in dividends. This policy also does not have any relationship to the earnings per share.

This policy is suitable in the case of companies which experience a steady progression in its earnings. But companies experiencing wide fluctuation in their earnings find it difficult to adopt this policy.

**15.3.3. Stable Dividend payout Ratio :** Dividend payout ratio is the ratio of dividends to earnings.

Payout ratio: $\frac{\text{Dividends per share (DPS)}}{\text{Earnings per share (EPS)}}$

Under this policy dividends fluctuate with earnings.

Some companies follow the policy of constant payout ratio which is a fixed percentage of earnings.

Suppose, a company decides to pay 40% of the earnings as dividends every year. In a year when the earnings per share are Rs.4, dividend per share would be Rs.1.60, and in another year when EPS is Rs.5, DPS would be Rs.2.

This policy does not pressure on companies when they incur losses. Dividends will be paid only when there are profits. This policy automatically decides the retention of policy of the company. If 40% is the payout ratio, remaining 60% is the retention ratio.

**(a) Advantages of Stable Dividend Policy:** A Stable Dividend Policy is advantageous to both the investors and the company on account of the following :

i) It is a sign of continued normal operations of the company.
ii) It stabilizes the market value of shares.
iii) It creates confidence among the investors.
iv) It meets the requirement of institutional investors etc.

**(b) Dangers of Stable Dividend Policy:** Inspite of many advantages, the Stable dividend policy suffers from certain limitations. Once a Stable Dividend Policy is followed by a company, it is not easier to change it. This is because, if stable dividends are not paid to the shareholders on any account including insufficient profits, the financial standing of the company in the minds of the investors is damaged and they dispose their holdings if adversely affects the market price of the shares of the company. It adversely affects the market price of shares of the company. And if the company pays stable dividends inspite of its capacity, it will be suicidal in the long run.

**15.3.4**. **Residual dividend policy** : Residual dividend policy supports the dividend irrelevance theories. Dividend policy is influenced by both investment opportunities and availability of funds to finance these opportunities. This dividend policy is called residual because a company first determines the capital budget (investment decision) and the amount of capital required to finance the project (financing decision). Then decides the amount of dividend paid (dividend decision) based on the remaining earnings.

Companies follow the following steps in the residual dividend policy.

i) determination of optimum capital budget
ii) assessment of capital required to finance that budget

iii) use of retained earnings to the extent possible to finance the project
iv) payment of dividend only if more earnings are available than needed to support the optimal capital budget.

Dividends are merely a residual remaining after all equity investments needs are satisfied. Residual dividend policy may be (i) pure residual dividend policy or (ii) smoothed residual dividend policy.

**i) Pure Residual Dividend Policy :** Pure residual policy requires a company to distribute the profits by way of dividends whatever earnings remain after meeting the equity requirement of the capital budget. Under this policy whenever there is a change in the earnings or capital requirement, dividend amount also changes. More fluctuations in the dividend may not be liked by majority of the shareholders, since shareholders expect stable dividend with growth.

The following example explains the pure residual dividend policy.

***Table 15.1 Pure Residual Dividend Policy***

(Rs. in crores)

| *Period* | *1* | *2* | *3* | *4* | *5* | *6* | *7* | *Total* |
|---|---|---|---|---|---|---|---|---|
| Earnings | 150 | 190 | 140 | 220 | 280 | 250 | 290 | 1520 |
| Capital budget | 140 | 160 | 180 | 200 | 220 | 260 | 270 | 1430 |
| Equity investment | 70 | 80 | 90 | 100 | 110 | 130 | 135 | 715 |
| Pure Residual Dividend | 80 | 110 | 50 | 120 | 170 | 120 | 155 | 805 |

In period 1 when earnings were Rs.150 crores the capital budget was to a tune of Rs.140 crores. Out of the total capital budget equity contribution is 50 per cent i.e. Rs.70 crores. After meeting equity investment, the earnings left are Rs.80 crores. These residual earnings are declared as dividends. If this policy is adopted dividends fluctuate. You can observe that in period 1 dividends are Rs.80 crores, in period 2 Rs.110 crores and in period 3 Rs.50 crores and so on.

**ii) Smoothed Residual Dividend Policy :** Smoothed residual dividend policy is more appropriate in which case dividends will show a steady progression. It is a combination of pure residual dividend policy and principle of steady change. Under this policy, dividends are gradually change over a period of time.

***Table 15.2 Smoothed Residual Dividend Policy***

(Rs. in crores)

| *Period* | *1* | *2* | *3* | *4* | *5* | *6* | *7* | *Total* |
|---|---|---|---|---|---|---|---|---|
| Earnings | 150 | 190 | 140 | 220 | 280 | 250 | 290 | 1520 |
| Capital budget | 140 | 160 | 180 | 200 | 220 | 260 | 270 | 1430 |
| Equity investment | 70 | 80 | 90 | 100 | 110 | 130 | 135 | 715 |
| Pure Residual Dividend | 85 | 95 | 105 | 115 | 125 | 135 | 145 | 805 |

Table 11.2 gives the data on smoothed residual dividend policy of a firm. In this case the amount of dividend steadily rose from Rs. 85 crores to Rs.145 crores. This method is best suited in the world of uncertainty where earnings are erratic and shareholders expect steady dividends.

According to Lintner's survey of corporate dividend behaviour, most of the companies think in terms of the proportion of earnings that should be paid out as dividends rather in terms of the proportion of earnings that should be ploughed back and companies try to reach the target payout ratio gradually over a period of time, because shareholders prefer a steady progression in dividends.

Thus, the dividends decision is an important means by which information about the prospects of a company are conveyed. Dividend policy should also resolve uncertainty and improve shareholders confidence, so that the market price of share stabilizes and grows steadily.

**15.4 Forms of dividend**

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

Let us understand this concept with a small example. Suppose a hypothetical company has the following share capital and reserves.

| | Rs. (crores) |
|---|---|
| Paid up share capital (1 crore shares @ Rs.10/-) | 10 |
| Reserves and surpluses (retained earnings) | 10 |
| Total net worth of the firm | 20 |

Suppose the company declares bonus shares at 1: 2 ratio. That means for every 2 shares held, one bonus share will be issued. That means for 1 crore equity shares existing, 50 lakhs bonus shares are issued by converting reserves into paid-up capital.

| After bonus issue the firm's capital structure is as under | Rs. (crores) |
|---|---|
| Paid up share capital (1.50 crores shares @ Rs.10/-) 15 | |
| Reserve & surpluses | 05 |
| Total net worth of the firm | 20 |

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

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

Before stock split

| | |
|---|---|
| Common Stock 2,00,000 shares with Rs.10 par value | Rs.20,00,000 |

After stock split

| | |
|---|---|
| Common Stock 4,00,000 shares with a Rs.5 par value | Rs.20,00,000 |

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

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

**15.5 Summary**

Dividend policy of a company is influenced by various factors: (a) external factors and (b) internal factors. While adopting to the changes in the internal factors and by taking into consideration the internal factors a company evolves a dividend policy.

Stable rupee dividend, stable dividend payout ratio, residual dividend policies are some of the dividend policies which are adopted by companies:

**15.6 Key words :**

| | | | |
|---|---|---|---|
| 1. Stock Dividend | : | Issue of bonus shares to the existing shareholders free of cost. | |
| 2. Stock Split | : | Dividing each equity share into two or more shares by reducing the par value. | : |
| 3. Reverse Split | : | Decreasing the number of equity shares by combining two ore more shares into one. | |
| 4. Dividend Policy | : | Policy related to the splitting of earnings into dividends and retained earnings. | |

| | | |
|---|---|---|
| 5. Earnings per share | : | Earnings available to shareholders divided by number of shares outstanding. |
| 6. Dividend per share | : | Dividends distributed to the shareholders divided by the number of shares outstanding. |
| 7. Dividend payout ratio | : | Percentage of earnings distributed by way of dividends. |
| 8. Retention Ratio | : | Percentage of earnings retained by the company after paying the dividends. |

**15.6 Self Assessment Questions**

1. What are the factors which influence the dividend policy of a company? Explain.
2. What is a residual dividend policy? Discuss various forms of residual dividend policy.
3. What is a stable dividend policy? Explain its merits and demerits.
4. Write short notes on:
   a) Stock dividend
   b) Stock split
   c) Stock repurchase
5. Write short notes on :
6. a) Tax considerations of dividend policy
   b) How does the composition of shareholders influence dividend policy ?
   c) What is the influence of recession on dividend policy?
   d) Which types of businesses are more affected by recession?

**KHP**