

Dividend policies and it`s types

[Business](#), [Management](#)



A dividend is the money that a company pays out to its shareholders from the profits it has made (Doughty, 2000: 11). Such payments can be made in cash or by issuing of additional shares as in script dividend. Davies & Pain (20012) however defined it as the amount payable to shareholders from profit or distributable reserves. Companies that are listed in the stock exchange are usually obligated to pay out dividends on a quarterly or semi-annual basis. The semi-annual or quarterly payment is referred to as the interim dividend. The final payment, which is usually made at the end of the financial year of the company, is known as the final dividend. Dividends are normally paid after the corporate tax has been deducted. Dividend policy is primarily concerned with the decisions regarding dividend payout and retention. It is a decision that considers the amount of profits to be retained by the company and that to be distributed to the shareholders of the company (Watson & Head, 2014).

According to Lahiri (2014), making reference to Hutchinson, 1995 and Kolb & Rodriguez, 1996), theoretically, there are different types of dividend policies. These include constant payout, progressive policy, residual policy, zero policy and non-cash policy. Investors are seen to belong to a particular group or clientele. This is because they tend to pitch their tent with a particular policy that might suite them and this is the clientele effect of dividend policy.

Constant or Fixed Policy

The company pays out a fixed amount of its profit after tax as dividend. Thus, the company maintains a fixed payout ratio of dividend. A company may, as a matter of policy, decide to constantly pay out sixty percent of its after tax profit as dividend to its shareholders and retaining the remaining

fraction. This type of policy allows the shareholders the opportunity to clearly know the amount of dividend to expect from their investments in the company. However, as noted by Watson & Head (2014), the policy could be traumatic to companies experiencing a fluctuating (especially downward) trend in the profit earning. This is because of the uncertainty of its profit. Equally, if there are viable capital projects, the policy can be chaotic as confusion sets in as to where to actually allocate earned profits.

Progressive Policy:

Here, payment of dividends is on a steady increase, usually in line with inflation. This could result in increasing dividend in money terms. The firm uses the policy as a way of convincing shareholders that there is steady progress. Every effort is made to sustain the increase even though marginal. Rarely, the company may be constrained to cut down on dividend payout. This is to enable it sustain its operations. This though not a frequent action as it sends a wrong signal to investors. Firms operating this policy will prefer to avoid paying dividends during the period rather than consistently cut down on the dividend (Kolb & Rodriguez, 1996 and Lahiri, 2014).

Residual Policy: dividends are just what is left after the company determines the retained profits required for future investment. This policy gives preference to its positive NPV (Net Present Value) projects and paying out dividends if there are still left over funds available. Dividend becomes a circumstantial payment, only made when the investment policy is satisfied. There is a tendency therefore that this type of policy could give rise to a zero dividend structure. Firms may need to modify this policy to ensure that

investors of the different clienteles are not chased out by a strict application of the policy (Kolb & Rodriguez, 1996 and Lahiri, 2014).

Zero Dividend Policy: Some firms may decide not to pay dividend. This is especially common in newly formed companies that rather require capital to execute its projects. All the profit is thus retained for expansion of the business. Investors who prefer capital gains to dividends because of taxation will naturally be lured by this kind of policy. This type of policy is quite easy to operate and avoids all the costs associated with payment of dividends (Watson & Head, 2014).

Alternative policies to paying cash: In order to give shareholders a choice between dividends or new shares, the company might choose to buy back shares. This is share or stock repurchase. This has a significant advantage in terms of tax to the shareholder. While the dividend is fully taxed just as ordinary income, the stock repurchase or buyback is not taxed until the shares are sold and the shareholder makes a profit or capital gain (Ross, Westerfield & Jordan, 2011 and Hussain, 2015). There is also the policy of stock dividends and splits. Shareholders are given additional shares in lieu of cash (Brealey, Myers & Marcus, 2013).

Theoretical Framework

Ever since Black's (1976) paper on dividend policy, which he termed "dividends puzzle" to illustrate the poor understanding and the difficulty of dividend payment policy, several theories have been postulated. However, Miller and Modigliani (1961) presented a paper, before Black, titled importance of dividend policy but Black's "Dividend puzzle" threw the stage

open (Osiegbu and Nwakanma 2013). In general, the theories underlining the understanding of taxes as it relates to dividend policy are highlighted below.

Dividend Relevant

Walter's Model

Corroborating the position of Walter (1967), Hussain (2015) argues that the choice of dividend policies almost affects the value of enterprises. His model, one of the earlier theoretical works, shows clearly the importance of the relationship between the company's internal rate of return, r , and its cost of capital, k , in determining the dividend policy that will maximize the wealth of shareholders. He argued that the decision to pay dividend should be based on profitability of invested capital rather than any other variable. Walter's formula, which can be used to determine the market value per share, is as follows:

$$P = \frac{D_p + \frac{d_p}{k_p} (E_p - D_p)}{K_p}$$

Where: P = Market price per share

D_p = Dividend per share within a period

E_p = Earnings per share within a period

K_p = Cost of capital or market capitalization rate.

Gordon's Model

One model that explicitly relates the market value of the firm to dividend policy was developed by Myron Gordon in 1962.

Gordon's formula to determine the market price per share is as follows:

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$$P_0 = \frac{D_1}{K-g}$$

$K-g$

Where: P_0 = Market price per share

D_1 = Current dividend per share

K = Cost of capital

g = Growth rate in dividend

According to Gordon's dividend capitalization model, the market value of share is equal to the present value of an infinite stream of dividends to be received by shareholders.

Gordon holds a somewhat similar view with Walter when he said that for companies with $r < k$, the whole earnings should be paid as dividend. r = internal rate of returns within a period.

The Bird-In-The-Hand Argument

This argument suggests that investors, behaving rationally, are risk-averse and therefore, have a preference for present dividends to future dividends. The logic underlying the dividend's effect on the share value can be described as a bird-in-the-hand argument.

As per Osiegbu and Nwakanma (2013), the bird-in-the-hand argument was first put forward by Bhattacharya, J. (1979) in the following words:

Of two stocks with identical earnings, record, and prospects, but the one paying a large dividend than the other, the former will undoubtedly command a higher price ratio because shareholders prefer present to future values. Myopic vision plays a part in the pricing process. Shareholders often act upon the principle that a bird in the hand is worth two in the bush and for this reason are willing to pay a premium for the stock with a higher dividend rate, as the discount rate of the one with the lower rate of return. The typical investor would most certainly prefer to have his dividend today and let tomorrow take care of itself. There are no instances or records in which the withholding of dividends, for the sake of future, has been hailed with enthusiasm as to advance the price of the stock.

The bird-in-the-hand argument has been expressed more convincingly and in formal terms by Myron Gordon (1962). According to him, uncertainty increases with futurity; that is, the more future one looks the more uncertain dividends become.

Dividend Irrelevants

According to Modigliani and Miller (1961), as cited by Jabbouri (2016), dividend policy of a firm is irrelevant as it does not affect the wealth of shareholders. They argue that the value of the firm depends on the firm's earnings which result from its investment policy. The assumptions of M & M's hypothesis of irrelevance are as follows:

The firm operates in perfect capital markets where investors behave rationally, information is freely available to all and transactions and floatation cost do not exist.

Taxes do not exist

The firm has a fixed investment policy.

Risk of uncertainty does not exist.

Under M & M assumptions, rate of returns; r , is given as:

$r = \text{Dividends} + \text{capital gains}$

Purchase price

Residual Dividend Policy: This is a little digression from the classical theories and it involves the treatment of dividend as a passive residual income determined strictly by the availability of acceptable investment proposals. There has been disagreement as to whether corporate financial managers should adopt a residual dividend policy or not. A study by Jabbouri (2016) suggests that a firm's investment and dividend policies are not independent of its profit. Jabbouri study was similar to Pye's (1972) study which examined 330 United States firms and found out that an abnormally low proportion of firms that issued new stocks also paid dividends. This suggests that firms tend to utilize retained earnings to finance investment before employing external financing.

Other Models

Corporate dividend policy has captured the interests of financial economists and has been an issue of intensive theoretical models and empirical examinations over the last few decades. Such other models as tax adjusted model, Masulis and Trueman (1988) model of cash payments, Farrar and Sewlyn (1967) model of income of investors, Auerbach (1979) Model of

shareholders wealth and Akerlof (1970) signal model, information asymmetric theories, Jensen (1986) free cash flow hypothesis, Feldstein and Green (1983) theoretical dividend behavioral models and Shefrin & Statman (1984) theory of self control are all measures to unmask firms' dividend policy (Akhtar, 2016).

The tax adjusted model groups investors into tax dividend clienteles. It purports that investors are happy with shares that offer higher returns but will accept lower value for shares due to the tax liability of the dividend. However, because investors have different tax liabilities, their choice of investment based on company's dividend policy will be at variance with each other. This agrees with the propositions of Modigliani (1982) and Masulis and Trueman (1988) models of grouping investors into tax clienteles. It is believed that dividend payment decreases or increases in opposite direction with tax liability (Frankfurter & Wood, 1997). The strategy of tax sheltering of income especially by high tax investors was instrumental to the Miller & Scholes (1978) and Miller (1986) attempt to inject rationality into the tax-adjusted model. An investor can choose to either buy or decline to buy shares with high dividend as a technique of avoiding the apparent tax liability on such shares. Investors could turn to tax free shares to counter balance it with the tax incidental on dividend paying shares.