

Financial management individual work 2 week 6

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Finance and accounting a Distribution policy refers to the firm's policy in respect to the form, the level and the stability of distributions

a. 2. The term Dividend irrelevance is a financial theory that explains that investors are indifferent between dividends and capital gains, making the dividend policy irrelevant in respect to its effect to firm are value. It was put forward by MM who made the following assumptions to prove his theory: zero transaction costa and zero taxes (Mueller, 2013). He argued that paying out per share would reduce the growth rate in dividends and earnings, this because new stock would be sold to replace the capital paid out as dividends.

Bird in hand theory is the theory that explains that dividends at hand are preferred by investors to dividends retained in a company in which the dividend policy would have affected the value of the firm. The theory was put forward by John Lintner and Myron Gordon. They argued that investors perceive dividends at hand to be less riskier than dividends of potential future capital gains. Stockholders therefore prefer actual dividends to retained earnings.

Tax preference theory knows that there are two tax related reasons for believing that investors may prefer low dividend payout to higher dividend payout. The taxes on capital gains are only paid when the stock is sold but when it is held by a person; no capital gains will be due at any given point in time.

a. 3 The theories are one way traffic such that if the dividend irrelevance theory is right, then dividend payout has no significance hence the firm can follow any dividend payout. If the bird in the hand theory is relevant, the firm can set a high payout if it wants to maximize the stock price. If the tax

preference is accurate, the firm can set a low payout if it is to maximize the stock price. Therefore in general, the theories are in total war with one another.

a. 4. Regrettably, empirical tests of theories have not been in conclusion, so it is absolutely difficult to tell if investors prefer either dividends or capital gains. However, the firms' managers' can use the analyses to a reasonable and rational decision over dividend policy.

b. 1. Different groups of stockholders choose different kinds of dividend payout policies for example pension funds which are tax bracket. This kind of group of stockholders might prefer high payout stocks. Investors can sell their stocks and incur some transaction costs hence forcing sales to be made in a down market.

2. Clienteles are in existence and the question that arises is whether there are more members of one clientele than the rest. There are relevant costs such as taxes and brokerage costs to the stockholders who may be forced to change from one stock to the other. MM said that one clientele is as good as the other and therefore their existence is immaterial to implication that one dividend policy is better than the other. Dividends should be shifted slowly than hurriedly to give stockholders time to alter accordingly.

3. MM proposed that a dividend announcement is a signal that communicates to management and investors. An increase in announcement of dividend signals an increase in the stock price while a fall in stock price is signaled by a declaration in dividend cut. There exists information asymmetry among the managers as they know more than even the investors.

c. 2. a variation in investment prospects would lead to an rise or reduction in the amount of equity desired hence the residual dividend payout.

c. 3. the advantage of residual policy is that firm sorts maximum use of lower cost retained earnings leading to minimization of transaction costs hence low cost of capital. Whatever negative signals are related with stock issues would be avoided.

If it were pragmatic accurately, the model would effect in dividend payments which varied meaningfully as capital needed and internal cash flows changed. This would consequently send investors contradictory signals over time concerning the firm's future forecasts leading to no specific clientele being paying attention to the firm. This clientele and signaling effects will lead to an advanced required ROI (return on investment) which can counter affect the effects of lower flotation costs.

d. a firm declares first of all dividends it will pay on regular basis to shareholders. The ex- dividend date thereafter follows which is usually four days before holder of record date for new buyers do not have a right to buy the dividends. All the stocks are recorded and holders receive the dividends. The payment date thereafter comes where the company mails dividend checks to holders of record

e. Stock repurchases refers to supply of cash to stockholders by repurchasing its own stock relatively than paying out cash dividends.

Advantages of repurchases:

1. Can be used to huge changes in capital structure.
2. Can be swiftly be varied over years without necessarily giving an adverse signals.
3. The repurchase declares a positive signal that indeed the shares are undervalued.

Disadvantages of repurchases:

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1. If IRS finds that the repurchase was mainly to evade taxes on dividends, then forfeits could be forced
 2. A repurchase can lower the stock's price if taken as signal to the firm with relatively few worthy speculation opportunities.
 3. Selling shareholders may not be completely knowledgeable about the repurchase; henceforth they may make an ignorant decision and later prosecute the company. To evade this, firms usually publicize repurchase programs early.
- g. Firms create dividend policy inside the agenda of their general financial plans. The steps in setting policy are listed below:
1. The firm projects its yearly capital accounts and its yearly sales, alongside with its working capital needs, for a somewhat long-term forecasting prospect, often 6 years.
 2. The targeted capital structure, apparently the one that minimizes the WACC whereas holding adequate reserve borrowing volume to deliver "financing elasticity," will also be well-known.
 3. With its capital structure and investment requirements in mind, the firm can estimate the approximate amount of debt and equity financing required during each year over the planning horizon.
 4. Long-term aim payout ratio is then predetermined, centered on the residual model thought. Because of initiation costs and possible negative signaling, the firm will not need to issue common stock if this is unconditionally necessary.

An actual dividend, say \$4 per year, will be categorical upon. The scope of this dividend will echo the long-run target payout ratio and the likelihood that the dividend, once established, will have to be dropped, or, shoddier

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yet, misplaced. If there is an unlimited deal of doubt about cash flows and capital requirements, then a moderately low original dividend will be established, for this will minimize the possibility that the firm can either decrease the dividend or trade new common stock. The firm will ride its company design model so that administration can see what is probable to happen with dissimilar original dividends and anticipated growth charges under diverse economic situations.

h. Stock dividend, firm issues new shares in respect to paying a cash dividend.

Stock split, if the number of shares unresolved is increased in an action unconnected to a dividend payment. For example, in a 4-for-2 split, the amount of shares unsettled is doubled. A 100% stock dividend and a 4-for-2 stock split would harvest the similar effect, but there would be changes in the bookkeeping treatments of the two scenarios.

Stock dividends and stock splits increase the quantity of shares unresolved. If the dividend and/or split do not happen at the similar time as some further event that would change perceptions about forthcoming cash flows, such as an declaration of advanced earnings, then one would imagine the price of the stock to regulate such that each investor's wealth rests unchanged (Sharan, 2009). For example, a 4-for-2 split of a stock selling for \$100 would consequence in the stock price being cut to \$50

It is hard to come up with an undoubted basis for small stock dividends, like 10 percent. No economic value is being fashioned, yet shareholders have to bear the administrative costs and costs of distribution. .

There is a decent reason for large stock dividends. Precisely, there is an extensive belief that an optimum price range occurs for stocks.

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Another factor that may affect stock splits and dividends is the certainty that they signal management's belief that the future is cheerful. If a firm's administration would be persuaded to pay a stock dividend only if it expected developments in earnings and dividends, then a split/dividend action would provide a optimistic signal and thus increase the stock price. However, if earnings and cash dividends did not afterwards rise, the price of the stock can fall back to its ancient level, or lower, because managers would lose trustworthiness.

i. DRIP refers to dividend reinvested plan. Shareholders have the option of automatically reinvesting their dividends in shares of the firm's common stock. In an open market purchase plan, a trustee pools all the dividends to be reinvested and then buys shares on the open market. Shareholders use the DRIP for three reasons: brokerage costs are reduced by the volume purchases, the drip is a convenient way to invest excess funds, and the company generally pays all administrative costs associated with the operation. In a new stock plan, the firm gives out new stock to the DRIP members in terms of cash dividends (Marsh, 2012). No fees are called for, and numerous companies even bid the stock at a 5% discount from market price on dividend date on the grounds that firm avoid launch costs that would otherwise be experienced. Firms that want fresh equity capital utilize new stock strategies, while firms with no essential for new stock use an open market acquisition plan.

References

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