The theory and arguments of dividend policy finance essay

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Dividend is a cash payment made by a company to its shareholders. A company's dividend decision has important implications for both its investment and financing decisions which would what money should be give to the shareholder and how much money should be kept in the firm which may be used in the later years.

The dividend decision, which consider the amount of funds retained by the company and the amounts to be distributed to the shareholders, is closely linked to both investment and financing decisions. For example the company with few projects should return the unused funds to shareholder by the way of paying more dividends. A company with several suitable projects that maintains high dividends will have to fund from external sources.

In the recent years, the decision what amount to retain and what amount to pay has become an important corporate decision. The Management should take into account the expectation of the shareholders and the capital market when making dividend decision.

Theory of Dividend Policy

Waston and Head (2007) state that there are two main theories of dividend policy which are as follows:

Dividend Relevance Theory: Lintner (1956) and Gordon (1959) claim that " dividend policy affects the value of a firm, because of shareholder prefer dividend to capital gain. The logic of their preference regarding dividend is that divided is certain but not capital gain. So, dividend policy affects the value of a company". The assumptions of Gordon findings are investors are

risk averse and uncertainty augments with regard to whether dividend payments would take place in future".

Dividend Irrelevance Theory: Miller and Modigliani (1961) claim that " value of a firm is not influenced by its dividend policy in perfect capital market with some assumptions". The assumptions which are needed for the perfect market are as follows:

There is no tax effect on dividend and capital gain

There is no transaction cost

All the investors are behaving rationally

There is a perfect market

Arguments for and against that a Higher Cash Dividend Payout Increases the Share Price

Arguments in favor of the statement:

Information content: Waston and Head (2007) mention that " a higher cash dividend payment plays an important role to provide favorable information to the investors. Higher cash dividend indicates that the company's financial condition is strength.

Reduce Conflict of Interest: Waston and Head (2007) states that " management tries to ensure their personal benefits, whereas owners are concerned about their own interest which cause agency problem. Higher dividend payment rate decreases conflict of interest, because it indicates

that agent (management) is doing all things for the wellbeing of the shareholders".

Risk free: Gitman (1997) argues that higher cash dividend reduces the uncertainty of shareholders income, so it leads to increase the share price of a company.

Arguments against the statement:

Shortage of Cash: High cash dividend payments cause shortage of cash which lead to forgo of making investments in profitable projects and it will act as a fuel to reduce the share price rather than increase.

Increase the Cost of Capital: The given company has to manage fund from the external source which is comparative expensive than retained earnings, because of paying higher cash dividend, the capability of the given firm decreases to collect fund from internal source i. e. retained earnings. Therefore, a higher payment of cash dividend increases the cost of capital and decreases the share price.

Hindrance of Growth: A higher payment of cash dividend hinders growth of the firm through squeezing the investment capacity.

Arguments for and against that Divided Payment is Irrelevant to Maximize the Shareholders Wealth

Argument in favour of the statement

Homemade Dividend: Dividend is irrelevant to the maximization of shareholders wealth, because of if the company does not pay dividend,

shareholders can continue their regular income through selling some holding shares which is called homemade dividend.

Profitability: The market price of share depends upon the earnings or profitability of the firm and not the dividend policy of the given firm.

Arguments against the statement

The Clientele Effect: There are some differences for the different types of investors which invested in the given stock of the firm. Normally, the investors such as Pensioners and Institutional investors expect regular income in order to meet their liabilities. But in case of wealthy investors, they expect capital gain rather than small regular income in the form of dividend. So, dividend payment ratio is relevant to change the share price.

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Argument for and against that Dividend payment should be avoided since it reduces Shareholders Wealth

Arguments in favour of the statement

Tax effect: Shareholders need to pay tax on the dividend received on the shares which decreases their net income as a result it will decrease wealth.

Reduction of investment in profitable projects: Payment of dividend to the shareholders will reduce the opportunity of the firm to invest in the profitable projects. So, the firm should try to avoid the dividend payment to its shareholders and try to concentrate on its investment opportunities.

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Determinants of Dividend Policy:

Samuels and Brayshaw (1995) and Weston, Beasely and Brigham (1996) mention that the following factors affect the dividend policy:

Constraints on dividend payments : There are some constraints in the dividend payments which includes

Debt contract imposes some restrictions because the interest on debt is to be paid before the dividend and it is the obligatory payment.

The face that the dividend payment should not exceed the retaining earning which was mentioned in the balance sheet

It is subject to the availability of the cash , because the dividend is paid only with cash.

Investment Opportunities: Company which pays more dividends it will postpones the opportunity to invest in the new acceptable projects which might be selected on the basis of Net present value of the project.

Alternative source of capital: When a firm want to raise a capital though either debt or equity it have to incur some cost which is known as Cost of capital. Generally, a firm which want to raise money should try to make the cost of capital low. Normally, the Equity cost of capital and cost of debt capital should be referred as external cost and the retained earnings should

be mentioned as internal cost. If have retained earning almost, its cost is less when compared to the cost of external cost. If the firms has strong Retained earning it should not depend upon the profit of firm which is not predictable, and you could not restrict your investment opportunities in new projects.

Ownership dilution: If the management of the company think that they should not allow any further shares by raising through equity capital or they are reluctant to dilute the ownership it should hold large amount of retaining earning or reserves. If the firm has large number amount of reserves then it need to raise capital for any future projects. Hence, the company which dont like dilution of control should hold sufficient amount of reserves or retaining earning and whenever they need they can use for the Business.

Effect of dividend policy: The effect of dividend policy depend on 4 factors this includes : Shareholder desire for current future income; the perceived riskiness of dividends versus capital gains; the tax affect on the capital gain or divided which may depend upon the relevant statues and the information content of dividend.

Distributable profits: The companies act stipulated that the dividend should be paid out accumulated net realized profit which includes the current profit and the previous accumulated profit. Because there is no concise definition of the word accumulated profit in the act the Committee of Accounting Bodies issued guidelines on the determination of the realized and the distributable profits and the mentioned that the profit is as per the Accounting standards and Generally accepted accounting principles i. e.,

Profit available for distribution should be calculated after providing accumulated loosed from the previous year.

Liquidity: When the firm announces the dividend it should have sufficient cash to pay the dividend otherwise there liquidity position should be strong. Because, the company may generate more profit its does not mean that it should have it have all the profit realised in terms of cash. It may invest some funds in Projects or investment for returns. So the management should consider the liquidity before announcement of dividend.

CONCLUSION

The dividend policy is the crucial part of the management decision that need to be handled carefully . If they handled properly they need not to worry about the investment decision and financial decision.

According to the dividend relevance theory, the dividend policy plays a vital role in hands of the investors because the wrong decision might affect the capital structure of the firm. We got from the theory that dividend give the signal effect to the investores and it has a clientele effect so we cant avoid the payment of dividend. On the other hand if we pay dividend regularly year by year it will affect the growth of the company and it will create liquidity problems. Big company like Mcdonals they avoid the dividend in the intial year and they will create a Brand name across the world and later they pay the dividend.