Subject Name Financial Management

Dividend policies

The term dividend refers to that portion of the profits of a business enterprise which is distributed among the shareholders of the enterprise. While taking decisions regarding the financial management of a company the decisions regarding dividend payment become relevant. In fact, the firm has to choose between distributing its net profits among the shareholders and ploughing back of net profits in to the business. Generally, a company would follow such a dividend payment policy that maximises the wealth of the owners or the value of the firm.

The decisions regarding the dividend payments to the shareholders of a company is a crucial area of financial management. A firm should frame an appropriate dividend policy that would maximise the wealth of its shareholders. thus, the term dividend policy refers to the policy concerned with the distribution of a portion of profits among the shareholders. In deciding dividend policy, the company has to choose between distributing profit as dividend to the shareholders and ploughing them back into the company to increase its capital base.

There are different theories relating to the impact of dividend decisions on the value of the firm. The financial analysts such as Myron Gordon, James Walter, John Linter etc are of the opinion that the dividend policy of a firm has significant impact upon the value of the firm. According to their views dividend policy is relevant in maximising the net worth of the business enterprise. However according to another school of thought led by F Modigliani and M.H. Miller the dividend policy of a firm has no impact upon the share price of the company. In this sense the dividend policy is irrelevant.

WALTER MODEL ------ this model is shows that the dividend policy chosen by a firm always effect the value of the firm. According to this model the market price of a share is estimated to be the sum of the present value of the future stream of cash dividend and capital gains. The following formula has been evolved by Walters to ascertain the market price of a share.

D = dividend per share E = Earnings per share Ke= cost of equity capital r = Expected rate of return P = price per share

$P=(D+r/Ke(E-D))/Ke$

If r> Ke that means if firm earns higher rate of return on its investment compared to its cost of equity capital the firm is termed as growth firm, in those case the optimum dividend pay-out ratio is zero. That means if entire earnings of the firm are ploughed back to business than market value per share will be maximum.

If r <Ke that means if firm earns at a lower rate on its investment as compared to its cost of equity capital the firm is termed as decline firm. in this case it is better to distribute dividend than ploughing back .so optimum dividend pay-out ratio will be 100 %.

If r= Ke the firm would remain indifferent between dividend pay out and retention of earnings. This type of firm is known as normal firm. in this case the market value of share will remain unaffected to change in D/P ratio of the firm.

Criticisms of Walter Model

1 in this model it is assumed that all investment of a firm are financed through retained earnings. However, in real world the business firms are used both retained

earnings and external sources of fund for financing their investment plan.

Thus, this model is only applicable in case of all equity firms.

2 this model also assumed that the internal rate of return remains constant. but this is not also a realistic assumption.

3 this model has also ignored the impact of business risks on the value of the firm but in real situation the business risk has an impact up on the value of the firm.

GORDON MODEL-------- Myron Gordon has also developed a model to establish the fact that the dividend pay outs of a firm influence the value of the firm .so this model also supports the relevance of the dividend policy of a firm.

The market value of a share, according to the Gordon s Model, is estimated with the help of the following formula

P = price of a share E= earnings per share b= Retention ratio (1-b) = D/P ratio Ke = cost of ratio br= Growth rate of return on investment

$$P=(E(1-b))/(Ke-br)$$

Criticism is same as Walter model.

MODIGLIANI AND MILLER MODEL------- the financial analysts F Modigliani and M H Miller are of the opinion that the dividend policy of a firm has no impact upon the value of the firm .it implies that the dividend policy of a firm does not influence the share prices or the wealth of the shareholders of the firm. Thus, the dividend policy is irrelevant so far as the value of the firm is concerned .in their model Modigliani and Miller have shown that the earnings oof a firm are determined by its investment decision and not by its dividend decisions.

Modigliani and Miller have expressed in the more comprehensive manner the theory of irrelevance. according to them investors are indifferent between dividend and retention of earnings in the sense that the value of the firm is is independent of it. this hypothesis is based on a number of simplifying assumptions. but these assumptions are unrealistic and untenable in practice. it has only theoretical relevance.