Unit 14 Dividend Policy

QN1 What is Dividend Policy? What is the dividend payment procedure? Explain

Portion of the profit paid out to shareholders is known as dividend. Dividends are paid in either cash or stock. Dividend policy is the firm's decision regarding the size of dividends it will pay to its equity holders. Policy includes the use of profit in different ways like expansion, debt reduction, share repurchase, cash dividend etc.

Dividend payment procedures on behalf of a corporation shall be given below:

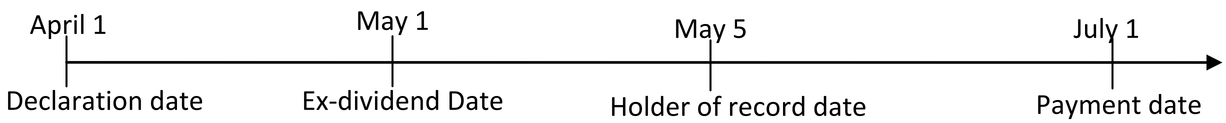

Fig: Dividend payment procedures of XYZ Co.

Declaration date:- This is the day on which the board of directors declares the dividend. At this time they set ate amount of the dividend to be paid, the holder-of- record date and the payment date. For example on April 1 2012, XYZ Co. declared its regular dividend of Rs 0.5 per share, payable on July 1 to holders of record on May 5.

Holder of record date: This is the date the company opens the ownership books to determine who will receive the dividend; the stockholders who purchased stock before ex- dividend date update his or her record on this date receive the dividend.

Ex-dividend date: This date is two to four days prior to the record date. Share purchased after the ex-dividend date are not entitled to the dividend. Effects of dividend payment on share price are seen on stock price in the market after this day.

Payment date: This is the day when dividend checks are actually mailed to the holders of record.

QN2 What are the factors of influencing dividend payment policy?

Many considerations may affect a firm's decision about its dividends. They are as follows:

Desire of Shareholders: Shareholders may be interested either in dividend incomes or capital gains. Wealthy shareholder in a high income tax bracket may be interested in capital gain as against current dividends.

Legal rules: Statutory restrictions may prevent a company from paying dividends. While specific limitations may by state, generally a corporation may not pay a dividend in following cases:

i. If the firm's liabilities exceed its assets, this provision is known as 'The insolvency rule'.

ii. If the amount of dividend exceeds the accumulated profit or R/E. This provision is known as ‘The net profit rules’.
iii. If the dividend is proposed from capital invested in the firm. This provision is known as ‘ The capital impairment rule’

Liquidity position: The cash or liquidity position of the firm influences its ability to pay dividends. A firm may have sufficient retained earnings. But it they are invested in fixed assets, cash may not be available to make dividend payment.

Need to repay debt: The need to repay debt also influences the availability of cash flow to pay dividend.

Restrictions in debt contracts: Restrictions in debt contracts may specify that dividend may be paid only out of earnings generated after net working capital is above specified amount.

Rate of asset expansion: A high rate of asset expansion creates a need to retain fund rather than to pay dividends.

Profit rate: A high rate of profit on net worth makes it desirable to retain earnings rather than to pay them out if the investor will earn less on them.

Stability of earnings: A firm that has a stable earnings trend will generally pay a large portion of its earnings as dividends.

Tax position of shareholders: Corporations owned by taxpayer in high income tax brackets tend toward lower dividend payout and vice-versa.

Control: Major influencing owners would prefer the use of debt and retained earnings for growth than issuing new common stock to maintain control of corporation. This will reduce payout ratio.

QN3 Write short notes following dividend payout schemes:

a) Residual Dividend Policy: Residual dividend policy is based on the premise that investors prefer to have a firm retain and reinvest earnings rather than pay them out in dividends if the rate of return the firm can earn on reinvested earnings exceeds the cost of retained earnings. It is less expensive for the firm to use retain earnings than it is to issue new common stock. A firm using residual policy would follow these four steps:

- Determine the optimum capital budget i.e. amount of investment
- Determine the amount of equity required to finance the optimum capital budget given its target capital structure
- To the extent possible, use retained earnings to supply the equity required.
- Pay dividends only if more earnings are available than are needed to support the optimal capital budget.

If firm rigidly follows the residual dividend policy, then dividend paid in any given year can be expressed as:

Dividends = Net income - (Target equity ratio × Total capital budget)

b) **Constant dividend per share:** A number of companies follow the policy of paying fixed amount per share as dividend every period, without considering the fluctuation in the earnings of the company. The policy does not imply that the dividend per share or dividend rate will never be increased. When the company reaches new level of earnings and expects to maintain it's the annual dividend per share may be increased. Figure shows that earnings may fluctuate from year to year but dividend per share remains relatively stable over the years and it increases along with the increase in earnings.

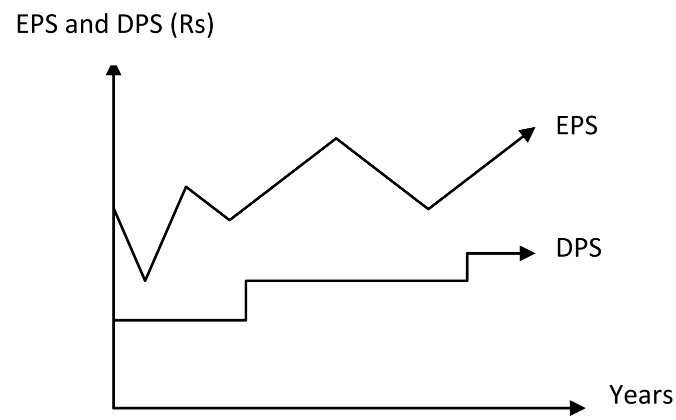

Fig: Constant Dividend Per Share

c) **Constant Payout Ratio:** When fixed percentage of earnings is paid as dividend in every period, the policy is called constant payout ratio. For example, if dividend payout ratio is 50%, firm always pays 50% of its annual earnings as dividend. Since earnings fluctuate, following this policy necessarily means that the rupee amount of dividends will fluctuate.

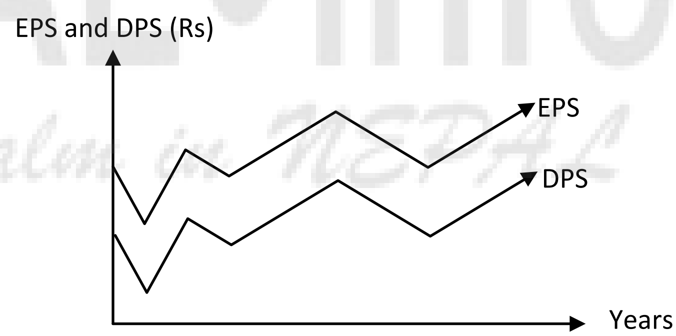

Fig: Constant Payout Ratio

d) **Low regular dividends plus extras:** The policy of paying a low regular dividend plus extras is a compromise between a stable dividend and a constant payout rate. Such policy gives the firm flexibility, yet investors can cunt on receiving at least a minimum dividend. The low regular dividend can usually be maintained even when earnings decline and extra dividends can be paid when excess funds are available.