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Dividend policy – A fundamental signal

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ABSTRACT

This article is about Dividend, forms of paying dividends, motives for dividend payment. It includes the reason for paying dividend and it shows dividend is important for certain classes of investors. This article also includes factors that affect dividend policy for management and general guidelines for payment of dividend. It also discusses the compulsory reserves for company according to Section 205 (2A) and optimum dividend payout ratio on the basis of rate of return and expected return. This paper consists of the leading determinants that affect the dividend payment decision by the company management.

Keywords : Dividend policy, guidelines and rules for payment of dividend, optimum payout ratio

Dividend
Dividends are payments made by an organization to its shareholders from earnings generated in current or previous periods. Shareholders earn income from two sources, the capital gain due to appreciation of share and dividend yield. Dividend yield is calculated by dividing the current dividend by the market price of a share.

One of the simplest ways for companies to communicate financial well-being and shareholder value is to say "the dividend check is in the mail." Dividends, those cash distributions that many companies pay out regularly to shareholders from earnings, send a clear, powerful message about future prospects and performance. A company's willingness and ability to pay steady dividends over time - and its power to increase them - provide good clues about its fundamentals.

Motives for Dividend payment
There are three reasons for investing in shares: Capital growth or income or both. Shares can generate an income stream through dividend payments. In essence, dividends are distributions of a portion of a company's earnings to its shareholders. That's an income stream that can be compared to interest on a money market deposit, though it has higher risk, as the dividend isn't certain.

Investors can use dividends to value a company using the dividend discount model (DDM). A share price can be seen as the current value of all future cash flows. The DDM discounts the projected dividend stream for the next few years back to a current value. If the DDM value is higher than the prevailing share price, the investor will buy the share.

The consistent payment of cash dividends gives investors an objective way of assessing that companies are cash generative, as it isn't possible to pay dividends over the long term if there's no cash in the bank. Investors should always evaluate a company on a total return basis that includes both capital growth and dividend income. In recent years, companies have become more rigorous in managing their balance sheets to create value for shareholders.

Other motives for paying Dividends
There is the desire on the part of small investors, fiduciaries and nonprofit organizations for a steady stream of dividends with which to finance consumption. Although the same consumption stream might be financed on a more favorably taxed basis by periodically selling shares, it is argued that small investors might have substantial transaction costs and that some fiduciaries and nonprofit organizations are required to spend only "income" and not "principal."

A more plausible explanation is that dividends are required because of the separation of ownership and management. According to one form of this argument, dividends are a signal of the sustainable income of the corporation: management selects a dividend policy to communicate the level and growth of real income because conventional accounting reports are inadequate guides to current income and future prospects.

Dividends Signal Fundamentals
Before corporations were required by law to disclose financial information in the 1930s, a company's ability to pay dividends was one of the few signs of its financial health. Despite the Securities and Exchange Act of 1934 and the increased transparency it brought to the industry, dividends still remain a worthwhile yardstick of a company's prospects.

Typically, mature, profitable companies pay dividends.
However, companies that do not pay dividends are not necessarily without profits. If a company thinks that its own growth opportunities are better than investment opportunities available to shareholders elsewhere, the company should keep the profits and reinvest them into the business. For these reasons, few" growth" companies pay dividends. But even mature companies, while much of their profits may be distributed as dividends, still need to retain enough cash to fund business activity and handle contingencies.

Dividend Policy
Dividend policy is the policy used by a company to decide how much it will pay out to shareholders in dividends. Part of the profit is kept in the company as retained earnings and the other part is distributed as dividends to shareholders.
a. Stable Dividend Policy
b. Fluctuating Dividend Policy
c. Small Constant Dividend per Share plus Extra Dividend.

Forms of Dividends
- ✓ Cash dividends
- ✓ Stock dividends
- ✓ Stock split

- ✓ Share repurchases

Factors affecting Dividend Policy

- ✓ Cost of Capital. Cost of capital is one of the considerations for taking a decision whether to distribute dividend or not. As decision making tool, the Board calculates the ratio of rupee profits that the business expects to earn (Ra) to the rupee, profits that the shareholders can expect to earn outside (Rc) i.e., Rs./Rc. If the ratio is less than one, it is a signal to distribute dividend and if it is more than one, the distribution of dividend will be discontinued.

- ✓ Realization of Objectives. The main objectives of the firm i.e., maximization of wealth for shareholders including their current rate of dividend-should also be aimed at in formulating the dividend policy.

- ✓ Shareholders' Group. Dividend policy affects the shareholders group. It means a company with low pay-out an heavy reinvestment attracts shareholders interested in capital gains rather than n current income whereas a company with high dividend pay-out attracts those who are interested in current income.

- ✓ Release of Corporate earnings. Dividend distribution is taking as a means of distributing unused funds. Dividend policy affects the shareholders wealth by varying its dividend pay = out ratio. In Dividend policy, the financial manager decides whether to release Corporate earnings or not.

Residual Theory of dividend policy

The essence of the residual theory of dividend policy is that the firm will only pay dividends from residual earnings, that is, from earnings left over after all suitable (positive NPV) investment opportunities have been financed. Retained earnings are the most important source for financing for most companies. A residual approach to the dividend policy, as the first claim on retained earnings will be the financing of the investment projects. With the residual dividend policy, the primary focus of the firm's management is indeed on investment, not dividends. Dividend policy becomes irrelevant, it is treated as a passive rather than an active, decision variables. The view of management in this case is that the value of firm and the wealth of its shareholders will be maximized by investing the earnings in the appropriate investment projects, rather than paying them out as dividends to shareholders. Thus managers will actively seek out, and invest the firm's earnings in, all acceptable (in terms of risk and return) investment projects, which are expected to increase the value of the firm. Dividends will only be paid when retained earnings exceed the funds required to finance the suitable investment projects. Conversely when the total investment funds required exceed retained earnings, no dividend will be paid.

Many companies with excess capital for their own investment requirements have returned capital to shareholders through either a share buyback or a special dividend.

In a share buyback, a company will buy its own shares on the stock exchange. These can either be held as treasury stock (in reserve for acquisitions or share incentive scheme payments) or cancelled. If shares are cancelled, the total number of issued shares reduces. That's positive for the value of the remaining shares, as the company's value and the total earnings base are now spread over a smaller number of shares.

Guidelines for Dividend announcement and payment
Declaration of Dividend

A company cannot declare dividend in the following circumstances:-

a) When a Company is not having profit i.e. is a loss making company.
b) When a Company fails to redeem its preference shares as per the provisions of Section 80A of the Companies Act. (Sub Section 2B)

Further, a Company cannot declare a dividend without the prior approval of Financial Institution, in case if the covenants of the loan agreement stipulates in this regard. Section 205(3) stipulates that no dividend shall be payable except in cash.

Dividends cannot be declared out of the Securities Premium Account or the Capital Redemption Reserve Account or Revaluation Reserve or Amalgamation Reserve or out of the Profit on re-issue of forfeited shares or out of profit earned prior to the incorporation of the Company.

Compulsory Reserves

Section 205 (2A) of the Act prescribes that before any dividend is declared or paid, certain percentage of profits as may be prescribed by the Central Government, but not exceeding 10% will have to be transferred to the reserves of the Company. The company may, however, voluntarily create more than the prescribed percentage and transfer to the reserves of the Company. If in a particular year, on account of inadequacy of profit, the company has to pay dividends out of the previous year's reserves, it should follow such rules as may be made by the Central Government. In case of any deviation from such rules, then the company can do so only with the previous approval of the Central Government. The term "Reserve" meant in the said Rules means "Free Reserves" i.e. reserve which are not created or set apart or intended for any special purpose. For e.g. Development Rebate Reserve, Capital Reserve or Special Reserve will not come under the category of free reserves for the purposes of this rule.

Entitlement -Equity Shareholders

A company can pay dividend only to the shareholders of that company

a) Whose name appears on the Register of members maintained by the Company (in case the shares are held in physical form) or

b) Whose name appear on the register of beneficial owners maintained by a Depository (in case the shares are held in dematerialised form)

Table showing optimum payout ratio on the basis of r (rate of return) and K (expected return)

(100% retention)	(indifference point)	(100% payout)
When, R > K	When, R = K	When, R < K

Procedure for declaration of Dividend

1) Recommendation by Board of Directors
2) Approval by the Shareholders
3) Dividend now includes interim dividend:-
4) Dividend to be deposited in a separate bank account
5) Dividend to be paid by cheque or warrant
6) Time frame for payment of dividend
7) Transfer of unpaid dividend
8) Transfer of unpaid or unclaimed dividend to the Investor Education and Protection Fund
9) Directors Report

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