

MAFA : CA FINAL

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Every effort is taken to avoid errors and omissions.

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DIVIDEND POLICY

Types of Dividend Policy

100% Retained
100% Payout
Partly payout

Dependency of Dividend Policy

It depends on Company objective
To maximise the MPS

Question

Relationship exists between
Dividend Policy &
Market Price per Share

Relationship doesn't exist between
Dividend Policy &
Market Price per Share

Chapter can be divided into 2 portions

Relationship exists
Walter Model
Gordon Model

Relationship doesn't exist
Modigliani & Miller model
Residuary Theory Model

Dividend Policy

WALTER Model

James walter, has proposed the following relationship between Dividend & MPS

$$P = \frac{D}{K} + \frac{R * r}{K^2}$$

Where,

P	Market Price per Share
D	Dividend per share
R	Retained Earnings per share (EPS - DPS)
r	Rate of Return on Investment of Company
k	Capitalisation rate Cost of Equity / Capital Discount rate Required rate of Return

GORDON Model

DIVIDEND GROWTH MODEL

gORDON, has proposed the following relationship between Dividend & MPS

$$P = \frac{E (1 - b)}{K - g}$$

Where,

E	EPS
b	Retention ratio $b = \frac{EPS - DPS}{EPS}$
g	Growth rate $g = b * r$

Assumptions, of Walter Model / Gordon Model

Retained earnings	The only source of Fiance available to the firm
r & k	Are Constant
Firm has infinite life	
For a given value of the firm the EPS & DPS remain constant	

Interpretation of Walter model / Gordon Model

r > k	Lower the payout ratio, Higher the Value of firm Higher the payput ratio, Lower the Value of firm
r < k	Higher the payout ratio, higher the value of Firm Lower the payout ratio, Lower the Value of firm
r = k	Value of Firm, doesn't get disturbed by Payout ratio

It is wise to keep in mind, that
neither success not failure is ever final

Dividend Policy

MILLER & MODIGLIANI Model

Dividend Irrelevance Theorem

They viewed that the value of a firm depends on its earning ability and is not influenced by the manner in which dividend is paid

$$P_0 = \frac{D_1 + P_1}{1 + K}$$

Where, P_0 = Value of the share calculated.

D_1 = Dividend per share @ the end of year one

P_1 = Market price of share @ the end of year one.

K = Discounting rate / Capitalisation rate / Cost of equity/
Required rate of return

$$mP_1 = I - (E - nD_1)$$

Where,

m = No. of shares to be issued @ year 1, for part finance

I = Investment

n = No. of shares outstanding @ year 0

D_1 = Dividend @ year 1

$$nP_0 = \frac{P_1(m + n) - I + E}{1 + K}$$

Value of Firm

(AS the RHS, of the equation, doesnot include D_1 , we can say that the value of the firm is not dependent on Dividend policy)

RESIDUARY THEORY Model

This theory is based on the assumption, that either

The external financing is not available, or

Their cost is too high

Therefore, the firm finances its investment decisions by retaining profit

The quantum to be distributed as dividends, is the residual figure

Dividend Policy

k : Discounting Rate

$$k = 1 / \text{PE Ratio}$$

Payout Ratio

$$\text{DPS} / \text{EPS}$$

Dividend Yield

$$\text{DPS} / \text{MPS}$$

Earning Yield

$$\text{EPS} / \text{MPS}$$