



SECTION - 7

DIVIDEND AND RETENTION POLICIES

This Section includes

- **Dividend Policy**
- **Bird in the hand' theory**
- **Dividends and Taxes**
- **Agency theory**
- **Signalling theory**

7.1 DIVIDEND POLICY

- 7.1.1 As already stated elsewhere in this chapter, Dividend policy is an area in which management can affect the financing structure of the company. The questions that come up generally while discussing dividend policy are:
- a. Why do companies pay dividend at all?
 - b. Whether changing dividend policy could perhaps add value?
 - c. Which dividend policy they should adopt – maximum distribution or maximum retention?
 - d. How should the dividend be increased from year to year?
 - e. When should management cut or skip dividends?
- 7.1.2 Dividend policy theories can be classified into four groups:
1. 'Bird in the hand' theory
 2. Dividends and taxes
 3. Agency theory
 4. Signalling theory

7.2 BIRD IN THE HAND' THEORY

- 7.2.1 This is the earliest model of dividend policy propounded by Gordon in 1959. This held that a dividend today is worth more than a potential capital gain in the future (two in the bush!). It relied on the initial concept in which all capital market securities were simply valued according to their income yield. The consensus was, the higher the risk, the higher should be the income yield.
- 7.2.2 There was no concept of return being only partly made up of dividend income and the rest capital gain. Dividend income was believed to be the total return from a share, and capital preservation the best that could be hoped for.



- 7.2.3 Proponents of the theory argued that investors viewed future earnings as uncertain and felt less uncertain about dividends, and applied a lower discount rate to dividends than to the capital gain element of their returns. This argument implies that companies with high dividend yields should have greater market values than companies with low dividend payouts, all other things being equal. This argument is flawed, as the risk of a company is determined by its operating risk. As is the case with capital structure, if corporate taxes are ignored, the choice of dividend policy will have no impact on the business risk of a company and hence on its market value.

7.3 DIVIDENDS AND TAXES

- 7.3.1 It can be proved that the choice of dividend policy is irrelevant to firm value if we follow the argument of Miller and Modigliani (M & M) (1961). They assumed the existence of perfect markets and also assumed that the company's choice of dividend policy does not affect the decision as to whether or not particular projects or investments should be undertaken. The issue here is whether changing the dividend policy of a firm will add or subtract value, assuming the investment strategy remains unchanged.
- 7.3.2 M & M showed that, with perfect capital markets, dividend policy, as with capital structure, could not be altered to add value to a firm. However, in exactly the same way as with capital structure, once we assume inefficiencies in markets and in particular tax, this irrelevancy of dividend policy no longer holds.

7.4 AGENCY THEORY

- 7.4.1 As in the case of capital structure, high dividends can be a means for managers to persuade investors that they were not frittering away the free cash flow.

7.5 SIGNALLING THEORY

- 7.5.1 The basic idea of the theory is that managers use dividends as a signal to investors about the future prospects of the firm.
- 7.5.2 M & M suggested that dividends might convey information about companies' future earnings if management pursued a policy of stable dividends and used a change in the dividend payout ratio to signal a change in their views about the firm's future profitability. This approach also has relevance in to the problems inherent in the separation of ownership and control. In this type of model, managers have significant inside information about the company that they cannot (or do not wish to) pass on to outside shareholders – for example better estimates of future earnings. Such a situation, where one group is better informed than another is known as one of 'information asymmetry'. In this type of situation, corporate dividends may be management's most cost-effective way of reducing the investor uncertainty about the company's value which has been created by information asymmetry. In other words, 'Dividends can thus be thought of as management forecasts of future earnings substantiated by cash' (Healy and Balepu, 1988).



- 7.5.3 Why should dividends be considered the most cost-effective way of signaling information? One argument is that earnings forecasts, or other more direct signals of future profitability, are hedged around with legal constraints and auditing requirements. So, companies with genuinely good prospects will be able to differentiate themselves from companies with poor prospects and which might wish to give false signals. Also, dividends are a highly visible form of signal compared with other types of forecast, such as debt/equity ratios which, in market value terms, change from day to day.