FINANCIAL MANAGEMENT

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SUBJECT :COST ACCOUNTING
ACADEMIC YEAR -2020-2021

FACTORS OF DIVIDEND POLICY

INTERNAL FACTORS	**EXTERNAL FACTORS**
Stability and size of earnings	Trade cycle
Liquidity of funds	Legal requirements
Investment opportunities	Corporate tax
Attitude of management towards control	General state of economy
Past dividends	Conditions in the capital market
Ability to borrow	Government policy
Need to repay debt	

TYPES OF DIVIDEND POLICY

- **REGULAR DIVIDEND POLICY**

Payment of dividend at usual rate is termed as regular dividend. The investor such as retired persons, widows, other economically weaker persons prefer to get regular dividend.

The regular dividend can be maintained only by the company of long standing and stable earnings. A company should establish the regular dividend at a lower rate as compared to average earnings of the company.

- **STABLE DIVIDEND POLICY**

The stability of dividend means consistency in the stream of dividend payments. It means payment of certain minimum amount of dividend regularly . A stable dividend policy may be established in any of the following three forms:

1. **Constant Dividend Per Share**

Some companies follow a policy of paying fixed dividend per share irrespective of the level of earning year after year. Such firm creates reserves i.e dividend equalization reserves to enable them to pay the fixed dividend even in the year when the earnings are not sufficient or when there are losses. The policy of constant dividend per share is more suitable to concerns whose earnings are stable over a no: of years.

2. **Constant Pay Out Ratio**

It means payment of fixed percentage of net earnings as dividend every year. The amount of dividend in such policy fluctuates in direct proportion to the earnings of the company. The policy of constant payout is preferred by the firm because it is related to their ability to pay dividends.

3. **Stable Rupee Dividend Plus Extra Dividend**

Some companies follow a policy of paying constant low dividend per share plus extra dividend in the years of high profits such policy is more suitable to the firm having fluctuating earnings from year to year.

- **IRREGULAR DIVIDEND POLICY**

  This policy is followed when there is uncertainty of earnings, unsuccessful business operations, lack of liquid resources, fear of adverse affects of regular dividend on the financial standing of the company.

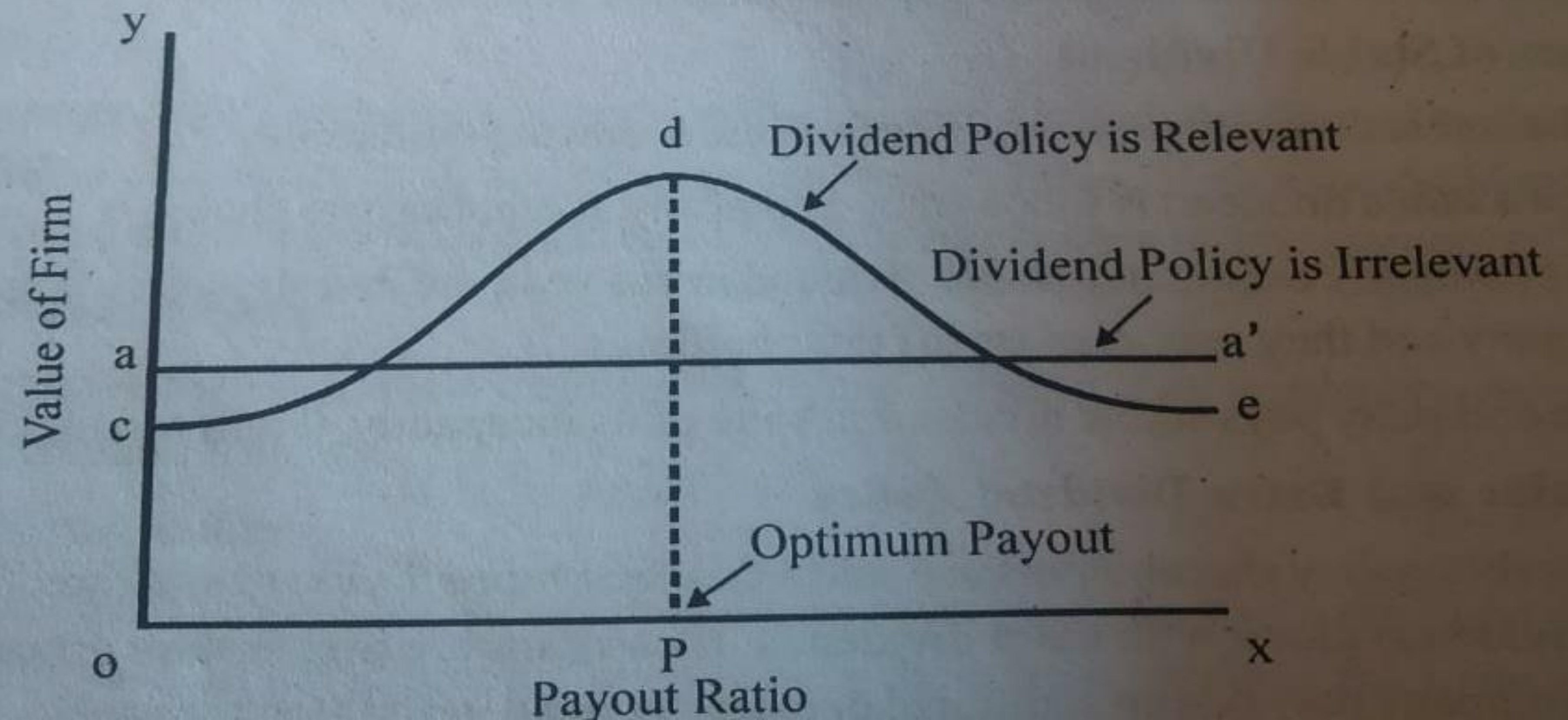
- **NO DIVIDEND POLICY**

  A company may follow a policy of paying no dividends presently because of its unfavorable working capital position or on account of requirements of funds for future expansions and growth.

Optimal Dividend Policy

Dividend policy is a controversial issue. Some firms pay 20% of their earnings as dividends. Some firms pay 60%. Some other firms pay no dividends at all. For example, Microsoft does not pay dividends. Thus there is great variability in dividend payouts. In short, dividend is a puzzle.

As regards optimal dividend policy a controversy exists. Some people say that there is no optimal dividend policy. Others say that there is an optimal dividend policy. Let us accept that there is an optimal dividend policy. An optimal dividend policy is one that maximizes the firm's value or its share price. The optimal dividend policy can be studied with the help of the following graph:

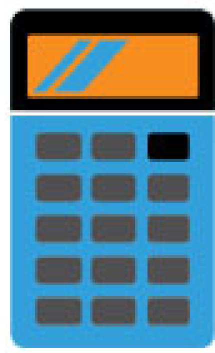


Dividend Payout Ratio

Dividend Payout Ratio is the amount of dividend that a company gives out to its shareholders out of its current earnings.

Formula:

$$\frac{\text{Dividend per Share (DPS)}}{\text{Earnings per Share (EPS)}}$$



Dividend Payout Ratio Formula

$$\text{Dividend Payout Ratio} = \left(\frac{\text{Total Dividends}}{\text{Net Income}}\right) \times 100$$

Dividend Theories

Relevance Theories
(i.e. which consider dividend decision to be relevant as it affects the value of the firm)

- Walter's Model
- Gordon's Model

Irrelevance Theories
(i.e. which consider dividend decision to be irrelevant as it does not affects the value of the firm)

- Modigliani and Miller's Model
- Traditional Approach

DIVIDEND THEORIES

1. **Relevance Theory :** According to relevance theory dividend decisions affects value of firm, thus it is called relevance theory.
   - Walter's Model
   - Gordon's Model

2. **Irrelevance Theory :** According to relevance theory dividend decisions do not affect value of firm, thus it is called irrelevance theory.
   - Residual Theory
   - Miller & Modigliani Hypothesis (MM Approach)

Miller Modigliani Hypothesis

Modigliani and Miller developed the two approaches of capital structure:

1. Modigliani and Miller Approach : Without Taxes (1958)
2. Modigliani and Miller Approach : With Taxes (1963)

MM Approach Explanation

- MM approach treats dividend as the irrelevant to the market price of the shares.
- The price at the end of the year will be offset by the dividend distributed by the company and in turn shall not affect the market price, so lower the dividend, higher the market price at the end of the period (as clearly visible in the second formula).
- Value of firm remains constant even on external finance since the EPS decreases with increase in share capital and thus causing the value of shares to go down.