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DIVIDEND POLICY AND DIVIDEND THEORIES: THE WAY AHEAD

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ABSTRACT
A major issue concerning dividend policy is whether decisions by corporate management as to the amount of dividend paid actually affect the wealth of the shareholders. However, the effect of dividend policy decision on the firm's market value of share is a long standing controversy. Conventional corporate finance wisdom specifies that the dividend decision does matter and that the time and effort spent by management and the board of directors on this decision is justified. The fact that dividends paid today have more value than those received tomorrow must be considered in the payout decision (Gordon, 1962). In other words, traditional financial theorists and most practitioners feel that dividends do matter. Arbitrary changes in dividends, especially dividend cuts, must be carefully considered (Lintner, 1956). Certain theories consider the dividends decision as relevant to the value of the firm measured in terms of market price of the shares. On the other hand, some theories says dividends paid has no effect on the valuation of the firm. So in this paper an attempt has been made with respect to dividend policy and dividend distribution theories in the context of relevant and irrelevant.

KEYWORDS
Dividend policy, corporate finance, Dividend decision, valuation.

INTRODUCTION
Dividend policy decision is considered one of the three major decisions of financial management. The decision of the firm regarding how much earnings could be paid out as dividend and how much could be retained is the concern of dividend policy decision. It determines what proportion of earnings is paid out to shareholders by way of dividends and what proportion is ploughed back in the company for reinvestment purposes. The development of such policy will be greatly influenced by investment opportunities available to the firm and the value of dividends as against capital gains to the shareholders. Management should develop such a dividend policy, which divides the net earnings into dividends and retained earnings in an optimum way to achieve the objective of maximizing the wealth of shareholders.

The dividend policy has been an issue of interest in financial literature since Joint Stock Companies came into existence. Academicians and researchers have attempted to solve several issues pertaining to dividends and formulate theories and models to explain corporate dividend behaviour. Despite many research conducted by financial economists, the issue of dividend policy determinants still remains debatable. Researchers have primarily focused on developed markets; however, additional insights into the dividend policy debate can be gained by an examination of developing countries which is currently lacking in the literature.

DIVIDEND DEFINED
Dividend is defined as the distribution of a portion of a company's earnings, decided by the board of directors, to a class of its shareholders. Dividends can be issued as cash payments, as shares of stock, or other property.

While determining dividend payment, a prudent manager strikes a balance between shareholder's expectations and firm's long-term interest. Such analysis is of great relevance to policy makers, because as the dividend literature suggest, if these decisions are handled efficiently, this is expected to be reflected in the firms' value.

LITERATURE REVIEW
- Mahapatra and Sahu (1993) analyzed the determinants of dividend policy using the models developed by Lintner (1956), for a sample of 90 companies for the period from 1977-78 to 1988-99. They found that cash flow was a major determinant of dividend followed by net earnings. Further, their analysis showed that past dividend-and not past earnings was a significant factor in influencing the dividend decision of companies.
- Gugler and Yurtoglu (2003) investigated the relationship between dividends, ownership structure and control rights for German and Australian firms, respectively and they found large shareholding of the largest owner reduces dividends pay-out ratio, while shareholdings by the second larger owner increases it and interpreted the results that state controlled firms engaged in dividend smoothening, while family controlled firms do not. The behaviour of the foreign controlled firms lie in between state controlled and family controlled firms in consistent with the "expected ranking" of information asymmetries and managerial agency cost hypothesis.
- De Angelo, De Angelo and Skinner (2004) observe that during the period of their study (1978-2000) nominal dividends paid by the companies in US increased manifold, even real dividends doubled during this period. This aggregate dividend increase is even in the face of radical decline in the number of dividend-payers. They find that both dividend and earnings concentration have increased substantially from the already high level.
- Subba Reddy Y. and Rath S. (2005) examined Dividend trends for large sample of stocks traded on Indian markets indicated that the percentage of companies paying dividend declined from over 57% in 1991 to 32% in 2001, and that only few firms paid regular dividends. Dividend – paying companies were less likely to be larger and more profitable than non-paying companies, though growth opportunities do not seem to have significantly influenced the dividend policies of Indian fi rms. The rise of the number of firms not paying dividends is not supported by the requirements of cash for investments
- Pal and Goyal (2009) conducted a study on the determinants of dividend policy pertaining to Indian IT industry for the period 1996-97 to 2005-06. They concluded that lagged dividend, PAT, Depreciation and sales are the most important factors affecting dividend decisions of the industry.

OBJECTIVES OF THE STUDY

1) To know the dividend policy decisions taken by the firm.
2) To know the dividend decision and value of shares based on dividend theories.
3) To trace out the assumptions and criticism of the dividend theories.

RESEARCH METHODOLOGY

This paper is theoretical modal based on the extensive research for which the secondary source of information has gathered. The sources include online publications, Books and journals.

DIVIDEND POLICY

Dividend is the part of company's profit which is given by company to its shareholders. As the shareholders invest their valuable money in the company, so they want to get the maximum return out of it. But in case the company pays the more of it's earning in form of dividend than the company has to depend upon the outside resources for its survival. So it is necessary for the growth of the company to pay adequate amount of dividend.

Dividend policy can be of two types: managed and residual. In residual dividend policy the amount of dividend is simply the cash left after the firm makes desirable investments using Net Present Value (NPV) rule. Normally, the amount of dividend is highly variable and often zero. If the manager believes dividend policy is important to their investors and it positively influences share price valuation, they will adopt managed dividend policy. Firms generally adopt dividend policies that suit the stage of life cycle they are in. For instance, high- growth firms with larger cash flows and fewer projects tend to pay more of their earnings out as dividends. The dividend policies of firms may follow several interesting patterns adding further to the complexity of such decisions. First, dividends tend to lag behind earnings, that is, increases in earnings are followed by increases in dividends and decreases in earnings sometimes by dividend cuts. Second, dividends are "sticky" because firms are typically reluctant to change dividends; in particular, firms avoid cutting dividends even when earnings drop. Third, dividends tend to follow a much smoother path than do earnings. Finally, there are distinct differences in dividend policy over the life cycle of a firm, resulting from changes in growth rates, cash flows, and project investments in hand. Especially the companies that are vulnerable to macroeconomic vicissitudes, such as those in cyclical industries, are less likely to be tempted to set a relatively low maintainable regular dividend so as to avoid the dreaded consequences of a reduced dividend in a particularly bad year. Over time, the number of factors identified in the literature as being important to be considered in making dividend decisions increased substantially. A number of conflicting theoretical models, all lacking strong empirical support, define recent attempts by researchers in finance to explain the dividend phenomenon. But to come with concrete conclusions an exhaustive study of all theoretical models together with empirical proof is needed. Previous empirical studies have focused mainly on developed economies. In Indian context, few studies have analyzed the dividend behavior of corporate fi rms. However, it is still not apparent what the dividend payment pattern of firms in India is.

DIVIDEND DECISIONS AND VALUATION OF SHARES

It is generally said that the value of the firm is maximized if the shareholders get maximum wealth which means if they get maximum dividend. But some believe that the dividend decision does not affect the value of the firm. For this purpose the two theories have been given and these are discussed below.

1) THEORY OF IRRELEVANCE

This theory states that the dividend decision does not affect the shareholders wealth as well as value of the firm. That's why this theory is called theory of irrelevance. This theory further explained with the help of two different approaches.

i) Residual approach: as per this approach dividend decision does not affect the shareholders wealth as well as value of the firm. The investors don't want to earn dividend only they want to earn high return on their investment. This means that if the firm is in the situation to gain high profit than the shareholders would like to keep their money with the firm and on the other hand if the firm is not in a position to get profitable opportunity than the shareholders would like to receive the earning in form of dividend.

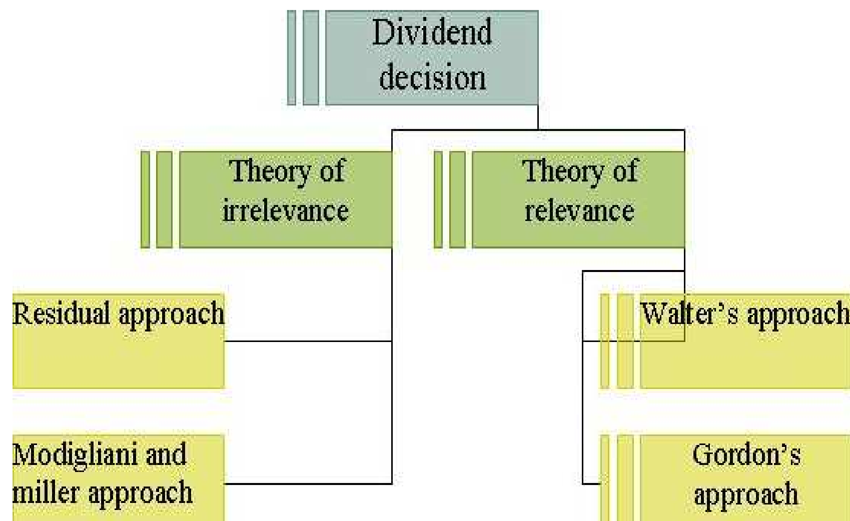
ii) Modigliani and miller approach: as per this approach also dividend decision does not affect the shareholders wealth as well as value of the firm rather it is decided by the earning capacity of the firm or its investment policy. This theory assumes:

a) There are no taxes
b) There is a perfect market
c) Investors act rationally
d) No transaction cost
e) All earning goes to the shareholders
f) Rigid investment policy of the firm

Po = D1+P1/1+Ke

The above formula means that the market price of the shares at the beginning of the period (Po) is equal to the present value of dividend paid at the end of the period (D1) plus market price of the shares at the end of the period (P1) divided by 1+ cost of equity
(1+ Ke)

FIGURE 1



Criticism of the approach: this approach has been criticized on the following grounds.

1. Perfect capital market does not really exist.
2. The firm has to incur flotation cost.
3. Taxes really exist.
4. There is no rigid investment policy.
5. The company information is available to all.

2) THEORY OF RELEVANCE

This theory states that the dividend decision affect the shareholders wealth as well as value of the firm. Because the dividend communicate the investors the information about the company's profit. That's why this theory is called theory of relevance. This theory further explained with the help of two different approaches.

a.) Walter's approach: as per this approach dividend decision affect the shareholders wealth as well as value of the firm. The relationship between the internal rate of return and cost of capital is helpful in determining the dividend policy, as this approach is based upon return on investment (r) and cost of capital (k). James. E. Walter has given three types of the firm

i) **growth firm;** in this case the r > k, it means that the firm earns higher rate of return than the required rate of return and have maximum value of the firm and optimum payout ratio would be 0 %.

ii) **Declining firm**; in this case the r < k, it means that the firm don't have enough profits and they have to give the entire earning as dividend optimum payout ratio would be 100 %.

iii) **Normal firm**; in this case the r = k, it means that the shareholders will get same return as expected by them. There is no optimum payout ratio.

THIS THEORY ASSUMES

a) Earnings per share, dividend per share do not change

b) External sources are not used by the firm

c) The company has long life

d) IRR and cost of capital are constant.

P = D/Ke + r (E-D)/ Ke / Ke

Criticism

a) Internal rate of return and cost of capital not always constant.

b) The firm need outside funds in real life.

b) Gordon's approach: his theory is similar to that of Prof. Walter. According to him market value of share is equal to the present value of dividend.

This theory assumes

a) There are no corporate taxes.

b) External sources are not used by the firm

c) Cost of capital is higher than growth rate.

d) IRR and cost of capital are constant.

P = D/ Ke-g

Criticism

a) Internal rate of return and cost of capital not always constant.

b) The firm need outside funds in real life.

CONCLUSION

Dividend decisions definition of dividend relevance or irrelevance are shown to be unnecessarily rigid and based on semantic conventions. While not all feasible dividend policies are optimal, all feasible dividend policies are optimal if the zero-NPV assumption is made (regardless of retention). Dividend decisions correct stance about misconceptions of dividend irrelevance is underlined, not only investment policy matters, dividend policy is an important determinant as well.

This paper shows that relevance or irrelevance of dividend policy has not to do with retention; it has to do with the rate of return of the extra funds (excess cash) used for reinvestment or financing: dividend policy is irrelevant if and only if zero-NPV activities are undertaken, with or without assumption of retention. The dichotomy retention/no-retention is nevertheless useful, if it is reinterpreted as a regard for agency problems.

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