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COURSE

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2



SUBJECT

FINANCIAL MANAGEMENT



MODULE

4

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MODULE 4:DIVIDEND DECISIONS

17.Dividend Policy, Types and Factors Influencing Dividend Decision

Meaning of Dividend

Dividend is the portion of profit distributed by a company to its shareholders.

After earning profit, a company may either:

Distribute part of the profit as dividend

Retain the profit for future expansion and business needs

The decision regarding how much profit should be distributed and how much should be retained is called dividend decision.

Dividend Policy

Dividend policy refers to the strategy followed by a company regarding payment of dividends to shareholders.

It is an important financial decision because it affects:

Shareholder satisfaction

Market value of shares

Availability of internal funds

Future growth of the company

A company must balance current shareholder income and future business growth.

Objectives of Dividend Policy

To provide regular income to shareholders

To maintain investor confidence

To support future expansion through retained earnings

To maximize market value of shares

Types of Dividend Policy

Stable Dividend Policy

Under this policy, the company pays a fixed or stable dividend regularly.

Even if profits fluctuate slightly, the company tries to maintain consistency.

This policy increases investor confidence because shareholders prefer predictable income.

Constant Payout Ratio Policy

The company distributes a fixed percentage of profits as dividend.

If profits increase, dividends increase.

If profits decrease, dividends also decrease.

Example:

If the payout ratio is 40%, then 40% of annual profit is distributed as dividend.

Irregular Dividend Policy

Under this policy, dividends are paid only when the company has sufficient profits and cash availability.

Dividend amounts may vary from year to year.

Small or growing companies often follow this policy.

No Dividend Policy

Some companies retain all profits for expansion and future growth instead of distributing dividends.

This is common in fast growing companies and startups.

Investors expect capital appreciation rather than regular dividend income.

Factors Influencing Dividend Decision:

Profitability

Higher profits generally allow higher dividends.

Companies with unstable profits may avoid large dividend commitments.

Liquidity Position

A company may earn profit but still face cash shortages.

Since dividends require cash payment, liquidity is very important.

Growth Opportunities

Companies with expansion plans often retain profits instead of distributing large dividends.

Retained earnings reduce dependence on external financing.

Shareholder Expectations

Some investors prefer regular income through dividends.

Others may prefer reinvestment for future growth.

Companies consider shareholder preferences while deciding dividend policy.

Legal Restrictions

Company laws may restrict dividend payments under certain conditions.

Dividends are usually paid only from profits.

Access to Capital Markets

Companies that can easily raise external funds may distribute higher dividends.

Companies with limited financing options may retain more earnings.

18.Theories of dividend policy: Relevance of Dividend Decision

Meaning of Dividend Relevance Theory.

Dividend relevance theory states that dividend decisions affect the value of a firm and the wealth of shareholders.

According to this theory, investors prefer current dividends because they are more certain than future capital gains.

Therefore, dividend policy becomes an important factor in determining share price.

Basic Idea

Investors generally consider dividends less risky than uncertain future profits.

A company paying stable dividends may attract more investors and increase market value.

This theory supports the idea that dividend policy is relevant to firm valuation.

Features of Relevance Theory

Dividends influence share prices.

Investors prefer certainty.

Higher dividends may increase market confidence.

Retained earnings involve future uncertainty.

Importance

The relevance approach highlights the psychological and financial importance of regular dividends.

It explains why many investors prefer companies with stable dividend policies.

Walter's Model and Gordon's Model are based on dividend relevance theory.

19.Theories of dividend policy: Irrelevance of Dividend Decision

Meaning of Dividend Irrelevance Theory

Dividend irrelevance theory states that dividend policy does not affect the value of a firm. According to this theory, shareholder wealth depends mainly on the earning power and investment decisions of the company, not on dividend distribution. This theory was mainly developed by Modigliani and Miller.

Basic Idea

Investors are concerned about total returns, not only dividends.

Returns may come from:

Dividends

Increase in share price

If a company retains profits and invests them efficiently, shareholders may benefit through higher future share prices.

Assumptions of Irrelevance Theory

Perfect capital markets

No taxes

No transaction costs

Rational investors

No information asymmetry

Under these conditions, dividend policy becomes irrelevant.

Explanation

Suppose two companies earn the same profits.

One company distributes dividends while the other retains profits for investment.

According to this theory, shareholder wealth remains the same because retained earnings increase future growth and market value.

Criticism

In reality, taxes, transaction costs, and investor preferences exist.

Many investors prefer stable dividend income.

Therefore, complete irrelevance may not always apply in practical situations.

20. Walter's Model

Meaning of Walter's Model

Walter's Model explains the relationship between dividend policy and market value of shares. According to Walter, dividend decisions directly affect shareholder wealth.

The model states that the choice between paying dividends and retaining earnings depends on the relationship between:

Rate of return on investment

Cost of equity capital

Formula

$$P = \frac{D + \frac{r}{k}(E - D)}{k}$$

Where:

P = Market price per share

D = Dividend per share

E = Earnings per share

r = Rate of return on investment

k = Cost of equity capital

Explanation

The company compares return on retained earnings with shareholder required return.

If retained earnings generate higher returns, retaining profits increases shareholder wealth.

If returns are lower, paying dividends becomes more beneficial.

Situations under Walter's Model

Growth Firm

When:

$$r > k$$

The company earns higher returns than shareholder expectations.

Retaining earnings is preferable.

Dividend payout should be low.

Normal Firm

When:

$$r=k$$

Dividend policy does not affect market value.

Declining Firm

When:

$$r < k$$

The company earns lower returns than shareholder expectations.

Higher dividends are preferable.

Assumptions of Walter's Model

The company uses only retained earnings for financing.

Internal rate of return and cost of capital remain constant.

All earnings are either distributed or reinvested immediately.

The firm has an infinite life.

21. Gordon's Model

Meaning of Gordon's Model

Gordon's Model is another dividend relevance theory.

According to Gordon, investors prefer current dividends because future returns are uncertain.

This idea is known as the "bird in hand" theory.

Investors consider dividends safer than future capital gains.

Formula

$$P = \frac{E(1 - b)}{k - br}$$

Where:

P = Market price per share

E = Earnings per share

b = Retention ratio

k = Cost of capital

r = Rate of return

Explanation

If the company can earn high returns on retained earnings, retaining profits may increase share value.

If returns are low, shareholders prefer dividends.

The model shows that dividend policy influences market price.

Assumptions of Gordon's Model

The firm is an all equity firm.

No external financing is used.

Rate of return and cost of capital remain constant.

The firm has perpetual life.

Retention ratio remains constant.

Importance of Gordon's Model

It explains the relationship between dividends, retained earnings, and market value.

It supports the view that dividend policy is relevant for shareholders.

22. Modigliani & Miller Approach

Meaning of Modigliani & Miller Approach

The Modigliani and Miller approach argues that dividend policy does not affect the value of a firm under perfect market conditions.

According to this theory, investment decisions are more important than dividend decisions.

Basic Principle

Shareholder wealth depends on the earning power of the firm and investment efficiency.

Whether profits are distributed or retained does not change total shareholder wealth.

Formula:

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

Where:

P_0 = Current market price

D_1 = Dividend at end of year

P_1 = Market price at end of year

k = Cost of equity capital

Explanation

If a company pays dividends, shareholders receive immediate cash.

If dividends are not paid, retained earnings may increase future share prices.

According to MM theory, both situations provide equal shareholder wealth.

Assumptions of MM Approach

Perfect capital market

No taxes

No flotation costs

No transaction costs

Rational investors

Fixed investment policy

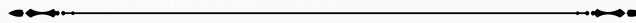
Criticism of MM Approach

The assumptions are unrealistic in practical business situations.

Taxes, market imperfections, and investor preferences affect dividend decisions.

Many investors still prefer stable dividends because they reduce uncertainty.

Therefore, dividend policy may influence firm value in real markets.



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