

A Critical Review of Dividend Theories

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Abstract

Modiglian and Millers' thinking on dividend policy revolutionizes the evolutionary dividend puzzle and builds upon what scholars inaugurated about six centuries ago when first joint-stock companies' dividend earnings history was all about sharing proceeds from voyages where parts were bought or sold by Captains in the open market. Later in the 16th-century, shares were invented and traded in denominations by various captains. Many scholars have since packaged the dividend argument into various theories of dividend. However, indecisiveness is witnessed on whether to eat the 'seed' or secure dividends from retained earnings and the impact this has on the value of the firm. The puzzle continues to be a conundrum to many researchers of modern times. This paper tries to underscore dividend theories analytically and zeroes in elaborately on Modigliani-Miller and Lintners' bird at hand theories from which all other theories of dividend draw.

Keywords:

The dividend, earnings, the seed, shares, value of the firm.

1 Introduction

Dividend refers to earnings that accrue to an investor who 'puts' her/his money in shares. The returns may be filed as a percentage on the shareholding held by investors. Dividend paid is not expensed in the income statement but set aside from the retained earnings and treated to the balance sheet as a liability.

Precursor for dividend distribution is the investing decision where traders who possess investible funds channel them to rewardable projects at some return or generation of cash flows on projects (capital budgeting). Investible are funded as sourced from the financing decision, both investing and financing decisions have the maximization of shareholder wealth as the catch. Therefore the investors' concern is not just about the earnings that the company will deliver back to the investor. Of critical importance is the impact of the results on the share price (Bishop et al, 2000).

Although numbers of scholars have advanced several theories that try to unveil the dividend puzzle, dividend decision continues to remain the most widely discussed topic in corporate finance. To this end, contributions by Modigliani and Miller (1961) signal the information content of growth in dividends as a pointer to future growth in company profit. Lintner (1962) posits that investors have a preference for some given level of certainty, a view that was supported by Myron Gordon (1959). They hold that dividend payments are more certain than capital gains that accrue in the future. Ramaswamy and Litzemberger (1979) argued that the tax rate on the dividend is higher than on dividends than on capital gains; hence firms that pay higher dividends to experience lower firm value. Richardzon and Pettit (1972) put forward the clientele hypothesis and segmented investors, profiling them into able and unable where the able investors had a lower propensity to withdraw dividends now while the unable ones take everything immediately. The able ones would rather defer their dividend receipts to the future hence avoid tax payments. Thus a firms' dividend policy setting will occasion shifting a clientele in and out of the firm until equilibrium is struck. Low income investors will shift to high dividend-paying firms and high-end shareholders to firms retaining more earnings.

2 Dividend policy theories:

2.1 Modigliani and Miller Dividend irrelevance theory: Empirical evidence

Basic arguments.

Modiglian and Miller (1961) held that dividend to be irrelevant such that the firms dividend policy had no effect on the firms' value or cost of capital and that the firms' value will be affected by its earnings power and business risk as produced by its assets and not how the firm shares its earnings between dividends and retained earnings. MM assumes that firms are not levered. They argue that if the firm depletes its earnings through issuing dividends, it can raise capital through new issues.

According to the dividend discounting model (DDM), the basic valuation of common stock is expressed as a function of future dividend discounted at the required rate of return. To DDM, future dividends determine the current share price and the share price is the determinant of the value of the firm. Thus the more the dividends are distributed, the higher the value of the firm and this will reflect in the high share price. In the perfect capital market, the required rate of return (RRR) on equity shares is the total sum of dividend paid and capital gain where the capital gain is the charge (appreciation) in share price ($p_1 - p_0$)

$$P_0 = \sum_{t=1}^{\infty} \frac{D_t}{(1+r)^t} \dots\dots\dots(i)$$

P_0 = is the current share price

t = Dividend earning time

D = Dividend paid in period t

r - Required rate of return

Therefore,

$$RRR = \frac{D_1 + (P_1 - P_0)}{P_0} \dots\dots\dots(ii)$$

P_0 = current share price

P_1 = market price. The share is expected to command at the end of the period.

D = Dividend at the end of the period

when equation is rearranged

$$P_0 = \frac{P_0 + P_1}{(1+r)}$$

Assuming the firm deals in n shares

$$npo = \frac{nd_1 + np_1}{(1+r)} \dots\dots\dots(iv)$$

But according to MM, the dividend is irrelevant and capital is also irrelevant; hence debt is excluded from this model i.e., the firm is unlevered. (Modiglian and Miller, 1958). Hence we employ equilibrium between sources and uses of funds where sources include cash flows (CF) and proceeds from new equity financing (mps). The funds are exclusively used to pay dividends and make investments.

$$CF_1 + MP_1 = ND_1 + I \dots\dots\dots(v)$$

I is investment made in period I

Rearranged

$$NDI = CF_1 + Mp_1 - I \dots\dots\dots(vi)$$

Back to equation (iv)

$$npo = \frac{CF_1 + mp_1}{(1+r)} - I + np_1$$

$$= \frac{CF_1 - I + (n+m) P_1}{(1+r)} \dots\dots\dots(vii)$$

The dividend has disappeared from this equation because the operating cash flows are not a function of dividend. Thus, the value of the firm is independent of dividend policy. Past empirical studies on dividend irrelevance have proved difficult to initialize and conclude because of the underlying assumptions or perfect

capital market. Black and scholes (1974) employed a linear regression model to examine the relationship between dividend yield and stock return through the CAPM to test the long run effects of dividend yield.

$$ECR_1 = \alpha^0 + (E(RM) - \alpha^0) \beta + \alpha^1 (D_1 - D_m) + E D_m$$

$E(R_1)$ – Expected return

α – Intercept

β – Systematic risk

D – Dividend yield (period and market)

E – Error term

The result showed that the dividend yield coefficient D_1 was not significantly different from zero over the time prior to the research (1936-1966). According to them, any yield (high or low) did not influence share price and this is quite consistent with the MM dividend irrelevance puzzle. Elton and Gruber, 1970 used daily data to establish a change to dividend ratio to support MM's hypothesis and the results suggested that changes in dividend policy caused changes in shareholders' wealth. There was noted a positive correlation between dividend yield and ex-dividend price. Their study demonstrated a high tax on dividends and low tax on capital gains. Kalay (1980) refined Elton and Gruber's study and supported the hypothesis that a high dividend tax allows traders to make arbitrage profits in the short run.

2.2 Bird at hand theory

Basic facts.

The theory was the work of John Lintner 1962 and jerked up by Myron Gordon 1963. It is summarized as the attitude of investors to desire to receive the current dividend as opposed to waiting to receive future dividends through capital gains because investors are risk averse and prefer a high level of certainty which can only be experienced in the current period. Firms that pay high dividends attract a high value as the shareholders will require using a lower discounting rate. The theory argues that firms prefer to pay stable dividends to elicit signaling and mitigating effects of conflict of interest between managers and shareholders. The issuance of dividends will signal a good image/reputation of the company before the prospective and current shareholders. Karim, Fauzi and Mansor, 2017 deviate from the use of conventional and use quartile regression methodology dividing sampled firms into high and low smoothing quantities to capture the levels of dividends stability/smoothing. This method clearly shows how variables interact across the quartiles, thereby achieving heterogeneous efficiency. The method is more robust to the outliers and non-linear relationships (Hallock, Madazozzo & Rock, 2010). The researchers sample out elements of dividend smoothing as size and age of the firm, asset tangibility, risk, growth, ownership, free-cash-flow and leverage, proving how information symmetry about them will smooth out dividends. Firm size is tested through natural logarithms of total assets (Lie & Li, 2006). In a separate study, Parasuraman, Ramudu & Nusrathuanisa, 2012, give empirical evidence on whether dividend payout holds good for SENSEX firms. The results showed that SENSEX firms did not follow any specific pattern in crafting a target payout ratio. Their research employed multiple regression analysis and significance level worked out through the F-test at 5% level significance on all predictor variables.

3 Conclusion

In spite of all the theoretical efforts, the dividend puzzle continues to take firm value round circles. That dividend is distributed out of retained profits may be an illusion in cases where management is seeking survival to lengthen their stream of salary earnings from the firm. Profit figure may just be a number as some auditors get compromised to declare firm performance a true and fair view of the state of affairs of the company. Firms may deceive and delay dividend stream of flow to shareholders on retained earnings for a number of years but which are not to be. Delayed dividends payments also negatively impact the time value of money because money gets discounted for risk with the passage of time and albeit sends bad signals to the potential market. This continues to make the dividend very irrelevant as a gauge of firm value. The indicator of firm performance

could naively be thought of as profit, customer retention, publicity, reserve surpluses as opposed to dividend payments the bottom-line being strengthening the financial position of the firm. Management insensitivity and apathy cause the relegation of the interests of shareholders to the back seat. In cooperative societies for instance, retention is a resolution from the members through the delegate system depending on the size of the society. Thus the members' voice is through the delegates. So dividends, in this case, depending on the feelings of the delegates and not necessarily the management. This scenario may make dividend policy payout for the period not to go through.

4 Recommendations

From the foregoing arguments, it is clear that dividends should not be taken as an indicator of the measure of firm value. Other measures such as customer care, customer retention, publicity, and reserve surpluses may as well successfully be a proxy for assuring firm value. Furthermore, certain enterprises that operate over the counter (OTC) do not issue dividends to anybody but their performance is above par. What is important about them is the service they offer to the customer which could elicit a repeat purchase reaction from customers thus guaranteeing firm profit; prompt payments to the supplier that are bound to ensure continuous supplies and avoidance of idle time; and tax payments to the government as opposed to how much dividends management proposes and subsequently pay. Therefore, the dividend theories, as studied in this paper, escalate the dividend irrelevance puzzle and need further and sustained serious scholarly effort to unravel and prove the ability of dividends to enhance firm value.

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