

If you are using this resource in your work please remember to reference and cite the original work found here:
<http://www.ukessays.com/essays/finance/dividends.php>

Subject Area - Finance

Dividends

Critically analyse the extent to which payment (or non payment) of dividends by companies is relevant in the real world. What factors should a CFO consider when deciding the size and timing of a company's next dividend payment.

Miller and Modigliani (1961) discussed the irrelevance of the dividend policy in a theoretical world. But as seen from time to time dividend payments or non-payments have an abnormal share price reaction. This could be due to tax differential, inefficient markets or irrational behaviour of shareholders.

Tax differential, due to difference in individual tax rates on dividend and capital gains results in different profile of shareholders. Shareholders buy shares that suits their investment and tax profile. Many institutional funds have a mandate of income style investment shares only and hence would like to buy shares that are high dividend paying. But the world of investors is huge and tax differential should not result in shortage of investors for a particular dividend paying company. Tax differential would probably result in shift in investor profile only.

Even if the tax rate on dividend and capital gains were to be same, different tax payment times result in different net tax. Taxes on dividends have to be paid immediately. But taxes on capital gains can be deferred until shares are sold and hence the present value of tax on gains is lower. The longer the delay in selling shares, the lower the value of tax. Investors who like regular income would prefer high dividend yield shares whereas investors who don't see dividend as a regular source of income would prefer stocks with higher capital gain.

Markets are inefficient – sharp reductions and abnormal gains are a testimony of this. There is information gap between management and shareholders. Management knows much more about the current status of the company than shareholders do. Shareholders look for any clues to judge the financial position and future potential of the company. Dividend declaration is one way on reducing the information gap.

The best way for investors to learn about company's policies is through their management's actions. Dividend payments allow them to judge the thoughts of the management. The investors know that a firm which reports good earnings and pays a regular dividend is confirming in action what it has reported in accounting profits. Investors value the information content of dividends more than the reported earnings unless the earnings are backed by an appropriate dividend policy.

It is important to look at dividend history rather than one year dividend alone. Managers can manipulate earnings and pay high dividend in short term. But if the company is facing serious troubles, they can't continue doing so as the firm will face serious cash flow problems.

Lets look at the five year dividend policy of Hays plc, a recruitment specialist company. Appendix I shows the five year dividend pay history of Hays. In the five year period from 2000 to 2004, dividend increased in the first three years and decreased only in the last year. In the first three years from 2001 to 2003, dividend increase each year by 15%. Only in the last year, dividend decreased by 44 %.

Find more free essays like this one...

We have a large reference library of essays that you can use as research materials to help with your own writing - check out our [free finance essays](#).

Share this resource with your friends...

We hope you found this information in this free pdf useful. Please spread the word and tell your friends how this information has helped you with your studies and feel free to share this pdf with others, so it can help them too.



Keep up to date with the latest essay writing hints, tips and free research materials to help you with your assignments - simply subscribe to our RSS feed or join us on Facebook now!

If you are using this resource in your work please remember to reference and cite the original work found here:
<http://www.ukessays.com/essays/finance/dividends.php>

But the dividend pattern is not reflected in the earning pattern of the company. While dividend increased by 15 % in the first three years, the basic earnings per share have declined in all three years.

It looks like that Hays was following one of the most common dividend policies – constant growth. ‘The Board intends to follow a progressive dividend policy’ (Hays, 2004). Security markets and investors prefer companies with less uncertainty. By adopting a constant dividend growth policy, companies want to convey the message that business is going well and take this opportunity to assure investors.

Hays earnings have declined in most of the five year period. Managers use progressive dividend policy to convey the message that fundamental business is strong and earnings will soon increase. Investors assume that if managers were not sure about Hays fundamentals, they would not have increased dividend and instead would like to conserve cash for future. Only in 2004, after prolonged periods of decline, did the management accept that decline in earnings has left the company in a tight position and won't be able to pay similar dividends. Any high dividend may leave company in a cash crunch. The announcement of dividend cut caused a sharp decline in Hays' share price. Though markets had idea about the tough competitive environment faced by recruitment and service companies, the acknowledgement by Hays in terms of dividend cut lead to price decline.

When a company reduces its dividends, it sends a strong signal to the market that managers have formally accepted that the business environment is tough and they don't see an improvement in short term. Normally a reduction in dividend is followed by a sharp fall in share price. When Nestor declared its interim results in 2004, it mentioned that tough market conditions still exist and the company won't be able to pay interim dividend. Its share price immediately had a sharp abnormal fall.

Though dividend is paid from past earnings, there is sufficient evidence to believe that managers do look to the future when they decide the dividend payment. Healy and Palepu (1988) reported that on average earnings increased by 43 % in the year that companies a dividend for the first time. This shows that managers were confident of increased earning in future when they first paid dividends. Additionally, management was confident that the earnings would be sustained in the future. If they thought that the earning growth was only for a short term, they would think carefully before committing themselves to a dividend. Healy and Palepu (1988) also showed that after paying first dividends, the companies increased their next four year earnings on average by 164 %.

That the payment of dividends is a significant factor is shown by the fact that announcement of dividend by new companies resulted in 4 % abnormal gain in share prices (Healy & Palepu, 1988).

Most of the companies have a long-term target dividend payout policy. But their short term earnings fluctuate and if they apply that constant ratio, then dividend will fluctuate. So companies smooth out dividend payout with an aim to reach payout ratio over time. But some companies prefer to keep a constant dividend payout ratio policy. BT is one of such companies that has now adopted constant dividend payout ratio policy.

Appendix II shows the five-year dividend history of the BT Group. In the five year period from 2000 to 2004, dividend decreased in the first three years and then increased in the last two years. In the first three years, dividend decreased 90% from 19.6p to 2.0p. The company has adopted a constant dividend payout ratio policy. The formula used for dividend

Find more free essays like this one...

We have a large reference library of essays that you can use as research materials to help with your own writing - check out our [free finance essays](#).

Share this resource with your friends...

We hope you found this information in this free pdf useful. Please spread the word and tell your friends how this information has helped you with your studies and feel free to share this pdf with others, so it can help them too.



Keep up to date with the latest essay writing hints, tips and free research materials to help you with your assignments - simply subscribe to our RSS feed or join us on Facebook now!

If you are using this resource in your work please remember to reference and cite the original work found here:
<http://www.ukessays.com/essays/finance/dividends.php>

payout ratio is

Dividend payout ratio = Dividend / Earning before goodwill amortisation and exceptional items

BT is using earning before goodwill and exceptional items rather than basic earning because basic earning fluctuates more due to goodwill write off which is a non cash item. The ratio initially declined from 66% to 33% before rising again to 50% in 2004. The rapid initial decline shows that, going forward, the company wasn't sure about its earning potential.

BT's policy is to increase dividend payout ratio to be around 60% for the financial year 2006 (BT, 2004). 60% is a very high number. It shows that the company doesn't have much capital intensive growth plans relative to its size, its business has stabilised and it is more like a mature company.

Constant payout ratio as opposed to constant dividend growth policy implicitly conveys that the company is not very sure of its ability to increase earnings each year. Yet the company also doesn't see a threat to the fundamental business and can easily repay its commitments.

Chief Financial Officer (CFO) is responsible for financial decisions a company takes. Dividend payment is an important decision which reflects not only the past earnings but also the future earning capacity and investments required. So CFO should look at different factors before announcing a dividend.

CFOs don't look at past only for dividend payment. They try to look at future more to ascertain the sustainability of dividend payments before making a dividend decision. Investors also take a clue from CFO decision on dividend payout about the future earning potential of the firm. When company announce an increase in dividend, investors gain confidence in future earning potential. If CFO is not sure about future sustainability of higher dividends, they should not increase dividend. They can pass on higher dividend as one time special payment only.

An important factor in CFO decision about dividend payment is requirement of investments for future projects. If the company has sufficient number of projects coming up which need a substantial investment then CFO would like to preserve internally generated funds for future deployment. If CFO return cash in form of dividend but then again ask for funds, then it may temporarily reduce the share price of the firm. Also growing companies normally have no or very little dividend payments. Many people buy such stocks because of their growth potential. But when such companies announce high amount of dividend payments, investors see that as an acceptance by the management that the company doesn't have big growth projects anymore. This reduces the high price to earning premium normally accorded to growing companies.

CFOs also have to look at the industry practices. Most of the investors look at companies in the similar sector for comparison. As an example, if it is a mature company like one in utility sector, then investors would expect it to pay high dividend. On the other hand if it is a company in fast growing sector like software, then an increase in dividend would send a signal that company's day of faster growth through acquisitions or projects is almost over. CFOs can use a sudden change in dividend policy to hint the same. When Microsoft announced a massive increase in dividend, investors took that as a signal that Microsoft is now too big to be a growing company.

Find more free essays like this one...

We have a large reference library of essays that you can use as research materials to help with your own writing - check out our [free finance essays](#).

Share this resource with your friends...

We hope you found this information in this free pdf useful. Please spread the word and tell your friends how this information has helped you with your studies and feel free to share this pdf with others, so it can help them too.



Keep up to date with the latest essay writing hints, tips and free research materials to help you with your assignments - simply subscribe to our RSS feed or join us on Facebook now!

If you are using this resource in your work please remember to reference and cite the original work found here:
<http://www.ukessays.com/essays/finance/dividends.php>

CFOs in companies which have recently announced bad news can take some liberty in announcing dividend cuts. When investors are already aware of tough conditions and which have been already acknowledged by the company, then reduction in dividend doesn't result in that severe movement in share price. Infact some times share price goes up as investors believe that management is concerned about the well being and continuity of the business rather than appeasing investors in short term. So when CFO has already shared the information about tough financial conditions, it makes sense to take a cut in dividend rather than first giving a dividend and then immediately asking investors for money.

Dividend decision is not based on just one year earnings and CFOs should look at various factors before deciding dividend payout.

Appendix I: Hays plc five year dividend history

2000

2001

2002

2003

2004

Dividend, p

3.54

4.07

4.68

5.38

3.00

% change

15.0%

15.0%

15.0%

Find more free essays like this one...

We have a large reference library of essays that you can use as research materials to help with your own writing - check out our [free finance essays](#).

Share this resource with your friends...

We hope you found this information in this free pdf useful. Please spread the word and tell your friends how this information has helped you with your studies and feel free to share this pdf with others, so it can help them too.



Keep up to date with the latest essay writing hints, tips and free research materials to help you with your assignments - simply subscribe to our RSS feed or join us on Facebook now!

If you are using this resource in your work please remember to reference and cite the original work found here:
<http://www.ukessays.com/essays/finance/dividends.php>

-44.2%

Basic earning per share, p

7.7

5.5

4.82

-28.39

3.87

% change

-28.6%

-12.4%

-689.0%

-

Source: Hays Annual Report 2004, Annual Report 2003 and Annual Report 2001; http://www.haysplc.com/investors/annual_reports.asp

Appendix II: BT plc five year dividend history

2000

2001

2002

2003

2004

Dividend, p

Find more free essays like this one...

We have a large reference library of essays that you can use as research materials to help with your own writing - check out our [free finance essays](#).

Share this resource with your friends...

We hope you found this information in this free pdf useful. Please spread the word and tell your friends how this information has helped you with your studies and feel free to share this pdf with others, so it can help them too.



Keep up to date with the latest essay writing hints, tips and free research materials to help you with your assignments - simply subscribe to our RSS feed or join us on Facebook now!

If you are using this resource in your work please remember to reference and cite the original work found here:
<http://www.ukessays.com/essays/finance/dividends.php>

19.6

7.1

2.0

6.5

8.5

% change

-63.9%

-71.8%

225.0%

30.8%

Earning per share before goodwill and amortisation, p

29.8

17.5

6.1

14.2

16.9

Dividend / Earning per share before goodwill and amortisation

66%

40%

33%

46%

Find more free essays like this one...

We have a large reference library of essays that you can use as research materials to help with your own writing - check out our [free finance essays](#).

Share this resource with your friends...

We hope you found this information in this free pdf useful. Please spread the word and tell your friends how this information has helped you with your studies and feel free to share this pdf with others, so it can help them too.



Keep up to date with the latest essay writing hints, tips and free research materials to help you with your assignments - simply subscribe to our RSS feed or join us on Facebook now!

If you are using this resource in your work please remember to reference and cite the original work found here:
<http://www.ukessays.com/essays/finance/dividends.php>

50%

Source: BT Group Annual Report 2004, <http://www.btplc.com/Sharesandperformance/Howwehavedone/Financialreports/Annualreports/AnnualReports.htm>

Bibliography and references

Brealey, R.A. and Myers, S.C.; 'Principles of Corporate Finance', Tata McGraw-Hill Publishing Company Limited, 6th edition, 2000.

BT Group[2004]; Annual Report, 2004, <http://www.btplc.com/Sharesandperformance/Howwehavedone/Financialreports/Annualreports/AnnualReports.htm>

Hays [2004]; Annual Report 2004, http://www.haysplc.com/investors/annual_reports.asp

Healy, P. and Palepu, K.; 'Earnings information conveyed by dividend initiations and omissions', Journal of Financial Economics, 21, 1988

Miller, M.H. and Modigliani, F.; 'Dividend policy, growth and valuation of shares', Journal of Business, 34, 1961

This essay was written by a student and then submitted to us to help other students. You should not hand in this essay as your own work - we do not condone plagiarism! If you need custom essay help, then check out our essay writing service.

Find more free essays like this one...

We have a large reference library of essays that you can use as research materials to help with your own writing - check out our [free finance essays](#).

Share this resource with your friends...

We hope you found this information in this free pdf useful. Please spread the word and tell your friends how this information has helped you with your studies and feel free to share this pdf with others, so it can help them too.



Keep up to date with the latest essay writing hints, tips and free research materials to help you with your assignments - simply subscribe to our RSS feed or join us on Facebook now!