Discuss the factors which a company may need to take into consideration when determining their dividend distribution and identify the three most commonly used dividends distribution policies.

A dividend policy is the plan of action adopted by the directors of a company whenever it is decided whether to distribute a company's profits as payments to individual shareholders. The decision of dividend policy is the responsibility of a company's directors. Under UK company law, directors cannot be forced to recommend a dividend and the shareholders cannot vote themselves a higher dividend than that recommended by the directors, although they may vote for a lower one.

There are a number of factors that may influence a company's decisions regarding dividend distribution. One of these factors is profitability. The 1985 Companies Act prevents distribution of dividends from sources other than distributable profits; therefore, if a company is not profitable then it will not be able to pay dividends. A company with liquidity problems will also have difficulties in sustaining dividend payments.

A company should also take tax issues into consideration when determining its dividend policy. Income from dividends and the capital gains that are realised when shares are sold may attract different rates of tax. The different rates will affect whether shareholders will prefer cash dividends or for the money to be reinvested to enhance the value of the company and the share. This difference in income taxes and capital gain taxes was largely removed in the UK in 1988.

Income from dividends in the UK contributes to personal income, which provides the basis for individual personal income tax. Dividends may lift a person into a higher tax bracket so they may prefer dividends to be reinvested, especially if capital gains tax is lower than income tax.

Many shareholders may be accustomed to stable or increasing dividends and so will expect a similar pattern to continue into the future. Reversal of the dividend policy may lead shareholders to dispose of their shares; this could result in outsiders to think that the company is in trouble and cause share prices to plummet.

A company's life cycle is another factor that may affect dividend policy. New companies are likely to use all of their money for investment in development and so may be unlikely to pay out dividends in their early years.

At small firms where there is little distinction between owners and managers, dividend payouts are low or non-existent. Large quoted companies will often pay a significant proportion of earnings as dividends.

Large companies' managers may strive to maintain optimum or balanced capital structure. If gearing levels become to high, a company may limit dividends in order to build reserves until a more balanced capital structure is achieved.

Investment opportunities may determine the level of dividends that a company pays out. "There is evidence to show that businesses which are growing quickly tend to select a policy of either no dividends or low dividends, but at a more mature stage of the business life cycle, increase the level of dividend distribution." (Antril, P. 2000. *Financial Management for Non-Specialists.* Pp. 318).

The most common types of dividend policy are smooth stream dividend policy, constant dividend payout ratio, constant dividend per share and low regular dividend with periodic enhancements.

Smooth stream dividend policy is where there is a payment of stable, but slowly increasing dividend per share. There is an implicit danger in this type of policy, which will lead to a slow reduction in the dividend cover ratio.

Constant dividend payout ratio is a payment of fixed percentage of the earnings per share. The danger with this type of policy is that if earnings fall in any given year, it may send out the wrong signals to the market and lead to shareholders selling shares and falls in the company's share price.

Constant dividend per share is when a fixed sum is paid out every year. The dangers of this approach are that the dividend will either become frozen at a low level that will discourage new investors, or directors will be reluctant to reduce payments even when it is practical to do so because they fear that shareholders and investors will interpret their action negatively.

Low regular dividend with periodic enhancements is a payment of a small regular dividend, supplemented in high earnings years by an enhanced dividend as part of the final dividend payment. Although this policy offers the shareholder certainty of a regular income and allows the company flexibility in dividend policy, there is a danger that the enhanced element will become part of the shareholders' expectation.

There are a number of theories surrounding dividend policies. It is often questioned whether dividend policies are important in terms of influencing share value. If dividend policy is influential, it is important to decide on the optimal dividend policy of what proportion of earnings should be distributed as dividends, or retained for other purposes, to maximise a company's share value.

One of the theories relating to dividend policy is the residual theory of dividend policy. S. Myers argues that managers would prefer to first use retained earnings for financial investment, rather than issuing debt or equity. Retained earnings can be both a cheaper and less risky way of raising finance than issuing debt or equity. With equity, companies have all the problems of raising equity such as issuing a prospectus and arranging underwriters, while the creation of extra shares bring a dilution of control that threaten the ownership of a company. Using debt to finance investment increases the gearing level and creates a threat to the company's independence.

The view of the management, presented by this theory, is that the value of the company and the wealth of the shareholders is maximised by investing earnings in appropriate investment projects, rather than paying out dividends. Dividends will only be paid when retained earnings exceed the funds required to finance suitable investment projects.

Dividend irrelevancy theory, implemented by Miller and Modigliani, suggests that it does not matter whether a company uses its earnings to pay dividends or it retains them to fund investment, as the value of a company will not be affected directly by that decision as long as an investment is fixed. This theory also suggests that dividends have no affect on the wealth of shareholders. "[Miller and Modigliani] point out that it is possible for an individual invest or to "adjust" the dividend policy of a business to conform to his or her particular requirements. If a business does not pay a dividend, the shareholder can create "homemade" dividends by selling a proportion of the shares held." (Antril, P. 2000. *Financial Management for Non-Specialists.* Pp 311).

The extent to which investors have to engage in homemade dividends may be limited by what Miller and Modigliani refer to as the dividend clientele effect. This refers to different companies that each have their own very different ratio of dividends paid to earnings retained for investment. The consequence is that investors will be presented with a wide range of different possible investment opportunities from which they may select.

Dividend signalling theory is where changes in dividend payments are interpreted as signals to shareholders and investors about the future earning prospects of a company. A rise in dividend payment is generally viewed as a positive signal about a company's future earning prospects. A decrease in dividends is viewed as a negative signal, resulting in a decrease in share prices. This may be why many companies choose to adopt a constant dividend policy.

The Bird in the Hand theory suggests that shareholders are adverse to risk and prefer dividend payments to reinvestment because any capital growth that this promotes will only take place in an uncertain future.

Agency cost theory states that agency costs are incurred as a means of resolving the agency problem that arises from the managers of a company being a distinctly separate group from the shareholders who expect the agents to act on their behalf.

From looking at the figures presented by EMI, I would infer that the dividend policy used by the company is the constant dividend per share policy. This is because that despite the company's profits decreasing rapidly throughout the years, the dividends have always remained constant. EMI may wish to keep their dividends constant to prevent shareholders from selling their shares and to keep share prices up. It will also aid them in attracting new investors.

This relates to the dividend signalling theory. The company may not be able to increase their dividends to keep share prices up and do not want them to decrease, so instead they keep the dividends constant to promote a positive future for the company.

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