Question

At the Board meeting, an argument arises over the payment of dividend to shareholders. Mr. A argues that is not necessary to pay dividend as shareholders are indifference between receiving dividend today or receiving capital gain in the future. You are to explain convincingly to the Board, by providing 4 reasons to support the payment of dividend. Make references to the various theories on dividend. (12 marks)

Dividends are distributions made to shareholders from the firm's earnings, whether those earnings were generated in the current period or in previous period. However, dividend policy involves the decision to pay out earnings to those shareholders or to retain the earnings for the reinvestment purpose in the firm. A company should pay out the retained earnings to the shareholders because of the following reasons or theories:

2.1 Bird-in-hand Theory

Bird-in-hand theory holds that the firm's value will be maximized by a high dividend payout ratio, because investors regard cash dividend as being less risky than potential capital gains. Also, according to Myron J. Gordon, dividend payments are cash in hand whereas capital gain is relatively uncertain. He argued that dividend which expected in the near future is less risky than those expected in the more distant future. This is because shareholders are risk adverse, then dividend expected in the more distant future will be discontinued at a higher rate to compensate for the extra risk taken. In addition, Gordon also suggests that investors are not different between a dollar of dividend and the capital gains that expected from a dollar of retained profits. The expected future capital gains are uncertain because it depends on the returns from risky future investment. As a result, the dividend payment will reduce investors' uncertainty (risk) about the rate of return. And a reduction in risk will reduce the cost of equity (K_e), and therefore increase in the share price. In the reason of investors are risks adverse; therefore, they will be prepared to pay a premium for the share of companies with higher current dividend.

Essentially, Gordon argues that if profits are retained and invested in risky assets, future profits should be discounted at a risk-adjusted rate related to the risk of those assets. Therefore, investors will discount the firm's earning at a lower rate and will cause increased in share price.

2.2 Agency Costs

Michael S. Rozeff stated that dividends are playing a role in resolving agency problems between managers and shareholders. Agency cost is the costs of involving the conflict of interest between managers and shareholders. It may be incurred as a result of shareholders afraid that managers may just attempt to increase their personal wealth at the expense of shareholders' wealth. It is argued that agency costs can be reduced by paying high dividends. Higher dividends will therefore force managers to raise capital and the capital raising is accompanied by the provision of information to investors, potentials new investors, capital markets users and others. As a result, investors will have the opportunity to scrutinize the company closely at a relatively low cost. An increase in the capital provides an efficient mechanism for contributors of new capital to monitor the performance of managers. The existing shareholders will also benefit because managers are more likely to act in shareholders' interests than managers subject to less scrutiny.

Furthermore, managers always have incentive to achieve growth because it is likely that the larger the company, the more power and higher remuneration for them. Therefore, managers are likely to retain cash and invest in new profits, even if the

projects have negative net present value or waste resource by allowing inefficiencies to develop. It follows that shareholders' wealth will be increased if managers commit themselves to paying dividends rather than retaining it within the company. Therefore, the agency cost can be reduced. Therefore, reduce in agency cost can increase in value of firm (share price).

2.3 The Information Content of Dividends: Signaling

Managers are those who manage and control the company's day-to-day affairs, and, who know more about the company's performance and financial position than the shareholders, who just own the company. Thus, investors may not have complete information about the company. Due to the reported accounting earnings of a company may not be a proper reflection of the company's economic earnings, management can use dividend policy to disseminate the information about the company's future expected earnings. Again, because actions speak lauder than words, the firm's actual dividend policy is more convincing than any written explanation. Therefore, the firm uses its dividend policy to convey information. In other words, dividends are said being used by investors as predictors of the company's future performance.

In addition, management can manipulate and distort reported earnings figures, but management cannot manipulate dividend, at least not in the long run, because they are actual cash flows.

Stephen Ross first developed the theoretical analysis of dividends as a signaling device. He suggested that if earning is falling but the dividends remain unchanged, management signals that the firm's earnings drop is temporary. On the other hand, if management makes a large reduction in dividends, it signals that the firm's financial distress is more permanent. Also, according to the signaling theory, a company with an expected decrease in earnings in the future has no motive to signal wrong positive information because such actions will be costly for it in the future.

When a company has enough the financial resources to pay cash dividend, and that dividends convey information about the company's profitability. For example, due to investors will not know whether the company has had a temporary or permanent setback. So, if management believes the setback is only temporary and recovery is forthcoming, it will try not to cut the dividend. However, if management cut the dividend, it may signal the financial distress or a more prolonged trend of decline in earnings and could rush to sell their stock, which would cause a decline in the firm's stock price.

On the other hand, if management privately knows future projects will likely by extraordinarily profitability, the best way it can signal that information is by increasing the regular dividend per share, rather than by paying an extra dividend. A firm with cash reserves may choose to increase its dividend, hence signaling to stockholders its potential for generating more cash.

Furthermore, due to most top managers have stock options and direct stock ownership that tie their wealth to the future value of the company's stock. So, they will use the payment dividend policy to give the positive signal to investors that the company will make profit or get a positive net present value in the future. It may lead the investors have confidence to the company and the share price or value of firm will increase. Therefore, managers may be motivated to send accurate signals because their own value in the marketplace will decline if the signals they send turn out to be false.

Moreover, managers can reduce shareholders risk through dividend policy because a predictable dividend stream makes one portion of the return to shareholders known. So, an increase in dividends serves as an effective way for managers to tell shareholders that uncertainty concerning the company's future cash flows has declined.

Information asymmetry is that management has valuable inside information that it is unable to release directly to investors. Due to the greater uncertainty for investors, those results may cause a company's share price to be lower than it would be if investors were not fully informed. So that, the adverse effect of information asymmetry can be reduced in a cost - effective way through dividend policy. The reason is that dividend has the potential to provide a credible signal because the payment of dividends is some proof of management's ability to ensure that the company generates sufficient cash to be able to pay dividends, and also provides information on management's expectations as to the company's future profitability.

2.4 The Clientele Effects

The clientele effect is the argument that stocks attract clienteles based on dividend yield or taxes. Those individuals in low tax bracket prefer high dividends and we can classify those investors into three categories. First, the individual investors in low bracket are likely to prefer some dividends if they desire current income or favor resolution of uncertainty. Second, since pension funds pay no taxes on either dividends or capital gains, those investors will also prefer dividends if they have a preference for current income. Finally, since corporations can exclude at least 70% of their dividend income but cannot exclude any of their capital gains, thus, corporations would prefer to invest in high dividend stocks, even without a desire to resolve uncertainty or a preference for current income.

On the other hand, paying dividend also can reduce the transaction costs for investors. Transaction costs are the costs that involved in the sales of securities and tend to restrict arbitrage process in the same manner as that described for debts. Shareholders who desire current income must pay brokerage fees on sale of portions of their share ownership if the dividend paid is not sufficient to satisfy their current desire for income. As a result, shareholders with consumption desires in excess of current dividends will prefer that the company pay higher dividends. Therefore, the price of share will increase in terms of the demand of the company's share increase.

In conclusion, paying dividends not only can absorb excess cash flow and may reduce agency costs that arise from conflicts between management and shareholders; it also can underscore good results and provide support to stock price. In addition, dividends may also attract institutional investors who prefer some return in the form of dividend. However, a mix of institutional and individual investors may allow a firm to raise capital at lower cost because of the ability of the firm to reach a wider market. Furthermore, the announcement of a new or increase in dividend may usually increase the share price.

Based on the four reasons above, as a result, the company should pay dividends to shareholders. Also, due to the effects of inflation, a dollar in the future always worth less than a dollar today. Thus, there is a difference between receiving dividend today and receiving capital gain in the future. Hence, there is a necessary for the company to pay dividends.