Irrelevance Theory of Dividend

Theories of Dividend

There are conflicting theories of dividend regarding impact of Dividend Decision on the valuation of the firm. As one school of thought feels that dividend decision does not affect the shareholders’ wealth and also the valuation of firm. While another thought feels Divided Decision materially affects the shareholders’ wealth and also the goodwill of the firm. Thus there are two groups.

(i) Irrelevance theory of Dividend
(ii) Relevance

Irrelevance theory of Dividend

Irrelevance theory of dividend is associated with Soloman, Modigliani and Miller. According to them Dividend Policy has no effect on the Share Price of the Company. In their opinion investors do not differentiate dividend the capital gains. Their basic desire is to earn higher return on their investment. The Company has adequate investment opportunities giving a higher rate of return than the cost of retained earnings, the investors would be contented with the firm retains the earnings.

Dividend Decision is a financial decision whether to finance company’s fund requirements by retained earnings or not. In case a Company has profitable investment opportunities, it will retain the earnings to finance them otherwise distribute there. The interest of shareholders is income whether it is in the form of Dividend or in the capital gains

Modigliani and Miller Approach

They have expressed their opinion in a more comprehensive way. They feel the price of share of a Company is determined by its earning potentiality and investment policy and never by the pattern of Income Distribution.

Under the condition of perfect capital market, rational investors, absence of tax
discrimination between dividend income and capital appreciation given in the company’s investment policy. If Dividend have no influence on the market price of the shares. The logic given by the above school of thought is that whatever increase in shareholders wealth results from Dividend Payments will be exactly offset by the effect of raising additional, capital.

Example

For example: If a Company having investment opportunities distribute its earning among shareholders it will have to raise the capital required from outside. This will increase the number of shares, result fall in future earning of shares.

Thus, whatever a shareholder gets as a result of increased Dividend will be neutralized completely on account of fall in the value of shares due to the decline in expected earnings per share.

Assumptions of M.M. Hypothesis

The M.M. Hypothesis approach is based on the following assumptions:

(i) Capital markets are perfect.
(ii) Investors behave rationally. Information is freely available to them and there are no floatation and transaction costs.
(iii) There are either no taxes or there are no differences in the tax rates applicable to capital gains and Dividend.
(iv) The firm has a fixed Investment Policy.
(v) Risk or uncertainty does not exist. Investors are able to forecast future prices and dividends with certainty and one discount rate can be used for all securities at all times.

Proof of M.M. Hypothesis.

The market value of a share in the beginning of the period is equal to the present value of Dividends paid at the end of the period plus market price of the share at the end of the period. This can be put as:

\[ PO = \frac{D_1 + P_1}{(1 + K)} \]

Where,
PO = Prevailing market price of a share
P_{1} = Market Price of Share at the end of period one
K = Cost of Equity Share
D_{1} = Dividend to be received at the end of period one.
I = Investment.

The value of P_{1} can be:

P_{1} = PO (I+K) - D_{1}

**Computation of New Shares to be Issued**

The Investment Programme of a Company in a given period of time can be financed, either by retained earning or by new shares or both. The following formula:

m \times P_{1} = i - (X - ND_{1})

Where,

M = No. of new shares to be issued.
P_{1} = Price at which new shares is to be issued.
I = Amount of investment required
X = Total Net profit of the firm during the period.
ND_{1} = Total dividend paid during the year.

**Example**

Z Ltd. has 1000 Share of 100 each. The Company is contemplating $10 Per Share Dividend at the end of the earned year. The Co. expects a Net Income of $25000.

What will be the price of Share if (i) Dividend is not declared. (ii) a Dividend is declared. Presume Company pays dividend and has to make new Investment of $48,000 in the coming Period. how many new shares be issued to Finance Investment Programme as per M.M. approach 20% risk factor.

**Solution**

Price of share can be known by the following formula:
\[ P_1 = PO (1 + k) - D_1 \]

**When dividend is not paid:**

\[ P_1 = \$100 (1 + 10) - 0 \]

= 100 x 1.10

= $110

**When dividend is paid:**

\[ P_1 = 100 (1 + .10) - 10 \]

= $100

**New Shares:**

\[ M \times P_1 = i - (X - ND_1) \]

\[ M \times 100 = 48,000 - (25,000 - 10,000) \]

110M = 33,000

\[ M = 33,000 / 100 \]

\[ M = 330 \text{ shares} \]

**Criticisms of M.M. Hypothesos**

**Note:** Give thought to Assumption:

1. **Tax Differential:** M.M. approach assumption is that Taxes do not exist, is far from reality.

2. **Floatation Cost:** A firm has to pay financing cost in the form of Under Writing Commission, brokerage etc. As a result External Financial is costlier than interventional.

3. **Transaction Costs:** The Shareholders has to pay brokerage fees etc. when he wants to sell shares. Thus Shareholders will like to have dividend rather shares.
4. **Discount Rate:** A single discount rate can be used for discounting cash inflow at different time periods is not correct. Uncertainty increases with the length of the time period. Investors prefer near Lesser Dividend is good rather high Dividend in future.