UMESCHANDRA COLLEGE (MAIN CAMPUS)

13, SURYA SEN STREET, KOLKATA 700012

SUBJECT: FINANCIAL MANAGEMENT

PROF KAHKASHAN ANWAR

CHAPTER 9: DIVIDEND DECISIONS (PART-3)

Various dividend policy theories or models

The theories on the relationship between the dividend policy and the value of the firm can be grouped into two categories:

1. Relevance theories: Here, dividend policy of a firm has a significant impact upon the value of the firm. In this theory we have two models **Walter's model** and **Gordon's model.**

2. Irrelevance theories: Here, dividend decision is irrelevant as it does not alter the value of the firm. This theory involves **Modigliani and Miller's Model.**

Walter's Model

The Walter's model is based on the following **assumptions:**

1. The firm does not depend on external sources of fund and all investment of the firm are financed through its retained earnings.

2. The business risks of the firm remain unchanged even when it takes additional investment projects. Thus, the values of r and ke remains constant.

3. For a given value of the firm, the dividend per share and the earning per share remains constant.

4. The firm has an infinite life.

CRITICISMS OF WALTER'S MODEL

1. In this model, it is assumed that all investments of a firm are financed through retained earnings. However in real world the business firms use both retained earnings and external sources of funds for financing their investment plans. Thus this model is applicable only in case of all-equity firms.
2. This model also assumes that the internal rate of return (r) remains constant. But this is also not a realistic assumption. In fact, r cannot remain constant with an increased investment undertaken by the firm. The marginal efficiency of investment may diminish with additional investment.
3. This model has ignored the impact of business risks on the value of the firm. The business risks have a direct bearing upon the value of a firm. So the cost of capital (ke) cannot be assumed to remain constant.

GORDEN'S MODEL

The model is based on the following **assumptions:**

1. The firm is assumed to be an all-equity firm, and all new investments in the firm are financed by its retained earnings.
2. The return on investment (r) and the cost of equity capital (ke) remains constant.

3. The retention ratio remains unchanged. So the growth rate of dividends also remains unchanged.
4. The cost of equity capital is higher than the growth rate i.e,ke>g
5. The firm has a perpetual life.
6. Corporate taxes do not exist.

<u>CRITICISMS OF GORDON'S MODEL</u>

1. Gordon model assumes that there is no debt and equity finance used by the firm.it is not applicable to present day business.
2. Ke and r cannot be constant in the real practice.
3. According to Gordon's model, there are no tax paid by the firm. It is not practically applicable.

(Note: here we have discussed Walter's model and Gordon model one by one as Modigliani and miller's model outside the ambit of the present syllabi of C.U B.com under CBCS.)

DATE: 8.04.2020.