Indigenous Business Toolkit Project

Dividend/Distribution Policy

Vern Bachiu
Murray Fulton
Kristy Jackson

Johnson Shoyama Graduate School of Public Policy
University of Saskatchewan
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Summary

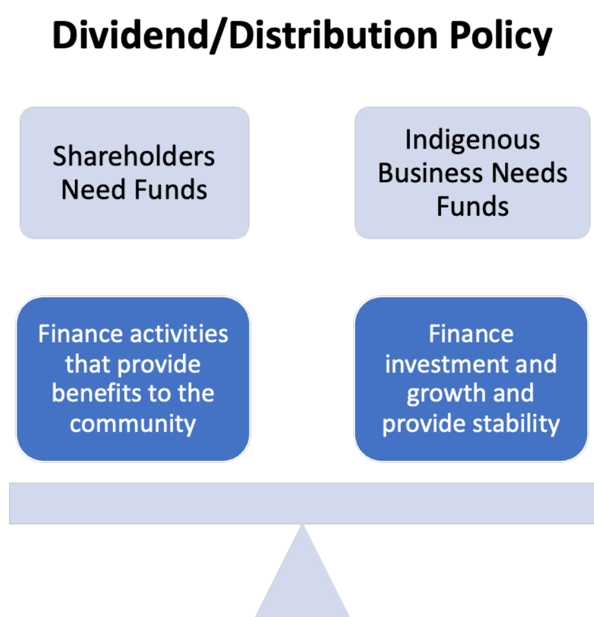
The purpose of this module is to provide Indigenous businesses, including economic development corporations (EDCs), with the background for creating a dividend or distribution policy. If the business is a limited corporation, the correct name is a dividend policy and if it is a limited partnership, the correct name is a distribution policy.[1]

Dividend/distribution policies are necessary because businesses will almost always earn profits (if they don't then they won't survive). Once profits are earned, a decision must be made as to how much is retained in the business and how much is paid to the shareholders. In the case of Indigenous businesses, the shareholders are often Indigenous communities.

Indigenous businesses often don't have access to equity capital outside of what the shareholder can provide, and it generally takes years for a business to reach a strong enough financial position to distribute dividends. If the money is kept in the business, it can be used to finance investment and growth, thus (hopefully) generating greater benefits and profits in the future.

At the same time, the shareholders are always in need of funds to meet their needs. If the money is paid to the shareholders, it can be used to finance activities that will (hopefully) generate direct benefits to the shareholders.

Paying a dividend or making a distribution thus invariably has trade-offs. To strike the right balance and to ensure that shareholders and the business retain each other's trust, it is important to acknowledge and understood these trade-offs.



A key factor in evaluating this trade-off is the primary purpose of the Indigenous business – i.e., has it been established to provide community services, community benefits, or wealth creation.[2] Businesses established to provide community services will generally have little, if any, profit to distribute – instead, the community benefits by having the service provided at the lowest price possible. At the other extreme, businesses established to create wealth will generally operate in higher-margin or higher-volume sectors. These businesses can be expected to generate larger profits, much of which will be retained in the business, at least in its early years, so that they can continue to grow.

Business Operations, Profitability and Dividends/Distributions

To be successful and continue operations, businesses must generate revenues sufficient to cover the cost of producing the goods they sell, maintain adequate working capital, retain the funds needed to cover asset maintenance and depreciation, and have access to capital to fund new business opportunities.

Generating revenue is critical – thus, businesses must create a product or service that customers wish to purchase. In addition, the cost of producing the product or service must be lower than the selling price. In competitive markets, maintaining both high quality and low costs is crucial, as high prices or low quality can drive customers to competitors.

Working capital is the financial backbone of a company, allowing it to function effectively and adapt to changing circumstances. Working capital supports day-to-day activities, offers flexibility for emergencies and expansion, allows the management of inventory, services debts, and facilitates strategic initiatives.

Businesses must also retain sufficient funds to pay for the regular maintenance, equipment replacement, regulatory compliance, and infrastructure upkeep that is required to keep the business safe and efficient.

Finally, businesses need to have access to some amount of growth capital. Growth capital is used to fund the expansion, development, and scaling of operations, the entering of new markets, and the launching of new products. Growth capital is needed to generate sustainable, long-term growth. Growth capital can be obtained through equity or debt financing.

The dividend/distribution policy must ensure that a business has sufficient funds to operate successfully over time. Thus, the starting point for a dividend/distribution policy is the net revenue that a business generates from its operations. Since working capital is vital for a business's overall success, a dividend/distribution policy should ensure that sufficient funds are retained for this purpose. Similarly, sustaining capital is crucial for preserving asset value and the long-term sustainability and profitability of a business and should not be compromised for dividend payments. Finally, a business needs to determine how much growth capital is required and how much should be financed through equity (which requires the firm to retain profits).

Striking the right balance between making payments to the shareholders (through dividends/distributions) and retaining the money for the business is difficult. The shareholders, particularly when they are Indigenous communities, are always in need of funds to meet community needs. At the same time, Indigenous businesses typically don't have access to equity capital and it often takes years for a business to reach a strong enough financial position to distribute dividends or returns. Thus, there are always trade-offs, trade-offs that must be acknowledged and understood if shareholders and the business are going to retain each other's trust.

Who Makes the Dividend/Distribution Policy?

The dividend/distribution policy is determined by the business's board of directors and not the shareholders. This allocation of decision-making authority is done because the board of directors has a legal fiduciary duty to act in the best interests of the business.[3] When setting a dividend/distribution policy, boards should consider the following:

1. Expertise: Boards possess business expertise and should ensure they have access to the information required to make informed decisions.

2. Strategic Planning: Dividend policies should align with the company's strategic goals and financial situation.

3. Regulatory Compliance: Boards have a duty to ensure that dividends adhere to legal and regulatory requirements. If the business is carrying debt, there are usually covenants from the bank restricting the payment of dividends/distributions.

4. Contractual Obligations: Boards must be able to tailor dividends/distributions to the contractual obligations they have with lenders, input suppliers, and customers.

5. Shareholder Diversity: Boards must balance the varying financial needs of shareholders.

6. Stability and Consistency: A well-defined dividend policy provides stability and reassurance to customers, debt holders, and shareholders.

While the board of directors determines the dividend/distribution policy, it may be influenced by the shareholders since they are the ultimate owners. Boards should engage with shareholders and communicate decisions transparently to strike a balance between shareholder interests and the company's health and growth. In fact, the shareholders are usually the ones that establish the fundamental business purpose which guides the dividend/distribution policy.[4] For instance, many EDC boards receive input from their shareholders before determining their dividend/distribution policy.

Financial institutions can influence a company's dividend or distribution policy in various ways. They may impose restrictions on loan agreements, offer financial advice, and have industry expertise. If the business has debt, financial institutions often have to approve payment of dividends.

Developing a Dividend or Distribution Policy

Setting a dividend or distribution policy is an important decision for a company, one that requires a thoughtful and well-defined process. Engaging the board of directors in the process is critical, since the board must review and approve the policy to ensure it aligns with the company's strategic goals and financial stability. The following steps should be considered when establishing or revising a dividend/distribution policy (for an example of a Draft Policy, see the Appendix):

1. Define Objectives: Clearly define the objectives of the dividend policy. Based on the purpose for which the business was established, determine whether the primary goal is to provide regular income to shareholders, grow the business, or strike a balance.

2. Assess Financial Health: Evaluate the business's financial health by reviewing financial statements, cash flow projections, balance sheets, and estimates of the available funds for dividends. Ensure that the company has a consistent and sustainable cash flow to support dividend payments.

3. Determine Future Financial Needs: Does the company require equity to make investments in new or existing assets, and/or to acquire new businesses? What are the expected benefits and risks of making these investments?

4. Consider Industry and Peer Comparisons: Analyzing the dividend practices of peer companies in the same industry can benchmark a business's dividend policy against industry standards and help it understand how its approach compares.

5. Evaluate Legal and Regulatory Requirements: Ensure compliance with legal and regulatory requirements, which may include restrictions on dividend payments based on the company's financial health and capital levels. Consult legal counsel if necessary.

6. Analyze Tax Implications: If the EDC is a taxable entity, consider the tax implications of dividend payments for both the company and the shareholders. Different tax regimes may influence the structure of dividend distributions.

7. Establish a Dividend Formula or Policy: Decide on the methodology for determining dividend payments. Common approaches include setting the payment as a percentage of income, a percentage of equity, or a percentage of assets.

8. Communicate Transparently and Seek Shareholder Feedback: Communicate the dividend policy clearly to shareholders, including the frequency of payments (e.g., quarterly, annually), the criteria for eligibility, and any potential adjustments based on

the company's performance. It is also important to engage with shareholders, solicit their feedback, and consider their preferences and concerns while maintaining a balance between shareholder interests and the company's financial stability

9. Monitor Performance: Continuously monitor the company's financial performance and cash flow to ensure the sustainability of dividend payments. Periodically review and adjust the policy, if necessary, based on changing market conditions, the company's financial situation, and shareholder expectations.

10. Recordkeeping and Reporting: Maintain detailed records of dividend payments and provide clear reporting to shareholders regarding dividend distributions, financial performance, and the company's adherence to the policy.

The process of setting a dividend or distribution policy should be well-documented and adhere to corporate governance principles, ensuring transparency, fairness, and alignment with the company's strategic goals. Additionally, it's crucial to make informed decisions.

The Opportunity Cost of Dividends/Distributions

One of the key questions for the business and its shareholders to consider is, "Where are the profits of the company best used – with the business or with the shareholder?" The way to think about this problem is through the concept of opportunity cost.

Opportunity cost is the value of the alternative that is foregone when a decision or choice is made. The opportunity cost is the benefit or gain that you could have had if you had chosen the other option.

If the dividend/distribution policy calls for profits to be retained in the business, the opportunity cost approach would ask – What would be the outcome if the money had instead been paid to the shareholder (e.g., the community)? Alternatively, if the dividend/distribution policy calls for profits to be paid to the shareholder, the opportunity cost approach would ask – What would be the outcome if the money had instead been retained in the business. The choice that is best is the one where the opportunity cost of the choice is less than the benefit associated with the choice.

In other words, the opportunity cost approach asks the question – Where is the money best used? Is the money best put in the hands of the shareholders who can then use it to invest in programs and activities aimed at improving their wellbeing? Or is the money best left in the hands of the business, thus enabling it to continue to grow and generate further profits?

One of the key factors in determining the answer to the above question is the basic purpose of the business – i.e., is it to provide services, to provide benefits, or to create wealth.[5] Businesses established to provide community services will generally have little, if any, profit to distribute – instead, the community benefits by having the service provided at the lowest price possible. At the other extreme, businesses established to create wealth will generally operate in higher-margin or higher-volume sectors. These businesses can be expected to generate larger profits, much of which will be retained in the business, at least in its early years, so that they can continue to grow. Of course, there are no black and white answers, and each situation must be considered on its own merits. Nevertheless, what is best can only be determined by understanding the intent of the shareholders and the situation in which the business finds itself.

Paying Dividends Versus Retaining Earnings

Even if the goal of the business is to generate a high rate of return, the interests of the shareholder and the business can influence the dividend policy. To see this, suppose an Indigenous community is planning to use the dividends from its businesses to finance community projects (e.g., building houses, providing health care). Among other factors, the community is likely concerned about the volatility of the dividend payments and when the dividends are paid (e.g., now or in the future). Both considerations might influence the dividend/distribution policy chosen by the business.

Since most businesses experience variability in their profitability, a dividend policy that pays a constant percentage of profits means that the community receives high dividends during good years and low dividends during bad ones. This payment variability makes planning difficult for both the community and the business. The business can reduce the volatility it experiences by adopting a dividend policy that reduces payments when profits are low. Such a policy, however, exacerbates the volatility experienced by the community. Of course, the volatility experienced by the community could be reduced if the dividend policy paid out higher amounts when profits were low; this, however, would exacerbate the volatility experienced by the business.

There is, obviously, no simple answer to how this trade-off should be made; the key point is that a dividend/distribution policy must consider these factors. The business's board must understand the impact of the policy on the business. And, since they are representing the shareholder, they must understand the impact of the policy on the community.

Trade-offs are also important when it comes to the timing of dividend payments. If a business pays out a significant portion of its profits as dividends each year, it is likely to experience slower growth since it must rely more heavily on debt financing to fuel growth. Alternatively, the business could retain more of its profits and grow faster, and thus be able to pay out much larger dividend payments in the future. In short, the dividend/distribution policy affects the timing and magnitude of the payments that flow to the community.

A key question for the Indigenous community that owns the business is whether it prefers a series of smaller payments over time as opposed to a set of much larger payments in the future. If the community can be patient, the latter is often preferable since the total payout will be larger. However, many communities need payments immediately. As with volatility, each dividend/distribution policy has its advantages and disadvantages, and the board of directors must consider both. There is no one-size-fits-all answer; it depends on the business's fundamental purpose as determined by the community and on the circumstances in which the business finds itself. What's crucial is that the dividend policy aligns with the community's purpose and is informed by the events taking place.

The following table can help businesses and communities understand the impact of paying out profits in the form of dividends versus keeping them in the business and continuing to see them grow through compounding. The table shows how long it takes for an investment to double if, each year, the profits are left in the business to grow. For example, if the return on investment is six percent, it will take 12 years for the investment to double; if the rate of return is 12 percent, it will take six years to double the investment.

The Effect of Compounding: Years to Double Investment for Given Rates of Return

	Rate of Return (%)			
	6.0	8.0	10.0	12.0
Years to Double Investment	12.0	9.0	7.2	6.0

The Shareholder's Use of Dividends/Distributions

How Indigenous communities use the dividends/distributions from the businesses they own is up to them and not the businesses that generate them – i.e., the businesses cannot put restrictions or constraints on how the shareholders use the funds. However, there are some wise practices that Indigenous communities have found valuable.

1. The dividends/distributions should go into a special fund set up to receive such payments; they should not go into a general revenue fund or account. The primary reason to set up a special fund is that it makes it easier to report to the community on how much money the businesses generated and how this money was then used.

2. Expenditures from the special fund should be used for specific and identifiable community projects or activities. In this way, when members ask – "Where are the profits from our business going?" – the leadership can give a specific answer. Specific answers are a key part of the accountability that is needed to ensure the community has trust in how the leadership is using community funds.

Conclusion

Shareholders invest in businesses to generate outcomes that are beneficial to the shareholders. This is as true for Indigenous communities that establish EDCs and other businesses as it is for any shareholder. When the shareholder is an Indigenous community faced with pressing socio-economic circumstances, the need for revenue to meet community needs can be significant. As a result, there will always be tremendous pressure placed on Indigenous businesses to return as many dividends as possible.

Making the maximum dividend possible, however, is unlikely to be the best strategy for either the community or the businesses. While the community may benefit in the short run, it will make running the business more difficult and generally less profitable in the future – as is well-known, seeds must be planted and left to grow if they are to survive and flourish. Less profits in the future mean less dividends for the future. Designing a dividend/distribution policy requires understanding the trade-offs involved when different dividend/distribution plans are in place.

In addition, and perhaps more importantly, designing a dividend/distribution policy requires an understanding of the fundamental purpose of the business, since it is through this purpose that the various trade-offs are evaluated. While it is the responsibility of the business's board of directors to establish the dividend/distribution policy, it should do so only after discussing the issue with the shareholders and ensuring that the policy matches the reasons why the business was created.

References

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Endnotes

[1] For a discussion of limited partnerships, see Bachiu, Fulton, and Jackson (2024) *Limited Partnerships*.
[2] For a discussion of the three business purposes, see Bachiu, Fulton, and Jackson (2024) *Economic Development Corporations*.
[3] For a discussion of the legal rights of the shareholders versus the board, see Bachiu, Fulton, and Jackson (2024) *Business Charters*.
[4] One way of establishing the fundamental business purpose is through a business charter. See Bachiu, Fulton, and Jackson (2024) *Business Charters*.
[5] For a discussion of these three business purposes, see Bachiu, Fulton, and Jackson (2024) *Economic Development Corporations*.

Indigenous Business Toolkit Project

The Indigenous Business Toolkit Project is designed to provide Indigenous communities and individuals with the practical tools they and their advisors can use to undertake successful economic development. Indigenous economic development is more successful when everyone – community members, community leaders, consultants, business professionals, employees, and/or potential partners – understands its many aspects.

The Toolkit provides step-by-step instructions on selected aspects of economic development based on the best practices of leaders in the field. The modules in the Toolkit cover everything from the role of economic development in nation building, to the importance of business charters, to the various legal forms that can be used to pursue economic development, to the steps needed to identify and negotiate beneficial partnerships, to the governance challenges that economic development must address.

The modules are available for free and for use by anyone. The full set of Toolkit modules can be found at: https://www.schoolofpublicpolicy.sk.ca/research-ideas/projects-and-labs/indigenous-leadership-governance-and-development-project.php.

The Indigenous Business Toolkit Project is part of the larger Indigenous Leadership: Governance and Development project designed to support long-term Indigenous economic development. In addition to the toolkit, the larger project involves capturing the economic development experience of Saskatchewan Indigenous communities through a series of case studies. The case studies, along with a description of the larger project, can be found at the website listed above.

Disclaimer

The information contained in this document is designed to provide an overview of a particular topic and should not replace legal and other expert advice. Groups wishing to use the concepts discussed should receive the appropriate professional advice necessary to ensure their specific goals and circumstances are considered and recognized.

The Authors

Vern Bachiu, President and CEO of Triall Consulting, is a business consultant with over four decades of experience in working with Indigenous communities in business, governance, and education.

Murray Fulton, professor emeritus with the Johnson Shoyama Graduate School of Public Policy (University of Saskatchewan campus), is an agricultural economist. He has done extensive research and writing on governance, rural development, and co-operative development.

Kristy Jackson, Director of Marketing and Communications at Athabasca Basin Development, (ABD), is a member of Whitefish Lake First Nation #128. Prior to her work at ABD, Kristy was director of communications at the Saskatchewan Indian Gaming Authority.