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Dividend Policy

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Introduction:

Dividend policy is concerned with taking a decision regarding paying cash dividend in the present or paying an increased dividend at a later stage. The firm could also pay in the form of stock dividends which unlike cash dividends do not provide liquidity to the investors, however, it ensures capital gains to the stockholders. The expectations of dividends by shareholders helps them determine the share value, therefore, dividend policy is a significant decision taken by the financial managers of any company.

Dividend

Meaning: Dividend is that part of the profits of a company which is distributed amongst its shareholders.

Definition:

According to ICAI, "Dividend is a distribution to shareholders out of profits or reserves available for this purpose."

Definition of Dividend Policy:

A dividend policy is a company's approach to distributing profits back to its owners or stockholders. If a company is in a growth mode, it may decide that it will not pay dividends, but rather re-invest its profits (retained earnings) in the business. If a company does decide to pay dividends, it must then decide how often to do so, and at what rate. Large, well-established companies often pay dividends on a fixed schedule, but sometimes they also declare "special dividends." The payment of dividends impacts the perception of a company in financial markets, and it may also have a direct impact on its stock price.

Dividend policies are the regulations and guidelines that companies develop and implement as the means of arranging to make dividend payments to shareholders. Establishing a specific dividend policy is to the advantage of both the company and the shareholder. In order to make sure the policy is workable, a company should develop a viable policy and then run this policy through a number of test scenarios in order to determine what impact the dividend policy would have on the operation of the business.

Factors affecting dividend policy

Nature of Dividend Decision

The dividend decision of the firm is crucial for the finance manager because it determines:

1. the amount of profit to be distributed among the shareholders, and

2. the amount of profit to be retained in the firm.

There is a reciprocal relationship between cash dividends and retained earnings. While taking the dividend decision the management take into account the effect of the decision on the maximization of shareholders' wealth. Maximizing the market value of shares is the objective. Dividend pay out or retention is guided by this objective.

Factors Affecting Dividend Policy:

1. External Factors
2. Internal Factors

1. General State of Economy:

In case of uncertain economic and business conditions, the management may like to retain whole or large part of earnings to build up reserves to absorb future shocks.

In the period of depression the management may also retain a large part of its earnings to preserve the firm's liquidity position.

In periods of prosperity the management may not be liberal in dividend payments because of availability of larger profitable investment opportunities.

In periods of inflation, the management may retain large portion of earnings to finance replacement of obsolete machines.

2. State of Capital Market:

Favourable Market: liberal dividend policy.

Unfavourable market: Conservative dividend policy.

3. Legal Restrictions:

Companies Act has laid down various restrictions regarding the declaration of dividend:

Dividends can only be paid out of:

- Current or past profits of the company.
- Money provided by the State/ Central Government in pursuance of the guarantee given by the Government.
- Payment of dividend out of capital is illegal.

A company cannot declare dividends unless

It has provided for present as well as all arrears of depreciation.

Certain percentage of net profits has been transferred to the reserve of the company. Past accumulated profits can be used for declaration of dividends only as per the rules framed by the Central Government

4. Contractual Restrictions:

Lenders sometimes may put restrictions on the dividend payments to protect their interests (especially when the firm is experiencing liquidity problems)

Example:

A loan agreement that the firm shall not declare any dividend so long as the liquidity ratio is less than 1:1.

The firm will not pay dividend more than 20% so long as it does not clear the loan.

Internal Factors affecting dividend decisions

Desire of the Shareholders

Though the directors decide the rate of dividend, it is always at the interest of the shareholders.

Shareholders expect two types of returns:

[i] Capital Gains: i.e., an increase in the market value of shares.

[ii] Dividends: regular return on their investment. Cautious investors look for dividends because,

[i] It reduces uncertainty (capital gains are uncertain).

[ii] Indication of financial strength of the company.

[iii] Need for income: Some invest in shares so as to get regular income to meet their living expenses.

Financial Needs of the Company: If the company has profitable projects and it is costly to raise funds, it may decide to retain the earnings.

Nature of earnings:

A company which has stable earnings can afford to have an higher divided payout ratio. Desire to retain the control of management: Additional public issue of share will dilute the control of management. Liquidity position: Payment of dividend results in cash outflow. A company may

have adequate earning but it may not have sufficient funds to pay dividends

Stability of Dividends

The term stability of dividends means consistency in the payment of dividends. It refers to regular payment of a certain minimum amount as dividend year after year. Even if the company's earnings fluctuate from year to year, its dividend should not. This is because the shareholders generally value stable dividends more than fluctuating ones. Stable dividend can be in the form of:

1. Constant dividend per share
2. Constant percentage
3. Stable rupee dividend plus extra dividend

Significance of Stability of Dividend

1. Desire for current income
2. Sign of financial stability of the company

3. Requirement of institutional investors
4. Investors confidence in the company

Danger of Stable Dividend Policy

Stable dividend policy may sometimes prove dangerous. Once a stable dividend policy is adopted by a company, any adverse change in it may result in serious damage regarding the financial standing of the company in the mind of the investors.

Forms of Dividend

1. Cash Dividend:

The normal practice is to pay dividends in cash. The payment of dividends in cash results in cash outflow from the firm. Therefore the firm should have adequate cash resources at its disposal before declaring cash dividend.

2. Stock Dividend:

The company issues additional shares to the existing shareholders in proportion to their holdings of equity share capital of the company. Stock dividend is popularly termed as 'issue of bonus shares.' This is next to cash dividend in respect of its popularity.

3. Bond Dividend:

In case the company does not have sufficient funds to pay dividends in cash it may issue bonds for the amount due to shareholders. The main purpose of bond dividend is postponement of payment of immediate dividend in cash. The bond holders get regular interest on their bonds besides payment of the bond money on the due date. [Bond dividend is not popular in India]

4. Property Dividend:

This is a case when the company pays dividend in the form of assets other than cash. This may be in the form of certain assets which are not required by the company or in the form of company's products. [This type of dividend is not popular in India]

Bonus Shares

When the additional shares are allotted to the existing shareholders without receiving any additional payment from them, is known as issue of bonus shares. Bonus shares are allotted by capitalizing the reserves and surplus. Issue of bonus shares results in the conversion of the company's profits into share capital. Therefore it is termed as capitalization of company's profits.

Key Factors That Influence Dividend Policies

A company can offer a dividend to convince an investor to buy its stock instead of the shares of a competitor, because the investor enjoys receiving a stream of income that does not force him to sell his shares. An investor may also decide against investing in a company if it pays out large dividends, because the investor wants the company to make profitable investments instead of giving his money back.

Shareholder Preferences

Stockholders' preferences influence dividend policies. An investor who has few additional sources of income, such as a retiree, is more likely to choose stocks that have significant dividend payouts.

Income Stability

A company that earns a steady income is more likely to pay out high dividends. When the managers can easily predict the level of profit that the company will earn in future years, the company can pay out more money without risking a future cash shortage.

Managers

Managers' power over the company affects the company's dividend policies. If managers receive large bonuses for good performance or hold a high percentage of the company's shares, they typically prefer to reinvest the company's profits. If managers hold fewer shares and have fewer performance incentives, outside stockholders may ask for higher dividends as a safeguard because managers have less motivation to achieve high profits with the assets they manage.

Alternative Activities

Under the residual-dividend model, the company pays a dividend because it has no better use for its profits. The company subtracts the cash that it can invest in worthwhile activities from its total profits and returns the remaining cash to its investors. The company decides which activities are worthwhile by establishing a threshold rate, such as stating that it will only invest in a project that offers a 7 percent return on its investment.

Economy

Economic conditions affect dividend policies. When the economy is performing badly, investors prefer greater dividends. If economic conditions are good and the stock market is rising, investors feel more confident about leaving their cash in the company, because the company has better prospects for growth and future income.

Types of Dividend Policies

A policy is a guideline for action. What are the guidelines followed in respect of dividend function? The guidelines relate to forms, scale, stability and timing of dividend payment. Accordingly dividend policies of diverse nature are available. Prominent of them are dealt with below.

Policy of No Immediate Dividend: Generally, management follows a policy of paying no immediate dividend in the beginning of its life, as it requires funds for growth and expansion. In case, when the outside funds are costlier or when the access to capital market is difficult for the company and shareholders are ready to wait for dividend for sometime, this policy is justified, provided the company is growing fast and it requires a good deal of amount for expansion. But such a policy is not justified for a long time, as the shareholders are deprived of the dividend and the retained earnings built up which will attract attention of laborers, consumers etc.

Regular or Stable Dividend Policy:

When a company pays dividend regularly at a fixed rate, and maintains it for a considerably long time even though the profits may fluctuate, it is said to follow regular or stable dividend policy. Thus stable dividend policy means a policy of paying a minimum amount of dividend every year regularly. It raises the prestige of the company in the eyes of the investors. A firm paying stable dividend can satisfy its shareholders and can enhance its credit standing in the market. Not only that the dividend must be regularly paid but the dividend must be stable. It may be fixed amount per share or a fixed percentage of net profits or it may be total fixed amount of dividend on all the shares etc. The benefits of stable dividend policy are (1) it helps in raising long-term finance.

Regular Dividend plus Extra Dividend Policy:

A firm paying regular dividends would continue with its pay out ratio. But when the earnings exceed the normal level, the directors would pay extra dividend in addition to the regular dividend. But it would be named 'Extra dividend', as it should not give an impression that the company has enhanced rate of regular dividend,

Irregular Dividend Policy:

When the firm does not pay out fixed dividend regularly, it is irregular dividend policy. It changes from year to year according to changes in earnings level. This policy is based on the management belief that dividend should be paid only when the earnings and liquid position of the firm warrant it.

Regular Stock Dividend Policy:

When a firm pays dividend in the form of shares instead of cash regularly for some years continuously, it is said to follow this policy. We know stock dividend as bonus shares. When a company is short of cash or is facing liquidity crunch, because a large part of its earnings are blocked in high level of receivables or when the company is need of cash for its modernization and expansion program, it follows this policy.

Regular Dividend plus Stock Dividend Policy:

A firm may pay certain amount of dividend in cash and some dividend is paid in the form of shares (stock). Thus, the dividend is split in to two parts. This policy is justified when (1) The company wants to maintain its policy of regular dividend and yet (2) It wants to retain some part of its divisible profit with it for expansion. (3) It wants to give benefit of its earnings to shareholders but has not enough liquidity to give full dividend in cash. All the limitations of paying regular stock dividends apply to this policy.

Liberal Dividend Policy:

It is a policy of distributing a major part of its earnings to its shareholders as dividend and retains a minimum amount as retained earnings. Thus, the ratio of dividend distribution is very large as compared to retained earnings. The rate of dividend or the amount of dividend is not fixed. It varies according to earnings. The higher is the profit, the higher will be the rate of dividend. In years of poor earnings, the rate of dividend will be lower. In fact, it is the policy of Irregular Dividend.

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