Determinants of Dividend Policy

Dividend Policy

The term dividend refers to that part of profits of a company which is distributed by the company among its shareholders. It is the reward of the shareholders for investments made by them in the shares of the company. The investors are interested in earning maximum return to maximize their wealth.

A firm needs funds to meet its long-term growth. If a company pays most of the profit as dividend, then for business requirement or further expansion then it will have to depend on outsiders for funds. Such as issue of debt or new shares.

Firms decision to pay dividend in equitable proportion of dividend and retained earnings.

Determinants of Dividend Policy

(i) Type of Industry

Industries that are characterized by stability of earnings may formulate a more consistent policy as to dividends than those having an uneven flow of income. For example, public utilities concerns are in a much better position to adopt a relatively fixed dividend rate than the industrial concerns.

(ii) Legal restrictions

Legal provision related to dividends are laid down in sec 93,205,205A, 206 and 207 of companies act. Dividend can be paid only out of current profit or past profit after providing depreciation Company providing more than 10% dividend to transfer certain percentage of current year profit to reserves.

(iii) Age of Corporation

Newly established enterprises require most of their earning for plant improvement and expansion, while old companies which have attained a longer earning experience, can formulate clear cut dividend policies and may even be liberal in the distribution of dividends.

(iv) Desire and type of shareholders

Discretion to declare dividend or not is decided by the board of directors. Directors give importance to the desire of the shareholder in declaration of dividends. Desire for dividend depends on their economic status. Investor such as retired person, widows and other economically weaker person view dividend as a source of funds to meet their day-to-day living expenses – the company will pay regular dividend. Investor with high income tax bracket will not prefer current dividend they will expect only capital gains.

(v) Extent of share distribution

A closely held company is likely to get consent of the shareholders for the suspension of dividends or for following a conservative dividend policy. But a company with a large number of shareholders widely scattered would face a great difficulty in securing such assent. Reduction in dividends can be affected but not without the co-operation of shareholders.

(vi) Business Cycles

During the boom, prudent corporate management creates good reserves for facing the crisis which follows the inflationary period. Higher rates of dividend are used as a tool for marketing the securities in an otherwise depressed market.

(vii) Changes in Government Policies

Sometimes government limits the rate of dividend declared by companies in a particular industry or in all spheres of business activity. The Government put temporary restrictions on payment of dividends by companies in July 1974 by making amendment in the Indian Companies Act, 1956. The restrictions were removed in 1975.

(viii) Future financial requirement

Future financial requirement is to be considered while deciding dividend. Company has profitable investment opportunities then the firm will pay limited amount as dividend and invest the remaining amount. If there is no investment opportunities then the company will pay more dividend.

(ix) Taxation policy

A high or low rate of business taxation affect the net earnings of company and thereby its dividend policy. A firm's dividend policy may be dictated by the income-tax status of its shareholders. If the dividend income of shareholders is heavily taxed being in high income bracket, then the shareholder will prefer capital gains and bonus shares.

(x) Trends of profits

The past trend of the company's profit should be thoroughly examined to find out the average earning position of the company. The average earnings should be subjected to the trends of general economic conditions. If depression is approaching, only a conservative dividend policy can be regarded as prudent.

(xi) Cash Balance

If the working capital of the company is small liberal policy of cash dividend cannot be adopted. Dividend has to take the form of bonus shares issued to the members in lieu of cash payment.

The regularity of dividend payment and the stability of its rate are the two main objectives aimed at by the corporate management. They are accepted as desirable for the corporation's credit standing and for the welfare of shareholders.

High earnings may be used to pay extra dividends but such dividend distributions should be designed as "Extra" and care should be taken to avoid the impression that the regular dividend is being increased.

A stable dividend policy should not be taken to mean an inflexible or rigid policy. On the other hand, it entails the payment of a fair rate of return, taking into account the normal growth of business and the gradual impact of external events.

A stable dividend record makes future financing easier. It not only enhances the credit- standing of the company but also stabilizes market values of the securities outstanding. The confidence of shareholders in the corporate management is also strengthened.