Subject :- Financial Management

Class :- M.Com Semester 2

Unit :- 4

Topic :- Determinants of Dividend Policy

Meaning of Dividend Policy

When the profits are earned by the company then it has to make decisions regarding how and where that profit will be used. The company can either retain profits earned or else they can decide to distribute the same in the form of the dividends to its shareholders. Dividend policy is the policy a company uses to structure its dividend payout to shareholders. In other words, Dividend policy determines how the earnings of a company are distributed either it is retained and reinvested in the company or is paid out to shareholders.

Payout Ratio:- Payout ratio or dividend payout ratio is the proportion of earnings paid out as dividends to shareholders.

Retention Ratio:- Retention ratio is the percentage of a company's earnings that are not paid out as dividends but credited to retained earnings. In other words, retention ratio is 100 percent minus payout percentage.

We can say that :-

Larger Retentions, Lesser Dividends;

Smaller Retentions, Larger Dividends.

Determinants of Dividend Policy

A determinant is a factor or cause that makes something happen or leads directly to a decision. So, the factors which influence dividend are called Determinants of Dividend Policy which are as follows:-

- **Legal Restrictions**
  Legal provisions relating to dividends as laid down in sections 93, 205, 205A, 206 and 207 of the Companies Act,1956 are significant because they lay down a framework within which dividend policy is formulated.
  These provisions require that dividend can be paid only out of current profits or past profits after providing for depreciation or out of the moneys provided by government for the payment of dividend in pursuance of a guarantee given by the government. Companies Act, further, provides that dividends cannot be paid out of

capital because it will amount to reduction of capital adversely affecting the security of its creditors.

- **Magnitude and trends of earnings**
  The past trend of the company's profit should be 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.

- **Nature of Industry**
  Nature of industry to which the company is engaged also considerably affects the dividend policy. Certain industries have a comparatively steady and stable demand irrespective of the prevailing economic conditions. If the earnings are uncertain, as in the case of luxurious goods, conservative policy should be followed. Thus, industries with steady demand of their products can follow a higher dividend payout ratio.

- **Age of the company**
  The age of the company also influences the dividend decision of a company. A newly established concern has to limit payment of dividend and retain substantial part of earnings for financing its future growth and development, while older companies which have established sufficient reserves can afford to pay liberal dividends.

- **Taxation Policy**
  The taxation policy of the government also affects the dividend decision of a firm. A high or low rate of business taxation affects the net earnings of company(after tax) and thereby its dividend policy. Similarly, 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, the shareholders may forego cash dividend and prefer bonus shares and capital gains.

- **Liquid Resources**
  The dividend policy of a firm is also influenced by the availability of liquid resources. Although, a firm may have sufficient available profits to declare dividends, yet it may not be desirable to pay dividends if it does not have sufficient liquid resources. Hence the liquidity position of a company is an important consideration in paying dividends.

  If a company does not have liquid resources, it is better to declare stock dividend, that is, issue of bonus shares to the existing shareholders. The issue of bonus shares also amounts to distribution of firm's earnings among the existing shareholders without affecting its cash position.

- **Desire and Type of Shareholders**

  Although, legally, the discretion as to whether to declare dividend or not has been left with the Board of Directors, the directors should give the importance to the desires of shareholders in the declaration of dividends as they are the representatives of shareholders. Desires of shareholders for dividends depend upon their economic status.

  Investors, such as retired persons, widows and other economically weaker persons view dividends as a source of funds to meet their day-to-day living expenses. To benefit such investors, the companies should pay regular dividends. On the other hand, a wealthy investor in a high income tax bracket may not benefit by high current dividend incomes. Such an investor may be interested in lower current dividends and high capital gains. It is difficult to reconcile these conflicting interests of the different types of shareholders, but a company should adopt its dividend policy after taking into consideration the interests of its various groups of shareholders.

- **Control Objectives**

  When a company pays high dividends out of its earnings, it may result in the dilution of both control and earnings for the existing shareholders. As in case of a high dividend payout ratio, the retained earnings are insignificant and the company will have to issue new shares to raise funds to finance its future requirements. The control of the existing shareholders will be diluted if they can't buy the additional shares issued by the company.

  Similarly, issue of new shares shall cause increase in the number of equity shares and ultimately cause a lower earnings per share and their price in the market. Thus, under these circumstances to maintain control of the existing shareholders, it may be desirable to declare lower dividends and retain earnings to finance the firm's future requirements.

- **Future Financial Requirements**

  It is not only the desires of the shareholders but also future financial requirements of the company that have to be taken into consideration while making a dividend decision. The management of a concern has to reconcile the conflicting interests of shareholders and those of the company's financial needs.

  If a company has highly profitable investment opportunities it can convince the shareholders of the need for limitation of dividend to increase the future earnings and stabilise its financial position. But when profitable investment opportunities, do not exist then the company may not be justified in retaining substantial part of its current earnings. Thus, a concern having few internal investment opportunities should follow high payout ratio as compared to one having more profitable investment opportunities.

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