



RESEARCH ARTICLE

THE STUDY ON FACTORS AFFECTING DIVIDEND POLICY AND DIVIDEND PROCESS OF THE COMPANY

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ABSTRACT

Dividend policy has been one of the areas of corporate finance to be analyzed with a rigorous model, and it has since been one of the most thoroughly researched issues in modern finance. There are a number of theories of dividend behavior, and empirical studies provide little evidence for one over the other. Also the conceptions concerning corporate dividend theories are different.

The financial manager must take careful decisions on how the profit should be distributed among shareholders. It is very important and crucial part of the business concern, because these decisions are directly related with the value of the business concern and shareholder's wealth. Like financing decision and investment decision, dividend decision is also a major part of the financial manager. When the business concerns decide dividend policy, they have to consider certain factors affecting retained earnings and the nature of shareholder of the business concern.

The main part of the discussion is related to the evaluation of financial research, because at all times researchers have tried to solve the dividend factors affecting dividend policy, the dividend Process and insights.

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INTRODUCTION

One of them is the dividend behavior of firms. Along with capital structure, dividend policy has been one of the first areas of corporate finance to be analyzed with a rigorous model, and it has since been one of the most thoroughly researched issues in modern finance<sup>1</sup>. In spite of this, much remains unexplained concerning the role of dividends.

Dividend policy determines the division of earnings between payments to stockholders and reinvestments in the firm. Managers' task is to allocate the earnings to dividends or retained earnings. Retained earnings are one of the most significant sources of funds for financing corporate growth. Corporate growth makes it eventually possibly to get more dividends. The goal of this study is to describe the discussion on dividends and dividend theories. The main part of that discussion is related to the evolution of financial research,

because at all times people have tried to solve the dividend factor by using new theories and insights. There are a number of theories of dividend behavior, and empirical studies provide little evidence for one over the other.

A share of the after-tax profit of a company, distributed to its share holder according to the number and class of held share by them. Smaller companies typically distribute dividends at the end of an accounting year, whereas larger, publicly held companies usually distribute it every quarter. The amount and timing of the dividend is decided by the board of directors who also determine whether it is paid out of current earnings or the past earnings kept as reverse. Holder of preferred stock received dividend at a fixed rate and are paid first. Holders of ordinary share are entitled to receive any amount of dividend, based on the level of profit and the company's need for cash expansion or other purposes. Corporate legislation generally forbids payment of dividend out of

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anticipated but not yet received unrealized profit. Normally all dividend payment are taxable, often at the sources.

### **Meaning of Dividend**

Dividend refers to the business concerns net profits distributed among the shareholders. It may also be termed as the part of the profit of a business concern, which is distributed among its shareholders.

According to the Institute of Chartered Accountant of India, dividend is defined as "A distribution to shareholders out of profits or reserves available for this purpose".

Dividend policy determines the division of earnings between payments to shareholders and retained earnings.

### **Factors Affecting Dividend Policy**

- **Stability of Earnings.** The nature of business has an important bearing on the dividend policy. Industrial units having stability of earnings may formulate a more consistent dividend policy than those having an uneven flow of incomes because they can predict easily their savings and earnings. Usually, enterprises dealing in necessities suffer less from oscillating earnings than those dealing in luxuries or fancy goods.
- **Age of corporation.** Age of the corporation counts much in deciding the dividend policy. A newly established company may require much of its earnings for expansion and plant improvement and may adopt a rigid dividend policy while, on the other hand, an older company can formulate a clear cut and more consistent policy regarding dividend
- **Liquidity of Funds.** Availability of cash and sound financial position is also an important factor in dividend decisions. A dividend represents a cash outflow, the greater the funds and the liquidity of the firm the better the ability to pay dividend. The liquidity of a firm depends very much on the investment and financial decisions of the firm which in turn determines the rate of expansion and the manner of financing. If cash position is weak, stock dividend will be distributed and if cash position is good, company can distribute the cash dividend.
- **Extent of share Distribution.** Nature of ownership also affects the dividend decisions. A closely held company is likely to get the assent of the shareholders for the suspension of dividend or for following a conservative dividend policy. On the other hand, a company having a good number of shareholders widely distributed and forming low or medium income group would face a great difficulty in securing such assent because they will emphasize to distribute higher dividend.
- **Needs for Additional Capital.** Companies retain a part of their profits for strengthening their financial position. The income may be conserved for meeting the increased requirements of working capital or of future expansion. Small companies usually find difficulties in raising finance for their needs of increased working capital for expansion programmers. They having no other alternative, use their ploughed

back profits. Thus, such Companies distribute dividend at low rates and retain a big part of profits.

- **Trade Cycles.** Business cycles also exercise influence upon dividend Policy. Dividend policy is adjusted according to the business oscillations. During the boom, prudent management creates food reserves for contingencies which follow the inflationary period. Higher rates of dividend can be used as a tool for marketing the securities in an otherwise depressed market. The financial solvency can be proved and maintained by the companies in dull years if the adequate reserves have been built up.
- **Government Policies.** The earnings capacity of the enterprise is widely affected by the change in fiscal, industrial, labor, control and other government policies. Sometimes government restricts the distribution of dividend beyond a certain percentage in a particular industry or in all spheres of business activity as was done in emergency. The dividend policy has to be modified or formulated accordingly in those enterprises.
- **Taxation Policy.** High taxation reduces the earnings of the companies and consequently the rate of dividend is lowered down. Sometimes government levies dividend-tax of distribution of dividend beyond a certain limit. It also affects the capital formation. In India, dividends beyond 10 % of paid-up capital are subject to dividend tax at 7.5 %.
- **Legal Requirements.** In deciding on the dividend, the directors take the legal requirements too into consideration. In order to protect the interests of creditors outsiders, the companies Act 1956 prescribes certain guidelines in respect of the distribution and payment of dividend. Moreover, a company is required to provide for depreciation on its fixed and tangible assets before declaring dividend on shares. It proposes that Dividend should not be distributed out of capita, in any case. Likewise, contractual obligation should also be fulfilled, for example, payment of dividend on preference shares in priority over ordinary dividend.
- **Past dividend Rates.** While formulating the Dividend Policy, the directors must keep in mind the dividend paid in past years. The current rate should be around the average past rat. If it has been abnormally increased the shares will be subjected to speculation. In a new concern, the company should consider the dividend policy of the rival organization.
- **Ability to Borrow.** Well established and large firms have better access to the capital market than the new Companies and may borrow funds from the external sources if there arises any need. Such Companies may have a better dividend pay-out ratio. Whereas smaller firms have to depend on their internal sources and therefore they will have to build up good reserves by reducing the dividend payout ratio for meeting any obligation requiring heavy funds.
- **Policy of Control.** Policy of control is another determining factor is so far as dividends are concerned. If the directors want to have control on company, they would not like to add new shareholders and therefore,

declare a dividend at low rate. Because by adding new shareholders they fear dilution of control and diversion of policies and programmes of the existing management. So they prefer to meet the needs through retained earnings. If the directors do not bother about the control of affairs they will follow a liberal dividend policy. Thus control is an influencing factor in framing the dividend policy.

- **Repayments of Loan.** A company having loan indebtedness are vowed to a high rate of retention earnings, unless one other arrangements are made for the redemption of debt on maturity. It will naturally lower down the rate of dividend. Sometimes, the lenders (mostly institutional lenders) put restrictions on the dividend distribution still such time their loan is outstanding. Formal loan contracts generally provide a certain standard of liquidity and solvency to be maintained. Management is bound to honour such restrictions and to limit the rate of dividend payout.
- **Time for Payment of Dividend.** When should the dividend be paid is another consideration. Payment of dividend means outflow of cash. It is, therefore, desirable to distribute dividend at a time when is least needed by the company because there are peak times as well as lean periods of expenditure. Wise management should plan the payment of dividend in such a manner that there is no cash outflow at a time when the undertaking is already in need of urgent finances.
- **Regularity and stability in Dividend Payment.** Dividends should be paid regularly because each investor is interested in the regular payment of dividend. The management should, in spite of regular payment of dividend, consider that the rate of dividend should be all the most constant. For this purpose sometimes companies maintain dividend equalization Fund.

### **The Dividend Process**

A share of the company's net profits distributed by the company to a class of its stock holders. The dividend is paid in a fixed amount for each share of stock held. Although most companies make quarterly payments in cash (checks), dividends also may be in the form of property, scrip, or stock. Unlike interest on a debt, dividends must be voted on by the company's directors before each payment. See also bond dividend capital dividend, cash dividend, consent dividend, constructive dividend, declaration date, declaration dividend, ex-dividend date, final dividend, illegal dividend, interim dividend, liquidating dividend, optional dividend and stock dividend.

Firms in the United States generally pay dividends every quarter, whereas firms in other countries typically pay dividends on a semi-annual or annual basis. Let us look at the time line associated with dividend payment and define different types of dividends.

**Regular dividend policy:** in this type of dividend policy the investors get dividend at usual rate. Here the investors are generally retired persons or weaker section of the society who

want to get regular income. This type of dividend payment can be maintained only if the company has regular earning.

### **Merits of Regular dividend policy**

- It helps in creating confidence among the shareholders.
- It stabilizes the market value of shares.
- It helps in maintaining the goodwill of the company.
- It helps in giving regular income to the shareholders

**Stable dividend policy:** here the payment of certain sum of money is regularly paid to the shareholders. It is of three types:

- **Constant dividend per share:** here reserve fund is created to pay fixed amount of dividend in the year when the earning of the company is not enough. It is suitable for the firms having stable earning.
- **Constant payout ratio:** it means the payment of fixed percentage of earning as dividend every year.
- **Stable rupee dividend + extra dividend:** it means the payment of low dividend per share constantly + extra dividend in the year when the company earns high profit.

### **Merits of stable dividend policy**

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- It helps in maintaining the goodwill of the company.
- It helps in giving regular income to the shareholders.

**Irregular dividend:** as the name suggests here the company does not pay regular dividend to the shareholders. The company uses this practice due to following reasons:

- Due to uncertain earning of the company.
- Due to lack of liquid resources.
- The company sometime afraid of giving regular dividend.
- Due to not so much successful business.

**No dividend:** the company may use this type of dividend policy due to requirement of funds for the growth of the company or for the working capital requirement.

### **Determinants of A Dividend Policy**

Dividend policy of a company sets the guidelines to be followed while deciding the amount of dividend to be paid out to the shareholders. The company needs to adhere to the dividend policy while deciding the proportion of earnings to be distributed and the frequency of the distribution. There are various types of dividend policies – regular, stable, constant and irregular.

A company needs to analyze certain factors before framing their dividend policy. These factors are termed as 'Determinants/Dimensions of a dividend policy'.

### **The following are the various factors that impact the dividend policy of a company**

The nature of industry to which the company belongs has an important effect on the dividend policy. Industries where earnings are stable may adopt a consistent dividend policy as opposed to the industries where earnings are uncertain and

uneven. They are better off in having a conservative approach to dividend payout

- **Ownership Structure:** The ownership structure of a company also impacts the policy. A company with a higher promoter' holdings will prefer a low dividend payout as paying out dividends may cause a decline in the value of the stock. Whereas, a high institutional ownership will favor a high dividend payout as it helps them to increase the control over the management.
- **Age of corporation:** Newly formed companies will have to retain major part of their earnings for further growth and expansion. Thus, they have to follow a conservative policy unlike established companies, which can pay higher dividends from their reserves.
- **Extent of Share Distribution:** A company with a large number of shareholders will have a difficult time in getting them to agree to a conservative policy. On the other hand, a closely held company has more chances in succeeding to finalize conservative dividend payouts
- **Different Shareholders' Expectations:** Another factor that impacts the policy is the diversity in the type of shareholders a company has. Different group of shareholders will have different expectations. A retired shareholder will have a different requirement vis-a-vis a wealthy investor. The company needs to clearly understand the different expectations and formulate a successful dividend policy.
- **Leverage:** A company having more leverage in their financial structure and consequently, frequent interest payments will have to decide for a low dividend payout. Whereas a company utilizing their retained earnings will prefer high dividends.
- **Future Financial Requirements:** Dividend payout will also depend on the future requirements for the additional capital. A company having profitable investment opportunities is justified in retaining the earnings. However, a company with no internal or external capital requirements should opt for a higher dividend.
- **Business Cycles:** When the company experiences a boom, it is prudent to save up and make reserves for dips. Such reserves will help a company declare high dividends even in depressing markets to retain and attract more shareholders.
- **Growth:** Companies with higher rate of growths, as reflected in their annual sales growth, ratio of retained earnings to equity and return on net worth, prefer high dividend payouts to keep their investors happy.
- **Changes in Government Policies:** There could be change in the dividend policy of a company due to the imposed changes by the government. Indian government had put temporary restrictions on companies to pay dividends during 1974-75.
- **Profitability:** The profitability of a firm is reflected in net profit ratio, current ratio and ratio of profit to total assets. A highly profitable company generally pays

higher dividends and a company with less or no profits will adopt a conservative dividend policy.

- **Taxation Policy:** The corporate taxes will affect dividend policy, either directly or indirectly. The taxes directly reduce the residual earnings after tax available for the shareholders. Indirectly, the dividend distribution is taxable after a certain limit.
- **Trends of Profits:** Even if the company has been profitable over the years, the trend should be properly analyzed to find the average earnings of the company. This average number should be then studied in relation to the general economic conditions. This will help in opting for a conservative policy if a depression is approaching.
- **Liquidity:** Liquidity has a direct relation with the dividend policy. If a firm has a strong liquidity and enough cash for its working capital, it can afford to pay higher dividends. However, a firm with less liquidity will choose a conservative dividend policy.
- **Legal Rules:** There are certain legal restrictions on the companies for dividend payments. It is legal to pay a dividend only if the capital is not reduced post payment. These rules are in place to protect creditors' interest.
- **Inflation:** Inflationary environments compel companies to retain major part of their earnings and indulge in lower dividends. As the prices rise, the companies need to increase their capital reserves for their purchases and other expenses.
- **Control Objectives:** The firms aiming for more control in the hands of current shareholders prefer a conservative dividend payout policy. It is imperative to pay less dividends to retain more control and the earnings in the company.

#### *Factors influencing dividend decisions:*

There are certain issues that are taken into account by the directors while making the dividend decisions:

- Free Cash Flow
- Signaling of Information
- Clients of Dividends

#### *Free Cash Flow Theory*

The free cash flow theory is one of the prime factors of consideration when a dividend decision is taken. As per this theory the companies provide the shareholders with the money that is left after investing in all the projects that have a positive net present value.

#### *Signaling of Information*

It has been observed that the increase of the worth of stocks in the share market is directly proportional to the dividend information that is available in the market about the company. Whenever companies announce that it would provide more dividends to its shareholders, the price of the shares increases.

#### *Clients of Dividends*

While taking dividend decisions the directors have to be aware of the needs of the various types of shareholders as a particular type of distribution of shares may not be suitable for a certain group of shareholders.

It has been seen that the companies have been making decent profits and also reduced their expenditure by providing dividends to only a particular group of shareholders

## CONCLUSION

In dividend decisions, the question is about decision-making and controlling power. The one who affects dividend decisions is doing it from the perspective of his/her own preferences. Controlling the corporation makes also it possible to control dividend decisions.

In particular, firms that have accumulated stockholders who prefer dividends to capital gains should continue to pay large, increasing dividends to keep their investor clientele happy. Furthermore, increasing dividends can operate as a positive signal to financial markets and allow a firm to change its financing mix over time.

The management of a company is completely free to frame the required dividend policy. There are no obligations to be adhered to. So, the company needs to judiciously weigh all the above-mentioned factors and formulate a balanced dividend policy. A dividend policy can also be revised in wake of changes in any of the factors.

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