UMESCHANDRA COLLEGE (MAIN CAMPUS)

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SUBJECT: FINANCIAL MANAGEMENT

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CHAPTER 9: DIVIDEND DECISIONS

DIVIDEND POLICY:

The decisions regarding the dividend payments to the shareholders of a company is a crucial area of financial management. Hence, a firm should frame an appropriate dividend policy that would maximise the wealth of its shareholders. According to Weston and Brigham,' Dividend policy determines the division of earnings between payments to shareholders and retained earnings'. Thus, the term 'dividend policy' refers to the policy concerned with the distribution of a portion of profits among the shareholders of the business firm. The power to declare dividends vests completely in the board of Directors of a company.

OBJECTIVES OF DIVIDEND POLICY:

The principal objectives of the dividend policy of a company are as follows

a. **Maximisation of owner's wealth:** the dividend policy of a company aims at the maximisation of wealth of the shareholders of the company. It is formulated not only to raise the share price during the short-run but also to maximise the owner's wealth in the long-run.
b. **Provision of sufficient funds for the future growth of the company:** The future growth of a company depends to a great extent on the availability of long term finance from the retained earnings of the company. There remains an inverse relationship between the present cash dividends and the retained earnings of the company. Thus, larger cash dividends would mean lesser amount of retained earnings which could be ploughed back for the future growth of the company.

NATURE OF DIVIDEND POLICY

1. **Tied up with the retention policy of the firm:** We have already shown that the dividend holding of a firm is closely tied up with its retention policy. Higher payments of dividends would mean lessor amount of retained earnings. Since the retained earnings can be used for the future expansion of the firm, so the dividend policy has an intimate relationship with the retention policy.
2. **Influence on the financial decisions of the firm**: The dividend policy of a firm has also an important bearing upon the financial decisions of a business enterprise. The firm has to depend on external sources of funds if its cash balance becomes insufficient to satisfy its needs after the payments of cash dividends.
3. **Influence on the share prices: The** dividend policy of a firm has also far reaching impact upon the growth rate of the firm, the share prices of the firm and the wealth of its existing shareholders. We have already noted that the shareholders assign higher weightage to the current dividend payment s compared to the future dividends and capital gains. Thus, higher payments of current dividends would attract the investors to purchase the shares of their company and it may lead to an enhancement in the market price of its shares. It would also mean an increase in the wealth of its shareholders.

4. **<u>Aiming at an optimum dividend policy</u>:** Considering the dividend policy as an active decision variable, the financial manager aims at framing an optimum dividend policy. A dividend policy is said to be at its optimum when, at any particular dividend pay-out ratio, the market price per share attains its maximum value.

   <u>FORMULATING A DIVIDEND POLICY:</u>

   The factors that should be considered in formulating a dividend policy of any business firm are stated below:

   1. Desires of shareholders
   2. Dividend clientele
   3. The dividend pay-out ratio
   4. Financial requirement of the company
   5. Liquidity position of the firm
   6. Stability of dividend
   7. Management's attitude towards control
   8. Magnitude and the trend of earnings of the firm
   9. The age of a firm
   10. Growth prospects of the firm
   11. Legal constraints
   12. Contractual requirement
   13. Tax policy of the government
   14. Condition of the capital market
   15. State of the economy

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