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BUSINESS FINANCE

Dividend Decision

The third important decision that every financial manager has to take relates to the distribution of dividend. Dividend is that portion of profit which is distributed to shareholders. The decision involved here is how much of the profit earned by company (after paying tax) is to be distributed to the shareholders and how much of it should be retained in the business for meeting the investment requirements. While dividend constitutes current income reinvestment as retained earning increases the firms future earning capacity. The extent of retained earnings, also influences the financing decision of the firm. Since the firm does not require finds to the extent of re-invested retained earnings, the decision regarding dividend should be taken keeping in view the overall objective of maximising shareholder's wealth. Factors Affecting Dividend Decision How much of the profits earned by a company will be distributed as profit and how much will be retained in the business is affected by many factors. Some of the important factors are discussed as follows:

(a) Earnings: Dividends are paid out of current and past earning. Therefore, earnings is a major determinant of the decision about dividend.

(b) Stability of Earnings: Other things remaining the same, a company having stable earning is in a position to declare higher dividends. As against this, a company having unstable earnings is likely to pay smaller dividend.

(c) Stability of Dividends: It has been found that the companies generally follow a policy of stabilising dividend per share. The increase in dividends is generally made when there is confidence that their earning potential has gone up and not just the earnings of the current year. In other words, dividend per share is not altered if the change in earnings is small or seen to be temporary in nature.

(d) Growth Opportunities: Companies having good growth opportunities retain more money out of their earnings so as to finance the required investment. The dividend in growth companies is, therefore, smaller, than that in the non– growth companies.

(e) Cash Flow Position: Dividends involve an outflow of cash. A company may be profitable but short on cash. Availability of enough cash in the company is necessary for declaration of dividend by it.

(f) Shareholder Preference: While declaring dividends, managements usually keep in mind the preferences of the shareholders in this regard. If the shareholders in general desire that at least a certain amount is paid as dividend, the companies are likely to declare the same. There are always some shareholders who depend upon a regular income from their investments.

(g) Taxation Policy: The choice between payment of dividends and retaining the earnings is, to some extent, affected by difference in the tax treatment of dividends and capital gains. If tax on dividend is higher it would be better to pay less by way of dividends. As compared to this, higher dividends may be declared if tax rates are relatively lower. Though the dividends are free of tax in the hands of shareholders a dividend distribution tax is levied on companies. Thus, under the present tax policy, shareholders are likely to prefer higher dividends.

(h) Stock Market Reaction: Investors, in general, view an increase in dividend as a good news and stock prices react positively to it. Similarly, a decrease in dividend may have a negative impact on the share prices in the stock market. Thus, the possible impact of dividend policy on the equity share price is one of the important factors considered by the management while taking a decision about it.

(i) Access to Capital Market: Large and reputed companies generally have easy access to the capital market and therefore may depend less on retained earning to finance their growth. These companies tend to pay higher dividends than the smaller companies which have relatively low access to the market.

(j) Legal Constraints: Certain provisions of the Company's Act place restrictions on payouts as dividend. Such provisions must be adhered to while declaring the dividends.

(k) Contractual Constraints: While granting loans to a company, sometimes the lender may impose certain restrictions on the payment of dividends in future. The companies are required to ensure that the dividends does not violate the terms of the loan agreement in this regard.