

SOS POLITICAL SCIENCE AND PUBLIC ADMINISTRATION

MBA FA 202

SUBJECT NAME: FUNDAMENTALS OF FINANCIAL MANAGEMENT

UNIT-V

TOPIC NAME: TYPES AND IMPORTANCE OF DIVIDEND POLICY

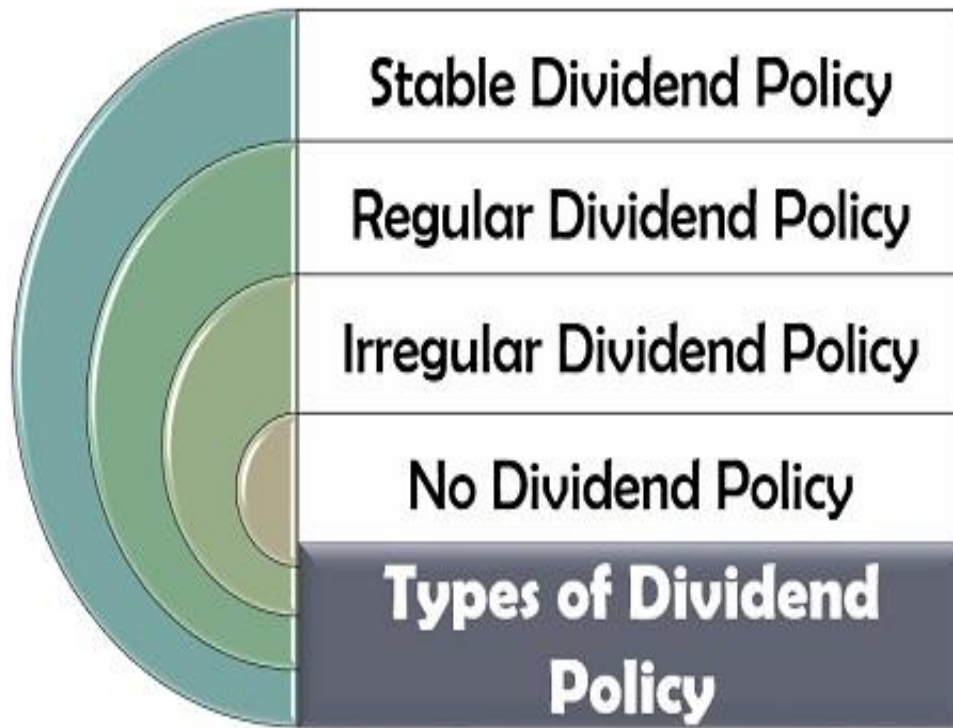
DIVIDEND POLICY

Definition: A dividend policy can be defined as the dividend distribution guidelines provided by the board of directors of a company. It sets the parameter for delivering returns to the equity shareholders, on the capital invested by them in the business. While taking such decisions, the company has to maintain a proper balance between its debt and equity composition. A dividend is nothing but the return declared to the equity shareholders through the distribution of a portion of profits earned by the organization.

Despite the suggestion that dividend policy is irrelevant, it is income for shareholders. Company leaders are often the largest shareholders and have the most to gain from a generous dividend policy. Dividends are often part of a company's strategy. However, they are under no obligation to repay shareholders using dividends.

TYPES OF DIVIDEND POLICY

What patterns do the companies follow while paying out dividends? The following categories of dividend policies provide the answer to the above question:



Stable Dividend Policy

In this policy, the company decides a fixed amount of dividend for the shareholders, which is paid periodically. There is no change in the dividend allowed even if the company incurs loss or generates high profit.

Regular Dividend Policy

Here, a certain percentage of the company's profit is allowed as dividends to the shareholders. When the gain is high, the shareholders' earnings will also hike and vice-versa. It is one of the most appropriate policies to be adopted for creating goodwill.

Irregular Dividend Policy

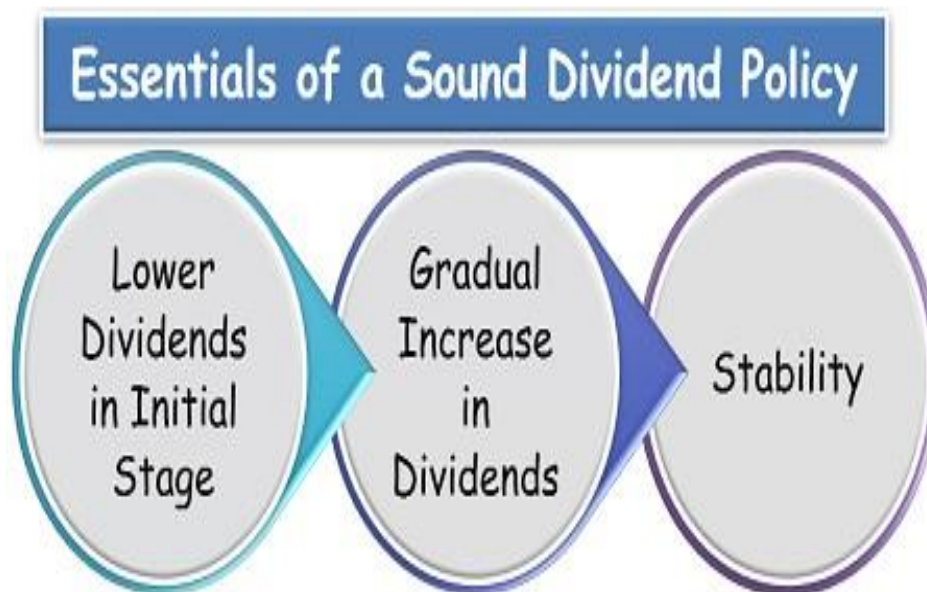
Under this changeable policy, the company may or may not pay dividends to the shareholders. The top management i.e., the board of directors solely take all dividend decisions, as per their priorities.

No Dividend Policy

Here, the company always retains the profits to fund further projects. Moreover, it has no intention of declaring any dividends to its shareholders. This strategy may seem to be beneficial for business growth but usually discourages the investors aiming for sustainable income.

ESSENTIALS OF A SOUND DIVIDEND POLICY

A company's dividend decisions and policy signify its future and financial well-being. Therefore, it needs to be systematically framed and implemented. Let us see the three essential steps to take flawless dividend decisions:



Lower Dividends in Initial Stage: When the company is at the beginning stage and earns little profit, it should still provide dividends to the shareholders, though less.

Gradual Increase in Dividends: As the company prosper and grow, the dividend should be kept on increasing proportionately, to build shareholders' confidence.

Stability: It is one of the crucial features of a superior dividend policy. When the company can survive in the market, it should ensure a stable rate of return in the form of dividends to its shareholders. This leads to retention of shareholders and gains investors' interest, all resulting in the enhancement of shares market value.

IMPORTANCE OF DIVIDEND POLICY

Dividend policy provides as a base for all capital budgeting activities and in designing a company's capital structure. A firm's dividend policy has the effect of dividing its net earnings into two parts: retained earnings and dividends. The retained earnings provide funds to finance the firm's long – term growth. It is the most significant source of financing a firm's investment in practice. Dividends are paid in cash. Thus, the distribution of earnings uses the available cash of the firm. A firm which intends to pay dividends and also needs funds to finance its investment opportunities will have to use external sources of financing, such as the issue of debt or equity. Following are some of the reasons for which dividend policy is essential in every business organization:

- Develop Shareholders' Trust
- Influence Institutional Investors
- Future Prospects
- Equity Evaluation
- Market Value Stability of Shares
- Market for Preference Shares and Debentures
- Degree of Control
- Raising of Surplus Funds
- Tax Advantage



**Importance
of Dividend
Policy**

Develop Shareholders' Trust:

When the company has a constant net earnings percentage, it secures a stable market value and pays suitable dividends. The shareholders also feel confident about their investment decision, in such an organization.

Influence Institutional Investors:

A fair policy means a strong reputation in the financial market. Thus, the company's strong market position attracts organizational investors who tend to leverage a higher sum to the company.

Future Prospects:

The fund adequacy for next project undertaking and investment opportunities is planned, decides its dividend policy such that to avoid illiquidity.

Equity Evaluation:

The value of stocks is usually determined through its dividend policy since it signifies the organizational growth and efficiency.

Market Value Stability of Shares: A suitable dividend policy means satisfied investors, who would always prefer to hold the shares for the long term. This leads to stability and a positive impact on the stocks' market value.

Market for Preference Shares and Debentures:

A company with the proficient dividend policy may also borrow funds by issuing preference shares and debentures in the market, along with equity shares.

Degree of Control:

It helps the organization to exercise proper control over business finance. Since, the company may land up with a shortage of funds for future opportunities, if the company distributes maximum profit as dividends.

Rising of Surplus Funds:

It also creates organizational goodwill and image in the market because of which the company becomes capable of raising additional capital.

Tax Advantage:

The tax rates are less on the qualified dividends, which are received as a capital gain when compared to the percentage of income tax charged.

EXAMPLE

A well known Indian company, 'Tata Chemicals Ltd.', listed on Bombay Stock Exchange, has a dividend policy to pay an annual return to its shareholders in the form of dividends.

The company also shares its intention of paying out special dividends on earning extraordinary profits or other events.

It has also listed all the factors which it considers while dividend decision-making process. These include past dividend payouts, investment opportunities, debt obligations, earnings, maintaining reserves for adverse situations, government policy, etc.