RAMA UNIVERSITY

www.ramauniversity.ac.in

FACULTY OF COMMERCE AND MANAGEMENT

COURSE: B.COM V SEM.

SUBJECT: FINANCIAL MANAGEMENT

SUBJECT CODE: BBA 303

LECTURE: 28

NAME OF FACULTY: DR. PALASH BAIRAGI

LECTURE-28

FACTORS DETERMINING DIVIDEND POLICY

1. Profitable Position of the Firm

Dividend decision depends on the profitable position of the business concern. When the firm earns more profit, they can distribute more dividends to the shareholders.

2. Uncertainty of Future Income

Future income is a very important factor, which affects the dividend policy. When the shareholder needs regular income, the firm should maintain regular dividend policy.

3. Contractual constraints

Often, the firm's ability to pay cash dividends is constrained by restrictive provisions in a loan agreement. Generally, these constraints prohibit the payment of cash dividends until a certain level of earnings have been achieved, or they may limit dividends to a certain amount or a percentage of earnings. Constraints on dividends help to protect creditors from losses due to the firm's insolvency. The violation of a contractual constraint is generally grounds for a demand of immediate payment by the funds supplier.

4. Internal constraints

The firm's ability to pay cash dividends is generally constrained by the amount of excess cash available rather than the level of retained earnings against which to charge them. Although it is possible for a firm to borrow funds to pay dividends, lenders are generally reluctant to make such loans because they produce no tangible or operating benefits that will help the firm repay the loan. Although the firm may have high earnings, its ability to pay dividends may be constrained by a low level of liquid assets. (Cash and marketable securities) We will take the previous example to explain this point. In our example, the firm can pay Rs.1, 40,000 in dividends. Suppose that the firm has total liquid assets of Rs.50, 000 (Rs.20, 000 cash +marketable securities worth Rs.30, 000) and Rs.35, 000 of this is needed for operations, the maximum cash dividend the firm can pay is 15,000 (Rs.50, 000 – Rs.35, 000)

5. Growth prospects

The firm's financial requirements are directly related to the anticipated degree of asset expansion. If the firm is in a growth stage, it may need all its funds to finance capital expenditures. Firms exhibiting little or no growth may never need replace or renew assets. A growth firm is likely to have to depend heavily on internal financing through retained earnings instead of distributing current income as dividends

6. Owner considerations

In establishing a dividend policy, the firm's primary concern normally would be to maximize shareholder's wealth. One such consideration is then tax status of a firm's owners. Suppose that if a firm has a large percentage of wealthy shareholders who are in a high tax bracket, it may decide to pay out a lower percentage of its earnings to allow the owners to delay the payments of taxes until they sell the stock. Of course, when the equity share is sold, the proceeds are in excess of the original purchase price, the capital gain will be taxed, possible at a more favorable rate than the one applied to ordinary income. Lower-income shareholders, however who need dividend income will prefer a higher payout of earnings. As of now, the dividend income is not taxed in the hands of the share holders in India. Instead, for paying out such dividends to its share holders, the company bears the dividend distribution tax.

7. Market Considerations

The risk-return concept also applies to the firm's dividend policy. A firm where the dividends fluctuate from period to period will be viewed as risky, and investors will require a high rate of return, which will increase the firm's cost of capital. So, the firm's dividend policy also depends on the market's probable response to certain types of policies. Shareholders are believed to value a fixed or increasing level of dividends as opposed to a fluctuating pattern of dividends.

8. Legal Constrains

The Companies Act 1956 has put several restrictions regarding payments and declaration of dividends. Similarly, Income Tax Act, 1961 also lays down certain restrictions on payment of dividends.

9. Liquidity Position

Liquidity position of the firms leads to easy payments of dividend. If the firms have high liquidity, the firms can provide cash dividend otherwise, they have to pay stock dividend.

10. Sources of Finance

If the firm has finance sources, it will be easy to mobilize large finance. The firm shall not go for retained earnings.

11. Growth Rate of the Firm

High growth rate implies that the firm can distribute more dividends to its shareholders.

12. Tax Policy

Tax policy of the government also affects the dividend policy of the firm. When the government gives tax incentives, the company pays more dividends.

13. Capital Market Conditions

Due to the capital market conditions, dividend policy may be affected. If the capital market is prefect, it leads to improve the higher dividend. Association provide any conditions, then it can pay bonus to its share holders in the form of cash. The dictionary meaning of bonus shares is a premium or gift, usually a stock, by a corporation to share holders. A Bonus share is neither dividend nor a Gift