

# Analyse the Factors Influencing Dividend Decisions

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**Abstract – Dividend policy has attracted greater attention at the global level over the last decade as it has significant effect on the performance of a firm or company enhancing the degree of attention worldwide. It has been considered as the most imperative financial decisions as per the consumers, employees, regulatory bodies and Government point of view. Dividend policy is very significant in managing the earnings of a firm or company; hence the decisions regarding the dividend policy have direct impact on the firm's credit standing, its share prices and the future growth in the business world. This conceptual paper researcher analyse the theories of dividend policy and factors affecting the dividend decisions.**

**Key Words: Dividend Policy, Dividend Decisions.**

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## INTRODUCTION TO DIVIDEND POLICY

The last decade has witnessed the increase in interests of investors management in the various matters related to dividend policy. It has a deep impact on the performance of the firm at the local and global market as well. The present chapter is the detail elucidation of the concepts related to dividend, dividend policy as well as factors influencing the dividend policy. The chapter also provides an impact of the theoretical perspectives that provides foundation for the preparation of guidelines related to dividend payments by the firms to the concerned shareholders in the present market. A proper dividend policy is required to retain the present shareholders to keep investing in the shares of the firm at the flexible prices and act as word-of-mouth communication for the other investors. A proper dividend policy is required for the long term sustainability of the firm in the market. The chapter provides an over view with regard to the basic and imperative aspects related to the dividend policy of the firms.

## MEANING OF DIVIDEND

Dividend generally defines the dissemination of economic reverts or earnings to the stockholders of any business institution. A study conducted by Kale and Noe stated that the dividend of a firm depicts the stability of its cash flow in future (Kale and Noe, 1990). Dividends are the compulsory distribution to the equity shareholders for taking risks pertaining to investments and time (Lipson et al., 1998). Dividends are the distribution of the past and the present earnings in terms of real assets among the shareholders of the firms as per their ownership in terms of investment in

shares or securities (Sruthi et al., 2017). Dividends could be described as the portion of the earnings by the firm or the enterprises, which is distributed among the stockholders in terms of interest on their investment. It reflects the return on investment made by the potential investors by taking risk in the company. The company gets capital to carry out its business activities and in return it gives them reward by way of dividend as well as encourage the other perspective investors to purchase new shares, stocks or securities at the higher price in the market (Ashum et al., 2018).

In the words of McLaney, dividends are the rewards in terms of distribution of income from present or past year as a determinant of the share price (McLaney, 1997). They do not only depict the regular channel for the transfer of corporate assets to stockholders. They directly represent the proportional division of corporate earnings to the shareholders with in the range of mustered net earnings in the current period (Saed, 2017). The dividends have the ability to be seen by the concerned shareholders who get them by way of interest payments and the management of the company who approves them to compensate the shareholders. The dividends are significant as they act as foundation to provide ample finance capital expenditure by incurring debts. They are basically from the net earnings with company and distributed per share. They symbolize the working capacity of the firm, efficiency to cope up with the changing environment and survive in the highly competitive environment. They are paid in regular cash on a quarterly basis and the company often tries to maintain their payments in the future as well. The payment of the dividends to the shareholders is often

made in comparison to the retained earnings of the firm or company.

## TYPES OF DIVIDEND

The dividends are the major proportions of the revenues that are paid to the shareholders or stockholders. The amount, which is to be divided among the shareholders that entirely depends upon the earnings of the firms and the final decision related to it is made by the board of directors of the particular business entity. The major types of Dividends, which are prevalent in the stock market are as (Arora, 2018, Gayathri, 2013, Merin, 2013):

- **Cash Dividend:** It is the most common types of dividend paid in the cash. In this kind of dividend, the amount of the dividend is assigned to the shareholders on the specified date of record and then the final payments are made on the date of payment. The cash is generated by the firms for paying the cash dividends to the shareholders as per their shares in the firms. The firms must have enough amount of retained earnings and then ample cash balance for making payments to the shareholders in cash. The stockholders have higher intensity of preference for the cash dividends. The firms also release the additional stock to utilize the proceeds, which are derived for making the payments of the cash dividends out of Earnings after interest and tax (EAIT).
- **Stock Dividend:** This kind of dividend is issued when a firm is unable to operate the cash but even then issue a common stock to keep the shareholders happy. The shareholders get extra shares in proportion to their already existing stocks issued to them by the firm and the shareholders are not supposed to pay extra for these bonus shares. The stock dividends have significant and direct effect on the concerned investors and this act as assertive long time good association of the shareholders with that firm. The payment is made in terms of the stock do not impact the cash and earnings of the firms and not even the ownership of the shareholders. There is transfer of the amount of the dividend from the additional earnings to the capital stock account, hence it increases the number of shares of the current shareholders but do not make any change in their equity.
- **Bond Dividend:** The bond dividend is somewhat similar to that of the scrip dividends but the major distinction is they carry a long maturity span and bear interest. They are also called as script dividends and is done when the firm lacks sufficient amount to pay back the cash dividend and the amount is paid by way of bond or notes to the shareholders.
- **Scrip Dividend:** These are paid when the firms are left with hardly any ample fund to make dividend payments in the near future. A firm generally offers the transferable promissory note to the shareholders, where it confirms the payment of the dividend on the specific future date. The scrip dividend has a comparatively shorter period of maturity and might or might not bear dividends. Such types of dividends are issued when firms don't have ample liquidity and need certain span for converting its current assets into the cash for the near future. It is generally paid to the shareholders at the later point of time.
- **Property Dividend:** Such dividends are paid by way of the property instead of cash. When the firms are unable to muster enough operating cash to pay off its shareholders, then it pays non-cash dividends to its investors. The property dividends could be in any of the form such as vehicles, real estate, inventory and the assets. The companies keep the track of the property given to its shareholders as dividend at the precise market value of the share. The firm also keeps track of the record of variation either as loss or gain.
- **Liquidating Dividend:** The Liquidating dividends are usually paid at the time of final stage of the firms in the real manner. The board of directors make decisions to pay back the original capital given by the equity shareholders in terms of the dividends is called as liquidating dividends. The entire calculation of the liquidating dividend is completely similar to that of the entries for the cash dividends.
- **Share Repurchase:** The repurchase of the share takes place as a firm gets its own shares back from the market and thus, reducing the numbers of shares outstanding as another option to pay back to the investors by the other way.

Hence, the dividend acts as a magnificent way to express the health and shareholder value of the firm.

## DIVIDEND POLICY

Every firm always aims at reverting adequately to their shareholders with the payout dividends. Dividend policy has attracted greater attention at the global level over the last decade as it has significant effect on the performance of a firm or company enhancing the degree of attention worldwide. It has been considered as the most imperative financial decisions as per the consumers, employees, regulatory bodies and Government point of view. Dividend policy is very significant in managing the earnings of a firm or company; hence the decisions

regarding the dividend policy have direct impact on the firm's credit standing, its share prices and the future growth in the business world as well as stock market (Sruthi et al., 2017). Dividend Policy is the decision taken by the finance managers whether a firm or company must disseminate or divide all of its profits or keep them or to divide a portion and keep the balance with them (Pandey, 1999). In the words of Garrison, the dividend policy is the payment made to the stockholders of the firm from their earnings and if those earnings were produced in the present period or in the previous periods (Garrison, 1999). It enables the investors to keep track of the company's capability to earn profitability (Narang, 2018).

The dividend policy of the firm has a short term as well as long run impact on the market rate of the shares. It is also said that dividend policy of the firms reflects the division between the dividend payouts and the retained earnings. It reflects the policy measure regarding the dividend declaration either in terms of stock dividends. The dividend policy of firms more often tries to strike a balance between the current income to the concerned shareholders and the income in near future (Kehinda and Abiola (2001). It reflects the larger cash expense on the part of the firms in the market. Dividend policy also specifies the payment policy formulated by the management while ascertaining the patterns and the sum of division to the concerned shareholders over a period of specific time. It represents the large cash expenses on the part of the firms. Dividend policy provides guidelines to balance the opposed force or factors that surround the dividend decision regarding to make payment or to retain the earnings from the profits earned by the firm. It is a very crucial decision to decide the ratio of payments to the shareholders because the main motive of the firm is to maximize the wealth of the its shareholders. So the financial managers have to keep it in consideration that their primary goal is the maximization of earnings of the shareholders. Hence, a strategic policy set up is required by the firm to prevent the surprises for the participants and protect the prices of shares of the firms.

## **DIVIDEND POLICY MODELS**

When the companies make profits and the management decides to distribute a share or the whole among the shareholders and retain few of them. There are some theories, which are the foundations for the formulation of dividend policies of the firms in the market and they are:

### **• Walter's Model or Theory on Dividend Policy**

Walter's theory or model related to dividend policy has faith in the relevance aspect of a dividend (Pal, 2019). As per the Model, the dividend decision taken by the company or a firm impacts its valuation. The companies or firms that make payments as higher dividends having more value in comparison to the

firms, which either pay lesser dividends or do not pay them at all. The entire concept of dividend policy has been explained by Walter in the Mathematical approach of share evaluation. As per Walter, the two factors which affect the share prices namely the dividend payout ratio of the particular firm as well as the association twixt the internal rate of return of the company as well as the cost of the capital. The model is based upon some pre-requisites that is a) Retained earnings are used to finance most of the investments and there is no issuance of the new equity and debt for the same; b) The earnings of the firms are either kept internally by the firms or distributed completely in the forms of dividends; c) The internal value of return ( $r$ ) and cost of capital ( $k$ ) of the firms are always supposed to be at constant value; d) The business risks have to remain same for almost entire decisions pertaining to investment; e) The dividends of the company and earnings in the beginning always remain the same and f) the company has a very long life. As per Walter, the dividend payout in relation to the Cost of Capital denoted by ' $K$ ' and Internal Rate of Return denoted by ' $r$ ' would have influence on the value of firm or company in numerous terms:

1. Association of  $r$  with  $k$  has a hike in the Dividend Payout Decrease in Dividend Payout
2.  $r > k$  (The firms' growth is featured by an internal rate of return  $>$  cost of the capital)
3. Value of the firm declines the Value of firm increases
4.  $r < k$  Declining companies have an intrinsic rate of return  $<$  cost of the capital
5.  $r = k$  Normal firms depict an intrinsic rate of return = cost of the capital
6. No change in the value of the firm and No change in the value of the firm. But the theory is also criticized on many grounds as the firms do not always have the exigency of external financing for the new requirements.

### **• Gordon's Theory on Dividend Policy (Baa, 2017)**

Gordon's Model on dividend policy entirely based on the concept of 'relevance of individuals. It is also reckoned as 'Bird-in-the-hand' approach, which defines that the current dividends of the firms are imperative to determine the firm's values. This model is one of the popular mathematical tools to ascertain the market value of the firm by using its dividend policy. The approach is entirely related to the market value of the firm to its dividend policy. The major factors that determine the market value of the share are the stream of the dividend payments likely to be made in the future, the estimated growth rate of the firm per annum and the cost of the capital. As per the

theory, the dividend payout policy of the company as well as the association between the cost of the capital (k) and rate of return affect the market price per share of the firm. The approach is based on certain assumptions which are a) the firm is an all equity firm without proration of debt in the whole capital structure; b) Retained earnings are used to finance all the investments of the firm and have no external financing as most requirement; c) the Internal Rate of Return (IRR) is always constant; d) the approach believes in the perpetual earnings for the company; e) this approach do not account for the Corporate taxes, f) k is always constant implying that business risks of the investments have to remain; g) the retention ratio is supposed to be same and h) the cost of capital (k) is always higher than the growth rate (g). The formula for calculating market price per share (P) is:  $P = \{EPS * (1 - b)\} / (k - g)$ .

Hence, the approach defines that the market value of firm's share is the aggregation of the current value of unlimited future dividends to be foregrounded. Hence, it could also be utilized to ascertain the cost of equity; if the market value of the firm is well acquainted, it could be useful to determine the future dividends. The approach is criticized due to its unrealistic assumptions.

#### • **Modigliani-Miller Theory on Dividend Policy (Baa, 2017)**

This approach is the foremost proponent of the "Dividend Irrelevance" apprehension in terms that the investors or potential customers do not play any imperative part to the entire past of the dividend of the particular company. Hence, the dividends are entirely irrelevant to ascertain the value of a firm deeming the dividends to be significant for determining the firms' value. The basic assumptions of the model are: a) taxes do not exist at all. Hence, both the capital gains as well as dividends are taxed at the same rate; b) The company does not change its existing investment policies, hence the new investments, which are financed with the firms' retained earnings do not change the rate of adequate return and the risk of the company; c) all the investors are thought are to be the rational being and there is no floating or the transaction costs. Hence, the large investors do not affect the market price of the existing share and d) all the potential investors are certain with regard to the market prices and the dividends. Hence, the same discount rate is applicable for all types of the stocks in all time period. The formula for calculating the value is  $= P_1 = P_0 * (1 + k) - D$ ;

Where  $P_1$  = Market price of the share at the end of the period

$P_0$  = Market price of the share at the beginning of the period

K = cost of capital

D = Dividends received at the end of a period

The approach of Modigliani – Miller of dividend policy is quite interesting and different in terms of valuation of the shares. This approach believes in the irrelevance of the dividends. Hence, it is criticized on certain grounds like the unrealistic assumption of the uncertainty; the perfect taxes are present in the capital markets; there exist no difference between the external and internal financing.

### **FACTORS AFFECTING DIVIDEND DECISIONS**

Livorika et al., have foregrounded several factors, which influence the dividend policy in terms of internal and external factors (Livorika et al., 2014). Klæe and Noe foregrounded cash flow considerations, after tax regime, liquidity earnings, and interests, past dividends practices, future growth projection and legal requirements as the major factors that influence dividend decisions of the investors (Kale and Noe, 1990). Management always try to ascertain the significant forces affecting the dividend payout decisions and try to include them in their strategy to get fruitful outcomes for the company as well as the investors. Twaijry conducted a study with 300 listed companies on the Kuala Lumpur Stock Exchange in Malaysia and revealed that firms' future earnings, its size, book value of share, size of the company and past earnings as the prominent factors impacting the dividend decisions (Twaijry, 2007).

- **Level of profitability:** The first and the foremost factor that influence the dividend decision is the level of profitability as it acts as the backbone to the business irrespective to its size. All the major business initiatives are undertaken on the basis of profitability of the firms and it has magnificent impact on the stability and dividend payout as well. When a firm has handsome earnings, it becomes possible for it to pay higher dividends to its shareholders who are the real owners of the firm (Najjar, 2009).
- **Entry to the capital market:** The large corporations with the higher rate of earnings and have quite ease to access to the capital markets as compare to the small corporations as well as the startups. These companies are capable of obtaining funds from the stock market. Moreover, the legal and contractual restrictions also play an important role in influencing the dividend decisions of the investors.
- **Awareness on the part of managers:** Awareness on the part of managers play an important role in influencing the investors (Moradi et al., 2010). The investors seek managers to acquire relevant information regarding the dividend policies so they want the managers' hands on with updated and

required information about the changing scenario of the market place. When the managers are capable ample to influence the potential investors, then the probability of making investment in a particular firm or entity increases.

- **The overall economy or cost of investment:** The level of earning is another factor that acts as word-of-mouth communication because the already existing investors could publicize the current situation of the company to the other investors and act as an important way to attract the new ones. During the period of profitability and prosperity, the management could be liberal to pay a genuine amount to profits to the shareholders. In case of the loss and period of depression, management might make decisions that are valuable for playing a significant part of the earnings with them in the way of retained earnings to overcome the situation and revive themselves in the future.
- **Expectations of the Shareholders:** The dividend rate is actually in context to meet the interests of the multiple shareholders. The shareholders while making investment decisions aim at reducing the echelon of uncertainty, increase his /her level of income and long term capital gains. The expectations of the shareholders are based upon their fiscal situations. The shareholders who have invested in the global firms prefer to replace the dividend with the higher income in the payroll list whereas the shareholders with the smaller income aims at increasing the level of their dividends.
- **Situation in the capital or stock market:** The situation or the condition of the capital market is prominent in affecting the dividend decisions of the potential investors. If the capital market or the stock market is stable and the companies face less price fluctuations; then the management has tendency to have more liberal dividend policy. In case the stock market is not stable and the companies have more price fluctuations then the conservative dividend policy is favored by the management.
- **Liquidity:** It is said that liquidity and dividend payout have the significant relationship as the liquidity position is regarded as the major determinant of the dividend payout (Ahmed and Javid, 2009, Komrattanapanya and Suntrauk, 2012). The dividend payments generally generate the cash outflows and could announce the higher dividends. As the firm passes through the process of development, it becomes difficult to offer dividends. The firms which are larger in size and has strong liquidity position pays more dividends.

- **Leverage and Earning Per share (EPS):** The companies with high leverage tend to protect their potential creditors as well as the cash out flows. The studies reveal the significant association between the leverage and dividend payout ratio. The firms with high leverage pay more dividends to their shareholders. As the dividends are payments made out of the net earnings with the firm, which is calculated by subtracting the interest, tax and depreciation from the total earnings and then divided over the number of shares to get the adequate outcome (Ahmed and Murtaza, 2015, Perreti et al., 2013).

## CONCLUSION

The study revealed that indicators like earning per share dividend yield, profitability aspects, return on equity return on asset were found having the highest impact on the dividend decision of the companies; followed by the financial risks aspects of financial leverage and asset volume. It was also revealed that companies with the fewer investment prospects as well as slow growth rate would pay more dividends as per the free cash flow. Significant association was found between the investment prospects of the firms and their dividend decision to attract the new investors in the stock market. Dividend policy provides guidelines to balance the opposed force or factors that surround the dividend decision regarding to make payment or to retain the earnings from the profits earned by the firm. It is a very crucial decision to decide the ratio of payments to the shareholders because the main motive of the firm is to maximize the wealth of the its shareholders. So the financial managers have to keep it in consideration that their primary goal is the maximization of earnings of the shareholders. Hence, a strategic policy set up is required by the firm to prevent the surprises for the participants and protect the prices of shares of the firms.

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