UNIT 83 – UPSC -Dividend policy

Dividend policy is an important element in financial management. This policy is associated with financial policies about paying cash dividend in the present or paying an increased dividend at a later stage. The term dividend denotes to that portion of profit which is distributed among the proprietors/shareholders of the firm. Whether to issue dividends, and what amount, is determined primarily on the basis of the company's unappropriated profit (excess cash) and influenced by the company's long-term generating revenues.

The word 'dividend' is derived from the Latin word "Dividendum" which means "that which is to be divided". This distribution is made out of the profits remained after deducting all expenses, providing for taxation, and shifting reasonable amount to reserve from the total income of the company (Agarwal, 2003). Institute of Chartered Accountants of India defined dividend as “a distribution to shareholders out of profits or reserves available for this purpose” (Guidance Notes on Term used in Financial Statements, 2003).

A company cannot announce dividend unless there is:

1. Sufficient profits
2. Board of Directors recommendation
3. An acceptance of the shareholders in the annual general meeting

Types of dividends:

1. Cash Dividend
2. Stock Dividend or Bonus Issue
3. Bond Dividend
4. Scrip Dividend or Promissory Note
5. Property Dividend

1. Cash Dividends: Such types of dividends are paid in cash, usually quarterly.

2. Stock dividend: Shareholders obtain new stock in the corporation as a form of a dividend. Like a “stock split”, the number of shares increases, but no cash changes hands. Bonus shares are therefore, shares allotted by capitalization of reserves or surplus of a corporate enterprise. Such shares are issued to the equity shareholders according to their holdings of the equity share capital of the company. But in India issue of stock dividend is not allowed. Dividend has to be paid in cash. According to SEBI's guidelines on issue of bonus shares, bonus shares cannot be issued in lieu of issue bonus shares frequently in addition to cash dividend.
3. Scrip Dividend: It is the dividend given in the form of promissory notes to pay the amount at a specific future date. The promissory note is known as scrip's or dividend certificates. When a company is a regular dividend paying company but temporarily its cash position is affected due to locking up of funds, which is likely to be released shortly, this opinion is preferred. Scrip may or may not be interest bearing.
4. Bond Dividend: When company do not have adequate money to pay dividend in cash, it may issue bonds for the amount due to the shareholders by way of dividends. It has longer maturity date than Scrip dividend. It always carries interest. Thus, bondholders get regular interest on their bonds besides payment of bond money on the due date. But this practice is not visualized in India nor legally permitted.
5. Property Dividend: In case of such dividend the company pays dividend in the form of assets other than cash. This may be in form of company's products. This type of dividend is not common in India.

Companies can announce both regular and “extra” dividends. Regular dividends generally remain unchanged in the future, but "extraordinary" or "special" dividends are unlikely to be repeated.

The term dividend policy denotes to the policy regarding quantum of profits to be distributed as dividend. The concept of dividend policy implies that companies through their Board of Directors evolve a pattern of dividend payments, which has a bearing on future action. According to Weston and Brigham, "Dividend policy determines the division of earnings between payments to shareholders and retained earning" (Kumar Arun and Sharma Rachana, 2004). Gitman stated that "The firm's dividend policy represents a plan of action to be followed whenever the dividend decision must be made (Kumar Arun and Sharma Rachana, 2004). The dividend policy of any company governs the amount of earnings is paid to shareholders by way of dividends and what proportion is ploughed back in the firm for reinvestment purposes. If a firm's capital budgeting decision is independent of its dividend policy, a higher dividend payment will call for a greater dependence on external financing. Consequently, the dividend policy has a bearing on the choice of financing. From other perspective, firm's capital budgeting decision is dependent on its dividend decision; a higher dividend payment will cause reduction of its capital budget and vice versa. In such case, the dividend policy has a bearing on the capital budgeting decision. The dividends are decided by the firm's board of directors and paid to the shareholders who are registered on the “record date”.

Objectives of Dividend Policy:

Dividend policy denotes to the decision of the board concerning distribution of residual earnings to its shareholders. The main objective of a finance manager is the maximization of wealth of the

shareholders. Payment of dividend leads to increase in the price of shares on the one hand but leads to a crux in liquid resources for financing of prospective projects. There is an inverse relationship between dividend payment and retained earnings.

I. Wealth Maximization: According to theoretical models, dividend policy has substantial impact on the value of the firm. Therefore the dividend policy should be developed keeping in mind the wealth maximization objective of the firm.
II. Future Prospects: Dividend policy is a financing decision and leads to cash outflows and also leads to reduction in availability of cash for financing of profitable projects. If sufficient funds are not available, a firm has to depend on external financing. Therefore the dividend policy must be devised in such a manner that potential projects may be financed through retained earnings.
III. Stable Rate of Dividend: Variation in the rate of return unfavourably affects the market price of shares. In order to have a stable rate of dividend, a firm should retain a high proportion of earnings so that the firm can keep adequate funds for payment of dividend when it faces loss.
IV. Degree of Control: Issue of new shares or dependence on external financing will decline the degree of control of the existing shareholders. Therefore, a more conservative dividend policy should be followed in order that the interest of existing shareholders is not hindered.

It can be established that dividend policy of the firm impact both the long-term financing and the prosperity of shareholders. Consequently, the firm's decision to pay dividends may be made as a long-term financing decision and as a wealth maximisation decision. Some financial scholars perceive dividends as irrelevant but this is not correct. In practice, every firm follows some kind of dividend policy. The typical dividend policy of most of the firms is to maintain a portion of the net earnings and distribute the remaining amount to shareholder.

Bulk of financial studies have demonstrated that dividend policy of a company develops some guidelines to be followed while deciding the amount of dividend to be paid out to the shareholders. The company needs to obey to the dividend policy while deciding the proportion of earnings to be distributed and the frequency of the distribution. There are various categories of dividend policies that include regular, stable, constant and irregular.

Factors affecting dividend policy:

1. Ownership Considerations
2. Firm Oriented Considerations
3. Nature of Business
4. Attitudes and Objectives of Management
5. Composition of Share Holding
6. Investment Opportunities
7. Desire for Financial Solvency and Liquidity
8. Regularity
9. Restrictions by Financial Institutions
10. Inflation

Other Factors that affect dividend policy are Age of the Company, The Demand For Capital Expenditure, Money Supply, and Tradition.

Determinants of dividend policy:

a. Type of Industry
b. Age of Corporation
c. Extent of share distribution
d. Need for additional Capital
e. Business Cycles
f. Changes in Government Policies
g. Trends of profits
h. Taxation policy
i. Future Requirements
j. Cash Balance.

Type of Industry: The nature of industry to which the company is associated has major impact on the dividend policy. Industries where earnings are stable, may espouse a consistent dividend policy in contrast to the industries where earnings are undefined and uneven. They are better off in having a conservative approach to dividend pay-out.

Determinants of dividend decisions ownership structure: The ownership structure of a company also affect the policy. A company with a higher promoter' holdings will prefer a low dividend pay-out as paying out dividends may cause a deterioration in the value of the stock. While, a high institutional ownership will favour a high dividend pay-out as it benefits them to increase the control over the management.

Age of corporation: Recently established companies will have to retain major part of their incomes for future development and expansion. Therefore, they have to follow a conservative policy dissimilar established companies, which can pay higher dividends from their reserves.

Extent of Share Distribution: A company with huge number of shareholders may face difficulty to agree them to follow a conservative policy. Instead, a closely held company has more chances in succeeding to finalize conservative dividend pay-outs.

Different Shareholders' Expectations: An important factor that has immense impact the policy is the multiplicity in the type of shareholders a company has. Different group of shareholders will have different anticipations. A retired shareholder will have a different requirement vis-a-vis a rich investor. The company needs to clearly understand the different beliefs and formulate an effective dividend policy.

Leverage: A company having more leverage in their financial structure and subsequently, frequent interest payments will have to decide for a low dividend pay-out. Whereas a company utilizing their retained earnings will prefer high dividends.

Future financial requirements: Dividend pay-out will also depend on the future necessities for the additional capital. A company having lucrative investment opportunities is reasonable in holding the earnings. However, a company with no internal or external capital requirements should opt for a higher dividend.

Business Cycles: When the company experiences a success, it is sensible to save up and make reserves for dips. Such reserves will help a company declare high dividends even in depressing markets to retain and attract more shareholders.

Growth: Companies experiencing higher rate of growths, as reflected in their annual sales growth, ratio of retained earnings to equity and return on net worth, choose high dividend pay-outs to keep their investors happy.

Changes in government policies: There could be change in the dividend policy of a company due to the compulsory changes by the government. Indian government had put temporary restrictions on companies to pay dividends during 1974-75.

Profitability: The productivity of a firm is reflected in net profit ratio, current ratio and ratio of profit to total assets. A highly profitable company usually pays higher dividends and a company with less or no profits will embrace a conservative dividend policy.

Taxation Policy: The corporate taxes also has considerable affect dividend policy, either directly or indirectly. The taxes directly decrease the residual earnings after tax available for the shareholders. Indirectly, the dividend distribution is taxable after a certain limit.

Trends of Profits: Experts indicated that whether company is getting continuous success and generating revenue over the years, the trend should be properly investigated to find the average earnings of the company. This average number should be then studied in relation to the general economic circumstances. This will aid in choosing a conservative policy if a depression is approaching.

Liquidity: Liquidity has a direct relation with the dividend policy. If a firm has a strong liquidity and sufficient money for its working capital, it can manage to pay for higher dividends. Conversely, a firm with less liquidity will choose a conservative dividend policy.

Legal Rules: In any country, there are some legal constraints on the companies for dividend payments. It is legal to pay a dividend only if the capital is not reduced post payment. These rules are formed to protect creditors' interest.

Inflation: Inflationary environments force companies to maintain major part of their earnings and indulge in lower dividends. As the prices increase, the companies need to increase their capital reserves for their purchases and other expenses.

Control Objectives: The firms that has aim to more control in the hands of current shareholders choose a conservative dividend pay-out policy. It is vital to pay less dividends to retain more control and the incomes in the company.

Types of Dividend Policies:

There are numerous dividend policies:

1. Stable Dividend Policy: Stability of dividend means similarity or no change in dividend payments over the years. It can be supposed that when a company pays dividend at a fixed rate and follows it for future years to come regardless of fluctuations in the level of earnings, it is said to be a stable dividend policy. Therefore, stability of dividends denotes to regular payment of dividend at a fixed rate. Stable dividend policy upsurges reliability

of the management in the market and shareholders also desire such stock giving minimum return at regular interval leads to increase in market price of shares. Those companies whose earnings are stable follow this policy. The stability of dividend is defined in two different ways that includes constant/fixed dividend per share and constant pay-out ratio.

1. Constant amount per share: In this policy, company pays fixed amount of dividend per share regularly, every year regardless of the earnings of the company. But it does not indicate that management has static nature and will adopt the policy for years to come. If the company's levels of earnings are augmented progressively and same level is to be maintained in the future then the dividend per share is increased correspondingly. This policy puts equity shares at par with preference shares which yields fixed dividend per share every year. Normally, this policy is chosen by those persons and institutions that depend upon the dividend income to meet their living and operating expenses.
2. Constant pay-out ratio: In this policy, a fixed percentage of net earnings are paid as dividend every year, that is, constant pay-out ratio.

2. Policy of No Immediate Dividend: This policy is devised as normally, management follows a policy of paying no immediate dividend in the inception because it requires funds for growth and development or they may be experiencing serious financial difficulties and may be incapable to pay dividend. In this case, the firm can decrease adverse effects on the stock price by carefully clarifying the reason for the removal of the dividend. After the, no dividend policy, it is sensible that the company should either issue bonus shares from its reserves or company's shares should be split into shares of small amount so that later on rate of dividend is maintained at a realistic rate.
3. Policy of Irregular Dividend: When the firm does not pay-out fixed dividend frequently, it is irregular dividend policy. It changes from year to year according to change in earnings level. This policy is based on the management conviction that dividends should be paid only when the earnings and liquid position of the firm warrant it. Firms having unbalanced earnings, particularly engaged in luxury goods adopt this policy.
4. Policy of Regular Dividend plus Extra Dividend: This policy is suitable for a firm with recurring earnings and restricted opportunities for growth. In a good earnings year, the firm would announce an extra dividend. The designation 'extra' is used in connection with the payment to tell the shareholders that this is extra and which might not be continued in future. When the earnings of the company have permanently increased, the extra dividend should be compounded with regular normal dividend and consequently, rate of normal dividend should be high.
5. Policy of Regular Dividend plus Stock Dividend: In this policy, company pays stock dividend along with the regular dividend. Consequently, the dividend is split into two parts. This policy is espoused when the company has earned huge profit and wants to give shareholders a share in the additional profit but wants to retain cash for development. It is not suitable to follow this policy for a long time, as the number of shares increases and the earning per shares reduces, which led to reduction in share price.

Theories of dividend policies:

Dividend policy is an important areas of corporate finance which must be analysed with a rigorous model. Many financial theorists developed different theoretical model to represent dividend policies. Major theories of dividend in financial management are as under:
1. Walter's model: The first theoretical model of dividend policy is Walter's theory on dividend policy which is the relevance concept of dividend. This notion of dividend policy articulate that a dividend decision of the company affects its valuation. The companies paying higher dividends have more value in comparison to the companies that pay lower dividends or do not pay at all. Additionally, Walter's theory clarifies this concept in a mathematical model (Pandey, 2009). James E Walter shaped a model for share valuation and he categorized two factors that influence the price of the share such as dividend pay-out ratio of the company and the relationship between the internal rate of return of the company and the cost of capital.

Assumptions of the Model: Walter's model is based on the following assumptions (Pandey, 2009):

I. Internal Financing: All the investments are financed by the firm through retained earnings. No new equity or debt is issued for the same.
II. Constant IRR and Cost of Capital: The internal rate of return (r) and the cost of capital (k) of the firm are constant. The business risks remain same for all the investment decisions.
III. Constant EPS and DPS: Beginning earnings and dividends of the firm never change. Though different values of EPS and DPS may be used in the model, but they are assumed to remain constant while determining a value.
IV. 100% Retention/ Pay-out: All the earnings of the company are either reinvested internally or distributed as dividends.
V. Infinite Life: The Company has an infinite.

Walter's Theory on Dividend Decisions: Valuation Formula and its Denotations: Walter's formula to calculate the market price per share (P) is:
$P = D/k + (r*(E-D)/k)/k$, where
P = market price per share
D = dividend per share
E = earnings per share
r = internal rate of return of the firm
k = cost of capital of the firm

Implications:

Walter's model has significant implications for firms in different levels of growth that are mentioned below:
1. Growth Firm: Growth firms are considered by internal rate of return > cost of the capital i.e. r > k. These firms will have excess profitable opportunities to invest. Due to this, the firms in growth phase can earn more return for their shareholders as compared to what the shareholders can earn if they reinvested the dividends. Therefore, for growth firms, the optimum pay-out ratio is 0%.
2. Normal Firm: Normal firms have internal rate of return = cost of the capital i.e. r = k. The firms in normal phase will make returns equal to that of a shareholder. Therefore, the dividend policy is not important in such situation. It will not impact on the market price of the share. So, there is no optimum pay-out ratio for firms in normal phase. Any pay-out is optimum.

3. Declining Firm: Declining firms have internal rate of return < cost of the capital i.e. r < k. Declining firms make returns that are less than what shareholders can make on their investments. So, it is not recommended to hold the company's earnings. Actually, the best setting to maximize the price of the share is to distribute whole earnings to their shareholders. The optimum dividend pay-out ratio, in such situations, is 100%.

Criticism of Walter's Model:

Walter's theory is criticized for the following impractical assumptions in the model:

1. No External Financing: Walter's assumption of complete internal financing by the firm through retained earnings is problematic to follow in the actual world. The firms do need external financing for new investments.
2. Constant r and k: It is very unusual to find the internal rate of return and the cost of capital to be constant. The business risks will certainly change with more investments which is not revealed in this assumption.

Though Walter's theory has some improbable assumptions, it follows the notion that the dividend policy of a company has an effect on the market price of its share. It elucidates the impact in the mathematical terms and finds the value of the share.

2. Gordon's model:

Gordon's theory on dividend policy is also significant. It rests upon the belief of the 'relevance of dividends' concept. It is also called as 'Bird-in-the-hand' theory that asserts that the current dividends are important in determining the value of the firm. Gordon's model is mathematical models to compute the market value of the company using its dividend policy (Pandey, 2009). Gordon's model clearly relates the market value of the company to its dividend policy. The factors of the market value of the share are the perpetual stream of future dividends to be paid, the cost of capital and the expected annual growth rate of the company. The Gordon's theoretical structure on dividend policy upholds that the company's dividend pay-out policy and the relationship between its rate of return (r) and the cost of capital (k) influences the market price per share of the company.

Assumptions of the Model:
Gordon's theoretical model of dividend policy is based on the following assumptions:

1. No Debt: The model adopts that the company is an all equity company, with no proportion of debt in the capital structure.
2. No External Financing: The model assumes that all investment of the company is financed by retained earnings and no external financing is required.
3. Constant IRR: The model assumes a constant Internal Rate of Return (r), ignoring the diminishing marginal efficiency of the investment.
4. Constant Cost of Capital: The model is based on the postulation of continuous cost of capital (k), implying the business risk of all the investments to be the same.

5. Perpetual Earnings: Gordon's model considers in the theory of unending earnings for the company.
6. Corporate Taxes: Corporate taxes are not accounted for in this model.
7. Constant Retention Ratio: The model assumes a constant retention ratio (b) once it is decided by the company. Since the growth rate (g) = b*r, the growth rate is also constant by this logic.
8. K>g: Gordon's model assumes that the cost of capital (k) > growth rate (g). This is important for obtaining the meaningful value of the company's share.

Valuation Formula and its Denotations:
Gordon's formula to compute the market price per share (P) is as follows:
P = {EPS * (1-b)} / (k-g)
Where,
P = market price per share
EPS = earnings per share
b= retention ratio of the firm
(1-b) = pay-out ratio of the firm
k = cost of capital of the firm
g = growth rate of the firm = b*r

Implications:

Gordon's model considers that the dividend policy has impact on the company in various scenarios that are mentioned below:

1. Growth Firm: A growth firm's internal rate of return (r) > cost of capital (k). It is advantageous to the shareholders more if the company invests the dividends instead of distributing it. So, the optimum pay-out ratio for growth firms is zero.
2. Normal Firm: A normal firm's internal rate of return (r) = cost of the capital (k). So, it does not make any difference if the company reinvested the dividends or distributed to its shareholders. There is no optimum dividend pay-out ratio for normal firms.
3. Declining Firm: The internal rate of return (r) < cost of the capital (k) in the declining firms. The shareholders get advantage if the dividends are distributed rather than reinvested. So, the optimum dividend pay-out ratio for declining firms is 100%.

Criticism of Gordon's Model:

Many financial theorists criticized the principles of Gordon's theory on dividend policy. It is critiqued mainly for the impractical assumptions made in the model.

1. Constant Internal Rate of Return and Cost of Capital: The model is imprecise in assuming that r and k always remain constant. A constant r means that the wealth of the shareholders is not improved. A constant k means the business risks are not accounted for while valuing the firm.
2. No External Financing: Gordon's philosophy of all investments being financed by retained earnings is defective. This mirrors sub-optimum investment and dividend policies. Gordon's theory of dividend policy is one of the conspicuous theories in the valuation of

the company. Though it comes with its own limitations, it is a broadly accepted model to define the market price of the share using the predicted dividends.

3. 3. Modigliani and Miller's hypothesis: Modigliani and Miller theory is a major supporter of 'Dividend Irrelevance' concept. This theoretical concept denotes that investors do not give more importance to the dividend history of a company and therefore, dividends are immaterial to calculate the valuation of a company. This theory is in direct contrast to the 'Dividend Relevance' theory which believes dividends to be important in the valuation of a company (Pandey, 2009).
   Modigliani and Miller theory was suggested by Franco Modigliani and Merton Miller in 1961. They were the innovators in suggesting that dividends and capital gains are equivalent when an investor considers returns on investment. The factor that impacts the valuation of a company is its earnings, which is a direct result of the company's investment policy and the future forecasts. This theory reveals that once the investment policy is identified to the investor, he will not need any further input on the dividend history of the company. The investment decision is, thus, dependent on the investment policy of the company and not on the dividend policy.
   Miller theory exemplifies the practical situations where dividends are not pertinent to investors. Regardless of whether a company pays a dividend or not, the investors are capable enough to make their own cash flows from the stocks depending on their need for the cash. If the investor needs more money than the dividend he received, he can always sell a part of his investments to make up for the difference. Similarly, if an investor has no present cash requirement, he can always reinvest the received dividend in the stock. This theory also infers that the cost of debt is equal to the cost of equity as the cost of capital is not affected by the leverage.

Assumptions of the Model:

Modigliani - Miller theory is based on the following assumptions:

1. Perfect Capital Markets: This theory considers in the presence of 'perfect capital markets'. It assumes that all the investors are sensible, they have access to free information, and there are no floatation or transaction costs and no large investor to influence the market price of the share.
2. No Taxes: There is no existence of taxes. Otherwise, both dividends and capital gains are taxed at the same rate.
3. Fixed Investment Policy: The Company does not change its current investment policy. This means that new investments that are financed through retained earnings do not change the risk and the rate of required return of the firm.
   No Risk of Uncertainty: All the investors are certain about the future market prices and the dividends. This means that the same discount rate is applicable for all types of stocks in all time periods.

Valuation Formula and its Denotations:
Modigliani - Miller's valuation model is based on the assumption of same discount rate / rate of return applicable to all the stocks.
P1 = P0 * (1 + k) – D

Where,
P1 = market price of the share at the end of a period
P0 = market price of the share at the beginning of a period
k = cost of capital
D = dividends received at the end of a period

Disapproval of Modigliani Miller's Model:
Modigliani - Miller theory on dividend policy has been criticized on following grounds:

1. Perfect capital markets do not exist. Taxes are present in the capital markets.
2. This theory indicates that there is no difference between internal and external financing. However, if the flotation costs of new issues are considered, it is incorrect.
3. This theory considers that the shareholder's wealth is not impacted by the dividends. Though, there are transaction costs related with the selling of shares to make cash inflows. This makes the investors choose dividends.
4. The assumption of no uncertainty is unrealistic. The dividends are pertinent under the certain conditions as well. It has been documented that Modigliani - Miller theory of dividend policy is different approach to the valuation of shares. It is a prevalent model which considers in the irrelevance of the dividends. Nonetheless, the policy has many drawbacks.

Dividend policy in India:

The main features of dividend policy in India are as follows (Manoj Ananad, 2003):

1. Most of the corporates have a policy of dividend for long run pay-out ratio.
2. Dividend changes follow shift in the long term sustainable earning.
3. Dividend policy as a residual decision after meeting the desired investment needs is endorsed by about 50% of the sample corporates. The corporates which are creating shareholder value significantly rescind dividend increase in the event of growth opportunities available to them. Large firms are considerably less willing to rescind dividend increases.
4. Dividend policy provides a signalling mechanism of the future prospects of corporate and to that exact affects in market share.
5. Investors have different relative risk perceptions of dividend income and capital gains and are not indifferent between receiving dividend income and capital gains. Management should be responsive to the shareholders preferences regarding dividend and the share buyback program should not replace the dividend payment of corporates.
6. Dividend payments provide a bonding mechanism so as to encourage manager to act in the best interest of shareholders.
7. The corporate enterprises of India seem to have a tendency to pay comparatively less dividends. In fact, large number of them hardly pay any dividend. The foreign controlled companies seem to follow a policy of larger distribution of profits relative to the domestic companies. Retained earnings are significant source of corporate finance.

8. Majority of Indian corporates follow a stable dividend policy in the sense that they pay either constant dividend per share in the following year with fluctuating EPS or increased dividend with increase in EPS.
9. The vast majority of corporates have long run target DIP ratio. The dividend charges follow shift in long run sustainable earnings. Their dividend policy is in agreement with the findings of Lintner's study on dividend policy.
10. Firms which are creating shareholder values are significantly more willing to rescind dividend increase in the event of growth opportunity available to them. Big firms are significantly less willing to rescind dividend increase than small firms.

Advantages dividend policy:

There are many advantages of dividend policy from the viewpoint of shareholders as well as company:

1. Resolution of investor's uncertainty: When a company follows a policy of stable dividends, it will not change the amount of dividend if there are momentary changes in the earnings, Thus, when the earnings of a company fail and it continues to pay same amount of dividend as in the past, it conveys to investors that the company is secure in future than suggested by drop in earnings.
2. Investor's desire for current income: The investors who desire (old and retired persons, women, children) to receive a regular dividend income, will prefer a company with stable dividends to one with fluctuating dividends.
3. Institutional investors' requirements: The financial institutions like IFC, IDBI, LIC and UTI usually invest in the shares of those companies which have a record of paying regular dividends.
4. Raising additional finances: An established dividend policy is also beneficial to the company to raise external finances. Stable and regular dividend policy tends to make the shares of a company and investment rather than a speculation.
5. The loyalty finds goodwill of shareholders towards the company increases with a stable dividend policy.

Disadvantages of stability of dividends:

There are many limitations of dividend policy. Stability of dividends has the following risks, once the stable dividend policy is adopted. It cannot be changed without seriously affecting investors' attitude and the financial standing of the company. A cut in dividend is considered as a cut in ‘Salary’. Because of the serious depressing effect on investors due to a dividend cut, the directors have to maintain constancy of dividends during lean years even though financial prudence would specify removal of dividends or a cut in it.

To summarize, the dividend policy of a firm is a major aspect of corporate financial management. Basically, dividends signify the source of cash flow for stockholders and provide information about firm’s performance. Important feature of dividend theory is to determine the amount of earning to be distributed to shareholders and the amount to be retained in firm (Pandey, 2009). Retained earnings are significant internal source of financing and growth of firm.