Need and Importance of Dividend Policy for Shareholders

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Abstract

The relevance of dividend policy as a promoter in major firms has been demonstrated over the world. Corporations are the backbone of the economy as a whole, a major source of employment, and the economy's greatest taxpayer. Cash dividends appear to be the most popular form of distribution in worldwide firms in recent years. In the market, we may encounter firms that do not pay cash dividends or do not pay any dividends at all. In today's market economy, corporations view the choice to pay dividends as critical since it identifies the residual cash flow available for reinvestment and the cash flow allocated to shareholders. A consistent dividend policy sends a favorable message to shareholders and might be seen as good business success. The link between corporate governance and economic efficiency is becoming more generally recognized across the world. Corporate openness and disclosure are regulated in all corporate governance principles across the world. To external investors, companies provide a variety of reports and announcements. One of the most crucial pieces of information for shareholders is the dividend policy.

Keywords: *Dividend policy; Shareholders; Earnings; Shares.*

I. INTRODUCTION

As a dividend, firms distribute a portion of their profits to their shareholders. It is the company's policy to determine how much dividends are paid out and how much money is saved for future investments. There is a strong belief that shareholders get a set dividend. It is considered a readily accessible source of capital for investment purposes. Both acceptable dividend payments and a short-term maintenance of profits should be guaranteed by the firms in this way. My head is spinning at the interplay between capital structure and dividend policy. The company's value might rise or fall as a result of the increased dividend payout, or the source of financing could become more expensive as a result. Long-term financing and shareholder value are both impacted by dividend selections. However, in certain organisations, changes in capital structure may have little or no effect on dividend choices. The term "dividend policy" refers to how much money will be distributed to shareholders in the form of dividends over the course of a year or two. The administration's primary goal is to increase shareholders' wealth, which translates into increasing the value of the organization's basic stock.

According to Richard, "Capital structure" refers to the financial framework through which a corporation's assets are funded. Long-term and short-term borrowings, the sale of appreciated and common shares, and the reinvestment of profits are all sources of this capital "As a matter of fact, The current moment is usually banned from account when breaking down a company's capital structure, he said, while several other companies only include long-term funding sources in their capital structures.

II. IMPORTANCE OF DIVIDEND POLICY

The dividend policy serves as the foundation for all capital budgeting and capital structure design efforts. A company's dividend policy divides its net earnings into two categories: retained earnings and dividends. The retained earnings are used to fuel the company's long-term expansion. It is the most important source of funding for a firm's practice investment. Cash dividends are paid. As a result, the earnings distribution makes use of the company's capital. A company that wants to pay dividends while simultaneously needing money to support its investment prospects will have to turn to other sources of funding, such as debt or stock offerings. The following are some of the reasons why a dividend policy is necessary in any corporation.

- **Develop Shareholders' Trust**

When a company's net profits % remains consistent, it maintains a steady market value and pays appropriate dividends. In such an organisation, the shareholders are likewise confident in their investment choice.

- **Influence Institutional Investors**

A great reputation in the financial industry comes with a fair policy. As a result, the business's strong market position attracts institutional investors who are willing to lend the company a larger sum.

- **Future Prospects**

The fund sufficiency for the next project endeavor and investment prospects is planned, and the dividend policy is decided so that illiquidity is avoided.

- **Equity Evaluation**

The value of a company's stock is largely defined by its dividend policy, which represents the company's growth and efficiency.

- **Market Value Stability of Shares**

Investors who are happy with the dividend policy are more likely to retain the stock for the long run. This results in stability and a beneficial influence on the market value of the equities.

- **Market for Preference Shares and Debentures**

Along with equity shares, a corporation with a good dividend policy might borrow money by issuing preference shares and debentures in the market.

- **Degree of Control**

It aids the corporation in maintaining effective financial control. If the corporation distributes the maximum profit as dividends, the company may run out of capital for future chances.

- **Tax Advantage**

When compared to the proportion of income tax levied, qualifying dividends received as a capital gain have lower tax rates.

III. VARIABLES OF DIVIDEND POLICY

The dividend policy is quantified using the following variables.

- **Earning per shares**

Shares that represent a significant amount of an organization's net worth. The profitability of a company may be gauged by looking at its earnings per share. It is widely accepted that earnings per share are the most important factor in determining a Share's value. It is also a significant factor in calculating the cost-to-earnings valuation ratio. Determined as

$$\text{Earnings Per Share} = \frac{\text{Net Income - Dividends on Preferred Stock}}{\text{Average Outstanding Shares}}$$

- **Dividend per share**

The sum of declared dividends for every ordinary share issued. Dividend per share (DPS) is the total dividends paid out over an entire year (including interim dividends but not including special dividends) divided by the number of outstanding ordinary shares issued. Dividend per share can be calculated by using the following formula:

$$\text{Dividend Per Shares} = \frac{D - SD}{S}$$

D - Sum of dividends over a period (usually 1 year) sd - special, one time dividends

S - Shares outstanding for the period

- **Retained earnings**

It is the net profit earned by the company after deducting all expenses like interest, depreciation and tax. Profit after tax can be fully retained by a company to be used in the business. However dividend is paid to the shareholders from this residue.

- **Dividend yield shares**

Dividend yield is used to calculate the earnings on investment (shares) considering only the returns in the form of total dividends declared by the company during the year. The dividend yield is calculated using the following formula:

$$\text{Dividend Yield} = \frac{\text{Annual Dividends Per Share}}{\text{Price Per Share}}$$

- **Market Price Per Share**

The market cost of a stock is the latest cost at which the stock was exchanged which depends on the information from an organization's asset report. The market cost per share is a financial metric that speculators use to decide if to buy a stock. An organization's reasonable worth for each share is characterized as the organization's surveyed market value dividend by the total number of shares held by stock owners of the organization.

$$\text{Market price per share} = \frac{\text{Net Income - Preferred Dividends}}{\text{Number of Shares of Common Shares Outstanding}}$$

IV. THEORIES OF DIVIDEND POLICY

1. Irrelevance Theory

According to irrelevance theory dividend policy do not affect value of firm, thus it is called irrelevance theory.

- **Residual Theory**

Dividend policy, according to this argument, has no impact on the wealth of shareholders or the values of their shares, and hence is irrelevant to the firm's valuation. Because the earnings available can be maintained in the firm for reinvestment, this approach views dividend policy as just a financial option. If the money aren't needed for the firm, they might be dispersed as a dividend. As a result, the option to pay dividends or keep earnings might be considered a residual decision.

- **Modigliani & Miller Approach (MM Approach)**

According to Modigliani-Miller, a company's dividend policy has no bearing on its value. According to this viewpoint, the market price of a share is determined by the firm's earnings on its investment rather than the dividend paid. The firm's earnings, which affect its value, are also influenced by the investment options accessible to it.

2. Relevance Theory

According to relevance theory dividend policy affects value of firm, thus it is called relevance theory.

- **Walter's Model**

The worth of a company is determined by its earnings level, dividend payout, constant reinvestment rate, and the shareholder's projected rate of return, according to Walter's Model. According to the concept, a company's dividend policy is determined by whether or not it offers attractive investment prospects. If the company does not have adequate investment prospects, it will issue a dividend; otherwise, the money will be kept. If the company distributes a dividend, shareholders can invest the money to increase their returns. The opportunity cost to the company, often known as the cost of capital (k_e), is the projected return on reinvestment of dividend income by shareholders. If, on the other hand, no dividend is given, the company will reinvest the remaining earnings in order to continue growing. The predicted rate of return on retained profits is referred to as rate of return (r).

- **Gordon's Model**

According to Gordon's Model, a company's dividend policy is important and can influence its value. The worth of the business under this strategy, like Walter's Model, is determined by the reinvestment rate (r) and shareholder expectations (k_e). This is predicated on the assumption that most investors are risk averse and prefer current income, such as dividends. As a result, there is a clear link between dividend policy and a company's worth.

V. CONCLUSION

Dividends to shareholders serve as compensation for management and staff. Nobody will put their money into a firm that does not provide a return on investment. Dividends are the primary driving element for many investors when deciding whether or not to invest in specific sectors or companies. Companies should give dividends at regular periods and in particular quantities to build a reputation in society. On the one hand, this provides management with possibilities to keep shareholders satisfied.

Dividends should be proportionate to company earnings. To make it easier for managers to maintain a good debt/equity ratio, it should not surpass the amount of profit for the year.

Since dividend decisions are so significant nowadays, it's crucial to keep them in mind whether your firm is operating at a loss or with a smaller profit margin. Various aspects must be considered when calculating dividend distribution, including the dividend effect on the company capital structure, the economy in which the corporation works, and business strategy, including the so-called six sites dice (cube). The dividend policy chosen may be influenced by shareholder preferences. Dividends in shares are frequently connected with cash payments. The challenge for all organisations throughout the world is deciding how to distribute the money created, whether it should be invested in the company or given to shareholders, while constantly considering the impact on the stock price of the dividend policy option. The impact of dividend policy on current stock prices is a critical consideration for dividend policymakers as well as investors constructing their financial portfolios.

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