Theoretical Position

Theoretically, a company should retain earnings rather than distribute them when the corporate return exceeds the return investors can obtain on their money elsewhere. Further, if the company obtains a return on its profits that exceeds the cost of capital, the market price of its stock will be maximized.

Capital gains arising from the appreciation of the market price of stock has a tax advantage over dividends. On the other hand, a company should not, theoretically, keep funds for investment if it earns less of a return than what the investors can earn elsewhere. If the owners have better investment opportunities outside the firm, the company should pay a high dividend.

Although theoretical considerations from a financial point of view should be considered when setting dividend policy, the practicality of the situation is that investors expect to be paid dividends. Psychological factors come into play which may adversely affect the market price of the stock of a company that does not pay dividends.)

FACTORS THAT INFLUENCE DIVIDEND POLICY

A firm's dividend policy is a function of many factors, some of which have been described. Other factors that influence dividend policy are as follows:

1. *Company growth rate.* A company that is rapidly growing, even if profitable, may have to restrict its dividend payments in order to keep needed funds within the company for growth opportunities.

2. *Restrictive covenants.* Sometimes there is a restriction in a credit agreement that will limit the amount of cash dividends that may be paid.

3. *Profitability.* Dividend distribution is keyed to the profitability of the company.

4. *Earnings stability.* A company with stable earnings is more likely to distribute a higher percentage of its earnings than one with unstable earnings.

5. *Maintenance of control.* Management that is reluctant to issue additional common stock because it does not wish to dilute its control of the firm will retain a greater percentage of its earnings. Internal financing enables control to be kept within.

6. *Degree of financial leverage.* A company with a high debt-to-equity ratio is more likely to retain earnings so that it will have the needed funds to meet interest payments and debts at maturity.

7. *Ability to finance externally.* A company that is capable of entering the capital markets easily can afford to have a higher dividend payout ratio. When there is a limitation to external sources of funds, more earnings will be retained for planned financial needs.

8. *Uncertainty.* Payment of dividends reduces the chance of uncertainty in stockholders' minds about the company's financial health.

9. *Age and size.* The age and size of the company bear upon its ease of access to capital markets.

10. *Tax penalties.* Possible tax penalties for excess accumulation of retained earnings may result in high dividend payouts.

L.MURALIDHARAN
09444048990