DIVIDEND POLICY

A finance manager's objective for the company's dividend policy is to maximize owner wealth while providing adequate financing for the company. When a company's earnings increase, management does not automatically raise the dividend. Generally, there is a time lag between increased earnings and the payment of a higher dividend. Only when management is confident that the increased earnings will be sustained will they increase the dividend. Once dividends are increased, they should continue to be paid at the higher rate. The various types of dividend policies are:

1. Stable dividend-per-share policy. Many companies use a stable dividend-per-share policy since it is looked upon favorably by investors. Dividend stability implies a low-risk company. Even in a year that the company shows a loss rather than profit the dividend should be maintained to avoid negative connotations to current and prospective investors. By continuing to pay the dividend, the shareholders are more apt to view the loss as temporary. Some stockholders rely on the receipt of stable dividends for income. A stable dividend policy is also necessary for a company to be placed on a list of securities in which financial institutions (pension funds, insurance companies) invest. Being on such a list provides greater marketability for corporate shares.

2. Constant dividend-payout-ratio (dividend per share/earnings per share) policy. With this policy a constant percentage of earnings is paid out in dividends. Because net income varies, dividends paid will also vary using this approach. The problem this policy' causes is that if a company's earnings drop drastically or there is a loss, the dividends paid will be sharply curtailed or nonexistent. This policy will not maximize market price per share since most stockholders do not want variability in their dividend receipts.

3. A compromise policy. A compromise between the policies of a stable dollar amount and a percentage amount of dividends is for a company to pay a low dollar amount per share plus a percentage increment in good years. While this policy affords flexibility, it also creates uncertainty in the minds of investors as to the amount of dividends they are likely to receive. Stockholders generally do not like such uncertainty. However, the policy may be appropriate when earnings vary considerably over the years. The percentage, or extra, portion of the dividend 8hould not be paid regularly; otherwise it becomes meaningless.

4. Residual-dividend policy. When a company's investment opportunities are not stable, management may want to consider a fluctuating dividend policy. With this kind of policy the amount of earnings retained depends upon the availability of investment opportunities in a particular year. Dividends paid represent the residual amount from earnings after the company's investment needs are fulfilled.