Dividends are simply the residual net cash inflows which cannot be re-invested and therefore their amount depends exclusively on the Company's investment decisions. Equity holders expect the company to find and execute the best possible investment strategy. The simplest policy for a company to follow on dividend is, first pay out as dividend to equity holders as cash which is not immediately needed to finance worthwhile investments; and secondly when additional finance is needed, immediately issue new equity to the required extent. This may be possible in case of certainty and perfect markets. In a world of uncertainty and less than perfect markets, the dividend decision is not so straightforward. The company is restricted in its freedom of action partly by company law, partly by other government regulations and partly by particular circumstances of the
company such as its equity. Equity holders might themselves become accustomed to receiving certain portions of dividend in certain frequencies may be half yearly or a year but any dramatic change will have its repercussions. In case the rate of dividend or frequency is increased any adverse deviations will affect the share price.

The question on dividend policy is to some extent controversial. Essential market reaction will depend on how a market values a company. In a perfect market, dividend policy does not really matter because the equity holders can always adjust the pattern of cash flow from the company to his desired consumption pattern by buying or selling equity on the market.

There are five ways in which dividend policy affects the share price.

Firstly, equity holders will value earlier dividends at higher rate than later dividends, because the later dividends are risky.
Secondly, short term market fluctuations make it difficult for investors to adjust their income pattern to their desired consumption pattern.

Thirdly, dividends convey information about the prospects of the company which is reflected in the share price.

Fourthly, it is unrealistic to suppose that investors are in agreement about the risks and return characteristics of the company.

Finally, tax position of investors and potential of investors may cause price differential between low-payout and high-payout shares.

There are several factors that influence the dividend policy of the company. Some of them are related to the company's consideration to the owners' interests and some are related to the company's interest. Yet, there are certain factors which are economic or statutory.
(1) **Current Preference**

A shareholder will prefer current dividend to future dividend and company's dividend policy will be influenced by some shareholders preferences. According to a survey nearly fifty percent of the investments are made having receiving regular return.

(2) **Alternative use for funds by a Shareholder**

Usually the earning of a firm are either distributed as dividend or retained for use in business which again comes back to the shareholder as potential increased earnings. It may be the policy of the company to pay fixed rates of dividend irrespective of the earning and transfer the surplus to general reserves, so that it can be utilised to cover shortfall as and when it arises.

(3) **Tax Considerations for Shareholders**

It is difficult to decide whether a company decides on the dividend policy considering the
shareholder's tax needs or the shareholder selects their investment portfolio on the basis of the company's dividend policy. An investor in a low tax bracket would prefer high dividend payments and lower capital appreciation, while an investor in a higher tax bracket would like to make capital appreciation which has lower tax rates than income in the form of dividend. Shareholders' needs, in any case, play an important role in formulating the dividend policy.

The factors that influence a dividend policy can be outlined as follows:

1. **The informational content of dividends.**

   Paying regular cash dividends leads investors to expect that they will continue. Changing dividends either upward or downward provides information to the shareholders. The new information is likely to lead to a change in expectations. This in turn leads to a change in the share price.
(2) **Industry 'norms' over time.**

The financial community comes to expect firms in certain industries to perform in certain ways. A maverick company may worry the financial community. This can lead to a flight of investors.

(3) **Reinvestment opportunities.**

Firms may have or, equally important be perceived to have, certain investment opportunities. If opportunities are limited as they might be in mature businesses such as brewing or tobacco, investors would expect profits to be paid out as dividends. Other companies such as high technology communications or information processing firms will have many potentially profitable investments. Investors might expect such companies to retain some or all of their profits.

(4) Restrictive covenants in lending agreements might place a limit on dividends.
(5) The tax status of the shareholders should influence the proposed policy.

(6) Revenue service regulations on the dividend policy in private firms will affect the policy. The Revenue Commissioners are keen to prevent owners retaining earnings which would be taxed as income if declared as dividends.

(7) The availability of cash. Irrespective of all other considerations, a business may lack the ready cash with which to pay dividends. Lenders rarely like to see their funds being paid out by way of dividends.

Dividend policies are basically dependent on the needs of the firm and the investor will have to select the company whose dividend policy suits the tax and other requirements best. It should also be appreciated that the company cannot always pay dividend that it wishes to, particularly in view of statutory constraints that may come in the way. For instance, Companies (Temporary Restrictions on Dividend) Act, 1974...
restricted payment of dividend beyond certain limits. Although the Act is no longer in force, there are certain rules like Companies (Transfer of Profit to Reserve) Rules, 1975 and Companies (Declaration of Dividend out of Reserve) Rules, 1975 under which certain requirements have to be complied with before dividend can be declared. While the first set of Rules has prescribed the percentage of profit that should be transferred to reserve before dividend could be declared, the second set of Rules specifies the requirements for paying dividend out of reserve in case of inadequate profit.

The company's dividend policy also depends on its liquidity position, but it often happens that dividend is paid without keeping in view the working capital requirement which has resulted in the entire operation of the company getting affected. The other factor that influences the dividend policy is the company's expansion and other capital project plans in hand. While determining the capital cost the inflation factor will also have to be considered. In the case of high inflation rate the tendency is to have low payout and reserve funds to meet higher capital needs.
As retained earnings act as an important source of finance, the company's future plans have direct relevance on dividend payout. Even if such capital plans are not in hand, it often happens that the company is stringently tied down by dividends that are usually paid out irrespective of the degree of profits made. It is the practice with most of the companies to adopt the policy of steady payout and transfer surplus profit to reserve, to be tapped at the time of shortfall. Such companies, usually, also have a higher risk bearing capacity and therefore command a better market at the Stock Exchange.

The amount of profit to be distributed as dividend is a crucial decision for financial management. It is for this that dividend policy followed by the company becomes important, because retention policy of the company follows the dividend policy. These two policies are related, in the sense that more dividend means less retention and vice versa.

One object of the management in mind in formulation of the dividend policy is to ensure maximisation
of the company's share prices at the Stock Exchange. While there are views as to whether the dividend policy of the company has an impact on the share prices or not it cannot be denied that the investors take into account the dividend payout of the company while deciding about investments. This becomes clear from the table in Annexure I where the share price of high dividend paying company and low or non dividend paying company are compared.

A number of models have been developed on dividend policy, some to the effect that dividend decision has relevance to the value of the company's share in the market while some of the with that reverse view. While JE Walter and MJ Gordon belong to the first school, MH Miller and F Modigliani hold the second view. According to Walter, if the company has ample avenues for profitable investments dividend payout will be nil, while the total distributable profit will be paid out in dividend in case the company has no investment proposals in hand. Between these two extremes dividend will vary between 0+ and -1. Gordon also holds a similar view and feels that market value of shares is equal to the present
value of infinite future stream of dividend. His model, like that of Walter's, states that dividend policy of a company is related to the availing of profitable investment avenue on which will depend the company's funds requirements.

Gordon also argues that investors are averse to risks and would prefer certain to uncertain returns. According to him shareholder's primary motive is to earn dividends from investments.

Another theory, called Residual Theory of dividends assumes that dividends is the 'left over' of the retained earnings after financing investment opportunities in hand. Residual Theory does not necessarily entail fluctuations in dividend rates as companies could follow a policy of steady dividend payouts by adjustments of surplus or shortfall arising every year.

Modigliani and Miller have formulated a theory which states that the value of the company is determined
solely by its earning and not by the manner in
which the earnings are distributed. This theory
on irrelevance of dividend is based on certain
assumptions viz:

(i) company operates in perfect capital market
    where all information are available;

(ii) all investors behave irrationally and are
    indifferent between 'dividend' and share price
    'appreciation' to maximise their wealth;

(iii) there is no tax differential between dividend,
    retained earnings and capital gains. In other
    words, there are no tax implications;

(iv) the company has a definite investment policy.

The limited evidence available suggests that a
company's dividend payout does influence the value of
a company to its shareholders. What is not at all
clear is the best way of determining the optimal allocation of a company's earnings between dividends and retentions. As with other financial policy decisions, a company's dividend policy should aim at maximising shareholders' wealth. In order to achieve an optimal dividend payout, the finance manager will have to consider both the company's requirements for funds to finance its investment proposals and the shareholders' preference for dividend vis-a-vis capital gains.

It has been argued that shareholders may prefer current dividends because of their preference of current income, and the associated transaction costs involved in selling a portion of their holding of shares to obtain current income if the desired dividend payments are not made. In addition, there is the alleged ability of current dividend payments to resolve uncertainty in the minds of shareholders. On the other hand, flotation costs and the difference in the tax treatment of dividend income as opposed to capital gains favours a company's retention of earnings.
In his quest to find an optimal dividend payout, the finance manager must first attempt to ascertain shareholders' preferences for current income compared with capital gains. Such information may be obtained from the company's shareholders by taking a survey of them and by a study of the relationship between dividend payout and share price for similar companies.

Let us assume that the finance manager finds that shareholders have an overall preference for current dividends, but that the company's profitable investment opportunities warrant the use of the company's total earnings. Therefore, if the company pays a current dividend it will be necessary to make a new share issue to replenish the company's finances. In this case the preference for current dividends must be compared with the extra costs of financing by means of a new issue vis-a-vis the retention of earnings.

Apart from the flotation costs, the cost of a new share issue will include the discount on the current market price of the shares which is necessary in
order to encourage investors' participation in a new share issue. These costs mean that a new share issue is a more costly method of financing a company's investment proposals than retaining the earnings in the first place. As a result, the finance manager has the job of deciding on an optimal dividend payout ratio by comparing the investors' preference for current dividends with the costs of a new issue. While conceptually this is feasible, in practice the major problem will be one of judging the extent of investors' preference, if any, for current dividends.

Alternatively, it may be assumed that the company has fewer profitable investment opportunities than would be necessary to use its total earnings. In this case the finance manager should use those earnings which cannot be profitably employed for the payment of dividends to shareholders. The dividend payment may be even greater than that indicated by the amount of funds remaining after undertaking the profitable investment opportunities, because the company may use the profits retained in past years. Once again, the finance manager will determine
Thus, even though it may seem foolish for a company to pay dividends with one hand and take them back with the other, practical observation points to companies doing just that. In other words, the executives of most companies behave as if dividends are relevant. For example, carefully examining Annexure I, we may observe recognised growth companies paying dividends which presumably would not be the case if management believed dividends were irrelevant. If dividends were believed to be irrelevant, growth companies would retain all their earnings and not pay dividends. However, observation indicates that the dividend payout ratio is greater than that which management would recommend if it made its decision solely on the basis of the funds needed for the company's investment proposals. A company is warranted in paying dividends greater than those indicated by its acceptable investment proposals, if there is an overall preference by shareholders for current dividends compared with retentions. This
preference, in turn, should be sufficient to counteract the fact that a new share issue is a more expensive form of financing than the retention of earnings.

So far only the factors affecting the determination of an optimum dividend payout ratio have been discussed. However, it should also be realised that, other things being equal, investors may place a premium on the shares of a company which pays stable dividends and only increases its dividend payment when it believes the increase can be maintained. It seems reasonable to expect that a stable dividend policy will lead to higher share prices, because shareholders will value more highly dividends they believe they are certain to receive. This may be compared with a company which has a dividend policy of paying a fixed percentage of its earnings, which will give rise inevitably to fluctuations in dividends. In this case the investors' likelihood of receiving a particular amount of money as a dividend payment is reduced and they may discount the share price accordingly.
Investors are said to prefer dividend stability for reasons which are similar to those suggested as possible reasons for investors preferring current dividends to the retention of earnings. Thus, stable dividends may be viewed as conveying useful information to investors. The stable dividend may convey to investors the management's view that the future of the company is better than the fall in profit it suggests. Clearly this can only be a short-run effect, for if investors observe that there is a permanent downtrend in earnings, the management will not be able to convince investors of a bright future for the company, even if the management continues to maintain a stable dividend. Similarly an increase in the dividend payout not based upon a "real" change in the prospects for the company can have only a temporary effect on share price.

Another reason investors may prefer stable dividends is their desire for current income. If shareholders want a specific annual income, they will prefer a company with a stable dividend policy to one that adjusts its dividend payments to fluctuations in
profit even though, apart from their dividend policy, the companies are identical in every respect.

Observation of individual shares in Annexure I tends to lend to the contention that most companies attempt to maintain stable dividend payments. It seems that company managers act as though shareholders have a preference for stable dividends.

Although there is reason to believe that stable dividends have a positive effect on a company's share price, Lintner has observed that companies seek to maintain a target dividend payout ratio over the long run. It is Lintner's contention that after earnings increase, dividends increase also but only after a lag. Generally, this contention has been supported. Thus, only after an increase in profit appears to be relatively permanent are dividends increased. Once a company's dividends have been increased there is a reluctance to reduce the amount of the dividend payments and a company will make every effort to maintain dividends at the new level. If there is a fall in the company's
profit, the Board of Directors will endeavour to maintain dividends at their previous level until it is clear that a recovery in profit will not take place in the foreseeable future.

There are other factors, including procedural and legal considerations as well as financial and other considerations, which influence a company's dividend policy in practice.

Dividends are generally paid twice a year. A company's Board of Directors, when it announces a cash dividend, specifies a date on which the books will close. For shares listed on a Stock Exchange, the rules of the exchange specify the number of days before the date the books close that shares are traded ex-dividend. In Calcutta Stock Exchange the ex-dividend date is about seven to ten business days before the books close. Investors who purchase shares prior to that date are entitled to the dividend; those who purchase shares after that date are not. Theoretically, the shares' market price should
fall by an amount equal to the amount of the dividend when the shares go ex-dividend. However, as many factors influence the market price of shares, this effect is generally difficult to measure.

Legally, in terms of Section 205 of the Companies Act, 1956 a company's cash dividend may only be paid out of profits and is not to be paid out of capital. Profits in this context include the accumulated retained earnings as well as the current year's net profit. Capital must not be returned to shareholders unless the company follows the procedure for reducing its capital or is in the process of being wound up. Normally, a company's cash dividend is a proportion of its current year's income. If the company's proposed dividend is legal, its dividend policy then becomes a matter of financial feasibility.

There are numerous demands on a company's cash flow including its dividend payments. Although legally a company may be able to pay a cash dividend, it may not have sufficient cash to pay the dividend. Thus, the operating profit earned in a
particular year does not necessarily result in an equivalent amount of cash being available for distribution in the form of dividends. Management's expectations as to the company's likely future cash position will play an important part in the company's dividend policy decision.

Another matter for consideration by management in setting an appropriate dividend policy is the company's ability to obtain cash on relatively short notice. This may be achieved by the company negotiating for a bank overdraft limit or having access to other short-term sources of funds.

In addition, if a company's ability to make a new issue of shares or to issue debt is restricted, it is likely that it will retain a higher proportion of its profit than a company which has ready access to funds from the capital markets. Companies which are likely to have difficulties in raising funds on the capital market include small companies, new companies, and companies, in what may be termed, venture capital fields.
If a company's operating profit is relatively stable it is better able to predict its future operating profit. A company in this position is therefore more likely to pay out a higher proportion of its profit in dividends than a company with a profit which fluctuates from one year to the next. This is an obvious consideration when the board of directors is determining the company's dividend policy.

The effect of inflation may also have an impact on a company's dividend policy. In the absence of a current value accounting system, it is possible for management inadvertently to distribute profit in excess of that which should be retained in order to maintain the company's earning power. In such circumstances a case can be made for the retention of profits so as to ensure that the company's earning power is maintained intact.

For each company there will be specific factors which influence the dividend policy decision for that company. For example, a company facing the possibility of a takeover bid may increase the proportion of its
profit paid out in dividends in order to retain the support of its shareholders. The Board of Directors may adopt such a policy in order that it may retain control of the company's operations. A company's dividend policy is therefore influenced by a company's investment and financing decisions and by other factors including legal considerations, the availability of cash, and the desire to maintain the control of the company in existing hands.

One of the major financial decisions facing management each year is the amount of dividend to be paid to the equity shareholders. In most cases, the decision is reached after taking a number of factors into account, not the least among which is the company's ability to pay. Shareholder's needs must also be taken into consideration. Some shareholders look for a steady income from their investment while others are more interested in the potential growth in the market value of their company's shares. In some ways these differing needs call for conflicting dividend policies. Rising share values are normally associated with expanding companies which need new finances to take on profitable investment projects.
Such companies are therefore, likely to distribute only a small part of their earnings as dividends. On the other hand, companies with few investment opportunities will be quite willing to distribute a large proportion of their earnings to shareholders. Because of the lack of new investment opportunities available to the latter companies, there is a correspondingly low expectation of future profits and this will expectedly be reflected in a low market rating for those companies' shares.

Profitability and the need to retain profits for future investment are possibly the two most important factors affecting the dividend decision. However, low profits in any single year do not necessarily mean a cut in ordinary dividends since low profits can be supplemented by undistributed profits from previous years to maintain the dividend level. This 'topping up' policy is not unusual, for example, in cyclical industries, though the extent will be related to the provisions to the Companies (Payment of Dividend out of Reserve) Rules, 1975. Nor do high profits necessarily permit increased dividends to be paid if restrictions as imposed by the Government in 1975 exists.
Government restrictions on dividend payments apart, the 
dividends may be restricted for a number of reasons, 
e.g. to conserve cash within the company in order 
to redeem debentures or to replace assets. In times 
of high inflation rates, companies may restrict 
dividends to enable them to increase working capital, 
to enable them to replace stocks at higher prices, and 
to enable them to increase the level of credit allowed 
to debtors. When interest rates are high, a company 
operating on a substantial bank overdraft may 
restrict dividends to allow it to cut both its 
overdraft and interest charges. In these circumstances, 
companies may decide to compensate shareholders by 
making a bonus issue of shares to existing shareholders. 
When this is done, part of the undistributed profits, 
equal in amount to the nominal value of the 
shares issued, is reclassified in the balance sheet 
as ordinary share capital. No cash is involved in 
the transaction.

Whatever policy the directors decide to adopt in 
connection with dividends, there is one overriding rule 
which should always be observed; the retention of 
profits in any year can be justified only if it is
possible for the company to earn a higher return on the retained profits than the shareholders can earn outside the company.
<table>
<thead>
<tr>
<th>Name of the Company</th>
<th>Year ending</th>
<th>Book value per share ((\text{Rs}))</th>
<th>Equity capital ((\text{Rs}) crores)</th>
<th>Reserves &amp; surplus ((\text{Rs}) crores)</th>
<th>Equity earning per share (\text{Rs})</th>
<th>Dividend per share ((\text{Rs}))</th>
<th>Previous year (\text{Rs})</th>
<th>Cover (times)</th>
<th>Price earning ratio 3-5-69 ((\text{Rs}))</th>
<th>Price High 1988 ((\text{Rs}))</th>
<th>Price Low 1988 ((\text{Rs}))</th>
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<td>Advani Oerlikon</td>
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<td>1.15</td>
<td>26.25</td>
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**Note:** The table lists various companies along with their financial details such as book value, equity capital, reserves, equity earning per share, dividend per share, previous year's earning, cover, price earning ratio, and high and low prices for the year 1988. The financial data includes details like equity capital, reserves, and share price comparison.
### ANNEXURE I

<table>
<thead>
<tr>
<th>Name of the Company</th>
<th>Year ending</th>
<th>Book value per share (R)</th>
<th>Equity capital &amp; surplus (R)</th>
<th>Equity earning (per share)</th>
<th>Running year</th>
<th>Previous year</th>
<th>Cover (times)</th>
<th>market Price 3-5-89 (%)</th>
<th>Price earning ratio 1988</th>
<th>1988 High (%)</th>
<th>1988 Low (%)</th>
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