CHAPTER TWO

LITERATURE SURVEY
2.1 INTRODUCTION

Dividend pay-out decision has always been a subject of interest to financial analysts, academicians and researchers for about five decades now. The researchers are interested in studying the extent to which the earning of a company are distributed as dividend among the shareholders as also the retained earnings.

Researches have typically used data on variables such as, dividend pay-out ratio and dividend yields to investigate theories of earnings pay-out. At least, in some cases, it may be more appropriate to look at earnings retention, rather than more common dividend variables.

Following the publication of Modigliani and Miller's two seminal papers on dividend policy, there has been a considerable amount of researches into what determines dividend policy. These theories may be better investigated by looking at the firm's retention polices rather than dividend polices. This is particularly true, specifically for engineering industries, where there is no dearth of positive NPV projects crying for attention and adequate funding.

The stable and sustainable national and sectoral growth crucially hinges on economic unit's own saving. From the point of view of risk and cost, their own savings are the best source of finance for the companies. There are no transaction and bankruptcy costs associated with the retained profits of companies. Internal finance has an advantage of easy availability and it effectively represents infusion of additional equity capital. The use of retained earnings, in contrast to external equity eliminates issue costs and loses on account of under pricing. Thus a corporate retained earnings are a very important source of finance for the firms.
The retention ratio of joint stock companies in India, particularly that of public limited companies has been relatively low in many years. In contrast with the theoretical expectation and unlike in many other countries the reserves and surpluses (internal resource) have not been having the first rank in the “pecking order” of choice of financing by the Indian companies. Therefore, a study of factors, which influence the decision of companies to retain part of their net earnings can throw light on this issue.

2.2 LITERATURE REVIEW

Information Asymmetry

Dividend payout has been an issue of interest in the financial literature. Jensen and Meckling (1976) argue that information asymmetry between an ‘insider’ and ‘outsider’ may lead to agency cost. One of the mechanisms, they suggest to reduce ‘outsiders’ expropriation is to reduce free cash flows available to managers through high payouts by the firm. Dividends are referred as reward for providing finances to a firm in the literature, as without any dividend payout, shares would not have any value. Dividend payout policy has been the primary puzzle in the economics of corporate finance since the work of Black (1976). The dividend literature has primarily relied on two lines of hypothesis: signaling and agency cost.

The cash flow hypothesis asserts that insiders have more information about firms’ future cash flow than do outsiders, and they have incentive to signal that information to outsiders. Dividends can be an ideal device for limiting rent extraction of minority shareholders. Large shareholders, by granting dividends, may signal their unwillingness to exploit them. Dividend payout, however
guarantee, equal payout for both insider and outsider equity holders. Corporate governance in India differs dramatically from the dominant form of corporate governance in US, UK or other developed economies. Even within India, corporate governance is not homogenous: some firms operate within industrial groups while others are independent. Group firms differ in depth and breadths of inter firm relationship than stand alone ones. Ownership structure in India differs from most of Anglo-Saxon countries like the US and UK. In India, large shareholders (especially directors and corporate) have ample incentives and ability to control. Empirical research on corporate governance and dividend payout policy has mostly concentrated using data from United States. In USA, regulated and dispersed shareholding leave salient agency problem between managers and shareholders. In emerging markets, widely held corporations are in the minority and mostly held in few hands (block shareholders).

Gugler and Yurtoglu (2003) and Gugler (2003) investigated the relationship between dividends, ownership structures and control rights for German and Austrian firms, respectively. Gugler and Yurtoglu (2003) find large shareholding of the largest owner reduces the dividends payout ratio, while shareholding by the second larger owner increases it. Gugler (2003) documents the evidence that state controlled firms engage in dividend smoothing, while family controlled firms do not. The behavior of the bank and foreign controlled firm lies in between state controlled and family controlled firms, consistent with the expected “ranking” of information asymmetries and managerial agency cost hypothesis.

The literature on signaling hypothesis builds upon the pioneering work of the Bhattacharya (1979), who derived the existence conditions for a non-
dissipative signaling model and show that dividends are signals for future cash flows, under the assumption that outside investors have imperfect information about the firm's profitability and the cash dividends are taxed at a higher rate than capital gains. Miller and Rock (1985) extend the standard finance model of the firms dividend by allowing the firms manager 'insider' to know more about the firm's financial health than 'outside' investors. They show that a consistent signaling equilibrium exists under asymmetric information. Healy and Palepu (1988) examine whether dividend policy changes convey information about the future earnings substantiated by cash. They find that investors interpret announcements of dividend initiations and omissions as manager's forecast of future earning changes. Brennan and Thakor (1990) develop a theory of choice for distribution of cash from firm to shareholders. They show that a majority of a firm's shareholders may support a dividend payment for small distribution, despite the preferential tax treatment of capital gains for individual investors.

For larger distributions as open market stock re-purchase, and for the largest distributions tender offer re-purchases is likely to be preferred by a majority of shareholders.

In case of India, Kevin (1992) shows that dividend stability is a primary determinant of payout while profitability is only of secondary importance.

Roy and Mahajan (2003), provide regulatory oversight on dividends payout and suggests that regulation of dividend payout should address the inherent conflict of interest between shareholders and lenders to address the issue of information asymmetry between the insiders and the outsiders.
The empirical evidence concerning the possible association of owners and payout policy is extremely limited, nearly none in case of emerging economies. Most of the studies have tried to explain these phenomena of dividends and institutional shareholders in developed countries.

In a recent study Short, Keasey, and Duxbury (2002) examine the link between dividend policy and institutional ownership for UK firms. They find a positive association between dividends and institutional shareholders and negative association with managerial ownership. In emerging markets like India, Korea, Taiwan, China etc., the institutional setup is quite different than those of the developed countries. Aivazian, Booth, and Cleary (2003) finds that emerging market firms exhibit dividend behavior similar to those of US. However, the authors do not consider the corporate governance issues. Manos (2003), using data from India, estimates the cost minimization model of dividends and finds that government ownership, insider ownership, risk, debt, and growth opportunities, have a negative impact on the payout ratio, whereas institutional ownership, foreign ownership and dispersed ownership have a positive impact on the payout ratio. However, his analysis is based on cross-sectional data.

Large shareholders, like other emerging markets, characterize Indian corporate firms ownership structure. Majority control gives the largest shareholder incentive and control over key decisions, like dividend payout. The dominance of large shareholders may affect the dividend payout in several ways. There have been changes in the taxation policy for dividend during the sample period, which gives us an opportunity to test the tax-preference theory and its implications for the dividend payout in case of an emerging economy, India.
The Indian Corporate Sector has a large number of corporate firms, lending it to large sample statistical properties. It is large by emerging market standards and the contribution of the industrial and manufacturing sectors (value added) is close to that of in several advanced economies. Unlike several other emerging markets, firms in India, typically maintain their shareholding pattern (dominant group) over the period of study, making it possible to identify the ownership affiliation of each sample firm with clarity. It is by and large a hybrid of the “outsider systems” and the “insider systems” of corporate governance. The legal framework for all corporate activities including governance and administration of companies, disclosures, share-holders rights, dividend announcements has been in place since the enactment of the Companies Act in 1956 and has been fairly stable. The listing agreements of stock exchanges have also been prescribing ongoing conditions and continuous obligations for companies.

India has a well-established regulatory framework for more than four decades, which forms the foundation of the corporate governance system in India. Numerous initiatives have been taken by Stock Exchange Board of India (SEBI) to enhance corporate governance practice, in fulfillment of the twin objectives: investor protection and market development, for example: streamlining of the disclosure, investor protection guidelines, book building, entry norms, listing agreement, preferential allotment disclosures and lot more.

Economists have proposed a number of explanations of the dividend puzzle. Of these, particularly popular is the idea that firms can signal future profitability by paying dividends (Bhattacharya (1979), John and Williams (1985), Miller and Rock (1985), Ambarish, John, and Williams (1987)). Empirically, this theory had considerable initial success, since firms that initiate (or raise) dividends
experience share price increases, and the converse is true for firms that eliminate (or cut) dividends (Aharony and Swary (1980), Asquith and Mullins (1983)). Recent results are more mixed, since current dividend changes do not help predict firms’ future earnings growth (DeAngelo, DeAngelo, and Skinner (1996) and Benartzi, Michaely, and Thaler (1997)). Another idea, which has received only limited attention until recently (e.g., Easterbrook (1984), Jensen (1986), Fluck (1998a, 1998b), Myers (1998), Gomes (1998), Zwiebel (1996)), is that dividend policies address agency problems between corporate insiders and outside shareholders. According to these theories, unless profits are paid out to shareholders, they may be diverted by the insiders for personal use or committed to unprofitable projects that provide private benefits for the insiders. As a consequence, outside shareholders have a preference for dividends over retained earnings. Theories differ on how outside shareholders actually get firms to disgorge cash. The key point, however, is that failure to disgorge cash leads to its diversion or waste, which is detrimental to outside shareholders’ interest. The agency approach moves away from the assumptions of the Modigliani-Miller theorem by recognizing two points. First, the investment policy of the firm cannot be taken as independent of its dividend policy, and, in particular, paying out dividends may reduce the inefficiency of marginal investments. Second, and more subtly, the allocation of all the profits of the firm to shareholders on a pro-rata basis cannot be taken for granted, and in particular the insiders may get preferential treatment through asset diversion, transfer prices and theft, even holding the investment policy constant. In so far as dividends are paid on a pro-rata basis, they benefit outside shareholders relative to the alternative of expropriation of retained earnings.
The presence of information asymmetry may also mean that managers need to signal their ability to generate higher earnings in future with the help of high dividend payouts (Bhattacharya, 1979, John and Williams 1985, and Miller and Rock, 1985). However, the credibility of signals depends on the cost of signaling – the cost being loss of financial flexibility. High payout results in reduction of free cash flow when in fact the firm needs more funds to pursue high growth opportunities.

Following Fama and French (2001), several attempts have been made to analyze the impact of profitability, size and growth on the dividend payout of firms.

Similarly, following Healy and Palepu (1988) an attempt has also been made to analyze the signaling hypothesis, i.e. earnings information conveyed by dividend initiations and omissions. Since, initiations and omissions construe extreme dividend events, changes in dividends i.e., increases and decreases and the information that they convey is also examined following DeAngelo, DeAngelo and Skinner (1992).

DeAngelo, DeAngelo and Skinner (1992) analyse the relationship between dividends and losses and the information conveyed by dividend changes about the earnings performance. They examine the dividend behaviour of 167 NYSE firms with at least one annual loss during 1980-95 and those of 440 firms with no losses during the same period, where all the firms had a consistent track record of ten or more years of positive earnings and dividends. They find that 50.9% of 167 firms with at least one loss during 1980-95 reduced dividends, compared to 1% of 440 firms without losses. Their findings support signaling hypothesis in that dividend changes improve the ability to predict future earnings performance.
Glen et al. (1995) study the dividend policy of firms in emerging markets. They find that firms in these markets have a target dividend payout rate, but less concerned with volatility in dividends over time. They also find that shareholders and governments exert a great deal of influence on dividend policy and observe that dividends have little signaling content in these markets.

Benartzi, Michaely, Thaler (1997) analyzes the issue of whether dividend changes signal the future or the past. For a sample of 7186 dividend announcements made by NYSE or AMEX firms during the period 1979-91, they find a lagged and contemporaneous relation between dividend changes and earnings. Their analysis also shows that in the two years following dividend increases, earnings changes are unrelated to the sign and magnitude of dividend changes.

The notion that financial decisions convey information about the firm value was proposed by Leland and Pyle (1977) and Bhattacharya (1979) in adaptations of the Spence (1973) signaling model. Which has extended Akerlof’s seminal work (Akerlof, G. 1970) to Job Market? Though from the accounting point of view there are some differences between stock split and bonus issue, the economic impact is the same.

Agency Cost

Substantial literature in the field of corporate finance (Linter (1956), Lintner (1962), Bhattacharya (1979), Miller and Rock (1985)), suggests that corporate dividend policy is designed to reveal earnings prospects of a firm to their investors. Recent empirical evidence in favor of this model are mixed. Fama and Babiak (1968) argues that the firms, a priori, set their target dividend level
and try to stick to it. In addition to the signaling approach, there may be interrelation between dividend payout policy and agency cost (Jensen and Meckling (1976), Easterbrook (1984)). Dividend payout policy is an outcome of the conflict between the insiders and the outsiders (issues related with corporate governance and ownership structure). Jensen and Meckling (1976), Rozeff (1982), and Easterbrook (1984) presents agency cost explanations for changes in dividend payout, while analyzing whether dividends can act as a method to align manager's interests with those of investors. They argue that firm pays dividend in order to reduce agency costs as payment of dividends reduce the discretionary funds available to managers. Jensen (1986) documents that in presence of free cash flows, the firms pay dividends or retire their debts to reduce the agency cost of free cash flow. Kalay (1982) investigate a large sample of bond indentures focusing on conflict between shareholders and bond holders on the dividend decision. The paper finds that the stockholders do not pay themselves as much dividends as they are allowed to. Jensen, Solberg, and Zorn (1992) examine the determinant of cross-sectional differences in insider ownership, debt, and dividend policy. The authors' find that firms with higher insider ownership chooses lower level of debt and dividends. Han, Lee, and Suk (1999) test the agency cost based hypothesis, which predicts, dividend payout to be inversely related to the degree of institutional ownership and the tax based hypothesis, predicting the dividends to be positively related with the institutional ownership. They provide support for the tax-based hypothesis, suggesting a “dividend clientele” for institution's preference for higher dividends.

Porta, Lopez-De-Silanes, Shleifer, and Vishny (2000) argue that the dividends play a basic role in limiting insider expropriation because they remove
the corporate wealth from insider control. They find that corporations in countries with strong legal protection of minority shareholders pay higher dividends. Faccio, Lang, and Young (2001) relate dividends rates to the discrepancy that exists between the shareholder’s ownership rights (O) and its control rights (C) as Claessens, Simeon, Fan, and Larry (1999) used. The O/C ratio is used as a measure of the corporation’s vulnerability to insider expropriation within a group of corporations. They find that significantly the corporations that are tightly affiliated pay higher dividends to a business group. By contrast, for corporations not tightly affiliated to a group is associated with significantly lower dividend rates. They provide evidence on the expropriation that takes place within business groups and on the differences in expropriation between Europe and Asia.

Fenn and Liang (2001) analyze how corporate payout policy is affected by managerial stock incentives. They find that managerial stock incentives mitigate the agency costs for firms with excess cash flow problems. They also find a strong negative relationship between dividends and management stock options.

Although the Indian Corporate Sector is a mix of government and private firms (which are again a mix of firms owned by business group families, and multi nationals and stand alone firms), it has not suffered from the cronyism that has dominated some of the developing economies. An empirical examination of the relationship between the ownership structure, corporate governance and dividend payout using a large panel of Indian corporate firms over 1994-2000, has been conducted by Narasimhan, M.S. and S.Vijayalakshmi (2002). It is the first attempt to use the well-established dividend payout models to examine the impact of ownership structures on dividend payout policies in context of an emerging market.
It has been found that ownership is one of the important variables that influence the dividend payout policy. However, the relationship is different for different class of owners and at different levels. This suggests that the ownership structure does not influence dividend pay out policy of the firm uniformly. The results support the hypothesis that the interest alignment between different classes of owners influences the dividend payout policy.

Further research may extend the present use of dividend payout models to examine the influence of ownership identity in case of other emerging economies. Examining the influence of board structure on dividend payout policy would be an interesting exercise, however, this is left for future research.

The so-called dividend puzzle (Black 1976) has preoccupied the attention of financial economists at least since Modigliani and Miller's (1958, 1961) seminal work. This work established that, in a frictionless world, when the investment policy of a firm is held constant, its dividend payout policy has no consequences for shareholder wealth. Higher dividend payouts lead to lower retained earnings and capital gains, and vice versa, leaving total wealth of the shareholders unchanged. Contrary to this prediction, however, corporations follow extremely deliberate dividend payout strategies (Lintner (1956)). This evidence raises a puzzle: how do firms choose their dividend policies? In the United States and other countries, the puzzle is even deeper since many shareholders are taxed more heavily on their dividend receipts than on capital gains. The actual magnitude of this tax burden is debated (see Poterba and Summers (1985) and Allen and Michaely (1997)), but taxes generally make it even harder to explain dividend policies of firms.
It has been found by many researchers that dividend policies vary across legal regimes in ways consistent with a particular version of the agency theory of dividends. Specifically, firms in common law countries, where investor protection is typically better, make higher dividend payouts than firms in civil law countries do. Moreover, in common but not civil law countries, high growth firms make lower dividend payouts than low growth firms. These results support the version of the agency theory in which investors in good legal protection countries use their legal powers to extract dividends from firms, especially when reinvestment opportunities are poor.

Conflicts of interest between corporate insiders, such as managers and controlling shareholders, on the one hand, and outside investors, such as minority shareholders, on the other hand, are central to the analysis of the modern corporation (Berle and Means (1932), Jensen and Meckling (1976)). The insiders who control corporate assets can use these assets for a range of purposes that are detrimental to the interests of the outside investors. Most simply, they can divert corporate assets to themselves, through outright theft, dilution of outside investors through share issues to the insiders, excessive salaries, asset sales to themselves or other corporations they control at favorable prices, or transfer pricing with other entities they control (see Shleifer and Vishny (1997) for a discussion). Alternatively, insiders can use corporate assets to pursue investment strategies that yield them personal benefits of control, such as growth or diversification, without benefitting outside investors (e.g., Baumol (1959), Jensen (1986)).

What is meant by insiders varies from country to country. In the United States, U.K., Canada, and Australia, where ownership in large corporations is relatively dispersed, most large corporations are to a significant extent controlled
by their managers. In most other countries, large firms typically have shareholders that own a significant fraction of equity, such as the founding families (La Porta, Lopez-de-Silanes, and Shleifer (1999)). The controlling shareholders can effectively determine the decisions of the managers (indeed, managers typically come from the controlling family), and hence the problem of managerial control per se is not as severe as it is in the rich common law countries. On the other hand, the controlling shareholders can implement policies that benefit themselves at the expense of minority shareholders. Regardless of the identity of the insiders, the victims of insider control are minority shareholders. It is these minority shareholders that would typically have a taste for dividends.

One of the principal remedies to agency problems is the law. Corporate and other law gives outside investors, including shareholders, certain powers to protect their investment against expropriation by insiders. These powers in the case of shareholders range from the right to receive the same per share dividends as the insiders, to the right to vote on important corporate matters, including the election of directors, to the right to sue the company for damages. The very fact that this legal protection exists probably explains why becoming a minority shareholder is a viable investment strategy, as opposed to just being an outright giveaway of money to strangers who are under few if any obligations to give it back.

As pointed out by La Porta et al. (1998), the extent of legal protection of outside investors differs enormously across countries. Legal protection consists of both the content of the laws and the quality of their enforcement. Some countries, including most notably the wealthy common law countries such as the U.S. and the U.K., provide effective protection of minority shareholders so that the outright
expropriation of corporate assets by the insiders is rare. Agency problems manifest themselves primarily through non-value-maximizing investment choices. In many other countries, the condition of outside investors is a good deal more precarious, but even there some protection does exist. La Porta et al. (1998) show in particular that common law countries appear to have the best legal protection of minority shareholders, whereas civil law countries, and most conspicuously the French civil law countries, have the weakest protection.

The quality of investor protection, viewed as a proxy for lower agency costs, has been shown to matter for a number of important issues in corporate finance. For example, corporate ownership is more concentrated in countries with inferior shareholder protection (La Porta et al. (1998), La Porta, Lopez-de-Silanes, and Shleifer (1999)). The valuation and breadth of capital markets is greater in countries with better investor protection (La Porta et al. (1997), Demirguc-Kunt and Maksimovic (1998)). Finally, there is some evidence that good investor protection contributes to the efficiency of resource allocation and to economic growth more generally (Levine and Zervos (1998), Rajan and Zingales (1998)). This paper continues this research by examining the dividend puzzle using shareholder protection as a proxy for agency problems.

In a world of significant agency problems between corporate insiders and outsiders, dividends can play a useful role. By paying dividends, insiders return corporate earnings to investors and hence are no longer capable of using these earnings to benefit themselves. Dividends (a bird in hand) are better than retained earnings (a bird in the bush) because the latter might never materialize as future dividends (can fly away). In addition, the payment of dividends exposes companies to the possible need to come to the capital markets in the future to raise
external funds, and hence gives outside investors an opportunity to exercise some control over the insiders at that time (Easterbrook (1984)). Unfortunately, there are no fully satisfactory theoretical agency models of dividends that derive dividend policies as part of some broad optimal contract between investors and corporate insiders, which allows for a range of feasible financing instruments. Instead, different models, such as Fluck (1998a, 1998b), Myers (1998), and Gomes (1998), capture different aspects of the problem. Moreover, the existing agency models have not yet fully dealt with the issues of choice between debt and equity in addressing agency problems, the choice between dividends and share repurchases, and the relationship between dividends and new share issues. They have attempted to distill from the available literature the basic mechanisms of how dividends could be used to deal with agency problems. In particular, they distinguished two very different agency “models” of dividends.

The predictions of these models that they tested are necessarily limited by the fact that they do not look at all the financing and payout choices simultaneously. Perhaps most importantly in this regard, they do not examine share repurchases, which have been commonly taken as an alternative to paying dividends. However, the share repurchases are most common precisely in the countries where firms pay high dividends, such as the U.S. and the U.K. For example, between June 1997 and June 1998 there were 1,537 share repurchases in the world recorded by the Securities Data Corporation, of which 1,100 occurred in the United States. By market value, the U.S. accounted for 72 percent of world share repurchases during this period, and the U.S., U.K., Canada, and Australia combined accounted for 83 percent. In some civil law countries, share repurchases are even illegal or heavily taxed (The Economist, August 15, 1998).
repurchases are complementary to dividends, rather than a substitute for them, our evidence only underestimates the difference in total cash payouts to shareholders between civil and common law countries.

Under the first view, dividends are an outcome of an effective system of legal protection of shareholders. Under an effective system, minority shareholders use their legal powers to force companies to disgorge cash, thus precluding insiders from using too high a fraction of company earnings to benefit themselves. Shareholders might do so by voting for directors who offer better dividend policies, by selling shares to potential hostile raiders who then gain control over non-dividend paying companies, or by suing companies that spend too lavishly on activities which only benefit the insiders. In addition, good investor protection makes asset diversion legally riskier and more expensive for the insiders, thereby raising the relative attraction of dividends for them. The greater the rights of the minority shareholders, the more cash they extract from the company, other things equal.

It is important to recognize that this argument does not rely on minority shareholders having specific rights to dividends per se, but rather on their having more general rights of voting for directors and protesting wealth expropriation. A good example from the United States is Kirk Kerkorian forcing Chrysler Corporation to disgorge its cash by paying dividends in 1995-1996. As a large shareholder in Chrysler, Kerkorian had no specific rights to dividends, but used the voting mechanism to put his associates on the board and then force the board to sharply raise dividends. Another good example is Velcro Industries, the producer of the famous “touch fastener” incorporated on the island of Curacao in the Netherlands Antilles, “where shareholders have no right of dissent” (Forbes,
Two-thirds of the shares of Velcro Industries are controlled by the Cripps family that runs Velcro (Forbes, May 23, 1994). In 1988, despite having a large cash reserve, the company suspended dividends “for the foreseeable future,” (Forbes, October 3, 1988), delisted itself from the Montreal Stock Exchange, and aggressively wrote down assets to slash earnings, evidently to “buy out Velcro minority holders cheap” (Forbes, May 23, 1994). The share price dived and, in 1990, with dividends remaining at zero, the Crippses offered to repurchase minority shares at slightly above the market price.

Minority shareholders sued in New York. “When a New York judge ruled that the U.S. was the proper jurisdiction, secretive Sir Humphrey Cripps decided to call off his offer rather than go under the light of U.S. court of law” (Forbes, May 23, 1994). The company subsequently resumed its dividend payments. This case illustrates that, in a high protection country like the U.S., in contrast to a low protection country like the Netherlands, shareholders are able to extract dividends from companies in virtue of their ability to resist oppression rather than having any specific dividend rights per se.

In a cross-section of countries with different quality of shareholder protection, the implication that better protection is associated with higher dividend payouts is testable. There is one further implication of this theory. Consider a country with good shareholder protection, and compare two companies in that country: one with good investment opportunities and growth prospects, and another with poor opportunities. Shareholders who feel protected would accept low dividend payouts, and high reinvestment rates, from a company with good opportunities, since they know that when this company’s investments pay off, they could extract high dividends. In contrast, a mature company with poor
investment opportunities would not be allowed to invest unprofitably. As a consequence, with good shareholder protection, high growth companies should have significantly lower dividend payouts than low growth companies. In contrast, if shareholder protection is poor, we would not necessarily expect such a relationship between payouts and growth since shareholders may try to get what they can -- which may not be much -- immediately. This also is a testable implication.

In an alternative agency view, dividends are a substitute for legal protection. This view relies crucially on the need for firms to come to the external capital markets for funds, at least occasionally. To be able to raise external funds on attractive terms, a firm must establish a reputation for moderation in expropriating shareholders. One way to establish such a reputation is by paying dividends, which reduces what is left for expropriation. For this mechanism to work, the firm must never want to "cash in" its reputation by stopping dividends and expropriating shareholders entirely. The firm would never want to cash in if, for example, there is enough uncertainty about its future cash flows that the option of going back to the capital market is always valuable (Bulow and Rogoff (1989)).

A reputation for good treatment of shareholders is worth the most in countries with weak legal protection of minority shareholders, who have little else to rely on. As a consequence, the need for dividends to establish a reputation is the greatest in such countries. In countries with stronger shareholder protection, in contrast, the need for a reputational mechanism is weaker, and hence so is the need to pay dividends. This view implies that, other things equal, dividend payout ratios should be higher in countries with weak legal protection of shareholders.
than in those with strong protection. Additionally, on this view, firms with better growth prospects also have a stronger incentive to establish a reputation since they have a greater potential need for external finance, other things equal. As a result, firms with better growth prospects might choose higher dividend payout ratios than firms with poor growth prospects. However, firms with good growth prospects also have a better current use of funds than firms with poor growth prospects. The relationship between growth prospects and dividend payout ratios is therefore ambiguous.

Referring to the two alternative agency models of dividends as "the outcome model" and "the substitute model" the outcome model predicts that dividend payout ratios are higher in countries with good shareholder protection, other things equal. The substitute model predicts the opposite. The outcome model further predicts that, in countries with good shareholder protection, companies with better investment opportunities should have lower dividend payout ratios. The substitute model does not make this prediction. In fact, it makes a weak prediction that, in countries with poor shareholder protection, firms with better investment opportunities might pay out more to maintain reputations.

Rozell (1994) models payout ratios as a function of three factors: flotation costs of external funding, agency cost of outside ownership and financing constraints as a result of higher operating and financial leverage.

Several theories have been proposed in explaining why companies pay dividends. While many earlier studies point out the tax-preference theory, more recent studies emphasize signaling and agency cost rationale of dividend payments. However, the dividend puzzle is yet unresolved and the words of Brealey (1992) poses the dividend policy decision as "What is the effect of a
change in cash dividends, given the firm’s capital-budgeting and borrowing decisions?" In other words, he looks at dividend policy in isolation and not as a by-product of other corporate financial decisions.

Narasimhan and Vijayalakshmi (2002) analyze the influence of ownership structure on dividend payout and find no influence of insider ownership on dividend behavior of firms. However, it is still not clear as to what is the dividend payment pattern of firms in India and why do they initiate and omit dividend payments or reduce or increase dividend payments.


**Differential Taxes**

Taxation policy is a key determinant of payout in developed countries (see Short, Keasey, and Duxbury (2002)). In case of India, taxation policy is different than those of developed countries. In India, dividends have been taxed at a flat rate of 10% for quite some time, which has been removed recently. Dividend payout may be beneficial, if used to offset tax liability against the capital loss, as after dividend payments, the prices of stocks fall. The signaling perspectives suggest that insiders use dividends as a signal of firm’s future earnings. Most of the signaling and agency cost models assumes that there is separation of ownership and control and finance is raised externally through capital markets. However, the characteristic of financing in India is different than those of the developed nations. In India, most of the financing comes from financial
institutions, and these lenders also have equity holding (in general) in the firm concerned. Hence, they have access to insider information as well. This reduces the importance of dividends as a signal of firms' financial health.

Economists are divided on the effects of taxes on the valuation of dividends (Poterba and Summers (1985)). The so-called traditional view holds that heavy taxation of dividends at both the corporate and personal levels -- at least in the United States -- is a strong deterrent to paying out dividends rather than retaining the earnings. There are two important objections to this view.

One objection, raised by Miller and Scholes (1978), states that investors have access to a variety of dividend tax avoidance strategies that allow them to effectively escape dividend taxes. This objection does not closely correspond to what investors actually do (Feenberg (1981)). Another objection, the so-called new view of dividends and taxes (e.g., King (1977), Auerbach (1979)), holds that cash has to be paid out as dividends sooner or later, and therefore paying it earlier in the form of current dividends imposes no greater a tax burden on shareholders than does the delay. According to this theory, taxes do not deter dividend payments. Harris et al. (1997) support this new view. In our empirical work, we include a measure of the tax disadvantage of dividends based on Poterba and Summers (1984, 1985) to assess the effect of taxes on dividend policies. Appendix A summarizes in detail our treatment of the tax effects of dividends, and also presents the data on taxes that we use in the empirical work.

Dr. Y. Subba Reddy examined the dividend behavior of Indian corporate firms over the period 1990 - 2001 and attempted to explain the observed behavior with the help of trade-off theory, and signaling hypothesis. Analysis of dividend trends for a large sample of stocks traded on the NSE and BSE indicate that the
percentage of companies paying dividends has declined from 60.5 percent in 1990 to 32.1 percent in 2001 and that only a few firms have consistently paid the same levels of dividends. Further, dividend-paying companies are more profitable, large in size and growth doesn't seem to deter Indian firms from paying higher dividends. Analysis of influence of changes in tax regime on dividend behavior shows that the tradeoff or tax-preference theory does not appear to hold true in the Indian context. Test of signaling hypothesis reinforces the earlier findings that dividend omissions have information content about future earnings. However, analysis of other non-extreme dividend events such as dividend reductions and non-reductions shows that current losses are an important determinant of dividend reductions for firms with established track record and that the incidence of dividend reduction is much more severe in the case of Indian firms compared to that of firms traded on the NYSE.

Black (1976) notes that in the presence of taxes, investors “prefer smaller dividends or no dividends at all”. According to Kalay (1982), in the absence of restraining covenants, shareholders can transfer wealth from bondholders by paying off dividend to themselves either by selling existing assets or by reducing investment or by using proceeds of a senior debt.

Narasimhan and Asha (1997) observe that the uniform tax rate of 10 percent on dividend as proposed by the Indian union budget 1997-98, alters the demand of investors in favor of high payouts.

There have been several changes in the tax regime in the last few years. The union budget 1997-98 made dividends taxable at the hands of company paying them and not in the hands of investors receiving them.
Similarly there have been changes in the capital gains tax and exemption of dividend income under Section 80 L of the Income Tax Act 1961. All these changes have implications for the dividend policy of corporate firms. According to tax-preference or trade-off theory, favorable dividends tax should lead to higher payouts.

Narasimhan and Asha (1997) discuss the impact of dividend tax on dividend policy of firms. They observe that the uniform tax rate of 10 percent on dividend as proposed by the Indian union budget 1997-98, alters the demand of investors in favor of high payouts rather than low payouts as the capital gains are taxed at 20 percent in the said period.

India operates a classical company tax system in which companies are taxed separately from the investors receiving the profits in form of dividends. Firms pay differential rate of corporate tax on their profits and shareholders pay income tax on the dividend income received.

This leads to twice taxation of profit earned by firm, one in the hands of company through corporate tax and other in hands of investors, in form of income tax. In such a case an investor should prefer to get less dividends paid and earnings to be retained by firm, as they can always get the amount by selling the shares in equity market, in form of 'home made dividend' (Black (1976).

**Investment Imperative and Free Cash Flow**

Dividend changes appear to signal contemporaneous and lagged earnings performance rather than the future earnings performance. From the practitioners' viewpoint, dividend policy of a firm has implications for investors, managers and lenders and other stakeholders. For investors, dividends – whether declared today

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or accumulated and provided at a later date - are not only a means of regular income, but also an important input in valuation of a firm. Similarly, managers' flexibility to invest in projects is also dependent on the amount of dividend that they can offer to shareholders as more dividends may mean fewer funds available for investment.

Lenders may also have interest in the amount of dividend a firm declares, as more the dividend paid less would be the amount available for servicing and redemption of their claims. However, in a perfect world as Modigliani and Miller (1961) have shown, investors may be indifferent about the amount of dividend as it has no influence on the value of a firm. Any investor can create a 'home made dividend' if required or can invest the proceeds of a dividend payment in additional shares as and when a company makes dividend payment. Similarly, managers may be indifferent as funds would be available or could be raised without any flotation costs for all positive net present value projects. But in reality, dividends may matter, particularly in the context of differential tax treatment of dividends and capital gains. Very often dividends are taxed at a higher rate compared to capital gains. This implies that dividends may have negative consequences for investors. Similarly, cost of raising funds is not insignificant and may well lead to lower payout, particularly when positive net present value projects are available. Apart from flotation costs, information asymmetry between managers and outside investors may also have implications for dividend policy. According to Myers and Majluf (1984), in the presence of information asymmetry and flotation costs, investment decisions made by managers are subject to the pecking order of financing choices available. Managers prefer retained earnings to debt and debt to equity flotation to finance the available projects. Information
asymmetry between agents (managers) and principals (outside shareholders) may also lead to agency cost (Jensen and Meckling, 1976). One of the mechanisms of reducing expropriation of outside shareholders by agents is high payout. High payout will result in reduction of free cash flow available to managers and this restricts the empire building efforts of managers.

In the Indian context, a few studies have analyzed the dividend behavior of corporate firms. Mahapatra and Sahu (1993) find cash flow as a major determinant of dividend followed by net earnings.

Bhat and Pandey (1994) undertake a survey of managers' perceptions of dividend decision and find that managers perceive current earnings as the most significant factor.

Mohanty (1999) finds that firms, which issued bonus shares, have either maintained the pre-bonus level or only decreased it marginally there by increasing the payout to shareholders.

Bernsterin (1998) expresses concern over the decline in payout over a period of time in the US market. He observes that given the 'concocted' earnings estimates provided by firms, the low dividend payout induces reinvestment risk and earnings risk for the investors. He asserts that "... try calculating the historical correlation between payout ratios in year t and earnings growth over t + 5. The correlation coefficient is positive and statistically significant".

Fama and French (2001) analyze the issue of lower dividends paid by corporate firms over the period 1973-1999 and the factors responsible for the decline. In particular they analyze whether the lower dividends were the effect of changing firm characteristics or lower propensity to pay on the part of firms. They
observe that proportion of companies paying dividend has dropped from a peak of 66.5 percent in 1978 to 20.8 percent in 1999. They attribute this decline to the changing characteristics of firms: “The decline in the incidence of dividend payers is in part due to an increasing tilt of publicly traded firms toward the characteristics – small size, low earnings, and high growth – of firms that typically have never paid dividends”.

Baker, Veit and Powell (2001) study the factors that have a bearing on dividend policy decisions of corporate firms traded on the Nasdaq. The study, based on a sample survey (1999) response of 188 firms out of a total of 630 firms that paid dividends in each quarter of calendar years 1996 and 1997, finds that the following four factors have a significant impact on the dividend decision: pattern of past dividends, stability of earnings, and the level of current and future expected earnings. The study also finds statistically significant differences in the importance that managers attach to dividend policy in different industries such as financial versus non-financial firms.

Ramachandran (2001) analyzes the variation in dividend yield for 21 emerging markets (including India) for the period 1992-99. His macroeconomic approach using country risk data finds evidence for pecking order hypothesis – lower dividends are paid when higher growth is expected. The study also finds that political risk factors have no significant impact on dividend payments of firms in emerging markets.

Lee and Ryan (2002) analyze the dividend signaling-hypothesis and the issue of direction of causality between earnings and dividends - whether earnings cause dividends or vice versa. For a sample of 133 dividend initiations and 165 dividend omissions, they find that dividend payment is influenced by recent
performance of earnings, and free cash flows. They also find evidence of positive (negative) earnings growth preceding dividend initiations (omissions).

Kevin (1992) analyzes the dividend distribution pattern of 650 non-financial companies which closed their accounts between September 1983 and August 1984 and net sales income of one crore rupees or more. He finds evidence for a sticky dividend policy and concludes that a change in profitability is of minor importance.

Mahapatra and Sahu (1993) analyze the determinants of dividend policy using the models developed by Lintner (1956), Darling (1957) and Brittain (1966) for a sample of 90 companies for the period 1977-78 – 1988-89. They find that cash flow is a major determinant of dividend followed by net earnings. Further, their analysis shows that past dividend and not past earnings is a significant factor in influencing the dividend decision of firms.

Bhat and Pandey (1994) study the managers’ perceptions of dividend decision for a sample of 425 Indian companies for the period 1986-87 to 1990-91. They find that on an average profit-making Indian companies have distributed about one-third of their net earnings and that the average dividend payout ratio is 43.6 percent. They also find that the average dividend payout ratio is 54 percent for the sample of both profit making and loss-making companies and the average dividend rate is in the range of 14.3 percent to 19.2 percent. They also observe variation in dividend policy of different industries.

Further, a survey of these 425 companies has been attempted. However, only 31 questionnaires have been received and of these they find 28 amenable for further analysis. Their analysis of the respondents shows that managers perceive
current earnings as the most significant factor influencing their dividend decision followed by patterns of past dividends. They also find two other variables increasing equity base and expected future earnings to have significant influence. However, they find industry to have the least influence on the dividend, which has been contrary to the expectations.

Mishra and Narender (1996) analyze the dividend policies of 39 state-owned enterprises (SOE) in India for the period 1984-85 to 1993-94. The find that earnings per share (EPS) is a major factor in determining the dividend payout of SOEs.

Mohanty (1999) analyzes the dividend behavior of more than 200 firms for a period of over 15 years. He finds that in most bonus issue cases firms have either maintained the pre-bonus level or only decreased it marginally there by increasing the payout to shareholders. The study also finds that firms that declared bonus during 1982-1991 showed higher returns to their shareholders compared to firms which did not issue bonus shares but maintained a steady dividend growth. He finds evidence for a reversal of this trend in the 1992- 1996 period. He attributes such a reversal in trend to the changed strategy of multi-national corporations (MNCs) and their reluctance to issue bonus shares.

Jijo Lukose P. J. and S Narayan Rao investigated the operating performance behavior around bonus distribution for a large sample of firms listed on Bombay Stock Exchange (BSE) to examine the relevance of signaling hypothesis in India. Previous work in this area with Indian data sets has focused on share price behavior around bonus issue. Consistent with the signaling hypotheses, bonus issuers exhibit superior operating performance relative to control firms with similar pre-event performance. The operating performance of
firms issuing bonus shares is superior to their industry peers both prior to and subsequent to the bonus issue. We link the impact of corporate control mechanism on signaling by documenting the relationship between ownership-structure and post bonus issue operating performance. Further, we examine announcement return and its relation with firm specific variables.

Inertia Theory

Mahapatra and Sahu (1993) do not find evidence in support of the Linter's model, whereas Mishra and Narender (1996) find support for the Linter's model in case of state-owned enterprises (SOEs). Bhat and Pandey (1994) find that payment of dividends depend on current and expected earnings as well as the pattern of past dividends. Dividends are used in signaling the future prospects, and dividends are paid even if there is profitable investment opportunity. Mohanty (1999) attempts to examine the behavior of payout after the bonus issue. He finds that bonus-issuing firms yielded greater returns to their shareholders than those that did not make any bonus issue but maintained a steadily increasing dividend rate. Reddy (2002) examines the dividend behavior and attempts to explain the observed behavior with the help of a trade-off theory and signaling hypothesis. The paper supports earlier finding that dividend omissions have information content about future earnings, but do not find any evidence in support of the tax-preference theory.

Lintner (1956) finds that firms pay regular and predictable dividends to investors, where as the earnings of corporate firms could be erratic. This implies that shareholders prefer smoothened dividend income. Bernstein (1998) observes that given the 'concocted' earnings estimates provided by firms, the low dividend payout induces reinvestment risk and earnings risk for the investors.
In the Indian scene, empirical researchers have documented the announcement return and cash dividend performance after bonus payment. One recent study by Mohanty (1999) finds that most of the companies either keep the same dividend rate after the bonus payment or decrease it less than proportionately (after considering bonus payment) thereby increases the cash flows to the shareholders. Obaidullah (1992) and Rao (1994) document positive stock market reaction to equity bonus announcement. Rao (1994) estimated cumulative abnormal return of 6.31% around the three days of bonus announcement. But so far no studies have been reported regarding the after-bonus operating performance of the firm.

Behavioral Finance

Baker, Powell and Veit (2002) survey different streams of research work on dividends. Fischer Black (Black 1976) may well apply in today’s context: “The harder we look at the dividend picture, the more it seems like a puzzle, with pieces that just don’t fit together”.

One of the striking aspects that have been noticed in recent periods is the lower dividend paid by corporate firms in the US. Fama and French (2001) analyze the issue of lower dividends paid by corporate firms over the period 1973-1999 and the factors responsible for such a decline. They attribute the decline to changing firm characteristics of size, earnings and growth. However, it is to be seen whether the change towards lower dividends is a permanent feature or will there be reversal. A decline in dividends, according to Fama and French, could be due to lower transaction costs, improved corporate governance mechanisms, and the increasing preference towards capital gains.
Academic research generally interprets the positive stock market reaction to split announcements as a response to managers signaling favourable inside information (Brennan and Copeland 1988; McNicholas and Dravid, 1990; Brennan and Hughes 1991). As per the signaling hypothesis, the declarations of bonus issues convey favorable private information about the future earnings to the investors. Managers have superior information about the future earnings, because there may be asymmetric information between managers and investors. Bonus issues should credibly signal such information if it is costly for firms without favourable information to imitate. For a signaling device to be valid there should be a cost associated with sending false signals; i.e. it should be prohibitively costly for firms with below average expected performance to mimic the signaling decisions of those firms enjoying above-average performance.

Grinblatt et al (1984) examine stock splits and stock dividends under the traditional signaling model and point out that it can be considered as a costly signal. In case of stock dividends, the reduction in retained earnings will restrict the firm’s ability to pay cash dividends if the firm does not anticipate increased earnings. They also propose another explanation that stock splits call attention to the firm (attention getting device) while under priced firms find such reassessment is in their interest, over priced firms do not. While presenting their transaction cost model Brennan and Hughes (1991) also argue that managers with favorable information will find it advantageous to have independent third parties produce information about their firms for investors. Another reason may be the indirect costs associated with false signaling such as loss of reputation. Managers who develop reputations for truthful signaling are likely to be believed the next time they signal. Here market uses post-split earnings changes to sort managers into
those that signal truthfully and those that signal falsely (Pilote and Manuel, 1996). Grinblatt et al. (1984), maintain that given the costs associated with stock splits and stock dividends, if managers possess unfavourable information about future growth, they may decide against increasing the number of shares even if they perceive the stock price to be ‘too high’ because they anticipate that, when this information is disclosed, stock prices will revert to the normal price anyway. In general, companies increase the number of shares outstanding only when they are confident that future-operating performance will be good enough to move share prices upward or at least to cope with market expectations. Another variation of this argument attaches more importance to ‘the implied promise of higher dividends’, as managers are reluctant to cut dividend per share (Nayak and Prabhala, 2001). The liquidity hypotheses has its base in ‘trading range hypotheses’ (Copeland (1979), Lakonishok and Lev (1987)) which argues that firms prefer to keep their share price within a popular price range.

There are a number of empirical studies on market reaction to stock dividend announcements and earnings behaviour associated with stock splits and stock dividends.

Grinblatt, Masulis and Titman (1984) provide empirical evidence indicating that stock prices, on average, react positively to stock dividend and stock split announcements. Lakonishok and Lev (1987) analyse the behavior of two major indicators of corporate performance, viz. growth in earnings and in cash dividends. The sample firms exhibited

Ikenberry et al (1996) also combine the information content hypothesis to trading range explanation in a similar fashion.
Survey of managers’ view on stock dividends/stock splits show that a vast majority regards it as a means to keep their stock’s price within an optimal trading range (Baker and Gallagher (1980) somewhat higher growth in earnings compared to ‘control firms’ within the same industry and similar asset size. Asquith, Healy and Palepu (1989) report companies that split their stocks have large earnings increase for several years before the split, as well as in the year of the split. Further, the stock price reaction to the split announcement is proportional to earnings increases in prior years. McNichols and Dravid (1990) provide evidence that firms signal their private information about future earnings by their choice of split factor. Another empirical regularity reported recently is the market inefficiency, specifically long run under reaction to stock dividend announcement (Ikenberry et al., 1996) and Desai and Jain (1997).

“Every investment is made on the expectation and assumption that it will yield some returns. Equity investment is not an exception to this. Every equity investor anticipates a good rate of return in the form of dividend to be declared by the company. So, every company pays higher attention in formulating its own dividend policy. Dividend decision is one of the most important decisions in the field of Financial Management. Dividend policy determines the relationship between a company and the capital market. Payment of dividend enhances the market price of the shares thereby increasing the wealth of the shareholders. Payment of dividend conveys to shareholders the information relating to the profitability of the firm. Economic studies generally show that the dividends act as booster of the shareholder’s confidence signalizing that the company is being managed well and its future is safe.
2.3 IDENTIFYING THE RESEARCH GAP THROUGH LITERATURE SURVEY

When we scan through the entire gamut of literature pertaining to the factors and considerations that have been governing the corporate dividend payout pattern the world over, by and large, most of these studies are not specific about the types of industries, particularly engineering industries or knowledge based industries. Most of the studies concentrate on dividend motivation with an eye on its impact on the market, rather than the internal and external compulsions of a particular type of industry.

Hence this study is intended to fill this research gap, specifically highlighting the internal and external compulsions pertaining to engineering industries in India.

These compulsions in a nutshell can be summerised as:

1. Wealth creation internally as the net worth.
2. Wealth creation externally as the market capitalization.
3. Fixed cost and depreciation in terms of the book value of plant and machinery.
4. Determining retention of internal control in the form of promoters equity.
5. Determining the dictates of financial institution in terms of institutional holding.
6. Liquidity, internally, in terms of net cash flow.
7. Liquidity, externally, in terms of interest paid.
Secondary data pertaining to these relevant factors have been collected from renowned business and economic publications and primary data through questionnaires designed to address these parameters and concerned officials and investors in the corporate sector and the capital market being the target respondents.