INTRODUCTION
CHAPTER I

INTRODUCTION

Investments with an intention to earn some extra rupees are very widely practiced today. Investment has come a long way from the time when it was confined to gold jewels and/or bullion, safeguarded in earthen pots underground in the backyard, to deposit with banks and investment in guilt edged securities, to the present state of wide participation in capital market securities like shares and debentures of public limited companies. This change had been the result of a number of factors some of which are: increased life expectancy, resulting in planning for old age and providing for their necessities and for a comfortable life during the evening of one’s life; increasing employment opportunities resulting in larger disposable income as well as the consequential increase in taxes compelling tax payers to resort to invest in eligible securities for avoiding taxes which has opened greater avenues for investment; the higher interest and returns from investments has added to the lure for investments; and the need for larger returns being accentuated by the need for people to protect themselves from the erosion in the money value due to inflation through compensatory increase in income.

The possibility of the institutions which accept investments defaulting on payments or cheating the investors, has been reduced.
considerably by providing legal safeguards whereby, information is being disseminated through disclosures and following certain procedures to avoid misuse of invested funds as well as through the overseeing of a number of watchdog institutions like the SEBI, credit rating agencies, etc. This has increased the confidence of the investors in the proliferating quantum of securities in the investment market. In other words what was previously a restricted domain of a privileged few has become wide open to any discerning person having extra rupees which he wants to stack away. The increase in the nature and the type of securities to invest in has also contributed its might to the change. The advent of different types of debentures, bringing in flexibility in risk and return, the mutual funds offering scope for well managed portfolios to the commoners and the varying schemes of the Unit Trust of India catering to the multifarious needs of the investing community can be cited as examples of the wide avenues and choice open to the investors.

The increasing phase of economic development and the resultant expansion in business activities as well as the steps taken up by the number of development institutions to promote entrepreneurs has started bearing fruits. This saw a tremendous increase in private sector entry in business, which contributed to the need for attracting business investments.
The growth in the capital market securities is more with respect to equity shares. The demand for equity shares has increased manifold as has been evidenced by the over subscription of many of the equity share issues especially during the latter half of the eighties and the early nineties. Greater participation of investors and traders has reflected in the increased volume of trading in the securities market as well as the enthusiastic reception accorded to new and additional issues of capital which has been partly reflected in the heavy subscription of equity issues in the capital market. "The attitude towards equity shares has varied from extreme pessimism to optimism from time to time. It is equity shares that entice most investors, and some investors have been known to feel a greater sympathy for their equity than their spouses. Presence of market and business risks associated with such investments fails to keep the investing public and institutions out of the market because of their confidence in the ultimate success of the equity shares."

The above discussion brings home the fact that investment in equity shares is currently being taken up very widely by different class of investors. The investing class may be broadly classified into individual investors and institutional investors. Before attempting to describe

these, it would not be out of place to mention the characteristic features of equity shares which places it in a unique position among the various investment channels open to investors:

1. The limited liability character ensures that the liability of a member is limited to the face value of shares he holds. This would mean that worst come worst, he would lose only the face value and nothing more.

2. Free transferability is ensured in law whereby, if a member decides to liquidate his holding of shares in the company he can readily do so, since law permits transfers. The ready market for such shares also makes it possible for the investors to sell away his shares and if needed buy some other shares according to the investor’s preference and need.

3. Investment in shares provides an opportunity for the investor to take part in the potential profit of the company. Participation in profits is possible not only from the earnings from current operations but also from the growth of the company, which in other words signify the potential future profit. It is this possibility of partaking in the results of the business activities of companies that has put shares in the prime list of investment as far as the investor is concerned.

The income earned by the investor from investment in shares may come in two forms. One is the share of earnings of the company appropriated to the shareholders and paid to them. The other is the income
received by way of an appreciation in the value of the share in the market. The former is referred to as the dividend while the latter is a gain. Even though these forms of income are interrelated in a restricted sense, a distinction will have to be made as between these two. An investor emphasizes upon and gives importance to the former namely dividend. A person who gives importance to changes in the market value and intends to make a profit on or due to changes in the market value is termed as a speculator. Speculators do not give any importance to dividends except in so far as it affects the market value. Whereas investors look for dividends as a main source of income and they consider market value only as a decision variable to decide whether to continue holding the share or to sell away. Even though investors might book a profit or incur a loss on such transactions the distinguishing feature is that they do not consider it as a regular source of earnings. Hence to an investor both dividend and market value are decision variables whereas to the speculator dividend does not matter. This study is with reference to the earlier category namely investor. While the above is from the view point of investor, from the point of view of company dividend is an important decision variable to the finance manager. Financial management today revolves around and is considered to be involved in three important decision areas namely, i) investment decision, ii) financing decision and iii) dividend decision. These three decisions are not exclusive of each other. Rather there is very
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high interdependence among these three. In other words, investment decision would lead to financing decision and dividend decision has a say in financing decision. To an extent dividend decision also designs the investment decision and sometimes even be designed by it. The dividend decision on the part of the company involves the choice as to appropriation of earnings of the company, the choices available being, giving away a substantial portion of the profit to the shareholders as dividend, or to give away only a very low amount of profit as dividends or even nil dividends. Hence, the choice in one extreme is a hundred percent payout where in, the entire profits are declared as dividends and the other extreme being zero percent payout that means nil dividends and 100% retention of earnings. These two extremes are seldom followed in practice and the decision would be some where in between these two extremes. This decision would determine the dividend policy of the company. In establishing the dividend policy so many factors act upon in determining the same. These aspects are discussed in detail in a subsequent chapter.

The balance left back with the company after declaring dividend is referred to as the retained earnings or the profit ploughed back into the business. The importance of retained earnings to a company is many. It is considered an important source of capital to the business. It is considered important because of its easiness, absence of any cost in one sense and also because of its convenience. While in some
companies retained earnings are treated as a residual decision in some companies the need for retention of earnings would determine the dividend available for distribution. This again would form the basis of the dividend policy of the company.

Even though the amount of dividend to be declared is a decision solely in the hands of the management, in the sense the shareholders do not have any say legally, in determining the quantum of dividend, in practice the finance manager is not given total freedom especially with regard to shareholders' consideration in deciding the quantum of dividend. This is mainly because of the fact that dividend is seen as a main source of income by the investors. Meeting the expectations or requirements of the shareholders is an important consideration on the part of the companies. This aspect is discussed in detail in the next chapter.

Dividend also carries information value in the sense, payment of dividend is considered by the market as well as the shareholders to signal the financial health and operational efficiency of the business. In the absence of dividend, however healthy and efficient a company is, it might send out wrong signals to the market and shareholders, which the company would like to avoid.

The company should also consider a situation in which without paying out dividend if earnings are accumulated, it might, in the long run, lead to under-capitalisation and its harmful effects.
Moreover in the present capital market conditions, where the institutional investors play a major role in investing in shares of a company, meeting the eligibility criteria of such institutions is an important requirement. One of the main eligibility criteria for the company is payment of regular dividends.

It is because of the above that most of the companies are required to pay some amount of dividend, the actual amount being decided taking into the consideration several determinants, one among which is the needs of the investors.

Reverting back to the earlier mentioned class of investors there are basically two classes of investors namely individual investors and institutional investors. The institutional investors themselves can be classified into two; i) Business institutions, having surplus funds which they would like to invest in other concerns either with an intention to earn an income out of such investments or to obtain a controlling interest in the investing company and ii) Institutions whose main business is investment, such as investment trusts, investment companies, mutual funds, etc. As mentioned earlier changes had taken place in the capital market whereby, presently the institutional investors have started dominating the capital market. The role of institutional investors and their importance is growing day by day. This is due to the fact that individual investors have started depending more on investment companies and mutual funds. Since the
investment game today has become highly complicated in the sense, the quantum of information required and that which is available has substantially increased and the timing of entry into and exit from the stock having become an important factor, both of which will have to be appropriately and efficiently made use of in arriving at decisions, in order to win the investment game. The potential investors who cannot involve themselves directly in the game either because they do not have the information or the know-how or the techniques, take the help of the professionals, indirectly investing through the investment companies and/or mutual funds which have specialised in the investment business. The main objective of resorting to such mode being, taking part and reaping extra riches from the stock market. Hence in effect, whatever the class of investors, dividend is considered as one among the important investment decision criteria.

The above discussion brings out the fact that dividends are looked upon not only as a source of income but dividends also to an extent determine the value of the stocks in the market, the variations in which contribute to the overall income of the investor.

**TYPES OF DIVIDEND**

Dividends are declared and paid in many forms.

Cash dividend is the amount paid in cash to the shareholders generally out of profits from the operations of the company.
Sometimes a company issues additional shares to the existing shareholders of the company, which can be construed as dividend and hence also referred to as bonus share or stock dividend. Stock dividend is paid by the company out of the retained earnings of the company, in effect capitalising the accumulated earnings of the company.

Scrip dividends are used when earnings justify a dividend, but the cash position of the company is temporarily weak. The shareholders are issued shares or debentures of other companies, which this company holds as part of its investment.

Dividend may be paid in the form of debentures or bonds or notes for a long-term period bearing interest at fixed rate.

Optional dividend is a method of payment of dividend either through cash or through stock.

**DIVIDENDS FROM CAPITAL SURPLUS**

Cash dividend from the current profits or income is the preferred method of paying the shareholders for their investment in a company. But sometimes the company may also pay dividend out of capital profit obtained out of revaluation of assets subject to the condition that all the assets are revalued and if Articles of Association permits it to do so. The dividend distributed in this manner from capital surplus does not affect the creditors of the company.³

The investors should bear in mind that there are several sources for a company to make the payment of dividends. The company can pay the dividends from its current earnings which arise out of the regular operations of the company. It may also pay dividend from the past accumulated profits. The company is also permitted to pay a dividend out of the income from its subsidiaries. The company is sometimes allowed to pay dividends out of other sources, but only, after certain stipulated conditions are met. These sources may be, from profits on sale of a property, when a company makes a surplus from mergers or purchase of subsidiaries etc.

Even though different types of dividend exist theoretically as stated above, the Company Law in India prohibits a company from paying dividends other than by cash. Stock dividend or bonus shares are to be issued only for capitalising reserves and not as an alternate to dividends. Hence in law there exists only one type of dividend namely, cash dividend.

LEGAL PROCESS

Dividend can be declared by the Board of Directors only on fulfilling certain conditions. The dividend that is declared should be out of surplus only, and after adequate provision for depreciation had been made. Also depending on the percentage of dividend declared, a certain percentage of profits will have to be retained for as reserves. Considering these
aspects, the Board of directors recommends a dividend, and a resolution to be adopted in the annual general body meeting is designed to that effect. The shareholders in the annual general body meeting have the right to either accept the dividend recommended by the Board of Directors or reduce the quantum, but they cannot increase it. Once the dividend has been declared the amount will have to be paid to the shareholders within 41 days. Any amount unpaid beyond 42 days is required to be transferred to a separate bank account.

The long-run considerations and the short-term factors may be stated as to constitute the dividend policies and practices of the company. This study has been taken up with an intention to analyse the dividend practices followed by companies as well as to ascertain whether any specific policy had been followed by such companies.

**STATEMENT OF THE PROBLEM**

Many considerations and factors both legal and financial will have to be taken into account by the finance manager when deciding on payment of dividend. The long-run considerations and the short-term factors may be stated as to constitute the dividend policies and practices of the company.

Dividend policy, as intimately related to retained earnings, refers to a policy concerning the quantum of profits to be distributed as dividend. This is probably one of the most important areas of
decision making for a finance manager. Action taken by the management in this area has important repercussions on the growth rate and value of the company. An erroneous dividend policy may land the company in financial predicament due to the capital structure of the company turning out unbalanced.

Dividend policy substantially affects the financial structure of a corporation, the flow of funds, liquidity, share prices and the investor satisfaction with regard to return on his investment. It helps in achieving the main financial objective of a company namely maximisation of its value. From the investors’ point of view, regularity in income received and market value enhancement are important considerations in the investment decision. To the extent dividend decision contributes to satisfaction of these requirements it affects the welfare of the investing public. Many earlier studies have identified several factors to have had an impact in determining the dividend policy and practices of a company. This study has been taken up with an intention to examine the dividend practices followed by companies as well as to ascertain whether the determinants, as have been theoretically found to have an impact, is applicable to companies in India. It is also intended to study the dividend policy that had been followed.
OBJECTIVES OF THE STUDY

The following are the objectives of the present study:

1. To study the dividend payment practices in terms of the study type of dividend policy adopted by the companies selected for the study.
2. To identify the determinants of dividend of the selected companies of the study.
3. To ascertain the extending influence of such determinants on the dividends paid by the companies, in general and industry wise.
4. To study the impact of dividends on the market value of the company in terms of share prices changes; and
5. To draw conclusions based on the findings.

METHODOLOGY ADOPTED

This study relates to an analysis of dividend policies and practices of companies in India. Secondary sources of data have been heavily relied on for its study. Financial information periodically published by the companies form the basic data of this study. The study had been confined to such secondary data which are obtained from the annual reports of the selected companies. Primary data of the required type could not be obtained, since most of the companies stated that they could not discuss or reveal policy matters that too, which related to the highest level of decision making body. Market value data namely quoted prices of the stocks of the selected companies as well as the general market values which are periodically published had also been made use of.
SAMPLING

Due to the large number of companies established and operating in India and since the public are not interested either as investors or as resource users, the study is confined to only public limited companies in which the public are substantially interested. The Registrar of Joint Stock Companies provides a list of companies registered in India which numbers around 12,000 as of 2006. All of them are not dividend paying companies nor are they traded in the market. Hence, the listed and widely traded companies in the BSE are to be selected. The number of such companies is 820.

Since this study relates to an analysis of dividend policies and practices of companies it had to be restricted to the dividend paying companies only. In other words, the study is proposed to be restricted to widely traded and dividend paying companies listed in the Bombay Stock Exchange (BSE). There were 3100 companies listed in the BSE. However these 3100 listed companies were neither regularly traded nor regularly dividend paying companies. Out of the 3100 listed companies, 820 were dividend paying companies but not regularly dividend paying ones. Out of these, 598 companies were listed under Group A category in the BSE which means they were traded on a regular basis in the exchange. These 598 companies satisfy both the criteria of dividend paying and regularly traded stocks. Since study of dividend practices required continuous payment of dividends, those companies which satisfy
both the requirements namely continuously and regularly paying dividends during the study period 1999-2008 and also regularly traded were selected for this study. The number of such companies was 120. These were identified as the companies for this study and data were collected. The scrutiny of the data showed that for some of the financial services companies, especially banks and insurance companies, the data were found not to be compatible with the data of other companies which may likely affect statistical analysis. Such companies were 10 in number. Hence these 10 companies were eliminated from the study. A scrutiny of the financial data of the remaining 110 companies showed that for 27 companies the data were highly inconsistent especially with relation to key variables such as working capital, annualized dividend, etc. Since such inconsistency is likely to have an adverse impact on results of statistical analysis they had to be eliminated in order to make a meaningful analysis of the rest of the companies. Hence the remaining 83 companies constitute the selected companies and were subject to analysis. The list of selected companies is shown in Appendix A.
SOURCES OF DATA

The data requirements for the 83 companies selected was the financial data namely, those published in the annual reports of the individual companies. Several data bases exist, which compiles the financial data of all the companies and also the related market data. The data bases used in this study for analysis were EBSCO, Pro Quest, Capital Line Database, CMIE – PROWESS, Cygnus Knowledge Portal, ICFAI online Database.

STATISTICAL TOOLS

Since the study mostly involved assessing the extent of relationship and influence among identified variables, the statistical tools, partial correlation, multiple correlation, standard deviation, coefficient of variation and regression analysis are used to assess the influence of the independent variables. Such data for the different variables identified were collected for the years from 1999 to 2008 and are subject to analysis. (A detail discussion on the selection of the independent variables is made in chapter three). To check the statistical significance of the model, ‘F’ test is used. DW statistic test is also applied to check for the existence of any auto correlation among residuals. To assess multicollinearity, tolerance and variance-inflation factor are used. To find out the impact of dividends on share prices, multiple partial regression is used. Analyses of the obtained data were made using SPSS and inferences were drawn.
The data obtained from the data bases which were used for the above analysis is also shown in Appendix A.

**PERIOD OF STUDY**

The study period for obtaining the required data was the ten year period from 1999 to 2008.

**SCOPE AND LIMITATIONS OF THE STUDY**

Since the study related to dividend practices of companies, it was purposely restricted to dividend paying companies only. In order to account for consistency of the financial data the period of study was limited to a ten year period namely, 1999 to 2008.

In dealing with policy options, first hand information from the respective companies would have added to the quality of conclusions. But as stated earlier since many of the companies were not prepared to discuss such matters with outsiders, the study had to be limited to the published data alone. However care had been taken in arriving at conclusions considering this aspect.

**CHAPTER SCHEME**

The report on the study is categorised and presented as follows:

The first chapter introduces the topic of the study and gives the statement of the problem, methodology adopted, statistical design, period of the study and limitations of the study.
The second chapter gives the theoretical foundations relating to dividend policies, determinants of dividend policy and also a brief review of related studies done in the past.

The third chapter deals with identification of determinants and gives the analysis and results with reference to the study companies.

The fourth chapter assesses the impact of dividend information on the stock values of the concerned companies.

The fifth chapter summarises the study and important conclusions arrived as also given.