CHAPTER 1
INTRODUCTION

1.1 INTRODUCTION TO DIVIDENDS

Dividends are commonly defined as the distribution of earnings (past or present) in real assets among the shareholders of the firm in proportion to their ownership. [1],[2]

Dividends are commonly defined as distribution of earnings (past or present) in real assets among the shareholders of the firm in proportion to their ownership. There are three parts of this definition, all equally important.¹

The first is that dividends can be distributed only from earnings and not from any other source of equity, like, paid –in – surplus etc.

The second is that dividends must be in form of a real asset. It is common practice to pay dividends in cash (in form of dividend cheque) because of the convenience of the matter. It is hard to imagine that Boeing, would send the right wing of a 747 as a dividend to one of its major stockholders. Regardless, evidence shows (from other countries) that some firms during high levels of inflation have paid dividends in the form of product they were producing.

The third part of the definition states that all stockholders’ share in dividends relative to their holding in the corporation.

Dividend policy has been an issue of interest in financial literature since Joint Stock Companies came into existence. The question of the ratio of retained earnings to distributed earnings is referred to as dividend decision or policy. The guiding philosophy of dividend decision is naturally to adopt a policy that maximizes the shareholders’wealth. Therefore, from the view point of financial management, the objective is to find out the dividend policy that will maximize or enhance the value of the firm.

¹ This section draws heavily from the thorough review provided by Frankfurter and Wood.
Dividends are paid from the firm’s after tax income. For the recipient, dividends are considered regular income and are therefore fully taxable. This tax treatment results de facto in double taxation of dividends in America (but not in several other countries, e.g. Canada and Germany), the only source of income that is subject to such treatment. In India the company declaring the dividend has to pay dividend distribution tax and dividend income is exempt from tax for the recipients or the shareholders.²

However in most of the countries the economic consequence of dividends is an involuntary tax liability to the owners (country like India being an exception).

There is an incongruity which becomes evident at this juncture. The incongruity is that dividend announcements and payment are considered good news, held and hailed as such by investors and most analyst, whereas dividend cuts and reductions are considered bad news suggesting impending financial doom. This incongruity is commonly referred to as “Dividend puzzle”. Three decades ago, Black (1976) wrote: “The harder we look at dividend picture, the more it seems like a puzzle, with pieces that just don’t fit together” [3] Brealey and Myers (2002) have enlisted dividend policy as one of the top ten puzzles in finance.[4],[5]

The questions of "Why do corporations pay dividends?" and "Why do investors pay attention to dividends?" have puzzled both academicians and corporate managers for many years.

Perhaps the answers to these questions are obvious. Perhaps dividends represent the return to the investor who puts his money at risk in the corporation. Perhaps corporations pay dividends to reward existing shareholders, and to encourage others to buy new issues of common stock at high prices. Perhaps investors pay attention to dividends because it is only through dividends or the prospect of dividends investors receive a return on their investment or the chance to sell their shares at a higher price in the future.

² There have been several changes in the tax regime in the last few years. The Union budget 1997-98 made dividend taxable in the hands of the company paying them and not in the hands of the 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 dividend policy of the corporate firms.
Or perhaps the answers are not so obvious. Perhaps a corporation that pays no dividends is demonstrating confidence that it has attractive investment opportunities that might be missed if it paid dividends. If it makes these investments, it may increase the value of the shares by more than the amount of the lost dividends. If that happens, its shareholders may be even more better off. They end up with capital appreciation greater than the dividends they missed out on, and they find they are taxed at lower effective rates on capital appreciation than on dividends.

In fact, the answers to these questions are not obvious at all. Although Professor Black's observations were made two decades ago, financial economists still are wrestling with the "dividend puzzle."

There is yet another dimension to academe's failure to solve the puzzle. Academic thinking about dividends – and whatever this thinking produced- has completely ignored the evolution of dividend payments in modern corporations. Dividend payment behavior, known as “dividend policy”, did not simply appear out of nowhere. It evolved with modern Corporation over a period of four centuries. The details of this evolution are chronicled in a number of publications; among them is an article by Franfurter and Wood (1997). The evolution of dividends by these eminent professors has been discussed in the succeeding section. Putting corporate dividend policy in a historical perspective makes one wonder how and why scholarly model of dividend policy could disregard such evolution.

In 20th century, emphasis on the importance of dividends emanated from the publication of a major investment text, which, in a short time, turned out to be the bible of financial analysts. The text, written by Graham and Dodd (1934), was later updated (Graham et.al., 1962). In this text, the authors proclaim dividends to be the only purpose of firm’s existence. They also contend that if two firms are operating in the same environment and are identical in every respect, the one that pays regular dividends would sell for a higher P/E multiple than the one that does not meaning that former is less risky than the latter.[6],[7]

Serious academic thinking and concomitant research into the dividend decisions and practice began in the early 1950s. Consistently with Graham Dodd thesis, early
models (often referred to as *bird-in-the-hand* models\(^3\)) intended to show that dividends are valued for the discounted cash stream they provide to the shareholder. These models advocated a dividend policy that amounted to a 100%, 0, and anything-in-between payout ratio of earnings; that is, not much of a policy at all, even if one accepted the value creating logic of the bird-in-the-hand models. Thus, it can be stated till the mid of 20\(^{th}\) century dividend payment primacy existed.

The debate over the importance of dividend policy first appeared in Miller and Modigliani (1961), who concluded that in a world of perfect capital markets, the payment of dividends does not affect the value of the firm and is therefore irrelevant. In such a world, firm value depends only on the distribution of future cash flows that result from the investments undertaken \([8],[9]\). For example, Bernstein (1996) contends “dividends, in and of themselves, do not matter, provided managers avoid driving down the spread between ROE and the cost of capital.”\([10]\) To accommodate the world in which market imperfections exist, academicians have developed many theories to explain reasons for a firm to pay dividends. For example, for mature companies with highly stable cash flows, paying too little in dividends could lead managers to investing excess cash flow in projects or acquisitions with insufficient net present value. Yet, for high growth firms, paying out too much in cash dividends may reduce the firm's financial flexibility and force it to pass up valuable investment opportunities. Either of these situations could negatively affect a firm's value over time. Despite much research intended to resolve the dividend puzzle, dividend policy remains one of the most judgemental decisions that a manager must make. As Ang (1987) notes, "Thus, we have moved from a position of not enough good reasons to explain why dividends are paid to one of too many. Unfortunately, some of these may not be very good reasons, i.e., not consistent with rational behaviour."

During the last several decades, the debate over the importance of dividend policy has continued leading the best academic minds to grapple with dividend puzzle. Financial economists posited -and still so a variety of theories that tried, almost exclusively, to justify the payment of dividends using the principles of wealth maximisation.

\(^3\) The allegory is that cash today is preferred to cash in the futures, as one bird in hand is preferred to two in the bush. Of course, it would depend on what the two birds are doing in the bush and on whether we are one of the birds.
Some researchers have surveyed corporate managers and institutional investors to determine their views about dividends. Despite extensive debate and research, the actual motivation for paying dividends remains a puzzle. Therefore this study is an endeavour to add to the existing body of knowledge and contribute towards solving the dividend puzzle prevalent in Corporate Finance.

Those who are proponents of the Dividend Relevance hypothesis emphasize that firm’s should design an appropriate dividend payout policy. However, while framing an appropriate dividend policy several questions may be posed in front of a Finance manager. To enumerate a few: How much cash should firms give back to their shareholders? And what form should payment take? Should corporations pay their shareholders through dividends or by repurchasing their shares, which is the least costly form of payout from tax perspective? Firms must take these important decisions over and over again (some must be repeated and some need to be revaluated each period on regular basis).

Because these decisions are dynamic they are labeled as payout policy. The word “policy” implies some consistency over time, and that payouts, and dividends in particular, do not simply evolve in an arbitrary and random manner.

Payout policy is important not only because of the amount of money involved and repeated nature of the decisions, but also because payout policy is closely related to, and interacts with, most of the financial and investments decisions firms make. Management and board of directors must decide the level of dividends, what repurchases to make (and the mirror image decision of equity issuance), the amount of financial slack the firm carries (which may not be a trivial amount); investment in real assets, mergers and acquisitions, and debt issuance. Since capital markets are neither perfect nor complete, all of these decisions interact with one another.

Understanding the payout policy may also help one to better understand the other pieces in this puzzle. The most common observations that play an important role in the discussion of payout policies:

a) Large and established firms typically pay out a significant percentage of their earnings in the form of dividends and repurchases.
b) Historically, cash dividends have been the predominant form of payout. Though nowadays stock repurchases, stock splits are also gaining importance.

c) Corporations smooth dividends relative to earnings.

d) Markets react positively to announcements of repurchases and dividend increases, and negatively to announcements of dividend decreases.

As it is known and well accepted that the objective of an organization is shareholders’ wealth maximization. The challenge to financial economists is to develop a payout policy framework where firms maximize shareholders’ wealth and investors maximize utility. Clear guidelines for an “optimal payout policy” have not yet emerged despite voluminous literature. An acceptable explanation for observed dividend behavior of companies has still not been obtained. The factors that drive dividend decisions and manner in which these factors interact need to be understood completely by the financial economist.

In nutshell, it can be stated Dividend decisions are recognised as centrally important because of increasingly significant role of the finances in the firm’s overall growth strategy. Dividend policy connotes to the payout policy, which managers pursue in deciding the size and pattern of cash distribution to shareholders over time. Managements’ primary goal is shareholders’ wealth maximization, which translates into maximizing the value of the company as measured by the price of the company’s common stock. This goal can be achieved by giving the shareholders a “fair” payment on their investments. However, the impact of firm’s dividend policy on shareholders’ wealth is still unresolved.

1.2 A SHORT HISTORY OF DIVIDEND POLICY

Corporate dividend payments to shareholders began more than 300 years ago and have continued as an acceptable, if not, required, activity of corporate managers, despite the apparent contradictory economic nature of these payments.

It seems that the corporation progressed from original liquidating dividend, to distribution of all profits (retaining some capital), to a token dividend payment, the
size and frequency of which are left to the discretion of management. At the same time, alternative schemes of distribution (such as repurchase of stock, green mail, etc.) and quasi-distribution (such as stock dividends and splits) have been devised and accepted.

Clearly, this evolution could not have occurred in vacuum. It has been paralleled, if not participated, by systematic removal of the owners from management, i.e., the separation of control from ownership.

Frankfurter and Wood (1997) provide an excellent comprehensive survey of the history of corporate dividend policy since the inception of shareholder-held corporations. It was noted early in the sixteenth century captains of sailing ships in Great Britain and Holland began selling to investors’ claims to the financial payoffs of the voyages. At the conclusion of the voyages, proceeds from the sale of the cargo and shipping assets, if any, were divided among the participants proportionate to ownership in the enterprise. These distributions were, in fact, payments that effectively liquidated the venture, or liquidating dividends. By this practice, claimholders avoided complex accounting practices, such as accrual accounting procedures. In addition, the liquidation of ventures minimized potentially fraudulent bookkeeping practices. By the end of the century, these claims on voyage outcomes began trading in the open market. These claims to outcomes were later replaced by share ownership.

Even before the development of modern capital market theory, along with the statistical measurement of the impact of diversification on portfolio risk, investors in these sailing ventures regularly purchased shares from more than one captain to diversify the inherent risk in these endeavors. Also, as in the modern corporation, investors provided capital for these ventures, while the captains offered their specialized skills—for instance, seafaring and management skills.

However, as time passed owners began to realize that the complete liquidation of assets at the end of each voyage was inefficient; start-up and liquidation costs for new ventures were significant. A track record of success for a captain, and increasing confidence by shareholders in the accountability of the management of the firm, gave

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4 This section draws heavily from the thorough review provided by Frankfurter and Wood.
way to a system of partial liquidation at the termination of specific ventures—dividends in the range of 20 percent of the profits but not liquidating dividends.

The concept of firms as "going concerns" without a finite life corresponding to the length of a "voyage" persisted and produced the first dividend payment regulation. Corporate charters included limitations of dividends to payments from profits only. By 1700, the British Parliament had passed two standards that regulated dividend payments: the profit rule and the capital impairment rule. The profit rule was intended to protect creditors from de facto liquidations of the firm to the benefit of shareholders. The capital impairment rule, which restricted transfers from retained earnings to dividends, was adopted to provide for the firm's continuing existence.

The success of the stock ownership structure of shipping companies spread to numerous new industries in the latter part of the seventeenth century—for example, mining, banking, retailing, and utilities.

The first dividend statute in the United States was enacted in New York in 1825 and was quickly emulated by other states. Following the Civil War, the majority of northern manufacturing firms paid regular dividends in the range of 8 percent of profits. The general lack of financial information resulted in investors trying to establish firm value by analyzing the firm's dividend track record. The general increases in dividend payments were reflected in rising share prices. After 1920, U.S. firms for the first time began to "smooth" dividend payments, that is, create a relatively stable dividend payment stream less volatile than earnings. During the 1920s, average payout ratios grew to about 70 percent of profits.

In the years following World War II, corporate dividend policy remained relatively unchanged, and payout levels have stayed fairly constant. By 1960, the payout level for all corporations was slightly in excess of 60 percent. Management continued to smooth dividends and, indeed, does so to this day.

Thus, the history of dividends began with the payout of liquidating dividends when sailing ventures were terminated upon completion and the profits and proceeds from asset sales were distributed to claimholders. However, due to inefficiencies induced by total liquidation, dividends began being paid from profits. Earnings were retained
to finance new investments, and dividend payments became only small partial, or symbolically, liquidations.\textsuperscript{5}

Frankfurter and Wood (1997) concluded their study on the evolution of dividends with the following observation:

Dividend-payment patterns (or what is often referred to as "dividend policy") of firms are a cultural phenomenon, influenced by customs, beliefs, regulations, public opinion, perceptions and hysteria, general economic conditions and several other factors, all in perpetual change, impacting different firms differently. \textit{Accordingly, it cannot be modeled mathematically and uniformly for all firms at all times.}

\section{1.3 Dividend Policy}

A dividend policy of a corporation may range from a mere decision regarding dividend action to rather complex formal statements approved by board of directors and reviewed on regular basis. Dividend policy may be reviewed at the annual shareholders’ meeting or may be published in the annual report.

Not all the firms require a formal dividend policy. Closely held businesses in which the equity participants hold a position on the board of directors or maintain a working knowledge of the business probably do not require a formal policy. Formal dividend policies are normally associated with firms that have achieved significant size in revenue and variety of shareholders. The complexity of financial management and planning play an important part in determining when a formal dividend policy is required. Industrial organizations that are capital intensive and must engage in long range planning to assure adequate supplies of capital in future may require a specific dividend policy to assure that sufficient amount of funds are available when asset acquisition is undertaken. At the same time, it is important to achieve a balance between retained earnings and dividends to assure a market for new equity shares in event additional equity capital is required.

\textsuperscript{5} Anytime a firm pays out cash as a dividend, or repurchases common stock, the firm has been reduced in size, or in a real sense partially liquidated.
In view of the multi-dimensional nature of dividend policy decision, a deliberate policy needs to be framed and pursued in this regard. It should not be allowed to become a series of ad hoc decisions taken on the spur of the moment considering only the immediate availability of cash for dividend payment (Chakrabarty et.al.1981). Thus, the objective of choosing a dividend policy should be to maximize the value of the firm.

Dividend policy can be of two types: managed and residual. In residual dividend policy the amount of dividend is simply the cash left after the firm makes desirable investments using NPV rule. In this case the amount of dividend is going to be highly variable and often zero. If the manager believes dividend policy is important to their investors and it positively influences share price valuation, they will adopt managed dividend policy. The optimal dividend policy is the one that maximizes the company’s stock price, which leads to maximization of shareholders’ wealth. Whether or not dividend decisions can contribute to the value of firm is a debatable issue.

As an outcome of limitations present in the real world, most factors favour retention of earnings rather than cash dividend. The tax advantage from capital gains is substantial, and favours retention. Other factors include the presence of floatation costs, the phenomenon of underpricing and legal hassles that are also in favour of retention of earnings, rather than its distribution. The presence of transaction costs is the only factor that favours cash dividend payment.

Due to the factors overwhelmingly supporting retention, firms ought to follow the following dividend policy:

1) Identify all possible positive NPV projects.

2) Retain the required cash to accept all such projects, so as to increase the value of the firm.

3) Maximise returns to shareholders through increase in the prices of shares

4) Distribute the remaining cash balance only when all positive NPV projects are funded.
5) Raise fresh capital only when internally generated earnings are not enough to accept all positive NPV projects.

Such a policy of dividend is referred to as \textit{passive residual dividend policy}. This policy dictates returning only excess cash. Following such a policy must lead to optimal results.

The passive residual dividend policy would imply fluctuating dividend from period to period, because the flow of earnings and the availability of positive NPV projects can hardly be said to be steady. Both earnings and available opportunities are volatile by nature. Therefore, following a passive residual dividend policy essentially implies volatile dividends over time.

However, the empirical evidence is contrary. Several studies have revealed that dividends are sticky and follow a smoother pattern than earnings, a phenomenon that is sustained by general observation. Firms generally do not raise dividends unless they are absolutely sure of sustaining this trend in future. Similarly, they do not reduce dividends unless they feel that the drop in earnings is due to bad economic conditions, or to other reasons that are likely to prevail for an extended time. Therefore dividends are likely to be more stable than earnings.

On occasion, the firm may have to maintain a stable dividend payout ratio simply because the shareholders expect it and reveal a preference for it. Shareholders may want a stable rate of dividend payment for a variety of reasons. Risk averse shareholders would be willing to invest only in those companies which pay high current returns on shares.

Some of them are partly or fully dependent on dividend to meet their day-to-day needs. This class of investors generally include pensioners and other small savers. Similarly, educational institutions and charity firms prefer stable dividends, because they will not be able to carry on their current operations otherwise. Such investors would, therefore prefer companies which pay a regular dividend every year. Some may like more dividends, while some other. Investors who favour dividend may chose high- dividend paying companies for their portfolios, while the group that does not need dividend would pick stocks that offer more capital appreciation may prefer capital gains; yet another group may like to have both. Thus the investors can be
grouped according to their preference for dividend or capital gains. These groups are refereed to as clienteles. The clientele effect refers to investors’ selection of firms that match their preference for dividends. A change in dividend policy would cause the clienteles to shift their investments. The argument that firms should not change their dividend policies for the sake of retaining the same clientele is a debatable one.

1.4 ECONOMIC RATIONALE TO DIVIDENDS

The dividend literature has primarily relied on two lines of reasoning to generate predictions about dividend behaviour: information asymmetry and agency conflicts.

The information asymmetry models argue that managers know more than investors about firm’s prospects and the dividends reveal some of that information to the market. This implies that dividends change announcements should be positively related to stock returns because a higher dividend level signals higher current or future earnings. A number of studies report significant excess returns around the announcement of dividend changes: positive (negative) returns are associated with positive (negative) changes in dividends. Information asymmetry also helps to explain the observed reluctance of managers to change dividends.

The collective wisdom of the literature suggests that, when a firm is underpriced relative to the private information held by managers, managers may be able to use dividends to establish a market value for the stock that is more in line with their private information. Since the payment of dividends has costs to management, managers have to evaluate the importance and urgency of establishing an appropriate market value. For example, if the firm or its shareholders are planning to sell securities, or if the firm is a potential takeover target, establishing the proper value of the firm—a value that incorporates favorable private information—is important. The extent of undervaluation by the market and the size of the required equity sale may be determinants of the dividend payout.

Lenders generally prefer to entrust their money to stable firms rather than ones that are erratic, as this reduces risk. Therefore it could be speculated that a consistent dividend flow helps to raise the credit standing of the firm and lowers the interest rate.
payable. Creditors suffer from information asymmetry as much as shareholders and may therefore look to this dividend decision for an indication of managerial confidence about firm’s prospects.

Firms should adopt a dividend policy that allows implementation of an investment policy that maximizes market value. In general, firms should not underpay dividends. Retained funds should be invested in projects that pass the NPV Rule. Having too much cash lying around is an ill-advised investment. Consistent with this observation is research that illustrates that the market responds positively to the announcement of increases in capital expenditures.

In short, excessive cash balances increase managers' degree of investment flexibility, which may be to the detrimental for the shareholders. After all, managers experience a normal set of human temptations. On the one hand, if management compensation and/or prestige is based on firm size or sales, the temptation exists to overinvest in projects or to acquire other firms that may not be strategically advisable nor value enhancing.

On the other hand, overpayment of dividends and underinvestment in positive NPV projects also are potential problems. These problems can be overcome by bond covenants that restrict dividend payouts.

In general, high-growth firms can afford to write strict or tight dividend constraints that severely limit their ability to pay future dividends. This is because these firms are not plagued by overinvestment concerns given the abundance of good investment projects. These firms are likely to need outside financing regularly and therefore are subject to the discipline of frequent capital market scrutiny. Further, these firms have less need for future dividend flexibility because of their need to finance investment. Moreover, dividends are less important to investors in high-growth firms who seek out these firms in the expectation of receiving little, if any, dividend income.

For the opposite reasons, low-growth firms should negotiate looser dividend constraints. With a scarcity of future positive NPV investments, these firms are likely to generate large free cash flows that should be paid to shareholders. Without the dividend payout commitment, overinvestment may be a temptation. [11]
Highly leveraged firms can write strict dividend policy constraints. Heavy debt service obligations limit these firms' ability to overinvest, and frequent refinancing provides capital market discipline. Indeed, empirical research indicates that growth firms and firms with higher leverage, all else being equal, choose tighter dividend constraints and pay fewer dividends (Kalay 1979). [12], [13], [14]

Low-leveraged firms also should negotiate looser dividend constraints relative to firms with high debt levels to provide future flexibility. Low debt service obligations mean less debt refinancing and discipline imposed by capital markets. Accordingly, dividends and dividend slack are relatively more important.

For high-growth firms with low leverage and broad ownership, dividends are relatively more important in controlling potential agency conflicts between managers and shareholders. All else being equal, dividend payments force a firm especially a high-growth firm to the capital markets more regularly. The scrutiny provided by the capital markets limits the extent of managements' self-serving behavior.

But, if managers own a significant percentage of outstanding shares, their interests are more closely aligned with shareholders than if they own few shares. Accordingly, one can expect the optimal dividend payout to be a function of the level of management ownership. From an agency perspective, high management ownership suggests that a lower dividend payout may be appropriate, and vice versa.

Thus it is evident that Dividend policy of a firm has implication for investors, managers and lenders and other stakeholders (more specifically the claimholders)[4], [5]. For investors, dividends – whether declared today 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. [8][10] 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

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6 Brealey (1992) poses that dividend policy decisions 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 the dividend policy in isolation and not as by products of other corporate financial decisions.

7 Linter (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.

8 Bernstein (1976) observes that given the ‘concocted’ earnings estimate provides by firms, the low dividend payout induces reinvestment risk and earnings risk for the investors.
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. The dividend payments present an example of the classic agency situation as its impact is borne by various claimholders. Accordingly dividend policy can be used as a mechanism to reduce agency costs. The payment of dividends reduce the discretionary funds available to managers for perquisite consumption and investment opportunities and require managers to seek financing in capital markets. This monitoring by the external capital markets may encourage the managers to be more disciplined and act in owners’ best interest.

The agency relationship between a corporation’s owners and its management creates opportunities for management to pursue goals other than shareholder wealth maximisation. The payment of cash dividends and managerial stock ownership may reduce agency conflicts.

1.5 DIVIDEND POLICY AND ITS LINKAGES WITH OTHER FINANCIAL POLICIES

Dividend Policy for a company is a pivotal policy around which other financial policies rotate. The dividend decision is an integral part of a company’s financial decision making, as it is explicitly related to the other two major decisions in Corporate Finance- investment decision and the financing decision. The board of directors must make inter-alia the decisions pertaining to investment, financing and dividends simultaneously as these three decisions are interrelated. Dividend policy decisions influences the financing decision of the firm through retained earnings. Financing decisions would relate to the amount of funds to be raised from external sources as investment needs of a firm can be fulfilled by a combination of retained earnings and external financing. Therefore, it is important to understand how profits are divided between dividend payments and retained earnings.

Given the firm’s investment and financing decisions, a small dividend payment corresponds to high earnings retention with less need for externally generated equity funds. A number of studies suggest that most firms have a long term target payout
ratio, and that many firms smooth dividends by moving only part way towards the target payout ratio every year. The management of the firms also takes into consideration the expected future income and current income in setting the long run target. Put differently, they think that if they pay high dividends, then less money will be available for reinvestment, and consequently may not have enough money to go ahead with their expenditure program. This in turn results in greater reliance on external financing. In these cases, the dividend decision feeds back on investment decision, and has an immediate impact upon firm’s capital structure.

Thus if the dividend policy is purely viewed as function of investment policy then it becomes the residual left after the firm has retained funds for investment in all available projects with positive NPV. Dividends will vary from year to year, larger in years of high cash flow and few investment opportunities, and will be reduced when the need for reinvestment is high relative to internally generated cash flow. Therefore, a CFO should establish a low maintainable regular dividend with steady increases every year.

**1.6 PURE vs SMOOTHED RESIDUAL DIVIDEND POLICY**

As discussed in the earlier sections dividend policy can be broadly of two types: Managed vs Residual. Residual dividend policy implies distribution of leftover cashflows.

The amount of dividend as residual can be worked as below:

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\text{Dividend} = \text{Net income} - \text{Capital outlay for new projects} - \text{debt to be raised as per target capital structure}
\]

Paying dividend strictly as per above equation is referred to as *pure residual dividend policy* It is likely to result in dividends that fluctuate from period to period. Paying dividend as residual; of earnings and investment requirements is against the tenets of value creation and would make returns on equity volatile. The pure residual dividend policy has following disadvantages:
1) It takes away the argument of the information content of dividends, because persistent variability in dividend provides ambiguous signals to investors. At best, it can lead to confusion in the mind of the investors.

2) It is not consistent with idea of clientele effect. Clientele effect is too based on the fact of fixed dividend rather than varying dividend.

To overcome the shortcomings of the pure residual dividend policy, the firm can adopt a policy of dividend distribution that reduces the element of uncertainty, provides useful signals, and does not disturb clienteles. Continuing to follow the residual policy, the amount of dividend needs to be smoothed over time. The firm may decide the level of initial dividend and then raise it gradually, even if this leaves the firm with some extra liquidity. This extra liquidity provides a cushion to maintain fixed dividend payouts in case there are temporary aberrations in projected cash flows and growth plans.

Besides providing such a cushion, the smoothed residual dividend policy remains consistent with arguments of (i) information content of dividends, (ii) investors’ preference for current income, to render stability to current income to meet current liabilities, and (iii) clientele effect

Most firms tend to follow the stable dividend policy with slow steady growth to indicate steady cash flows. The general principle is to increase or decrease dividend only if it becomes necessary. Drastic changes in dividend are generally avoided and serve no useful purpose.

1.7 DIVIDEND DECLARATION PROCESS

Most firms in the India pay dividends quarterly. After making the dividend decision during a board meeting, a firm's board of directors releases information on the size of the dividend on the announcement date. Further, the announcement states that the cash payment will be made to "shareholders of record" as of a specific record date. However, because of delays in the share transfer process, the stock goes "ex-dividend" two business days before the record date, or the ex-dividend date. After the
stock goes ex-dividend, the shares trade *without* the rights to the *forthcoming* quarterly dividend. The dividend cheques are mailed to shareholders of record on the *payment date*, which is about two weeks after the record date. Figure 1 shows the time line of the period from the board meeting through the mailing of the dividend checks.

![Board of Directors Meeting](Min 7 days) → **Ex-Dividend Date (Two Business Days before Record Date)** → **Shareholder Record Date** → **Payment Date (About Two weeks after Record Date)** → **Time line for dividend**

**Notice to the Exchange** — Min. 7 days

**Min. 14 days** → **Min. 7 days** → **2 days** → **Max. 30 days**

**Dividend Announcement Date** → **Payment Date**

**Figure 1.1**: Dividend Time line

### 1.8 ALTERNATIVE FORMS OF DIVIDENDS

Firms normally reward shareholders with regular cash dividends. Firms follow stable dividend policy and refrain from increasing dividend, even when earnings continue to grow. These earnings get accumulated over a period of time, enhancing the shareholders’ wealth and causing share prices to rise consistently.

Besides cash payment, firms also have alternative methods to provide rewards to shareholders that directly or indirectly are in the interest of shareholders. These special types of dividend avoid any possibilities of miscommunication arising from the increased dividend, because such actions are taken as one-off measures.

There are ways other than regular or periodic cash dividends to reward shareholders. Three other ways of rewarding shareholders are very popular. They are as follows:
1.8.1 STOCK REPURCHASES OR SHARE BUY BACKS

Following a stable dividend policy, firms normally do not increase dividend payout, despite increased earnings, for the sake of reducing chances of misinterpretation of information content of dividend, and also as in pursuit of a policy to retain a good proportion for future requirements, should good opportunities come by. Firms may be uncertain of future capital expenditure requirements with several projects under study. These may relate to acquisitions that require huge outlays. When flush with sufficient funds, with no relevant growth opportunities in sight, firms may decide to return the excess cash back to shareholders.

Hence, the firm faces two choices for returning the excess cash—either give bumper dividends or buyback shares. An increasingly popular method of rewarding shareholders in a form other than regular cash is the share buyback. Under stock repurchase plan, a firm buys back some of its outstanding stock, thereby decreasing the number of shares. This, in turn, increases both EPS and stock price. It is a substitute for dividend payment when it is large. It provides an option to shareholders to continue or exit their investment in any desired ratio. Till 1998, share buyback was not allowed in India. After it was allowed, several firms in India have offered share buyback. A share buyback has several advantages. It communicates the worth of the firm in the opinion of management, is capable of increasing promoters’ shareholding, provides protection against hostile takeovers, and alters shareholding pattern and capital structure.

1.8.2 BONUS SHARES

Issue of bonus shares is a way of capitalizing reserves into shares. It only changes the form and not the content or wealth of shareholders.

Adhering to a stable dividend policy despite continuous excess earnings implies an accumulation of reserves. Shareholders are owners of the capital subscribed and residual profit that is retained in the business. These retained profits appear as ‘Reserves and the Surplus’. The sum of the Capital subscribed and the reserves is referred to as shareholders’ fund. These retained profits keep enhancing the value of the reserves and surplus, period after period. This increase in book value is reflected in share prices.
When proportion of reserves and surplus becomes relatively high in relation to subscribed capital, firms normally issue bonus shares, to get back an appropriate proportion of subscribed capital to reserves and surplus. The issue of bonus share is mere reorganization of shareholders’ funds, keeping the overall value same as before.

1.8.3 STOCK SPLITS

The stock split too is a reward to shareholders that works in the same way as bonus shares. It is an action taken by a firm to increase the number of shares outstanding. Normally, splits reduce the price per share in proportion to the increase in shares because splits merely “divide the pie into smaller slices”. A stock dividend is a dividend paid in additional shares of stock rather than in cash. Both stock dividends and splits are used to keep stock prices within an "optimal” range.

Stock splits are identical to bonus issues in respect of the effects on valuation, liquidity, price, book value, and EPS. The only difference between two lies in the books of accounts. In case of bonus share issue ‘reserves and surplus’ is capitalized and transferred to paid up capital, while in case of split ‘reserves and surplus’ as well as ‘capital’ remain unaffected. The number of shares simply gets multiplied.

1.9 DECLARATION AND DISTRIBUTION OF DIVIDENDS BY A COMPANY UNDER INDIAN LAW

A range of firm and market characteristics have been proposed as potentially important in determining dividend policy. Dividend policy decisions are affected by legal, tax and accounting factors of a country. These factors of legal, tax and accounting may substantially vary from country to country. Taxation policy is assumed as a major determinant of dividend payout in the developed countries. In the case of India, the tax policy is different from those of developed countries. In India Companies Act 1956 has imposed statutory restrictions. The Companies Act 1956, governs the declaration and payment of dividends. A company paying dividends should adhere and comply with these norms, which are discussed as follows.
1.9.1 LEGAL REGIME

Section 205 of the Act regulates the declaration and distribution of dividend. All the companies which have share capital other than section 25 of Companies Act and make profit are bound by law to declare and distribute dividends. As per Section 205 of the Companies Act, 1956, a dividend (including interim dividend) can be paid out of current profits or profits accumulated of earlier years. However, depreciation for the entire year has to be provided before a dividend is declared or paid. For this purpose, the Board needs to approve the provisional financial results (unaudited) and a working of the profits available for distribution as dividend, post providing for depreciation for the full year and amount required to be transferred to reserves as per the Companies. 9Sections 205 A, B and C deal with some other aspects of distribution of dividend such as establishment of Investor Education and Protection Fund, Payment of unpaid and unclaimed dividend etc.

Separate bank account needs to be opened and the amount of dividend will have to be transferred to that account. Dividend will have to be remitted within 30 days of declaration. The other procedure of record date/book closure, payment of tax on dividend within 7 days of declaration, etc. will have to be complied with. Dividend is also payable out of divisible profits or out of the money provided by the Central or any State Government for the payment of dividend in pursuance of a guarantee given by that Government.

1.9.2 MODE OF DECLARATION

Dividend can be declared out of four sources. Firstly it can be declared out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of the Act. Secondly, out of the profit of the company for any previous financial year or years arrived at after providing for depreciation in accordance with those provisions and remaining undistributed. Thirdly, out of both the sources above or lastly, out of the money provided by the Central Government or State Government for the payment of dividend in pursuance of a guarantee given by that Government.

---

9 (Transfer of Profits to Reserves) Rules, 1975
1.9.3 PROHIBITION

A company, which has failed to redeem the redeemable preference shares within the stipulated time, cannot declare dividend.

1.9.4 STEPS INVOLVED IN THE PROCESS OF DECLARATION AND DISTRIBUTION OF DIVIDEND

a) Computation of depreciation

Depreciation shall be provided either at the rate specified in Schedule XIV of the Companies Act or any other basis approved by the Central Government.

b) Compulsory transfer of profits to reserves

Before declaring the dividend, some part of the profit has to be compulsorily transferred to the Reserves of the Company. This amount is based on the proposed rate of dividend.\(^{10}\) However voluntary transfer of higher percentage to reserves is permitted subject to the conditions stipulated in the Act.

c) Board resolution

The most important step in the process is the Board Resolution for declaration of dividends. Unless the Board recommends the payment of dividend, the same cannot be declared at an Annual General Meeting.

d) Annual General Meeting (“AGM”)

The item pertaining to declaration of dividend should be included in the agenda of the notice for AGM which should be sent to members as well as the creditors. An ordinary resolution is required for declaration of dividend. However shareholders cannot increase the amount of dividend recommended by the Board.

\(^{10}\) The Companies (Transfer of Profits to Reserves) Rules, 1975 set out different thresholds/limits for the percentage of profits to be transferred to reserves depending upon the extent of the dividend proposed to be paid. Under the said Rules, if the proposed dividend exceeds 20% of the paid-up capital, the amount to be transferred to reserves should be at least 10% of the current profits. The Company has informed us that they have applied this threshold in arriving at the amount of INR 20 crores and have assumed, for such computation, that the profits (net of tax) for the entire year would be approximately INR 200 crores.
**e) Time Limit for payment of Dividend**

The dividend account should be opened with the company’s bankers and the dividend amount payable should be transferred to that account. Within 30 days of the AGM the dividend warrants should be sent to the shareholders.

**f) Transfer to unpaid dividend account**

Within 7 days from the date of expiry of 30 days from the date of dividend declaration, the amount remaining unpaid or unclaimed should be transferred to the ‘unpaid dividend account’ to be opened in a scheduled Bank. Dividend which remains unpaid or unclaimed for a period of 7 years shall be transferred to the Investor Education and Protection Fund within a period of 30 days of its becoming due for the transfer.\(^\text{11}\)

**g) Circumstances under which dividend need not be paid**

i) Where it could not be paid because of operation of any law;

ii) Where a shareholder has given direction to the company regarding payment of dividend and those directions could not be complied with;

iii) Where there is a dispute regarding the right to receive the dividend;

iv) Where the dividend has been lawfully adjusted by the company against any sum due from the shareholders; and

v) Where the dividend could not be paid but not due to any default on part of the company.

**h) Tax Limit**

In addition to the income tax chargeable in respect of the total income of a company for any assessment year, any amount declared, distributed or paid by such company by way of dividends (whether interim or otherwise) and also whether paid out of current or accumulated profits is charged with additional tax at the rate of 15 %.\(^\text{12}\) The

\(^{11}\text{Governed by Investor Education and Protection Fund (Awareness and Protection of Investors) Rules, 2001 and section 205 C of the Act}\)

\(^{12}\text{Excluding surcharge and cess (which may vary every financial year)}\)
liability of payment of tax is on the principle officer of the company. The tax has to be paid within 14 days of declaration, distribution or payment of any dividend whichever is the earliest. The tax on distributed profit paid by the Company would be treated as the final payment of tax in respect of dividend.

i) Special Provisions relating to Listed Company

In addition to the steps mentioned above the listed companies also need to advance intimation regarding the venue of the Board Meeting to the stock exchange where the securities are listed. Within 15 minutes of the closure of the Board meeting, intimation is also to be sent to the stock exchange containing the particulars of dividend. Details regarding the general meeting for the declaration of dividend are also to be given to the Stock Exchange.

It is clear from the above discussions that there are various steps, which are usually involved in the declaration and distribution of dividend by a company incorporated under the Act. However depending upon the facts and the memorandum and articles of the company there might be some variation or addition to these steps.

1.10 DIVIDEND PAYMENT PATTERNS ACROSS THE LIFE CYCLE OF A FIRM.

There are distinct differences in dividend policy over the life cycle of a firm, resulting from changes in growth rates, cash flows, and project investments in hand. Firms generally adopt dividend policies that suit the stage of life cycle they are in. For instance, high- growth firms with larger cash flows and fewer projects tend to pay more of their earnings out as dividends. In a promising start-up firm initiated by a small group of entrepreneurs using their own capital, perhaps supplemented by funds from family members and/or venture capitalists. At the same time outsiders understand little about the firm and its prospects. Management believes that growth prospects are outstanding but, to finance this growth, capital requirements will be large. However, access to the capital markets on any reasonable terms is not possible. Accordingly, at this early stage of the firm's life cycle, no dividends are practical.[11]
After a period of sales and asset increases, along with favorable earnings growth, the firm undertakes an initial public offering. At this point the underwriters, as well as the disclosure mandated by SEBI filing requirements, serve as the signaling device for the market. However, ownership is still heavily concentrated among insiders and capital requirements are large. In order to issue debt financing on reasonable terms, the firm writes tight dividend constraints. Again, through this period of the firm's life cycle, a zero payout is best.

During a rapid growth phase with favorable earnings increases, the firm begins to tap the capital markets with debt issues and seasoned equity sales, although most of the investment is still financed with internally generated funds. Ownership concentration begins to fall as new equity investors are added. Some institutional investors begin to take positions in the firm. With frequent tapping of the capital markets, disclosure increases and the level of asymmetric information begins to fall.

Even though the firm has heavy investment needs, it may begin to pay a modest dividend to establish a dividend track record and appeal to a broader group of institutional investors. Competition begins to challenge the firm's dominant market position. The dividend constraint in the new debt issues is reduced, and the firm starts to build its capacity for dividend payments, or its reservoir of payable funds, for periods in which it will face declining investment opportunities.

As the firm matures it attracts growing institutional ownership, and the ownership level of officers and directors shrinks. Periodic external financing and continuous following by analysts reduces asymmetric information. However, positive NPV projects are harder to discover and sales growth slows. Potential agency costs begin to develop as the classic problem of the separation of ownership and control arise. Although leverage ratios remain at levels consistent with the firm's basic business risk, the firm may gradually increase its dividend payout in a sustainable manner based on forecasts of free cash flows.

Finally, further market erosion and new technology began to supplant the firm's basic markets. Operating cash flows far exceed investment requirements. Potential agency problems become increasingly large. The firm can begin to self-liquidate through extremely high dividend payout levels.
The dividend policies of firms may also follow several interesting patterns adding further to the complexity of such decisions. First, dividends tend to lag behind earnings, that is, increases in earnings are followed by increases in dividends and decreases in earnings sometimes by dividend cuts. Second, dividends are “sticky” because firms are typically reluctant to change dividends; in particular, firms avoid cutting dividends even when earnings drop. Third, dividends tend to follow a much smoother path than do earnings. Especially the companies that are vulnerable to macroeconomic vicissitudes, such as those in cyclical industries, are less likely to be tempted to set a relatively low maintainable regular dividend so as to avoid the dreaded consequences of a reduced dividend in a particularly bad year.

1.11 DIVIDEND DISTRIBUTION AND ITS IMPACT ON SHAREHOLDERS’ VALUE

There are two divergent schools of thought on dividend policy. One school of thought believes that on dividend policy, while the other school of thought advocates that dividend decision is irrelevant to the determination of the value of the firm. The set of people who believe that dividend policy affects the value of the firm link the dividend policy to investment opportunities available in comparison with the expectations of shareholders.

Assuming sufficient business opportunities are available to the firm, then the dividend policy affecting firm’s value will depend upon the returns that are being offered by these opportunities, compared to the expectations of shareholders. If these business opportunities offer higher returns than the expectations of shareholders, then a dividend policy oriented towards retention of earnings for exploiting new business will be more rewarding to shareholders than a policy that favors distributing the earnings and forgoing any profitable business opportunities. In such situations, the dividend policy favoring retention of earnings should lead to a larger increase in value of the firm than dividend policy favoring distribution of earnings.

On the contrary, if variable business opportunities provide a return that is less than expected return to the shareholders, then retention of earnings to finance the new
business opportunities will diminish the value of the firm rather than adding to it. In such a situation, distributing earnings to shareholders, rather than retaining them in the business, will be advisable. A dividend policy favoring greater payout will add more value to the firm.

Shareholders wealth is represented in the market price of the company’s common stock, which, in turn, is the function of the company’s investment, financing and dividend decisions. Managements’ primary goal is shareholders’ wealth maximization, which translates into maximizing the value of the company as measured by the price of the company’s common stock. Shareholders like cash dividends, but also like the growth in EPS that results from ploughing earnings back into the business. The objective of the finance manager should be to find out an optimal dividend policy that will enhance value of the firm. It is often argued that the share prices of a firm tend to be reduced whenever there is a reduction in the dividend payments. Announcements of dividend increases generate abnormal positive security returns, and announcements of dividend decreases generate abnormal negative security returns. A drop in share prices occur because dividends have a signaling effect. According to the signaling effect mangers have private and superior information about future prospects and choose a dividend level to signal that private information. Such a calculation, on the part of the management of the firm may lead to a stable dividend payout ratio.

It has been recognized by various research studies that a dividend policy could make significant impact on corporate future value when established and carefully followed. The goal of wealth maximisation is widely accepted goal of the business as it reconciles the varied, often conflicting, interest of the stakeholders.

The interest in shareholders value is gaining momentum as a result of several recent developments:

- The threat of corporate takeovers by those seeking undervalued, under managed assets.

- Impressive endorsements by corporate leaders who have adopted the approach.
• The growing recognition that traditional accounting measures such as EPS and ROI are not reliably linked to the value of the company’s shares.

• Reporting of returns to shareholders along with other measures of performance in business press.

• A growing recognition that executives’ longterm compensation needs to be more closely tied to returns to shareholders.

The “shareholders value approach” estimates the economic value of an investment (e.g. shares of a company, strategies, mergers and acquisitions, capital expenditure) by discounting forecasted cash flows by the cost of capital. These cash flows, in turn, serve as the foundation for shareholder returns from dividends and share price appreciation.

A going concern must strive to enhance its cash generating ability. The ability of a company to distribute cash to its various constituencies depends on its ability to generate cash from operating its business and on its ability to obtain any additional funds needed from external sources. Debt and equity financing are two basic external sources. Borrowing power and the market value of the shares both depend on a company’s cash generating ability. The market value of the shares directly impacts the second source of financing, that is, equity financing. For a given level of funds required, the higher the share price, the less dilution will be borne by current shareholders. Therefore, management’s financial power to deal effectively with corporate claimants also comes from increasing the value of the shares. This increase in value of shares can be brought about by rewarding shareholder with returns from dividends and capital gains.

The most famous statement about the relationship between dividend policy and corporate value claimed that, in the presence of perfect markets, “given a firm's investment policy, the dividend payout policy it chooses to follow will affect neither the current price of its shares nor the total return to its shareholders”. However, "market imperfections as differential tax rates, information asymmetries between insiders and outsiders, conflicts of interest between managers and shareholders, transaction costs, flotation costs, and irrational investor behaviour might make the dividend decision relevant".
The relevance of dividend policy to corporate value is due to market imperfections. Shareholders can receive the return on their investment either in the form of dividends or in the form of capital gains. Dividends constitute an almost immediate cash payment without requiring any selling of shares. On the contrary, capital gains or losses are defined as the difference between the sell and buy price of shares. Friction costs are one of the market imperfections and are further distinguished in transaction costs, floatation costs and taxes. Another market imperfection is that of information asymmetries between the insiders (e.g. managers) and the outsiders (e.g. investors). Agency conflicts, stemming from the different objectives of company's stakeholders, form the third market imperfection. Finally, there are some other issues that are related to dividend policy and cannot be placed among the previously mentioned imperfections.

The significance of Modern goal of Shareholders’ Wealth maximization in Corporate Finance and its linkage with dividend decision has been reflected in the above text. Therefore, one of the objectives of this research is to study the relationship between the shareholders’ wealth and the dividend payout and to analyse whether the dividend announcements has an effect on wealth of the shareholders as reflected by shareprices.

1.12 DIVIDEND PAYMENTS: AN INDIAN SCENARIO

In this segment a brief outline of the findings of the major studies done in Indian milieu is given. The dividend payment patterns and trends of various Indian companies are highlighted.

Reddy Y.Subbba and Rath Subhrendu (2005) examined the dividend behavior of Indian corporate firms. Dividend trends for large sample of stocks traded on Indian markets indicated that the percentage of companies paying dividend declined from over 57% in 1991 to 32% in 2001, and that only a few firms paid regular dividends. Even though regular payers consistently paid higher dividends than did other firms, on average. Dividend-paying companies were less likely to be larger and more profitable than non-paying companies, though growth opportunities do not seem to have
significantly influenced the dividend policies of Indian firms. Overall for all firms, investment opportunities faced by Indian firms do not show any distinguishing pattern or trend over the years. The rise of the number of firms not paying dividends is not supported by the requirements of cash for investments. [15],[16]

In a study done by Sharma Dhiraj, “Are dividends in vogue in India? An empirical study of Sensex companies”, the dividend behavior of the Indian firms with the help of signaling and tax effect theory for 1990-2005\textsuperscript{13} was analyzed. It was found that firms paying dividend during this period have followed continuous progressive trend. In the recent years, companies in the growth sector like software firms have paid greater dividends as compared to other sectors firms. The level of dividend payout has increased substantially from Rs. 167.97 crores to Rs. 13602.20 crores in 2005. The level of average dividend has also gone up from Rs. 6.46 crores in 1990 to 523.18 crore in 2005. Though the dividend behavior has followed a continuous up trend, there have been variations in each year’s payout pattern. In 1998, the level of dividend payout fell down drastically due to tax imposition on payers by Indian government in 1997, but unlike this, the year 2004 did not show any substantial increase in dividend payout behavior of companies even after the withdrawal of taxes in the hands of shareholders in 2003. Similarly, 2000 and 2004 witnessed low dividends in comparison to the previous years, due to the instable political environment and volatile market conditions. The following Table1.1 shows the percent increase or decrease in the level of average dividend from preceding year.

\textsuperscript{13}The data shown under this section draws heavily from Sharma Dhiraj, “Are dividends in vogue in India? An empirical study of Sensex companies”, The ICFAI journal of Applied Finance, March 2007
Table 1.1: Dividend payout of Sensex 30 companies

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Payout (Rs. Crore)</th>
<th>Average Dividend</th>
<th>Percent change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>167.97</td>
<td>6.46</td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>356.31</td>
<td>13.71</td>
<td>112.23</td>
</tr>
<tr>
<td>1992</td>
<td>429.62</td>
<td>16.52</td>
<td>20.50</td>
</tr>
<tr>
<td>1993</td>
<td>546.56</td>
<td>26.02</td>
<td>57.50</td>
</tr>
<tr>
<td>1994</td>
<td>890.42</td>
<td>34.25</td>
<td>31.63</td>
</tr>
<tr>
<td>1995</td>
<td>1297.21</td>
<td>49.89</td>
<td>45.66</td>
</tr>
<tr>
<td>1996</td>
<td>1854.14</td>
<td>71.31</td>
<td>42.94</td>
</tr>
<tr>
<td>1997</td>
<td>2244.30</td>
<td>86.32</td>
<td>21.05</td>
</tr>
<tr>
<td>1998</td>
<td>244.30</td>
<td>94</td>
<td>8.90</td>
</tr>
<tr>
<td>1999</td>
<td>3236.00</td>
<td>124.46</td>
<td>32.40</td>
</tr>
<tr>
<td>2000</td>
<td>3885.60</td>
<td>149.45</td>
<td>20.10</td>
</tr>
<tr>
<td>2001</td>
<td>5121.05</td>
<td>196.96</td>
<td>31.79</td>
</tr>
<tr>
<td>2002</td>
<td>6860.70</td>
<td>263.87</td>
<td>33.97</td>
</tr>
<tr>
<td>2003</td>
<td>10684.04</td>
<td>410.93</td>
<td>55.73</td>
</tr>
<tr>
<td>2004</td>
<td>11768.33</td>
<td>452.63</td>
<td>10.15</td>
</tr>
<tr>
<td>2005</td>
<td>13602.70</td>
<td>523.18</td>
<td>15.59</td>
</tr>
</tbody>
</table>

The dividend yield is a simple measure that tells the shareholders and investors what would be the return from owning a stock irrespective of any capital gain or loss. It is worth mentioning here that new companies either do not pay dividend or pay small one. The underlying notion is that they are investing in future of the business rather than returning cash to shareholders. Only mature and old companies pay a high yield. The average dividend yield of the Indian firms have gone up from 5.655% in 1990 to 17.5% in 2005, which is a 210% increase. Thus, it can be inferred that dividend yield has increased over the years showing that companies have generated more income per share as one moves from 1990 to 2005.[17]

Table 1.2 given below shows that growth does not follow a consistent pattern. There are substantial variations in the shareholder’s dividend yield. Since dividend yield is not only a function of dividend payout but also of market price of the stock. The fluctuations in the yield can be attributed to the volatility in stock prices.
Table 1.2: Dividend yield of Sensex 30 companies

<table>
<thead>
<tr>
<th>Year</th>
<th>Dividend yield (%)</th>
<th>Total Yield (%)</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>454.95</td>
<td>17.50</td>
<td></td>
</tr>
<tr>
<td>1991</td>
<td>274.87</td>
<td>10.57</td>
<td></td>
</tr>
<tr>
<td>1992</td>
<td>427.46</td>
<td>16.44</td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td>317.34</td>
<td>12.21</td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td>311.23</td>
<td>11.97</td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>239.04</td>
<td>9.19</td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td>360.25</td>
<td>13.86</td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td>274.68</td>
<td>9.68</td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td>251.74</td>
<td>10.51</td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td>242.48</td>
<td>9.35</td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>223.89</td>
<td>8.61</td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td>157.47</td>
<td>6.06</td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td>185.60</td>
<td>7.14</td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td>88.23</td>
<td>3.40</td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td>301.10</td>
<td>11.58</td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td>146.99</td>
<td>5.65</td>
<td></td>
</tr>
</tbody>
</table>

From the trends in the payout, it is apparently conspicuous that the Indian firms are distributing dividend consistently\(^\text{14}\). The market recognizes and favors the dividend distribution decisions of a firm. The fact that such a large number of firms in India are paying dividends and continuous progressive upward trend reveals that “Dividend decisions are relevant” as far as the Indian firms are concerned. Thus it can be said, “Dividends are still in vogue in India”. These results are in sharp contrast to the prediction of the made by Y.Subbba Reddy and Rath Subhrendu (2005) in their study that there would be decline in dividend payments in the time to come.

Singhania Monica (2005) studied 590 manufacturing, non-government, non-financial, non-banking companies listed on the Bombay Stock Exchange for a period from 1992 to 2004. The sample companies were categorized into payers and non payers, in the period understudy. Payers were further classified into regular payers, initiators and

\(^{14}\) The conclusion has been made based on the dividend payout of Sensex 30 companies.
current payers. Non-payers companies were further categorized as never paid, former payers and current non-payers.

It was found that the percentage of companies paying dividends declined from 75.93% in 1992 to 63.73% in 2004. Total non-payers steadily increased from 1992 up to 1996 but increased thereafter. Companies, which have never paid continuously declined throughout the sample period from 86% in 1991-92 to 16% in 2003-04. The number of companies, which have paid dividend at some point during the period of study, increased over time and reached almost 80% of non payers in 2004.

It was evident from the findings that companies in payer group have declined. In payer group, regular payers and initiators have consistently declined whereas current payers continuously increased. It can be inferred from the study that the never-paid companies and former payers have consistently declined while current non payers increased throughout the sample. The total number of companies paying dividend increased up to 1996 and registered a sustained decline thereafter, except for the year 2004 where there is an increase.

Among the sample companies, regular payers are more in number as compared to initiators and current payers throughout the period of study, ranging from 430 companies in 1993 to 239 companies in 2004 and have paid higher average dividend compared to that of current payers and initiators. Further, current payers paid higher dividend compared to initiators except in the year 1995. The number of initiators declined throughout the sample period from 30 in 1993 to 4 in 2004, whereas current payers steadily increased in number from 35 in 1994 to 133 in 2004 throughout the period of study.

An analysis of average percentage dividend payout during 1992-2004 showed a volatile trend. Percentage increased from 25.47 in 1992 to 46.02 in 1997 and then showed a declining trend till 2000 before reaching the peak average percentage DPR of 67.86 in 2004. However, 1% trimmed average percentage DPR showed a more stable pattern, ranging between 22–40% up to 1997 and then recorded a declining trend up to 2000 before finally reaching 57.37 percent in 2004. An analysis of industry-wise DPR showed an increasing trend across all industries during the sample
Companies in the business of metals and metal products registered a stable pattern of around 25% in dividend payout throughout the sample period.

**Table 1.3 : Average Percentage Payout During 1992-2004**

<table>
<thead>
<tr>
<th>Year</th>
<th>Average % Payout</th>
<th>Std. Deviation</th>
<th>1% Trimmed Average% Payout</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>25.47</td>
<td>57.85</td>
<td>22.54</td>
</tr>
<tr>
<td>1993</td>
<td>29.46</td>
<td>49.63</td>
<td>27.34</td>
</tr>
<tr>
<td>1994</td>
<td>29.84</td>
<td>38.97</td>
<td>28.37</td>
</tr>
<tr>
<td>1995</td>
<td>30.15</td>
<td>38.01</td>
<td>28.84</td>
</tr>
<tr>
<td>1996</td>
<td>38.98</td>
<td>103.94</td>
<td>34.39</td>
</tr>
<tr>
<td>1997</td>
<td>46.02</td>
<td>100.07</td>
<td>41.90</td>
</tr>
<tr>
<td>1998</td>
<td>38.51</td>
<td>68.80</td>
<td>35.74</td>
</tr>
<tr>
<td>1999</td>
<td>47.93</td>
<td>214.67</td>
<td>37.25</td>
</tr>
<tr>
<td>2000</td>
<td>37.71</td>
<td>76.62</td>
<td>35.03</td>
</tr>
<tr>
<td>2001</td>
<td>43.75</td>
<td>91.99</td>
<td>41.12</td>
</tr>
<tr>
<td>2002</td>
<td>49.73</td>
<td>152.90</td>
<td>42.56</td>
</tr>
<tr>
<td>2003</td>
<td>48.69</td>
<td>146.52</td>
<td>42.61</td>
</tr>
<tr>
<td>2004</td>
<td>67.86</td>
<td>246.75</td>
<td>57.37</td>
</tr>
</tbody>
</table>

The aforementioned trends largely indicated that among the sample companies, the number of those declaring dividend in any given year has declined over the period of study from 448 in 1992 to 376 in 2004. However, the average dividend payout ratio increased significantly over the period of study. This implies that those companies, which declared dividend, paid high amounts as dividends over the period of study. Dividend payout ratio showed a volatile trend, ranging from about 25 to 68% during 1992-2004. In addition, wide industry-wise fluctuations are visible over the period of study. Moreover, a major proportion of the sample companies follow a
dividend policy of part retention of profits and part distribution of profits over the period of study.

It is known that primarily, there are three basic approaches regarding dividend policy:

1. One hundred per cent retention of profits i.e. no dividend: Some managements may prefer to plough back their entire earnings indefinitely on the consideration of financial stability of the company.

2. One hundred per cent distribution of profits, i.e., no retention: Some managements may prefer to distribute all the earnings to the shareholders. This is carried out in order to give the due share of profits to the shareholders.

3. Part distribution and part retention of profits: Some managements prefer to adopt a course between the first and second policy. They plough back a part of the earnings and distribute the remaining part among shareholders.

The study also highlighted that predominantly a major proportion of the sample companies follow a dividend policy of part retention of profits and part distribution of profits over the period of study. However, companies following such a dividend policy have declined from about 75% in 1992 to about 56% in 2004. Conversely, companies following a policy of 100% retention of profits have increased over the period of study from 142 in 1992 to 214 in 2004 (i.e., from about 24% in 1992 to about 36% in 2004).

It may be emphasized that companies following a dividend policy of 100% distribution of profits have been an insignificant number (i.e., below 1% of sample companies) throughout the period of study. However, companies following such a dividend policy have increased in number from 5 in 1992 to 46 in 2004 over the period of study. [18]

The various studies done in Indian context have several implications but there is no consensus as to what should be the dividend policy of the firms in India. Therefore it becomes important to study dividend behavior of Indian companies using the framework of empirical models.
1.13 DIVIDEND POLICY: THE GLOBAL PERSPECTIVE

Dividends are important in other countries where public companies are a common form of corporate organization. However, economic environments around the world differ in terms of laws, regulations, and customs. Consequently, dividend policies systematically vary from country to country. For example, cash dividend payments are smaller and less relevant for firms in Japan, Switzerland, and Israel but are relatively more important in Canada and the United Kingdom. The frequency of dividend payments also varies from country to country. Dividends typically are paid quarterly in the United States and Canada, but most firms in Finland, Italy, and many other countries pay dividends annually.

In the following sections the dividend payment patterns and trends in countries in Europe, the Pacific Rim, and North America has been discussed. These countries have developed sophisticated economic and capital market systems and their financial markets are studied frequently by researchers.

1.13.1 DIVIDEND SIZE AND FREQUENCY ACROSS THE WORLD

The average annual dividend yield in the European industrial countries, such as Germany, France, Switzerland, and Italy, is between 2.5 percent and 3.5 percent. This yield is less than the 4 percent average annual dividend yield in Canada and the United States.

Most firms in these European countries pay dividends only once a year. Again, this practice is in contrast to the United States and Canada, where dividends are typically declared quarterly and sometimes even monthly. The European country that seems unique in its firms' dividend policies is the United Kingdom. There, average dividend yields are higher (6.12 percent, according to one study) and dividends are paid semiannually. In recent years, most Japanese firms have increased their annual dividends and now declare dividends more frequently (twice a year rather than once). Moreover, firms have to pay dividends in order to be listed on the Tokyo Stock Exchange.
1.13.2 INSTITUTIONAL FEATURES

The differences in dividend practices throughout the world can be attributed to unique institutional features in various countries. In most European countries and Japan, shareholders must typically approve the proposed dividend. In Germany, Switzerland, Brazil, and several other countries, the law specifies the minimum percentage of earnings that must be distributed as dividends. However, corporations in these countries usually are able to exploit loopholes in the tax code to circumvent these requirements. In Switzerland, firms raise considerable equity and simultaneously pay dividends. The information provided to the market concerning forthcoming dividend payments ranges from being available at the beginning of the ex-dividend month in Switzerland to the absence of any dividend announcement prior to the ex-dividend day in Japan.

1.13.3 TAX DIFFERENCES

A variety of tax codes, which change frequently as tax reforms are passed in various countries, also can have an important effect on dividend policies. Dividends and capital gains are the alternative sources of return for shareholders, but, in many countries, there are no capital gains taxes or they were introduced for the first time during the last decade of 20th century. For instance, in Canada capital gains taxes were introduced in the tax reform of 1971 and in Japan in the tax reform of 1988. In Israel, the government attempted to introduce capital gains taxes in 1994 but backed down under public pressure in 1995.

In contrast, capital gains have been taxed in the United States since early in the twentieth century. Under the U.S. tax code, capital gains received a preferential tax treatment relative to dividends between 1921 and the Tax Reform Act of 1986, when the rates were equalized. However, since the Omnibus Reconciliation Act of 1993, capital gains again have been taxed at a lower rate than dividends in the United States. In 1997, the capital gains tax rate was lowered again relative to dividends. U.S.A has removed the dividend tax both from companies and the recipients. Dividends received by low income individuals were taxed at a 5% until December 31, 2007 and will become fully untaxed in 2008. These provisions are set to expire on January1,
In England there are two different Income tax rates on dividends. The rate an individual pays depends on whether the overall taxable income (after allowances) falls within or above the basic rate Income tax limit, varying from 10-32.5%.

In India, the dividend distribution tax was first introduced by Finance Act of 1997, was accepted by the Finance Minister, Yashwant Sinha, while presenting Finance Bill for 2002-03. Before that, dividends were taxed in hands of the recipients as any other income. This tax was again abolished in the year 2002. The budget for the financial year 2002-2003 proposed the removal of dividend distribution tax bringing back the regime of dividends being taxed in the hands of the recipients and the Finance Act 2002 implemented the proposal for dividends distributed since 1 April 2002. But presently, the new dividend distribution tax rate for companies was higher at 12.5%, and was increased with effect from 1st April 2007 to 15%. This Dividend distribution tax (DDT) was introduced by Section 115(O). In addition to the company tax, the Government sought to tax dividends distributed by the companies. However the introduction of DDT has evoked several controversies and debates in India. It has been severely criticized by the companies on the pretext of double taxation. Dividend is paid after paying income tax on the profits earned by the companies. DDT is further levied on profits distributed to shareholders of a company. The profits of the company are supposed to be the income of shareholders. This way they as part owners i.e. the shareholders have already been taxed. DDT thus amounts to double taxation.

Shares or mutual funds become long term assets after one year of holding in Indian context. Sale of such long-term assets gives rise to long term capital gains. As per Section 10(38) of Income Tax Act, 1961 long term capital gains on shares or securities or mutual funds on which Securities Transaction Tax (STT) has been deducted and paid, no tax is payable. STT has been applied on all stock market transactions since October 2004 but does not apply to off-market transactions and company buybacks; therefore, the higher capital gains taxes will apply to such transactions where STT is not paid. However short term capital gains, on sale of shares and mutual funds are taxed at the rate of 10% under section 111A where STT...
is paid from Assessment Year 2005-06 as per Finance Act 2004. For Assessment Year 2009-10 the tax rate is 15%.

Dividend tax laws vary greatly among countries. The Canadian tax code calls for a dividend tax credit, although the details change from time to time (e.g., the tax reform of 1971). A dividend tax credit is part of the tax code in Japan and also was adopted in Germany in 1977. In the United Kingdom, a dividend imputation system is used off and on, depending on whether the Conservative Party or the Labour Party is in power.15 A complicated dividend imputation system also was in place in Australia until recently. In New Zealand, until 1985, dividends were taxed or not taxed, depending on the source of the funds that financed the dividend. In Italy, dividends on registered stocks and savings stocks are taxed at different rates. The tax code for individuals in the United States is costly for shareholders. Dividends are subject to taxation both at the corporate and the individual level. Further, the United States has no tax credit or imputation system, although from time to time small amounts of dividend income are exempted from taxation. Tax laws for corporate income from dividends also are different in various countries, although the general rule in most of them is that corporate investors enjoy a preferential tax treatment of dividend income.

1.13.4 DIVIDEND PAYOUT PATTERNS AROUND THE WORLD

Despite the statistical differences in the characteristics (size, yield, frequency, etc.) of the dividend streams of corporations in various countries—and the range of tax laws, regulations, and institutional features—some similarities can be pointed out in corporate dividend policies in various countries. Specifically, dividend smoothing seems to be a management tendency everywhere which is in alignment with findings of classic study

Lintner's (1956) on corporate dividend decisions in the United States(Refer to the Literature review section for details). Numerous researchers have replicated Lintner's methodology and have observed similar corporate payout decisions in different countries. These researchers, using variations of Lintner's model, have documented patterns of dividend streams similar to those he found for U.S. companies. The

15 In an imputation system the personal tax liability on dividends is reduced by the amount of taxes the corporation paid on the income that was used to pay out the dividend. The rationale for this system is the desire to avoid double taxation of corporate income.
evidence suggests that managers tend to maintain smooth dividend payout patterns; they pay out stable amounts of dividends and avoid sudden changes, especially cuts in dividends. This practice transcends national boundaries.

1.14 RELEVANCE AND SCOPE OF THE STUDY

Previous empirical studies have focused mainly on developed economies like UK and US. The study undertaken looks at the issue from emerging markets perspective by focusing exclusively on Indian Information Technology, FMCG and Service sector respectively. The major objective of this research is to empirically examine rationale for stable dividend payments by finding the applicability and validity of Lintner Model in Indian scenario. Inspite of importance of dividend policy decisions various theoretical determinants of dividend decision are not well established. Therefore, the present research work also seeks to examine and identify the relative importance of some of known determinants of dividend policy in Indian context.

Empirical research on corporate governance and dividend payout policies has mostly concentrated on developed economies like US and UK and Japan. Some studies in Indian context before 2000, have provided evidence of ownership as one of the important variable that influences dividend payout policies. The relationship between ownership and dividends is different for different classes of owners and at different levels, which suggests that influence of ownership structure on dividend payout policy is non linear. The impact on dividend payout changes with the change in holding size as well as with their identities. However, some recent studies have found that ownership is not a significant variable affecting dividend payout policy of a firm. The research work also has made an endeavor to bring to light the influence of ownership groups of a company on dividend payout behavior of a firm.

This research has also tried to unfold the relationship between the shareholders wealth and the dividend payout and analyse whether the dividend payout announcements affects the wealth of the shareholders. The findings would bring to light whether Dividend relevance or Dividend irrelevance hypothesis holds good in IT,FMCG and Services sector in India.
Given the diversity in corporate objectives and environments, it is conceivable to have divergent dividend policies that are specific to firms, Industries, markets or regions. Through the research an attempt has been made to suggest how dividend policy can be set at micro level. Finance managers would be able to examine how the various market frictions such as asymmetric information, agency costs, taxes, and transaction costs affect their firms, as well as their current claimholders, to arrive at reasonable dividend policies. Previous research studies have focused on dividend payment pattern and policies of developed markets, which may not hold true for emerging markets like India. In Indian Context, few studies have analysed the dividend behavior of corporate firms and focused on Indian cotton textile Industry, Banking sector and Manufacturing sector. However, it is still not apparent what the dividend payment pattern of firms in India is. Very few studies have analyzed the dividend behavior of corporate firms in the Indian context. To date, most studies have paid attention on influence of cash flows or earnings on the dividend payment of a firm.

Further, for the dividend policy makers of the Indian IT, FMCG & Service Industry, the study may prove to be useful for re-sketching their dividend policy keeping in view the analysis, results and discussions presented. Through the research one can have better understanding of the factors that should systematically affect firms’ payout decisions. It also gives insight into what kind of ownership structure is beneficial for the shareholders.

1.15 CHAPTER PLAN

The research is organized into nine chapters. Chapter One introduces the topic and the research. This chapter familiarizes the readers with the dividend puzzle. It throws light on the theoretical background, genesis, concept and meaning of dividends. The primacy and importance of dividend decision has also been discussed in this chapter. The chapter also talks about the dividend trends in India and in other countries. Literature Review has been discussed in details in chapter Two. Both conceptual models and methodological and empirical studies done till date in India and abroad related to the research objectives has been incorporated in this chapter. Chapter three gives an Overview of the industry. This chapter highlights briefly the financial
performance, growth prospects, and characteristics of the various sectors chosen for study. Chapter four is focused on Research Methodology adopted for the accomplishment of the research objectives. This chapter discusses in detail the various models developed, tools and techniques used for analyzing the research objectives.

The next four chapters deals with the data analysis. Chapter Five covers the empirical analysis of the Lintner model proposed by John Lintner (1956) in the three sectors under study. The chapter highlights the target payout ratios and speed of adjustment coefficients of each sector respectively using pooled and panel data analysis. Chapter six highlights the model developed to identify the corporate Dividend Policy determinants. It contains the analysis and findings of factor analysis and Multiple Linear Regression analysis in each of the sectors respectively. Chapter seven discusses in detail the data analysis and findings of quadratic polynomial regression analysis. This model has been developed to find the impact of various ownership groups on the dividend payout ratios. Chapter eight unfolds the impact of dividend announcement on shareholder’s wealth as reflected by the share prices through the use of most sophisticated technique in Corporate Finance i.e. Event study. The chapter reports whether the abnormal returns are generated on dividend announcement or not. Chapter nine summarizes and concludes the research. It also brings to light the future areas of research.

1.16 CONCLUSIONS

Cash dividends as a payout mechanism are an important method of rewarding shareholders everywhere in the world where public companies are a common form of corporate organization. However, economic environments differ from country to country in terms of laws, regulations, and customs. Consequently, dividend policies vary among countries in terms of relevance, payment frequency, dividend size, and the decision-making process.

Corporate dividend policies are similar in certain respects all over the world. Specifically, the smoothing of dividends appears to be a common management practice everywhere.
Much of the research in the global scenario has examined the different institutional features in various countries to analyze the impact of market imperfections on dividend policy. The idea is to shed light on some puzzles associated with dividend policies by examining how a variety of economic and market settings affect dividend decisions.

The major purpose the present study is to empirically examine rationale for dividend existence by finding the applicability and validity of Lintner dividend Model in Indian scenario. The present research work also seeks to examine and identify determinants of dividend policy in Indian context with specific focus on Information Technology, FMCG and Service sector. The ownership pattern of Indian companies is disperse. Therefore, the study is an endeavor to investigate to what extent ownership structure can influence dividend payout of the company. As discussed in the chapter two schools of thought exist, one that are proponents of Dividend relevance hypothesis and other that refutes dividends linkages with shareholders’ wealth and support dividend irrelevance hypothesis. The research work also strives to find the impact of dividend announcements on shareholders’ wealth in IT, FMCG and Service sector. So far to the best of our knowledge this is the very first attempt to study dividend behavior in these three sectors respectively. The research findings could be useful for CFO’s of these sectors in framing an optimal dividend policy and shareholders who plan to invest in the sectors under study.