## CHAPTER 1
### INTRODUCTION

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CHAPTER 1
INTRODUCTION

1.1 BACKGROUND:
Dividends are payment made to the shareholders of the company. Dividends are based on the company’s earnings. Dividend decision considers the allocation of surplus to the shareholders. The determination of the proportion of profits paid out to the shareholder is called as the dividend policy. Companies usually follow deliberate dividend payout strategies that can be driven by several goals. The optimal dividend decision should be considered in terms of its impact to shareholders wealth, which maximizes the market value of the firm’s shares.

The corporate earning distributed to shareholders is called dividend. The dictionary meaning of dividend is a proportion of company’s profit paid to its shareholders\(^1\). It is also called a share of surplus or an unexpected gain, benefit or advantage. Financial meaning of dividend is an amount of money a corporation pays, normally a portion of profits, a board of directors distributes to the ordinary shareholders of the corporation. In other words, it is a distribution of value to the shareholders.

Dividend is the reward of the shareholders for investment made by them in the shares of the company. Dividends are usually paid to the owners or shareholders of the business at specific periods. The term dividend refers to that part of profits of a company which is distributed by the company among its shareholders. Dividend is a receipt of a part of the profits of the company by the members in proportion to the shares purchased by them.

The portion of earnings not distributed to the shareholders is known as retained earnings. Distribution of dividend to shareholder involve outflow of cash. Retained earnings are one of the easiest and cheapest way of financial resources for expansion and growth of the company.
Definition of Dividend:

1. Prof. Gilbreth, an eminent economist, defined dividend “as a receipt of a part of the profits of the organization by an individual in order to proclaim himself as a genuine member of the said company for future profits and for future dividend”

2. According to Prof. Haney, “The term dividend is defined as a method of allotting part of the said profits of the company to the individual who had procured shares under the provision of the act”

3. According to ICAI, “Dividend is a distribution to shareholders out of profits or reserves available for this purpose”.

4. “Dividend is a taxable payment declared by the company’s board of directors and given to its shareholders out of the company’s current or retained earnings”.

Nature of Dividend Decision:

The dividend decision of the firm is crucial for the finance manager because it determines the amount of profit to be distributed among the shareholders, and the amount of profit to be retained in the firm.

There is a reciprocal relationship between cash dividends and retained earnings. While taking the dividend decision the management takes into account the effect of the decision on the maximization of shareholders wealth. Maximizing the market value of shares is the objective and dividend payout or retention is guided by this objective. What portion of earning is to be distributed by way of dividend and what portion is to be retained is a very important consideration before the management for formulation of an appropriate dividend policy.

1.2 DIVIDEND POLICY:

Dividend policy plays a vital role because dividend is the major financial decision for every company. The dividend policy should be determined in terms of its impact on the shareholders wealth. Dividend policy involves decision to pay out earnings or to retain them for re-investment. The objective of a dividend policy should be to maximize a shareholder’s return so that value of his
Return consists of two parts: one is dividends and another is capital gains. Dividend policy has a direct influence on these two parts of return. There are two issues involved in setting up of dividend policy.

One is high payout policy and another is low payout policy. High payout policy means high payment of dividends to the shareholders and less retained earnings or less retention of money in the business. High payout will result in slower growth of the business. Lower payout policy is exactly opposite to the high payout. It means low payment of dividends to the shareholders and high retained earnings or high retention of money in the business. Lower policy will result in higher growth of the business and higher market price per share. Therefore, the financial manager must understand the various conflicting factors which influence the dividend policy before deciding the allocation of company’s earning into dividend and retained earnings. Dividend policy of the firm is a residual decision and dividends are a passive residual. The amount of dividend will fluctuate from year to year depending upon the availability of acceptable opportunities.

A finance manager’s objective for the company’s dividend policy is to maximize owner’s wealth while providing adequate financial resources for the company. Normally a portion of the profit is retained for reinvestment in the business and the remaining is paid out to the shareholder as dividend to maximize their wealth. The major problem is to decide that what portion of the profit is to be distributed. Investors always invest their money in the stocks or shares of the company in expectation of a return on their investment. The return on the stock holders’ investment consists mainly of dividend and capital gain. They make capital gains by selling their stock and get dividend from the company.

a) **High Pay out Policy**: - In this type of policy the company distributes the total earnings per share as dividend. The company’s direct purpose is to increase the stockholders wealth. In high dividend distribution policies the goal of the company is to satisfy the stakeholders and a positive effect in the market price of their stock.

b) **Low pay out policy**: - This policy states that the company distributes low dividend and keeps maximum amount in the company for financing of its
future investment projects. In this policy, the goal of the company is to maintain an income in order to allocate it for payment of the principal and the interest of the debts and to finance company’s investment projects.

1.3 THE DIVIDEND PROCESS:
Normally company’s pays dividend annually or semi-annually basis. The date on which the Board of Director’s declares the dividend that will be paid for the year. This date is important because by announcing its intent to increase, decrease or maintain dividend, the firm conveys information to financial markets. It is also termed as a Record Date.

The next date of note is the ex-dividend date, at which time investors must have bought the stock to receive the dividend. At the close of business a few days after the ex-dividend date, the company closes its stock transfer books and makes up the list of the shareholders to date on the holders - of - record date. These shareholders will receive the dividends. The final steps involve mailing out the dividend on the dividend payment date or the date when the company actually pays the declared dividend.

1.4 IMPORTANCE OF DIVIDEND POLICY:
Shareholders look into the capability of companies to initiate a dividend. Dividends are payments made by a company to a shareholder usually after a company earns a profit. It is not considered a business expense but a sharing of recognized assets among shareholders. Dividends are either paid regularly or can be called out anytime. Consequently, a dividend policy is a set of company rules and guidelines used to decide how much the company will pay out to its shareholders.

A dividend policy is first known as a heavy factor in a company’s stock value. However, more scholars are suggesting that corporate dividend policies do not matter and should not matter in a company’s stock value. Arguments against dividend policies start from the fact that investors can create their own dividends
on other investment option. A wise investor can look at more stable bonds to earn a return of investment rather than a dividend policy that can fluctuate.

Some companies believe that a no-dividend policy is just as sound as companies with a dividend policy. Companies without a dividend policy can use their profit earnings to reinvest and expand the company shares or buy assets. Having dividend policy forgoes these opportunities.

For people who value profit certainty of a company, a sound dividend policy is important. It follows that a high and regular corporate dividend policy means that companies have a benchmark for doing well. Therefore, more dividends can equate to the overall health of the company. Dividend policies are more valuable to small companies or cooperatives with excess cash and a few good projects where the net present value of these projects is positive. Meanwhile companies, without excess cash but have several good projects where NPV is also positive will only derail the undertaking of current projects. While a good corporate dividend policy is equated to excess cash, the value of the company is not hinged on the value of dividends as there are other indicator’s of a company’s performance.

There are different kinds of dividend policies; First, residual dividend policy is a method of distribution where dividends are paid after all the requirements for capital are met. Thus, dividends are computed from the residual cash after spending on new capital goods. The aim of this dividend policy is to decide if there is enough money left after all costs are met.

A cyclical policy or stable policies falls on investor decisions. While there are contrasting views of its usefulness, the most important factor is achieving the best bang-for-buck. The importance of dividend lies in their tax benefits and ultimately generate saving in the common man. Therefore, the nation’s economic objective of generating saving in the country is fulfilled.
1.5 FACTORS AFFECTING DIVIDEND POLICY:

1) Internal factors affecting dividend policy:
   i) **Desire of Shareholders**: The board of directors of the company decides the dividend in the interest of the shareholders of the company. Shareholders expect two types of returns: a) Dividends i.e. regular return on their investment, b) Capital gains i.e. an increase in the market value of shares.

   Cautious investors look for dividends due to:-
   a) Reduction of uncertainty (Capital gains are uncertain)
   b) Indication of financial strength of the company
   c) **Need for income**: some invest in the shares to get regular income for meeting up their living expenses.

   ii) **Financial needs of the company**: If the company has profitable projects and it is costly to raise funds, company may decide to retain the earnings instead of giving return to the shareholders in the form of dividend.

   iii) **Nature of earnings**: A company which has stable earnings can afford to pay a higher dividend or a higher dividend payout ratio.

   iv) **Liquidity position**: Payment of dividend results in cash outflows. A company may have adequate earning but it may not have sufficient funds to pay dividends.

   v) **Desire to retain the control of management**: Additional public issue of share will dilute the control of management.

2) External factors affecting dividend policy:
   i) **General state of Economy**: In case of uncertain economic and business conditions, the management of the company may like to retain whole or large part of earnings to build up reserves for meeting future uncertainty of the company. In the period of recession the management may also retain a large part of its earnings to preserve the company’s liquidity position. In the periods of prosperity the management policy may not be liberal in the payment of dividend because of availability of large profitable investment opportunities. In the period of inflation, the management may retain large portion of earnings to finance capital expenditure decisions.
ii) **State of Capital Market**: - If a favourable market condition exists, company may follow dividend policy and if unfavorable market conditions exists company follows conservative dividend policy.

iii) **Legal Restrictions**: - Indian companies’ act 1956 has laid down various restrictions regarding the declaration of dividend.

iv) **Contractual Restrictions**: - Lenders sometimes may put restrictions on the dividend payments to protect their interests (especially when the firm is experiencing liquidity problems). For example, a loan agreement that the firm shall not declare any dividend so long as the liquidity ratio is less than 1:1. The firm will not pay dividend more than 20 percent so long as it does not clear the loan.

1.6 **NEED OF THE STUDY:**

The scope of financial management has undergone significant changes over the years. Its scope was not restricted to the procurement or acquisition of funds but also its (funds) effective utilization in the business. Besides procurement of funds, modern approach of financial management includes dividend decision as one of the major financial decision. Therefore, this study focuses on studying dividend decision in detail. Dividend decision is a crucial decision from the point of view of the finance manger, shareholders (investors), lenders etc. There is need to find out the following:-

   a) What factors do sample pharmaceutical companies selected for the study consider while setting up their dividend policy?
   b) How much should be paid out as dividend?
   c) Should company follow stable dividend policy?

Dividend behaviour of the emerging markets is quite different from the developed markets because of its differential characteristics. There is need to study the different trends of dividend payout of the sample pharmaceutical companies selected for the study.
1.7 OBJECTIVES OF THE STUDY:

1. To know the dividend policy of pharmaceutical companies and its impact on the market value of the firm.
2. To find out the different trends in the dividend payment pattern of the pharmaceutical companies.
3. To study the factors affecting the dividend policy of the pharmaceutical companies.
4. To study whether dividend policy affects the growth of the companies.
5. To study whether dividend policy affects the investment decision of the companies.

1.8 STATEMENT OF THE PROBLEM:

Dividend policy is a key decision area in the field of financial management. It has been a subject of enquiry of financial analysts, academicians and researchers for the past few decades. The dividend decision is an integral part of a company’s financial decision making. The dividend payout decision has been a crucial decision. Dividend payout ratio is studied in detail for the purpose of analyzing trends in the dividend payment of pharmaceutical companies. Is dividend decision is the wealth maximization decision?

1.9 SIGNIFICANCE OF THE STUDY:

Although many studies on dividend are available in the Indian context, only a few studies discuss the impact of dividend payout on the value as well as future earnings of the company. Therefore, this research will enrich literatures on dividend payment, pharmaceutical company’s performance, growth, investment etc. and to support the existing literature. From the investors perspective it is about making the right decision and to have more knowledge about the dividend. Further it will help to investors for making better financial decision. This research finding will enlighten company’s management on predicting the direction of company’s performance in future. Regular dividend payouts are clearly the preferred distribution mechanism adopted by the companies. There are important differences in distribution methods across the companies. Regular cash dividends
are most important However, special dividends and buybacks also important considerations.

As far as dividend policies of the pharmaceutical companies are concerned, majority of the companies have a dividend per share and dividend payout ratio target in mind. Dividends are likely increase as the company grows and these companies may set dividend per share targets in the short run whereas setting other types of targets in the long run. The listed companies will prefer stable dividend and if possible will avoid cutting the dividend. On the other hand, non listed companies are less concerned due to information gap between the company and the investors. As such they are less concerned with the signaling power of dividend. During the study period, few pharmaceutical companies have paid special dividend. A firm either paid special dividend to distribute excess cash holdings or have a policy of paying special dividend to distribute excess cash on a regular basis.

Dividends continue to be the most important distribution mechanism than buy back of shares. Companies that pay dividends have a payout ratio target. However, they are willing to deviate from the target when they set the level of dividend. When companies are faced with insufficient cash flows to maintain the dividend, their first response is to cut the dividend, followed by cutting deferrable investment and borrowing up to the credit limit.

1.10 RESEARCH METHODOLOGY:
There are approximately 727 pharmaceutical companies in India, whereas, approximately 166 companies exist in Maharashtra State. With the help of Krejcie & Morgan formula the researcher has selected 08 sample pharmaceutical companies for the study. These sample pharmaceutical companies are listed on the Bombay Stock Exchange (BSE). For the study purpose, 08 pharmaceutical companies have been selected on the regional basis. The regions are as follows:

i) Developed zone i.e. Western Maharashtra
ii) Less developed zone i.e. Marathawada, Konkan and Vidarbha regions
iii) Metropolitan city zone i.e. Mumbai

Considering the Judgment Sampling Technique, 05 Indian companies and 03 multinational companies were selected from the above mentioned zone. The selected companies are as follows:

Table 1.1: Distribution of Sample Pharmaceutical Companies

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<th>Less Developed Zone: Marathawada, Konkan, Vidarbha</th>
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<th>Metropolitan City Zone: Mumbai</th>
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1.10.1 Period of the study:

The period of the present research is 10 years commencing from the year 1997 to year 2006. There are two basic reasons behind selection of this period. First, this period relates to the post liberalization era of the Indian economy and second, this is the period for which maximum financial information is available.

1.10.2 Primary Data:

The present research is based on the primary data source. A structured questionnaire is prepared to know the opinion of the managers regarding dividend policy. Further to know the various factors which consider while formulating the dividend policy of the sample pharmaceutical companies selected for the study. The questionnaire on dividend policy contained 17 questions. It further indicates
the belief of the management regarding important factors and management’s opinion of dividend policy on a scale of 1 to 5 (i.e. Likert Scale). The questionnaire was sent to the sample pharmaceutical companies’ corporate office through mail.

1.10.3 Secondary Data:
The present research is also based on the secondary data source. Secondary data consists of the 10 years annual report of the sample pharmaceutical companies selected for the study. The secondary data collected from the SANSCO SERVICES - Annual Reports Library Services source. Annual reports have been online subscribed by the researcher from the annual reports library services. The data collected from this source have been complied and used with due care as per the requirement of the study (i.e. hypothesis testing purpose).

1.10.4 Hypothesis of the study:
1. Investment decision is independent of its dividend decision
2. Dividend policy is influenced by the profit
3. Dividend policy is influenced by the cash flow
4. Dividend policy affects the growth of the company

1.10.5 Tools used for data analysis:
To analyze the data, the statistical tools such as Mean, ANOVA, Correlation, t test and Trend analysis have been used. The calculation has been carried out with the help of SPSS Computerized Software. Further, hypothesis has been tested with the help of SPSS Software.

1.10.5.1 Arithmetic Mean:
The arithmetic mean of set values is the quantity commonly called “the mean or the average”. In mathematics and statistics, the arithmetic mean or simply the mean of a list of numbers is the sum of all the numbers of the list divided by the number of items in the list. If the list is a statistical population, than the mean of that population is called a population mean. If the list is a statistical sample, therefore, the resulting statistic is called as a sample mean.
1.10.5.2 Correlation Analysis:
Correlation is defined as the degree of relationship between two or more variables. It is also referred to as co-variation (variation in one variable affecting the variation in the other variable). The degree of correlation between two variables is called simple correlation. The degree of correlation between one variable and several other variables is called multiple correlations. The quantitative measurement of the degree of correlation between two variables given by a parameter called correlation coefficient. Testing of significant of corelation coefficient “t test” has been used. Further, calculated t values are compared with t table values and accordingly hypothesis are accepted or rejected.

1.10.5.3 ANOVA:
The analysis of Variance, popularly known as ANOVA, is very useful technique for testing of more than two means of populations. The word ‘analysis of variance’ is used because the technique involves first finding out the total variation among the observations in the collected data, than assigning causes or components of variation to various factors and finally drawing conclusions about the equality of means. In the present research ANOVA technique is used for knowing the significant difference or variations of dividend payout ratios of different Indian Pharmaceutical companies selected for the study.

1.10.5.4 Trend Analysis:
Trend analysis is the tool that analyzes the financial statements by comparing the figures of different years and examining its trend. The dictionary meaning of trend is a “general tendency or direction\(^1\). In the present study, an attempt has been made to analyze the different trends in the dividend payout with the help of trend analysis. Dividend per share, Earnings per share and dividend payout ratio is an important variable which are used for the purpose of analysis of dividend payment trend.

1.11 SCOPE OF THE STUDY:
The analysis of this research is confined only to Bombay Stock Exchange (BSE) listed sample pharmaceutical companies selected for the study. The reason is that
the listed companies are required to follow the norms set by the Securities and Exchange Board of India (SEBI) for financial reporting. Another reason for selection is that after New York Stock Exchange (NYSE), Bombay Stock Exchange (BSE) has the second largest number of domestic companies than either London or Tokyo Stock Exchanges.

1.11.1 Geographical Scope:
The study is limited to the Maharashtra state. 08 pharmaceuticals companies have been selected. Out of these 08 selected companies, 05 are of Indian origin; the remaining 03 are multinationals. The study is based on the primary and the secondary data to evaluate the dividend payment pattern and its trends of 08 sample pharmaceutical companies. The 10 year period of study is quite adequate to analyze the dividend policy of the pharmaceutical companies selected for the study.

1.11.2 Operational Scope:
Operationally, the scope of this study is well focused on the dividend policy of the pharmaceutical company. The study is mainly depending upon the secondary data sources. The analysis of the study was done on the basis of the framed hypothesis. Further, opinion of the financial executives regarding setting up of dividend policy in practice has been found out.

1.11.3 Temporal Scope:
The study has covered the period of 10 years from 1997 to 2006. The dividend policy related data of 08 sample companies have been collected and analyzed on an annual basis in order to find out the dividend payment pattern trends during the study period.

1.12 LIMITATIONS OF THE STUDY:
The present study is based on the data taken from the annual reports of the company. The basic limitations are figures, calculations, statistical analysis and human error. This study has considered only dividend and not share purchases or buyback of shares and bonus shares. Share purchases or buyback of shares has
been permitted in the Indian context recently. And this may well have influence
the dividend behaviour of the Indian companies. Share purchase has a substitute
for dividend. In the present study only dividend is considered. Further, the
present study has not considered the stock market reactions to dividend events
and has not examined at greater depth the interactions between dividend and
other corporate finance decisions.

The study is carried out for limited number of companies only. Therefore, much
care has been taken to have a nice representation of population in the sample but
also a sample survey is not as good as a population survey. Therefore, the
limitations of sample survey are applicable to the present study.

The study is carried out for a period of 10 years to derive inferences and
conclusions about the dividend policy of the pharma companies. This study is not
universal study. This is sample study. This study is only limited to selected
pharmaceutical companies which are listed on the Bombay Stock Exchange.
Further, this study possesses all the inherent limitations of the financial data.

**1.13 ORGANIZATION OF THE STUDY:**

The study is organized into seven chapters. The structure is listed as follows:
Chapter 1 provides an introduction comprising the background, dividend policy,
its importance, dividend setting process, factors affecting dividend policy, need
of the study, objectives, statement of the problem, significance of the study,
methodology of the study, hypothesis, tools used for the data analysis, scope and
limitations of the study.

Chapter 2 contains the profile of the pharmaceutical companies selected for the
study. This chapter provides the brief overview of the historical perspective,
manufacturing, marketing operation, product, performance and jurisdiction of
market of the sample pharmaceutical companies.

Chapter 3 contains the review of literature. In this chapter, the researcher review
different models, reviews the existing literature regarding dividend decision. The
Literature review has been carried out to cover various aspects of dividend policy.

Chapter 4 discusses the dividend policy and its trend. An attempt has been made to analyze the dividend policy of different pharmaceutical companies selected for the study and tries to find out the different trend in the dividend payment pattern over the period of 1997 to 2006. Dividend per share, Earnings per share and Dividend Payout Ratio is an important variable which are used for the purpose of analysis of dividend payment trend. Further, an attempt has been made to analyze the different trends in the dividend payout with the help of trend analysis.

Chapter 5 provides an impact of dividend policy on the growth of the pharmaceutical companies. In this chapter, Growth can be classified as internal growth rate, sustainable growth rate, profit growth rate and assets growth rate. Further to know the impact of dividend policy on the growth of the company, hypothesis is framed and tested accordingly.

Chapter 6 presents the detailed analysis and interpretation of data. This chapter is divided into two sections. Section I deals with the primary data analysis i.e. opinion analysis of the executives of pharmaceutical companies selected for the study. Section II deals with testing of framed hypothesis. Further, it presents empirical results.

Chapter 7 summarizes the findings of the sample pharmaceutical companies selected for the study. Further it includes conclusions and suggestions. And it also indicates important directions for further research on this topic.
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