CHAPTER – 2

CONCEPTUAL FRAMEWORK OF DIVIDEND AND DIVIDEND DISCOUNT MODELS
# CONCEPTUAL FRAMEWORK OF DIVIDEND AND DIVIDEND DISCOUNT MODELS

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2.1 INTRODUCTION

The word ‘dividend’ comes from the Latin word “dividendum” (‘thing to be divided’). A dividend is a payment made by a Company to its shareholders, usually as a distribution of profits. When a company earns a profit or surplus, it can re-invest it in the business (called retained earnings), and pay a fraction of this reinvestment as a dividend to shareholders.

In India, companies declaring or distributing dividend, are required to pay a Corporate Dividend Tax in addition to the tax levied on their income. Dividend received is exempt in the hands of the shareholders, in respect of which Corporate Dividend Tax has been paid by the company.

2.2 MEANING OF DIVIDEND

The term ‘dividend’ has been defined under Section 2(35) of the Companies Act, 2013. The term ‘Dividend’ includes any interim dividend. It is an inclusive and not an exhaustive definition. According to the generally accepted definition, ‘dividend means the profit of a company, which is not retained in the business and is distributed among the shareholders in proportion to the amount paid-up on the shares held by them.’

Dividends are usually payable for a financial year after the final accounts are ready and the amount of distributable profits is available. Dividend for a financial year of the company (which is called ‘final dividend’) are payable only if it is declared by the company at its annual general meeting on the recommendation of the Board of directors. Sometimes dividends are also paid by the Board of directors between two annual general meetings without declaring them at an annual general meeting (which is called ‘interim dividend’).

2.3 MEANING OF DIVIDEND POLICY

The term dividend policy refers to the policy concerning quantum of profits to be distributed as dividend. The concept of dividend policy implies that companies through their Board of Directors evolve a pattern of dividend payments, which has a bearing on future action.
According to Weston and Brigham, “Dividend policy determines the division of earnings between payments to shareholders and retained earnings”.

According to Gitman, “The firm’s dividend policy represents a plan of action to be followed whenever the dividend decision must be made.

According to MM hypothesis (Miller-Modigliani) that supports that dividends are of irrelevance and has no effect on the valuation of the firm.

Walter and Gordon support and suggest that investment policy and dividend policy are interlinked and affects the price of the shares of a firm. Hence, dividend is relevant.

2.4 DIVIDEND UNDER THE COMPANIES ACT, 2013

The Companies Act, 2013 lays down certain provisions for declaration of dividend, which are:

(i) Section 51 permits companies to pay dividends proportionately, i.e. in proportion to the amount paid-up on each share when all shares are not uniformly paid up, i.e. pro rata. Pro rata means in proportion or proportionately, according to a certain rate. The Board of Directors of a company may decide to pay dividends on pro rata basis if all the equity shares of the company are not equally paid- up. However, in the case of preference shares, dividend is always paid at a fixed rate.

- The permission given by this section is, however, conditional upon the company’s articles of association expressly authorizing the company in this regard.

(ii) Final Dividend is generally declared at an annual general meeting [Section 102(2)] at a rate not more than what is recommended by the directors in accordance with the articles of association of a company.

(iii) An interim dividend is declared by the Board of directors at any time before the closure of financial year, whereas a final dividend is declared by the members of a company at its annual general meeting if and only if the same has been recommended by the Board of directors of the Company.
(iv) In accordance with Section 134 (3) (k), Board of directors must state in the Directors’ Report the amount of dividend, if any, which it recommends to be paid.

- The dividend recommended by the Board of directors in the Board’s Report must be ‘declared’ at the annual general meeting of the company. This constitutes an item of ordinary business to be transacted at every annual general meeting. This does not apply to interim dividend.

(iv) No dividend shall be declared or paid by a company for any financial year except out of the profits of the company for that year arrived at after providing for depreciation in accordance with section 123 (2) of the Act or out of profits of the company for any previous financial years arrived at after providing for depreciation in accordance with the provisions of above sub section and remaining undistributed or out of both or out of moneys provided by the Central Government or a State Government for payment of dividend in pursuance of a guarantee given by the concerned Government [Section 123(1)].

(v) A company may before the declaration of any dividend in any financial year, transfer such percentage of its profits for that financial year as it may consider appropriate to the reserves of the company.

(vi) If owing to inadequacy or absence of profits in any year, a company proposes to declare dividend out of the accumulated profits earned by it in any previous financial years and transferred to reserves, such declaration of dividend shall not be made except in accordance with the Companies (Declaration and Payment of Dividend) Rules, 2014.

(vii) Depreciation, as required under Section 123(1) of the Companies Act has to be provided in accordance with the provisions of Schedule II to the Act.

(viii) A company which fails to comply with Section 73 and 74 of the Companies Act shall not declare any dividend on its equity shares till such default continues.

(ix) The amount of dividend (final as well as interim) shall be deposited in a separate bank account within 5 days from the date of declaration. [Section 123(4)]

(x) Dividend has to be paid within 30 days from the date of declaration.
(xi) In case of listed companies, Section 24 of the Companies Act, 2013 confers on SEBI, the power of administration of the provisions pertaining to non-payment of dividend. In any other case, the powers remain vested in Central Government.

(xii) If dividend has not been paid or claimed within the 30 days from the date of its declaration, the company is required to transfer the total amount of dividend which remains unpaid or unclaimed, to a special account to be opened by the company in a scheduled bank to be called “Unpaid Dividend Account”. Such transfer shall be made within 7 days from the date of expiry of the said period of 30 days.

(xiii) In accordance with Section 70, a company cannot buy its own shares if apart from other things provided in the section; it makes default in payment of dividend to any shareholder.

(xiv) Any money transferred to the unpaid dividend account of a company in pursuance of section 124 which remains unpaid or unclaimed for a period of seven years from the date of such transfer shall be transferred by the company to the Investor Education and Protection Fund and the company shall file a statement in “Form DIV-5” to the Authority constituted under the Act to administer the fund and such authority shall issue a receipt to the company as evidence of such transfer. [Section 124(5)]

(xv) Where a dividend has not been paid by the company within 30 days from the date of declaration, every director shall, if he is knowingly a party to the default, be punishable with imprisonment for a term which may extend to 2 years and shall also be liable to a fine of rupees 1000 for every day during which default continues and the company shall be liable to pay simple interest @ 18% per annum during the period for which such default continues. [Section 127]

(xvi) If the company delays the transfer of the unpaid/unclaimed dividend amount to the unpaid dividend account, it shall pay interest @ 12% p. a. till it transfers the same and the interest accruing on such amount shall ensure to the benefit of the members of the company in proportion to the amount remaining unpaid to them. [Section 124(3)]

(xvii) Any dividend payable in cash may be paid by cheque or warrant through post directed to the registered address of the shareholder who is entitled to the payment of the dividend or to his order or in any electronic mode sent to his banker. [Section 123(5)]
Source for Payment of Dividend: Dividend can be paid out of Followings:

Section- 123 (1) (a)

- Profit of the current year after providing of the depreciation; or
- Profit of the previous financial year or years after providing for depreciation for previous years; or
- Out of the money provided by Central or State Government for payment of dividend in pursuance of guarantee given by that, if any.
- Term ‘Profit’- Profit can be either revenue profit or Capital profits or both. Thus, dividend can’t be paid by revaluation of assets, as the surplus has not been actually realized.

Note: It is not necessary to distribute whole of profits among shareholders.

2.5 TYPES OF DIVIDENDS

Dividends can be classified into different categories depending upon the form in which they are paid. The various forms of dividend are as under:-

1) Cash Dividend
2) Stock Dividend or Bonus Issue
3) Bond Dividend
4) Scrip Dividend or Promissory Note
5) Property Dividend

1) Cash Dividend: The usual practice is to pay dividends in cash. Payment of dividend in cash results in outflow of funds from the firm. The firm should, therefore, have adequate cash resources at its disposal or provide for such resources so that its liquidity position is not adversely affected on account of distribution of dividends in cash. Generally, shareholders are interested in cash dividend and according to sec. 205(3) of the Companies Act also dividend is payable in cash only.

2) Stock Dividend: Stock dividend is next to cash dividend in respect of its popularity. Payment stock dividend is popularly termed as “issue of bonus shares” in India. Issue of bonus shares results in conversion of company’s profit into share capital. Bonus shares are therefore, shares allotted by capitalization of reserves or
surplus of a corporate enterprise. Such shares are issued to the equity shareholders in proportion to their holdings of the equity share capital of the company. When the company pays stock dividend, there is no change in the company’s assets or liabilities or in total market value of the company ‘shares. A shareholder does not gain or lose as a result of the new shares, because he retains the same old proportion of total share capital.

3) Scrip Dividend: It is the dividend given in the form of promissory notes to pay the amount at a specific future date. The promissory note is known as scrip’s or dividend certificates. When a company is a regular dividend paying company but temporarily its cash position is affected due to locking up of funds, which is likely to be released shortly, this opinion is preferred. Scrip may or may not be interest bearing.

4) Bond Dividend: In case the company does not have sufficient funds to pay dividend in cash it may issue bonds for the amount due to the shareholders by way of dividends. It has longer maturity date than Scrip dividend. It always carries interest. Thus, bondholders get regular interest on their bonds besides payment of bond money on the due date. But this practice is not seen in India nor legally allowed.

5) Property Dividend: In case of such dividend the company pays dividend in the form of assets other than cash. This may be in form of company’s products. This type of dividend is not popular in India.

2.6 FACTORS AFFECTING DIVIDEND POLICY

It is a generally accepted principle that the directors of a company have sole right to declare dividend and determine its amount out of company’s earnings. But, in addition to legal restrictions, they have to consider following factors while deciding the dividend policy:

1) Preference of Shareholders: The preference of shareholders may influence the dividend policy of the firm. Dividend income provides investors a regular income and builds confidence amongst the investors of the company. However, there are certain shareholders, especially from high tax brackets, like to get the benefit of capital gains in the form of appreciation in the value of share. In such a case, the policy should try to satisfy the dominating group of shareholders.
2) **Current Year’s Earnings:** Earnings of a company fix the upper limit of dividends. A company has to determine the amount of dividend keeping in view the actual earnings of the current year only. Of course, the whole of earnings is not to be distributed by the company, but it is the base of dividend policy.

3) **Past Dividends:** Shareholders do expect that the company would pay not less than dividend paid in the past. Of course, if conditions change, departure has to be made from the past trend of dividends. But generally directors are hesitant to reduce the previous year’s dividend rate, and if needed, they would maintain the rate by withdrawing from accumulated profits.

4) **Management Control Motive:** The existing shareholders or management’s control motive also influences the dividend policy of a company. If the management wants that the existing shareholders should continue to retain control over the company it would not be wise to raise finance through issues of new shares, for that control is diluted into the hands of new shareholders. Therefore, the firm may rely more on retained earnings. It is likely to have a lesser dividend payout policy.

5) **Liquidity Position:** Dividends entail cash payments. Hence, the liquidity position of the firm has a bearing on its dividend decisions. A firm may have earned handsome profits, but may not have enough cash to pay dividend. This is typically the case of new establishments or highly profitable but rapidly expanding firms, which, thanks to their substantial investment and other commitments do not have adequate liquidity.

6) **Future Financial Requirements:** A company should consider its financial requirements for expansion programmers’ or increased needs of working capital before taking a dividend decision. Generally, firms, which have substantial investment proposals and consequently considerable funding needs, should retain maximum of its earnings and minimum dividend payout ratio.

7) **Access to Capital Market:** If a firm has an easy access to capital market (it can raise fund, whenever it is required, at minimum cost), it can afford to adopt liberal dividend policy. If the firm does not have easy access to capital market, it cannot raise funds externally easily and so it will have to depend more on retained earnings for funds required for its expansion programmers’. This consideration also affects the dividend policy of the companies.
8) **Contractual Restrictions:** Sometimes a firm’s dividend policy is restricted by certain specific conditions in loan agreements. When the finance is raised from external sources, creditors may impose various restrictions to exempt themselves from possible insolvency of the firm. The creditors may withdraw their money from the firm if these requirements are violated.

9) **Taxation Policy:** The corporate taxes affect the rate of dividend of the company. High rate of taxation reduces the residual profits available for distribution to shareholders and consequently the rate of dividend is lowered down. Further, in some circumstances, government levies additional dividend tax on distribution of profits beyond a certain limit.

10) **Inflation:** Inflation may also affect the dividend policy of a company. With rising pricing, funds generated by depreciation may fall short in order to replace obsolete equipments. The firms have therefore to rely on retained earnings for this purpose and have to retain greater part of earnings for replacement. As such, the dividend payment ratio tends to be low during the inflation period.

11) **Stability of Earnings:** The stability of earnings has a significant impact on formation of dividend policy. A firm having a stable income over a long period of time will be more liberal in its dividend policy, usually; firms dealing in necessities suffer less from fluctuating income and can adopt stable dividend policy. A firm having fluctuating earnings for example firms dealing in luxurious product would have to be very careful in determining its dividend policy, as it would not be able to adopt a stable dividend policy.

12) **Legal Restrictions:** The Company may have to legally pay all arrear and current interest on loans/debentures, all arrear and current dividend to preference shareholders and charge depreciation on depreciable assets before payment of dividend.

### Table No. 1 Legal Framework of Dividend

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<td>205(1) &amp; (2) Depreciation should be</td>
<td>A company can pay dividend out of current profit and profit earned in any earlier financial years after charging depreciation as per the requirement of the Companies Act. Depreciation is</td>
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Charged before payment of dividend

Provided as the rates given in Schedule XIV to the Companies Act. This Schedule gives minimum depreciation rate. But a company can charge higher depreciation. For this purpose it has to charge at least 95% of the original cost of the asset over its useful life.

205(2A) Compulsory transfer to Reserve before payment of dividend

As per the Companies (Transfer of Profits to Reserves) Rules, 1975 a company has to transfer the following % of current profits. (a) Dividend proposed exceeds 10% but not 12.5% of the paid up capital 2.5% (b) Dividend proposed exceeds 12.5% but not 15% of the paid up capital 5.0% (c) Dividend proposed exceeds 15% but not 20% of the 27 paid up capital 7.5% (d) Dividend proposed exceeds 20% of the paid up capital 10.0%

Can a company transfer higher % to reserves? Voluntary transfer of higher % of profit to reserves is allowed, when the company declared dividend: (i) It has to maintain average rate of dividend declared by it over the last three years. (ii) In case bonus shares are issued and its paid up capital has been increased, a company has to maintain average amount of dividend declared over the last three years. However, in case the net profit after tax of the company is lower by 20% or more in a year as compared to the average net profits after tax of the two preceding financial years, it is not required to maintain average rate or amount of dividend as stated above. If the company does not declare dividend, then amount proposed to be transferred from reserves should be 28 lower than the average amount of dividend declared by it over last three immediately preceding financial years.

205(2B) Compliance with the requirements of Section 80A

Dividend on equity shares cannot be paid unless the company redeems irredeemable preference shares. Presently, it is not permissible to issue irredeemable preference shares.

205(3) Dividends should be paid in cash only. However, a company can capitalize profit by way of issue of bonus shares.
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| 205A(1) | Dividend is declared by the shareholders in the annual general meeting on the basis of the dividend proposed by the Board of Directors. Dividend should be paid within 30* days from the date of declaration. In case a company cannot pay such dividend, it is to be transferred to a special account called “Unpaid Dividend Account of …… Company Ltd/ (Pvt.) Ltd. |
| 205(3) | In case company wants to pay dividend out of reserves because of inadequacy of profit in any year, it should follow the Companies (Declaration of Dividend out of Reserves) Rules, 1975. The guidelines are – (i) The rate of dividend cannot exceed the average rate of dividend declared in the immediately preceding five years, or 10% of the paid up capital, whichever is less. (ii) Total amount to be drawn from accumulated profit earned in the previous years. The profits so drawn should be utilized first to set off any loss incurred during the financial year before payment of dividend. (iii) The balance of reserves after such transfer shall not fall below 15% of its paid share capital Free reserves do not mean capital reserve & revaluation reserves. |
| 205(5) | Any money transferred to the Unpaid Dividend Account and remains unpaid or unclaimed for a period of seven years should be transferred to Investor Education and Protection Fund established under section 205C of the 30 Companies Act |
| 206 | Dividend is to be paid to the registered shareholders or to their order or to their bankers. |
| 207 | Penalty for failure to distribute dividends within forty two days – where a dividend has been declared by a company but has not been paid, or the warrant in respect thereof, has not been posted, within forty two days from the date of the declaration, to any shareholders entitled to the payment of the dividend, every directors of the company shall, if he is knowingly a party to the default, be punishable with “simple imprisonment for a term which may extend to seven days and shall also be liable to fine”. |
2.7 TYPES OF DIVIDEND POLICIES

The dividend policy should be determined by taking into consideration the above stated factors. A financial manager can recommend any one of the following dividend policies:

1) Stable Dividend Policy: Stability of dividend means similarity or no change in dividend payments over the years. In other words, when a company pays dividend at a fixed rate and follows it for future years to come regardless of fluctuations in the level of earnings, it is said to be a stable dividend policy. Thus, stability of dividends refers to regular payment of dividend at a fixed rate. Stable dividend policy increases credibility of the management in the market and shareholders also prefer such stock giving minimum return at regular interval leads to increase in market price of shares. Those companies whose earnings are stable follow this policy. The stability of dividend is described in two different Ways viz. (a) Constant/Fixed Dividend per Share (b) Constant Payout Ratio.

(a) Constant Amount per Share: In this policy, company pays fixed amount of dividend per share regularly – every year irrespective about the earnings of the company. But it does not mean that management has static nature and will adopt the policy for years to come. If the company's levels of earnings are increased gradually and same level is to be maintained in the future then the dividend per share is been increased respectively. This policy puts equity shares at par with preference shares which yields fixed dividend per share every year. The fact that equity shareholders bear the total risk of the business is forgotten here. Generally, this policy is preferred by those persons and institutions that depend upon the dividend income to meet their living and operating expenses.

(b) Constant Payout Ratio: In this policy, a fixed percentage of net earnings are paid as dividend every year, that is, constant payout ratio. For example, a company adopts a 60 per cent payout, that is, 60 per cent of net earnings of the company will be paid as dividend and 40 per cent of net earnings will be transferred to reserves. No
dividend is paid in the year of loss. Companies generally, prefer this policy because it reflects the ability of the company to pay dividends. But it is not preferred by shareholders as the return fluctuates with the amount of earnings.

2) Policy of No Immediate Dividend: Generally, management follows a policy of paying no immediate dividend in the beginning of its life, as it requires funds for growth and expansion or they may be experiencing serious financial difficulties and may be unable to pay dividend. In this case, the firm can minimize adverse effects on the stock price by carefully explaining the reason for the elimination of the dividend. After the, no dividend policy, it is advisable that the company should either issue bonus shares from its reserves or company’s shares should be split into shares of small amount so that later on rate of dividend is maintained at a reasonable rate.

3) Policy of Irregular Dividend: When the firm does not payout fixed dividend regularly, it is irregular dividend policy. It changes from year to year according to change in earnings level. This policy is based on the management belief that dividends should be paid only when the earnings and liquid position of the firm warrant it. Firms having unstable earnings, particularly engaged in luxury goods, follow this policy.

4) Policy of Regular Dividend plus Extra Dividend: This policy would be appropriate for a firm with cyclical earnings and limited opportunities for growth. In a good earnings year, the firm would declare an extra dividend. The designation ‘extra’ is used in connection with the payment to tell the shareholders that this is extra and which might not be continued in future. When the earnings of the company have permanently increased, the extra dividend should be merged with regular normal dividend and thus, rate of normal dividend should be raised.

5) Policy of Regular Dividend plus Stock Dividend: In this policy company pays stock dividend in addition to the regular dividend. Thus, the dividend is split into two parts. This policy is adopted when the company has earned handsome profit and wants to give shareholders a share in the additional profit but wants to retain cash for expansion. It is not advisable to follow this policy for a long time, as the number of shares increases and the earning per shares reduces, which led to decrease in share price.
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2.8 DECLARATION OF DIVIDEND

2.8.1 Notice of Dividend:

- [As per Clause 87 of Model Articles of Company Limited by shares as Contained in Table-F of Schedule-I of the 2013 Act] Notice of dividend declared shall be given to the persons entitled to share in it.

2.8.2 Process for declaration of Dividend:

(1) [As per Clause 80 of Model Articles of Company Limited by Shares as Contained in Table - F of Schedule - I of the 2013 Act]:

- Company in Board Meeting may decide the amount of dividend which they want to recommend in General Meeting.

- Company will mention the resolution for Dividend in the Notice of General Meeting.

- Company will hold the General Meeting:

- Declaration of Dividend is Ordinary Business.

- Ordinary Resolution for declaration of dividend will be passed in the General Meeting.

- Once dividend is declared, it must be paid within 30 days.

Note:

- Dividend declared in General Meeting can’t exceed the dividend recommended by the Board.

- Dividend declared in General Meeting by member can be less than the dividend recommended by the Board.

- Dividend paid in General Meeting is Final Dividend.

(2) Transfer Portion of Profit in Reserve:

- Before declaration of dividend, a company may transfer a portion from the profit to the reserves of the company. The company is free to decide the percentage for such transfer to the reserve.
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☐ Mandatory transfer to reserve is not required under Companies Act 2013. Companies are free to transfer such percentage of its profits for that financial year as it may consider appropriate to the reserves. {First Proviso to Section 123(1) of the Companies Act, 2013}.

☐ The reserve shall, at the discretion of the Board, be applicable for any purpose to which the profits of the company may be properly applied, including provision for meeting contingencies or for equalizing dividends. {As per Clause 82 (i) of Model Articles of Company Limited by shares as Contained in Table-F of Schedule-I of the 2013 Act}.

☐ Thus transfer of specific amount to reserves is not mandatory.

(3) Procedure for Declaration and Payment of Final Dividend:

The following steps are required to be taken by a company in respect of declaration and payment of final dividend:

(1) Issue notice for holding a meeting of the Board of directors of the company to consider the matter. The notice must be in accordance with Section 173 of the Companies Act. It must state time, date and venue of the meeting and details of the business to be transacted thereat and be sent to all the directors for the time being in India and to all other directors, at their usual address in India either by post or by hand delivery or by electronic means.

(2) In case of listed companies, notify stock exchange(s) where the securities of the company are listed, at least 2 working days in advance of the date of the meeting of its Board of Directors at which the recommendation of final dividend is to be considered [Clause 19 of listing agreement] and will immediately after the meeting of its Board of Directors intimate declaration of dividend to the Stock Exchanges where the company is listed (within 15 minutes of the closure of the board meeting) by phone, fax, telegram, e-mail.

(3) Hold Board meeting for the purpose of passing the following resolutions:

i) Approving the annual accounts (balance sheet and profit and loss account of the company for the year ended);
ii) Recommending the quantum of final dividend to be declared at the next annual general meeting and the source of funds for the payment thereof and amount to be transferred from the current profits to reserves as the board may deem appropriate.

(The Board may also carry forward any profits which it may consider necessary not to divide, without setting them aside as a reserve)

(4) Fixing time, date and venue for holding the next annual general meeting of the company, inter alia, for declaration of dividend recommended by the Board;

(5) Approving notice for the annual general meeting and authorizing the company secretary or any other competent person if company does not have a company secretary to issue the notice of the AGM on behalf of the Board of directors of the company to all the members, directors and auditors of the company and other persons entitled to receive the same.

(6) Determining the date of closure of the register of members and the share transfer register of the company as per requirements of Section 91 of the Companies Act, 2013 and the listing agreements (in the case of listed companies) signed by the company with the stock exchanges where the securities of the company are listed. In the case of listed companies, the date of commencement of closure of the transfer books should not be on a day following a holiday. The dates so fixed should also not clash with the clearance programme in the stock exchanges. It is advisable to consult in advance the regional stock exchange and then fix the dates for closure of books.

(7) Ensure that the required percentage of profits as decided by the Board is transferred to company’s reserves.

(8) In case of listed company, publish notice of book closure in a newspaper circulating in the district in which the registered office of the company is situated at least seven days before the date of commencement of book closure. Further:

i) To give notice of book closure to the stock exchange at least 7 working days or as many days as the stock exchange may prescribe, before the closure of transfer books or record date, stating the dates of closure of its transfer books/record date.
ii) To send the copies of notice stating the date of closure of the register of transfers or record date, and specifying the purpose for which the register is closed or the record date is fixed, to other recognized stock exchanges.

iii) Time gap between two book closures and record date would be at least 30 days (Clause 16 of Listing Agreement).

iv) To declare and disclose the dividend on per share basis only.

[Clause 16, 20A of listing agreement read with Section 91 of Companies Act, 2013].

9) Close the register of members and the share transfer register of the company.

10) The amount of dividend as recommended by the Board of directors shall be shown in the Directors’ Report.

11) Hold a Board/committee meeting for approving registration of transfer/transmission of the shares of the company, which have been lodged with the company prior to the commencement of book closure. In compliance with the Board resolution, register transfer/transmission of shares lodged with the company prior to the date of commencement of the closure of the register of members and mail the share certificates to the transferees after endorsing the shares in their names.

12) Hold the annual general meeting and pass an ordinary resolution declaring the payment of dividend to the shareholders of the company as per recommendation of the Board. The shareholders cannot declare the final dividend at a rate higher than the one recommended by the Board. However, they may declare the final dividend at a rate lower than the one recommended by the Board. The following should be noted in this regard:

i) Once a company has declared a dividend for a financial year at an annual general meeting, it cannot declare further dividend at an extraordinary general meeting in relation to the same financial year; it is beyond the powers of the company to do so, although the Companies Act does not prohibit the declaration of a dividend at a general meeting other than an annual general meeting.
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ii) Pro-rata means in proportion or proportionately, according to a certain rate. It denotes a method of dividing something between a numbers of participants in proportion to some factor. The profits of a company are shared, pro rata, among the shareholders, i.e. in proportion to the number of shares each shareholder holds.

iii) Subject to the rights of persons, if any, entitled to shares with special rights as to dividends, all dividends shall be declared and paid according to the amounts paid or credited as paid on the shares in respect whereof the dividend is paid, but if and so long as nothing is paid upon any of the shares in the company, dividends may be declared and paid according to the amounts of the shares [Table F, Article 83].

13) Prepare a statement of dividend in respect of each shareholder.

14) Ensure that the dividend tax is paid to the tax authorities within the prescribed time.

15) Open a separate bank account for making dividend payment and credit the said bank account with the total amount of dividend payable within five days of declaration of dividend.

16) If the company is listed, then for payment of dividend it has to mandatorily use, either directly or through its Registrars to an Issue and Share Transfer Agents (RTI & STA), any Reserve Bank of India approved electronic mode of payment such as Electronic Clearing Services (ECS), National Electronic Fund Transfer (NEFT), etc.

17) Make arrangements with the bank and in collaboration with other banks if required, for payment of the Dividend Warrants at par. Instructions to all the specified branches of the bank that dividend should be paid at par should be sent by the Bank.

18) No RBI approval is required for payment of dividend to shareholders abroad, in case of investment made on repatriation basis.

19) Where an instrument of transfer has been received by company prior to book closure but transfer of such shares has not been registered when the dividend
warrants were posted, then keep the amount of dividend in special A/c called “Unpaid Dividend Account” opened under section 124 unless the registered holder of these shares authorizes company in writing to pay dividend to the transferee specified in the said instrument of transfer.

(20) Dispatch dividend warrants within thirty days of the declaration of dividend. In case of joint shareholders, dispatch the dividend warrant to the first named shareholder.

(21) Arrange for transfer of unpaid or unclaimed dividend to a special account named “Unpaid dividend Account” within 7 days after expiry of the period of 30 days of declaration of final dividend. (Section 124)

(22) Identify the unclaimed amounts as referred to in sub-section (1) of section 124 of the Act and, separately furnish a statement and upload on company’s own website or any other website as may be specified by the Government in such form as may be prescribed. The company shall prepare the above statement within a period of 90 days of making any transfer to unpaid dividend account.

(23) Transfer unpaid dividend amount to Investor Education and Protection Fund (IEPF) after the expiry of seven years from the date of transfer to unpaid dividend A/c. The company while effecting credit to the Fund, should separately furnish a statement with the authority constituted to administer the fund in Form DIV-5 of Companies (Declaration and Payment of Dividend) Rules, 2014 and obtain a receipt from the authority as evidence of such transfer.

(24) Company shall also transfer all the shares in the name of Investor Education and Protection Fund (IEPF) on which unpaid or unclaimed dividend has been already transferred to IEPF and any lawful claimant of those shares/dividend shall be entitled to claim the transfer of shares/dividend from IEPF in accordance with such rules, procedure and submission of documents as may be prescribed by the Central Government in this regard. [Section 124 (5) / (6) & Section 125(3) (a)]

(4) **Payment of Dividend without Providing for Depreciation:**

- Section 123 (1) (a) of the Companies Act, 2013 provides that no dividend shall be declared or paid by a company for any financial year except out of the
profits of the company for that year or out of the profits of the company for
any previous financial years arrived at after providing for depreciation in
accordance with the provisions of Schedule II to the Act and remaining
undistributed, or out of both.

Further, rule 3(5) of Companies (Declaration and Payment of Dividend) Rules,
2014 provides that no company shall declare dividend unless carried over
previous losses and depreciation not provided in previous year are set off
against profit of the company of the current year the loss or depreciation,
whichever is less, in previous years is set off against the profit of the company
for the year for which dividend is declared or paid.

(5) Declaration of Dividend out of Company’s Reserves:

In the event of inadequacy or absence of profits in any year, a company may declare
dividend out of surplus reserves subject to the fulfillment of the following conditions,
amely:-

(1) The rate of dividend declared shall not exceed the average of the rates at which
dividend was declared by it in the three years immediately preceding that year.
However, this condition shall not apply to a company, which has not declared any
dividend in each of the three preceding financial year.

(2) The total amount to be drawn from such accumulated profits shall not exceed one-
tenth of the paid-up share capital and free reserves as appearing in the latest
audited financial statement.

(3) The amount so drawn shall first be utilized to set off the losses incurred in the
financial year in which dividend is declared before any dividend in respect of
equity shares is declared.

(4) The balance of reserves after such withdrawal shall not fall below 15% of its paid
up share capital as appearing in the latest audited financial statement.

The procedure is as follows:

Give notice as per Section 173 to all the directors of the company for holding a
Board meeting. In the meeting, take decision to declare dividend out of
company’s reserves because of inadequacy or absence of profits and also fix the date, time and place of the Annual General Meeting. Authorize the Company Secretary or any competent person if company does not have a company secretary to issue the notice of the AGM on behalf of the Board of directors of the company to all the members, directors and auditors of the company and other persons entitled to receive the same.

☐ Ensure that the conditions prescribed under Companies (Declaration and Payment of Dividend) Rules, 2014 are complied with.

☐ Rests of the procedural steps are same as in case of payment of final dividend.

2.8.3 Interim Dividend:

Procedure for Declaration and Payment of Interim Dividend:

(1) Verify from company’s Articles of Association that they authorize the directors to declare interim dividend; if not then alter the Articles of Association accordingly.

(2) Issue notice for holding a meeting of the Board of directors of the company to consider the matter. The notice must be in accordance with Section 173 of the Companies Act. It must state time, date and venue of the meeting and details of the business to be transacted thereat and be sent to all the directors for the time being in India and to all other directors, at their usual address in India either by post or by hand delivery or by electronic means.

(3) In case of listed companies, notify stock exchange(s) where the securities of the company are listed, at least 2 working days in advance of the date of the meeting of its Board of Directors at which the declaration of interim dividend is to be considered [Clause 19 of listing agreement] and will immediately after the meeting of its Board of Directors intimate declaration of dividend to the Stock Exchanges where the company is listed (within 15 minutes of the closure of the board meeting) by phone, fax, telegram, e-mail.

(4) At the Board meeting, the Board of Directors considers in detail all the matters with regard to the declaration and payment of an interim dividend including:
(A) Before declaring an interim dividend, the directors must satisfy themselves that the financial position of the company allows the payment of such a dividend out of profits available for distribution.

(B) The Board of Directors of a company may declare interim dividend during any financial year out of the surplus in the profit and loss account and out of profits of the financial year in which such interim dividend is sought to be declared.

(C) In case the company has incurred loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend shall not be declared at a rate higher than the average dividends declared by the company during the immediately preceding three financial years.

(D) The directors of a company may be held personally liable in the event of wrong declaration of an interim dividend. Therefore, it is prudent on the part of the directors to have a Performa profit and loss account and balance sheet of the company prepared up to the latest possible date of the financial year in respect of which interim dividend is proposed to be declared and provision must be made for all the working expenses and depreciation for the whole year.

(E) The board should pass a suitable resolution for declaration and payment of interim dividend on equity shares of the company.

(F) Authorities for signing the dividend warrants and pass appropriate resolutions covering all these aspects of the matter.

(G) Interim dividend on preference shares: Generally, dividend on preference shares is paid annually. However, the dividend at a fixed rate on the preference shares can be paid more than once during a year, in proportion to the period of completion of current financial period over the whole financial year, by declaring it as interim dividend, in the Board meeting by the Board of directors. A suitable resolution should be passed to the effect that the dividend will be paid to the registered preference share holders whose names appear in
the register of preference shareholders as on the date of commencement of closure of share transfer books.

(5) In case of listed company, publish notice of book closure in a newspaper circulating in the district in which the registered office of the company is situated at least seven days before the date of commencement of book closure. Further:

(i) To give notice of book closure to the stock exchange at least 7 working days or as many days as the stock exchange may prescribe, before the closure of transfer books or record date, stating the dates of closure of its transfer books/record date.

(ii) To send the copies of notice stating the date of closure of the register of transfers or record date, and specifying the purpose for which the register is closed or the record date is fixed, to other recognized stock exchanges.

(iii) Time gap between two book closures and record date would be at least 30 days.

(iv) To declare and disclose the dividend on per share basis only.

[Clause 16, 20A of listing agreement read with Section 91 of Companies Act, 2013].

(6) Close the register of members and the share transfer register of the company.

(7) Hold a Board/committee meeting for approving registration of transfer/transmission of the shares of the company, which have been lodged with the company prior to the commencement of book closure. In compliance with the Board resolution, register transfer/transmission of shares lodged with the company prior to the date of commencement of the closure of the register of members and mail the share certificates to the transferees after endorsing the shares in their names.

(8) Round off the amount of interim dividend to the nearest rupee and where such amount contains part of a rupee consisting of paisa then if such part is fifty paisa or more, it should be increased to one rupee and if such part is less than fifty paisa, it should be ignored.
Open the “Interim Dividend Account of ……………. Ltd.” with the bank as
resolved by the Board and deposits the amount of dividend payable in the account
within five days of declaration and gives a copy of the Board resolution containing
instructions regarding opening of the account and give the authority to Bank to
honor the dividend warrants when presented.

- If the company is listed, then for payment of dividend it has to mandatorily
use, either directly or through its Registrars to an Issue and Share Transfer
Agents (RTI & STA), any Reserve Bank of India approved electronic mode of
payment such as Electronic Clearing Services (ECS), National Electronic
Fund Transfer (NEFT), etc. In order to enable usage of electronic payment
instruments, the company (or its Registrar & Share Transfer Agent) shall
maintain requisite bank details of its investors as under -

(A) For investors that hold securities in demat mode, company or its RTI & STA
shall seek relevant bank details from the depositories.

(B) For investors that hold physical share / debenture certificates, company or its
RTI & STA shall take necessary steps to maintain updated bank details of the
investors at its end.

(C) In cases where either the bank details such as MICR (Magnetic Ink Character
Recognition), IFSC (Indian Financial System Code), etc. that are required for
making electronic payment are not available or the electronic payment
instructions have failed or have been rejected by the bank, company or its RTI
& STA may use physical payment instruments for making cash payments to
the investors. Company shall mandatorily print the bank account details of the
investors on such payment instruments.

(D) Depositories are directed to provide to companies (or to their RTI & STA)
updated bank details of their investors. [Refer SEBI Circular No.
CIR/MRD/DP/10/2013 dated March 21, 2013]

(10) Make arrangements with the bank and in collaboration with other banks if
required, for payment of the Dividend Warrants at par.
Prepare a statement of dividend in respect of each shareholder containing the following details:

(A) Name and address of the shareholder with ledger folio
(B) No. of shares held.
(C) Dividend payable.

Ensure that the dividend tax is paid to the tax authorities within the prescribed time.

To have sufficient number of dividend warrants printed in consultation with the company’s banker appointed for the purpose of dividend. To get approval of the RBI for printing the warrants with MICR facility. Get the dividend warrants filled in and signed by the persons authorized by the Board.

No RBI approval is required for payment of dividend to shareholders abroad, in case of investment made on repatriation basis.

Prepare two copies of the list of members with names and addresses only for mailing purposes – one to cut and paste on envelopes which could even be printed on self-sticking labels and the other for securing receipt from the Post Office.

Where an instrument of transfer has been received by company prior to book closure but transfer of such shares has not been registered when the dividend warrants were posted, then keep the amount of dividend in special A/c called “Unpaid Dividend Account” opened under section 124 unless the registered holder of these shares authorizes company in writing to pay dividend to the transferee specified in the said instrument of transfer.

Dispatch dividend warrants within thirty days of the declaration of dividend. In case of joint shareholders, dispatch the dividend warrant to the first named shareholder.

Instructions to all the specified branches of the bank that dividend should be paid at par should be sent by the Bank.

Publish a Company notice in a newspaper circulating in the district in which the registered office of the company is situated to the effect that dividend warrants have been posted and advising those members of the company who do not receive
them within a period of fifteen days, to get in touch with the company for appropriate action (in the case of listed companies, as a good practice).

\(20\) Issue bank drafts and/or cheques to those members who inform that they received the dividend warrants after the expiry of their currency period or their dividend warrants were lost in transit after satisfying that the same have not been encashed.

\(21\) Arrange for transfer of unpaid or unclaimed dividend to a special account named “Unpaid dividend Account” within 7 days after expiry of the period of 30 days of declaration of final dividend. (Section 124)

\(22\) Confirm the interim dividend in the next Annual General Meeting.

\(23\) Identify the unclaimed amounts as referred to in sub-section (1) of section 124 of the Act and, separately furnish a statement and upload on company’s own website or any other website as may be specified by the Government in such form as may be prescribed containing the following:

- a) The names and last known addresses of the persons entitled to receive the sum;
- b) The nature of amount;
- c) The amount to which each person is entitled;

The company shall prepare the above statement within a period of 90 days of making any transfer to unpaid dividend account.

\(24\) Transfer unpaid dividend amount to Investor Education and Protection Fund (IEPF) after the expiry of seven years from the date of transfer to unpaid dividend A/c. The company while effecting credit to the Fund, should separately furnish a statement with the authority constituted to administer the fund in Form DIV-5 of Companies (Declaration and Payment of Dividend) Rules, 2014 and obtain a receipt from the authority as evidence of such transfer.

\(25\) Company shall also transfer all the shares in the name of Investor Education and Protection Fund (IEPF) on which unpaid or unclaimed dividend has been already transferred to IEPF and any lawful claimant of those shares/dividend shall be entitled to claim the transfer of shares/dividend from IEPF in accordance with such
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rules, procedure and submission of documents as may be prescribed by the Central Government in this regard. [Section 124 (5)/ (6) & Section 125(3) (a)]

2.8.4 Procedure for Transfer of Unpaid or Unclaimed Dividend to the Investor Education and Protection Fund*:

(* Based on Draft Rules)

The following procedure should be followed by the company:

(1) Section 124(5) of the Act, provides that any money transferred to the unpaid dividend account of a company which remains unpaid or unclaimed for a period of seven years from the date of such transfer is required to be transferred by the company along with interest accrued, if any, thereon to the Investor Education and Protection Fund (IEPF) established under Section 125.

(2) The amount shall be remitted into the specified branches of State Bank of India or any other nationalized bank along with challan (in triplicate) within a period of 90 days of such amount becoming due to be credited to the IEPF. The Bank will return two copies duly stamped to the Company as token of having received the amount and the company shall file one such copy of challan to the authority.

(3) The company shall send a statement of amount credited to Investor Education and Protection Fund in Form DIV 5 to the authority which administer the fund and the authority shall issue a receipt to the company as evidence of such transfer.

(4) On receipt of this statement, the authority shall enter the details of such receipts in a register maintained by it in respect of each company every year and reconcile the amount.

(5) The company shall keep a record consisting of names, last known addresses of the persons entitled to receive the same, the amount to which each person is entitled, folio number/ client ID, certificate number, beneficiary details etc. of the persons in respect of whom amount has been remain unpaid or unclaimed for 7 years and transferred to IEPF. Such record shall be maintained for a period of 8 years from the date of such transfer to IEPF and authority shall have the powers to inspect such records.
2.8.5 Procedure for Transfer of Shares in Respect of which Unpaid or Unclaimed Dividend has been transferred to IEPF*:

(* Based on Draft Rules)

Section 124 (6) provides that all shares in respect of which unpaid or unclaimed dividend has been transferred under sub-section (5) of section 124 shall also be transferred by the company in the name of the IEPF. In case shares are held in electronic mode in any depository and the beneficial owner has encashed any dividend warrant during the last seven years, such shares shall not be required to be transferred to IEPF even though some dividend warrants may not have been encashed. The following procedure is required to be followed in this regard:

(I) The shares shall be credited to an IEPF Suspense Account (name of the company) with one of the Depository Participants as may be notified by the Fund within a period of thirty days of such shares becoming due to be transferred to the Fund. For the purposes of effecting transfer of such shares, the Board shall authorize the company secretary or any other person to sign the necessary documents. The company shall follow the procedure as stated below:

(A) For the purposes of affecting the transfer where the shares are dealt with in a depository:

(i) The company secretary or the person authorized by the Board shall sign on behalf of such shareholders, the delivery instruction slips of the depository participants where the shareholders had their accounts for transfer in favour of IEPF Suspense Account (name of the company).

(ii) On receipt of the delivery instruction slips, the depository shall affect the transfer of shares in favour of the Fund in its records.

(B) For the purposes of affecting the transfer where the shares are held in physical form:

The company secretary or the person authorized by the Board shall make an application, on behalf of the concerned shareholders, to the company, for issue of duplicate share certificates.
(i) On receipt of the application, a duplicate certificate for each such shareholder shall be issued and it shall be stated on the face of it and be recorded in the Register maintained for the purpose, that the duplicate certificate is “Issued in lieu of share certificate No for purpose of transfer to IEPF”. Further, the word “duplicate” shall be stamped or punched in bold letters across the face of the share certificate.

(ii) Particulars of every share certificate issued as above shall be entered forthwith in a Register of Renewed and Duplicate Share Certificates maintained in the prescribed format.

(iii) After issue of duplicate share certificates, the company secretary or the person authorized by the Board shall sign the necessary securities transfer form in prescribed form, for transferring the shares in favour of the Fund.

(iv) On receipt of the duly filled transfer forms along with the duplicate share certificates, the Board or its committee shall approve the transfer and thereafter the transfer of shares shall be affected in favour of the Fund in the records of the company.

(2) The company/depository, as the case may be, shall preserve copies of the depository instruction slips, transfer deeds and duplicate certificates for its records.

(3) While affecting such transfer, the company shall send a statement in prescribed form to the Authority.

(4) The voting rights on shares transferred to the Fund shall remain frozen until the rightful owner claims the shares.

(5) All benefits accruing on such shares e.g. bonus shares, split etc. shall also be credited to such IEPF suspense account (name of the company).

(6) The IEPF suspense account (name of the company) with depository participant, shall be maintained by the Fund, on behalf of the shareholders who are entitled for the shares and shares held in such account shall not be transferred or dealt with in any manner whatsoever except for the purposes of transferring the shares back to the claimant as and when he/ she approaches the Fund. However in case the company is getting delisted IEPF shall surrender shares on behalf of the shareholders in
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accordance with the Securities and Exchange Board of India (Delisting of Equity Shares Regulations), 2009 and the proceeds realized shall be credited to the account of the shareholder.

(7) Any further dividend received by IEPF on such shares shall be credited to respective accounts of the shareholders maintained by IEPF.

2.8.6 Claiming of Unclaimed/Unpaid Dividend*

(* Based on Draft Rules)
The claimant shall make an application in prescribed form under his own signature or through a person holding a valid power of attorney granted by him.
The application shall be accompanied by the following documents

i) Indemnity Bond in prescribed format (not required in case applicant is Central/State Government, a Government Company or a public financial institution within the meaning of Companies Act, 2013

ii) Authority may on its satisfaction about the title to the money, allow the claim up to rupees 5 000/- without Indemnity bond

iii) Documents in support of the claim i.e. dividend warrant/ letter issued by the company etc.

iv) A stamped advance receipt bearing the signature of claimant and two witnesses.

v) Proof of Identity & Proof of Address

vi) In case of deceased person, legal representative shall furnish a succession certificate/probate/letter of administration. If the securities have to be transmitted in the name of claimant, a certificate from the company may be furnished.

On receipt of application the authority shall verify and certify whether the claimant is entitled to the money claimed by him.

After certification of the title of the claimant to the amount claimed, the authority shall issue a payment order in prescribed form sanctioning the payment and issue and deliver the cheque in favour of the claimant.
2.8.7 Claim for Shares Transferred to IEPF *:

(* Based on Draft Rules)
Section 124 provides that shares transferred in the name of Investor Education and Protection Fund (IEPF) can be claimed back by the lawful claimant. Following is the procedure to claim back the shares transferred to IEPF:

i) Claimant should file its claim before the fund.

ii) The fund shall refer the claim to the respective company for verification of details of the claim including the Identity of claimant and verification of numbers of shares.

iii) After the verification, the fund shall either credit the shares which are lying with Depository Participant in IEPF suspense account to the demat account of the claimant to the extent of his entitlement and pay the unpaid dividend or in case of physical certificate, transfer the shares in favor of the claimant and pay the unpaid dividend.

2.8.8 Secretarial Standard on Dividend (55-3):

Declaration and distribution of dividends is a complicated task involving both financial and non-financial considerations. The Secretarial Standard lays down a set of principles in relation to the declaration and payment of dividend, interim dividend and treatment of unpaid dividend, revocation of dividend as well as the preservation of dividend warrants, maintenance of dividend registers, disclosure requirements and matters incidental thereto. The Standard, by stipulating requirements in regard to all allied and significant matters such as intimation to members before transferring unpaid dividend to Investor Education and Protection Fund, preservation of dividend registers, validity of dividend warrants etc. attempts to give the right direction to the corporate sector, promote uniformity of practices and ensure effective corporate governance.

2.9 HOW TO DECIDE THE SHAREHOLDERS TO WHOM DIVIDEND WILL BE GIVEN?

- Unlisted Companies (Include unlisted Public and Private Limited Company).
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- It is not necessary to close register.
- There are few transfers in these Companies.
- General Meeting can decide the ‘Cut off’ date or could be date of General Meeting.

2.10 ISSUE OF SHARES WITH DIFFERENTIAL RIGHTS

- If share with differential right have been issued, dividend will be declared and paid on the basis of terms of issue. [Regulation 83 (iii) of Model AOA Table-F of the Act, 2013].

2.11 DIVIDEND IN CASE OF JOINT SHAREHOLDERS

i) In case of Joint shareholders, the cheque or warrant of dividend should be sent to the holder first named in the register of members.

ii) If the joint holders direct in writing the cheque or dividend can be send to another person as directed by the joint shareholders [Regulation 85(i) of Model Articles Table- F as per the 2013 Act.]

2.12 PROHIBITION ON DIVIDEND

- A company which has default under Section 73 and 74 related to deposit and repayment of deposit or interest thereon may not declare dividend.

- A company cannot declare dividend if the company fails to comply with acceptance of deposits and repayment of deposits accepted prior to the commencement of this Act. (Section 73 & 74 of Companies Act 2013.

2.13 PUNISHMENT FOR FAILURE TO DISTRIBUTE DIVIDEND (SECTION 127)

Where a dividend has been declared by a company but has not been paid or the warrant in respect thereof has not been posted within thirty days from the date of declaration to any shareholder entitled to the payment of the dividend, every director of the company shall, if he is knowingly a party to the default, be punishable with imprisonment which may extend to two years and with fine which shall not be less than one thousand rupees for every day during which such default continues and the
company shall be liable to pay simple interest at the rate of eighteen percent per annum during the period for which such default continues.

No offence under this section shall be deemed to have been committed:

a. Where the dividend could not be paid by reason of the operation of any law;

b. Where a shareholder has given directions to the company regarding the payment of the dividend and those directions cannot be complied with and the same has been communicated to him;

c. Where there is a dispute regarding the right to receive the dividend;

d. Where the dividend has been lawfully adjusted by the company against any sum due to it from the shareholder; or

e. Where, for any other reason, the failure to pay the dividend or to post the warrant within the period under this section was not due to any default on the part of the company.

2.14 PROVISIONS OF DIVIDEND GIVEN IN ARTICLE OF ASSOCIATION

[TABLE - F OF SCHEDULE – I OF COMPANIES ACT, 2013]

Dividends and Reserve

(1) The company in general meeting may declare dividends, but no dividend shall exceed the amount recommended by the Board.

(2) Subject to the provisions of section 123, the Board may from time to time pay to the members such interim dividends as appear to it to be justified by the profits of the company.

i) The Board may, before recommending any dividend, set aside out of the profits of the company such sums as it thinks fit as a reserve or reserves which shall, at the discretion of the Board, be applicable for any purpose to which the profits of the company may be properly applied, including provision for meeting contingencies or for equalizing dividends; and pending such application, may, at the like discretion, either be employed in the business of
the company or be invested in such investments (other than shares of the company) as the Board may, from time to time, thinks fit.

ii) The Board may also carry forward any profits which it may consider necessary not to divide, without setting them aside as a reserve.

iii) Subject to the rights of persons, if any, entitled to shares with special rights as to dividends, all dividends shall be declared and paid according to the amounts paid or credited as paid on the shares in respect whereof the dividend is paid, but if and so (iv) long as nothing is paid upon any of the shares in the company, dividends may be declared and paid according to the amounts of the shares.

iv) No amount paid or credited as paid on a share in advance of calls shall be treated for the purposes of this regulation as paid on the share.

v) All dividends shall be apportioned and paid proportionately to the amounts paid or credited as paid on the shares during any portion or portions of the period in respect of which the dividend is paid; but if any share is issued on terms providing that it shall rank for dividend as from a particular date such share shall rank for dividend accordingly.

(3) The Board may deduct from any dividend payable to any member all sums of money, if any, presently payable by him to the company on account of calls or otherwise in relation to the shares of the company.

i) Any dividend, interest or other monies payable in cash in respect of shares may be paid by cheque or warrant sent through the post directed to the registered address of the holder or, in the case of joint holders, to the registered address of that one of the joint holders who is first named on the register of members, or to such person and to such address as the holder or joint holders may in writing direct.

ii) Every such cheque or warrant shall be made payable to the order of the person to whom it is sent.

(4) Any one of two or more joint holders of a share may give effective receipts for any dividends, bonuses or other monies payable in respect of such share.
(5) Notice of any dividend that may have been declared shall be given to the persons entitled to share therein in the manner mentioned in the Act.

(6) No dividend shall bear interest against the company.

2.15 DIVIDEND POLICY THEORIES

Dividend policy theories (By Munene Laiboni)

Introduction:

Dividend policy theories are propositions put in place to explain the rationale and major arguments relating to payment of dividends by firms. Firms are often torn in between paying dividends or reinvesting their profits on the business. Even those firms which pay dividends do not appear to have a stationary formula of determining the dividend payout ratio. Dividends are periodic payments to holders of equity which together with capital gains are the returns for investing in a firm’s stock. The prospect of earning periodic dividends and sustained capital appreciation are therefore the main drivers of investors’ decisions to invest in equity. In this paper, we explore various theories which have been postulated to explain dividend payment behavior of firms.

Major Schools of thought:

At the heart of the dividend policy theories discussion are two opposing schools of thought: One side holds that whether firms pay dividends or not is irrelevant in determining the stock price and hence the market value of the firm and ultimately its weighted cost of capital. In retrospect, the opposing side holds that firms which pay periodic dividends eventually tend to have higher stock prices, market values and cheaper WACCs. The existence of these two opposing sides has spawned vast amounts of empirical and theoretical research.

Scholars on both sides of the divide appear relentless on showcasing the case for their arguments. Several decades since interest in the area was sparked off by Modigliani and Miller (1961), no general consensus has emerged and scholars can often disagree even on the same empirical evidence! The arguments about dividend policy theory are so discordant in modern day research, that at least there is consensus with Black (1976)’s famous words who defined dividend policy as a puzzle: “the harder we look
at the dividends picture, the more it seems like a puzzle, with pieces that just do not fit together”

**School of Dividend Irrelevance:**

The main proponents of this view are Franco Modigliani and Merton Miller (1958, 1961). Their key premise is that to investors, payment of dividends is irrelevant as investors can always sell a portion of their equity if they need cash. Therefore, two firms of the same industry and scale should have the same value even when one of the firms pays dividends and the other one does not. The Modigliani and Miller Approach & the residual theory of dividends are the main theories supporting the dividend irrelevance notion.

**School of Dividend Relevance:**

Supporters of this theory argue that proposers of the dividend irrelevance theory made unrealistic assumptions in crafting their respective theories. As such, they argue that if those assumptions, key of which are the absence of taxes and transaction costs, are relaxed, the dividend irrelevance theories won’t be able to hold water. Their main argument is that in a real world, payment of periodic dividends will have a positive impact on the stock price of a firm, its market value and its weighted average cost of capital.

The ideals of this school of thought were solidified mainly by Gordon (1963), Lintner (1962) and Walter (1963). There are other subsidiary hypotheses which support the notion of dividend relevance. These include the tax preference theory, the Agency theory, the Signaling Hypothesis, and The Clientele Effect Hypothesis.

**DIVIDEND IRRELEVANCE THEORIES**

1. **The Modigliani and Miller Theorem:**

Modigliani and Miller in 1961 rattled the world of corporate finance with the publication of their paper: Dividend Policy, Growth, and the Valuation of Shares in the Journal of Business. They proposed an entirely new view to the essence of dividends in determining the future value of the firm. As such, they argued that subject to several assumptions, investors should be indifferent on whether firms pay dividends or not. The 1961 paper was a sequel to the 1958 paper in which they argued
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that the capital structure of a firm is irrelevant as a determinant factor its future prospects.

The M&M theorem holds that capital gains and dividends are equivalent as returns in the eyes of the investor. The value of the firm is therefore dependent on the firm’s earnings which result from its investment policy and the curativeness of its industry. When a firm’s investment policy is known (its industry is public information), investors will need only this information to make an investment decision.

The theory further explains that investors can indeed create their own cash inflows from their stocks according to their cash needs regardless of whether the stocks they own pay dividends or not. If an investor in a dividend paying stock doesn’t have a current use of the money availed by a particular stock’s dividend, he will simply reinvest it in the stock. Likewise, if an investor in a non-dividend paying stock needs more money than availed by the dividend, he will simply sell part of his stock to meet his present cash need.

Assumptions of the Modigliani and Miller Model

Modigliani and Miller pinpointed certain conditions which must hold for their hypothesis to be valid:

1) The capital markets are perfect, i.e. investors behave rationally, information is freely available to all investors, transaction and floatation costs do not exist, and no investor is large enough to influence the price of a share.

2) Taxes either do not exist or there is no difference in the tax rates applicable to both dividends and capital gains.

3) The firm has a fixed investment policy.

4) There is no uncertainty about the firm’s future prospects, and therefore all investors are able to forecast future prices and dividends with certainty and one discount rate is appropriate for all securities over all time periods.

Critique:

The validity of the Modigliani and Miller theory is highly dependent on two critical assumptions, which unfortunately are not tenable in the real world. The theory
assumes a world in which transaction costs and taxes are absent. In real sense, it is not possible to have an economy in which these two aspects are absent.

2. The Residual Theory:

The residual theory holds that dividends paid by firms are residual, after the firm has retained cash for all available and desirable positive NPV projects. The gist of this theory is that dividend payment is useless as a proxy in determining the future market value of the firm. As such, the firm should never forego desirable investment projects to pay dividends. Investors who subscribe to this theory therefore do not care whether firms pay dividends or not, what they are concerned with is the prospect of higher future cash flows which might lead to capital appreciation of their stocks and higher dividends payouts.

Critique:

The residual theory has been criticized as having no empirical support, but it’s just an illustration of logic which is all too obvious for corporate decision makers. Firms tend to meet the financing needs of their growth strategies before paying anything out to shareholders and hence a theory stating so would simply be stating the obvious.

DIVIDEND RELEVANCE THEORIES

1. The Gordon/Lintner (Bird-in-the-Hand) Theory:

The bird-in-the-hand theory, hypothesized independently by Gordon (1963) and by Lintner (1962) states that dividends are relevant to determining of the value of the firm. In a popular common stock valuation model developed by Gordon, The determinants of the value of a firm’s cost of equity financing are the dividends the firm is expected to pay to perpetuity, the expected annual growth rate of dividends and the firm’s current stock price.

Where:

- \( k \) is the return on equity to equity investors
- \( d_1 \) is the forward looking yearend dividend payout
- \( p \) is the current stock price of the firm’s stock
- \( g \) is the expected future annual growth rate of the firm’s dividend
The dividend yield and the future growth of the dividends provide the total return to the equity investor. This model insists that dividend yield is a more important measure of the total return to the equity investor than the future growth rate of the dividends (which is the rate at which the net earnings and the capital gains of the firm will grow at in the future). Future growth, and hence capital gains cannot be estimated with accuracy and are not guaranteed at all as firms might lose even their entire market value in the stock exchange and go bankrupt. If a firm does not pay dividends therefore, its forward looking market value is severely affected by the uncertainty surrounding the possibility of the investors’ ever booking the capital gains.

Assumptions of the Bird-in-the-Hand theory

This theory is based on a number of assumptions, as enumerated below:

1) The firm is an all equity firm, i.e. it has no debt in its capital structure.

2) No external financing is available and consequently retained earnings are used to finance any expansion of the firm.

3) There are constant returns which ignores diminishing marginal efficiency of investment.

4) The firm incurs a constant cost of capital.

2. The Walter Model:

Walter (1963) postulated a model which holds that dividend policy is relevant in determining the value of a firm. The model holds that when dividends are paid to the shareholders, they are reinvested by the shareholder further, to get higher returns. This cost of these dividends is referred to as the opportunity cost of the firm (the cost of capital), \( k_c \) for the firm, since the firm could use these dividends as capital if they were not paid out to shareholders.

Another possible situation is where the firm does not pay out dividends, and they invest the funds which could be paid out as dividends in profitable ventures to earn returns. This rate of return, \( r \), for the firm must at least be equal to \( k_c \). If this happens then the returns of the firm is equal to the earnings of the shareholders if the dividends
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were paid. Thus, it’s clear that if \( r \) is more than the cost of capital \( k_e \), then the returns from investments is more than returns shareholders receive from further investments. Walter’s model says that if \( r<k_e \) then the firm should distribute the profits in the form of dividends to give the shareholders higher returns. However, if \( r>k_e \) then the investment opportunities reap better returns for the firm and thus, the firm should invest the retained earnings. The relationship between \( r \) and \( k \) are extremely important to determine the dividend policy. It decides whether the firm should have zero payout or 100% payout.

In a nutshell, if \( D \) = the dividend payout ratio,

If \( r>k_e \), the firm should have zero payout and make investments. \( (D = 0) \)

If \( r<k_e \), the firm should have 100% payouts and no investment of retained earnings. \( (D=E) \)

If \( r=k_e \), the firm is indifferent between dividends and investments.

Mathematical representation of Walter’s Model:

Where,

\[ P = \text{Market price of the share} \]
\[ D = \text{Dividend per share} \]
\[ r = \text{Rate of return on the firm’s investments} \]
\[ k_e = \text{Cost of equity} \]
\[ E = \text{Earnings per share} \]

The market price of the share consists of the sum total of:

The present value of an infinite stream of dividends

The present value of an infinite stream of returns on investments made from retained earnings.

Therefore, the market value of a share is the result of expected dividends and capital gains according to Walter.

Assumptions of Walter’s Model

Retained earnings are the only source of financing investments in the firm, there is no external finance involved.

The cost of capital, \( k_e \) and the rate of return on investment, \( r \) are constant i.e. even if new investments decisions are taken, the risks of the business remains same.

The firm’s life runs to perpetuity.
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Basically, the firm’s decision to give or not give out dividends depends on whether it has enough opportunities to invest the retain earnings i.e. a strong relationship between investment and dividend decisions is considered.

Critique of the Bird-in-Hand and Walter’s Hypotheses

Because the structural underpinnings and implication of the Bird-in-Hand and Walter’s theories are similar, they can be jointly critiqued. Although these models provide a simple framework to explain the relationship between the market value of the share and the dividend policy, they have some unrealistic assumptions. The assumption of no external financing apart from retained earnings, for the firm to make further investments is not really followed in the real world. The constant r and k_s are seldom found in real life, because as and when a firm invests more the business risks change.

Subsidiary Hypotheses of Dividend Relevance

3. The Tax-Preference Theory:

The M&M assumption of a perfect capital market excludes any possible tax effect. It has been assumed by Modigliani and Miller that there is no difference in tax treatment between dividends and capital gains. However, in the real world taxes exist and may have significant influence on dividend policy and the value of the firm. In general, there is often a differential in tax treatment between dividends and capital gains, and, because most investors are interested in after-tax return, the influence of taxes might affect their demand for dividends.

The tax-preference hypothesis suggests that low dividend payout ratios lower the cost of capital and increase the stock price. By extension, low dividend payout ratios contribute to maximizing the firm’s value. This argument is based on the assumption that dividends are taxed at higher rates than capital gains. In addition, dividends are taxed immediately, while taxes on capital gains are deferred until the stock is actually sold. These tax advantages of capital gains over dividends tend to predispose investors, who have favorable tax treatment on capital gains, to prefer companies that retain most of their earnings rather than pay them out as dividends, and are willing to pay a premium for low-payout companies.
Another important tax consideration is that in an estate situation; where an heir is entitled to shares after the death of a benefactor, no capital gains taxes will be due from the heir in such a situation.

The Agency in practice, however, this assumption is questionable where the owners of the firm are distinct from its management. In these cases managers are always imperfect agents of shareholders and managers’ interests are not necessarily the same as shareholders’ interests, and therefore they do not always act in the best interest of the shareholders.

Shareholders therefore incur (agency) costs associated with monitoring managers’ behavior, and these agency costs are an implicit cost resulting from the potential conflict of interest among shareholders and corporate managers. The payment of dividends might serve to align the interests and mitigate the agency problems between managers and shareholders, by reducing the discretionary funds available to managers (Rozeff, 1982).

2.16 THE SIGNALING HYPOTHESIS

Another hypothesis for why M&M’s dividend Irrelevance theory is inadequate as an explanation of financial market practice is the existence of asymmetric information between insiders (managers and directors) and outsiders (shareholders). M&M assumed that manager and outside investors have free, equal and instantaneous access to the same information regarding a firm’s prospects and performance. But managers who look after the firm usually possess information about its current and future prospects that is not available to outsiders.

This informational gap between insiders and outsiders may cause the true intrinsic value of the firm to be unavailable to the market. If so, share price may not always be an accurate measure of the firm’s value. In an attempt to close this gap, managers may need to share their knowledge with outsiders so they can more accurately understand the real value of the firm. Historically, due to a lack of complete and accurate information available to shareholders, the cash flow provided by a security to an investor often formed the basis for its market valuation (Baskin and Miranti, 1997). In this way dividends came to provide a useful tool for managers in which to convey their private information to the market because investors used visible (or actual) cash
flows to equity as a way of valuing a firm. Many scholars also suggest that dividends might have implicit information about a firm’s prospects. Even M&M (1961) suggest that when markets are imperfect share prices may respond to changes in dividends. In other words, dividend announcements may be seen to convey implicit information about the firm’s future earnings potential. This proposition has since become known as the “information content of dividends” or signaling hypothesis. According to the signaling hypothesis, investors can infer information about a firm’s future earnings through the signal coming from dividend announcements, both in terms of the stability of, and changes in, dividends. However, for this hypothesis to hold, managers should firstly possess private information about a firm’s prospects, and have incentives to convey this information to the market. Secondly, a signal should be true; that is, a firm with poor future prospects should not be able to mimic and send false signals to the market by increasing dividend payments.

Thus the market must be able to rely on the signal to differentiate among firms. If these conditions are fulfilled, the market should react favorably to the announcements of dividend increase and unfavorably otherwise (Ang, 1987, and Koch and Shenoy, 1999).

As managers are likely to have more information about the firm’s future prospects than outside investors, they may be able to use changes in dividends as a vehicle to communicate information to the financial market about a firm’s future earnings and growth. Outside investors may perceive dividend announcements as a reflection of the managers’ assessment of a firm’s performance and prospects. An increase in dividend payout may be interpreted as the firm having good future profitability (good news), and therefore its share price will react positively. Similarly, dividend cuts may be considered as a signal that the firm has poor future prospects (bad news), and the share price may then react unfavorably. Accordingly, it would not be surprising to find that managers are reluctant to announce a reduction in dividends.

Lintner (1956) argued that firms tend to increase dividends when managers believe that earnings have permanently increased. This suggests that dividend increases imply long-run sustainable earnings. Lipson, Maquieira and Megginson (1998) also observed that, “managers do not initiate dividends until they believe those dividends can be sustained by future earnings”.

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Dividends are considered a credible signaling device because of the dissipative costs involved.

2.17 THE CLIENTELE EFFECT HYPOTHESIS

Since most of the investors are interested in after-tax returns, the different tax treatment of dividends and capital gains might influence their preference for dividends versus capital gains. This is the essence of the Clientele effect. For example, investors in low tax brackets who rely on regular and steady income will tend to be attracted to firms that pay high and stable dividends. Some institutional investors with major periodic cash outflows also tend to be attracted to high-dividend stocks. On the other hand, investors in relatively high tax brackets might find it advantageous to invest in companies that retain most of their income to obtain potential capital gains, all else being equal. Some clienteles, however, are indifferent between dividends and capital gains.

My Stand:

Due to its logic and more favorable empirical support, I favor the dividend relevance theory. This hypothesis has more realistic assumptions that the M&M hypothesis and therefore is more probable to be tenable in a realistic world. The assumption that shareholders tend to be indifferent to current dividends or prospective future capital gains cannot go unchallenged. Inasmuch as we assume businesses are going concerns, a probability of bankruptcy, loss of market value or financial distress cannot be ruled out for any particular firm in the future.

This means that which do not pay dividends might actually end up paying nothing to their shareholders. This uncertainty should not be compared with the return on investment actualized by a periodic dividend. The subsidiary theories supporting the dividend relevance hypothesis are all based on observed phenomena across different domains. Hence it’s likely that indeed in the real world, dividends policy is relevant in determining the value of a firm’s stock and by extension its market value.
2.18 IMPACT OF DIVIDEND POLICY ON SHAREHOLDER’S VALUE

Key Terms Dividend Payout Ratio:

Hypothesis

The assumption of a perfect capital market under the dividend irrelevance theory implies that there are no conflicts of interests between managers and shareholders.

Dividend Policy: The policy a company uses to decide how much it will pay out to shareholders in dividends.

Shareholders’ Value: The value delivered to shareholders because of management’s ability to grow earnings, dividends and share price. In other words, shareholder value is the sum of all strategic decisions that affect the firm's ability to efficiently increase the amount of free cash flow over time.

Lintner Model: A model stating that dividend policy has two parameters: the target payout ratio and, the speed at which current dividends adjust to the target.

Agency Cost: A type of internal cost that arises from, or must be paid to, an agent acting on behalf of a principal. Agency costs arise because of core problems such as conflicts of interest between shareholders and management. Shareholders wish for management to run the company in a way that increases shareholder value. But management may wish to grow the company in ways that maximize their personal power and wealth that may not be in the best interests of shareholders.

Dividend Smoothing: A concept that has its genesis in the dividend model proposed by John Lintner (1956). It states that the firms strive towards dividend stability and consistency. The dividend paid during current year is governed by dividend paid during previous year and variations in the earnings should not be reflected in the dividend payout.

Information Asymmetry: A situation in which one party in a transaction has more or superior information compared to another. This often happens in transactions where the seller knows more than the buyer, although the reverse can happen as well. Potentially, this could be a harmful situation because one party can take advantage of the other party’s lack of knowledge.
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Event Study: An empirical study performed on a security that has experienced a significant catalyst occurrence, and has subsequently changed dramatically in value as a result of that catalyst. The event can have either a positive or negative effect on the value of the security. Event studies can reveal important information about how a security is likely to react to a given event, and can help predict how other securities are likely to react to different events.

Pecking Order Hypothesis: This hypothesis states that a company which prefers retention of profits for financing the capital expenditure from internal resources distributes fewer dividends compared to a firm which finances the investment expenditure from external sources. Thus, a negative relationship exists between CAPEX and dividend payout.

Entrenchment Hypothesis: The hypothesis suggests a inverted U shaped relationship between dividends and level of insider ownership. Dividend may act as a substitute for corporate governance below the entrenchment level insider ownership leading to a negative relationship between these two variables. Sujata Kapoor, JBS, JIIT, Dec’ 2009 4 After such critical entrenchment level, however, when insider ownership increases are associated with additional entrenchment related agency costs, dividend policy may become a compensating monitoring force and accordingly a positive relationship with insider ownership would be observed.

Dividend Signaling: A theory that suggests company announcements of an increase in dividend payouts act as an indicator of the firm possessing strong future prospects. The rationale behind dividend signaling models stems from game theory. A manager who has good investment opportunities is more likely to "signal" than one who doesn't because it is in his or her best interest to do so.

Abnormal Returns: A term used to describe the returns generated by a given security or portfolio over a period of time that is different from the expected rate of return. The expected rate of return is the estimated return based on an asset pricing model, using a long run historical average or multiple valuations.

Factor Analysis: Factor analysis is a statistical procedure used to uncover relationships among many variables. This allows numerous inter correlated variables to be condensed into fewer dimensions, called factors.
Panel Data: Panel data is data from a (usually small) number of observations over time on a (usually large) number of cross-sectional units like individuals, households, firms, or governments.

Multiple Regression Analysis: Statistical procedure that attempts to assess the relationship between a dependent variable and two or more independent variables.

Example: Sales of a popular soft drink (the dependent variable) is a function of various factors, such as its price, advertising, taste, and the prices of its major competitors (the independent variables).

2.19 IMPACT OF DIVIDEND POLICY ON SHAREHOLDERS’ VALUE: A STUDY OF INDIAN FIRMS

Introduction:

Dividend policy has been an issue of interest in financial literature since Joint Stock Companies came into existence. 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. 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 the area of corporate dividend policy has attracted attention of management scholars and economists culminating into theoretical modeling and empirical examination. Thus, dividend policy is one of the most complex aspects in finance. Three decades ago, Black (1976) in his study on dividend wrote, “The harder we look at the dividend picture the more it seems like a puzzle, with pieces that just don’t fit together”. Why shareholders like dividends and why they reward managers who pay regular increasing dividends is still unanswered. According to Brealey and Myers (2002) dividend policy has been kept as the top ten puzzles in finance. The most pertinent question to be answered here is that how much cash should firms give back to their shareholders? 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 period after period (some must be repeated and some need to be revaluated each period on regular basis.) 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. For instance, high-growth firms with larger cash flows and fewer projects tend to pay more of their earnings out as dividends. The dividend policies of firms may 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 Sujata Kapoor, JBS, JIIT, Dec’ 2009 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.

Finally, 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. 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. 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. Among the most crucial decisions to be taken for efficient performance and attainment of objectives in any organization are the decisions relating to dividend. Dividend decisions are recognized as centrally important because of increasingly significant role of the finances in the
firm’s overall growth strategy. 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 occurs because dividends have a signaling effect.

According to the signaling effect managers 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. Dividend policy of a firm has implication for investors, managers and lenders and other stakeholders (more specifically the claimholders). 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. Similarly, managers’ flexibility to invest in projects is also dependent on the amount of dividend that they can offer to shareholders as more dividends may mean fewer funds available for investment. Lenders may also have interest in the amount of dividend a firm declares, as more the dividend paid less would be the amount available for servicing and redemption of their claims. 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 reduces the discretionary funds available to managers for perquisite consumption and investment opportunities and requires managers to seek financing in capital markets. This monitoring by the external 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. 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. 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. Sujata Kapoor, JBS, JIIT, Dec’ 2009 capital markets may encourage the mangers to
be more disciplined and act in owners’ best interest. Companies generally prefer a stable dividend payout ratio 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 adverse shareholders would be willing to invest only in those companies which pay high current returns on shares. The class of investors, which includes pensioners and other small savers, are partly or fully dependent on dividend to meet their day-to-day needs. 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. This clustering of stockholders in companies with dividend policies that match their preference is called clientele effect.

**Relevance of the Study:**

Previous empirical studies have focused mainly on developed economies 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 of Irrelevance and relevance theory in Indian scenario with respect to IT companies in India. The present research work also seeks to examine and identify the relative importance of some of known determinants of dividend policy in Indian context. 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 the concern IT Company. This research tries to unfold the relationship between the shareholders wealth and the dividend payout and analyze whether the dividend payout announcements affects the wealth of the shareholders. 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 mangers 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 analyzed the dividend behavior of corporate firms and focused on Indian cotton textile Industry 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, and 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.

2.20 SHAREHOLDERS’ VALUE CREATION AND ITS LINKAGE WITH DIVIDEND POLICY DECISIONS

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 maximization 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’ long term 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 Sujata Kapoor, JBS, JIIT, Dec’ 2009 interest between managers and shareholders, transaction costs, flotation costs, and irrational investor behavior 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.