RESEARCH PAPER | Company Affairs | Volume : 2 | Issue : 2 | November 2012 | ISSN - 2249-555X

Dividend Payouts and Allowability of Dividend to Shareholders' Satisfaction

KEYWORDS

Ms. M. MALATHI	Dr.P.K.MUTHAPPAN
Research Scholar, Dept. of Corporate Secretaryship, Alagappa University, Karaikudi – 630 004.	Professor, Dept. of Corporate Secretaryship, Alagappa University, Karaikudi – 630 004.

ABSTRACT *There are a large number of investment avenues for savers in India. Making an investment might seem to be an activity that is too far in the future for an individual to consider now. However, if the importance of it is understood, then investment would increase the money an individual will count tomorrow. The shareholders, is the real company owners because they invest their money. They indirectly control the company by appointing the board of directors as their representatives to supervise the company for their best interest. The dividend per share is increased over the years when the earnings of the firm increase and it is expected that new level of earning can be maintained. The term investment is used in a wide variety of contexts, where both individuals and business houses visualize pay off by putting their money in productive avenues. Protecting the interest of the investors dealing in securities is one of the main objectives of SEBI.*

DIVIDEND MEANING

The term 'dividend' refers to that part of the profits of a company which is distributed amongst its shareholders. It may, therefore be defined as the return that a share holder gets form the company, out of its profits, on his shareholding. According to the Institute of Chartered Accountants of India, Dividend is a distribution to shareholders out of profits or reserve available for this purpose.

The word "Dividend" is derived from the Latin word "DIVIDENDUM" meaning "that which may or is to dividend or shared", in common parlance, "dividend" means the amount paid by a company to its members from profits earned by it as return on investment made by them in the shares of the company. We have to look in to some judicial pronouncements to have an idea of the meaning of the term dividend.

DIVIDEND PAYOUT (D/P) RATIO

A major aspect of the dividend policy of a firm is its dividend payout (D/P) ratio, that is the percentage share of the net earnings distributed to the share holders as dividends. Dividend policy involves the decision to pay out earnings or to retain them for reinvestment in the firm. The retained earnings constitute a source of financing. The payment of dividends results in the reduction of cash and, therefore, in a depletion of total assets. In order to maintain the asset level, as well as to finance investment opportunities. The firm must obtain funds from the issue of additional equity or debt. If the firm is unable to raise the external funds, its growth would be affected. Thus, dividends imply outflow of cash and lower future growth. In other words, the dividend policy of the firm affects both the shareholder's wealth and the long-term growth of the firm. The optimum dividend policy should strike a balance between current dividends and future growth which maximizes the price of the firm's shares.

The D/P ratio of a firm should be determined with reference to two basic objectives- Maximizing the wealth of the firm's and providing sufficient funds to finance growth. These objectives are mutually exclusive, but interrelated. Given the objective of wealth maximization, the firm's dividend policy (D/P) ratio should be one which can maximize the wealth of its owners in the 'long-run'. In theory, it can be expected that the share holders take into account the long-run effects of D/P ratio, that is, if the firm is paying low dividend and high retention they recognize the element of growth in the level of future earnings of the firm. However, in practice, they have a clear cut preference for dividends because of uncertainty and imperfect capital markets. The payment of dividend can, therefore be expected to affect the price of shares; a low D/P ratio may cause decline in share price, while a high ratio may lead to a rise in the market price of the shares.

Making sufficient provision for financing growth can be considered a secondary objective of dividend policy. Without adequate funds to implement acceptable projects, the objective of wealth maximization cannot be achieved. The firm must forecast its future needs for the funds, and taking into account the availability of funds, and taking into account the availability of funds and certain market considerations, determine both the amount of retained earnings needed and the amount of retained earnings available after the minimum dividends have been paid. Thus, dividend payments should not be viewed as a residual, but rather a required outlay after which any remaining funds can be reinvested in the firm.

STABILITY OF DIVIDENDS

The second major aspect of the dividend policy of a firm is the Stability of dividends. The investors favour a stable dividend as much as they favour the payment of dividends (D/P ratio). The term Dividend stability refers to the consistency or lack of variability in the stream of dividends. In more precise terms it means that a certain minimum amount of dividend is paid out regularly. The stability of dividends can take any of the following three forms.

1. Constant dividend per share
2. Constant / stable D/P ratio and
3. Constant dividend per share plus extra dividend.

CONSTANT DIVIDEND PER SHARE

Under this form of stable dividend policy, a company follows a policy of paying a certain fixed amount per share as dividend. For example, on a share of face value of Rs.10, a firm may pay a fixed amount of, say Rs.2 as dividend. This amount would be paid year after year, irrespective of the level of earnings. In other words fluctuations in earnings would not affect the dividend payments. In fact, when a company follows such a dividend policy, it will pay dividends to the shareholders even when it suffers losses.

A stable divide policy in terms of fixed amount of dividend per share does not, however, mean that the amount of dividend is fixed for all times to come. The dividend per share is increased over the years when the earnings of the firm increase and it is expected that new level of earning can be maintained. Of course, if the increase is expected to be temporary, the annual dividend remains at the existing level. The relationship between the earnings per share (EPS) and dividend per share (DPS) with a constant dividend policy per year is shown in that report.

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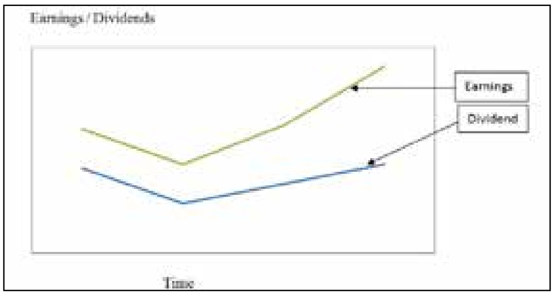
STABLE DIVIDENDS OR STEADILY CHANGING DIVIDENDS

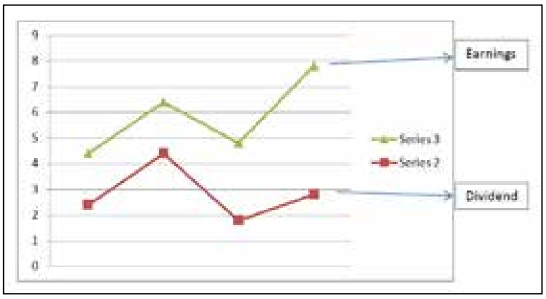


It can be seen from the figure that while the earnings may fluctuate form year to year, the dividend per share is constant. To be able to pursue such a policy, a firm whose earnings are not stable would have to make provisions in years when earnings are higher for payment of dividend in lean years. Such firms usually create a reserve for dividends equalisation'. The balance standing in this fund is normally invested in such assets as can be readily converted into cash.

CONSTANT PAYOUT RATIO

With constant / target payout ratio, a firm pays constant percentage of net earnings as dividends to the shareholders. In other words, a stable dividend payout ratio implies that the percentage of earnings paid out each year is fixed. Accordingly, dividends would fluctuate proportionately with earnings and are likely to be highly volatile in the wake of wide fluctuations in the earnings of the company. As a result, when the earnings of a firm decline substantially or there is a loss in the given period, the dividends, according to the target payout ratio, would be low or nil. To illustrate, if a firm has a policy of 50 percent target payout ratios, its dividend will range between Rs.5 and zero per share on the assumption that the earnings per share are Rs. 10 and zero per share on the assumption that the earnings per share are Rs.10 and zero respectively.

The relationship between Earning per share (EPS) and dividend per share (DPS) under the policy of constant dividend payout ratio is shown in Figure 5.



COSTANT DIVIDEND PER SHARE PLUS EXTRA DIVIDEND

Under the constant dividend per share policy, the amount of dividend is set at a high level, and this policy is usually adopted by the companies with stable earnings. For companies with fluctuating earnings, the policy to pay a minimum dividend per share with a step-up feature is desirable. The small amount of dividend is fixed to reduce the possibility of ever missing a dividend payment. By paying extra dividend (a number of companies in India pay an interim dividend followed by a regular final dividend) in periods of prosperity, an attempt is made to prevent investors from expecting that the dividend represents an increase in the established dividend amount. This type of a policy enables a company a constant amount of dividend regularly without a default and allows a great deal of flexibility for supplementing the income of shareholders only when the company's earnings are higher then the usual, without committing itself to make larger payments as a part of the future fixed dividend. Certain shareholders like this policy because of the certain cash flow in the form of regular dividend and the option of earning extra dividend occasionally.

SHAREHOLDER

The shareholders are owner of a corporate form of enterprise. There are two methods by which the shareholders can enjoy the profits / benefits from a company. The first being Managerial remuneration allows only the promoter group to enjoy the benefit from a company. The second common form is the 'Dividends' by which all the shareholders enjoy / benefits from the company.

There is always a fear that the limited liability concept of corporate form of organization is being misused to defraud the creditors. When the shareholders swallow all the profits in the name of dividends, leaving nothing to take care of the future losses, the creditors will be the worst affected in case of losses. The law has a moral responsibility to safeguard the interest of creditors. Towards this goal, the law provides a lot of conditions and restrictions through different legislations, to restrict the siphon age of funds in the form of Dividends to safeguard the interest of creditors/ lenders. The dividend decisions are significantly influenced by different enactments. Among them, the Companies Act 1956 has stipulated several restrictions in respect of dividends. The other laws governing dividends are the Foreign exchange requirements through restrictive clauses in Listing Agreement.

AGENCY THEORY, INVESTORS' EXPECTATION AND SATISFACTION FROM STOCK INVESTMENT

The separation of ownership from management of a firm creates principal/agent relationship between the owners, shareholders; and the management, agent. Differences in management and shareholders priorities have been recognized and accepted to exist. These differences create problems in the agency being compounded by unsuccessful attempts by the principal, shareholders; to monitor the agent, management, with huge attendant costs.

Modern agency theory seeks to explain corporate structure as the result of attempts to minimize costs associated with the separation of corporate ownership and control. Agency problems are known to result from information asymmetries, potential wealth transfers from debt instrument holders to stockholders through the acceptance of high-risk and high return projects by managers, and their failure to accept potential investment with positive net present values and expenditures in excess of the level expected by perceived prudent managers.

ALLOWABILITY OF DIVIDEND TO SHAREHOLDER

The dividend paid by a company to its shareholders is a payment to service for the share capital already raised and used for the purpose of business of the company. Shareholders and companies are two different persons. Dividend once declared goes out of pocket of the company and therefore, it is a revenue expenditure incurred wholly for the purpose of business. It was contended that dividend paid by companies is not covered by any provisions of section 30 to 36, 40 and 40A of the Income-tax Act, 1961 (at the relevant time section 115-o was not in the Income- tax Act). Therefore, dividend can be considered as an allowable expenditure under section 37(1), as it satisfies all conditions for allowability as business expenditure and there is no bar to allow the same.

It appears that many companies might have claimed dividend at that time and in many cases the same might have been allowed also. For example see CITV Arihant Industries Ltd. [2002] 225 ITR 458 (P & H) in which assessee claimed dividend paid amounting to Rs.1,27,98,515 and it was not disallowed in intimation under section 143(1) [and perhaps under section 143(3) as well-it is not very clear, from reported judgment]. Then the revenue rectified the order under section 154(1) b to disallow dividend, which was not permitted by the CIT (A), ITAT and the High Court. The reason given

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is that because notice under section 143(2) was issued. The High Court has noted that order under section 154(1)b is dated, 9.3.1992 and the order under section 143 (3)is dated, 27.3.1992. The Court held that if any action is required, it can only be in relation to order under section 143(3) and not 143(1).

STATUTORY RECOGNITION OF COMMERCIAL EXPEDIENCY

It found that under law also there is recognition of 'commercial expediency' and nature of 'expenditure' involve in payment of dividend by companies to its shareholders.

1) Dividend is paid only on recommendation of the Board of Directors to the shareholder, while recommending dividend requirement of funds of the company and commercial expediency in paying dividend to maintain reputation and goodwill are also considered besides other factors.
2) Under the Companies Act, 1956, the payment of dividend is to be made out of profits after providing depreciation. However, in certain circumstance the Central Government may, if it thinks necessary so to do in the public interest, allow any company to declare or pay dividend for any financial year out of the profits of the company for that year or any previous financial year or years without providing depreciation. Section 205(1)c of the Companies Act.
3) Under section208 of the Companies Act, in some circumstances, company may pay interest on share capital where share capital is raised to defray long gestation projects or assets which cannot be made profitable before a long time. By nature, and circumstances such interest is in lieu of dividend. This also shows that interest to shareholders or dividend is a payment out of commercial expediency.
4) Unpaid dividend has to be kept in separate accounts from where only shareholder can claim and ultimately unclaimed amount will be transferred to investor education and protection fund-section 205A, 205B, and 205C of the Companies Act.
5) Penalty – If dividend is not distributed within specified time then penalty can be levied under section 207 of the Companies Act.
6) In case of non-payment of dividend the shareholder can bring action against company.

The above provisions of the Companies Act clearly show that dividend is paid out of commercial expediency and once dividend is paid the money goes out of pocket of the company fir ever. In case of other expenses, in some situations a company or any other person may get some refund or credit against payment made by him or liability incurred by him earlier. However, in case of dividend there in no such chance that company may get a refund or waiver.

APPROPRIATION /BELOW THE LINE OR APPOICATION OF INCOME.

As per standard forms of profit and loss account dividend declared, amount contributed to any fund or reserves etc. are shown below the line but that should really not make a difference. Many reserves like investment allowance reserve, development allowance reserve, molasses reserves, statutory reserves etc. are show below the line still deduction in respect of the same is allowed. The company and shareholder are different persons and dividend is paid out of discretion of the Board of Directors (and not by the shareholder). Therefore, dividend is expenditure and not an application of income; it is for purpose of sidered as application of income. Even if dividend is considered as application of income, it is for purpose of business- maintaining and improving goodwill, servicing capital, maintaining and improving share price and price earnings ratio, etc. therefore, it will be for the business purpose.

LARGE SHAREHOLDERS AND CORPORATE OVERSIGHT

The large outside shareholders can play an important role by monitoring management actions and influencing management decisions to favor shareholders, thereby improving the performance of a corporation and raising the price of its stock. This process as monitoring, but it should be understood to involve as well a decision-altering ingredient that may deter or compel management actions. Their monitor may well be a disciplinarian. If monitoring can play this valuable role in reducing agency losses in the management-shareholder relationship is effective one.

The protagonist in our model is a large shareholder, denoted Large Shareholder, who assumes a substantial position and then monitors the performance of the company. Given his influential position, he improves that performance on behalf of all shareholders. The large shareholder's only productive role is as a monitor. The increment that he offers in performance of the company, and hence stock price, is positively related to the size of his position. There is likely to be a range of increasing returns.

DIVIDEND TO SHAREHOLDERS' FUND

Share capital and reserve constitute shareholders' fund and its represents the genuine investment of the shareholders in the company. Dividend is the reward for capital. The ratio of dividends to shareholders' fund indicates the percentage of return or reward given to the shareholder.

This ratio is calculated with the following formula.

$$\text{Ratio of Dividend to shareholders fund} = \frac{\text{Dividend paid}}{\text{Shareholder' fund}} \times 100$$

This ratio is expressed in percentage and it is the true indicator of the effective rate of return received by the shareholders on their investments.

A comparison of rate of returns of different avenues of investments will be meaningful only when this ratio is taken as the rate of return on equity investment. This ratio represents the return on opportunity cost of capital which otherwise belongs to the shareholders.

SHAREHOLDERS RECEIVE BENEFITS THROUGH INVESTMENT

TAXES

The dividend policy of a firm may be dictated by the income tax status of its share holders. If a firm has a large percentage of owners who are in high tax brackets, its dividend policy should seek to have higher retentions. Such a policy will provide its owners with income in the form of capital gains as against dividends. Since capital gains are taxed at a lower rate than dividends, they are worth more, after taxes, to the individuals in a high tax bracket. On the other hand, if a firm has a majority of low income share holders who are in a low tax bracket, they would probably favour a high payout of earnings because of the need for current income and greater certainty associated with receiving the dividend now, instead of the less certain prospects of capital gain later. The Tax on dividends has been changed frequently in the recent years. The dividend Tax has been shifted from the shoulders of the shareholders to the company by changing 10 percent of dividend distribution as tax and allowing the income in the hands of recipient as tax free. The Government once again changed its treatment on dividend income by taxing the share holder instead of the distributing company. These frequent changes in the tax treatment of dividend income will certainly affect the long –run policy of the firms on dividend distribution.

OPPORTUNITY

The firm should not retain funds if the rate of return earned by it would be less than one which could have been earned by the investors themselves from external investments of funds. Such a policy would obviously be detrimental to the interest of shareholders. It is difficult to ascertain the alternative investment opportunities of each of its share holders and, therefore, the alternative investment rate. However, the firm should evaluate the rate of return obtainable from external investments in firms belonging to the same risk class. If evalu-

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ation shows that the owners have better opportunities outside, the firm should opt for a higher D/P ratio. On the other hand, if the firm's investment opportunities yield a higher rate than that obtained from similar external investment, a low D/P is suggested. Therefore, in formulating dividend policy, the evaluation of the external investment opportunities of owners is very significant.

DILUTION OF OWNERSHIP

The financial manager should recognize that a high D/P ratio may result in the dilution of both control and earnings for the existing equity holders. The control aspect has already been discussed. Dilution in earnings results because low retentions may necessitate the issue of new equity shares in the future, causing an increase in the number of equity shares outstanding and ultimately lowering earnings per share and their price in the market. By retaining a high percentage of its earnings, the firm can minimize the possibility of dilution of earnings.

Thus, in framing the dividend policy of a firm, consideration must be given to the requirements of equity holders. To quote from Gitman "Although the ultimate dividend policy depends on numerous factors, the avoidance of shareholders' discontent is important. If the shareholders become dissatisfied with the existing dividend policy, they may sell their share, increasing the possibility that control of the firm will be seized by some outside group. The 'takeover' of a firm by outsiders is more likely when owners are dissatisfied with its dividend policy. It is the financial manager's responsibility to keep in touch with the owner's general attitude towards dividend".

RETURN

Another factor, influencing the pattern of investment is its return, which is referred to as the yield plus capital appreciation if any. Here the difference between the purchase price and the sale price is capital appreciation and the yield here is referred to the interest or dividend divided by its purchase price.

SAFETY

The safety of capital refers to the certainty of return on capital without and pertinent loss of money or time involved in all cases. Practically speaking, some transactions do incur some cost and certain period of time is involved in fetching the funds back leaving aside the usual cost involved with it. Apart from this, the time involved is also an important factor to be given its due importance. It is always seen that if the money is returnable not on the same day but after a period of time, then the loss of liquidity is involved further the issue is complicated if the time of return of funds is not certain. Further it is found that if costs of selling or realization of proceeds are also involved, then the factors of investing funds in these investment avenues are bot perfect. Thereby it makes one to think that, if the factors of investing capital are to be assured, then risk less returns are to be rendered, as found in the case of Government bonds. While if an investor opts to get high returns for his/her investment made, then he/she have to make a sacrifice in the degree of safety.

LIQUIDITY

If a capital asset is readily realizable, saleable or marketable, then it is said to be liquid. If an investment can be encased with a time lag, then it is said to be having less degree of liquidity. Hence it can be said that an investor generally prefers more degree of liquidity for his investments, safety of his funds, a good return with a minimum risk or minimization of risk and maximization of returns.

RISK- RETURN RELATIONSHIP

Risk is inherent in any investment. This risk may relate o loss or delay in repayment of the principal capital or loss or non-payment of interest or variability of returns. Investment options in Government securities or some deposits are almost risk free, while others are more risky. Hence, there are differences in risks as regards various options of instruments.

CONCUSION:

The companies that offer dividends are most often companies that have progressed beyond the growth phase, and no longer benefit sufficiently by reinvesting their profit so they usually choose to pay them out to their shareholders. Income tax Act 1961 provides that expenditure incurred in relation to exempt income shall not be deductible in computing the taxable income but they provide exempt for Dividend income. All the shareholders enjoy / benefits from the company. This paper is describe about Constant dividend per share, Constant / stable D/P ratio and Constant dividend per share plus extra dividend.

REFERENCE 1. Chartered Accountant, volume 57, November 2008. | 2. www.google.com |