3. DIVIDEND POLICY IN INDIA- A SYSTEMATIC REVIEW

Prof.Gauri S. Kalmegh*

Abstract:

The company's management has to decide that which part of their earning should be paid as dividend & how much amount of profit should be retained. Dividends still remains the stumper part of modern finance. Dividends and the dividend policy play an important role as many investors consider this as an important factor while deciding whether they should invest in the stocks of the particular company or not. The main objective behind this research work is to understand the complete scenario of dividend policy in India as how does it work in Indian Corporation as well as in Foreign Corporation running in India. Financial Management teaches us the objective of any firm is to increase the shareholder's wealth. Dividend is also treated as a percentage of net profit of a company which is distributed among the shareholders.

Keywords: Dividend, policies, shareholder's interest, financial Management, etc.

I. Introduction:

Dividend policy of a firm is one of the important areas of a company's financial decision making. It has always been a subject of interest and delicate to financial analysts, academicians and researchers, for a long time. Dividends are payments from company to shareholders. It was generally paid in cash form but also it can be paid in allocation of additional shares in the company. Dividend policy refers to the proportion of earning distributed as dividend and the rest kept for further investment i.e. retained earnings. Dividend policy is a guiding principle of a company to decide the portion of its earnings and its pay out to shareholders to show weather the company goes either for pay dividend to its owners or for retaining a share out of profits to plough back in the firm or at the end of each year and it is the company's decision to how much to return to their stockholders in the form of dividends.

Dividend policy of a firm has implication for investors, managers, lenders and other stakeholders. The dividend policy framed by an organization is one of the crucial issues in corporate finance since it may have an impact on the firm's value and shareholder wealth. From the viewpoint of financial management, the key objective is to determine the dividend policy that will maximize the market price of the shares of the firm. Dividend policy remains one of the most debatable matters in corporate finance

Dividends may matter, particularly in the context of differential tax treatment of dividends and capital gains. Very often dividends are taxed at a higher rate compared to capital gains. This implies that dividends may have negative consequences for investors.

II. Types of Dividend

- **Cash dividend:**

The cash dividend is by far the most common of the dividend types used. On the date of declaration, the board of directors resolves to pay a certain dividend amount in cash to those investors holding the company's stock on a specific date. The date of record is the date on which dividends are assigned to the holders of the company's stock. On the date of payment, the company issues dividend payments.

- **Stock dividend:**

A stock dividend is the issuance by a company of its common stock to its common shareholders without any consideration. If the company issues less than 25 percent of the total number of previously outstanding shares, then treat the transaction as a stock dividend. If the transaction is for a greater proportion of the previously outstanding shares, then treat the transaction as a stock split. To record a stock dividend, transfer from retained earnings to the capital stock and additional paid-in capital accounts an amount equal to the fair value of the additional shares issued. The fair value of the additional shares issued is based on their fair market value when the dividend is declared.

- **Property dividend:**

A company may issue a non-monetary dividend to investors, rather than making a cash or stock payment. Record this distribution at the fair market value of the assets distributed. Since the fair market value is likely to vary somewhat from the book value of the assets, the company will likely record the variance as a gain or loss. This accounting rule can sometimes lead a business to deliberately issue property dividends in order to alter their taxable and/or reported income.

- **Scrip dividend:**

A company may not have sufficient funds to issue dividends in the near future, so instead it issues a scrip dividend, which is essentially a promissory note (which may or may not include interest) to pay shareholders at a later date. This dividend creates a note payable.

- **Liquidating dividend**

When the board of directors wishes to return the capital originally contributed by shareholders as a dividend, it is called a liquidating dividend, and may be a precursor to shutting down the business. The accounting for a liquidating dividend is similar to the entries for a cash dividend, except that the funds are considered to come from the additional paid-in capital account.

III. Dividend policy

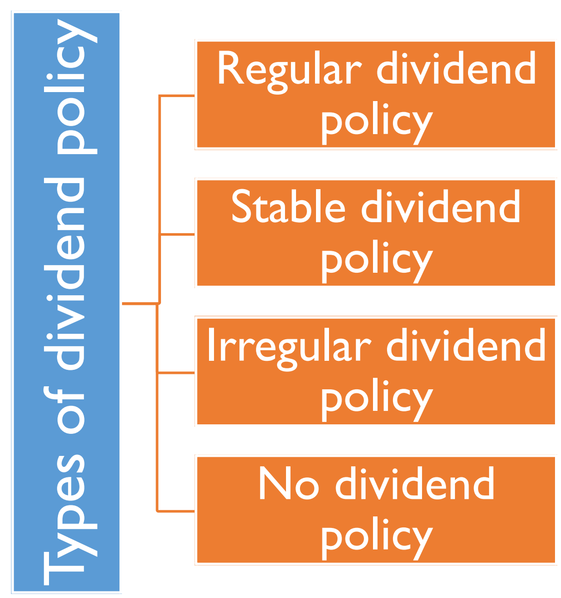
Dividend policy is about the decision of the management regarding distribution of profits as dividends. This policy is probably the most important single area of decision making for finance manager. The dividend policy used by a company can affect the value of the enterprise. The policy chosen must align with the company's goals and maximize its value for its shareholders. While the shareholders are the owners of the company, it is the board of directors who make the call on whether profits will be distributed or retained.

The directors need to take a lot of factors into consideration when making this decision, such as the growth prospects of the company and future projects. Action taken by the management in this area affects growth rate of the firm, its credit standing, share prices and ultimately the overall value of the firm.

Erroneous dividend policy may plunge the firm in financial predicament and capital structure of the firm may turn out unbalanced. Progress of the firm may be hamstrung owing to insufficiency of resources which may result in fall in earnings per share.

The policy of the dividend distribution of the company dictates the number of dividends that the company pays to its shareholders along with the frequency with which dividends are paid. When the profits are earned by the company then it has to make regarding how and where that profit will be used. The company can either retain profits earned or else they can decide to distribute the same in the form of the dividends to its shareholders. Some researchers suggest that dividend policy may be irrelevant, in theory, because investors can sell a portion of their shares or portfolio if they need funds. If it has had a bad year and it doesn't have enough profit to cover its investment needs and the dividend, but expects the poor performance to be a one-off, then it may still make a payout to investors by either dipping into any surplus cash it has or using debt. Since dividend is a right of shareholders to participate in the profits and surplus of the company for their investment in the share capital of the company, they should receive fair amount of the profits. The company should, therefore, distribute a reasonable amount as dividends (which should include a normal rate of interest plus a return for the risks assumed) to its members and retain the rest for its growth and survival.

IV. Types of Dividend Policy



- **Regular Dividend Policy**

Under the regular dividend policy, the investors gets dividend at usual rate.

These investors are generally retired persons or weaker section of the society who want to get regular income. This type of dividend payment can be maintained only if the company has regular earning.

Application of Regular dividend Policy indicates that company has a profitable record and it also helps to creates confidence amongst the shareholder. Generally, regular dividend policy can be adopted by long lasting companies and those who have stable earning.

- **Stable Dividend Policy**

The stability in dividend policy means consistency or lack of variability in the stream of dividend payments. It means the amount paid as a dividend will remain the same for many years. Firm used to reserve fund to pay fixed amount of dividend in the year when the earning of the company is not enough. It is suitable for the firms having stable earning. Else the payment of low dividend per share constantly in addition with extra dividend in the year when the company earns high profit can be paid.

- **Irregular Dividend Policy**

The company does not pay regular dividend to the shareholders. Due to uncertain earning of the company or due to lack of liquid resources, the company may sometimes afraid of giving regular dividend. It may happen that company may not have consistency in the growth of business, so company can decide upon to imply irregular dividend policy. On the other hand, the company might retain all or major amounts of profit and distribute no or less amount of dividend with the aim of increasing the growth of the company by using the retained earnings.

- **No Dividend Policy**

Under this type of dividend policy, the company follows the procedure of paying no dividend to the shareholders irrespective of its profit or loss scenario. The payout ratio will be 0%. The total earning will be retained by the company with the objective of reinvesting into the company model of business to expand it further with an increased rate and without hurdling into the issues like liquidity. The company gets funds through the earning for shareholders and it is the cheaper cost of financing resulting in an increase in profit.

V. Why Companies are Paying Cash Dividend?

The researcher has tried to rationalize that why companies are paying cash dividends since more than half a century & thus, they have proposed various theories & explanation.

1. Bird-in-the-Hand Theory

Investors value cash in the hand more than a future promise of capital gains when making decisions related to stocks due to lower risk (Gordon, 1959, 1963; Walter, 1963; Bhattacharya, 1979).

2. Signaling Explanation

As insiders, managers choose dividend payment levels to convey private information about the firm's future prospects to investors, which in turn reduces asymmetries (Bhattacharya, 1979, 1980; John and Williams, 1985).

3. Agency Theory

Dividends help to overcome the agency problem stemming from the separation of ownership and control in a firm with diffused ownership (Jensen and Meckling, 1976; Rozeff, 1982; Easterbrook, 1984; Jensen, 1986).

4. Taxes and Clientele Effects

Differentials in tax rates between dividends and capital gains lead to different clienteles (Elton and Gruber, 1970; Miller and Scholes, 1978, 1982).

5. Firm Life Cycle Theory of Dividends

Dividend policy is a function of a firm's life cycle. That is, firms tend to begin paying dividends when their growth rate and profitability are expected to decline in the future (Mueller, 1972; Fama and French, 2001; De Angelo et al., 2006).

6. Catering Theory of Dividends

Managers give investors what they currently want. They cater to investor demand by paying dividends when investors put a stock price premium on payers and by omitting or reducing dividends when shares of dividend-paying firms trade at a discount (Baker and Wurgler, 2004a, b).

7. **Financial Flexibility**

Managers seek financial flexibility in making capital structure decisions. Therefore, firms characterized by high financial leverage and consequently limited financial flexibility may have to be more flexible with aspects of their dividend policy decisions than firms with lower financial leverage (Graham and Harvey, 2001).

VI. Significance of Dividend Policy

A firm's dividend policy has the effect of dividing its net earnings into two parts: retained earnings and dividends. The retained earnings provide funds to finance the firm's long-term growth.

- **Resolutions of Investor's Uncertainty**

When a company follows a policy of stable dividends, it will not change the amount of dividend if there are temporary changes in the earnings, Thus, when the earnings of a company fail and it continues to pay same amount of dividend as in the past, it conveys to investors that the future of the company is bright than suggested by drop in earnings.

- **Investor's Desire for Current Income**

The investors who desire (old and retired persons, women, children etc.) to receive a regular dividend income, will prefer a company with stable dividends to one with fluctuating dividends.

- **Institutional Investors' Requirements:**

The financial institutions like IFC, IDBI, LIC and UTI Generally invest in the shares of those companies which have a record of paying regular dividends.

- **Raising Additional Finances**

A stable dividend policy is also advantageous to the company in its efforts to raise external finances. Stable and regular dividend policy tends to make the shares of a company and investment rather than a speculation. The loyalty finds goodwill of shareholders towards the company increases with a stable dividend policy.

VII. Drawbacks of Dividend Policy

- **Clientele Effect**

If a dividend-paying company is not in position to pay dividends for a certain period of time, it may result in loss of old clientele who preferred regular dividends. These investors may sell-off the stock in short term.

- **Decreased Retained Earnings**

When a company pays dividends, it decreases its retained earnings. Debt obligations and unexpected expenses can rise if the company does not have enough cash.

- **Limits Company's Growth Paying Dividends Results**

Paying dividends result in the reduction of usable cash which may limit the company's growth. The company will have less money to invest in the business growth.

- **Logistics**

The payment of dividends requires a lot of record-keeping at the company's end. The company has to ensure that the right owner of the share receives the dividend.

VIII. Conclusion:

Dividends help the investors investing in the company to earn the high rate of return on the investment done by them, and the dividend payment policy of the company is the reflection of the financial performance of the company. Thus the company should choose the dividend policy that it will be following properly as it is critical to the company's financial growth and success. If dividend is given out to shareholders without considering the factors and the company falls short of funds for conducting its business then the operations of the company might also stop due to lack of funds. Whereas on the other hand, if dividend is not paid or paid very less than the company needs to invest it into various investment proposals, else, idle and excess cash would bring pressure on the management to fetch better returns for the investors. Since dividends are important for keeping the investors happy, a company should decide upon the time and the form of dividends diligently. It should also keep in the mind the advantages and the disadvantages of the dividends before framing a dividend policy.

IX. References:

- Bernstein, P.L. (1998), "The Hidden Risks in Low Payouts", the Journal of Portfolio Management, Vol. 25, No.1, fall, p. 1.
- Solomon, Ezra: Theory of Financial Management, Columbia University Press, 1963.
- Easterbrook, F.H. (1984), "Two agency-cost explanations of dividends", American Economic Review, Vol. 74 No. 4, pp. 650-659.
- Gordon, M.J. (1959), "Dividends, earnings and stock prices", Review of Economics and Statistics, Vol. 41 No. 2, pp. 99-105.
- Hsieh, J. and Wang, Q. (2009), "Stock repurchases: theory and evidence", Parts 1 and 2, in
- Baker, H.K. (Ed.), Dividends and Dividend Policy, John Wiley & Sons, Hoboken, NJ,

  pp. 241-273.
- Linter, J. (1956) "The distribution of incomes of corporations among dividends, retained earnings and taxes" American Economic Review, 46, 97 – 113.
- Miller, M. and Modigliani, F. (1961) "Dividend policy, growth and the valuation of shares" Journal of Business, 34, 411 – 433.
- Gizelle F. Perretti, Marcus T. Allen, H. Shelton Weeks (2013). Determinants of dividend policies for ADR firms.

Websites:

https://www.wallstreetmojo.com/dividend-policy-types/

Name of First Author: Prof.Gauri S Kalmegh
Designation of first author: Assistant Professor
Email address of first author: gsdhale@mitra.ac.in
Contact Number of first author: 8605559426/9021728627

Cite this article:
Kalmegh, G. S., (2020). Dividend Policy in India- A Systematic Review. *International Journal of Social & Scientific Research*, *5*(III), 14-23