UNIT 20 DIVIDEND- ISSUES AND TYPES

20.1 INTRODUCTION

Every individual tries to generate income from their investments, some investments are less risky and some are risky, consequently there are different investments avenues matching investor's needs, one of the most preferred investment avenues is share market and the earning investor gets from investing in share market is called Dividend. Dividend declaration is a cumbersome task for the company and due consideration is required before paying dividend. This unit cover the area of dividend issuances, types and legal consideration of dividends to make students aware of different technicalities attached with dividend declaration.

20.2 OBJECTIVES

After reading this unit, you would be able to;

- understand the concept of dividend.
- understand the types of dividend.
- identify different features of dividend declaration .
- highlight the Legal consideration attached.

20.3 DIVIDEND: ISSUES AND TYPES

According to Institute of Chartered Accountant of India, “A dividend is a distribution to shareholders out of profit or reserve available for this purpose”

In other words Dividend is a portion of income which is given by the company to its shareholders. It is a part of profit distributed by the firms to the stakeholders. Dividend is important because it helps in building confidence among the shareholders and as per relevance theories it also helps the market value of shares. Dividend can be given in the form of cash, shares or other means.

Company has to deal with the problem of deciding that what portion of their income they will distribute as dividend and what portion they will keep for further investments. It is a crucial decision for any firm that what they should retain and what they should distribute as retain earning helps in further investment options.

Dividend is generally decided on the basis of earning per share and sometime it is also given as percentage of earnings and in that case it is called dividend yield.

20.4 DIVIDEND PAYOUT POLICIES

A company that issues dividends may choose the amount to pay out using a number of methods.

- Stable dividend policy: Even if corporate earnings are in flux, stable dividend policy focuses on maintaining a steady dividend payout.
- Target payout ratio: A stable dividend policy could target a long-run dividend-to-earnings ratio. The goal is to pay a stated percentage of earnings, but the share payout is given in a nominal dollar amount that adjusts to its target at the earnings baseline changes.

- Constant payout ratio: A company pays out a specific percentage of its earnings each year as dividends, and the amount of those dividends therefore vary directly with earnings.
- Residual dividend model: Dividends are based on earnings less funds the firm retains to finance the equity portion of its capital budget and any residual profits are then paid out to shareholders.

20.5 IMPLICATIONS OF DIVIDEND

Price implication : When dividend is declared it affect the share price generally share price see a downfall as amount of profit of company is reduced in paying dividend thus reducing market capitalization of company and it finally affect the share price.

Companies Implication: When dividend is declared it affect the retained earning thus further investment gets affected because of investment decision.

Investor's implications: Receiving dividend although beneficial for the investors but it also affect the investors in the form of tax liability attached.

So dividend decision is very crucial for a company and taking this decision after studying all the pros and cons is very important for a firm.

20.6 TYPES OF DIVIDEND

There are three categories of dividend:

On the basis of shares:

a) Preference share dividend

b) Equity share dividend

On the basis of Payment:

a) Cash Dividend

b) Stock Dividend

c) Bond Dividend

d) Property Dividend

e) Composite Dividend

On the basis of time of payments

a) Interim

b) Regular

c) Special

Classification of Each:

- Preference share dividend: These shareholders have the preferential right to receive dividend and commonly the dividend is also fixed.
- Equity Shareholders are the shareholder who receive dividend after the payment of preference shareholders.
- Cash Dividend: This is the most preferred way of paying dividend. Under this dividend is paid in the form of cheque to the shareholders or to the brokerage firms.

  For example: Example:

  ABC pays an Rs .10 dividend to shareholders. An investor who owns 1,000 shares of ABC will receive $100:

  1,000 shares x Rs .10 = Rs 100.

- Stock Dividend: Sometime the firm want to keep cash for business need and the firm also want to reward its shareholders so in that case they give stock instead of cash to existing shareholders on the basis of their previous shareholdings. When stock dividend is given it reduces the share price of company as new shares are issued but the market capitalization remains the same.

  Example:

  If ABC pays a 10% stock dividend to its shareholders, an investor with 500 shares will receive an additional 50 shares. This is determined by multiplying the number of shares owned by the amount of the dividend to be paid.

  500 x 10% = 50

- Product /Property:

This is the least common way of giving dividend. As per this method dividend is paid in the form of property or product of the company.

- Right/ scrip dividend:

Under this way shareholders are given the rights to buy the share before any new purchasers. All common stockholders have a pre-emptive right to maintain the proportional ownership in the company. The shareholders are given the offer to buy the shares at a lower price than the market price under this scheme. 45 days time period is given to buy the shares.

- Interim dividend:

These are the dividends which are declared even before the annual general meeting and making of financial statement.

- Regular dividend:

These are the dividends which are pain regularly and in fixed amount over the years.

- Special Dividend:

A special dividend is a non-recurring distribution of company assets, usually in the form of cash, to shareholders. A special dividend is larger compared to normal dividends paid out by the company. Also referred to as an "extra dividend".

So these are some of the form of dividend paid by the companies to the shareholders.

20.7 DIVIDEND STABILITY

Stable or regular dividend means when dividend is paid at frequent intervals. The decision to distribute dividend depends on a trade off between future earnings and investments. A firm has to decide what portion they should retain and what portion they distribute as dividend.

Some companies pay constant dividend in amount form, some pay constant dividend in percentage form, some pay small constant dividend plus extra as bonus. Stable dividend policy although create positive attitude among the shareholders, plus reduces the uncertainty and also assist in earning current income rather than future income.

Stable dividend policy has certain limitations like it create unnecessary pressure on the firm, it affect the retained earnings also to an extent.

20.8 STOCK DIVIDEND

At times the company faces the shortage of cash or the company wants to store cash for further investments so in that case the company uses stock in the form of dividend. In other words when company pays shares to shareholders in the form of dividends than it is called stock dividend.

These distributions are generally acknowledged in the form of fractions paid per existing share, such as if a company issued a stock dividend of 0.05 shares for each single share held by existing shareholders.

The board of a public company, for example, can approve a 5% stock dividend, which gives existing investors an additional share of company stock for every 20 shares they already own. However, this means that the pool of available equities increases by 5%, diluting the value of existing shares. So, even though an investor who owns 100 shares in a company may receive 5 additional shares, the total market value of those shares remains the same. In this way a stock dividend is very similar to a stock split.

20.9 STOCK SPLITS

It is a process where a company divides its existing shares into multiple numbers of shares. In this method numbers of share increases whereas the market capitalization remains the same. The most common split ratios are 2-for-1 or 3-for-1, which means that the stockholder will have two or three shares for every share held earlier.

For example:

If a company has 100 shares outstanding with the value of Rs 1000 per share in this case the market capitalization is 100x Rs 1000=Rs 100000.

Now if the company takes the decision of splitting 2 for 1 share than in this case the number of shares become 200 whereas the value per share remains Rs 500 whereas the market capitalization remains the same i.e. 200 x Rs 500= Rs 10000

Benefits of Stock Splits:

First, a split is usually undertaken when the stock price is quite high, making it pricey for investors to acquire a standard board lot of 100 shares

Second, the higher number of shares outstanding can result in greater liquidity for the stock, which facilitates trading and may narrow the bid-ask spread.

While a split in theory should have no effect on a stock's price, it often results in renewed investor interest, which can have a positive impact on the stock price. While this effect can be temporary, the fact remains that stock splits by blue chip companies are a great way for the average investor to accumulate an increasing number of shares in these companies.

Check Your Progress-A

Q1. What are the various types of dividend?

Q2. What do you mean by Dividend Payout Policy?

Q3. What do you mean by Stock Splits?

20.10 LEGAL CONSIDERATION OF PAYING DIVIDENDS

Some of the most important determinants of dividend policy are: (i) Type of Industry (ii) Age of Corporation (iii) Extent of share distribution (iv) Need for additional Capital (v) Business Cycles (vi) Changes in Government Policies (vii) Trends of profits (vii) Trends of profits (viii) Taxation policy (ix) Future Requirements and (x) Cash Balance.

The declaration of dividends involves some legal as well as financial considerations. From the point of legal considerations, the basic rule is that dividend can only be paid out profits without the impairment of capital in any way. But the various financial considerations present a difficult situation to the management for coming to a decision regarding dividend distribution.

These considerations are discussed below:

(i) Type of Industry:

Industries that are characterised by stability of earnings may formulate a more consistent policy as to dividends than those having an uneven flow of income. For example, public utilities concerns are in a much better position to adopt a relatively fixed dividend rate than the industrial concerns.

(ii) Age of Corporation:

Newly established enterprises require most of their earning for plant improvement and expansion, while old companies which have attained a longer earning experience, can formulate clear cut dividend policies and may even be liberal in the distribution of dividends.

(iii) Extent of share distribution:

A closely held company is likely to get consent of the shareholders for the suspension of dividends or for following a conservative dividend policy. But a company with a large number of shareholders widely scattered would face a great difficulty in securing such assent. Reduction in dividends can be affected but not without the co-operation of shareholders.

(iv) Need for additional Capital:

The extent to which the profits are ploughed back into the business has got a considerable influence on the dividend policy. The income may be conserved for meeting the increased requirements of working capital or future expansion.

(v) Business Cycles:

During the boom, prudent corporate management creates good reserves for facing the crisis which follows the inflationary period. Higher rates of dividend are used as a tool for marketing the securities in an otherwise depressed market.

(vi) Changes in Government Policies:

Sometimes government limits the rate of dividend declared by companies in a particular industry or in all spheres of business activity. The Government put temporary restrictions on payment of dividends by companies in July 1974 by making amendment in the Indian Companies Act, 1956. The restrictions were removed in 1975.

(vii) Trends of profits:

The past trend of the company's profit should be thoroughly examined to find out the average earning position of the company. The average earnings should be subjected to the trends of general economic conditions. If depression is approaching, only a conservative dividend policy can be regarded as prudent.

(viii) Taxation policy:

Corporate taxes affect dividends directly and indirectly— directly, in as much as they reduce the residual profits after tax available for shareholders and indirectly, as the distribution of dividends beyond a certain limit is itself subject to tax. At present, the amount of dividend declared is tax free in the hands of shareholders.

(ix) Future Requirements:

Accumulation of profits becomes necessary to provide against contingencies (or hazards) of the business, to finance future- expansion of the business and to modernise or replace equipments of the enterprise. The conflicting claims of dividends and accumulations should be equitably settled by the management.

(x) Cash Balance:

If the working capital of the company is small liberal policy of cash dividend cannot be adopted. Dividend has to take the form of bonus shares issued to the members in lieu of cash payment.

The regularity of dividend payment and the stability of its rate are the two main objectives aimed at by the corporate management. They are accepted as desirable for the corporation's credit standing and for the welfare of shareholders.

High earnings may be used to pay extra dividends but such dividend distributions should be designed as "Extra" and care should be taken to avoid the impression that the regular dividend is being increased.

A stable dividend policy should not be taken to mean an inflexible or rigid policy. On the other hand, it entails the payment of a fair rate of return, taking into account the normal growth of business and the gradual impact of external events.

A stable dividend record makes future financing easier. It not only enhances the credit-standing of the company but also stabilises market values of the securities outstanding. The confidence of shareholders in the corporate management is also strengthened.

Legal rules governing payment of dividends:

It is illegal to pay a dividend, if after its payment; the capital would be impaired (reduced). This requirement might be met if only capital surplus existed. An upward revaluation of assets, however, would create a capital surplus, but at the same time might operate as a fraud on creditors and for that reason is illegal.

Basically the dividend laws were intended to protect creditors and therefore prohibit payment of a dividend if a corporation is insolvent or if the dividend payment will cause insolvency.

The corporate laws must be taken into consideration by the directors before they declare a dividend. The company can postpone the distribution of dividend in cash, which may be conserved for strengthening the financial condition of the company by declaring stock dividend or bonus shares.

To sum up, the decision with regard to dividend policy rests on the judgement of the management, since it is not a contractual obligation like interest. The formulation of dividend policy requires a balanced financial judgment by judiciously weighting the different factors affecting the policy.

Stock dividend or bonus shares:

A stock dividend is a distribution of additional shares of stock to existing shareholders on a pro-rata basis i.e. so much stock for each share of stock held. Thus, a 10% stock dividend would give a holder of ICQ shares, as additional 10 shares, whereas a 250% stock dividend would give him 250 additional shares. A stock dividend has no immediate effect upon assets.

It results in a transfer of an amount from the accumulated earnings or surplus account to the share capital account. In other words, the reserves are capitalised and their ownership is formally transferred to the shareholders.

The equity of the shareholders in the corporation increases. Stock dividends do not alter the cash position of the company. They serve to commit the retained earnings to the business as a part of its fixed capitalisation.

Reasons for declaring a stock dividend:

Two principal reasons which usually actuate the directors to declare a stock dividend are:

(1) They consider it advisable to reduce the market value of the stock and thereby facilitate a broader distribution of ownership.

(2) The corporation may have earnings but may find it inadvisable to pay cash dividends.

The declaration of a stock dividend will give the stock holders evidence of the increase in their investment without interfering with the company's cash position. If the stock holders prefer cash to additional stock in the company, they can sell the stock received as dividend.

Sometimes, a stock dividend is declared to protect the interests of old stock holders when a company is about to sell a new issue of stock (so that new shareholders should not share the accumulated surplus).

20.11 LIMITATIONS OF STOCK DIVIDENDS

The bonus shares entail an increase in the capitalisation of the corporation and this can only be justified by a proportionate increase in the earning capacity of the corporation. Young companies with uncertain earnings or companies with fluctuating income are likely to take great risk by distribution stock dividends.

Every stock dividend carries an implied promise that future cash dividends will be maintained at a steady level because of the permanent capitalisation of reserves. Unless the corporate management has reasonable grounds of entertaining this hope, the wisdom of large stock dividend is always subject to grave suspicion.

The existence of legal sanction for distributing the accumulated earnings or reserves does not warrant the issue of stock dividends from the point of view of sound financial practice. There should be other conditioning factors also for the issue of stock dividend.

(a) Bonus shares bring about a capitalisation of undistributed profits in the companies where the profits originate and this lead to a linear development of corporate enterprise and greater concentration of economic power.

(b) By issuing stock dividends-the corporations deprive the capital market of 'secondary' funds which would otherwise have flowed into more widely dispersed investments.

(c) Bonus shares enable companies to appropriate to their own use undistributed profits which, otherwise, would have led either to an increase in the share of labour or a reduction in prices for the consumer.

20.12 SUMMARY

In short this unit tries to make student understand that dividend is a sort of earning which is distributed to investors in the form of reward. Dividend can be given in the form of cash, dividend and cash plus dividend too. Dividend decision is important as it affects the retained earnings of the company and if company is not distributing dividend it affect the investor confidence. Thus studying all parameters and then distributing dividend is advisable for the firms.

20.13 GLOSSARY

Dividend: Dividend is a portion of income which is given by the company to its shareholders. It is a part of profit distributed by the firms to the stakeholders.

Target payout ratio: A stable dividend policy could target a long-run dividend-to-earnings ratio.

Cash Dividend: This is the most preferred way of paying dividend. Under this dividend is paid in the form of cheque to the shareholders or to the brokerage firms.

Stock Splits: It is a process where a company divides its existing shares into multiple numbers of shares. In this method numbers of share increases whereas the market capitalization remains the same.

Stock Dividend: A stock dividend is a distribution of additional shares of stock to existing shareholders on a pro-rata basis i.e. so much stock for each share of stock held.

20.14 REFERENCES

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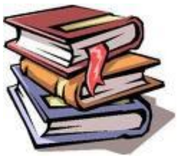

20.15 SUGGESTED READINGS

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20.16 TERMINAL QUESTIONS

Q1.What do you understand by dividend? State the different forms of dividend.

Q2. Differentiate between stock splits and cash dividend.

Q3. Critically evaluate the implications attached with dividends.

Q4. List out the different types of dividend in brief.

Q5. What to you understand by the term dividend?