UNIT: DIVIDEND DECISION

Meaning of Dividend

Dividend refers to the part of profits of the company which is distributed by the company among its shareholders.

OR

It's the reward of the shareholders for investments made by them in the shares of the company.

Meaning of Dividend Policy

Dividend policy is a policy which is maintained by the business concern for the payment of dividend to its shareholders.

Forms of Dividends

- Cash Dividend.
- Scrip or Bond Dividend.
- Property Dividend.
- Stock Dividend.

Cash dividend:

A cash dividend is a usual method paying dividends. Payment of dividends in cash results in outflow of funds and reduces the company's net worth, though the shareholders get an opportunity to invest the cash in any manner they desire. This is why the ordinary shareholders prefer to receive dividends in cash. But the firm must have adequate liquid resources at its disposal or provide for such resources so that its liquidity position is not adversely affected on account of cash dividends.

Scrip or Bond Dividend:

A Scrip dividend promises to pay the shareholders at a future specific date. In case a company does not have sufficient funds to pay dividends in cash, it may issue notes or bonds for amounts due to the shareholders. The objective of scrip dividend is to postpone the immediate payment of cash. A Scrip dividend bears interest and is accepted as a collateral security.

Property Dividend: Property dividends are paid in the form of some assets other than cash. They are distributed under exceptional circumstances and are not popular in India.

Stock dividend:

Stock dividend means an issue of bonus shares to the existing shareholders. If a company does not have liquid resources it is better to declare stock dividends. Stock dividends amounts to capitalization of earnings and distribution of profits among the existing shareholders without affecting the cash position of the firm.

Types of Dividend Policy

- Regular dividend policy
- Stable dividend policy
- Irregular dividend policy
- No dividend policy

Regular dividend policy:

Payment of dividend at the usual rate is termed as regular dividend. The investors such as retired persons, widows and other economically weaker persons prefer to get regular dividends.

MERITS:

- It establishes a profitable record of the company.
- It creates confidence amongst the shareholders.
- It aids in long term financing and renders financing easier.

- It stabilizes the market value of shares.
- The ordinary shareholders view dividends as a source of funds to meet their day to day living expenses.

Stable dividend policy:

The term stability of dividend of dividends means consistency or lack of variability in the stream of dividend payments. In more precise terms, it means payment of certain minimum amount of dividend regularly.

A stable dividend policy may be established in any of the following 3 forms:

(a)Constant dividend per share.

Some companies follow a policy of paying fixed dividend per share irrespective of the level of earnings year after year. Such firms usually create a Reserve for Dividend Equalization to enable them pays the fixed dividend even in the year when the earnings are not sufficient or when there are losses. A policy of constant dividend per share is most suitable to concerns whose earnings are expected to remain stable over a number of years.

(b)Constant payout ratio:

Constant payout ratio means payment of a fixed percentage of net earnings as dividends every year. The amount of dividend in such a policy fluctuates in direct proportion to the earnings of the company. The policy of constant payout is preferred by the firms because it is related to their ability to pay dividend.

(c)Stable rupee dividend plus extra dividend:

Some companies follow a policy of paying constant low dividend per share plus an extra dividend in the years of high profits. Such policy is most suitable to the firm having fluctuating earnings from year to year.

MERITS:

- It is sign of continued normal operations of the company.
- It stabilizes the market value of shares.
- It creates confidence among the investors.
- It improves the credit standing and makes financing easier.
- It meets the requirements of institutional investors who prefer companies with stable dividends.

DEMERITS:

- Once a stable dividend policy is followed by a company, it is not easy to change it.
- The stable dividends are not paid to the shareholders on any account including insufficient profits; the financial standing of the company in the minds of the investors is damaged.
- It adversely affects the market price of shares of the company.
- If the company pays stable dividends in spite of its incapacity, it will be suicidal in the long run.

Irregular dividend policy:

Some companies may follow the irregular dividend payments on account of the following:

i. Uncertainty of earnings.
ii. Unsuccessful business operation.

iii. Lack of liquid resources.

No dividend policy:

A company may follow a policy of paying no dividends presently because of its unfavorable working capital position or on account of requirements of funds for future expansion and growth.

Determinants of Dividend Policy:

1.	Legal Restrictions
2.	Desire and Type of shareholders
3.	Nature of Industry
4.	Age of company
5.	Future Financial Requirements
6.	Government Economic Policy
7.	Taxation Policy
8.	Requirements of Institutional Investors
9.	Stability of dividends
10.	Liquid Resources
11.	Magnitude and Trend of Earnings
12.	Inflation
13.	Control objective

(1) Legal provisions relating to dividends as laid down in Companies Act of 1956. These provisions require that dividend can be paid only out of current profits or past profits after providing for depreciation or out of the moneys provided by Government for the payment of dividends in pursuance of a guarantee given by the Government.

(2) The Directors should give the importance to the desires of shareholders in the declaration of dividends as they are the representatives of shareholders. Desires of shareholders depend upon their economic status. Investors, such as retired persons, widows and other economically weaker persons view dividends as a source of funds to meet their day to day living expenses. To benefit such investors, the companies should pay regular dividends.

(3) Nature of industry to which the company is engaged also considerably affects the dividend policy. Certain industries have a comparatively steady and stable demand irrespective of the prevailing economic conditions.

EX: people used to drink liquor both in boom as well as in recession. Such firms expect regular earnings and hence can follow a consistent dividend policy. On the other hand, if the earnings are uncertain, as in the case of luxury goods, conservative policy should be followed.

(4) The age of company also influences the dividend decision of a company. A newly established concern has to limit payment of dividend and retain substantial part of earnings for financing its future growth and development, while older companies which have established sufficient reserves can afford to pay liberal dividends.

(5) It is not only the desires of the shareholders but also future financial requirements of the company that have to be taken into consideration while making a dividend decision. If a company has highly profitable investment opportunities it can convince the shareholders of the need for limitation of dividend to increase the future earnings and stabilizes its financial position its financial position. But when profitable investment opportunities, do not exist then the company may not be justified in retaining substantial

part of its current earnings. Thus, a concern having few internal investment opportunities should follow high payout ratio as compared to one having more profitable investment opportunities.

(6) The dividend policy of a firm has also to be adjusted to the economic policy of the Government as was the case when the Temporary Restriction on Payment of Dividends Ordinance was in force. In 1974 and 1975, companies allowed to pay dividends not more than 33 percent of their profits or 12 percent on the paid up value of the shares, whichever was lower.

(7) The taxation policy of the Government also affects the dividends decision of a firm. A high or low rate of business taxation affects the net earnings of company and thereby its dividend policy. Similarly a firm dividend policy may be dictated by the income tax status of its shareholders. If the dividend income of shareholders is heavily taxed being in high income bracket, the shareholders may forego cash dividend and prefer bonus shares and capital gains.

(8) Dividend policy of company can be affected by the requirements of institutional investors such as financial institutions, banks insurance corporations, etc. These investors usual favour a policy of regular payment of cash dividends and stipulate their own terms with regard to payment of dividend on equity shares.

(9) Stability of dividends is another important guiding principle in the formulation of a dividend policy. Stability of dividend simply refers to the payment of dividend regularly and shareholders, generally, prefer payment of such regular dividends. A policy of constant dividend per share is most suitable to concerns whose earnings are expected to remain stable over a

number of years or those who have built up sufficient reserves to pay dividends in the year of low profits.

(10) The dividend policy of a firm is also influenced by the availability of liquid resources. Although a firm may have sufficient available profits to declare dividends, yet it may not be desirable to pay dividends if it does not have sufficient liquid resources. Hence the liquidity position of a company is an important consideration in paying dividends.

(11) The amount and trend of earnings is an important aspect of dividend policy. As dividends can be paid only out of present or past years profits, earnings of a company fix the upper limits on dividends. The dividends should generally be paid out of current year's earnings only as the retained earnings of the previous year's become more or less a part of permanent investment in the business to earn current profits. The past trend of the company earnings should also be kept in consideration while making the dividend decision.

(12) As in case of a high dividend payout ratio the retained earnings are insignificant and the company will have to issue new shares to raise funds to finance its future by the company. Thus, under these circumstances to maintain control of the existing shareholders, it may be desirable to declare lower dividends and retain earnings to finance the firm's future requirements.

(13) When a company pays high dividends out of its earnings, it may result in the dilution of both control and earnings for the existing shareholders. Similarly issue of new shares shall cause increase in the number of equity shares and ultimately cause a lower earnings per share and their price in the market. Thus in such circumstances to maintain control of the existing shareholders, it may be desirable to declare lower dividends.

BONUS(stock dividend) SHARES:

Stock dividend means the issue if bonus shares to the existing shareholders instead of paying dividend in cash without affecting cash position of the company.

MERITS:

- It makes available capital to carry an a large and more profitable business.
- It is felt that financing helps the company to get rid of market influences.
- The balance sheet of the company will reveal a more realistic picture of the capital structure and the capacity of the company.
- It enables the company to make use of its profits on a permanent basis and increases creditworthiness of the company.
- It is the cheapest method of raising additional capital for the expansion of the business.
- When a company pays bonus to its shareholders in the value of shares and not in cash, its liquid resources are maintained and the working capital of the company is not affected.

DEMERITS:

- The fall in the future rate of dividend results in the fall of the market price of shares considerably, this may cause unhappiness among the shareholders.
- The reserves of the company after the bonus issue decline and Leaves lesser security to investors.

Sources of Bonus Issue:

- Balance in the profits and loss account.
- General Reserves.
- Capital Reserves.
- Capital Redemption Reserve A/C.
- Premium received in cash.

RIGHTS ISSUE:

Rights issue is an invitation to the existing shareholders to subscribe for further shares to be issued by a company.

MERITS:

- The expenses to be incurred, otherwise if shares are offered to the public are avoided.
- There is no certainty of the shares being sold to the existing shareholders.
- It betters the image of the company and stimulates enthusiastic response from shareholders and the investment market.

UNIT:

WORKING CAPITAL MANAGEMENT

Meaning of working capital:

It refers to the funds invested in current assets, i.e. investment in sundry debtors, cash and other current assets.

- Gross working capital:

It is the capital which is invested in total current assets of the enterprises.

- Net working capital:

It is the excess of current assets over current liabilities.

NWC = CA – CL

CA= Current Assets.

CL=Current Liabilities.

Importance of working capital:

1. Solvency of the business:

Adequate working capital helps in maintaining solvency of the business by providing uninterrupted flow of production.

2. Goodwill:

Sufficient working capital enables a business concern to make prompt payments and hence helps in creating and maintaining goodwill.

3. Easy loans:

A concern having adequate working capital, high solvency and good credit standing can arrange loans from banks and others on easy and favorable terms.

4. Cash discounts:

Adequate working capital also enables a concern to avail cash discounts on the purchases and hence it reduces costs.

5. Regular supply of raw materials:

Sufficient working capital ensures regular supply of raw materials and continuous production.

6. Regular payment of salaries, wages and other day to day commitments:

A company which has ample working capital can make regular payment of salaries, wages and other day to day commitments which raises the morale of its employees, increases their efficiency, reduces wastages and costs and enhances production and profits.

7. Exploitation of favorable market conditions:

Only concerns with adequate working capital can exploit favorable market conditions such as purchasing its requirements in bulk when the prices are lower and by holding its inventories for higher prices.

8. Ability to face crisis:

Adequate working capital enables a concern to face business crisis in emergencies such as depression because during such periods, generally, there is much pressure on working capital.

9. Quick and regular return on investments:

Every Investor wants a quick and regular return on his investments. Sufficiency of working capital enables a concern to pay quick and regular dividends to its investors as there may not be much pressure to plough back profits. This gains the confidence of its investors and creates a favorable market to raise additional funds in the future.

10. High morale:

Adequacy of working capital creates an environment of security, confidence, high morale and creates overall efficiency in a business.

Need or objects of working capital:

1. For the purchase of raw materials, components and spares.
2. To pay wages and salaries.
3. To meet the selling costs as packing, advertising, etc.
4. To provide credit facilities to the customers.
5. To maintain the inventories of raw material, work in progress, stores and finished stocks.
6. To incur day to day expenses and overhead costs such as fuel, power and office expenses, etc

Excess working capital:

Disadvantages:

1. Due to low rate of return on investments, the value of shares may fall.
2. The redundant working capital gives rise to speculative transactions.
3. It may result into overall inefficiency in the organization.

4. When there is excessive working capital, relations with banks and other financial institutions may not be maintained.
5. It may leads to unnecessary purchasing and accumulation of inventories causing more chances of theft, waste and losses.

Inadequate working capital:

Disadvantages:

1. The rate of return on investments also falls with the shortage of working capital.
2. It becomes impossible to utilize efficiently the fixed assets due to non availability of liquid funds.
3. It cannot buy its requirements in bulk and cannot avail of discounts, etc.
4. It becomes difficult for the firm to exploit favorable market conditions and undertake profitable projects due to lack of working capital.
5. A concern which has inadequate working capital cannot pay its short term liabilities in time. Thus, it will lose its reputation and shall not be able to get good credit facilities.

Factors Determining the Working capital Requirements:

1	Nature or character of Business.
2	Size of business or Scale of operation.
3	Production policy.
4	Manufacturing process or Length of production cycle.
5	Seasonal variations.
6	Working capital cycle.
7	Rate of stock turnover.
8	Credit policy.
9	Business cycles.

	10	Rate of growth of business.
	11	Earning capacity and Dividend policy.
	12	Price level changes.
	13	Other factors.

(1) The working capital requirements of a firm basically depend upon the nature of its business. Public utility undertakings like Electricity, water supply and railways need very limited working capital because they offer cash sales only and supply services, not products. On the other hand trading financial firms require less investment in fixed assets but have to invest large amounts in current assets like inventories, receivables and cash as such they need large amount of working capital.

(2) The working capital requirements of a concern are directly influenced by the size of its business which may be measured in terms of scale of operations. Greater the size of a business unit, generally larger will be the requirements of working capital. However, in some cases even a smaller concern may need more working capital due to high overhead charges, inefficient use of available resources and other economic disadvantage of small size.

(3) In certain industries the demand is subject to wide fluctuations due to seasonal variations. The requirements of working capital in such cases depend upon the production policy. The production could be kept either steady by accumulating inventories during slack periods with a view to meet high demand during the peak season or the production could be curtailed during the slack season and increased during the peak seasons. If the policy is to keep production steady by accumulating inventories it will require higher working capital.

(4) In manufacturing business the requirements of working capital increase in direct proportion to length of manufacturing process. Longer the process period of manufacture, larger is the amount of working capital required.

(5) In certain industries raw material is not available throughout the year. They have to buy raw materials in bulk during the season to ensure and uninterrupted flow and process them during the entire year. A Huge amount is thus blocked in the form of material inventories during such season, which gives rise to more working capital requirements.

(6) In a manufacturing concern, the working capital cycle starts with the purchase of raw material and ends with the realization of cash from the sale of finished products. This cycle involves purchase of raw materials and stores, its conversion into stocks of finished goods through work in progress with progressive increment of lab our and service costs, conversion of finished stock into sales, debtors and receivables and ultimately realization of cash and this cycle continues again from cash to purchase of raw material and so on.

(7) There is a high degree of inverse co relationship between the quantum of working capital and the velocity or speed with which the sales are affected. A firm having a high rate of stock turnover will need lower amount of working capital as compared to a firm having a low rate of turnover.

(8) The credit policy of a concern in its dealings with debtors and creditors influence considerably the requirements of working cap ital. A concern that purchases its requirements on credit and sells its products/services on cash requires lesser amount of working capital. On the other hand a concern buying its requirements for cash and allowing credit to its customers, shall

need larger amount of working capital as very huge amount of funds are bound to be tied up in debtors or bills receivables.

(9) Business cycle refers to alternate expansion and contraction in general business activity. In a period of boom i.e., when the business is prosperous, there is a need for larger amount of working capital due to increase in sales, rise in prices, optimistic expansion of business, etc. On the contrary in the times of depression i.e., when there is a down swing of cycle, the business contracts, sales decline, and difficulties are faced in collections from debtors and firms may have a large amount of working capital lying idle.

(10) Although, if is difficult to determine the relationship between the growth in the volume of business and the growth in the working capital of a business, yet it may be concluded that for normal rate of expansion in the volume of business, we may have retained profits to provide for more working capital but in fast growing concerns, require larger amount of working capital.

(11) Some firms have more earning capacity than others due to quality of their products, monopoly conditions, etc. Such firms with high earning capacity may generate cash profits from operation and contribute to their working capital. The dividend policy of a concern also influences the requirements of its working capital.

(12) Changes in the price level also affect the working capital requirements. Generally, the rising prices will require the firm to maintain larger amount of working capital as more funds will be required to maintain the same current assets. The effect of rising prices may be different for different firms. Some firms may be affected much while some others may not be affected at all by the rise in prices.

(13) Certain other factors such as operating efficiency, management ability, irregularities of supply, import policy, asset structure, importance of labour, banking facilities, etc., also influence the requirements of working capital.

UNIT: DEPOSITORY SYSTEM AND DEMATERIALISATION

Depository system:

A Depository is an organization which holds the securities of a shareholder in electronic form at the request of the shareholder.

The development of Information technology has paved the way for many innovative things in the stock exchange. The stocks scam which shook the stock market during the 1990s also made the government to take preventive measures to avoid the recurrence of such scams. All these resulted in the introduction of a new type of stock trade called dematerialization.

Dematerialization on the other hand is a process wherein the shares, after being handed over to the depository will be used at the time of sale or transfer of the shares from one shareholder to another. Since the physical transfer of share / stock does not occur, it is called Scripless transfer or scripless trade.

Under **dematerialization of shares**, physical transfer of shares is avoided and the transactions take place through the electronic media. This saves time and stationery and also prevents the loss of documents in transit.

PLAYERS OF Depository system:

There are essentially four players in the depository system:

(i) The Depository

(ii) The Participant

(iii) The Beneficial Owner, and

(iv) The Issuer.

(i) The Depository:

A depository is a firm wherein the securities of an investor are held in electronic form and who carries out the transactions of securities by means of book entry. The depository acts as a defecto owner of the securities lodged with it for the limited purpose of transfer of ownership. It functions as a custodian of securities of its clients.

The name of the depository appears in the records the issuer as the registered owner of securities.

At present there are two depositories in India:

(a) National Securities Depository Ltd. (NSDL), and

(b) Central Depository Services (India) Ltd. (CDSL).

National Securities Depository Limited which commenced operations during November 1996 was promoted by IDBI, UTI and National Stock Exchange (NSE). Central Depository Services (India) Limited commenced operations during February 1999. It was promoted by Mumbai Stock Exchange in association with Bank of Baroda, Bank of India, State Bank of India and HDFC Bank.

(ii) The Participant:

A participant is an agent of the depository. He functions as a bridge between the depository and the beneficial owners. He maintains the ownership records of every beneficial owner in book entry form. Both the depository and the participant have to be registered with the Securities and Exchange Board of India.

SEBI grants necessary approval for the same only on the satisfaction of the condition that adequate systems and safeguards are available in such companies in order to ensure against manipulation of records and transactions.

(iii) The Beneficial Owner:
Beneficial owner means a person whose name is recorded as such with a depository. A beneficial owner is the real owner of the securities who has lodged his securities with the depository in the form of book entry. He has all the rights and liabilities associated with the securities.

(iv) The Issuer:
The issuer is the company which issues the security. It maintains a register for recording the names of the registered owners of securities, the depositories. These issuers send a list of shareholders, who opt for the depository system, to the depositories.

Facilities Offered By Depository System:

The following are some of important facilities offered by depository system:

(a) Dematerialisation.

(b) Rematerialisation.

(c) Electronic settlement of trade.

(d) Nomination facility.

(e) Electronic credit of securities allotted in public, rights and bonus issue.

(f) Pledging or hypothecation of dematerialised securities.

(g) Freezing of demat accounts.

(h) Stock lending/borrowing facilities, etc.

Advantages of the Depository System:

1. Reduction in paper work.
2. Elimination of risks associated with physical scrips such as theft, forgery, multilation, loss of share certificates etc.
3. Elimination of bad delivers.
4. Increased liquidity of scrips through speedy settlement and reduction in delays in registration.
5. Low transaction costs for purchase and sale of securities compared to physical mode.
6. No stamp duty on transfer of securities.
7. Facilities the issuer companies to update the information regarding shareholders and to communicate with them in better ways.
8. Attract foreign investors and promoting foreign investment.
9. Emergence of healthy and efficient capital market.
10. Greater opportunity for the development of sophisticated custodial services etc.

11. Depository system takes hold of all securities in the country listed in that particular stock exchange.
12. Introduction of electronic system enables speedy transactions and accuracy.
13. In a depository system, the security holders can sell and buy securities by which liquidity is brought to the securities.
14. Blank transfers are avoided and holding of shares in Benami names is also prevented.
15. Registration and stamp charges for the sale of securities could be easily collected by the government which was evaded under the previous system.
16. Depository promotes more activity in the capital market as trading in genuine share. is ensured under Depository system.
17. Depository avoids use of stationery and prevents delay in registration of transfers.
18. Dividend and interest on securities are properly distributed through this system and in the case of convertible debentures, on the due date, the securities are converted into company shares.
19. Depository acts as collateral security for the raising of 1oans from any financial institution.