(v) Policy of irregular dividends

1. Stable dividend policy: Stable dividend policy is one that maintains regularity in paying some dividend even though its amount fluctuates from year to year and may not be related to earnings. Thus, stability of dividends refers to regularity of the amount paid out. Stability of dividends can take three distinct forms.

(i) Constant dividend per share.
(ii) Constant percentage of net earnings.
(iii) Constant dividend per share and extra dividend.

(1) Constant dividend per share: In this case, the management follows the policy of paying a fixed amount of dividend per share every year irrespective of the fluctuations in the earnings. This does not imply that the rate of dividend will never be increased. When the earnings of the company increase at a new space level of earnings, it increases the rate of dividend per share.

This policy is easy to follow when company earnings are stable. If earnings fluctuate widely the company can follow this policy by maintaining a dividend fluctuation fund in surplus years, which is invested in marketable securities so that they may easily be realized in bad years to pay the dividend in those years.

[ii] Constant percentage of net earnings: Some companies follow the policy of paying a fixed percentage of net profit as dividend every year, i.e. a policy of constant payout ratio. For example a company adopts a 40 percent payout ratio, which means, 40% net earnings of the company will be paid-out to shareholders every year as dividend. No dividend is paid in the year of loss. Under this policy internal financing is automatic. For example in the above case, 60% of the profits are transferred to reserves. This policy leaves nothing to the management's discretion.

[iii] Constant dividend per share plus extra dividend: In this case, the management fixes the minimum rate of dividend per share to reduce the possibility of not paying a dividend. In the years of prosperity the company pays extra dividend. This policy commits a fixed rate of dividend per share plus an extra dividend in the periods of prosperity.

☆☆ ADVANTAGES OF STABLE DIVIDEND POLICY

Advantages to investors:

(1) Confidence among shareholders : A regular and stable dividend payment

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creates confidence and removes uncertainty from the minds of the shareholders. It presents a bright future of the company and thus gives confidence to the shareholders.

(2) Income conscious investors: As the investors are generally income conscious they favor a stable rate of dividend and never an unstable rate of dividend.

(3) Stability in market price of shares: Other things being equal, the market prices vary with the rate of dividend the company declares on its equity shares. The values of shares of a company having a stable dividend policy do not fluctuate widely even if the earnings of the company are lower than the previous year. Thus, this policy stabilizes the market price of the stock.

(4) Encouragement to institutional investors: A stable dividend policy attracts institutional investors who generally prepare a list of securities mainly incorporating the securities of the companies having stable dividend policy in which they invest their surpluses or their long-term funds such as pensions or provident funds etc.

Advantages to company:

(1) **Increase in good will and credit of the company**: Stability and credit of the company affects the market price of shares and increases the general credit of the company that pays the company in long run.

(2) **Financial planning:** A company with stable dividend policy may formulate its financial planning faster and easily because the financial manager can correctly estimate the future demand and supply of capital in the firm. Timing of dividend payment can be forecasted easily by preparing cash flow statement.

Disadvantages:

However, the stable dividend policy is not without any drawbacks. The greatest danger associated with a stable dividend policy is that once the firm adopts it, it cannot be changed without seriously affecting the confidence of shareholders in management and the credit-worthiness of the company. Therefore it is prudent that the dividend rate is fixed at a lower level so that it can be maintained even in years with reduced profits.

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FORMS OF DIVIDEND

Dividends can be classified in various forms. Dividends paid in the ordinary course of business are known as *Profit dividends,* while dividends paid out of capitl are known as *Liquidation dividends.* Dividends may also be clasified on the basis of medium in which they are paid :

(a) **Cash Dividend.** A cash dividend is a usual method of paying dividends. Payment of dividend 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 ordianry 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.

(b) **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.

(c) **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.

(d) **Stock Dividend.** Stock dividend means the issue of bonus shares to the existing shareholders. If a company does not have liquid resources it is better to declare stock dividend. Stock dividend amounts to capitalisation of earnings and distribution of profits among the existing shareholders without affecting the cash position of the firm. This has been discussed in detail under "Bonus Issue".

BONUS ISSUE

A company can pay bonus to its shareholders either in cash or in the form of shares. Many a times, a company is not in a position to pay bonus in cash inspite of sufficient profits because of unsatisfactory cash

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position or because of its adverse effects on the working capital of the company. In such cases, if the company so desires and the articles of association of the company provide, it can pay bonus to its shareholder in the form of shares by making partly paid shares as fully paid or by the issue of fully paid bonus shares.

The dictionary meaning of bonus shares is : 'a premium or gift, usually of stock, by a corporation to shareholders' or "an extra dividend paid to shareholders in a joint stock company from surplus profit." However, in legal context the meaning is not the same. A bonus share is neither dividend nor a gift. It is governed by so any regulations that it can neither be declared like a dividend nor gifted away. Issue of bonus shares in lieu of dividend is not allowed as according to Section 205 of the Companies Act, 1956, no dividend can be paid except in cash. It cannot be termed as a gift also because it only represents the past sacrifice of the shareholders.

❐ EFFECTS AND OBJECTS OF BONUS ISSUE

When a company accumulates huge profits and reserves, its balance sheet does not reveal a true picture about the capital structure of the company and the shareholders do not get fair return on their capital. Thus, if the Articles of Association of the company so permit, the excess amount can be distributed among the existing shareholders of the company by way of issue of bonus shares.

The effect of bonus issue is two–fold,viz.,

(i) It amounts to reduction in the amount of accumulated profits and reserves.

(ii) There is a corresponding increase in the paid up share capital of the company.

By the issue of bonus shares, the accumulated profits and reserves of the company are converted into share capital which is used permanently in the business and hence it is also known as *Capitalisation of Profits and Reserves.*

The following circusmstances warrant the issue of bonus shares.

(1) When a company has accumulated huge profits and reserves and it desires to capitalise these profits so as use them on permanent basis in the business.

(2) When the company is not able to declare higher rate of dividend on its capital, in spite of sufficient profits, due to restrictions imposed by the Government in regard to payment of dividend.

(3) When higher rate of dividend is not advisable for the reason that the shareholder may expect the same higher rate of dividend in future also.

(4) When the company cannot declare a cash bonus because of unsatisfactory cash position and its adverse effects on the working capital of the company.

(5) When there is a large difference in the nominal value and market value of the shares of the company.

Hence, the bonus issue is made to achieve the following objects :

(1) To bring the amount of issued and paid up capital in line with the capital employed so as to depict more realistic earning capacity of the company.

(2) To bring down the abnormally high rate of dividend on its capital so as to avoid labour problems such as demand for higher wages and to restrict the entry of new entrpreneurs due to the attraction of abnormal profits, as illustrated below :

Balance Sheet of X Co.

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❐ ADVANTAGES OF ISSUE OF BONUS SHARES

(A) Advantages from the viewpoint of the company

(1) It makes available capital to carry an a larger and more profitable business.

(2) It is felt that financing helps the company to get rid of market influences.

(3) 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.

(4) It enables a company to make use of its profits on a permanent basis and increases creditworthiness of the company.

(5) It is the cheapest method of raising additional capital for the expansion of the business.

(6) Abnormally high rate of dividend can be reduced by issuing bonus shares which enables a company to restrict entry of new entrepeneurs into the business and thereby reduces competition.

(7) The balance sheet of the company will reveal a more realistic picture of the capital structure and the capacity of the company.

(B) Advantages from the viewpoint of investors or shareholders

It is generally said that an investor gains nothing from the issue of bonus shares. It is so because the shareholder receives nothing except some additional share certificates. But his proportionate ownership in the company remains unchanged.

For example, say, a company has 10,000 equity shares of Rs. 10 each, out of which Mr. A owns 1,000 shares. Now the company issues bonus shares at the rate of 1 share for every 2 shares held in the company. After the bonus issue, the total share capital of the company shall be 10,000+5,000=15,000 shares of Rs.10 each of which Mr. A shall own 1,000+500=1,500 shares. His proportionate ownership prior to the bonus issue was $\frac{1,000}{10,000} \times 100 = 10\%$

And after the bonus issue, his proportionate owhership shall be $\frac{1,500}{15,000} \times 100 = 10\%$

Hence, the proportionate ownership remains the same and on this account, he does not gain anything. But in any case, he should be happy as he owns 1,500 shares now against 1,000 shares owned prior to bonus issue as he is the gainer by 500 shares received free of cost, which he should be able to sell in the market. But what happens is that generally, a company is not able to maintain the same rate of dividend on its shares in

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future and the prices of the shares fall in the market as a result of bonus issue. Therefore, practically, the shareholder gains nothing. This can be illustrated with the help of the following example.

Equity Share Capital

10,000 Equity Shares of Rs.10 each = Rs. 1,00,000

Say, the company's average profit prior to bonus issue is Rs. 20,000

That income return on capital is $\frac{20,000}{1,00,000} \times 100 = 20\%$

After the bonus issue of 5,000 equity shares, the capital of the company shall be 15,000 shares of Rs.10 each i.e. Rs. 1,50,000.

But the earning capacity of the company does not increase because the assets of the company remain the same. And hence there is every possibility that the average profit shall remain the same, Rs.20,000 making return on $\frac{20,000}{1,50,000} = 13.33\%$. It is clear that the return on capital has fallen from 20% to 13.33%. So the prices of the shares in the market shall fall accordingly, making the value of 1,500 shares nearly the same as it was for 1,000 shares prior to bonus issue, which proves that there is no gain to the investor. But in case the company is able to maintain or increase the rate of dividend on its shares after the issues of bonus shares, the prices of its shares will not fall and the investor will gain substanially. To sum up, the advantages to the shareholders are :

(1) The bonus shares are a permanent source of income to the investors.

(2) Even if the rate of dividend falls, the total amount of dividend may increase as the investor gets dividend on a larger number of shares.

(3) The investors can easily sell these shares and get immediate cash, if they so desire.

❑ DISADVANTAGES OF ISSUE OF BONUS SHARES

Inspite of many advantages, the issue of bonus shares suffers from the following diadvantages :

(1) The issue of bonus shares leads to a drastic fall in the future rate of dividend as it is only the capital that increases and not the actual resources of the company. The earnings do not usually increase with the issue of bonus shares. Thus, if a company earns a profit of Rs. 2,00,000 against a share capital of Rs. 5,00,000 and the capital of the company is raised by the issue of bonus shares to Rs. 8,00,000, the rate of dividend falls from 40% to 25%.

(2) 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.

(3) The reserves of the company after the bonus issue decline and leave lesser security to investors.

❑ NEW GUIDELINES FOR THE ISSUE OF BONUS SHARES (13.4.1994)

New guidelines on bonus shares have been issued by the Primary Market Department of SEBI vide press release dated 13.4.1994 modifying the earlier guidelines issued by SEBI on 11.6.1992. SEBI believes that, while deciding on bonus issues, the Board of Directors of the companies wishing to make bonus issues will take into consideration the relevent financial factors and observe the following modified guidelines :

1. These guidelines are applicable to existing limited companies who shall forward a certificate duly signed by the issuer and duly signed by its statutory auditor or by a company secretary in practice to the effect that the terms sand conditions for issue of bonus shares, as laid down in these guidelines, have been complied with.

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2. Issue of bonus shares after any public/rights issue is subject to the condition that no bonus issue shall be made which will dilute the value or rights of the holders of debentures convertible fully or partly.

In other words, no company shall, pending conversion of FCDs/PCDs issue any shares by way of bonus unless similar benefit is extended to the holders of such FCDs/PCDs, through reservation of shares in proportion to such convertible part of FCDs or PCDs. The shares so reserved may be issued at the time of conversion (s) of such debentures on the same terms on which the bonus issues were made.

3. The bonus issue is made out of free reserves built out of the genuine profits or share premium collected in cash only.

4. Reserves created by revaluation of fixed assets are not capitalised.

5. The declaration of bonus issue, in lieu of dividend, is not made.

6. The bonus issue is not made unless the partly paid shares, if any existing, are made fully paid.

7. The company :
   - (i) has not defaulted in payment of interest or principal in respect of fixed deposits and interest on existing debentures or principal on redemption there of, and.
   - (ii) has sufficient reason to believe that it has not defaulted in respect of payment of statutory dues of the employees such as contribution to provident fund, gratuity, bonus, etc.

8. A company which announces its bonus issue after the approval of the Board of Directors must implement the proposals within a period of six months from the date of such approval and shall not have the option of changing the decision.

9. There should be a provision in the Articles of Association of the company for capitalisation of resources, etc., and if not, the company shall pass a resolution at its general body meeting making provision in the Articles of Association for capitalisation.

10. Consequent to the issue of bonus shares, if the subscribed and paid–up capital exced the authorised share capital, a resolution shall be passed by the company at its general body meeting for increasing the authorised capital.

3. SOURCES OF BONUS ISSUES

The bonus shares can be isued out of the following :

1. Balance in the Profits and Loss Account.
2. General Reserve.
3. Capital Reserve.
4. Balance in the Sinking Fund Reserve for Redemption of Debentures after the debentures have been redeemed.
5. Development Rebate Reserve, Development Allowance Reserve, etc., allowed under the Income Tax Act 1961, after the expiry of the specified period (8 years).
6. Capital Redemption Reserve Account.
7. Premium received in cash.

However u/s 78 (2) of the Companies Act, 1956 Share Premium Account and u/s 80(5) Capital Redemption Reserve Account can be used to declare fully paid bonus shares only.

Bonus shares are usually issued out of accumulated profits although the issue can be made even out of current profits. As per the Government Press Note dated 9th July, 1974, the bonus issue is permitted to be made out of free reseves built out of genuine profits or share premium collected in cash only. Bonus shares cannot be issued out of reserves created for specific purposes, premium received in kind and reserves created–out of revaluation of assets.

❒ ACCOUNTING TREATMENT FOR THE ISSUE OF BONUS SHARES

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Stock Splits

Although there is little empirical evidence to support the contention, there is nevertheless a widespread belief in financial circles that an *optimal price range* exists for stocks. "Optimal" means that if the price is within this range, the firm's value will be maximized. Many observers, including Porter's management, believe that the best range for most stocks is from $20 to $80 per share. Accordingly, if the price of Porter's stock rose to $80, management would probably declare a two-for-one **stock split,** thus doubling the number of shares outstanding, halving the earnings and dividends per share, and thereby lowering the stock price. Each stockholder would have more shares, but each share would be worth less. If the post-split price were $40, Porter's stockholders would be exactly as well off as before the split. However, if the stock price were to stabilize above $40, stockholders would be better off. Stock splits can be of any size—for example, the stock could be split two-for-one, three-for-one, one-and-a-half-for-one, or in any other way.

Sometimes a company will have a **reverse split.** For example, International Pictures Corp. (IPIX) developed the iPIX computer imaging technology, which allows a user to "walk through" a 360-degree view. Its stock price was in the $30 range prior to the dot-com crash of April 2000, but by August 2001 its price had fallen to $0.20 per share. One of Nasdaq's listing requirements is that the stock price must be above $1 per share, and Nasdaq was threatening to delist IPIX. To drive its price up, IPIX had a 1:10 reverse stock split before trading began on August 23, 2001, with its shareholders exchanging 10 shares of stock for a single new share. In theory, the stock price should have increased by a factor of 10, to around $2, but IPIX closed that day at a price of $1.46. Evidently, investors saw the reverse split as a negative signal.

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❒ BONUS ISSUE (STOCK DIVIDEND)VS. STOCK SPLIT

Stock dividend means the issue of bonus shares to the existing shareholders of the company. It amounts to capitalisation of earnings and distribution of profits among the existing shareholders without affecting the cash position of the firm. Stock split, on the other hand, means reducing the par value of the shares by increasing the number of shares proportionately, viz; a share of Rs. 100 may be split into 10 shares of R. 10 each Thus, the two terms are quite different from each other.

The effect of bonus issue is that it amounts to reduction in the amount of profits and reserves, whereas, stock split does not affect the accumulated profits at all. Further,in bonus issues, the par value of the stock remains unchanged, whereas, it is reduced in case of stock split. However, in both the cases, the book value per share, earnings per share and the market price per share declines. That is why a stock dividend is considered very much like a stock split. The distinction between the two is of technical nature. A stock dividend is reflected in the balance sheet by way of transfer from retained earnings to equity capital wheareas a split is shown as a reduction in par value of each share. Although, it is generally said that neither an investor nor the company gains anything from stock dividend or stock split, yet there may be a positive effect of informational content of bonus/split annnouncement. The prices of shares may not fall in direct proportion to the increase in number of shares thereby increasing the wealth of the shareholders. The prospects of the firm in regard to raising additional funds may also improve. Hindustan Lever Limited, a well kown company in the Indian corporate sector, recently announced stock split in the month of Februray 2000 and there has been a favourable impact on the value of its shares in the market.

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Reasons for Share/stock split: The following are reasons for splitting of a company's ordinary shares:

(i) To make trading in shares attractive.
(ii) To signal the possibility of higher profits in the future
(iii) To give higher dividends to shareholders

BONUS SHARES VS STOCK SPLIT

S.NO.	BONUS SHARES	STOCK SPLIT
01	The par value of the share is unchanged.	The par value of the share is reduced
02	Part of the reserves is capitalized	There is no capitalization of reserves.
03	The shareholders' proportional ownership remains unchanged	The shareholders' proportional ownership remains unchanged
04	The book value per share, the earnings per share and the market price per share decline.	The book value per share, the earnings per share and the market price per share decline.
05	The market price per share is brought within a more popular trading range	The market price per share is brought within a more popular trading range

In nutshell, a sock split is similar to a bonus issue from the economic point view; there are some differences from the accounting point of view.

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hostile bids.

☆☆ SHARES REPURCHASE (BUYBACK OF SHARES)

In times of surplus cash available with the firm and no investment opportunities are available to profitably deploy the surplus funds, a company may use those funds to repurchase shares from the shareholders. With repurchase of shares, few shares remaining outstanding which will result in increasing earnings per share and increase in the market price of share and reduction in amount required in the form of dividends.

The share repurchase price can be calculated as follows:

$$P^* = \frac{(S \times Pc)}{(S - N)}$$

Where S = Number of shares outstanding prior to distribution

Pc = Current market price per share prior to distribution

N = Number of shares to be repurchased

P* = Equilibrium repurchase price

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DISTRIBUTIONS THROUGH STOCK REPURCHASES

Stock repurchases, which occur when a company buys back some of its own outstanding stock, have become an important part of the financial landscape.[12] In fact, large companies have repurchased more shares than they have issued since 1985. Repurchases have also become the preferred method of initiating cash distributions to shareholders. In 1998, 81 percent of those firms initiating a distribution did so with a stock repurchase instead of a cash dividend, substantially higher than the 27 percent doing so in 1973.[13] Stock repurchases have also steadily replaced dividends as a form of distribution, with more cash returned to shareholders in repurchases than as dividend payments since 1998. This section discusses stock repurchases and their effect on value.

Three principal situations lead to stock repurchases. First, a company may decide to increase its leverage by issuing debt and using the proceeds to repurchase stock, as we described in Chapter 16. Second, many firms have given their employees stock options, and they repurchase stock for use when employees exercise the options. In this case, the number of outstanding shares reverts to its pre-repurchase level after the options are exercised. Third, a company may have excess cash. This may be due to a one-time cash inflow, such as the sale of a division, or it may simply be that the company is generating more free cash flow than it needs to service its debt.[14]

Stock repurchases are usually made in one of three ways: (1) A publicly owned firm can buy back its own stock through a broker on the open market.[15] (2) The firm can make a tender offer, under which it permits stockholders to send in (that is, "tender") shares in exchange for a specified price per share. In this case, the firm generally indicates that it will buy up to a specified number of shares within a stated time period (usually about two weeks). If more shares are tendered than the company wants to buy, purchases are made on a pro rata basis. (3) The firm can purchase a block of shares from one large holder on a negotiated basis. This is a targeted stock repurchase as discussed in Chapter 15

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COMPARISON OF DIVIDENDS AND REPURCHASES

The advantages of repurchases are as follows:

1. Repurchase announcements are viewed as positive signals by investors because the repurchase is often motivated by management's belief that the firm's shares are undervalued.
2. The stockholders have a choice when the firm distributes cash by repurchasing stock—they can sell or not sell. Thus, those stockholders who need cash can sell back some of their shares, while those who do not want additional cash can simply retain their stock. With a cash dividend, on the other hand, stockholders must accept a dividend payment.
3. Dividends are "sticky" in the short run because managements are reluctant to raise the dividend if the increase cannot be maintained in the future—managements dislike cutting cash dividends because of the negative signal a cut gives. Hence, if the excess cash flow is thought to be only temporary, management may prefer to make the distribution in the form of a share repurchase rather than to declare an increased cash dividend that cannot be maintained.
4. Companies can use the residual model to set a *target cash distribution* level, then divide the distribution into a *dividend component* and a *repurchase component*. The dividend payout ratio will be relatively low, but the dividend itself will be relatively secure, and it will grow as a result of the declining number of shares outstanding. The company has more flexibility in adjusting the total distribution than it would if the entire distribution were in the form of cash dividends, because repurchases can be varied from year to year without giving off adverse signals. This procedure, which is what Florida Power and Light employed, has much to recommend it, and it is one reason for the dramatic increase in the volume of share repurchases.
5. Repurchases can be used to produce large-scale changes in capital structures. For example, several years ago Consolidated Edison decided to borrow $400 million and use the funds to repurchase some of its common stock. Thus, Con Ed was able to quickly change its capital structure.

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6. Companies that use stock options as an important component of employee compensation can repurchase shares and then use those shares when employees exercise their options. This avoids having to issue new shares and thus diluting earnings. Microsoft and other high-tech companies have used this procedure in recent years.

Disadvantages of repurchases include the following:

1. Stockholders may not be indifferent between dividends and capital gains, and the price of the stock might benefit more from cash dividends than from repurchases. Cash dividends are generally dependable, but repurchases are not.
2. The *selling* stockholders may not be fully aware of all the implications of a repurchase, or they may not have all the pertinent information about the corporation's present and future activities. However, firms generally announce repurchase programs before embarking on them to avoid potential stockholder suits.
3. The corporation may pay too much for the repurchased stock, to the disadvantage of remaining stockholders. If the firm seeks to acquire a relatively large amount of its stock, then the price may be bid above its equilibrium level and then fall after the firm ceases its repurchase operations.

When all the pros and cons on stock repurchases versus dividends have been totaled, where do we stand? Our conclusions may be summarized as follows:

1. Because of the deferred tax on capital gains, repurchases have a tax advantage over dividends as a way to distribute income to stockholders. This advantage is reinforced by the fact that repurchases provide cash to stockholders who want cash while allowing those who do not need current cash to delay its receipt. On the other hand, dividends are more dependable and are thus better suited for those who need a steady source of income.
2. Because of signaling effects, companies should not vary their dividends—that would lower investors' confidence in the company and adversely affect its cost of equity and its stock price. However, cash flows vary over time, as do investment opportunities, so the "proper" dividend in the residual model sense varies. To get around this problem, a company can set its dividend low enough to keep dividend payments from constraining operations and then use repurchases on a more or less regular basis to distribute excess cash. Such a procedure would provide regular, dependable dividends plus additional cash flow to those stockholders who want it.
3. Repurchases are also useful when a firm wants to make a large shift in its capital structure, wants to distribute cash from a one-time event such as the sale of a division, or wants to obtain shares for use in an employee stock option plan.

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