CHAPTER I INTRODUCTION

1.1 Concept of Financial Management

Financial management is connected to the inflow and outflow of funds. It is considered as a key determinant of the success of any business function. This is the reason that finance is called the lifeblood of business. Production, marketing and finance are the key functioning areas in case of any business activity out of which the finance is the most essential area. It is so because the functions of production and marketing are also related to finance. The decision regarding funds may make or destroy the organisation. (Inamdar, 2004) \(^1\). Therefore, decisions pertaining to finance are very fundamental and financial manager has to be more cognisant while taking them.

With a change in times, the concepts of finance and decisions pertaining to finance have changed. Even the elucidation of the term finance function has been undergoing invariable changes from time to time. The various views on the finance can be classified into three following categories:

**Traditional Approach:** The traditional phase lasted for four decades till 1950. According to this primary approach, the term finance was limited to procurement of funds only with a view to meet financing needs
The approach covered the following issues of the corporate enterprises (Dewing, 1918):

1) The focus was mainly on creation, issuance of capital, major growth, merger, reorganisation and insolvency of the corporate enterprises.

2) It also included instruments of financing for raising the funds and the institutions and procedures used in capital markets thereof.

3) It was seen from the investment bankers, lenders and other external stakeholders’ perspective only.

**Extensive Approach:** Under this approach, finance is concerned with cash because all the dealings of business endeavours are expressed in terms of the money. Thus, it is a wide approach covering various business functions i.e. Production, Marketing, Purchasing, personnel administration, research and Development and so on. As it is too broad and impractical, it is not so momentous and has to be leftover.

**Modern Approach:** The modern approach is the practical approach. It came into force in 1950. It focused not only on procurement of funds but effective utilisation thereof also. In broad sense, it is viewed as a vital component of overall management (Khan and Jain, 2010). The main contents of this approach are listed as under (Solomon, 1969):
(1) What is the total volume of funds an enterprise should commit?

(2) What specific assets should an enterprise acquire?

(3) How should the funds required be financed?
1.2 Decisions in Financial Management

In short financing consists of the raising, providing, managing of all the money, capital or funds of any kind to be used in connection with the business. Thus as per the modern phase the scope of the term finance function is concerned with the following three types of decisions:

1) **Investment Decision**: Investment decision is concerned with the selection of the assets in which raised funds should be invested. Company can make an investment of funds in following two types of assets.

**Long term assets**: These are the assets which the yield returns over a period of time. For taking investment decision related to long term assets, method of capital budgeting is used and decide that whether investment will be beneficial or not in future in terms of return.

**Short term assets**: These are the assets which are created in the normal course of business and which are converted into cash usually within a year. Working capital management can be utilised for taking investment decision of short term assets and come to a decision about the quantity of funds invested in short term assets to maintain the balance between liquidity and profitability.
2) **Financing Decision:** At the centre of financing decision is the problem of capital structure for instance how much finance to obtain through shares and how much of it should be obtained through debentures and other long term debts. There are two aspects of the financing decision. One dimension of the financing decision whether there is an optimum capital structure (reasonable proportion of debt and equity) and in what proportion should funds be raised to maximise the return to the shareholders? The second aspect of the financing decision is the determination of an appropriate capital structure given the facts of a particular case. (Khan and Jain, 2010).vi.

3) **Dividend Decision:** When profit is earned by the company, it has two alternatives (1) Profit is distributed as dividend to shareholders (2) Profit is retained in the company itself. Final alternative will be selected after considering preference of the shareholders, factors determining dividend policy and profitable investment opportunities available within the company

The concrete framework for optimum financial decisions is the goal of the financial management. In other words, to make optimum financial decision a clear understanding of the objectives of the company is essential. These objectives are as follows.
Profit maximization: According to basic principle, the main objective of any business activity is to earn profit. Similarly the main goal of the finance function is also to earn profit as per conventional belief. But now profit cannot be the only goal of the finance function because of following reasons:

1) Which type of profit should be maximized? Whether long term profit or short term profit, before tax profit or after tax profit and so on.

2) To earn more profit sometimes company ignores the risk factor.

3) To achieve the goal of profit maximization time pattern of returns is ignored.

4) Social and moral essentials are not taken in to consideration.

Wealth Maximisation: The dividend policy of a firm aims at the maximising of the owner’s wealth. It is formulated not merely to increase the share price in the short run but to maximise the owners’ wealth in the long run. The shareholders’ may not fully appreciate such a dividend policy and may prefer immediate dividends to future dividends and capital gains and the share prices may drop in the market. It is the responsibility
of the management to make the owners aware of the objectives and implication of the dividend policy so that the market reaction is favourable. Wealth maximisation objective would remain a sheer dream in the absence of the adequate finances. One of the important sources of long term finances is retained earnings. The management has to decide what shall be the proper ratio between dividends and retained earnings so that the twin objectives of the short term interest of the shareholders and long term gain of expansion are released.
1.3 Basic Issues Involved in Dividend Policy

**Cost of capital:** One of the considerations for taking a decision whether to distribute dividend or not is cost of capital. The board calculates the ratio of rupee profits, the business expects to earn (Ra) to the rupee profits that the shareholders can expect to earn outside (Re) i.e. Re/Ra. If the ratio is less than one, it is a signal to distribute dividend and if it is more than one, the distribution of dividend will be discontinued.

**Realisation of Objectives:** In formulating the dividend policy the main objectives of the firm i.e. maximisation of wealth for shareholders including the current rate of dividend should be aimed at.

**Shareholder Group:** Dividend policy affects the shareholders group. A company with low pay-out heavy reinvestment attracts shareholders interested in capital gains rather than in current income. On the contrary, a company with high dividend pay-out attracts those who are interested in current income.

**Release of Corporate Earnings:** Dividend distribution is a means of distributing unused funds. By varying its dividend payout ratio, dividend policy affects the shareholders’ wealth. The financial manager decides in dividend policy, whether to release corporate earnings or not.
1.4 Determinants of Dividend Payment Decision

One of the factors that affect Shareholders wealth is Dividend Payment Decision. Increase and decrease therein is determined by the management’s decision on Dividend. Simultaneously, there are several determinants that affect the decision pertaining to dividend payment. In this section, an attempt to focus light on the various determinants affecting dividend payment decision has been made. Following are the determinants thereof:

**Dividend Payout Ratio:** An investor primarily should invest in equity shares of a company with high pay-out ratio. It doesn’t mean that a company having low-pay-out ratio is financially weak company because it may like to finance expansion and diversification out of income earned and thus low-pay-out ratio. An investor interested in stock-price appreciation may well invest in such a company even though the pay-out ratio is low. Therefore, the dividend pay-out ratio has been used as the dependent variable in this study. The following formula has been used:  
Dividend pay-out ratio = Dividend per Share/ Earning per Share. The dividend payout ratio of a firm should be determined with reference to two basic objectives – maximising the wealth of the firm’s owners and providing sufficient funds to finance growth. These objectives are mutually exclusive, but interrelated. Dividend payment should not be
viewed as a residual, but rather a required outlay after which any remaining funds can be reinvested in the firm. (Gitman, L. J., 1976)\textsuperscript{vii}

**Stability of dividends:** Irrespective of the long-run payout ratio followed, the fluctuations in the year-to-year dividends may be determined mainly by one of the following strategy:

1. **Stable dividend payout ratio:** As per this course of action, the percentage of earnings paid out as dividends remain constant. It means dividends vary in line with earnings. As a result, when the earnings of a firm decline substantially or there is a loss in a given period, the dividends, according to the target payout ratio, would be low or nil. Hence such a policy rarely adopted by the firm.

2. **Stable dividends or steadily changing dividends:** As per this policy company pays dividend as a per cent of the paid up capital per share. This can be converted into dividend per share. As per this policy the rupee level of dividends remain stable or gradually increases or decreases in response to changes in earnings per share. This policy is followed by so many companies in India. According to this policy, when a company retains earnings in good years for this purpose, it earmarks this surplus as dividend equalisation reserve. These funds are invested in current assets like marketable
securities, so that they may easily be converted into cash at the
time of paying dividends in bad years. (I M Pandey, 2008)

**Legal constraints:** Government of every country puts certain
restrictions on payment of dividend in public interest. As per company
law management of every company has to frame dividend policy
keeping in mind all those restrictions. The important provisions in this
respect are as follows:

1. Dividend has to be paid in cash only. (with the exception of
   bonus shares)

2. A company can pay dividend only out of profits earned during
   the financial year after providing for depreciation and after
   transferring to reserves such percentage of profits as prescribed
   by law.

3. In case of inadequacy of profit in any year, dividends may be
   paid out of accumulated profits of previous years, subject to
certain restrictions.

**Owners’ perspectives:** As per this determinant following points are
taken into consideration while deciding dividend policy.

1. **The tax brackets of the owners:** If a firm has a large percentage
   of owners who are in high tax brackets, its dividend policy should
   seek to have higher retentions. On the other hand, if a company
has a majority low income shareholders who are in lower tax bracket they would probably prefer higher dividend.

2. **Availability of outer opportunities of investment:** While framing dividend policy, the evaluation of the outer investment opportunities of owners is very important. If evaluation shows that the owners have healthier opportunities outside, the company should follow for higher dividend payout ratio. On the other side, if reverse situation is there, the firm should opt low dividend payout ratio.

3. **Objective of control and earnings of the owners:** Because of above objectives dividend policy is affected. If owners wish to retain control of the company in their own hands, company will follow low dividend payout ratio and opt high retention ratio and vice-a-versa. Same way in case of objective of earnings, the financial manager has to remain in constant touch with the owner’s general attitude towards dividend.

**Capital market’s perspective:** This determinant also affects the dividend policy. If it is easy for the firm to procure funds from the capital market, either because it is financially strong or large in size, it can pay high dividend but in opposite situation the firm is likely to adopt low dividend payout ratios.
1.5 Shareholders’ Wealth and Its Linkage with Dividend Policy

Decisions

It has been recognized by various research studies that a dividend policy could make significant impact on shareholders’ wealth when established and carefully followed. The goal of wealth maximisation is widely accepted goal of the business as it reconciles the varied, often conflicting, interest of the stakeholders. The interest in shareholders’ wealth is gaining momentum as a result of several recent developments:

1. The threat of corporate takeovers by those seeking undervalued, under managed assets

2. Impressive endorsements by corporate leaders who have adopted the approach

3. The growing recognition that traditional accounting measures such as EPS and ROI are not reliably linked to the value of the company’s shares

4. Reporting of returns to shareholders along with other measures of performance in business press.

5. A growing recognition that executives’ long term compensation needs to be more closely tied to returns to shareholders.

The “shareholders value approach” estimates the economic value of an investment (e.g. shares of a company, strategies, mergers and acquisitions, capital expenditure) by discounting forecasted cash flows by
the cost of capital. These cash flows, in turn, serve as the foundation for shareholder returns from dividends and share price appreciation. A going concern must strive to enhance its cash generating ability. The ability of a company to distribute cash to its various constituencies depends on its ability to generate cash from operating its business and on its ability to obtain any additional funds needed from external sources. Debt and equity financing are two basic external sources. Borrowing power and the market value of the shares both depend on a company’s cash generating ability. The market value of the shares directly impacts the second source of financing, that is, equity financing. For a given level of funds required, the higher the share price, the less dilution will be borne by current shareholders. Therefore, management’s financial power to deal effectively with corporate claimants also comes from increasing the value of the shares. This increase in value of shares can be brought about by rewarding shareholder with returns from dividends and capital gains.

The most famous statement about the relationship between dividend policy and shareholders wealth claimed that, in the presence of perfect markets, “given a firm's investment policy, the dividend payout policy it chooses to follow will affect neither the current price of its shares nor the total return to its shareholders” However, "market imperfections as differential tax rates, information asymmetries between insiders and outsiders, conflicts of interest between managers and shareholders,
transaction costs, flotation costs, and irrational investor behaviour might make the dividend decision relevant’

The relevance of dividend policy to shareholders' wealth is due to market imperfections. Shareholders can receive the return on their investment either in the form of dividends or in the form of capital gains. Dividends constitute an almost immediate cash payment without requiring any selling of shares. On the contrary, capital gains or losses are defined as the difference between the sell and buy price of shares. Friction costs are one of the market imperfections and are further distinguished in transaction costs, floatation costs and taxes. Another market imperfection is that of information asymmetries between the insiders (e.g. managers) and the outsiders (e.g. investors). Agency conflicts, stemming from the different objectives of company's stakeholders, form the third market imperfection. Finally, there are some other issues that are related to dividend policy and cannot be placed among the previously mentioned imperfections.
1.6 Dividend Policy and Agency Problems

The level of dividend payments is in part determined by shareholders preference as implemented by their management representatives. However, the impact of dividend payments is borne by a variety of claim holders, including debt holders, managers, and supplier. The agency relationship exists between

- The shareholders versus debt holders conflict, and
- The shareholder versus management conflict

Shareholders are the sole receipts of dividends, prefer to have large dividend payments, all else being equal; conversely, creditors prefer to restrict dividend payments to maximize the firm’s resources that are available to repay their claims. The empirical evidence discussed is consistent with the view that dividends transfer assets from the corporate pool to the exclusive ownership of the shareholders, which negatively affects the safety of claims of debt holders.

In terms of shareholder- manager relationships, all else being equal, managers, whose compensation (pecuniary and otherwise) is tied to firm profitability and size, are interested in low dividend payout levels. A low dividend payout maximizes the size of the assets under management control, maximizes management flexibility in choosing investments, and reduces the need to turn to capital markets to finance investments. Shareholders, desiring managerial the need to turn to capital markets to
finance investments. Shareholders, desiring managerial efficiency in investment decisions, prefer to leave little discretionary cash in management’s hands and to force managers to turn to capital markets to fund investments. These markets provide monitoring services that discipline managers. Accordingly, shareholders can use dividend policy to encourage managers to look after their owners’ best interests; higher payouts provide more monitoring by the capital markets and more managerial discipline.

La Porta, Lopez- de – Silannes, Shleifer, and Vishny (2000)\textsuperscript{ix}, have argued that a legal environment provides strong protection to shareholders enables them to force companies to disgorge cash. The implication is that effective monitoring by shareholders in UK, where legal protection is strong, should be associated with higher dividend payments. Studies for the UK where empirical evidence on the relationship between dividends and ownership structures is rather limited show that there is a negative relationship between ‘inside’ ownership and dividends. However, evidence regarding financial institutions is not only limited but also contradictory: some researchers report a positive relationship between dividends and shareholding by financial institutions while others find a negative. Some of the important Research studies on agency conflicts have been also done by Jensen & Meckling (1986)\textsuperscript{x} and Agrawal and Jayaraman (1994)\textsuperscript{xi}.
1.7 Dividend Policy and Asymmetric Information

In a symmetrically informed market, all interested participants have the same information about a firm, including managers, bankers, shareholders, and others. However, if one group has superior information about the firm’s current situation and future prospects, an informational asymmetry exists. Most academics and financial practitioners believe that managers possess superior information about their firms relative to other interested parties. Dividend changes (increases and decreases), dividend initiations (first time dividends or resumption of dividends after lengthy hiatus), and elimination of dividend payments are announced regularly in the financial media. In response to such announcements, share prices usually increase following dividend increases and dividend initiations, and share prices usually decline following dividend cuts and dividend eliminations. The idea that dividend payouts can signal a firm’s prospects seems to be well accepted among the chief financial officers (CFOs) of large US corporations. In a survey of these executives conducted by Abrutyn and Turner (1990), 63% of the respondents ranked signalling explanation as the first reason for dividend payouts.

Keeping in view an importance of impact of Dividend Policy in determining shareholders’ wealth and also in corporate value, an attempt to study position of Indian pharma units has been made in this study.
1.8 Summary

From the above discussion, it is clear that dividends constitute an almost immediate cash payment without requiring any selling of shares. On the contrary, capital gains or losses are defined as the difference between the sell and buy price of shares. Friction costs are one of the market imperfections and are further distinguished in transaction costs, floatation costs and taxes. Another market imperfection is that of information asymmetries between the insiders (e.g. managers) and the outsiders (e.g. investors). Agency conflicts, stemming from the different objectives of company's stakeholders, form the third market imperfection. Finally, there are some other issues that are related to dividend policy and cannot be placed among the previously mentioned imperfections.

Therefore, an attempt to study the impact of dividend policy on shareholders’ wealth of various pharmaceutical units in India has been made so as to suggest ways and means to strengthen their roots and compete with global players.