Payment of dividend – Sec-123 (Part-1)

1. Legislative Background

The notes on clauses to the Companies Bill, 2011 read as follows:

"Clause 123. — This clause corresponds to section 205 of the Companies Act, 1956 and seeks to provide that dividend shall be declared by a company for any financial year at a general meeting out of the profits for that year or any previous year or years arrived at after providing for depreciation or out of money provided by the Central Government or a State Government for the payment of dividend and no dividend shall be declared or paid by company from its reserves other than free reserves. However, before the declaration of any dividend certain percentage of profit may be transferred to the reserves of the company. In case of inadequacy of profits or absence of profit in any financial year subject to dividend can be declared out of accumulated profits transferred to reserves such rules as may be made by the Central Government in this behalf. The clause provides that the depreciation shall be provided in accordance with Schedule II to the Act. The Board may declare interim dividend out of profits. The amount of dividend shall be deposited in a scheduled bank in separate account within five days. Dividend may be paid by cheque or warrant or in any electronic mode to the shareholders entitled to the payment of dividend. No dividend can be declared in the event of failure to repay the deposits accepted by company. Capitalization of profits for issuing bonus shares is not prohibited."

2. Meaning of the term 'dividend'

The term 'dividend' is defined in clause (35) of section 2 the Act to mean "dividend" includes any interimdividend. Therefore, it can be said that the term 'Dividend' per se is not defined under the Act; however, only interim dividend is made part of it.

The term 'dividend' takes its root from Latin noun 'dividenda' which means 'something to be divided'. The meaning of the term 'dividend' as defined in jurisprudence is a share of profit, whether at a fixed rate or otherwise, allocated to the holder of share in the company as held in Henry v. Great Northern Railway Company *[(1857) 1 De G&J 606]*. It was also held that dividend payment usually occurs periodically. Where profits are distributed outside these periodic dates, these are usually referred to as "bonuses or bonus dividend" as held in Griffith, Carr v. Griffith *[(1879) 12 ChD 655]*. Preference dividends are the dividends paid in relation to shares that have preferential rights over other shares.

It was held in Kantilal Manilal and Ors v. The Commissioner of Income-Tax, Bombay *[1961 SCR (2) 584]* that "Dividend" in its ordinary meaning is a distributive share of the profits or income of a company given to its shareholders'. Further elaborating this point, it was held in Navnitlal C. Javeri v. K. K. Sen, Appellate Assistant Commissioner of Income Tax *[1965 SCR (1) 909]* that 'The essence of an amount paid as dividend is that it has to represent the proportionate amount a particular shareholder is to get on the basis of the shares held by him out of the profits of the company set apart for payment of dividend to shareholders. Any ad hoc payment of money to a shareholder as advance or loan unrelated to his share in the accumulated profits cannot rationally come within the expression "dividend" '.

As per Black's Law dictionary *[9th Edition, Page 547]*, dividend is 'A portion of a company's earnings or profits distributed pro rata to its shareholders, usu. in the form of cash or additional shares'. It is a share allotted to each of several persons entitled to a share in a division of profits or property. Hence, dividend may denote a fund set apart by a company out of its profits, to be apportioned among the shareholders, or the proportional amount falling to each shareholder.

Therefore, dividend is a return on the share capital subscribed for and paid to its shareholders by a company. In simple words, dividend means the payment made by a company to its shareholders out of its distributable profits.

In the UK Companies Act, 2006, the term 'distribution' is used for denoting payments to members. It is defined in sub-section (1) of section 829 of the UK Companies Act 2006 as follows: 'In this Part "distribution" means every description of distribution of a company's assets to its members, whether in cash or otherwise, subject to the following exceptions.' Sub-section (2) of the same section provides the exceptions for the same in the form of bonus shares, reduction of share capital, redemption or purchase of shares and distribution of assets on winding up.

3. Type of companies allowed to pay dividend

Dividend can be paid by all types of companies except section 8 companies (i.e companies with charitable objects etc.) which prohibit the payment of any dividend to its members. These companies apply the profits in promoting their objects. In case of producer companies, dividend is termed as 'Limited Return' as defined in clause (c) of section 581A of the Companies Act, 1956. It is the maximum rate of dividend as the Articles of the producer company may specify. Another form of giving benefit to the members of the producer company is by way of 'Patronage Bonus'. As there are no corresponding sections with respect to producer companies under the Act, the relevant sections of Companies Act, 1956 under Part IXA continue to be in force.

4. Proportionate dividend

Section 51 of the Act provides that a company may, if so authorised by its articles, pay dividend in proportion to the amount paid-up on each share. Hence, only in cases where the Articles provide that dividend shall be payable in proportion to the amount paid up on each share, dividend shall be paid in proportion to the amount paid up. However, where the Articles are silent and specifically exclude Table F, dividend shall be paid uniformly on each share irrespective of the amount paid up.

Further, as per sub-regulation (3) of regulation 41 of the SEBI (LODR) Regulations, 2015, the listed entity is prohibited from issuing shares in any manner which may confer on any person, superior rights as to voting or dividend vis-à-vis the rights on equity shares that are already listed. Regulation 83(iii) of Table F of Schedule I of the Act states that if shares with differential rights have been issued, dividend will be declared and paid on the basis of terms of issue.

As per regulation 43of SEBI (LODR) Regulations, 2015, the listed companies are mandated to declare and disclose the dividend on per share basis only.

5. Dividend v. Interest

Dividend is a distribution of a company's earnings to its shareholders. Dividend is not an expense of the company.

Interest on bonds and other debt is an expense of the company. The interest, being an expense, reduces the company's net income and consequently its taxable profits.

Interest is charged against the profit of the company whereas dividend is the appropriation of profit. Dividend is appropriation of profit which is arrived after providing for all expenses including interest. On the other hand, the interest is a liability which has to be discharged even if the company has suffered losses. Hence, interest and dividend are not the same. Interest is always a commitment which is to be paid by the borrower as per the terms decided between lender and borrower whereas dividend is not a commitment.

6. Manner of payment of dividend

A company may pay dividend

(1) out of the profits of the company for that year arrived at after providing for depreciation or out of the profits of the company for any previous financial year or years arrived at after providing for depreciation and remaining undistributed, or out of both; or

(2) out of money provided by the Central Government or a State Government for the payment of dividend by the company in pursuance of a guarantee given by that Government; or

(3) out of the accumulated profits earned by it in previous years and transferred by the company to the reserves in case of inadequacy or absence of profits in any financial year.

The Companies (Declaration and Payment of Dividend) Rules, 2014 set out the provisions in relation to declaration of dividend by a company out of the reserves. Final Dividend can be declared at the annual general meeting only, the Board of Directors proposes and the members declare the same as held in Raghunandan Neotia v. Swadeshi Cloth dealers Ltd *[AIR 1964 Cal 247, 68CWN 302].*

No enhancement of rate of dividend than that recommended by the Board is possible as it was held in Maharani Lalita Rajya Lakshmi v Indian Motor Co (Hazaribag) Ltd *[(1962) 32Comp Cas 207(Cal)(DB)]*.

Further, it was also held in the case of Tarajan TeaCo. (P) Ltd. v CIT *[(1994)13CLA 75(Gau)]*, that a dividend declared by the members at an annual general meeting is a debt against the company and is recoverable by the members only after declaration by members and not at the time of recommendation made by the board of directors.

7. Meaning of 'Profit'

For thepurpose of the Act, profit is the surplus amount lying in the profit and loss account of the company which is being transferred to the Balance Sheet. A recommendation made by JJ Irani Committee, 2005 at Point 17 of the Report which reads as follows:

"After a detailed debate relating to declaration of dividend only out of the profits of the Company arrived at after complying with the Accounting Standards, the Committee endorse this principle for declaration of dividend."

As per Schedule III ofthe Act,

(i) Reserves and Surplus shall be classified as:

- (a) Capital Reserves;
- (b) Capital Redemption Reserve;
- (c) Securities Premium Reserve;
- (d) Debenture Redemption Reserve;
- (e) Revaluation Reserve;
- (f) Share Options Outstanding Account;
- (g) Other Reserves–(specify the nature and purpose of each reserve and the amount in respect thereof);
- (h) Surplus i.e., balance in Statement of Profit and Loss disclosing allocations and appropriations suchas dividend, bonus shares and transfer to/ from reserves, etc.; (Additions and deductions since last balance sheet to be shown under each of the specified heads);

(ii) A reserve specifically represented by earmarked investments shall be termed as a "fund".

(iii) Debit balance of statement of profit and loss shall be shown as a negative figure under the head "Surplus". Similarly, the balance of "Reserves Surplus after adjusting negative balance of surplus, if any, shall be shown under the head "Reserves and Surplus" even if the resulting figure is in the negative.

(iv) Surplus i.e., balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves, etc..

(Additions and deductions since last balance sheet to be shown under each of the specified heads); Therefore, surplus is to be shown after disclosing allocations and appropriations such as dividend.

8. No compulsory transfer to reserve

Proviso to sub-section (1) of section 123 provides that a company may, before the declaration of any dividend in any financial year, transfer such percentage of its profits for that financial year as it may consider appropriate to the reserves of the company.

Therefore, it is not obligatory on the part of the company to transfer any percentage of its profit for the financial year to the reserves. However, company may voluntarily choose to transfer any sum which it thinks appropriate to the reserves of the company.

This provision is in accordance with the recommendation made by JJ Irani Committee in its report wherein the committee took a view that 'transfer of profit to reserve is irrelevant in the present environment and may be deleted'.

Traditionally there is a tendency among the promoters not to transfer profits to general reserves but to keep as surplus needs to be reviewed since the definition of free reserves currently excludes the surplus in profit of the company. In order to gain the limit base advantages under the Act promoters may voluntarily think of transferring more profits to general reserves.

9. Depreciation

It is mandatory to provide for the depreciation in accordance with the provisions of schedule II of the Act as per the provisions of sub-sections (1) and (2) of section 123.

Depreciation is the systematic allocation of the depreciable amount of an asset over its useful life. The depreciable amount of an asset is the cost of an asset or other amount substituted for cost, less its residual value.

The useful life of an asset is the period over which an asset is expected to be available for use by an entity, or the number of production or similar units expected to be obtained from the asset by the entity. The term depreciation includes amortization.

(To be continued...)

Contents of Geeta Saar, as extracted from ICSI Premier on Company Law, is as per notified law as on 30th September, 2016.