GUIDANCE NOTE ON DIVIDEND

The "Secretarial Standard on Dividend" (SS-3), formulated by the Secretarial Standards Board (SSB) of the Institute of Company Secretaries of India (ICSI) and issued by the Council of the ICSI, has been effective from 1st January 2018. Adherence to SS-3 is recommendatory.

This Guidance Note sets out the explanations, procedures and practical aspects in respect of the provisions contained in SS-3 to facilitate compliance thereof by the stakeholders.

INTRODUCTION

Dividend is a return on the investment made in the share capital of a company, as distinct from the return on borrowed capital, which is in the form of interest.

In commercial usage, the term "Dividend" refers to the share of profits of a company that is distributed amongst its Members.

The term "Dividend" has been inclusively defined in the Act to the effect that it includes Interim Dividend. The Act neither specifically defines the term Dividend nor makes any distinction between Interim and Final Dividend.

For the purposes of SS-3, capitalization of profits in the form of bonus shares is not Dividend.

The allotment of bonus shares does not entail release of any of the assets of the company. The existing shareholders, instead of receiving any moneys out of the undistributed profits, only receive pro rata fresh shares [Sivagnanamal v. Thirumagal Mills Ltd., (1948) 18 Comp. Cases 286 AIR 1949 Mad 521]. There is no distribution of profits among shareholders and hence capitalization of profits in the form of bonus shares would not be construed as Dividend in terms of the Act and for the purposes of this Guidance Note.

Companies licensed under Section 8 of the Companies Act, 2013 or corresponding provisions of any previous enactment thereof are prohibited by their constitution from paying any Dividend to its Members.

SCOPE

SS-3 prescribes a set of principles in relation to the declaration and payment of Dividend and matters related thereto. These are equally applicable to Final as well as Interim Dividend unless otherwise stated.

The principles set out in SS-3 relate to declaration and payment of Dividend on equity as well as preference share capital in accordance with the provisions of the Act and are in respect of Dividend as it relates to a going concern.

Distribution of any amount of profits or assets by the liquidator during winding up or liquidation will not be construed as Dividend.

The principles enunciated in SS-3 are in conformity with the provisions of the Act. In addition, the provisions of the Securities Contracts (Regulation) Act, 1956 and the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 are applicable to listed companies. Any specific provision relating to Dividend in the Income-tax Act, 1961 or under any other statute shall also be applicable. If due to subsequent changes in the Act or other applicable laws, a particular Standard or any part thereof becomes inconsistent with the Act or other applicable laws, the provisions of the Act or such applicable laws shall prevail.

SS-3 shall not apply to a company limited by guarantee not having share capital and does not deal with Dividend, if any, declared by companies under liquidation.

DEFINITIONS

The following terms are used in this Guidance Note with the meaning specified:

"Act" means the Companies Act, 2013 (Act No. 18 of 2013) or any previous enactment thereof, or any statutory modification thereto or re-enactment thereof and includes any Rules and Regulations framed thereunder.

"Dividend" means a distribution of any sums to Members out of profits and wherever permitted out of free reserves available for the purpose.

"*Final Dividend"* means the Dividend recommended by the Board of Directors and declared by the Members at an Annual General Meeting.

"Interim Dividend" means the Dividend declared by the Board of Directors.

"Free Reserves" means such reserves which, as per the latest audited balance sheet of a company, are available for distribution as Dividend. However, the following amount shall not be treated as free reserves:

(i) any amount representing unrealised gains, notional gains or revaluation of assets, whether shown as reserve or otherwise, or

(ii) any change in carrying amount of an asset or of a liability recognised in equity, including surplus in profit and loss account on measurement of the asset or the liability at fair value.

"*Member*", in relation to a company, means –

(i) the subscriber to the memorandum of the company who shall be deemed to have agreed to become member of the company, and on its registration, shall be entered as member in its register of members

(ii) every other person who agrees in writing to become a member of the company and whose name is entered in the register of members of the company;

(iii) every person holding shares of the company and whose name is entered as a beneficial owner in the records of a depository;

"Preference Shareholder" means a holder of such shares which carry a preferential right, in respect of payment of Dividend, of a fixed amount or an amount calculated at a fixed rate and in respect of capital, to repayment of capital.

"Shareholder" means a Member as defined above and, where the context requires or admits, includes a Preference Shareholder.

"*Listing Regulations*" means the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, including any amendment thereto.

Words and expressions used and not defined herein shall have the meaning respectively assigned to them under the Act or other applicable laws.

GUIDANCE ON THE PROVISIONS OF SS-3

1. Ascertainment of amount available for payment/distribution as Dividend.

1.1 Out of profits

1.1.1 Dividend shall be paid out of the profits of the financial year for which such Dividend is sought to be declared and/or out of profits for any previous financial year(s) which remains undistributed after providing for depreciation in accordance with the provisions of the Act. Dividend may also be declared

out of money provided by the Central Government or a State Government in pursuance of a guarantee given by such Government for this purpose.

No Dividend shall be declared or paid by a company for any financial year except –

(a) out of the profits of the company for that year arrived at after providing for depreciation in accordance with the provisions of Schedule II to the Act, or out of the profits of the company for any previous financial year or years arrived at after providing for depreciation in accordance with the provisions of that sub-section and remaining undistributed, or out of both;

Provided that in computing profits any amount representing unrealised gains, notional gains or revaluation of assets and any change in carrying amount of an asset or of a liability on measurement of the asset or the liability at fair value shall be excluded; or

(b) 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. [sub-section (1) of Section 123 of the Act]

This is to clarify that the declaration of Dividend out of profits for previous years which are disclosed under the head 'Surplus' in the Financial Statements will not tantamount to declaration of Dividend out of reserves and accordingly will not attract the statutory requirements relating to declaration of Dividend out of reserves.

Dividend shall not be declared unless carried over previous losses and depreciation not provided in the previous year(s) are set off against the profit of the company for the current year. The company may, before declaration of Dividend, transfer such percentage of profits for that financial year, as it may consider appropriate, to its reserves.

In line with the requirements of Fourth Proviso to sub-section (1) of Section 123 of the Act, this Standard provides that no company shall declare Dividend unless carried over previous losses and depreciation not provided in the previous year or years are set off against profit of the company for the current year.

In addition, the First Proviso to sub-section (1) of Section 123 of the Act 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, the transfer of profits to reserves is left to the discretion of the Board of Directors of the company.*

Dividend, being a portion of the profits of the company, is distributable amongst the Members of the company in accordance with the provisions of the Act. The Act requires a company to prepare a statement of profit and loss, which should give a true and fair view of the profit or loss of the company for a financial year. The terms 'profit' and 'true and fair' have not been defined by the Act. Therefore, these terms should be understood in their natural and proper sense.

The Act does not define the term "Profit", which must, therefore, be understood in its natural and proper sense. In Re. Spanish Prospecting Co. Ltd (1911) 1 Ch 92, Moulton L.J. explained the term 'Profit' as under:

"Profit implies a comparison between the state of business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates. If the total assets of the business at the two dates are compared, the increase which they show at the later date as compared with the earlier date (due allowance, of course, being made for capital introduced into or taken out of the business in the mean while) represents, in strict sense, the profits of the business during the period in question".

Profit means the net proceeds of the company after deducting the necessary expenses without which those proceeds could not be earned [Bharat Insurance Co. Ltd., Lahore v. Commissioner of Income Tax (1931)1 Comp. Cases 192 (Lah)].

The statement of profit and loss shall be prepared in accordance with the generally accepted accounting principles, applicable accounting standards and presented in conformity with the requirements set out in the Act or other applicable laws.

Depreciation, as computed in accordance with Schedule II to the Act, shall be provided in the books of account of the company.

Sub-section (2) of Section 123 of the Act provides that the depreciation shall be provided in accordance with the provisions of Schedule II.

Depreciation is a measure of the loss of value of a depreciable asset arising from use, efflux of time or obsolescence through technological and market changes. Depreciation is allocated so as to charge a fair proportion of the *depreciable amount in each accounting period during the expected useful life of the asset. Depreciation includes amortization of assets whose useful life is pre-determined.*

The Act lays down the useful life of various assets. The depreciation rate is thus based on the useful life of an asset. Where the management estimates that the useful life of an asset is shorter than that envisaged under the provisions of the relevant statute, the depreciation provision is appropriately computed by applying a higher rate. However, if the management estimates that the useful life of the asset is longer than that envisaged under the statute, a rate lower than that envisaged in the statute can be applied only in accordance with the requirements of the statute.

Illustration

The useful life of building with RCC frame work is 60 years as per the schedule. Residual value as per Schedule II has to be taken at maximum 5%. A company which intends to apply the straight line method, can easily ascertain the same by dividing the amount of cost less residual value by 60 years. On the said basis the rate for straight line method would be 1.58%. However, to ascertain the rate of depreciation as per the written down value method, the following formula may be used instead of computing manually:

$$R = \left\{1 - \sqrt[n]{\frac{S}{c}}\right\} \times 100$$

WDV Method :

"R" Rate of Depreciation

"S" Scrap Value @ 0% to 5% (rounded-off) of Original Cost

"C" Cost remaining to be (further) depreciated

"n" Number of years

1.1.2 A company shall not declare Dividend on its equity shares in case of non-compliance of provisions relating to the acceptance of deposits under the Act, till such time the deposits accepted have been repaid with interest in accordance with the terms and conditions of the agreement entered with the depositors.

A company shall also not declare any Dividend, if it has defaulted in –

(a) Redemption of debentures or payment of interest thereon or creation of debenture redemption reserve,

(b) Redemption of preference shares or creation of capital redemption reserve,

(c) Payment of Dividend declared in the current or previous financial year(s), or

(d) Repayment of any term loan to a bank or financial institution or interest thereon,

till such time the default is subsisting.

No Dividend shall be declared by the company during the extended time, if any, granted by the Tribunal/Court for repayment of above liabilities.

In line with the requirements of sub-section (6) of Section 123 of the Act, paragraph 1.1.2 restricts declaration of Dividend on equity shares, if there is non-compliance of the provisions relating to the acceptance of deposits under the Act.

The term "any Dividend" used in the subsequent paragraph refers to declaration of Dividend on both equity and preference shares. Accordingly, as a good governance practice, the restrictions in clause (a) to (d) as stated above are equally made applicable to declaration of Dividend on equity as well as preference shares. In such cases, the Board should neither declare nor recommend any Dividend.

The above restrictions also get reference from Section 70 of the Act which prohibits Buy-Back of shares if a default is made by the company, in the repayment of deposits, interest payment thereon, redemption of debentures or preference shares or payment of Dividend to any shareholder, or repayment of any term loan or interest payable thereon to any financial institution or banking company.

Default in redemption of debentures/payment of interest thereon

The company shall create a Debenture Redemption Reserve for redemption of debentures, out of the profits of the company available for payment of Dividend. [Rule 18(7)(a) of the Companies (Share Capital and Debentures) Rules, 2014].

As a measure of good corporate governance, the Standard prohibits a company *from declaring any Dividend if it has subsisting default in redemption of debentures or payment of interest thereon.*

Where the Debenture Redemption Reserve is required to be created by the company in accordance with the Companies (Share Capital and Debentures) Rules, 2014 and the company has defaulted in creation of such reserve, then the company shall not declare any Dividend.

Default in redemption of preference shares or creation of Capital Redemption Reserve.

Preference shares issued by a company shall be redeemed out of the profits of the company which are available for payment of Dividend or out of proceeds of a fresh issue of shares made for the purposes of such redemption. In case it is proposed to redeem such shares out of the profits of the company, a sum equal to the nominal amount of the shares to be redeemed shall be transferred to a Capital Redemption Reserve account.

Therefore as a measure of good corporate governance, the Standard provides that the company should not declare Dividend if there is a subsisting default with regard to redemption of preference shares or creation of Capital Redemption Reserve. In case the preference shares are redeemed out of proceeds of a fresh issue of shares made for the purposes of such redemption, there is no need to create any Capital Redemption Reserve and in such cases Dividend may be declared without creation of Capital Redemption Reserve.

Default in payment of Dividend declared in the current or previous year(s).

No Dividend should be declared if there is default by company in payment of Dividend of current or previous year(s). Section 127 of the Act deals with penal provisions for the same. However, no specific restriction is placed on declaration of further Dividend. Therefore, as a measure of good corporate governance, the Standard prohibits a company from declaring any further Dividend in such cases.

Default in repayment of any term loan

In keeping with good corporate governance principles, the Standard prohibits a company from declaring any Dividend if it has a subsisting default in repayment of a loan to any bank or financial institution or interest thereon.

Impact of Extension of time by the Tribunal/Court

A company which fails to comply with the provisions of Sections 73 and 74