



BEHAVIOR OF DIVIDEND PAYOUT AND RETAINED EARNINGS: EVIDENCES FROM INDIAN COMPANIES

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Abstract

The relationship between corporate earnings, dividend payments, raising of funds from the capital market and borrowings (bank, institutional or retail) have varied significantly over decades in India. The changes in the payment ratio have had a significant effect not only on the current income of shareholders, but also on the value of corporate securities, total investment and the nation's economic growth. The objective of this research paper is to study whether Indian firms make greater use of internal funds on account of lesser payout or do they have better access to borrowings from various sources (including capital market). The paper also strives to reflect on empirical evidences to the corporate finance literature by emphasizing on financing & restructuring issues, namely firms' dividend policies that affects the payout and their capital structure decisions, in the context of Indian market.

Keywords: *Dividend policy, Dividend Payout Ratio, Retained Earnings, Determinants of Dividend Policy.*

Introduction

Net earnings or after tax profit of a firm can be used by a firm, partly or fully either for retention or for the payment of dividend to its equity and preference shareholders. Reserves and surpluses or retained earnings, are one of the major sources of financing long term needs for the existing companies. From the point of view of the ownership, retained earnings are considered as shareholders' funds since it represents a part of earnings which has not been distributed as dividends to the shareholders of an enterprise. In other words, had the entire profit been distributed, shareholders of the firm would have been in normal position of receiving dividends distributed by the firm which they would have reinvested once again back in the business or elsewhere after adjusting for the income taxes, if any. Retained earnings, from the cost of capital point of view can be compared to similar as equity capital. This is because dividend forgone by the equity shareholders in the form of retained earnings is a type of indirect investment in the firm in many cases, especially for similar projects where fund raising can be a bit of problem, or expensive, the need to finance long term uses could be met through retained earnings. For these companies, dividend decisions can become a less important issue than the issue to retain internally generated profits. In fact for all major financing objectives, the capital budget should start from planning of the use of retained earnings and finding the balancing source of funds.

It is true that internally generated funds play a very crucial role in financing the growing requirements of firms for assets expansion, replacement or diversification. Another important merit of these funds is their relatively low cost since all other sources have both implicit and explicit costs. The fact that the funds do not involve any flotation costs such as underwriting cost, brokerage, commission or even other miscellaneous costs such as publicity costs which are generally present for any public or right issue of shares or bonds, makes it cheaper. Unlike loans from banks or other financial institutions which normally work intermediaries between depositor (those who save) and users (the who borrow), internally generated funds have low cost also due to the absence of these intermediaries who work purely on the base of profit making objectives.

However, contrary to popular belief, retained earnings, which constitute a major chunk of internal funds, do entail a cost they may correspond to an opportunity cost to the shareholders who have forgone dividend when the board of directors take a decision retain, cut or skip dividend. Alternatively it could be viewed as opportunity cost to the firm which would invest the funds externally rather than retaining for the internal use. In first case after-tax-after expense dividend rate and in the latter event it would approximate to the external yield from an outside firm of the same risk class. Also equity is generally considered to be slightly costlier than debt capital especially for those firms which have not done financially too well. Moreover dividend on equity/preference capital is not deductible, unlike interest on loans, since dividend is paid on taxes. And if a firm has created large funds of internally generated profits, it may find, at least theoretically having a lesser overall cost of capital except that the retained earnings cost must be adjusted with floating costs.

Despite all these arguments in considering some cost for internally generated funds as well, the permanence of such funds minimize solvency risks too. A substantial proportion of expansion, both at a micro and a macro levels, is reported to have been financed through reinvestments. Corporate financing trends observed in countries like the USA and UK point to thrusts in internal funds synchronizing with zoom in assets expansion & capital formation. For instance, *Burns (1970)* Hypothesized that many business firms were able to finance their requirements whether for new plant and equipment's, or the accumulations of inventories or the carrying of receivables without any borrowing or without much borrowings



(Burns,1971). What business is to finance their requirements largely from internally generated funds, that is undistributed profits, depreciation allowances, shares premium and related charges. From 1960 through 2010, corporations in the U.S.A and U.K retained on an average 54 percent of their profits. Between 1960 and 2010, on the other hand retained corporate profit averaged only 33 percent in these countries. Deprecation funds and other allowances for capital consumption have likewise important in corporate financing. In all, internally generated funds of business corporations exceeded their externally generated funds –that is new capital issues, bank loans, trade debt and other liabilities by 42 percent during the decade 1947-56. Between 1960 and 2010, on the other hand corporate internal funds appear to have exceeded their external funds by about 10 to 20 percent in the US. Burns argues on the basis of this data that the growing importance of internal financing has reduced the reliance of business firm on externally generated funds so that they are hedged effectively against the ordinary fluctuation is the credit market.

Objectives of the study

It is pertinent to look into the major reasons for retaining a part of net earnings as retained earnings and its relationship with net profit and dividend and also find the trend in retained earnings in aggregate. In this study we will also look into the fact that despite having contributed enormously to the financing and growth of corporations in recent years, more work has been done to study the trends of retained earnings in India. Corporate financing trends in the advanced countries point to a synchronization of thrusts in internal funds with peak in asset expansion and capital formation.(Kuznets,1961). In this paper we will see whether similar trend can be noticed in the Indian situation. This will also help us to identify variables explaining the corporate saving behavior.. We will therefore attempt to address following issues henceforth:

1. The historical trend from 1950-60 to 2001-14 to see whether there has been any strong trend during the period towards internal finance for non-governmental companies in the private sector
2. To identify and isolate variables explaining the corporate saving behavior in the form of internal funds.

Literature Review

Lintner (1956) developed a model to explain the inter temporal behavior of dividend levels. The model assumes that a firm's target dividend level in year t (D_t^*) is related to the earnings in that year ($E_{sub t}$) by a target payout ratio (r). This payout ratio is a function of the firm's borrowing and investment opportunities and shareholders' marginal tax bands:

$$(1) D_t^* = rE_{sub t}$$

Stewart (1987), *Barrett and Cotter (1990)* and *Green and McIlkenny (1991)* provide empirical evidence from an analysis of published financial data, both at the aggregate and individual firm level, which supports the contention that the *Lintner (1956)* model is descriptive of the dividend policies.

There has been a considerable controversy on the true role of internal finance as a secular force *Lintner (1960)*, For instance, observed no long term trend toward increasing reliance about internal funds. Using evidence of the secular stability of the ratio of new common stock issues to all new securities finance, and assuming that short term financial trends were irrelevant. *Hiller (1963)* hypothesized that the ratio of new common stock to total new corporate finance was stable and finally inferred that the corporate propensity to save remained essentially unchanged (*Miller, Modigliani 1961*).

According to the *Miller and Modigliani (1961)* argument, under the assumptions of perfect capital markets, rational behavior, no taxation and zero transaction costs, the choice between the three alternative dividend policies above is irrelevant, as only investment policy determines firm value. It has, however, been suggested that if external financing costs are recognized e.g. issue costs, then a residual policy is preferred as such costs are minimized (see, for example, West and Bierman, 1968 and Van Home and McDonald, 1971). Assuming that a firms' profitability and investment opportunities vary over time, a residual dividend policy would result in dividend levels which similarly fluctuate over time. The empirical evidence documented above is consistent with Irish companies having a policy of dividend stability and consequently does not support this view of dividend behavior. Hence, it is a fundamental hypothesis of this paper that a residual dividend policy is not pursued by Irish companies.

An independent dividend policy implies that there is at least one motive for making dividend payments, other than to reduce surplus liquid funds. Within the framework of their stylized analysis, *Modigliani and Miller (1959)* recognize that management may use the change in dividend level to signal to investors expectations about the future economic performance of the company, but contend that this is a temporary phenomenon, as investors will be able to determine whether management's expectations are justified as information about future performance is obtained from other sources, such as realized earnings numbers (see *Ross 1977, Bhattacharya 1979 and Miller and Rock 1985*, for examples of signaling models). A number of studies have investigated whether dividends convey information (see *Taylor, 1979*, for a good analytical review of early studies and *Aharony and Swary, 1980, Kwan, 1981, Riding, 1984, Lobo, Nair and Song, 1986*) and in general have



concluded that there is some evidence to support the contention that dividends have information content. Partington (1985) surveyed the perceptions of senior managers in 93 large Australian companies and found that managers did perceive dividends to be important in signaling their views on future company profitability. Miller and Modigliani (1961), introduced the concept of "clientele effect". They proposed that a firm will tend to attract a 'clientele' consisting of those shareholders who prefer the particular payout ratio of the firm. If all clienteles are satisfied, their demands for high or low dividend will have no effect on company valuation (see, Black and Scholes, 1974, Miller and Scholes, 1978 and Miller, 1986). The clientele effect does, however, provide a possible motive for paying dividend, ie to maintain shareholder loyalty (see Pettit 1977 and Partington 1985, for empirical evidence on clientele effects).

However contrary Miller and Modigliani (1961) postulates, Partington (1985) suggested that senior managers believe that dividend payments support or increase share price. Previous studies have investigated the relationship between firm value and dividend levels (see, for example, Friend and Puckett 1964, Black and Scholes 1974, Long 1978, Miller and Scholes 1982, Litzenberger and Ramaswamy 1982 and Poterba 1986). The empirical evidence tends to favour the Miller and Modigliani (1961) view.

Several studies have relaxed the assumptions of no taxation in Miller and Modigliani (1961) analysis. (see, for example, Farrar and Selwyn (1967), Brennan (1970) and Miller and Scholes 1978). Masulis and Trueman (1986) model the investment and dividend decision with differential personal income tax and a zero rate of capital gains tax has the following two implications:

1. Firms with many profitable investment opportunities will use up all their internally generated funds without paying dividend, and mature firms will pay dividend because they may not have enough investment opportunities.
2. While a decrease in current earnings should leave unchanged the investment expenditures of externally financed firms, it is likely to decrease investment expenditures of firms that initially planned to internally finance all their investments. Such firms would be reluctant to raise external finance in order to meet planned investments. Thus the Masulis and Trueman (1986) model does recognise that interdependencies between dividend, investment and financing decisions may exist.

Historical Trends for internal funds

Table 1 summarizes the main trends and shifts in the relative share of internal and external funds as percentage of total resources, percentage of short term funds of total source, percentage of external funds to total sources, percentage of external funds to total sources and percentage of internal funds to external funds. Table 2 presents the same data over various years in India. The principal trends emerging from these data are presented below.

Internal Sources

As can be seen in Table 1, internal sources have become far important source of financing of assets requirements for the firms in private sector over most of the period between 1950-60 to 2000 - 14. Its proportion to overall funding has grown decade after decade and reached over 50 pc of total requirement between 2001 – 14. The growth seems to be most robust during the post liberalization period. One of the most striking aspects of the trend is the increasing reliance on internal accrual for financing needs than dependence of external sources. According to data, the ratio of retained profits to profits after tax (PAT) too has increased from 62.9 pc in the 1980s to 70.7 pc in the early 2000.

The data over the past 60 years also shows decade to decade fluctuations in some of the components. The highest level of internal funds was attained in 2010-14 when it reached a level of 64.5 percent. While during most of fifties .it was around 50 percent or more, in sixties they moved within a range of 40-50 percent of internal sources with the lowest of the decade at 40.1 percent in earlier years marked by industrial recession.

The recovery in the ratio started to improve once again to 46.0 percent in the early 2000. From than onward for the entire seventies and eighties, this ratio kept growing to attain average of 33 percent for 2010. It was during this decade only when percentage of internal fund came to the lowest level of 15.7 percent. How ever during the decade of 2001-14 shows once again a sharp recovery to 47.8 percent .

It is therefore evident from the data for the years that although internal funds remain one of the most important sources of funds, yet it has varied significantly over the decades. The table also shows that internal funds were more than one or even close to twice as important as external sources. For most of other years during the period, they held a nearly equal rank.



In earlier years, the relative share of internal funds in total sources could did not demonstrate any substantial change. Thereafter early 1990's, their share showed a highly appreciable change.

Statistical Analysis

Even the statistical analysis of data from table 2 indicate conclusions drawn so far . Both the internal funds and external funds were found to have high negative correlation to an extent of requirement of high internal funds, expect when the climate is excessively investment oriented. The correlation results are as under:

1. Between column 3 and column 4 - highly negative, i.e.-0.9579, which once again highlights the conclusion shown earlier.
2. On the other hand, while short terms funds and external funds were found to be somewhat positively correlated (+0.4402),
3. Short terms funds (external) were found somewhat negatively correlated (-0.441).

Both these results indicates that internal funds have not been the best alternative for short term funds and a large part of external funds constituted long term sources of finance such as equity or debt.

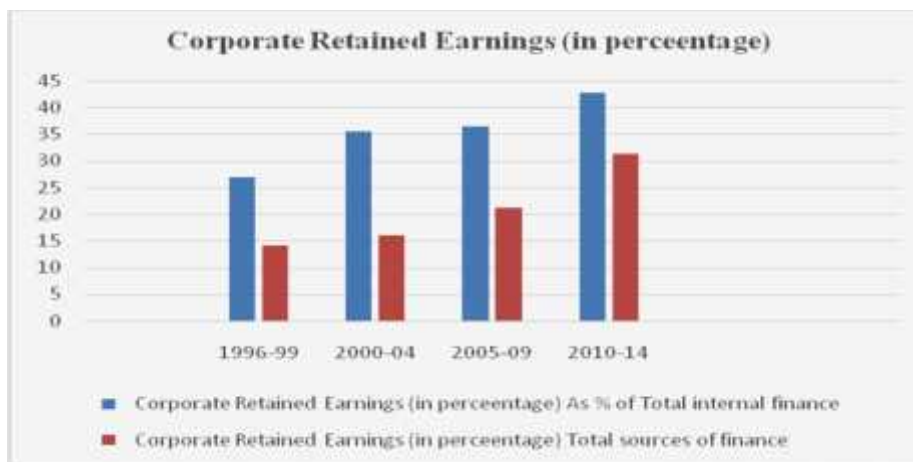
Results of regression analysis (y= a + bx) is as follows:

Dependent	Independent	Y = a + bx
Internal funds	External funds	= 100.03 - 1.008X ... (1)
External funds	Internal funds	= 99.91 + 0.999 X..... (2)
Short terms fund	Internal funds	= 59.96+ 0.449 X... .(3)

Equation 1 indicates that changes in External funds appear to be one of the important factors responsible for variations in the amount retained. Similar result is obtained in equation 2 .The Inverse relationship between external funds and internal funds is evident in equation 1. These equations however do indicate predictive trend of various sources of funds dependent on certain variables as sources .

Trends in Retentions

Aggregate data of sample firms in India for retentions as a part of internal source in given in Table 3. When retentions are expressed as a percentage of total sources, the upward trend starts only in early 2005. Prior to that retentions averaged at around 32 pc of total internal finance and just about 18-19 pc of the total source of finance. This is accounted for by the larger expansion of internal funds and short term funds in total funds. The trend shows consistent growth thereafter.



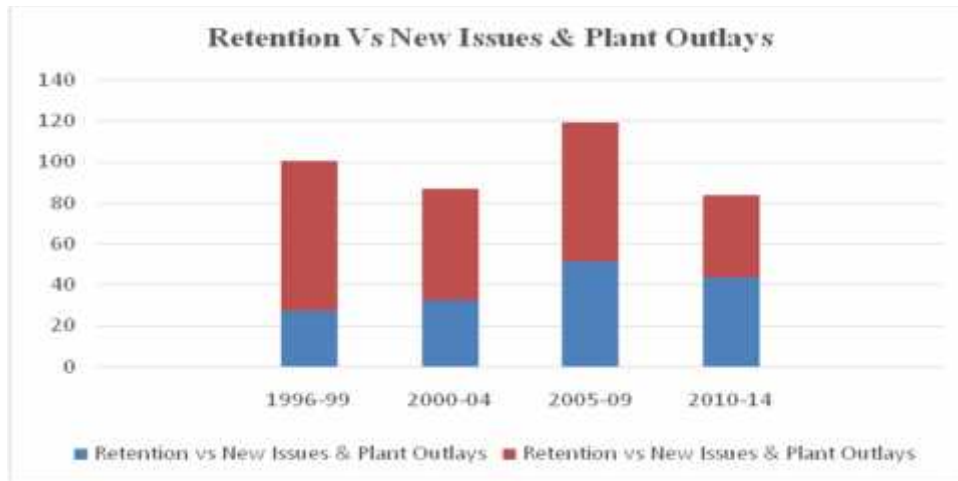
A very interesting trend is discerned when corporate retentions are compared with new stock and total equity over the entire period. Table 4 relates trends in retentions to those in new stock issues and total equity over various periods under study. It is evident that whenever retention rose, new stock issues fell significantly. A simple reason for this seems to be the fact that an important and a constantly rising component of total equity happens to be retained profits themselves. This increase that base for the ratio of retentions to total equity and moderate the wide swing .It would thus, be seen that retentions and new stock issues are largely substitutable sources and over long run, the former replaces the latter given the size of profitable investment projects . It was tentatively by hypothesized that this trend is best induced and has important implication for



financial management (Kishore, 1977). Easy access to the capital had made it easy for corporate to start replacing retentions or at least have made them insufficient to meet growing requirements of firms for investments.

Plants outlays and retentions

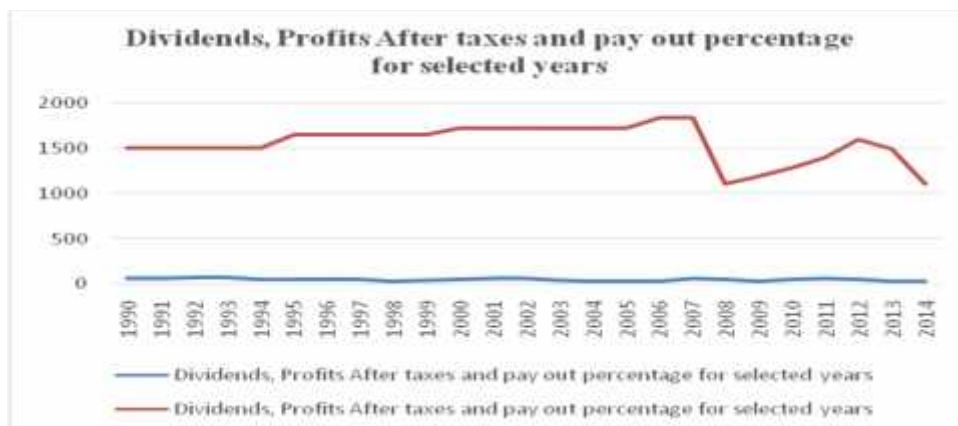
The Table 4 also shows role of retention in plant outlays. We have already noted so far that retained profits continue important sources of financing net assets expansion or addition. This holds especially true for a growing industrial sector which relies heavily on self-generated low cost funds for addition of physical plant and machinery. This table provides relevant data to examine the relationship and plant outlays over selected years of our study. It shows a positive strong correlation between retention and expenditure on



plant and equipment. A rise in the expenditure on plant all years under study resulted in the increase of retention as percentage of plant outlays. Thus the principal trends in this relationship between retention and plant layout are quite evident. In general, rising plant outlays were financed by a rising proportion of relationship and vice versa. However, in exceptional years of intensive investment activity not accompanied by an equal strong trend in retention.

Trends in Aggregate corporate Dividends

Estimate of various department on dividends and profits after taxes reveal several pronounced trends in the aggregate payout ratio of companies in the private sector. The aggregate payout ratio is the ratio of net corporate dividends to net profits after taxes and depreciation. It may be noted that variations in the payout ratio reflect changes in profits as well as direct adjustments of dividends, and thus are not necessarily indicative of short-run variations in the level of dividends.



The Aggregate data presented is based on the selected number of joint stock companies presented. These selected companies represent mainly profit making companies represent mainly profit making companies and those who made dividend payments. Even though the data is based on selected number of companies, however the relative changes in the series of data remained the same as before. The first, as we can see in the Table 5 was an upward trend and then fell. This downward trend is most clearly visible in the data. This is followed once again by rising trend in the payout. It is assumed that the ability to pay, as measured by corporate should have a heavy influence on dividend payments and poses several questions:



- why do dividends rise faster?
- why were rise in dividends not comparable to rise in profits?
- why did dividends rise in certain years even though drop in profits after tax was witnessed ?

Trends in aggregate dividends were roughly parallel to those in individual industries and firms. Although there are some disparities in individual behavior, dividends for industries and firms tend to show the same trends with a high degree of consistency.

Conclusion

The role of Dividend payments to shareholders in the overall financial policy of the corporate sector has been a problem that has eluded the theories for a long time. Despite large amount of academic effort put in and the articles published particularly from India's corporate point of view, the answer to several questions remained more or less incomplete and unsatisfactory. Several factors affect firm's decision to maintain a constant dividend payout ratio or even increase the payout ratio.

The study began with in theoretical fame work proposed by several researches. Lintner's hypothesis that dividends are based primarily on net income levels and are adjusted slowly in response to income changes was tested and substantiated. The Statistical explanation of dividends was strengthened by generalization of this basic model. Net profit and other determinants of dividends were isolated by demonstrating their contribution to observed medium-term variations in the payout scale.

It therefore became necessary to approach the problem from the vantage point for exploring primacy of dividends decisions in the context of financial policy of private sectors companies. But since theoretical framework remains absolutely necessary to develop an empirically estimable model as a first three chapters of the research report emphasized on the entire gamut of financial areas directly or indirectly important for dividend policies of firms.

Relationship between dividend payments and corporate earnings varied widely in the past. These changes had a payment in a significant impact not only on the current income shareholders, but also on the value of corporate securities, investment and the nation's economic growth.

Funds have contributed enormously to the financing and growth of corporations in recent years. Corporate financing trends in advanced countries point to a synchronization of thrust in internal funds with peak in assets expansion and capital formation.

Although internal firms remain one of the most important sources of funds for financing of assets requirements by private sectors companies in India, yet it has varied significantly over the past several decades. Similarly, a continuous decline in the internal sources as percentage of total sources demonstrates reduced reliance on this major source of funds mainly due to sharp increase in the investment requirements of firms which far exceeded availability of internal sources. In general, internal funds have been replaced by both short term and long term external funds over the period of 1990-2000. However in the growth of long term external funds such as shares, debentures and institutional loans have been more than even short term external funds.

The last few conclusions in the study were even verified by statistical tests which showed high negative correlation between internal and external funds. The tests concluded that internal funds have not been the best alternative for external funds since the investment requirements in later parts of seventies and eighties far exceeded the ability of internal funds to provide sufficient capital.

Further, to answer a very natural question that what could have resulted in the changing emphasis on internal funds in India and also whether the partial recovery indicate once again growing importance of internal funds, the first normal conclusion was that the aggregate of internal funds, the first normal conclusion was that the aggregate of internal funds has been insufficient to meet financial deficits. And secondly the growing accessibility of capital markets helped firms to rely more on external funds instead on internal funds. Growth in retentions has seen to be a pace faster than both internal finance and total sources. Both retentions and new stock issues were found to be largely substitutable sources over long runs, the former replaces the latter given the size of profitable investments projects. Thus the data suggest that despite huge retentions, viable projects made it necessary for firms to go for fresh issues of stock.

The principal trend in the relationship between retentions and plant outlays was also found to be quite clear. In general rising plant outlays were financed by a rising proportions of retentions and vice versa. However in exceptional years of intensive investment activity not accomplished by an equal trends in retention were mainly due to poor corporate profitability.



Table – 1, Share of Internal vs External Funds of Sampled Indian Companies

Source of Funds	1950-	1961-	1971-	1984-	1992-	2001-
Internal Sources (a+b)	18.6	22.6	28.6	33.30	37.28	54.26
(a) Reserves & Surplus	8.6	9.3	11.4	9.80	15.50	21.06
(b) Depreciation	10.0	13.3	17.2	23.50	21.76	42.20
External Sources (A+B+C)	81.4	51.4	59.4	66.70	62.71	45.74
(A) Funds from Capital Market	2.65	2.88	1.65	6.93	16.73	22.24
(B) Borrowings (Debt)	58.75	48.52	57.75	36.88	30.19	16.23
(a) Bank Borrowings	33.11	33.16	27.11	12.19	12.43	14.44
(b) Institutional Borrowings (FI)	21.16	11.16	24.16	9.15	6.23	3.25
(c) Bonds & Debentures	4.48	4.20	6.48	10.54	4.88	0.96
(C) Other Liabilities of short term	20.00	26.0	12.0	22.89	15.79	17.27

Source: RBI & Stock Exchanges

Table 2: Share of internal and external funds in total sources (In pc)

Year	Internal to	ST to	Av	External to	Av	Internal to	Av
1977	154.3	70.0		-54.3		-284.2	
1978	94.9	-11.7		5.1		184.2	
1979	54.0	40.7		46.0		117.2	
1980	54.3	33.6		45.7		118.7	
1981	33.3	54.6		66.7		50.0	
1982	56.4	29.4		43.6		129.5	
1983	64.5	13.6	av=37.6	35.5	av=51.4	181.6	av=106.2
1984	49.9	41.8		50.1		99.8	
1985	52.7	32.9		47.3		111.6	
1986	49.4	40.3		50.6		97.6	
1987	49.3	34.0		50.7		97.4	
1988	43.7	43.7		56.3		77.8	
1989	40.7	46.5		59.3		68.7	
1990	47.1	52		52.9		89.1	
1991	40.1	44.3		59.9		67.0	
1992	47	32.9		53		88.7	
1993	52.7	39.3	av=40.7	47.3	av=52.7	111.5	av=90.9
1994	55.1	43.1		44.9		122.5	
1995	53.6	38.1		46.4		115.6	
1996	59.8	26.2		40.2		148.6	
1997	46.0	47.5		54.0		85.3	
1998	26.3	17.1		73.7		55.8	
1999	32.3	45.1		67.7		63.1	
2000	35.2	59.6		64.8		54.4	
2001	25.5	60.1		74.5		34.1	
2002	42.9	46.2		57.1		75.3	
2003	43	40.4	av=42.3	56.9	av=58.0	75.5	av=83.1
2004	38.3	37.6		61.6		62.1	
2005	37.0	57.5		63		53.4	
2006	30.4	36		69.5		43.8	
2007	31.6	38		68.3		46.2	
2008	35.4	55.7		64.5		54.9	
2009	33.4	56.1		66.5		50.3	
2010	15.7	40.7		84.3		22.3	
2011	40.1	28.9		59.9		67.1	
2012	37.9	42.5		62.4		61.1	
2013	39.7	31.4	av=42.4	60.2	av=66.1	65.9	av=52.7
2014	47.8	30.9		52.1		91.7	

Table-3



Corporate Retained Earnings		
Period	Total internal finance	Total sources of finance
1996-99	36.8	24.2
2000-04	35.5	16.0
2005-09	30.1	14.1
2010-14	34.7	18.2

Source: RBI & Stock Exchanges

Table 4

Retention vs New Issues & Plant Outlays		
Period	As percentage of plant outlays	As percentage of New Issues
1996-99	27.3	73.2
2000-04	32.4	54.4
2005-09	51.3	67.7
2010-14	43.1	40.5

Source: RBI & Stock Exchanges

Table 5

Dividends, Profits After taxes and pay out percentage for selected years		
Year	Pay out	No of Companies selected from the
1990	63.58	1501
1991	60.89	1501
1992	72.97	1501
1993	74.08	1501
1994	58.06	1501
1995	52.98	1650
1996	55.39	1650
1997	52.86	1650
1998	38.77	1650
1999	48.13	1650
2000	56.96	1720
2001	65.11	1720
2002	59.84	1720
2003	48.05	1720
2004	37.81	1720
2005	36.27	1720
2006	37.76	1838
2007	60.67	1838
2008	51.48	1107
2009	38.58	1193
2010	54.95	1283
2011	63.33	1396
2012	55.4	1595
2013	39.4	1489
2014	34.56	1108

Source: RBI & Stock Exchanges



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