Declaration and payment of Interim dividend-Some pertinent Issues

Senior CS **Mr. Ramaswami Kalidas ji** has deliberated on this topic and took the reader through definition and other provisions of "Surplus", "Free Reserves", Net worth, under the Companies Act,1956 , the Companies Act, 2013, Schedule I and III to the Companies Act , 2013, Accounting Treatment of Profit , Secretarial Standard -3, various Judgements and Income Tax rulings etc.

The author has clarified the meaning of the word Profit, Reserves and Surplus under the provisions of section 180 and 186 of the CA 2013. He has also sought from MCA to clarify whether Interim Dividend need to be mentioned in Ordinary Business in AGM. The topic appears to be simple to Professionals but there are number of ambiguity around it, which the author has tried to clarify.

Introduction

In contrast with the provisions in the 1956 Act, the Companies Act, 2013(hereinafter referred to as "The Act")contains under Section 123 (3) specific provisions which empower the Board to declare interim dividend. Under the previous dispensation, Regulation 86 in Table A in Schedule I to the Act, empowered the Board from time to time to pay to the members such interim dividends as appeared to be justified based on the profits of the company.

It is intriguing to note that it was considered necessary only through the insert of the Companies (Amendment) Act, 2000 notified with effect from 13th December, 2000 to have a legal definition to the term "Dividend" in the Act.Section 2(14A)defined dividend inclusively to include any interim dividend. It is pertinent to note that the present Act retains under Section 2(35) the earlier definition.

The definition in the Act does not provide any insight on the term except for suggesting that, being an inclusive definition, it is extensive and that its amplitude shall therefore be extendible beyond the contours of the words used therein.

Dividend –what does it mean

It is therefore important, at the outset, to understand the meaning and etymology of the term"Dividend". The term originates from the Latin expression *"Dividendum*" which refers to the total divisible sum. It is the return on the investment made by shareholders in the company.

The Legal Lexicon defines the term Dividend to mean:

"a participation in the profits usually based on the number of shares of stock in a corporation and the rate of payment approved by the Board of Directors or Management that is paid to shareholders for each share they own".

In *BarjorHashanajiVakil V Mettur Chemical and Industrial Corporation Ltd (1963)33 Comp Cas 932(Mad.)*, it was defined to mean the share of the company's profit which is distributed amongst the members of a company.

Where it comes to interim dividend, as the term "interim" suggests, as per the Legal Lexicon to "meanwhile, in the meantime," interim dividend is something which is paid generally midstream during the duration of the year. However, Section 123(3) widens the contours of the traditional concept associated with f interim dividendby providing the additional latitude to the Board to declare interim dividend even after the conclusion of the financial year but prior to the date of holding the Annual General Meeting.

Dividend declaration –Availability of profits the *sine quo non*to declaration

For declaration of dividend, be it interim or final, the Board has to dip into the profits of the company made either during the current financial year or out of accumulated profits of past years retained in the coffers of the company.

Profits as explained by FLETCHER MOULTON , L.J in *Re.Spanish Prospecting Co.Ltd (1911)1 Ch.92)"implies a comparison between the state of business at two specific dates usually separated by an interval of an year. The fundamental meaning is the amount of gain made by the business during the year. This can 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 be compared, the increase which they show at the later date as compared with the earlier date(due allowance , of course being made for capital introducedinto or taken out of the business in the meanwhile) represents in strictness, the profits of the business during the period in question".*

In *Bharat Insurance Co.Ltd v CIT (1931)(1 Com cases 192),* profits were referred to mean the net proceeds of the concern after deducting the outgoings without which those proceeds could not be earned.

Income includes Loss in a limited sense

There is a repository of judicial precedents to state that the term "income" includes "loss".Profit is "positive income " whereas loss is negative or minus income.(*Commissioner of Income Tax v C.R.Niranjan*),(Raptakos, Brett & Co. Ltd , Mumbai vs Assessee).However , we would hasten to add that where it comes to carry forward and set off of losses under the taxation laws ,losses of every genre such as speculation losses do not come within the ambit of the general rules relating to set off and therefore it cannot be said that for all intents and purposes profit includes loss.

Board to consider past losses and provide depreciation if any, not provided for earlier years, before considering dividend

It is important to understand that before declaring dividend, the Board has to take cognizance of past losses and set off the losses as also provide the depreciation for earlier years inclusive of arrears if any, thereto before arriving at the profit available for distribution .For interim dividend.accounting entries to be the above effect need not be put through since the declaration is midstream during the year and does not involve construction of

financial statements midstream. The board must of course be conscious of the existence of past losses and cushion the profits available for distribution against such losses.

Profits-per the Accounting convention suffers from inherent limitations

The apparent chink in the determination of profits as per the accounting convention is that it does not distinguish between profits which are sustainable and are earned out of core business activities and profits which are unsustainable in nature such as one –off gains arising out of the sale of capital assets, sale of investments etc. Both types of income enter the arena where it comes to determination of the pool of profits for facilitating declaration of dividend.Ideally, the law should provide for declaration of dividend only out of sustainable earnings since that is the best indicator of the resilience of a business.Having said that, one would hasten to add that the better managed companies do isolate from the pool of profits,,the unsustainable portion thereof and allow distribution only from sustainable earnings and isolate the capital profits to the credit of "Capital Reserve' for separate consideration.

Section 123(3) scanned

Section 123(3) in the Act lays down as under the specific provisions relating to distribution of interim dividend.

- The Board is empowered to declare interim dividend any time during the financial year or at any time during the period after the closure of the financial year till the date of the Annual General Meeting.(AGM).Thus the Board now has the flexibility to declare interim dividend post the completion of the financial year also.
- Interim dividend can be declared out of the surplus in the profit and loss account representing undistributed profits of past years or out of the profits of the financial year for which interim dividend is sought to be declared or out of profits generated in the financial year till the quarter preceding the date of declaration before the date of holding the AGM.
- Payment can therefore be made out of three distinct silos –namely out of surplus of r past years, profits for the financial year or even out of the profits for the subsequent financial year earned till the quarter preceding the declaration.
- Proviso under Section 123(3)stipulates that in the event the companyhas suffered loss during the current financial year up to the end of the quarter immediately preceding the date of declaration of interim dividend, such interim dividend cannot be declared at a rate higher than the average dividend declared by the company during the immediately preceding three financial years.

It is pertinent to note that Section 123(3) was amended by the Companies (Amendment) Act , 2017 with effect from 9.2.2018 to enable distribution of interim dividend even out of the profits generated in the financial year till the quarter preceding the date of its declaration.

We shall address the following important questions which have engaged the minds of the fraternity from the inception of the law on the subject as under:

Does declaration of interim dividend by the Board require ratification of shareholders at AGM

Section 123(3) empowers the Board of directors to declare an interim dividend, subject to compliance with the requirements laid down therein read in conjunction with the Companies (Declaration and Payment of Dividend) Rules, 2014.

The prima facie view is that the Board's powers on distribution of interim dividend is unbridled and absolute because of the above provision and therefore such authority should not be impinged upon by subjecting the declaration to confirmation by shareholders at the AGM.

It is pertinent to note that under the old Act also, the directors could pursuant to Article 86 in Table A of Schedule I pay to the members such interim dividend as appeared to it to be justified by the profits of the company.

The only difference in the legal position is that the powers of the Board to declare interim dividend are now enshrined in the Act as against the previous position.

It is pertinent to note that the Act acknowledges under Section 102(2)(a) which corresponds to Section 173(2)(a) in the previous Act that the declaration of a dividend shall be the ultimate prerogative of the shareholders as part of the ordinary business to be transacted at the AGM. In as much as the term "dividend" includes interim dividend, it follows that interim dividend declared by the Board shall logicallybe ratified by members in AGM.

If the intention in the Statute were that interim dividend paid shall be independent of confirmation by members, Section 102(2)(a) could have been reframed in the wake of introduction of Section 123(3) to exclude ratification of interim dividend from the scope pf their r consideration. That this has not been done in the Statute fortifies the view that confirmation of members is perhapsnecessary.

Further, Section 123(3) contemplates,*inter alia*, that interim dividend could be paid till the date of the AGM. This therefore presupposes that every payment of interim dividend shall be ratified by shareholders.

The Supreme Court has also examined the question whether shareholders get any vested rights to the interim dividend once it is declared by the Board in *CIT vExpress Newspapers Ltd (1998)230 ITR 447(SC).*The Apex court noted that the resolution passed by the board for declaration of dividend is revocable and that being so, the vested right to the interim dividend arises only after the declaration of dividend at the AGM.

Reference may also be made to the decision in *Kothari Textiles Limited v CWT (1963)33 Comp Cas 217)(Mad.)* and in *Lagunas Nitrate Co.Ltd v Schroeder &Coand Schmidt(1901)(85LT 22)* where it was held that the generalbody can rescind the declaration of interim dividend before payment thereof has been made.

In view of the above, despite the fact that interim dividend once distributed cannot be recalled, the requirement of seeking the approval of the shareholders for the confirmation of the interim dividend already declared will have to be gone through in

view of the inclusiveness in the definition of the term "dividend" .This is the conservative view that emerges on the subject.

Subjecting the declaration to the shareholders'confirmation may appear,albeit, to be an idle formality , given that the interim dividend must have been already paid before the AGM. The moot point that remains unanswered is can procedure prescribed in the law be sacrificed at the altar of the substantive Statute.

The Act ought to have been amended simultaneously with the introduction of Section 123(3)by excluding interim dividend from the scope of Section 102(2)(a).

It is also important to refer to the views of the Department of Company Affairs in its letter No.8/13/(205A)/79-CL-V dated 18.7.1981 as under:

"*The Department is of the view that approval of dividend is the privilege of the general meeting and the board can pay interim dividend if so authorized by the articles of association subject to regularization of the interim dividend at the general meeting."*
The legal position in respect of interim dividend in our view has not changed even after the introduction of Section 123(3 under the present Act.

Guidance Note of ICSI on Dividend
SS3 issued by the ICSI effective from January 1, 2018 is still voluntary in application.The Guidance note on SS3 issued by the ICSI states that "*once an interim dividend is declared by the board, its noting, approval, confirmation or ratification in a general meeting is not required. However, the Board's Report should mention the amount of interim dividend paid by the company".*

It is pertinent to note that the legal basis for the above averment has not been provided by the ICSI.

Companies which are conservative in their approach still, subject the payment of interim dividend to ratification at AGM.

To remove the cobwebs of doubt on the issue, it would be appropriate if the MCA comes up with a clarification on the issue.

Interim dividend can be paid out of surplus in Profit and Loss Account
Surplus in Profit and Loss account –What does it represent

As stated above, sub-section (3) under Section 123, *inter alia,* considers declaration of interim dividend from the surplus in the profit and loss account. The above term "Surplus" has not been defined in the Act.

It is a settled rule of statutory interpretation that where the definition of a word has not been given in the Statute, it must be construed in its popular sense if it is a word of everyday use. Popular sense means that sense with which people conversant with the subject matter with which the Statute dealing with it would attribute to it.

(*Commissioner of Income Tax ,Andhra Pradesh v Taj Mahal Hotel, Secundrabad (1972)(1)SCR 168).*

Another presumption that is followed is that where an Act does not define a word used in it, the Legislature must be taken to have used that word in its ordinary, dictionary meaning .*(Union of India v Delhi Cloth &General Mills Ltd.(AIR 1963 SC 791).*

In Accounting Parlance, the term " Surplus in the profit and loss Account "is used to refer to the credit balance in the profit and loss account after providing for dividends, bonus, provision for taxation and general reserves. The surplus may also be earmarked for special purposes such as reserves for obsolescence of plant and machinery to be made in the future.

Schedule III to the Act which corresponds to Section 129 of the Act sets out the general instructions for the preparation of Balance Sheet and Statement of profit and loss of a company. It refers to "Surplus" as i.e. balance in Statement of Profit and Loss disclosing allocations and appropriations such as dividend, bonus shares and transfer to/from reserves etc. Debit balance of Statement of Profit and loss shall be shown as a negative figure under the head "Surplus" .Similarly the balance of "Reserves and 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.

Therefore the said Schedule also clearly distinguishes between a "Reserve " and a "Surplus" although both are to be disclosed under the single head "Reserves and surplus".
The surplus in the profit and loss statement represents an amorphous mass of profits that has remained undistributed after appropriations have been made for creation of different reserves including those that are statutory in nature and after providing for dividend and hence it has to be viewed in isolation from a Reserve.

Another connotation to the term "Surplus" in the accounting arena is that it refers to the amount of retained earnings recorded on an entity's balance sheet .A surplus is considered goodsince it implies that there are excess resources available which can be deployed in the future.

Is Surplus in Profit and loss account to be considered as part of "Free Reserves"
Section 2(43) of the Act defines "Free Reserves" as under:
"such reserves which as per the latest audited balance sheet of the company are available for distribution as dividend:

***Provided** that –*

i. *any amount representing unrealized gains , notional gains or revaluation of assets, whether shown as a reserve or otherwise or*
ii. *any change in carrying amount of an asset or of a liability recognized in equity, including surplus in profit and loss account on measurement of the asset or liability at fair value , shall not be considered as free reserves.***"**

The above definition is a “means” definition and is therefore exhaustive. When a word is defined to “mean” something, the definition is *primafacie* restrictive.(*Vanguard Fire and General Insurance Co.Ltd v Fraser &Ross(AIR 1960 SC 971 at page 975).* A “means” definition as provided by the Statute is a “hard and fast” definition and no meaning other than that what is put in the definition can be assigned to the same. It is not possible to include within the ambit of such a definition, words or meanings beyond what has been contemplated in the same.

As has been explained above, “Surplus in the profit and loss account” has a separate classification in Accounting parlance and considering the restrictive meaning given in the Act to “Free Reserves”, Surplus in the profit and loss account cannot be classified under the head “Free Reserves”, although it has the inherent characteristic of being used for distribution as dividend, being an amorphous mass not identified for application for any specific purpose.

The above argument also stands fortified by the provisions contained in Table F of Schedule I of the Act. Table F in the Statute provides the standard Articles which can be applied by a company if it does not wish to draw up its articles on its own. Clause 82 (i) therein provides that the Board, may, before recommending any dividend, set aside out of the profits of the company ,such sums as it thinks fit as a reserve or reserves which shall, at the discretion of the Board, be applicable for any purpose to which the profits of the company may be properly applied including a provision for meeting contingencies or for equalizing dividends; and pending such application , may, at the like discretion , either be employed in the business of the company or be invested in such investments (other than shares of the company) as the Board may, from time to time, think fit.

Clause 82(ii) in Table F stipulates that the Board may also **carry forward any profits which it may consider necessary not to divide, without setting them aside as a reserve**. (Emphasis supplied).

Thus Schedule I in the Act itself gives to the Board the flexibility to treat a portion of the undistributed profits as part of “Reserves” or to carry forward the same as a surplus without setting them aside as a reserve.

It is pertinent to note that although Table F has no mandatory application for all classes of companies, its relevance cannot be underscored considering that it is part of the Act and Companies have the flexibility to adopt the same as their Articles. Schedules which are appended to an Act form part of the statute as held in *Ujagar Prints v Union of India (AIR 1989 SC 516 at pages 531 and 532*) and in many other cases. The division of a statute into Sections and Schedules is a mere matter of convenience and a Schedule therefore may contain substantive enactment which may even go beyond the scope of the Section to which the Schedule may be connected by its heading. It has been held that in case of a conflict between the body of the Act and the Schedule, the Act shall prevail.
(Aphali Pharmaceuticals Ltd v State of Maharashtra (AIR 1989 SC2227).

It is pertinent to note from the provisions of Section 2(43) that "Free Reserves" are those that stand transferred to "Reserves" not intended for specific purposes. On the other hand, Surplus in Profit & Loss Account has a separate classification under the accounting convention under the head "Surplus" as specified in Schedule III to the Act as elaborated above. The common thread that runs between a Free Reserve and Surplus in profit & loss account is that both are capable of being distributed as dividend. Looking at the contents of Schedule III as also based on the reading of the relevant clauses in Table F in Schedule I as reproduced above, it can be inferred that the intention in the law is to drive a wedge between surplus and reserves and to differentiate between the two as separate and distinct species. Profits of earlier years remaining undistributed not transferred to Free Reserves would form a part of "Surplus" and not be a constituent of "Reserves" of the genre contemplated within the meaning of Section 2(43).

The distinction between "General Reserves" which expression is synonymous with "Free Reserves" and surplus in profit& loss account has also manifested itself in Jurisprudence under the Income Tax Act, 1961.The distinction has been drawn, albeit, for specific purposes under the Income Tax Act . However, such references are also relevant for the purposes of the issues dealt in this discussion.

It is pertinent to refer to some passages of the decision of the Appellate Tribunal (Bangalore Bench) of the Income Tax Appellate Tribunal in Appeal No.(ITA 861/Bang./2010) involving *Canfin Homes Ltd v Deputy Commissioner of Income Tax* which are of significance to the above issue under scrutiny. In the said case, the Assessee claimed exemption under Section 36(1)(viii) of the Income Tax Act holding out that it should get deduction on the aggregate of its paid up share capital, General Reserves, amount standing to the credit of Securities premium Account and surplus standing to the credit of the profit &loss Account.

It is pertinent to note that the expression "Reserves " has not been defined under the Income Tax Act,1961. It has, therefore, to be understood in the manner in which it is used in commercial practice. A reserve by its very nature is a fund which is created and maintained for the purpose of being drawn upon in future. The Assessee had intended to bring share premium and profit and loss account balance into the definition of reserve.
In its order, the Tribunal observed that:

"*A mass of undistributed profits cannot automatically become a reserve and somebody possessing the requisite authority must clearly indicate that a portion thereof has been earmarked or separated from the general mass of profits with a view to constituting it either as a general reserveor as a specific reserve.In order to constitute a reserve, however, there must be a conscious act by the company withholding an amount and the word reserve can have no application to profits with respect to the application of which there is as yet, neither a proposal nor a decision. A Reserve may be a general reserve or a specific reserve, but in order to constitute a reserve, there must be a clear indication to show that it was a reserve either of the one or the other kind. A mass of undistributed profit is not a reserve even though it is shown in the balance sheet as a reserve."*

The above judgment was delivered by the Bench on 24.1.2012 and reference has been made therein to several precedents on the same issue.

The above arguments conclusively prove that “surplus” in the profit and loss Account does not form a part of “free reserves” as contemplated under Section 2(43) of the Act although both are eligible for use in the distribution of dividend with “Surplus” alone being considered for interim dividend as propounded in the Act.

Surplus in Profit and loss Statement not being part of “Free Reserves”-Implications thereof

Despite the fact that both Surplus in Profit &loss Account and Free Reserves have something in common between them, namely that they both represent undistributed profits for past years, they are classified differently under the Act as demonstrated above. The fact that the surplus in the profit and loss statement does not form a part of “free reserves” as per arguments adduced above, throws up some consequences which were perhaps not visualized or intended by the Legislature. These need to be elaborated.

Under Section 180(1)(c) of the Act, a public limited company needs the authorization of its shareholders for resorting to borrowings in excess of the aggregate of its paid up share capital, free reserves and securities premium. As any surplus in the profit and loss account is not part of free reserves, the same cannot be taken into consideration for the purpose of determining the borrowing limits of companies. The company’s capacity to borrow will be curtailed due to the non -inclusion of the surplus in the above aggregate.

Similarly under Section 186, a public limited company needs the authorization of its members by special resolution if it wants to make investments in other bodies corporates or to make loans/provide guarantees etc. if the aggregate of the same is intended to exceed sixty percent of its paid up share capital, free reserves and securities premium or one hundred percent of its free reserves and securities premium account whichever is more. For the purpose of computing the above limit also the surplus in the profit & loss statement shall not be taken into account.

The above give rises to an anomalous position in the Statute in that despite the commonality that runs through them, Free Reserves and Surplus in the Profit & loss statement need to be treated differently in the Statute for specific purposes.

Surplus in Profit & Loss Statement however forms part of “Net worth” under amended Section 2(57)

The term “net worth” has been defined restrictively by Section 2(57) to refer to the aggregate value of the paid up share capital and all reserves created out of the profits of the company after deducting the aggregate value of accumulated losses, deferred expenditure and miscellaneous expenditure not written off, as per the audited balance sheet but does not include reserves created out of revaluation of assets, write-back of depreciation and amalgamation.

It is pertinent to note that through an amendment made to the definition by the Companies (Amendment) Act, 2017 notified with effect from 9.2.2018, apart from Securities premium account, the debit or credit balance of profit and loss account shall form a part of the “Net worth”. Any credit balance in the profit and loss account, shall with effect from the date of the above amendment bolster the quantum of net worth of the

company. Any debit balance in the profit and loss account will have the effect of lowering the quantum of net worth.

Reference to the definition of “net worth” and the amendment thereto is relevant for the purpose of this discussion since it clearly drives home the point that the legislature intends to provide a separate identity to Free Reserves and to the credit or debit balance in the profit and loss account as manifested in the amendment made to the definition under Section 2(57).

Considering the above, one can conclude that interim dividend can be declared out of the surplus in the profit and loss Account .The moment the amount is transferred to the “General reserve” it is no longer available for such declaration.

It would be a prudent policy to retain a portion of the undistributed profits as a “surplus” in the P&L Account as it can be handy for declaration of interim dividend.

Other requirements relating to payment of interim dividend

- In case of a listed company, advance notice has to be provided to the Stock exchange under Regulation 29 of the Listing Regulations as regards the holding of a board meeting for considering the proposal for an interim dividend.
- Notices to directors and the Agenda note which must contain the proposal for interim dividend shall be provided as per requirements of SS1.
- As in the case of final dividend, separate bank Account needs to be opened for distribution.
- Like final dividend, interim dividend shall always be disclosed for payment on per share basis and not as a percentage of share capital paid up.
- All other formalities as in case of final dividend need to be ensured.

Conclusion

We have run through the gamut of the law concerning interim dividend. Interim dividend is of course a very good tool for ensuring loyalty of shareholders and to bolster their confidence in the company. Having said this, one should ensure that there is no excessive exuberance in this area and the Board shall ensure that necessary compliance with the legal provisions are made so that the declaration of interim dividend can meet the purposes for which it is intended.

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