

CHAPTER TWO

LITERATURE REVIEW

2.0 INTRODUCTION

The previous Chapter outlines the reasons for the project to be undertaken. This Chapter discusses a need to identify existing literature bearing relevance to the subject being researched. A comprehensive review of the standards, technical updates, Companies act, related published works and their major findings or shortcomings is useful in justifying and explaining this research and this shall be analysed under the broad categories of individual application of the distribution of profits among different countries and the relative suitability of each of those methods to the Malaysian scenario.

2.1 GENERAL CONSIDERATION ON PROFITS

The availability of cash, stability of earnings, current earnings, prospective earnings, the existence or absence of contractual restrictions on working capital or retained earnings and a retained earnings balance influence the dividend policy of a company. E.Kieso; Weygandt and D. Warfield (2001)

Normally, retained earnings is decreased by net losses, prior period adjustments, cash dividends and stock dividends and increased by net income, prior period adjustments. Treasury stock transactions, quasi-reorganizations and business combinations can also affect retained earnings. E.Kieso; Weygandt and D.Warfield) (2001)

Usually earnings are retained in the business for one of the following reasons i.e firstly when there are agreements with specific creditors to retain all or a portion of the earnings in the form of assets to build up additional protection against possible loss for those creditors. Secondly for the requirements of state corporation laws requiring that earnings equivalent to the cost of treasury shares purchased be restricted against dividend declarations. Thirdly to satisfy the

desire for use of the assets represented by retained earnings in the operations of the business. This is sometimes called financing, reinvesting earnings or "plowing" the profits back into the business. Fourthly to smooth out dividend payments from year to year by accumulating earnings in good years and using such accumulated earnings as a basis for dividends in bad years. Lastly, it would act as a cushion or buffer against possible losses or errors in the calculation of profits. P.V.Viswanath (1997,1999,2000)

In declaring a dividend, the board of directors must consider the condition of the corporation such that a dividend is {1} legally permissible and {2} economically sound. E.Kieso; Weygandt and D.Warfield (2001) The empirical work conducted in United States gives an additional perspective on the distribution and the importance of creditor protection.

2.2 Empirical Work conducted in U.S

The theory of agency was first developed to explain aspects of industrial organization and corporate finance over twenty years ago (Alchian and Demsetz, 1972; Jensen and Meckling, 1976). It posits that business firms are fundamentally contractual in character, and seeks to explain their structure as an efficient contractual response to "agency costs". The primary agency relations in corporate finance are those between managers and outside investors and those between holders of equity and holders of debt (Jensen and Meckling, 1976; Barnea et al, 1985).

The most commonly advanced rationale for restrictions on distributions to shareholders is that they can assist in the reduction of financial agency costs (Myers, 1977; Smith and Warner, 1979; Kalay, 1982). This has been driven by empirical findings that such restrictions are commonly found in leading agreements in the US. An obvious potential problem for creditors is the so-called "liquidating dividends". This involves shareholders procuring the firm

to liquidate assets and to transfer the proceeds to themselves. Such a transfer reduces the pool of assets available to satisfy creditors claim.

Another problem is referred to as "under investment" (Myers, 1977; Barnea et al, 1985). This refers to shareholders reduced incentive to commit money to good investment projects when the firm has debt outstanding. An investment opportunity will be worth taking if it has a positive "net present value". Where the firm has debt outstanding, then increases in firm value will also increase the face value of the debt by lowering the probability of default. In short, the gains from the investment will be shared between the firm's debt and equity holders.

Restrictions on distributions are said to play a role in reducing under investment (Smith and Warner, 1979; Kalay, 1982). Under investment occurs where projects, which have a positive net present value, do not attract necessary investment from shareholders, because the gains must be shared with creditors. Shareholders could finance new investment by issuing fresh shares or from profits retained in the firm.

2.2.1 Critique of the Financial Agency Cost Rationale

Why might creditors not be concerned with share capital? First, the share capital entries in a company's memorandum and accounts convey very little information to creditors. The concept of share capital is essentially historic (Manning, 1981; Cheffins, 1997). It is based on the price paid to the company for shares issued at some previous time. This money is no longer be represented by corporate assets (Cheffins, 1997)

Second, if subsequently creditors want to have restrictions on distributions, then they are free to bargain for them by contract. Such contractually agreed provisions are indeed commonly observed, and far more likely to be tailored to the needs of creditors than statutorily imposed ones (Manning, 1981; Cheffins, 1997)

2.2.2 Capital maintenance and Corporate Insolvency

The California Corporate Code's restrictions on distribution (Ben-Dror, 1983) contains two alternative tests for use in determining whether a corporation may make a distribution to its shareholders. One is a so-called "retained earnings" test, which is structurally similar to the distributable profit test used in the Companies Act 1985 (U.K). The study is strongly suggestive that restrictions based on retained earnings do have some efficacy in preventing distressed firms from making matters worse for creditors by paying a dividend to shareholders. The study was done in US firms, but there is no reason for thinking that results in respect of UK firms would be systematically different (Ben-Dror, 1983)

2.2.3 Do creditors investigate share capital?

Berry et al, (1993) conducted a large number of interviews with bankers, asking them to discuss recent decisions about lending to small businesses and reasoning underlying them. The borrowing company's financial stability was found to be a significant factor, alongside a number of others. However, share capital was not one of the variables that the lending officers took into account.

Coleshaw (1989) states, the greater the share capital, the easier it is to borrow money, and to show the world that the owners are committed to the business".

2.2.4 Do creditors bargain for similar protection?

A "loan covenant" is a term in a loan agreement that is not related to the repayment of interest or capital, but rather relates to the borrower's conduct during the course of the loan. Studies show that such provisions are prevalent in corporate borrowing agreements both in the US (Smith and Warner, 1979; Duke and Hunt, 1990; Press and Weintrop, 1990).

Restrictions on the borrower's ability to pay dividends are commonly found amongst the covenants in US corporate loan agreements. Two US surveys using

data on randomly selected firms in 1985 found that such covenants had been made by 61% and 55.1% of the sample firms respectively (Press and Weintrop, 1990; Duke and Hunt, 1990). In both cases dividend restrictions were the most commonly occurring covenant.

Studies also suggest that the terms used in the US dividend covenants bear a strong similarity to the distributable profit formula used in the Companies Act 1985. The precise terms of US dividend covenants were analysed in Kalay, 1982. The majority of the dividend covenants in the sample conformed to the terms of the "boilerplate" provision found in the American bar Foundation's Commentaries on Indentures. This is similar in structure to the Companies Act 1985 provisions restricting distributions. First, both prohibit not only the payments of dividends, but also share repurchases and redemptions. Second, the prohibition is not absolute. Debtors are permitted to make distributions to the extent that they are financed out of a fund calculated by reference to a formula.

The pattern emerging from empirical research in the UK is rather different from that in the US. Covenants directly restricting dividend payments are something of a rarity. Citron, 1992 found no dividend restrictions amongst a sample of 22 loan contracts. Bankers interviewed by Day and Taylor (1995) stated that dividend restrictions were only used in their leading agreements where the loan was made to a private company.

It appears clear that restrictions on the distributions, which a company can make to its shareholders, can reduce financial agency costs or in other words protect creditors. However, it is a big step forward to assert that the capital maintenance rules, as set out in the Companies Act 1985(U.K), are able to reduce the expected agency costs experienced by any creditor who lends money to a company.

The empirical evidence indicates that (i) the dividend covenants demanded by US creditors are very familiar in structure to the distributable profit test in the Companies Act 1985; and (ii) that UK creditors rarely demand dividend covenants. The capital maintenance rules can assist managers of publicly traded firms to signal private information about future expected profits to investors. Day and Taylor (1995)

3.0 ISSUES IDENTIFIED IN RELATION TO INTERNATIONAL DEVELOPMENT.

Two main issues, which have been identified with relation to the developments in the distribution of dividends, were the realisation principle and the capital maintenance principle. Draft guidance on the determination of profits and distributable profits under Companies Act 1985, ICAEW TR 25/00 (2000)

3.1 Realisation Principle

In essence, Companies Act 1980 (U.K), interpreted 'realisation ', but did not define it. The court determined profits available for dividend, as we have seen, and in those cases where the question of realised profits arose for consideration (e.g the Dimbula case already referred to), the context of the case gave sufficient clarity to the meaning of the term 'realised'. By the time Companies Act 1981 was passed, however it was obvious that a much clearer notion of realisation would be required in statutes.

Under the Companies Act 1985 (U.K), distributable profits has been defined as "Accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, as far as not previously written off in a reduction or reorganisation of capital".

Realisation is central to the determination of profits, which can be legally distributed, to shareholders in either cash or non-cash form. The U.K Companies Act provides for "only profits realised at the balance sheet date shall be included

in the profit and loss account. This applies to only a few specific provisions about whether certain events are to be treated as realised or unrealised. Three such provisions are the Development cost, fixed asset revaluation and Cost and expense recognition. (Draft guidance of realised profits and distributable profits under the Companies Act 1985 - ICAEW Technical Release 481)

Under the Companies Act, 1985, section 264(3), the following are considered undistributed reserves: share premium (also section 130), capital redemption reserve (also section 170), the excess of accumulated unrealised profits, so far as not previously utilised by capitalisation, over the accumulated unrealised losses, so far as not previously written off in a reduction or reorganisation of its share capital.

3.1.1 Capital Maintenance

"Share Capital" is used in many different senses in accounting and legal parlance. It can be used to refer to the value of a company's net worth or to the total value of the company's assets (Chambers; 1995). The rules relating to share capital concentrate primarily on issued share capital. Share capital is raised when a company issues shares. The value of the consideration is matter for agreement between the company and the allottee, although its face value may not be lower than the par value of the shares, which are issued to the allottee. (Pendlebury and Groves, 1999)

To understand the concept of capital maintenance, it is important to appreciate the relationship between a company's accounts and its share capital. A corporate balance sheet shows the value of the company's assets and liabilities to creditors. A company's profit and loss account, as shown in the balance sheet, is therefore the difference between its "net assets", determined in accordance with accounting valuations, and its capital accounts. (Pendlebury and Groves, 1999)

The underlying idea of the maintenance of capital principle is that a company to its shareholders may distribute only profits whilst it is a going concern. This will "maintain" the capital in the sense that where a company's net assets are less than or equal to the amount of its capital accounts, a distribution to shareholders would deplete the assets, which represent the value of the capital. The principle is really a negative one: distributions may not be made when net assets are less than the capital accounts. It does not amount to a positive obligation on shareholders to contribute fresh assets. (Companies Act 1985 Schedule 4, para 8, United Kingdom)

A Company may not reduce the amount of the figures stated in its capital accounts without the consent of the court under section 135 of the Companies Act 1985. However the court has a discretion to waive the procedure where satisfied that "special circumstances of the case" demonstrate that the interests of creditors are otherwise protected. It is possible for the company to satisfy the court in this fashion by obtaining a bank guarantee of all its outstanding debts. (Companies Act 1985 s136.2)

4.0 DIFFICULTIES WITH PRESENT LAW AND PRACTICE

The issuance of dividends from profits has to justify the prudence concept in the disposal of company assets to members for the benefit of the creditors and for the purposes of maintaining capital. However there is conflicting interest between the both issues mentioned. (Consultation document Company Formation and Capital Maintenance published October 1999)

One possible general objection to the rules is that a prudent approach to distribution questions requires that directors should retain an appropriate level of working capital to secure that the business remains viable. Absolute distribution rules of the kind in the Act, as opposed to a flexible standard, may be neither sufficient nor necessary to achieve this, depending on the condition of the business. A closer approximation to such a results-orientated policy would be the

New Zealand Companies Act approach, which allows directors to make distribution so long as they sign a declaration of solvency assuring that the business will remain a going concern notwithstanding the distribution. (Fourth Directive, Article 33, Companies Act 1985, Schedule 4, paragraph 34)

However, the above approach has a wide implication on the capital maintenance issues on all relevant rules. It would be a major departure from the established European approach, which would be most unlikely to be attractive to other member states, and from current practice in the U.K. It is well established that the general directors duties of loyalty and care and skill, require directors to consider the prudence of a distribution before recommending it, even where the specific distribution rules are satisfied. (Section 135 of the Companies Act 1985)

Although the above subject concentrated more on the flexible rules on the retention of working capital however the case "Aveling Barford" has brought more light on the issue. It was held that the transaction was void because it was: an unlawful reduction of capital at common law, being a disguised distribution or return of capital to shareholders in circumstances where there were no assets available for distribution, and therefore ultra virus and incapable of ratification by the shareholders.

The above issues discussed in length the issues on the implementation of a just distributable system, however a review on the hierarchical classification of the legal system would help in evaluating the accounting practices by way of cluster and hence identify the rules and regulations on the distribution of dividends.

5.0 Overview of distribution of dividend from profits in other countries according to hierarchical classification of legal system.

Salter and Douplik (1992) examined the relationship between worldwide legal systems and accounting practices and concluded that a country's legal system is a significant predictor of membership in a particular accounting cluster. David

and Brierley(1985) have identified three major families of legal systems: Romano-Germanic (Code) law, Common law and Socialist law. Based on David and Brierley's work, a hierarchical classification of legal systems was developed for 50 countries (Salter and Doupnik, 1992)

The Common law legal system is used in the United Kingdom and all the countries that have some time been a British possession or protectorate. There are two main branches of this family legal system: British and United States (Salter, et.al.,2001). It is obvious from figure 1 below that most of the countries under the British family allows more stringent rules on the distribution of dividends from profits i.e ranging from maintaining minimum legal reserve to substantive provision concerning realised profits and losses. According to Salter,et.al.,(1992), due to its early break form the British empire, the legal system in the United States has evolved to be distinctively different from that in Britain. U.S policies and procedures on the distribution of dividends are rather conclusive.

The Romano-Germanic (RG) family is European in origin whereby most of the countries in this family codified their laws during the nineteenth and twentieth centuries adopting the organizational framework of the French Napoleonic Codes written during the period 1804-1811 (Salter,et.al.,1992). Within the European branch of this family, practically all the countries maintain a minimum reserve prior to distribution of profit.

There are unique subsets within the European branch for Germany and Sweden/Finland. In Sweden/Finland, the structure of the law is different from other members of the RG family (Salter,et.al.,1992). Thus, it can be that Sweden does not set a minimum reserve prior to distribution however there is other requirements which are rather similar to the rest of the European countries. Salter,et.al.,(1992) had grouped Sweden/Finland separately because these

countries adopt a single code of law prior to the writing of the Napoleonic Codes that dates 1734.

David and Brierley (1985) indicate most of the non-British Asian countries have adopted codes. However these is not evident here as the Asian country has no specific guidelines on distributability of dividends. Japan is different in these sense because since 1945 "Anglo-American influence has been at work on, and is sometimes in competition with the Romanist influence" (David, et.al.,1985). Here, Japan has its own commercial code together with its minimum legal reserve requirement.

David and Brierley (1985) also have grouped the Latin American as a secondary grouping within the RG family whereby they had questioned the extent to which the laws of America, which grew to maturity in conditions very different from those prevailing in Europe, have developed original characteristics when compared to the European laws of the RG family. Looking at the two Latin American countries, there was no specific pattern as there were no specific rules and regulations on distribution of reserves.

China falls under Socialist law and Socialist law was not under the scope of Salter,et.al.,(1992) study and therefore is depicted in Figure 1. However as per the analysis conducted on the developments in China, there were no specific regulations on the distribution of dividends.

David and Brierley (1985) suggested that differences in the nature of the Common Law system in Europe (the United Kingdom and Ireland) and outside Europe are most likely to exist in Islamic countries, India and North America whereby alterations in the basic system vary in importance and nature according to strength of ties with England, geographical factors and other factors. Likewise in Bahrain and India, there were no specific guidelines on the distribution of dividends.

In summary, the above clearly shows that there is a strong relationship existing between legal systems and accounting practices for the distribution of profits from reserves for the Common Law countries under the British and United States branch. However even though there is close relationship between the European counterparts but it was not evident in Latin America and Asian countries.

Figure 2: Overview of distribution of dividends in Other Countries- According to Hierarchical Classification of Legal Systems

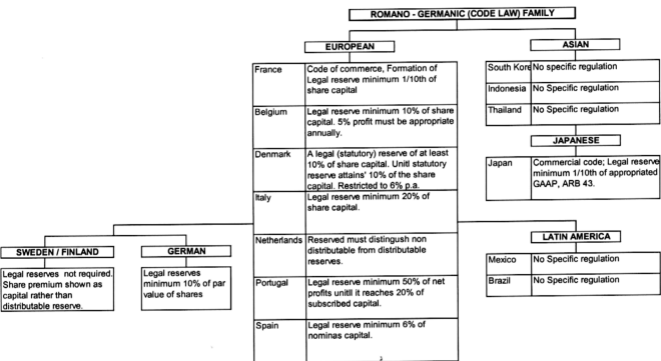
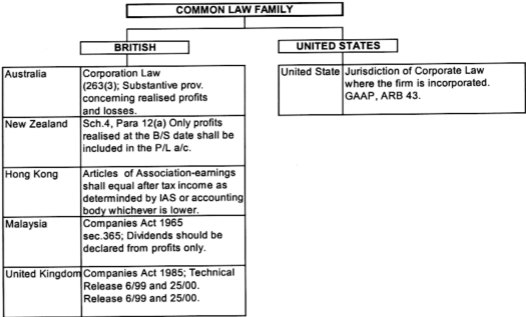


Figure 2 Continuation



In the case of Malaysia, Salter et.al.,(1992) had classified Malaysia under the British branch of the Common law family. However, a review of the annual reports of the 817 listed Companies (refer figure 5 on Chapter 4), at least thirty (30) companies declared dividends on average once from the period 1990 to 2001, twenty five (25) companies declared on average twice from the period 1990 to 2001 and twenty (20) companies declared on average thrice from the period 1990 to 2001 out of negative earnings. It appears that Malaysia is quite lax on its rules on the distributability of dividends from profits.

6.0 CONCLUSION

The issues discussed need to be further probed by way of sample selection to identify the crux of the subject matter.