CHAPTER VI

CONCLUSION

The study generally corroborates the Lintner's hypothesis on the relationship between retained earnings and dividends. The pattern of profit disposition, the determinants of retained earnings and the trends in the dividend behaviour have all been analysed for the select twenty four companies in Tamil Nadu during 1969-77. Some of the important financial ratios have been computed for the five groups of industries and their implications have been interpreted in comparison with the all-India average values of the ratios for the respective industry groups.

MAJOR FINDINGS:

1. The pattern of apportionment of net profit into retained earnings and dividend payments has shown (a) an increasing trend in the ratio of retained earnings to net profits and (b) declining trend in the ratio of dividends to net profits, for the sample period. Among the five industry groups the chemical, and cement industries have registered relatively higher retention ratios of as high as 70%; the other industries of engineering,
textiles and sugar also do not lag too much behind the former group in this regard. The chemical industry has shown consistently higher retention ratio; the rate of increase in the retention ratio is slightly higher in textile and cement than in the other groups. The ratio of dividends to net profits have declined in all the industries, the rate of decrease being more pronounced in the textiles and cement. The chemical industry has registered a very stable but lower dividend ratio when compared with other groups. The sugar industry has drawn blank during the last three years while the engineering industry has paid possibly the highest ratio of net profits as dividends. The linear trends of both the ratios of retained earnings and dividends have been graphically illustrated for the different industry groups.

2. The empirical analysis of the determinants of retained earnings lead to the following inferences:

(a) The retained earnings are better explained by dividends and gross cash flow (net profits plus depreciation provision). The regression coefficients of dividends and cash flow are as high as 0.9351 for engineering, 0.8595 for textiles and 0.8456 for chemical industries.
For the industries of sugar and chemical, the regression coefficients are 0.6157 and 0.6049 respectively. So, on the whole, in all the five groups of industries, the dividends together with cash flow can be reasonably taken to be the key explanatory variables of retained earnings.

(b) Among the independent variables of dividends and cash flow, the dividends have substantially higher coefficients in all the industry groups, excepting in the cement industry whose cash flow coefficient is marginally higher than that of the dividend. For the industries of sugar, chemicals and engineering and textiles the dividends have as high as the following coefficients respectively: 0.9622, -1.9839, -0.9663 and 0.3860; corresponding coefficients of the cash flow for the respective industries are 0.1147, 0.83403, 0.7889 and 0.2721. Hence it may be concluded that among the variables of cash flow and dividends, the latter emerges as a key explanatory variable of the retained earnings in the majority of the select companies. Thus the hypothesis of Lintner that the dividends are the autonomous decision variable upon which the retained earnings mainly depend, is confirmed. This result may be accepted in all the industry groups at 1% and above level of significance; the level of significance is as high as
30% in cement, 20% in textiles and 10% in sugar. Moreover, the existence of inverse relationship between the dividends and retained earnings is illustrated by the negative coefficients of dividends for the chemical, engineering and cement industries; the positive coefficients of dividend in the remaining industries of textiles and sugar explain the inter-play of reserve funds in dividend payments. In other words, co-linearity is observed among the dividends and retained earnings because the firms have dipped into their reserve fund partially or fully for dividend payments.

(c) When the multiple regression analysis was repeated by taking the dividend as the dependent variable and the retained earnings and the cash flow as the independent variables, the regression coefficients are found to be substantially lower uniformly in all the industry groups. They are 0.2307 (0.8595) for textiles, 0.2308 (0.6150) for sugar, 0.4115 (0.6049) for cement, 0.5397 (0.8456) in chemical and 0.8499 (0.9351) in engineering—(The figures in the parentheses are the regression coefficients of dividends and cash flow, taking the retained earnings as the dependent variable). It may be concluded,
therefore, that the dividends and the cash flow explain the retained earnings very significantly; but the retained earnings and the cash flow do not explain the dividends significantly. Thus it becomes clear that retained earnings mainly depend upon the dividends and not the vice versa.

(d) The relative significance of cash flow, when compared with net profits, in explaining the retained earnings has been tested by computing the regression coefficients of dividends and net profits taking the retained earnings as dependent variable. The regression coefficients in this test (as given below) are found to be having uniformly lower values than that of dividend and cash flow (given in the parentheses) in explaining the retained earnings: textiles, 0.3182 (0.8595); sugar, 0.5285 (0.6150); chemicals, 0.4940 (0.8456); engineering, 0.8987 (0.9351) and cement 0.5285 (0.6049). This only proves the proposition that it is the gross cash flow rather than net profits, which is more reliable determinant of retained earnings. The gross cash flow, comprising depreciation fund and net profit, by means of its more effective influence on dividend, ultimately influences the retained earnings. The dividends are influenced by net profits only
partially in many cases because the firms have resorted to accumulated reserve fund to meet the dividend payments.

(e) Moreover, the analysis of F-ratios for all the three series of relationships (Retained earnings as a function of dividends and cash flow; retained earnings as a function of dividends and net profits; and dividends as a function of retained earnings and cash flow) indicates the existence of a stronger degree of association in the first relationship, that is, retained earnings as a function of dividends and cash flow, than in the other two cases; and the results are found to be acceptable at 1% and above level of significance. Hence this further strengthens our the major hypothesis of dividends (and cash flow) being the key determinant of retained earnings.

3. The analysis of the dividend rates reveals a tendency on the part of the majority of the companies to maintain a stable dividend behaviour over the period. About 50% of the companies have revolved round a dividend rate ranging between 9% and 14%; very few companies are on the high side of 19% to 26%. About one third of the companies could not pay any dividend during 1969-74; in
the last three years 1975-77, the no-dividend companies accounted for about 50% of the sample. But the dividend record of the individual companies in most of the cases shows fairly a consistent trend. This has been explained with reference to the financial experience of the individual companies in the fourth Chapter. Among the industry groups, engineering and chemicals have shown relatively more consistent and stable dividend behaviour. If the sources of dividend payments are considered, it is interesting to note that more than 50% of the sample companies have drawn from reserve funds, either partially or fully, to meet the dividend commitments during 1970-73. In the remaining years, excepting in 1976-79, about one third of the companies have dipped into their reserve funds for dividend distribution. This only goes to prove the fact that there is a general tendency among the companies to maintain a stable dividend record, irrespective of the fluctuations in the current profits. Throughout the sample period only less than 50% of the companies restrained themselves within their current net profits for the payment of dividends.
IMPLICATIONS AND LIMITATIONS:

The financial management of the select industries in Tamil Nadu conforms largely to the normal standards of efficiency and the practices of profit disposition in particular. The share of internal funds (retained earnings gross of depreciation) in the total sources of funds has also shown an increasing trend over the period, which is welcome feature from the point of view of capital formation. The security prices are generally sensitive to the fluctuating trends in the production and gains of respective firms; hence the stock exchange in the State may be considered to be an efficiently organised capital market.

The savings behaviour of the firms need to be further explored in order to bring out the actual interconnection between the internally generated funds and investment requirements of the firm. The impact of the cost and the availability of external funds on the ratio of retained earnings, has not been considered in this study. These aspects may throw further light on the relationship between the constituent elements of the capital structure.
The entire amount of retained earnings and other reserves such as depreciation reserves and developmental charges, accumulated over the period, are not necessarily put to investment use by all the firms. The pattern of utilisation of these reserves may reveal that they were not fully reinvested in the same firm for its expansion; they might have been used to start a new business, either related to the present one as a feeder unit, or completely different from the existing one (diversification); or at times, the reserves might be frittered away in paying fresh and additional dividends or spending on welfare and other social considerations. Hence, an intensive study of the use-pattern of retained earnings may be relevant to estimate the actual ratio of earnings which are ploughed back for the capacity expansion of the same firm.

An attempt may be made to find out how far the normal practice of using the retained earnings for long term fixed capital formation, is observed in reality by the corporate sector. Further, utilisation of dividend income by the equity holders may be surveyed and analysed to study the ultimate impact of dividend on investment.
The impact of taxation on the pattern of profit disposition may also be considered; the possible effects of differential tax rates on the dividend income and the capital gains on the financial practices of the management and on the responses of the stockholders may be analysed. An exhaustive concept of savings which is inclusive of the tax component may be adopted in estimation of the gross savings by the corporate sector.

However, one serious limitation in the analysis of corporate finances arises, apart from the difficulties in the availability of data, from the accounting practices and book adjustments (if not manipulations) followed by the companies. These complicated secretarial practices do not reflect the economic realities of the situation. The accounting concepts that underlie financial statements are not the exact counterparts of the concepts of economic theory, as for instance, depreciation provision as given in the financial statements does not exactly reflect the using up of plant and machinery.

The accumulated reserve fund provides vast scope for the company to make adjustments and compensate for the current fluctuations. Sometimes, very peculiar book-keeping procedure has been followed by some of the companies;
when the company has incurred loss, it pays not only dividends but also shows a positive retained profit account, probably by just transferring funds from its past reserves and showing it as a current item of retained profits. This is nothing but an ingenious method of 'window dressing' to camouflage the pitfalls in the current accounts. For example, in the sugar industry, in one or two years, on the aggregate, there have been positive entries in both dividends and retained earnings while the net profits have been negative. But this is found only in negligible cases and hence may not seriously limit the validity of the inferences.

Though there are many interesting areas into which further research can be pursued, this thesis is confined to the verification of the hypothesis that the dividends are the autonomous and key decision variable and the retained earnings are just the residual. The alternative hypothesis tested is that dividends do not affect the pattern of retained earnings.

By pursuing the road of systematic doubt and analysing the systematic interconnection of facts, it has
been concluded that there are logically adequate
grounds for accepting the former hypothesis and reject-
ing the alternative when applied to the conditions
existing in the corporate sector of Tamil Nadu. The
acceptable evidence has been weighed carefully and the
conclusion arrived is compatible with the data avail-
able. The logic of the facts points out that the
preponderant probability of accepting the hypothesis
is much greater than accepting its alternative. Hence
I conclude that dividends are the key decision variable
and the retained earnings are just the residual.