CHAPTER I

INTRODUCTION

BACKGROUND:

The financial behaviour of the private corporate sector in Indian economy deserves a systematic comprehension and analysis because of two reasons: (a) the significant role that the corporate sector has played in the promotion of industrial expansion of the country during the last three decades of planning and (b) the close correlation between the financial management and the growth of an enterprise.

A century of industrial development pales into insignificance when compared with the rapid industrial growth witnessed during the post-independence era. In this period the government actively promoted the expansion of the public sector. Yet the private sector continued to play an important role both in terms of net domestic capital formation and net domestic product. At current prices the share of private sector in the net domestic capital formation was Rs. 787 crores in 1960-61, Rs. 1,194 crores in 1965-66, Rs. 2,547 crores in 1970-71, and Rs. 4,569 crores in 1975-76. The share of private sector to total works out at 43.5%, 37.8%, 52.1% and 41.3%
respectively for those years. The importance of private sector is more clearly revealed in its share in the net domestic product of the country: it was Rs. 11,913 crores in 1960-61; Rs. 28,058 crores in 1965-66; Rs. 29,698 crores in 1970-71; and Rs. 50,269 crores in 1975-76 (all at current prices). The share of private sector to total works out at 89.3%, 86.8%, 85.5% and 82.9% respectively.

The private sector comprises of small enterprises, corporate sector and others. The small enterprises consist mainly of individual proprietorship and partnership. Corporate sector consists of both private and public limited companies. In 1974-75, the private corporate sector accounted for about 75% of the total industrial value-added of the economy. The figures on the gross fixed assets formation by the RBI sample of medium and large public limited companies in the private sector may provide a better index of its substantial progress; at current prices, the gross fixed assets formation which was Rs. 122,62 crores in 1960-61 increased


to Rs.230,60 crores in 1965-66, Rs.304,26 crores in 1970-71 and Rs.747,23 crores in 1975-76.

The growth of private corporate sector depends upon its ability to satisfy demand and the availability of internal and external resources. Given the demand structure and the terms and conditions of external finance, the significance of internal finance in the expansion of the corporate sector is immense. The growth of the private corporate sector in India has been facilitated by frugal financial management, involving a high rate of reinvestment of its profit earnings. The gross internal funds (retained earnings and depreciation provision) constituted a share of 50% to 60% of the total investment in the private corporate sector, during the period 1951-1978. The external funds also played a very significant role in financing the growth of the private corporate sector. The government endeavoured to supply external funds through term-financing institutions.


2. RBI - Ibid.
This dissertation is primarily concerned with the contribution of internal funds to the development of the corporate sector in Tamil Nadu and seeks to analyse the flow of internal funds and the underlying determinants. The internal funds has not received its due attention in the studies of corporate financing. H.M. Smith opines that although corporate savings is a larger and volatile component of total savings, it has received much less systematic study than the personal saving component and much less is known about its behaviour. K. Krishnamurthy and D.U. Sastry are even more caustic in their review of literature on the Indian corporate investment and financing in general: "The earlier work in the area of corporate investment in India is limited, inadequate and unsatisfactory in many respects. Except for a couple of studies, others are rather superficial. In most of the studies, the specification is naive, in some, inter-industry differences are ignored and in others, the results are generally weak. The conclusions, therefore, are not definitive.

However, these studies indicate that apart from accelerator which is of some importance, financial variables (profits/retained earnings and external finance) are important determinants of private corporate investment in India$^1$.

The studies on the financial behaviour of the corporate sector have mainly examined the trends and the underlying determinants of the disposition of profits between dividends and savings (retained profits), and also that of external financing. The major question attempted in this study is to answer whether there is any inter-dependence among the decisions on dividends, retentions and profits and cash flow and if so, which of the decisions is predominant over others. On these lines, in their classical and pioneering work, Modigliani and Miller$^2$ argue that the decision on dividend payment is 'irrelevant' to the actual investment decision because, under conditions of perfect capital market, the external sources of funds.


would suffice the finance requirements of the firm pursue constant growth over time. That is, the investment decision is independent of dividend behaviour. But Gordon and others believe that there is a trade-off relationship between dividends and retained earnings and that the former is a central variable. Regarding the long-term movement, John Lintner theorises that there is a tendency for the dividend behaviour to follow a stable or sticky path; and the retentions are largely the 'residual' of the pre-determined dividend payments. The finances of the Indian corporate sector have been analysed by scholars like H. Masumdar, J. Purnanandam & K.S. Hanumantha Rao, C.R. Rao & Y.S.R. Sarma and K. Krishnamurthy & D.U. Sastry.

Most of these studies have made use of the framework of Lintner's hypothesis. Masumdar in his pioneering


study on the Indian Corporate behaviour, explains the business savings in terms of profits or profitability, and current dividends partly in terms of past reserves and partly in terms of current earnings. Rao and Sharma\(^1\) have concluded that the corporate dividend behaviour in many industries can be better explained by Lintner's model with profit variable, while the cash-flow variable seems to explain the behaviour of certain industries. Purnanandam and Hanumantha Rao\(^2\) analyse the size distribution of the estimates of dividend ratios in the cotton textile industry. Krishnamurthy and Sastry\(^3\) in their empirical work on the corporate finances, have conclusively established the relevance of the Lintner's model to the Indian context and have also analysed the inter-industry differences in the inter-dependence between internal savings and external finances.


PROBLEM AND OBJECTIVES:

Against the background of the above studies and in view of the significance of the retained earnings for industrial expansion, the present study makes an attempt to analyse the pattern of profit disposition and the underlying determinants of retained earnings and dividends. It is perhaps a general impression that the firms first retain as much of its net profits as necessary for its own investment and then only the reminder is distributed as dividends. In other words, popular belief is that reinvestment aspect is given the primary consideration and that the dividend distribution is only of secondary significance in the decision making process. But in actual reality, the fact seems to be just the reverse. The present study makes an empirical analysis, with reference to the select industries in Tamil Nadu, of the degree of dependence of retained earnings on the explanatory variables of dividends and gross cash flow (net-profit plus depreciation) or net profits. The specific objectives may be stated as follows:

1. To examine the trends in the pattern of apportionment of net profit into retained earnings and dividend
payments and to analyse the underlying determinants.

2. To analyse the validity of Lintner's hypothesis that the dividends are the key decision (autonomous) variable and the retentions are just the residual part of net profits; to examine, in addition to dividends, whether it is the net profit or the gross cash flow that effectively explains the trends in the retained earnings.

3. To examine whether the firms have followed a stable dividend behaviour during the sample period, 1969-77.

HYPOTHESIS:
The dividends and the cash flow are the key explanatory variables of the retained earnings; among the dividends and cash flow, the dividends have relatively higher coefficient of explanation. In addition to dividends, it is the cash flow and not the net profit which explains better the trends in retained earnings. Most of the firms tend to follow a stable dividend behaviour.
DATA AND METHODOLOGY:

SAMPLE SELECTION:

The companies selected for the study are divided into five industry groups, namely, Cotton textiles and Sugar (consumer goods industries), Chemicals (intermediate goods industry), and Engineering and Cement (capital goods industries).

The five industrial groups of cotton textiles, sugar, chemicals, engineering and cement, of course, represent about 60 to 70% of the gross industrial output of Tamil Nadu. The findings on these major groups are therefore likely to reflect the general trends in the manufacturing sector in the state.

Five firms were chosen under each of the five categories (excepting the cement industry in which only four private firms exist), totalling the sample size to 24 firms. The firms selected were all non-government and non-financial manufacturing units, with fairly long record of existence. These units are neither too big nor too small, but of intermediate size, being representative of the respective industrial character. In the case of cement
and sugar industries, almost all the major units in the private corporate sector have been covered. Of the industries of engineering and chemicals, care was taken to select a heterogeneous group of units producing various types of products to provide comprehensive picture of these progressive industries of the State. The traditional textiles group really posed a problem of selection; as far as possible the major units with long periods of production, and which did not suffer "sickness" typical of the industry during the recent decades were selected. Following these norms of selection, another practical criterion observed was the availability of financial data and the accessibility to the records of Balance-Sheet and Profit and Loss accounts. Subject to the above constraints, a sample selection has been made for intensive study. The undeflated book values of the various items of accounts were taken as such. And for each industrial group, a cross-section aggregation of data on retained earnings, depreciation, dividends and net profits were made to find out the trends in their behaviour, for the group as a whole. The behaviour of individual units are not taken for intensive analysis; but any serious deviation from the industrial character is explained.
SAMPLE PERIOD:

The period under reference covers nine years from 1969-1977. This is the latest possible period for which the financial data were made available by the respective companies. The firms, have, of course, followed different accounting years. But the units chosen mostly have adopted the same accounting years though with one or two exceptions, which may not substantially alter the results of the study.

METHODS:

Multiple regression technique has been used in the empirical analysis of estimating the inter-dependence among the variables of retained earnings, dividends and cash flow or net profits. The following three sets of regressions have been computed: (a) retained earnings as a function of dividends and cash flow (b) Retained earnings as a function of dividends and net profits and (c) Dividends as a function of retained earnings and cash flow. The dividend (and retained earnings) is taken both as independent variable and dependent variable and the regression test is repeated to find out whether there is any interdependence among dividends and retained earnings or whether there is
only one way relationship of dividends determining the retained earnings and not vice versa. The F-ratios have also been estimated for all the three sets of regressions, to analyse the degree of inter-relationship among the variables. The changes in dividend rates paid by the sample companies and also the sources of dividend payments are analysed to estimate whether the firms have a tendency to follow a stable dividend behaviour. The dividend payments have been made not necessarily from the current net profits alone; a considerable number of companies have dipped into their reserve fund, either partially or fully, to meet their dividend payments over the period. Because the reserve fund is supplementary to net profits in paying dividends, the variables of dividends and retained earnings have, at times, been co-linear. This aspect also has been kept in mind while interpreting the results. The inter-industry differences in the quantum and determinants of retained earnings have also been explained.

In order to provide a broad perspective to the above analysis, the trends in some of the financial ratios—ratios of total liabilities to net worth, current assets to current liabilities, cash flow to equity, depreciation reserves to gross block, depreciation provision to gross
block, tax provision to pre-tax profit, dividends to net profits and retained earnings to net profits - of the select industries for the period, 1969-77, have also been analysed. This ratio analysis brings out the salient features of financial management.

**Scheme of the Thesis:**

The thesis is divided into six chapters, including the introductory one. In the Introductory Chapter, a brief account of the theoretical background and relevance of the problem, the statement of specific objectives and the hypothesis and the methodological notes on the data, definitions and the techniques of analysis have been given. The problem-setting and the perspective of analysis pursued in the thesis have been thus introduced in the first Chapter.

The second Chapter on "The Role of Retained Earnings in Industrial Finance" explains the concept of retained earnings in relation to reinvestment and also the replacement reserve (depreciation). The depreciation provision and the retained earnings form the gross savings or internal funds, for all practical purposes. The tax payments by the corporate sector also constitute an item of
capital formation for the economy as a whole, but this is not considered as an item of internal funds for the firms. The significant role played by the retained earnings in the development process has been illustrated with reference to the developed economies as well as the developing economies, especially the Indian experience. The inherent advantages associated with the internal funds when compared with external funds are also explained. The theoretical significance attached to retained earnings in relation to dividends and external finance in the leading studies of corporate finance has been surveyed.

In continuation of the thread of discussion in the second chapter, the third chapter on "The Entrepreneurial Decisions on the Dividends, Retained Earnings and External Finance", discusses the theoretical considerations and the practical norms governing the pattern of disposition of earnings into dividends and retained earnings in relation to the requirements and the availability of external funds. Here the emphasis has been shifted from retained earnings (unlike in the preceding chapter) to dividends. The impact of dividends on the retained earnings and on the availability and cost of external funds is discussed in detail. The determinants of stable dividend behaviour and the
implications of dividend record on the security prices and market value of the firm are also analysed. The risk element involved in the debt capital and curtailment of the internal freedom of decision-making by the external finance are taken into account while deciding the desirable debt/equity ratio of the firm. In short, the guidelines of holding an optimal capital structure are discussed.

The fourth Chapter on "The Financial Background of Select Industries" surveys the various aspects of the finances of the sample companies under the five industrial groups. A brief assessment on the development and special problems of each of the five industries, namely, textiles, sugar, chemicals, engineering and cement has been given by way of introducing the samples under the respective groups. Relatively the textile and sugar industries are found to be less dynamic and progressive than the chemical, engineering and cement industries. The financial aspects, changing trends in the capital structure, production, net profits, dividends, retained earnings, depreciation provisions and the security prices of all the twenty four companies have been analysed in detail. The financial picture of the individual companies are illustrated
adequately with the necessary time-series data for the period, 1969-77. Though these data-based statements of a long list of twenty four samples do not make an interesting reading, this chapter becomes all the more essential to provide the detailed background of the select samples and thereby give a broad perspective to the empirical analysis undertaken in the next chapter.

The central hypothesis of the study is empirically tested in the fifth Chapter, "The determinants of retained earnings - An Empirical Analysis". Before taking up the multiple regression analysis to test the significance of inter-relationship between dividends, retained earnings and cash flow or net profits, the first part of the chapter deals with some of the significant financial ratios and their growth implications for the five industrial groups during the sample period. The changing trends in these ratios have been interpreted, with due emphasis on the ratios of retained earnings to net profits, dividends to net profits and depreciation provision to gross block. The ratio of internal funds to total funds and the pattern of earnings distribution for the select industries have also been compared with the
all-India average values of the respective financial ratios. The ratio of retained earnings to net profits has been found to be on the increasing trend, whereas the ratio of dividends to net profits has been declining during the period, 1969-77. The linear trends of the ratios of dividends and the retained earnings to net profits are also graphically illustrated; the actual ratios are represented in the Bar Chart. The multiple regression analysis supports the conclusion that the dividends and cash flow explain the trends in retained earnings much better than it is explained by net profits and dividends. The dividend factor emerges as the key explanatory variable; the retained earnings have relatively very low or negligible coefficients in explaining the dividends and hence the residual character of the former is established. The F-test has been done for all the three sets of relationships to estimate the degree of interdependence among the said variables. The sources of dividend payments and the trends in the rates of dividend have also been interpreted. The actual values on which the regression analysis is based, have been appended to the chapter.

The last Chapter summarises the findings of the
study, besides giving an account on the theoretical and practical implications as well as the limitations of the present work. The saving behaviour of the firms need to be further explored in order to bring out the actual impact of investment proposals and the availability of external funds on the ratio of internal funds to the total funds. The implications of the savings trend on the composition of capital (in terms of fixed components and inventory structure) can also be analysed to establish the broad relationships between the source-pattern and the use-pattern of funds. The actual utilisation pattern of the dividend income as well as the retained earnings may be studied with a view to assess the ultimate investment effect of the net earnings of the corporate sector.

The appendix to the thesis gives the list of journal articles, books and reports which have been made use of for the present work. The statistical tables with special reference to the trends in the finances of the medium and large public limited companies in the Indian corporate sector and also in some of the developed economies, provide a relevant data background to the study.