CHAPTER IV

DETERMINATION OF CORPORATE EARNINGS
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Absolute figures of the corporate earnings are analysed with the help of indices and common size ratios. Though they indicate directions and dimensions of the changes in the efficiency of the different types of corporations, yet the same do not enlighten on the pattern of performance. Earnings, being a relative term, can be properly analysed with reference to the turnovers, fixed assets and capital stock at different levels. Earnings turn-over ratio show the margin of gross and net profit i.e. the excess of sale proceeds over cost. Earning fixed assets ratio reflects the extent of effective utilisation of the capital block. However, it is the size of capital employed which can justify the adequacy of quantum and rate of earnings. The starting point of budgeting investments is the determination of normal rate of return, which is expected on the capital invested. Return on capital has assumed great importance in the formation of public policies, specially in the planned economies of developing countries like India, where optimum utilisation of scares resources including capital on priority basis is the crux of the problem of economic development.

Concept of Return

Concept of return on capital is as old as the concept of money. It is ascertained for evaluating investment and measuring the performance. It represents the ratio of profit earned on the
capital employed. With a view to attracting capital to a particular business concern, a fair return has to be ensured. All businesses involve a process of choice. The correct choice of an alternative should lead to a creation of surplus, at least at a normal rate. But the determination of normal rate is far from easy. One has to define the terms like return and capital, i.e. what type of profit should be considered as a return on which capital. Capital is broadly represented by 3 factors of production i.e. machinery, raw material and labour employed in an undertaking. The return on capital is the joint contribution of machinery and labour, presuming a regular supply of raw material and normal conditions of production. In other words, capital means the total money resources available for the disposal of a business concern i.e. share capital and borrowings. An ideal rate of return is the one which provides a reasonable return on the capital employed as well as an adequate setting aside of earnings for ensuring security of capital stock and replacement of assets in the case of inflation and technological revolutions. That is to say, in addition to the payment of a normal return, earnings must provide a cushion for successful running of the modern industrial undertakings. The rate of return depends mainly upon the sales price, scale and cost of production and capital structure of the corporations.

As the surplus results out of selling at a price above the cost, the return on capital is basically inter-linked with the pricing policy and there is an element of public interest associated with profitability. Fixation of prices and grant of bonus to workers
inevitably lead to the question as to what contributes a fair return to the owners. The problem of fair return is naturally a controversial one. There are likely to be divergent opinions about the same. It is felt that a fair return should cover the reward for risk-taking, waiting, change in price level and cost of renovation and should be more than the prevalent minimum rate of interest.

Measurement of Earnings

Measurement of earnings involves computation of rate of return accruing to the capital obtained from various sources and pooled together at different levels of business operations. Besides the capital sale proceeds and capital block have come to be used as basis for computation of rates, serving different purposes like reviewing the efficiency of an undertaking which enables the entrepreneur to take any decision for starting a new business or expansion on liquidation of the existing one. It may assist in measuring the performance of different production-mix and sale organisation. Thus, it is the purpose which determines the basis to be adopted for computation of rates. Generally, the basis for computation can be classified under two categories.

1. Cost basis of computation of return-profit planning is an essential element of budgetary control. Business forecasting and standard costing have made it easy to estimate the possible cost of each and every activity of production in advance. The selling price of the standard products has always to be advertised long before the attainment of the actual sales. Socialist Governments have
to exercise an effective control over the production and prices of the commodities of mass consumption, which are short in supply. The industrialists engaged in the production of basic capital goods are compelled not to cross their licensed capacity and distribute goods at controlled prices. In a good number of production lines, producers receive subsidies from the exchequers to the extent of losses. For all such purposes, cost accountants prepare comparative cost-statements of product-mix with the help of break-even and performance analysis whereby the profit model of a company, reflecting the current and future trends and cost volume and profit relationship is constructed. But these studies provide only guidelines to decision-makers. Actual performance is bound to vary from the budget of the cost accountant. Ultimately, the financial analysis becomes superior to cost analysis. The usual bases used for the computation of profit ratios are the cost of production and sale proceeds. Rates of interest or earning capital employed ratios are less significant to the cost accountant, in general. However, the popularity of management accounting has made the costing and financial accounting as the complementary parts of financial management.

2. **Financial Basis of Computation of Return**

The computation of rate of return of financial basis involves post-mortem analysis of facts and is more useful than the cost accounting. Here the overall performance is
carefully reviewed. Items like interest, earnings, net worth and capital employed, which are not studied in cost accounting, are given proper consideration. A distinct feature of financial analysis is that, unlike cost accounting, it is governed by the interest of investors rather than by the input-output relationship. There is a close connection between the interest of management and investors. Investors supply most of the funds to carry on corporate activities and are directly affected by the performance, even though the individual investor has little contact with day-to-day working of the enterprise. Regular flow of finance is a sine-quo-non of efficient conduct of business. Hence the measurement of earnings from investors' point of view has assumed greater importance. Profitability ratios based on financial analysis can be of much help to all those who are interested in the smooth running of corporations. We have computed the following important ratios to highlight the profit position of the corporate units under study.

i] Main Earnings Turnover Ratio : (Table No. 4.01)

Turnover is the prime source of earnings. Without sufficient turnover of merchandise or service, business cannot become a profitable venture. It is not the rupee-value of the sales, but the margin of profit i.e. the excess of sale proceeds over the cost which is the most important item of final accounts of all the undertakings. Gross profit turnover ratio
helps the cost accountant and management, who are required to ascertain the margin for recovering the indirect expenses and reasonable return on capital stock, while fixing prices and sales programmes. This ratio can become a useful measure of earnings in the case of undertakings having a high return on capital. Earning turnover ratio reflects the fact that changes in cost, competition, price and demand, influence the margin of profit to a considerable extent, and are a valuable measure of profit potentiality.

Size-wise Analysis

In the case of small companies this ratio varied from 6.6% (1988) to 7.5% (1990). The average of the ratio worked out to 7.2%.

In medium companies this ratio was between 6.7% (1986) and 8.7% (1990). The average amounted to 7.5% which was greater by 0.30% with that of small companies.

In large companies the ratio fluctuated from 5.5% (1986) to 8.3% (1985). The average came to be 7.3% which in higher by about 0.10 than that of small companies but less by 0.20 than that of medium companies.

Considering all the companies together, we find that the ratio travelled between 5.9% (1986) and 8.3% (1990). The average worked out to 7.3% which is lower by 0.05 than that of large companies.
Industry-wise Analysis: (Table No. 4.02)

Industry-wise analysis of the main earning turnover ratio varied between 6.06% (1986) and 7.51% (1989) in Pharmaceutical, 4.78% (1986) and 6.79% (1988) in Food, and 9.43% (1986) and 16.49% (1990) in Tea. In most of the industries, there was a mixed trend. The ratio in 1986 was lower than that in 1990. The average rate for six-year period was the highest in Tea 12.08% and was followed by Pharmaceutical 6.86% and Food 5.88%.

Aggregating this ratio for all the companies included in this study, it is found that the same maintained more or less fixed percentage on sale proceeds, with minor fluctuations. This indicates that the producers were in a position to recover the direct cost out of sales, leaving about 1/6 of the total revenue for meeting the indirect expenses and return on capital.

ii] Net Earnings Total Revenue Ratio: (Table No. 3.11)

Though the profit before the tax turnover ratio is an important indicator of the net margin coming out of sale proceeds, which is appropriated into corporation tax, dividend and retained profits, yet it is not possible to compute the same correctly from the published accounts of the companies. Net profit appearing in the final accounts is arrived at after charging the total amount of nonoperating expenses and losses together with the ordinary overheads and crediting the nonoperating earnings like interest, rent etc.
Under such circumstances the proper way of analyzing the profit before tax appears to be related to the same total revenue, i.e. the net sales plus income credits. We have computed this ratio vide Table No. 3.11 and our observations are as follows:

The small companies' net earning total income ratio witnessed the declining trends up to 1988. In 1985 this ratio was 5.17%, it went up to 6%. In 1990 which was the highest and remained below average i.e. 5.31%. The average for the period under study worked out to 5.31%. In medium companies, this ratio fluctuated between 4.41% (1985) and 6.70% (1990). The average worked out to 5.31%. In large companies this ratio was between 4.14 (1986) and 6.19% (1985) and indicated mixed trends. The average worked out to 4.94%. Aggregating the financial data of net earnings of all the companies under study, this ratio was found to be varying between 4.30% (1986) and 5.95% (1990). The average was 5.08%. The trends were of mixed nature.

Industry-wise analysis of this ratio indicates that the same was the highest in Tea fluctuating between 5.97% (1986) and 12.49% (1990) which was followed by Pharmaceutical 4.00% (1988) and 5.17% (1989) and Food 3.44% (1985) and 5.13% (1988).

In all the industries the trends were mixed. Despite a steady growth in the total income of all types of
companies analysed size-wise and industry-wise, there had been a falling rate of net earning. Absolute amount of earning before tax has been rising in tune with the rise in total income and gross profit but on a lower scale in most of the companies.

iii] Earnings Before Tax : Capital Block Ratio :
(Table No. 4.03)
Capital block ratio is an indicator of the extent of utilisation of the fixed assets available in a business undertaking. Earnings before tax is that portion of total revenue which accrues on the owned funds i.e. net worth. Generally, the capital block is financed out of owned funds. This ratio will explain as to how far the corporate units of various sizes and different industries, included in this study, could ensure the effective exploitation of their fixed assets during the period 1985-1990.

Size-wise Analysis
The earning before tax : capital block ratio varied between 45.75% (1985) and 75.54% (1990) in small companies. The same was 68.24% in 1986 fluctuated downward till 1988 and witnessed a upward trend thereafter. The average worked out to 63.56%.
In medium companies this ratio varied from 40.78% (1986) to 97.58%. The average worked out to 62.72%.
The capital block ratio of large companies was between 33.21% (1988) and 65.20% (1985). The average for the
period worked out to 42.35% which was less in comparison to that of small and medium companies. Thus, it is found that the medium companies had an edge over both small and large companies, so far the utilisation of capital block is concerned.

Analysing the aggregate of all the companies, we find the ratio travelling between 39.14% (1987) and 62.89% (1985). The average worked out to 46.29%.

Industry-wise analysis reveals that the ratio was the highest in Tea, varying between 29.1% (1986) and 89.8% (1985) and was followed by Pharmaceutical with 46.9% (1987) and 62.00% (1990) and Food 38.7% (1986) and 56.6% (1985). This ratio witnessed downward trends in Food and stability in Pharmaceutical and upwards trends in Tea. The average worked out to 64.6% in Tea and was followed by Pharmaceutical 55% and Food 49.4%.

Thus, the rate of asset utilisation was lower in Food because of a huge base of capital block. In other industries trends conformed to the general trends, depending upon the size and proportion of capital block vis-a-vis the amount of earnings.

iv) Earning Before Interest and Tax : Capital Employed Ratio : (Table No. 4.05)

Earnings before interest and to the capital employed ratio provides the primary test of the profit producing (i.e. capital servicing) capacity of the
corporations. It is computed with reference to the total capital committed to the enterprise in the form of share capital, surplus and debts. It is a measure of overall financial performance of the business without any regard to the source of capital. Inter-unit comparison of profitability is possible only with reference to the earning before interest and tax ratio, because the rate of net earning to net worth varies greatly with the changes in debt-equity relationship. Thus, the rate of earning before interest and tax is a more precise and effective measure of profitability.

In our study, this ratio varied between 32.63% (1988) and 38.87% (1986) in small companies. The ratio witnessed mixed trends throughout the period under study. The average worked out to 36.17%. In the case of medium companies this ratio fluctuated between 31.18% (1990) and 46.43% (1985). The average worked out to 36.93% which was higher by 0.76 than that in small companies. In the case of large companies this ratio varied between 27.50% (1986) and 47.09% (1985). The average rate worked out to 32.77% which was lower by 4.16% than that of medium companies and 3.40% of small companies. This shows that the small and medium companies took better utilisation of their capital stock. Considering all the companies together, it is observed that the earning before interest and tax to
capital employed ratio travelled between 29.68% (1986) and 45.39% (1985). The same recorded mixed tendency throughout the period under study. The average comes to 33.70% which is higher by 0.93% than that in large companies, and lower by 3.23% than the same in medium companies. Here also the overall average has been influenced by the performance of medium companies.

Analysing these figures industry-wise, we find that the rate of earning fluctuated between 26.90% (1987) and 35.55% (1989) in Pharmaceutical, 26.16% (1990) and 40.62% (1985) in Food and 25.05% (1988) and 73.09% (1985) in Tea. Stability was seen in earnings of all the industries. Computing the average of the rates of earning, it is found that the same was the highest in Tea 39.19% and was followed by Food 32.78% and Pharmaceutical 31.19%.

Payment of Interest
Creditors differ from the owners as a general class of investors in the matters of distribution of earnings on two considerations. First, the rate of interest on borrowings is always fixed at a pre-determined rate. Second, the income accruing to the lenders is more or less certain. Unlike interest on borrowings, there is no compulsion to pay dividend to shareholders. Lenders have prior claim on income and repayment over the shareholders. They receive lower rates of interest because of their priority claim. They do not
have any choice in day-to-day operations of the corporations. Their influence on the business policies comes indirectly through restrictions placed on the functions of management at the time of granting the loans. Such restrictions tend to be more effective, if the term of loan is longer. A skillful management would try to avoid financial exigencies which injure the credit standing of the corporations. Unlike the proprietors and shareholders, form and nature of business organisation make little difference in the position of creditors. They are essentially in the same position whether extending credit to proprietorship, partnership or corporation, except that in the case of dissolution, the creditors may find owners' private assets as means of recovery, in addition to the business assets of the sole trader and partnership concern. However, the influential factor for creditors generally constitutes the size of security within the enterprise rather than the form of organisation. Corporations with huge resources possess greater credit-worthiness and can attract more money at lower rates of interest.

Thus the factor of early maturity plus the priority of claim to business assets, over that of owners, induce the lenders willing to advance funds at comparatively lower rates of interest, without seeking any right of control or participation. This is generally true for
short-term lending. In the case of long term borrowings risk is greater and more priority of claim is often found insufficient. Security in the form of pledge of specific assets can reduce the risk.

In the case of corporations, borrowings are of many types: debentures, long term institutional borrowings, public deposits and short-term loans and advances from bank and suppliers. For the purpose of our study we have classified them into two broader categories i] debentures and ii] borrowings. In the second category we have included all the interest-bearing loans and advances whether received from public, institutions, banks and others. In the final accounts of companies interest paid on various types of borrowings is not separately mentioned. Hence, it is difficult to analyse the trends in the rate of interest on different types of borrowings except in the debentures.

v] Rate of Interest on Debentures
Debentures as a source of finance have not been very popular in comparison to the cheap and easy borrowings made available from public institutions. The issue of debentures does not suit to the companies with unstable earnings. Empirical study of the companies under study reveals that debentures were not favoured by small companies. Out of 26 small companies, the
number of debenture-issuing companies was only 4 during the period. The total maximum capital raised through debentures amounted to Rs. 0.91 crores (1990) which worked out only 26.76 of the total capital. In 1986 debentures of these companies were worth Rs. 0.35 crores. The average rate of interest was 18%.

Debentures were also issued by the medium companies, included in this study. Out of 24 only 9 companies had debentures worth Rs. 15.60 crores in 1990, which amounted to 40.4 of the total capital. The average rate of interest was 20% of the nine companies.

Debentures had been utilised much also by the large companies as they could afford to pay interest regularly because of huge profits at their disposal. Out of 25 large companies only 10 had debentures amounting to Rs. 15.00 crores (1990), which contributed to the extent of 23.1% their capital employed. The average rate of interest was 14.7 which is lower by 5.3% than that in medium companies. Looking at the proportion of debentures to capital employed, the position does not appear to be an encouraging one. Industry-wise analysis of the large companies reveals that debenture-issuing companies numbered 2 out of 11 in Tea, 3 out of 6 in Food and by 4 out of 8 Pharma industry. Considering the amount of debentures, we find that Pharma industry topped the list with debentures worth Rs. 60.07 crores and was
followed by Food worth Rs. 56.12 crores and Tea with Rs. 33.85 crores.

Considering the average rate of interest paid on debentures, it is observed that the Medium companies paid the highest rate of interest and were followed by Pharma and Food. Analysing the debenture data of all the companies together, it is found that out of 25 companies only 9 tapped the debentures as the source of long term finance. Total maximum amount of debentures was Rs. 8.52 crores in 1985 which amounted to only 10.9% of the capital employed. The average rate of interest worked out to 14.7. Excepting the Tea companies, in all other industries the rate of interest recorded an upward trend, which is natural, as the general rate of interest has always been increasing day-by-day.

vi)] Interest on Borrowings: (Table No. 4.07 & 4.08)

Unlike debentures, borrowings have shown steady growth in all types of companies. In 1985 the total borrowings amounted to Rs.13.07 crores and the interest amounted to 5.72 crores, whereas the same in 1990 rose to Rs. 23.21 crores indicating moderate rise. However, interest went up to 13.16 crores.

Analysing these figures size-wise and industry-wise, one envisaged similar trends. The average rate of interest on borrowings in respect of small companies
varied between 41% (1985) and 74.1% (1990). During
the period from 1985-1989 the rate of interest was
stagnant at 56.02 and witnessed a steep rise
thereafter. The same in medium companies varied from
34% (1986) to 84.4% (1989). The rate was ever-increasing from 1985-89 and thereafter declined
slightly. In the case of large companies, the average
rate of interest travelled from 44.9% (1985) to 59.6%
(1990). Thus the average rates were higher in medium
companies than those in small and large companies.
Nevertheless, the medium companies could avail cheaper
institutions borrowings because of their better
credit-worthiness. The average rate of interest in
respect of all the companies under study fluctuated
between 43.8% (1985) to 62.8% (1988) and the trend has
been influenced by the same in medium companies.

Industry-wise analysis of the rate of interest in all
the companies show that the same was between 40.7%
(1988) and 65.3% (1989) in Pharmaceutical 44.2% (1986)
and 75.04% (1988) in Food and 34.06% (1985) and 67.5%
(1988) in Tea. In all the industries the average rate
in 1990 had 56.70% which is higher by 12.9% of that in
1985. this shows that the cost of capital has
increased itself in six year period from 1985-90,
because of tight money policy of the RBI and low level
of savings in the country.
vii] Distributable Earnings: Net Worth Ratio:
(Table No. 4.09)

By distributable earnings is mean profit after tax
which can be appropriated as dividend and retained for
internal financing. It is the residual profit which
remains after meeting the liability of interest and
corporation tax out of earning before interest and
tax. The entire amount of divisible profit belongs to
the share-holders, whose interest is represented by
net worth. Net worth, generally referred to as 'owned
funds', comprises the paid-up amount of share capital
and reserves and surpluses accumulated out of day-to-
day profits as well as capital profits. There are two
measures of evaluating the performance of a
corporation from shareholders' interest point of view:
i] earning per share, which are ascertained by
dividing the profit after tax by the number of shares
and ii] distributable earnings - net worth ratio which
is computed as percentage of divisible profit over the
net worth. As the different corporations have shares
of different denominations, earnings per share do not
suit to the macro analysis. Thus, by resorting to the
distributable earning ratio, we can compare the
performance of different corporate units in a lucid
way.

Financial figures, pertaining to the distributable
earning: net worth ratio, have been analysed size-
wise and industry-wise vide Table No.4.09. It is observed that in the case of small companies this ratio was quite uncertain and unstable. During the year under study, the same fluctuated between -17.4% (1985) to 23% (1990). The curve depicting the trends in divisible profits was quite lop-sided. The net worth of these companies kept rising up to 1990. The average worked out to 19.86%.

Medium size companies' distributable earning ratio varied between 18.6% (1988) to 23.6% (1989). The average for the period worked out to 20.62% which is slightly more than that of small companies. The net worth of these companies too had a continuous rise whereas the distributable earnings recorded mixed trends.

In the case of large companies this ratio travelled between 14% (1987) and 25.2% (1985). The average for the period worked to 17.36% which is less than the average of small and medium companies. In comparison to lower and upper rates, the rate was more stabilised in medium companies. Taking all the companies together, we find that the distributable earning ratio fluctuated between 15.6% (1986) and 23.5% (1985). The average rate of all the companies was 18.24% i.e. it is less by 2.34% than that of medium companies.
Industry-wise analysis reveals that this ratio fluctuated between 14.3\% (1987) and 20.8\% (1989) in Pharmaceutical, 16.5\% (1990) and 21\% (1987) in Food and -11.9\% (1988) and 36.6\% (1985)\% in Tea. Considering the average, it is found that the same was the highest in Tea at 19.35\% and was followed by Food 18.40\% and Pharmaceutical 17.24\%.