CHAPTER V

APPROPRIATION OF CORPORATE EARNINGS
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Appropriation of earnings is the most crucial problem of corporation finance. It influences the rate of capital formation and day-to-day working of corporate sector. Managerial skills and discretion used in the distribution of profits amongst various provisions like depreciation, interest on borrowings, corporation tax, dividends and ploughed back profits in general and the rate and quantum of dividends in particular, determine the price movement in stock exchanges and provide a test of competence and viability of the concern. Today, when the assets depreciate and become obsolete rapidly because of technological renovations, operating expenses mount up and contingencies arise frequently. Inadequate earnings or excessive payouts may eventually destroy a sound financial structure of corporations. In the present situation of shortage of capital, accumulation of earnings is far more necessary for maintaining stability and financing expansions and modernisation. At the same time, too much conservation in dividend disbursement may deprive the shareholders of the right to enjoy and reinvest their earnings in shares.

In this chapter, the salient features of profit appropriation policies of the corporations of various size and different industries have been studied.
Traditional Approach

Historically speaking, most of the industrial undertakings in India were started with inadequate capital resources. They used to borrow substantial amounts at higher rates of interest. In the initial years, profits after meeting interest and tax liability were often found insufficient for payouts. Because of the anxiety to pay as high dividend as the corporation could, the huge profits earned during the period of prosperity were squandered away in paying high dividends without providing for even the minimum requirements of depreciation. Indian companies did not care for ploughing back of profits, so essential for withstanding economic adversities and future expansions. Considerable amounts of profits earned during the period of World War Ist (1914-1919) were recklessly used in paying very high dividends, without any provisions for lean years. The comments of the Bengal Provincial banking Enquiry Committee on the distribution of large dividends by plantation industry are of great significance. The Committee was unable to understand why no serious attempts were made for building substantial reserves whereas high dividends as much as 50-150% were paid. If the dividend was limited to say 15% for a few years, most of the tea gardens would have been able to accumulate a sufficient reserve for matching their annual recurring expenses. Borrowings then would have been larger than dividends in future. Thus the faulty management of earnings during the period of prosperity,

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made the impact of depreciation during more severe years for Cotton, Jute and other traditional industries. Industrialists had to repent for the erroneous appropriation policies of the past. Economic adversities experienced during such a period made them quite rational in their approach towards the distribution of profits. Recovery followed by the World War II in 1939 provided a long lease of profitable working to the corporate sector. But abnormally high dividends were never declared. Adequate plough back of current profits was considered essential for regular and stable dividends. Only a moderate rise in dividend rates was affected during 1939-49.

Till the amendment to Companies Act in 1960, the importance of provision for depreciation was not properly understood. Indian companies treated 'depreciation provision' as a flexible item of appropriation whereby they could increase or decrease the size of divisible profits as it was not obligatory to write off the entire amount of depreciation from the current year's earnings before the payments of dividends. The amendment made the adequate provision for depreciation as a precondition for dividend disbursement. Accordingly, companies are not permitted to declare dividend so long as they have not written off arrears of depreciation. The grant of 'development rebate' subject to the ploughing back of 75% of the actual development rebate allowed, the same out of current profits, in addition to liberal depreciation allowance, has made the appropriation of earnings a saving-oriented process which is conducive to the financial needs of a developing economy like ours.
Postulates of Rational Policy

Appropriation of divisible profits into payout and retention is the peculiar feature of the corporate form of business. As the personal liability of shareholders is limited to the amount subscribed towards share capital, certain legal restrictions on dividend have been imposed in almost all the countries to protect creditors and preference shareholders against the excessive depletion of the surplus. The essence of such restrictions is that the dividends should be paid out of the surplus actually earned and realised. In India, articles of association of most of the companies and obligations towards debenture holders and creditors call upon the board of Directors to allocate the earnings to different reserves before recommending any dividend. Thus the basic principle of financial discipline as well as the provisions of corporate laws force upon the payment of dividends exceeding profits. Excessive payout is a blot on the record of the company and a handicap to the sale of securities. For the payment of steady dividends, it is necessary to retain part of profits in prosperous years, irrespective of the financial needs of the company, so that dividends in lean years can be assured without impairing the original capital. Thus the rational policy governing the appropriation of earnings must protect capital against unwarranted payouts. While considering the rate and quantum of dividend, management has the moral obligation to formulate such a policy which could maximise the economic interest of the shareholders. Accordingly dividend rates should be maintained in such a way that the share price may not fall and retained earnings are sufficient to meet replacement and
modernisation programmes. The one is concerned with the present and the other with the future developments. Although regular and increased payouts are generally expected by individual shareholders, the rational approach in this regard should ensure that desired quantum of earnings could be ploughed back as and when circumstances demand. Such a policy has to resolve with great foresight, the conflict between the demand for maximum dividend and the adequate retention for growth. In fact, the smooth running of a corporation is more advantageous than mere regular receipts of dividend. Reserve and surplus are vital for success and growth of the business and help to establish confidence in the mind of all those who come in the contact with the corporations. Judicious use of trading on equity is facilitated through proper appropriation of earnings.

Managerial Decisions
The statutory provisions incorporated in the Companies Act and Income Tax Act do not prescribe minimum or maximum dividend rates nor limits for ploughing back but because of legal provisions governing determination of profits, management has lost much of the discretion influencing the amount of the distributable earnings. The creation and maintenance of development rebate reserve and statutory provision for depreciation amount to compulsory saving whereby a substantial portion of current profits is used as working capital. This ensures financial stability and facilitates smooth running of the corporate units. Further, dividend on preference shares has become customarily a permanent item of appropriation of divisible profits, leaving
only the question of distribution of the residue into equity dividend and retained earnings on the recommendations of the Boards of Directors. Here also the financial standing and the ability to raise or redeem the capital and liquidity position of the corporation have to be considered before any dividend is recommended. As a general rule, Directors would not recommend dividend unless sufficient funds are on hand or at least in sight to pay the same in addition to the day-to-day financial needs.

The Companies Amendment Act 1974, vide section 205A, provides that the amount to be declared as dividend out of profit shall be transferred to a separate bank account within 7 days from the date of such declaration. In case of default, the company shall pay interest at the rate of 12% p.a. on such amount. Any amount unclaimed within 3 years shall be transferred to the general revenue of the Central Government. The reasons advanced for this amendment are i] to prevent companies from declaring dividends when no adequate cash resources are available, ii] to conserve reserves for ploughing back in furtherance of the company’s business and iii] to prevent misuse of the unclaimed dividend by the company. It is thus clear that the new provisions amount to further curtailment of discretionary powers of the Board and lay a great emphasis on the payment of dividend out of current profits.

Change or absence of change in distributable earnings provides a good number of options to the management. In case of substantial rise in divisible profits, they can increase payouts
and plough back or either of the two, while with stagnant earnings, both dividend and retained earnings may be kept stagnant or increase in one may cause corresponding decrease in the other. In case of declining trend in earnings, management may reduce the one, keeping the other unchanged or reduce both, whereas in the event of loss or insufficient earnings, a company may not declare any dividend for want of accumulated surplus or pay the same out of past reserves if any. Thus financial expediencies and the desire to maintain dividend rates are the dominant factors determining the trends in the distribution of profit. Correct forecast of the financial requirements is the sine-quo-non of the fool-proof policy of the appropriation of the corporate earnings.

Empirical Study

Trends obtaining in the appropriation of the corporate earnings can be studied differently on the basis of different viewpoints about distributable profits. In a wider sense, earnings before depreciation, interest and corporation tax becomes the subject matter of appropriation, whereas in a narrow sense only residual earnings, after development rebate reserves and preference dividend, which are distributed between equity dividend and retained profits purely at the discretion of Boards of Directors would be treated as appropriable earnings. As observed by us in the 2nd chapter of this study, managerial decisions influence to a greater extent the amount to be earmarked for amortization through additions on replacement of capital block, interest by resorting to or redeeming the borrowings and thereby the tax
liability and the divisible profits. However, from realistic point of view, interest and corporate taxes are not items of appropriation. Management can exercise little discretion over them, once a given amount is borrowed and a certain sum is earned. Interest is the payment for using capital and an allowable business expense and tax provision is the contribution by corporation to the exchequer, whereas depreciation and development reserves, though legally allowed as deductions, constitute first and foremost items of appropriation. The amount earmarked under these provisions is left within the corporations for meeting the working capital requirements, whereby the size of divisible profits is directly curtailed and demand for plough back reduced. It can be said that depreciation and development rebate encourage companies enjoying substantial divisible profits to declare steady and regular dividends without caring much for retained earnings, whereas companies with insufficient earnings left after such provisions find it difficult to maintain their payout ratios, except at the cost of heavy loss of accumulated surplus.

We have analysed the appropriation of earnings after interest and tax but before the depreciation and development rebate in respect of the companies under study, size-wise and industry-wise vide Table No. 5.01 to 5.12 and our findings are as follows:

1. **Amortization** : (Table No. 5.01 & 5.02)

   In all the companies analysed size-wise and industry-wise, the actual provision for depreciation showed a continuous and steep rise during 1985-1990, which indicates heavy
investment in capital block resorted to by the corporate sector. On an average, amortization claimed about 30% of the profits before such provisions. This ratio travelled from 20.5% (1990) to 30.6% (1988) in small companies, 22.6% (1990) to 35.3% (1985) in medium companies and 24.7% (1986) to 40.4% (1987) in large companies. The same for all the companies worked out to 30.8%. Industry-wise amortization ratio was between 30.8% (1985) and 42.5% (1988) in Pharmaceutical, 24.4% (1988) and 30.9% (1989) in Food and 18.4% (1985) and 40.7% (1987) in Tea.

2. Preference Dividends: (Table No. 5.05 & 5.06)

Most of the companies under study issued cumulative preference shares on which a fixed amount of dividend like interest on debentures has to be paid for each year, irrespective of the size of divisible profits or liquid resources. Hence, it is said that the payment of preference dividend is a compulsory item of appropriation, involving little discretion exercised by the Board of Directors. In the case of small companies such dividends claimed about 0.07% (1985) to 0.65% (1987) of the distributable earnings. The same in respect of medium and large companies amounted to 0.02% (1989) to 0.33% (1985) and 0.04% (1990) to 0.20% (1986) respectively. Industry-wise analysis of the preference dividend reveals that the ratio fluctuated from 0.01% (1990) to 0.27% (1985) in Pharmaceutical, 0.11% (1988) to 0.26% (1985) in Foods and 0.02% (1990) to 0.07% (1986) in Tea. The actual amount of
'preference dividend - divisible profit ratio' were mixed because of fluctuating trends in the latter.

3. **Earnings Accruing to Equity Dividends**: (Table No. 5.07)

By earnings accruing to equity, is meant the portion of divisible profits which remains after the payment of preference dividends i.e., the residual earnings purely on the recommendations of the Board of Directors. From the financial figures analysed, vide Table No. 5.07, it has been observed that on an average only 39.85% of the total distributable earnings was appropriated on the recommendation of the Board of Directors. This proportion varied from 22.5% (1985) to 32.6% (1988) in small companies, 31.4% (1987) to 42.4% (1988) in medium companies and 31.9% (1985) to 55% (1990) in large companies. Industry-wise analysis shows that this ratio fluctuated from 30.2% (1985) to 41.1% (1988) in Pharmaceutical, 29.6% (1987) to 51% (1989) in Food and 32.1% (1985) to 54.6% (1989) in Tea.

From the close look at the actual figures, it is observed that the companies of small and medium and large size had a consistent amount of residual earnings to be apportioned between equity dividend and ploughed back profits.

4. **Equity Dividend**

Payment of equity dividend is the most important item of appropriation of corporate earnings. Substantial increase in the provision for depreciation and development reserve
cut the size of divisible profits and narrow down the scope of discretion exercised by the Board of Directors.

Declaration of steady dividends is considered to be the primary thing and the whole approach to the problem of appropriation becomes dividend oriented. Implicitly, management strikes for a gradual rise in the payout ratios and the question of retained earnings is considered as a secondary problem. Cheap institutional finance, in addition to the statutory "left overs" for depreciation and development reserve, has lessened the importance of the ploughed back profits for the stable dividend. Only medium and large companies with sufficient earnings could afford to plough back and at the same time pay regular and steady dividends. A good number of small companies and those in traditional and low profitability industries either avoided the payment of dividend for want of profits or maintained the same at the cost of loss of accumulated surplus. It is obvious that the companies which needed plough back very much for stabilising their dividends could not do so because of insufficient earnings.

i. Equity Dividend : Total Distributable Earnings :

(Table 5.07 & 5.08)

Analysis of Equity Dividend : total distributable profits (after preference dividend) ratio shows that in the case of small companies the same varied from 22.5% (1985) to 32.6% (1988). In all the years,
appropriation of earnings of these companies can be said to be satisfactory.

In the case of medium companies this ratio fluctuated between 31.4% (1987) and 42.4% (1988). In all the years, dividend disbursement was below the residual earnings and appropriation of earnings of these companies can be said to be satisfactory.

Coming to large companies, it has been observed that equity dividend fluctuated between 31.9% (1985) and 55% (1990) of the total distributable earnings. Taking all the companies together we find that the trends obtaining in the equity dividends were similar to those in large and medium companies. Like all other items of our analysis, trends in large and medium companies completely wiped out the adverse situation faced by the small companies.

Industry-wise computation of equity dividend ratio reveals that the same fluctuated between 30.02% (1985) and 41.1% (1988) in Pharmaceutical 29.6% (1987) and 51% (1989) in Food and 32.1% (1985) and 54.6% (1989) in Tea.

ii. Dividend Declaring Companies: (Table No. 5.09 & 5.10)
Table No. 5.09 presents an analytical view of the number of dividend-declaring companies. Out of 26 small companies, the number of dividend declaring companies deviated from 19 (1985-86) to 21 (1988-90)
i.e. about 27% to 19% of the total number of companies could not pay dividend. In the case of medium companies this number varied between 18 (1986-87) and 22 (1985). 25% out of 24 companies and only 25% to 8% did not declare dividend. In the case of large companies, this number ranged from 24 (1985) to 25 (1986-90) out of 25 companies almost all companies declared the dividend.

Thus the number of dividend-declaring companies was greater in medium and large companies than that in small companies. Taking all the companies together, the number was found varying from 62 (1986) to 67 (1990), which shows that about 89% on an average paid equity dividend each of the years under study. Thus the overall average has been affected by the adverse trends in small companies. In all the types of companies the number of dividend-declaring companies was the lowest in Food because of the lower profitability.

Industry-wise number of such companies fluctuated from 19 (1985) to 22 (1987-89) out of 25 in Pharmaceutical, and 16 (1986-90) to 17 (1985) out of 20 in Food and 25 (1986-87) to 29 (1985) out of 30 in Tea. Computing the six year average as present of the total number, it is found that the Tea topped the list with 53.67% and was followed by Pharmaceuticals 51.60% and Food 48.50%.
All dividend-declaring companies paid dividend out of current earnings except only one which declared dividend despite loss in the current year. This shows that there was strong tendency to pay dividend out of current earnings as far as possible. Once a company ploughed back some profit, it becomes difficult to withdraw the same for payouts. Further, the decade was marked with low industrial activities resulting into lower profitability and increase in losses. Once a company sustained loss, it was very difficult for it to recoup arrears of depreciation and development reserves along with the current provisions for the same from its yearly earnings. There was a continuous process of carry-forward of losses and arrears of depreciation leading to the postponement of equity dividends for years together in the case of a good number of companies.

Analysis of a number of companies, which did not declare dividend, reveals that a good number of them were such as had residual earnings but because of arrears of depreciation and losses they could not declare any dividend. Their number varied from 7 (1985-86) to 5 (1988-90) in small companies, 6 (1986-87) to 2 (1985) in medium companies, 1 (1985) to nil (1986-90) in large companies and 13 (1986) to 8 (1990) in all the companies included in this study. The industry-wise number of such companies fluctuated

iii. Payout Frequency : (Table No. 5.11)

By 'Payout Frequency' is meant the rate of yearly recurrence of the payment of the dividend i.e. for how many years during a given period dividend was paid by corporations. It reflects the degree of steadiness and certainty in dividend disbursement and is of great importance for all those who are interested in the perpetual life of the corporate units. We have computed the payout frequency of the companies covered by this study vide Table No. 5.11. It is found that out of 75 companies, only 71 i.e. about 94.6% could pay equity dividend for all six years, 5 for 4 years, 3 for 3 years, 1 for 2 years, 4 for 1 year.

The number of such companies which did not pay any dividend continuously for 6 years was 4 i.e. about of 5.3% of the total number.

Size-wise analysis of the payout frequency reveals that out of 26 small companies only 17 i.e. about 65% paid equity dividend for all the six years, 3 for 4 years, 2 for 3 years, nil for 2 years, 2 for 1 year. The number of such companies, which did not declare dividend continuously for all the six years covered by this study, was 2 i.e. 7.7%. Out of 24 medium
companies 16 i.e. about 66.7% declared dividend for all the six years, 2 for 4 years, 1 for 3 years, 1 for 2 years, 2 for 1 year. Those, which did not declare any dividend continuously for six years, numbered only 2, i.e. about 8.3% of the total. Coming to large companies, out of 25 companies 25 companies i.e. about 100% declared dividend regularly in all the six years and nil for 4 years. Those with zero frequency numbered nil i.e. about nil of the total. Thus it is obvious that the payout frequency was greater in medium and large companies than that in small companies.

Industry-wise payout frequency reveals that the number of companies with regular dividends was 19 out of 25 (76%) in Pharmaceutical, 14 out of 20 (70%) in Food and 25 out of 30 (83%) in Tea.

The number of such companies, which did not declare any dividend continuously for six years were 1 in Pharmaceutical, i.e. 4%, 2 in food i.e. 10%, and 1 in Tea. i.e. 33%.

5. Earnings Retained

Earnings retained out of residual profits i.e. divisible profits less development rebate and preference and equity dividend reflect the savings effected by the Board of Directors at their discretion. While giving our comments on payout ratios, it has been pointed out that the
corporate units in India prefer steady dividends to ploughed back profits and are at the same time reluctant to draw upon the past surplus. Their capacity to retain out of divisible profits has been drastically reduced by the statutory provision for depreciation and development reserves vis-a-vis the desire to pay steady dividends. Only medium and large companies with sufficient earnings could do both i.e. they paid steady dividends and at the same time retained the profits. Small companies suffered an aggregate loss while paying equity dividends. Our study shows that earnings retained in addition to development rebate amounted between 0.85 crores (1986) and 1.92 crores (1985) in small companies, 1.34 crores (1985) and 6.37% crores (1990) in medium companies, 4.58 crores (1986) and 8.69 crores (1990) in large companies and 6.83 crores (1986) and 16.90 crores (1990) in all the companies. Actual amount of retained earnings shows mixed trends. Computing the yearly averages, we find that the same was 1.38 crores in small companies and 10.59 crores in all the companies included in this study. It is thus observed that the aggregate disbursement of small companies were most unsatisfactory. Medium companies had an edge over large companies.

Industry-wise analysis reveals that this fluctuated between 3.02 crores (1986) and 7.12 crores (1990) in Pharmaceutical, 2.09 crores (1985), and 4.66 crores (1990) in Food and 1.53 crores (1985) and 5.12 crores (1990) in
Tea. Computing the average it is found that Pharmaceutical retained the highest of divisible profits (4.57% and was followed by Food (3.23%) and Tea (2.78%).

7. **Overall Plough Back**: (Table No. 5.12)
This refers to the total amount of earnings which are left within the corporation by way of depreciation, development reserves and retained earnings i.e. total distributable earnings less preference and equity dividends. It indicates the total increase in the funds flowing inside the corporations from the business operations and reflect their aggregate propensity to save. As already observed, the trends obtaining in the overall saving confirms our hypothesis. Overall plough back to the total earnings ratio fluctuated between 1.78 crores (1986) and 3.29 crores (1990) in small companies, 3.61 crores (1985) and 9.06 crores (1990) in medium companies, 11.70 crores (1986) and 22.01 crores (1990) in large companies and 17.44 crores (1986) and 34.36 crores (1990) in all the companies included in this study. The six year average worked out to 2.39 crores in small companies, 5.80 crores in medium companies, 17.08 crores in large companies and 25.27 crores in all the companies. Thus the large companies witnessed the highest rate of plough back, whereas in the case of net retained earnings, medium companies had the highest rate of saving. Large companies' overall saving rate was higher than that of medium companies owing to the fact that these companies earmarked more funds by way of depreciation and development rebate reserves.
Industry-wise study shows that overall plough back varied between 7.40 crores (1985) and 13.42 crores (1990) in Pharmaceutical, 4.80 crores (1985) and 10.52 crores (1990) in Food and 6.19 crores (1988) and 12.42 crores (1990) in Tea. The six year average of total retention was the highest in Pharmaceuticals at 61.37 crores and was followed by Tea 50 crores and Food 44.27 crores. Percentage was the lowest in Food because of the fact that this industry declared the highest payouts and claimed smaller allowance for depreciation and development.

CONCLUSION
It can be concluded that the Indian corporate sector has got greater propensity to save, which is quite conducive to the financial needs of a growing economy like India. More than 42.64% of the average current earnings before depreciation, is generally reinvested within the corporations, by way of amortization and development reserves. Size of a company and kind of industry exerted considerable influence over the capacity to plough back. It can be pointed out that the small companies which needed retained earnings most, could not do so because of inadequate earnings, whereas the large and medium companies with substantial profits could easily plough back even at the risk of being over capitalised. These companies acquired a huge capital block and claimed greater amount of depreciation and development rebate in ordinary course of appropriation of their earnings.