CHAPTER VII

COST AND USES OF RETAINED EARNINGS
CHAPTER VII
COST AND USES OF RETAINED EARNINGS

Retained Earnings refer to the residual profits which are withheld from the dividend disbursement and are called ploughed back profits. Traditionally, the same were termed as earned surplus, often misunderstood as an indicator of an excessive profitability. Attempts to do away such a misconception brought in vogue many terms like reinvested for undistributed earnings, corporate surplus or savings. The process of retention is described as auto or self financing.* By its very nature, the amount of retained earnings does not represent any specific assets but the increment in aggregate assets, which results from successful running of the business. As the entire divisible profits belong to share-holders, the earnings set aside by way of lower payout reflect the growth in equity so essential for withering adverse business conditions and strengthening the competitive position of the corporations. Unreliability of accounting statements and the impossibility of measuring the exact money incidence of business transactions have made the retention a necessary part of management of earnings. Provision for amortisation and other contingencies may prove inadequate and reserves for losses hidden inventories and account-receivables may become insufficient, warranting plough back of some portion

* Financing from internal sources by S.C. Kuchhal corporation Finance Page No.514.
of current earnings. Thus the retained earnings display the business prosperity of the company, exhibit the conservative outlook as against the adventurism of the management and also reveal the quality and efficiency with which operations are performed.*

RETAINED EARNINGS

Internal financing accounts for a substantial proportion of financing for a number of reasons:

1. It is an inexpensive method of acquiring funds. The cost of acquiring internal funds is negligible.

2. Ploughing back earnings avoids taxation leakage.

3. It stimulates a high growth rate.

Corporate management is responsible for preserving its solvency. To this end retained earnings are desirable. Business corporations are subject to variations in earnings, and it would be foolhardy not to retain a part of these earnings during periods of high profits so that they may be profitably employed when cyclical, seasonal and/or social factors cause earnings to decline sharply.

Retained earnings are the earnings of a corporation which are retained in the business. They constitute the sum total of those profits which have been realised over the years since incorporation and which have been re-invested in the business rather than distributed in the form of dividends. These earnings

stand to the credit of equity stockholders and the stockholders’ equity, therefore, includes them. Retained earnings constitute that part of the owner’s equity representing the undistributed earning of the corporation and are its net earnings since the beginning, less dividends distributed to stockholders. The accumulation of earnings is a dynamic process and takes several years; and it is accelerated with profits and decelerated with losses. The process of creating internal savings and their utilisation in business is referred to as ‘ploughing back of profits.’

Retained earnings are often referred to as earned surplus or re-invested income. The term undivided profits may be used to explain the meaning of retained earnings. Though the amount of retained earnings or undivided profits may be legally available for dividend declaration, it merely represents the amount already ploughed back into the business to effect an over-all increase in its net assets. It is not represented by any specific asset, nor is there any relationship between the amount of cash and the amount of retained earnings. The latter represents a source of assets, but not any specific asset.

In the ordinary course of things, revenues are profits which are either distributed to the owners or kept within the business. When a company is engaged in diverse activities, it may show as income the profits from non-recurring transactions, or direct
certain income-items to retained earnings. With respect to costs, too, it may make certain non-recurring charges to income or directly to retained earnings. The management has the discretion to determine the extent to which such items may effect its net income.

Retained Earnings - A Case

It would be worthwhile to explain the case of retained earnings. It may well be diagnosed under the following sections:

1. Retained earnings and the industry.
2. Retained earnings and the corporation.
3. Retained earnings and the stockholders.
4. Retained earnings and society.

1. Retained Earnings and Industry

Retained earnings may enable an industry to withstand downswings in the business cycle. With the help of retained earnings, it may be well-equipped to ward off tensions which are temporarily created during the lean years. Secondly, an industry may be able to implement schemes of modernisation out of accumulated profits. It may be able to face problems of depreciation, replacements and obsolescence. Thirdly, during a critical period, it may get a sufficient time-lag to adjust or re-adjust itself without affecting stockholders, creditors, etc.

2. Retained Earnings and the Corporation

This is the most convenient source of finance for a corporation. For example:
i) Funds can be made available to it with the least effort. When retained earnings are used, uncertainties of public financing are removed, and the difficulty of having to measure market conditions need not be experienced.

ii) Small companies find it extremely difficult to approach the organised capital market or to raise loans through commercial banks and other financial institutions. It is, therefore, very convenient for them to resort to internal financing.

iii) A corporation need not pay interest on bonds or dividends to stockholders.

iv) Retained earnings, if used for productive purposes within the business, have a multiplier effect on accumulated surplus. They project a healthy financial picture of the corporation. Satisfactory accumulated earnings are an indicator of the prosperity of a corporation. Further, when corporations use retained earnings, the latter may often be less costly than external financing.

v) Retained earnings can be used for regular working capital when they are created out of expanding business operations and growing inventories.

vi) It is possible to pay cash dividends out of retained earnings and to have a stable dividend policy.

vii) The presence of retained earnings enlarges a company's credit base, for it increase the amount of residual equity.
Retained earnings are an important source of capital for expansion purposes, for corporate profits can be readily ploughed back into business. Since expansion money is venture capital, the employment of a firm's own funds is a sound, conservative means of financing expansion.

It may be more profitable to retain corporate profits for additional capital rather than raise it by the sale of new securities. Retained earnings have been a very important, if not the most important, source of funds for financing the growth of nearly all successful corporations.

They may be used in order to extinguish bonded indebtedness or to retire preferred stock.

Slow, rather than rapid growth, may result from the use of retained earnings, the former involves less risk than the later.

More optimistic managements not only reinvest the profits which have already accumulated but also those hoped for in the future. In that case, expansion policies are of course, limited to conservative estimates of future earnings.

Reinvestment of earnings and even reinvestment in expansion is determined by the corporate management and not by stock-holders. The corporate management can take such investment decisions as are in the ultimate interest of the corporation.
Earnings can be retained without difficulty so long as they can be invested at a return which is higher than the cost of capital.

3. Retained Earnings and Stockholders

i] The retained earnings increase the residual amount of equity, which gives stockholders security against business uncertainties.

ii] On account of retained earnings the reputation of corporations in the organised market is enhanced, and their market value goes up.

iii] Stockholders develop a sense of participation when sharing in the profits of the company. Moreover, in the case of closely-held corporations, stockholders in high income brackets may welcome the non-receipt of dividends which otherwise would have inflated their income.

iv] Retained earnings give an assurance to stockholders that the corporation is keeping itself at arm's length from failures and financial difficulties.

v] Retained earnings, which are likely to be reinvested profitably by the corporation, are the most convincing evidence of its prosperity.

vi] They provide a cushion of safety and serve as risk absorbers in so far as stockholders are concerned.

4. Retained Earnings and Society

i] Retained earnings play an important role in the process of capital formation and in the economic prosperity of the country.
Retained earnings are a positive indicator of the growth and stability of a business enterprise. With retained earnings, a corporation avoids failures and financial disabilities. They ensure that society does not fall a prey to chaos and financial embarrassment resulting from a foreclosure of the corporation.

A corporation may be able to implement schemes of modernisation, as a result of which it may usher in a better standard of living for society. Moreover, retained earnings facilitate the storage of wealth, which is vitally essential for social progress.

The presence of retained earnings guards against technical insolvency.

A corporation can function with a greater degree of flexibility because retained earnings are at its disposal.

Thus, the practice of retaining a large chunk of the year's earnings in the business and distributing only a small portion of the theoretical earnings to equity has become a hallowed one in the administration of corporate finance. Not only is it freely resorted to; often, it is glorified.

**ADVANTAGES OF RETAINED EARNINGS**

1. The most important justification for the retention of earnings is often cited as the need to finance expansion.

2. Another and of late, a much-trumpeted reason for ploughing back is the omnipresent feature of inflation. Even if a
company does not contemplate any expansion of its physical activity, the falling value of the currency results in an upward movement of the cost of financing the same level of operations as last years.

3. another occasion, which is often used to rationalise the use of shareholders' earnings in the business, is when the management, by a conscious decision, opts to over-invest in inventory as judged by its conventional requirements.

4. The reason why resources are conserved is the divergence between profitability and liquidity.

5. Profits are retained to ensure a good market for the company's scrip on the stock exchange.

6. Another ground advocated in favour of the retention of profits is the frequent exhortations of the government to all and sundry to conserve resources.

LIMITATIONS OF RETAINED EARNINGS

However, retained earnings have their own limitations, which are outlined below:

1. Funds cannot invariably be used for productive purposes, as a result of which the process of retained earnings is likely to be diluted.

2. Because of the availability of funds through internal financing and the low cost of financing involved in it, a corporation may not be encouraged to earn a profitable rate of return on invested funds.

3. An impression is likely to be created among investors that the corporation must be suffering from an inability to
approach the organised market for finance or to meet the cost of external financing.

4. Waste is likely to be encouraged with the temptation to purchase excessive inventories and fixed assets.

5. A corporation may not bother to develop relation with institutional financiers and thus impair its image in the credit market.

6. If corporation chooses to expand by ploughing back most of its earnings in the business instead of declaring dividends, it tends to contract the number of stockholders. Those who depend on dividends for their income would shy away from it.

7. The retention of earnings gives rise to a form of involuntary investment by stockholders. The management should take decisions on retained earnings with respect to the effects on stockholders in order to avoid their resentment.

8. Ideally, from the social viewpoint, all earnings should be distributed to stockholders who should be left free to choose whether or not to reinvest them.

9. Earnings are subjected to the forces of competition in the capital market and market and are supposedly allocated to those segments of the economy which have the highest earning prospects. Retained earnings which are sheltered from these competitive forces and are under the management’s exclusive control, may be wasted on low earning projects within the company.
10. The policy to retain earnings is highly individualistic, for it depends on a company's needs, competition, stockholder attitudes and public relations. Moreover, unless there are special tax considerations, stockholders may justifiably be suspicious of companies which retain an exceptionally high proportion of earnings and thus decline to submit to the financial scrutiny and discipline involved in raising external equity.

11. There is some evidence to support the hypothesis that ploughing back earnings depresses the price of stock and raises the cost of capital, at least temporarily.

12. Retention of profits strengthens monopolistic tendencies in the economy and does not lead to the best allocation of the available investible resources.

**Arguments For and Against the Retention**

Divergent viewpoint for and against the retention of corporate profits have been expressed by the persons of different interests. One school of thought headed by the eminent industrialists, planners and financial experts gave strong support in favour of plough back. In a seminar held at Madras in June 1970, shri E.V. Raigopalan, President of Madras Stock Exchange, expressed the view that corporations should plough back funds sufficiently into their business. Late Dr. P.S. Lokanathan, a leading economist in India, opined that the policy of dividend limitation could be appreciated and the tax system which militated against the provision of reserves out of profits for further expansion did not have equal justification. Financial experts feel that a business enterprise, like a human
body, must have reserve strength for every possible emergency. Prof. S.C. Kuchhal of Indian Institute of Management, Ahmedabad, in reply to Shri M.P. Chitale's two articles, advocating a larger distribution of dividend, held that "retention of earnings involves a self-imposed financial discipline in which not only a company and its share-holders but also the society as a whole got high stakes. The corporate savings are one of the important forms of capital formation so essential for the economic growth. Corporate savings are anti-inflationary, propensity of investors is more to consume than to save. Corporate savings provide the financial stability and flexibility which are indispensable for successful operations of corporate management. Without this cushion, the corporate mortality rate grows higher. Thus by avoiding failure and other financial embarrassments, undistributed profits prove a vital factor in relieving the society from possible chaos and confusion. The low payout ratio enables an enterprise to face nicely the seasonal reactions and cyclical fluctuations."

Others led by professional share-holders oppose the retention of earnings on many grounds. They allege that this practice deprives the share-holders of their legitimate right of enjoyment and reinvestment. It interferes with the inherent function of the capital market to decree where capital shall flow and where it shall not. In many cases it results into over-capitalisation and social waste of resources, serves and encourages the vested inter-corporate investments, whereby a few industrialists remain

* From 'The Economic Times' Bombay, 9-7-70 Page No. 5.
in the possession of huge funds and create industrial empires dominated by their own interests. The shares of such concerns become more speculative and are subject to stock exchange manipulations, shuttering the credit-worthiness of many industrial enterprises.

An eminent Chartered Accountant Shri M.P. Chitale expressed great concern over the plough back profits.* He warned that the company law and tax laws have a positive bias towards a policy favouring limitations of dividend and encouraging plough back of profits, particularly in the case of widely held companies. This policy has retarded the development of capital market in India and has been largely responsible for unhealthy features in company management and enables to withhold the profits accountable to shareholders and made use of the funds without their consent. Spectacle of large profits owing to the assured protected market and cost free retained earnings induces the management to pass on the benefits to the executives and workers. The policy that helps to provide the cheapest sources of finance to the management ends up in building high cost economy.

Retention creates barrier against opening and widening new entrepreneurial class. It is against the financial discipline, as vigour is involved in the case of compulsory distribution of profits and the circumstances that the fresh capital would be

Forthcoming only on the basis of yield and security. Limitation on dividend has kept the large mass of investors in India, who belong to lower and middle income groups, away from the investment in company shares.

**Government Policy**

To combat the evil effects of unwanted accumulation of surplus funds and manipulation of stock exchange transactions, the Government of India has taken a number of measures like ban on forward trading in shares, withdrawal of development rebate and tax exemption to priority industries from 1971-72 and curbing the economic growth of monopoly and big business houses. The Companies (Amendment) bill 1972 proposed strict control over the withdrawal of accumulated surplus for dividend disbursement. Accordingly, companies have to seek permission from the Government before declaring dividends from the past profits.

Shri Chitale's plea for compulsory distribution of dividends for strengthening the capital market appears to be self-defeating. Disbursement of profits without regularity and gradual rise in payouts will weaken rather than strengthen the capital market as well as the capacity to invest of the lower and middle class and at the same time will deprive the corporation of the benefits accruing from the accumulated funds. Techno-structure of companies is bound to suffer for want of retained earnings, not to talk of loss-making companies. A close look at the history of the private sector reveals many instances of corporate failures caused by liberal dividend payments. There would be hardly a
single case of fatality owing to plough back. Appropriation of earnings into payouts and retention involves a complex decision making the process influenced by a number of considerations and financial exigencies of individual company. It is difficult to generalise them and prescribe common workable limits for disbursements and retentions. Profits earned by a company in one particular year cannot be ascribed only to the operation of that year. These are the results of so many past actions and future expectations.

In the present situation of acute shortage of capital and slackness in investment, it can be said that the corporate saving is a must for speeding up the economic development of the country. Corporate sector being well organised, can contribute more out of its huge profits to the plan resources. The fourth plan envisaged corporate saving of the order of Rs. 1950 crores (Rs. 390 crores every year) during the period from 1964-74, which account for about 8% of the total plan outlay. This figure for the first three plans amounted to Rs. 200 crores, Rs. 300 crores and Rs. 600 crores respectively. (Financial outlays of the respective PLANS). However, the actual plough back was less than the targets during the three plans. Industrial recession, leading to a fall in the overall profitability and steep decline in the income generating capacity of corporate assets has been responsible for the low rate of corporate savings. Many industries are still growing under the pressure of rise in costs, wages, fiscal burden and unremunerative prices for their products. The decision of raising the minimum bonus from 4% to
8.33% from 1976, irrespective of whether the concerns are making profits or losses, would lower down the profitability of the corporate sector. Bonus decision will affect the marginal units which constituted nearly one third of the industrial undertakings. Restriction on fresh investments by what are known as monopoly companies and big business houses is another factor. To a greater extent high costs and increased taxation serve as disincentives to savings. It was complained in the Annual Session of the Federation of Indian Chambers of Commerce and Industry, held at New Delhi on March 25, 1972, that the continued erosion of retained profits is the root cause of the present slack in investment. "Government imposed more and more taxes and discouraged retention and plough backs and thus forced industry to run to financial institutions for succour. Now a fear psychosis was being created by the threat for conversion of loans into equity".

The leading economist E.D.W. Decosts pointed out that during the last ten years, the retained profits of the companies had fallen by 50% and that was the root of the evil and advised the industrialists to ask for tax exemption for their retained profits.

---

** The Economic Times, Bombay dated 27-3-1972.
• From 'The Economic Times', bombay dated 27-3-1972.
Our study proves this fact in the case of small companies only. We have already studied the trends obtaining in the ploughed back profits in the preceding chapters under various headings and found that the size of the companies and the nature of industry exert great influence over their propensity to save. In the present chapter we shall examine the costs, composition and uses of corporate surplus i.e. accumulated reserves and surplus as increased and decreased by ploughed back profits, capital transactions and bonus issue.

Composition of Retained Earnings

The accumulation amount of corporate surplus comprises various types of reserves, provisions and surplus like development reserves, general and capital reserves, dividend equalisation fund, balance in profit and loss appropriation account and the like. It is not only the profit ploughed back out of current earnings, but also the capital receipts like premium on issue of shares and debentures, share forfeited, discount on redemption, capital gains from transfer or sale of fixed assets which increase the accumulated surplus.

Transactions like premium on redemption, issue of bonus shares, writing off the capital losses are the major means through which corporate surplus is utilized or reduced. We have studied the trends in the corporate surplus of the companies included in this study under three headings like "retained earnings", "capital adjustments" and "bonus issues".

233
1. **Ploughed Back Profits**: (Table No. 3.14 & 5)

Retained earnings are popularly known as ploughed back profits and refer to the total amount of current earnings which are reinvested in the business as development reserves, the balance left in the profit and loss account and other reserves. In the case of small companies, in 2 out of 26 companies in 1985 there was a net accumulated loss of Rs. 0.07 crores to Rs. 0.14 crores (1990) in the case of 3 companies and in the remaining years the amount of ploughed back was only a nominal one. The period from 1986 to 1989 was marked by considerable withdrawals. These companies could not retain current earnings even to the extent of development reserves. In the case of medium companies retained earnings varied between 3.61 crores (1985) and Rs. 9.06 crores (1990). Every year the amount retained was more than that required to be transferred to development reserve. Propensity to save was far greater in large companies than that in small and medium companies and their ploughed back profits enjoyed a greater degree of upward trend. In (1986) the total retained earnings were worth Rs. 11.70 crores and became Rs. 22.01 crores in 1990. Aggregating the retained profits of all types of companies, we found the trend similar to those of large companies.

Industry-wise analysis reveals that there was the loss of accumulated surplus sustained by Pharmaceutical companies ranged between Rs. 0.00 crores (1985) to Rs. 0.11 crores (1986), the same was Rs. 0.07 crores (1985) to rs. 0.20
crores (1990) in the case of Food and in the case of Tea it was Rs. 0.00 crores (1985) to Rs. 0.14 crores (1988). (Table No. 3.14).

It can be said that the rate of quantum of plough back profits directly depends upon the factors which determine the profitability and also influence the propensity to save. Low profitability was responsible for lower payouts and small savings in small companies and those belonging to the traditional and recession affected industries. At the present juncture it is difficult to eliminate completely the capitalistic character of the Indian economy. The existence of low profitable units cannot be denied in any of the industries. The progressive rate of corporate tax and other incentives can go a long way in improving the payouts and plough backs of such companies and provide a check on the mis-management of retained earnings by the large and high profitability of companies. In this regard the recommendations of Wanchoo Committee on tax evasion appear to be of much significance. The Committee has suggested that in the case of small companies with paid-up capital not exceeding Rs. 5 lakhs distributable profits up to 8% of the paid-up capital or Rs. 25,000, whichever is less is to be exempted in computing the total income under tax laws. In the case of companies with paid-up capital exceeding Rs. 5 lakhs, distributable profits up to 8% should be taxed at the rate of 30%. However, we are of the opinion that the paid-up capital of Rs. 5 lakhs is a quite
meager amount these days. Companies with paid-up capital and long-term borrowings upto 50 lakhs should be classified as small companies for this purpose.

2. Capital Adjustments: Table No. 5.13

Under the capital adjustments we have computed the net and combined effect of capital transactions, including the bonus issue, which increase or decrease the total surplus funds available in a corporation. In almost all the companies classified size-wise and industry-wise capital adjustment witnessed mixed and uncertain trends.

In the case of small companies, the impact of such transactions on the accumulated surplus varied to Rs. 6.14 crores in 1986 to Rs. 11.97 crores (1990). The same in medium companies varied from Rs. 10.15 crores (1985) to Rs. 43.67 crores (1990) and in large companies from Rs. 46.74 crores (1985) to Rs. 90.51 crores (1990). Industry-wise capital adjustments varied between Rs. 5.24 crores (1986) and Rs. 30.55 crores (1990) in Pharmaceutical, Rs. 0.34 crores (1987) and 27.89 crores (1990) in Food and 0.50 crores (1985) and Rs. 32.07 crores (1990) in Tea. It is thus obvious that capital adjustment brought about substantial increase and decrease in the accumulated surplus of the cost.

Bonus Issue

the Issue of bonus share is a common method of capitalization of accumulated surplus, whereby funds available in capital and
general reserves are transferred to share capital account and the ownership of the same is formally transferred to the shareholders. These shares are issued free to the existing shareholders and are called the gift shares. In the Western countries such shares are known as stock dividend. The process of capitalization provides a permanent fund for expansion without any effect on assets or cash position of the issuing company. It suits only to the under-capitalised companies, which enjoy a higher rate of return on the capital employed. Thus the bonus issue reflects the business propensity and enhances the credit-worthiness of the corporation. Issue of these shares can be justified by a substantial increase in the current earnings. Companies with fluctuating and uncertain earnings would take a great risk by capitalising their surplus.

By their very nature, Bonus Shares increase the paid-up capital and widen the share market. Issue of such shares is subject to the provision of Capital Issue control Act, 1947 and the guidelines issued by the Central Government. The objectives of the control are:

1) To prevent the investment going to wasteful channels
2) To ensure a sound capital structure of the company
3) To regulate the capital market in accordance with the financial needs of the Five Year Plan.

The Controller of Capital Issue performs his duties with the help of the Advisory Committee, which takes into consideration many financial and economic factors like the reasonableness of the
size of issue, debt equity ratio, price, terms and the rate of return on bonus issue before permitting the issue.

Historically speaking, the control over capital issue was introduced in the World War II with effect from May 17, 1943 under the Defence of India Rule 94 A and was to lapse on September 30, 1946. The same has been continued since Corporate Legislation was enacted the stringent regulation of the control taxation policy of the Government of India has been a factor of great significance, deciding the trends in Bonus issue. The Controller has to ensure that such shares are issued out of free responsibilities built out of genuine profits or share premiums collected in cash and the company does not get over-capitalized after the shares are issued and the residual surplus does not fall below the limit prescribed by the Government. This limit was 20% of the paid-up capital till March 1971 and has been increased to 33 1/3% thereafter. However, the said limit has been increased to 40% with effect from 19 August 1981. Government permitted only one bonus issue in a year before this date. No two bonus issues with a time gap of 18 months are allowed in the 5 years' period. Now the time gap between the two bonus issues is 36 months that too with effect from 12 August 1981.

The company issuing bonus shares is expected to pay more to their shareholders after such issue. For this purpose directors have to explain the dividend prospects while seeking approval of the Controller of capital Issues for capitalisation of reserves. With a view to discouraging excessive bonus issue, the Government
of India imposed bonus tax in 1956 by reducing the rebate from super tax to the extent of 30% of the face value of bonus shares. This rate was reduced to 12½% in 1962-1963 and abolished in 1966. Shareholders too had to pay capital gain tax on profits accruing to them on such shares on a notional basis for the year 1964-65 and 1965-66. This tax was taken back in 1966. Thus the abolition of bonus tax and capital gain tax provided a fillip to bonus issue whereby the company with sufficient surplus funds could rationalize its capital structure. As per our study, one cannot deny the fact that one of the attractions of investment in equity is the prospect of bonus shares. As reserves of the companies grow, whenever the announcement of bonus shares was made, the reaction in the share market was favourable. However, it should be remembered that the issue of bonus shares is a delicate matter requiring great foresight as regards the future prospects of earnings, the profits by the concerned company and the impact on their payouts. Strict regulations prescribed recently in August 1981 are expected to improve the image of corporate sector and help in removing the sickness in investment. Companies could have to go in for higher payouts in lieu of bonus shares.

Net Increase in Corporate Structure: (Table No.5.13 & 5.14)

The net result of all the three factors: ploughed back profits, capital adjustment and bonus issue, affecting the quantum of corporate surplus, has been computed vide Table No.5.13. It is noted that the accumulated surplus of the small companies was gradually slashed down by the losses of payouts. The surplus of
small companies ranging from 6.14 crores (1986) to 11.97 crores (1990). In large companies the rate of increase in the accumulated profits was quite encouraging i.e. 46.74 crores (1985) to 90.51 crores (1990), there was a progressive trend. In medium size companies the net increase in the surplus worked out to be Rs. 10.15 crores (1985) and it became the highest in (1990) at Rs. 43.67 crores.

Industry-wise analysis of increase in the corporate surplus reveals that the same varied from 30.44 crores (1985) to 56.47 crores (1990) in Pharmaceutical Rs. 15.51 crores (1985) to 55.11 crores (1990) in Food and Rs. 18.89 crores (1985) to 34.57 crores (1990) in Tea.

With a view to studying the trends obtaining in the increase or decrease of accumulated surplus, easily understandable, we have computed the indices of the total amount of the corporate surplus at the end of every year, taking (1985) as the base. It has been observed that the index number for corporate surpluses recorded continuous growth in medium companies and large companies. It went as high as 477% in the medium companies and 196% in the large companies. Its growth was far from satisfactory in small companies, specially in the years after (1986) till that index recorded a gradual rise and became the highest at 150%. there was a heavy loss of accumulated surplus thereafter. The index number fell down to 77 in (1986) and improved to 89% in (1987).

Industry-wise analysis of indices of account surplus reveals that the index number recorded continuous growth in all industries.
Companies derive equity capital from retained earnings as well as from the sale of equity stock. Since virtually all corporations rely primarily on the equity source of capital, the cost of retained earnings is the same as the cost of financing by means of equity stock. Yet the companies apparently prefer the former because of the convenience and ready availability of internal financing. A management can simply use funds as part of its recurring activities. It does not draw a line of distinction between funds obtained from stockholders and retained earnings.

Some managements consider retained earnings financing as cost-free. They believe that a large injection of equity capital which comes through retained earnings with no explicit out of pocket loss would be treated as if it were a cost-free resource. Since the internal sources of funds are much more important to corporations than equity funds raised externally, it becomes a matter of considerable importance whether or not to measure the cost to retained earnings. Managements which assign no cost or a low cost to internally generated funds may, as a result, undertake projects which they would not touch if they had to raise equity capital externally.

Retained earnings may be appropriated or unappropriated. Appropriated retained earnings indicate that apart of them has been made unavailable for dividends or any other purpose except that specified by the appropriation, such as for working capital. Retained earnings may be appropriated or earmarked at the discretion of the Board of Directors so that they may be used:
To cover losses occurring in the future — appropriation for possible future decline in inventory loss due to a flood or unfavourable law suit and similar other happenings;

To expand plant, retire preferred stock, redeem long-term debt;

To replace assets at a higher cost;

To appropriate for self-insurance;

To appropriate for working capital;

To appropriate for meeting restrictions imposed by law or by contract, such as bond indentures which may restrict the payment of dividends or other charges against retained earnings. Appropriation of retained earnings does not necessarily restrict the payment of dividends. It merely indicates that a portion of retained earnings, although legally available for dividends, should not be used for that purpose for the time being, because the directors are of the opinion that it is financially inexpedient to do so. They have the right to return the appropriation to unappropriated retained earnings at any time unless otherwise specified, say, for example, in bond indenture. Unappropriated retained earnings represent that portion of retained earnings which has not been appropriated for any specific use and which is available for general corporate purposes, including dividends.

The return earned on the reinvested surplus is the most important measure for the desirability or otherwise of the plough back. The marginal or additional profits, arising out of the
utilization of surplus, ought to be equal to the opportunity cost i.e. rented or transfer value which could be obtained at a point of time if the funds were put to alternative uses. In other words, retained earnings should bring in a return better than or at least matching to the minimum or normal rate of return. Generally speaking, the divisible profits net worth ratio should not fall with increased doses of funds reinvested in the business of the individual corporate. But from practical point of view it is not always a foolproof measure for the efficient use of extra funds. A good number of factors, affecting the cost and demand of the goods other than the quantum of capital, influence the profitability of a corporation. It is difficult to isolate the impact of increase in net worth caused by retained earnings on the rate of return. However, it can be safely opined that ordinarily the infusion of retained profits within the business should not result into over-capitalization and overall profitability should not fall. Earnings accruing on net worth (particularly to the equity interest) should be more than the normal rate of return. Trends visualized in the aggregate data on earning before interest and tax to capital employed ratio vide Table No. 4.05 reveals that in all companies analysed size-wise and industry-wise, this ratio was more than the normal rate of return. Analysing divisible profit net worth ratio as per Table No. 4.10, it is again found that the rate varied between 17.24 (1985) to 19.43 (1990) and was in tune with the normal rate except in (1987) and all the small companies. Here also it cannot be said that the lower rate was caused by heavy plough
back major portion of their earnings. This trend is in keeping with the normal rate of interest on fixed deposits and other investments and provides sufficient margin for additional risk involved in equity. Thus it can be concluded that the retained earnings were better utilized by the companies despite adverse circumstances created by recession and rising costs. Low return on capital in Food was caused by the working of these units which was below capacity.

Shareholders' View-point

Like corporation, the cost of reinvested profit to shareholders is the opportunity cost of such funds to them. Opportunity cost of retained earnings for shareholders is equal to the income that would otherwise accrue to them after paying the individual tax thereon. Hence, the cost of retained earnings would be equal to (E-T) x (Rate of Interest), where E stands for earnings and T for tax rate. But the marginal rate of Income Tax being the function of personal tax liability of the shareholder, different for the different investors, there cannot be a single tax rate which would correctly reflect the opportunity cost of the retained profits for a public company with a large number of shareholders. Many shareholders, who feel uncertain about the earning capacity of the company in future and virtually live on the dividend income, always prefer to receive the entire amount of divisible profits as dividend immediately, whereas others like

---

trust and other public institutions remain indifferent towards the dividend disbursement policies of corporation. The recent amendment to Section 80L of the Income Tax Act, exempting dividend and interest income to the extent of Rs. 3,000 has changed the situation in respect of tax liabilities of investor vice versa cost of retained earnings. In our opinion, it is difficult for the corporate units to fulfill the wishes of all the classes of investors. The management is expected to follow consistent financial policies which are most reasonable to shareholders as well as to the corporation.

That is to say, the corporation should earn a normal rate of ploughed back profit.

It appears unreasonable for the management to consider tax liability for shareholders. Again, the cost of equity capital is determined on the basis of the normal rate of return. The argument for using a separate rate of return and the opportunity cost of retained earnings appears to be less important.

**Use of corporate Surplus**

The plough back of surplus funds plays a very prominent role in financing industrial expansion. Before the setting up of Financial Institutions at the national as well as state levels, inadequacy of external funds was not felt much because of the low level of industrial activities. The financial needs of the corporate sector were met out of the public deposits, debentures and ploughed back profits. During the Second Plan period, institutional financing became more important for rapid
industrialization. There was a significant change in the sources and uses of funds of the corporate sector in the Third Plan. Disproportionate increase of financial assistance provided to private sector by public institutions was very much criticized. Nationalization of 17 leading commercial banks in 1969 and change in the lending policies of the institutions on the recommendations of Licencing Inquiry Committee have caused a sharp decline in the corporate sector's dependence on institutional financing. Conversion of loans into equity has been resorted to in a good number of companies. The growing share of internal resources in financing industrial activities has been the most important feature of the changing pattern of corporate structure during the first two years of the Fourth Plan. The recent boom in corporate savings has enabled the private industrial sector to reduce its dependence on the financial assistance from financial institutions. As per the survey of the financial pattern of 1019 companies appearing in "The Economic Times", dated 20th June 1972. The internal funds financed about 49.1% of the assets during the Third Plan which was higher than 44.7% in the Second Plan but was substantially lower than 58% during First Plan period. As a result of the recession during the non-plan years 1966-69 the share of the internal resources for financing the assets fell quite significantly to 43.7%. However, with the beginning of the Fourth Plan and the revival of industrial climate, production and profitability, there has been a perceptible importance in the contribution of internal resources with the result that during
the first two years of the Fourth Plan these sources financed 55.7% of the assets. The bulk of the same came from depreciation though the growth rate in the retained profits was much higher.

With a view to studying the trends obtaining in the uses of accumulated surplus available with 75 companies covered for this study, we have computed 3 important ratios as follows:

% of accumulated surplus over
a. Paid up capital
b. Net worth
c. fixed Assets.