Chapter II

Retained Earnings as a Source of Corporate Finance

The amount of profit that can be ploughed back to business depends on the amount that is available for appropriation for the said purpose from the post tax profit. Post tax profit is not only a combination of net financial results of the company by way of turnover, as adjusted by reduction of expenses, but also the extent to which fiscal incentives have been availed of. In other words, profit is the indicator of performance of the company, and the economy it has been able to achieve thereunder on the one hand, and also the extent to which a fiscal opportunity as offered by the Government has been availed of by it. Post tax profit, needless to mention, greatly depends on successful tax planning by the organisation. Out of post tax profit what remains after payment of dividend is the retained earnings including reserve. Retained earnings therefore are directly linked with the dividend policy of the organisation. Basic difference
between investment as lender and investment in equity is that in the case of the former the return is known while in the case of latter, the return is dependent on the company's performance and policy. The investor in equity will expect not only a steady return on his investments but also capital growth. Growth of capital, again, depends on how healthy the company's financial position is allowed to grow whose indicator is the company's reserve position. In other words the company's policy should be to combine a reasonable dividend with sufficient growth in retained earnings to allow the reserves to grow.

Equity holders are the owners of the business and hence own whatever is left after meeting contractual liabilities. These 'left overs' can come to him either in the form of dividend or in the form of a bonus issued by capitalisation of reserves composed mainly of Retained Earnings or in the form of higher return arising from utilisation of retained earnings for growth of business. Issue of bonus shares increase the holding of the investor without any corresponding investment by him and
thus entitles him to a higher amount of dividend. Utilisation of retained earnings in business growth improves the networth of the company and thus fetches a higher price for the shares in the stock market. The investor can either sell his shares for immediate capital gain or may decide to hold on to the shares in the hope of higher dividend in future. A valuation model to determine the cost of equity can be formulated as follows:

\[
V = \frac{D_1}{(1+k)} + \frac{D_2}{(1+k)^2} + \frac{D_n}{(1+k)^n}
\]

where \( V \) is the current market value of shares, \( D_1 \) to \( D_n \) is the stream of accepted dividend and \( k \) is the cost of equity finances. From the point of view of the individual shareholder the dividend stream may be cut short if he decides to sell his investments and thus foregoes his right to future dividends. What he gets by selling is the capitalised value of future dividends as discounted by the risks and uncertainty associated therewith.
The retained earning is an indicator of such future dividends which pushes up the price of shares in the stock market. An additional price that the buyer has to pay is the opportunity cost in the form of return foregone by the seller on his investments. Investor's Preference, whether high dividend low retained earnings or low dividend and high retained earnings, will depend on the tax slab in which the investor falls. The investor paying high rate of income tax would prefer to get less dividend which will be eaten away by tax and make capital gains (having a low tax element) by selling the shares in the stock market at a higher price based on better retained earnings position. On the contrary, a low tax payer's preference will be for higher dividend because of the immediate liquidity rather than capital gain which does not make much difference to him so far as tax is concerned.

Company law requires certain disciplines to be observed at the time of declaration of payment of dividend. In India Companies (Transfer of Profits to Reserve) Rules, 1975 requires the transfer of the following percentage of current profit based on the proposed dividend:
<table>
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<tr>
<th>Proposed Dividend (as percent of paid up capital)</th>
<th>Transfer to Reserves (percent on current profit)</th>
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<tbody>
<tr>
<td>more than 10 percent but upto 12.5 percent</td>
<td>at least 2.5 percent</td>
</tr>
<tr>
<td>more than 12.5 percent but upto 15 percent</td>
<td>at least 5 percent</td>
</tr>
<tr>
<td>more than 15 percent but upto 20 percent</td>
<td>at least 7 percent</td>
</tr>
<tr>
<td>more than 20 percent</td>
<td>at least 10 percent</td>
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Another set of Rules of the Government of India which governs dividend is the Companies (Declaration of Dividend out of Reserves) Rules, 1975. Under these Rules, in the event of inadequacy or absence of profit in any year dividend may be declared by the company for that year out of the cumulative profits earned by it in previous years and transferred by it to the reserves subject to the conditions that:

(a) the rate of dividend declared shall not exceed average of last five years' dividend or ten percent whichever is less;
(b) the amount to be drawn out of the general reserves shall not exceed ten percent of the paid-up capital and free reserves and shall first be utilised to set off the losses incurred in the financial year, and

(c) the balance of reserves left after withdrawal shall not fall below fifteen percent of paid-up capital.

These regulatory provisions have been made to discipline dividend payments and to ensure that dividend declared is not disproportionately high compared to the profit made and also to compel the company to transfer part of its profits to reserve for future needs.

As mentioned earlier the cost of equity capital was taken to be the rate of discount which would equate the current market value of the share with the expected future dividend stream which for simplicity is assumed to be constant and also represents the rate which the shareholder expects to obtain from the best alternative use. The investor will retain the funds in the company only if the expected return from the investments is at least as great as the best alternative internal opportunity foregone.
In discovering the best alternative use for the many thousands of shareholders in public companies E Soloman had suggested two approaches to the problem. The first one is the 'present use' approach, i.e. the use to which the shareholder can put the money if he receives it as dividend. Unfortunately this is quite impracticable because consumption pattern of shareholders will vary with time and will also depend on the tax slab he falls into and the second approach suggested by Soloman was that the assumption should be made that shareholders could reinvest the money, if released to them, in equivalent-risk securities in the market. Therefore, the minimum rate would be the rate at which the company could reinvest the money on behalf of the shareholders in securities in other firms. This is known as 'external yield' approach. The biggest disadvantage of this is that the company tends to determine the minimum required rate of return rather than trying to gauge accurately the best alternative to internal reinvestments. It is therefore the endeavour of the Company to reach an equitable reconsideration of the different circumstances of their shareholders in terms of company's retention and reinvestment policy. As it would be extraordinarily difficult to reconcile these interests, perhaps the least undesirable strategy for the company would be to be explicit about their future policies and thus attract
those shareholders who would prefer such policies to suit their investments and tax requirements. Shareholders wanting other policies could transfer their interests to other investments. The problem of uncertainty and secrecy, however, would make such a strategy difficult to adopt.

There are other sources of retention which act as sources of finance. These are sources like depreciation provision which is charged against profit but does not involve any cash outlay and to that extent is a source of funds. Similarly provision for payment of taxation at sometime in the future which is retained in the company temporarily also acts as a source of finance till the tax is paid.

Profits are retained for diverse reasons some of which are specific, some general. Sometimes these profits are transferred initially to reserves or alternatively they may be carried forward to the next year as the balance on the Profit & Loss Account. Reserves are created in two ways, one is by setting aside part of the profit and creating a revenue reserve while the other is by creating reserves from the surplus on 'Capital Transactions,' which is called 'Capital Reserves.'
Reserves can again be specific or general depending on their purposes. Some reserves are created for specific purposes relating to events which might happen at a future date with reasonable certainty. When a company has issued preference shares with a known redemption date the directors may pursue a policy of setting aside from profits each year sufficient amount to ensure that by redemption date they have created sufficient funds to repay preference shareholders. This reserve would obviously be created with a specific purpose in view.

Another specific reserve may be to cover the increased cost of replacement of fixed assets which may be required in addition to the asset covered by depreciation to ensure normal depreciation charge and the specific reserve which may aggregate to withstand fluctuation in dividend rates due to varying profits, this may be called 'Dividend Equalisation Reserve'. However, the tendency is to take cash from the fluctuating profits by means of tapping the General Reserve where balance of Profit and Loss Account is transferred.

Another type of reserve is General Reserve. This reserve is basically created to provide funds for expansion, to
withstand fluctuation in profit for payment of stable dividend or for capitalisation by issue of bonus shares. Projects can be financed either by internal financing or by external financing or by a combination of both. Usually in any financing scheme the company has to provide marginally as its share in the total project cost. Such marginal finance usually comes from the General Reserve that the company has been able to create. Again, there are activities for which external financing should be difficult to attract, like Research and Development. Such projects are best financed out of the company's own general reserve.

One outcome of very high general reserve is pressure from shareholders for its capitalisation by issue of bonus shares. In India the Controller of Capital Issues Government of India usually mentions, as a condition for his approval to the bonus issue, that the average aggregate amount of dividend for the last three years will be distributed even after bonus. In other words, the shareholder is entitled to receive same amount of dividend on his increased holding by reducing the rate of dividend on shares. For the company, therefore, there is no additional demand on funds for dividend payment and the only impact is that the
amount in the general reserve comes down. It also means that the company has to shell out more money in case it decides to increase the rate of dividend. For the investor though the aggregate total amount of profit may remain the same, he stands to make profit out of capital gains inspite of the fact that the share price will come down after the bonus issue compared to the pre-bonus-issue quotation.

There is a false belief that retention is free of cost. Debt capital bears a contractual interest cost, but there is no physical transfer of funds analogous to interests involved in the use of retentions. But there is an opportunity cost. If funds are retained and reinvested on behalf of the shareholders, they forego the direct use of that money to consume goods and services now, or through investment, later. The opportunity cost of retained funds is the return in the form of dividend foregone by shareholders they would have otherwise received, but for the decision to retain the funds. Basic decision on retaining the funds lies with the Directors though shareholders, through stock market, can exercise a more subtle influence on the company's decision by valuing shares according to the dividend attached to them.
Strong market preference for some dividends may influence the Board of Directors to honour acceptance of return prevailing amongst the investors.

Modern theory about corporate behaviour, is that large companies must be regarded as a coalition of very different interests in a dynamic and continually changing environment. Main interest groups may include the ordinary shareholders, preference shareholders, debenture-holders and other lenders, directors, employees, other group of work people, trade unions, creditors, customers, suppliers, community and the government.

Amongst these groups the Directors hold the lever of power on a day to day basis and one of the most important tasks is to keep the different interest groups satisfied without paying too high a price for doing so. It is the Board of Directors who decides about the profit retention and there are a number of factors which influence them. Profit retention avoids or reduces the need for approaching the market for funds and thus gives an opportunity to the Company for further growth with internal resources. Depending too much on external market for funds may upset the long term
investment programmes due to unpredictable market fluctuations. Moreover raising funds from the market either in the form of equity or debentures involves costs which sometimes become substantial. The question comes what is the cost of capital in respect of retention of profits.? It is not true that no costs are incurred in obtaining these funds. What has to be considered is the opportunity cost in case of such funds. In other words, the directors ought not to retain profits as the source of new funds for the companies operation unless they are satisfied that they will be employed effectively and profitably. If there are any immediate alternative investments then the opportunity cost can be considered to be the return which can be obtained by investing the funds in guilt-edged securities.

The danger of regarding any source of funds as costless, or as lower than their credited cost is that the funds will be invested in a project which prompts only a low rate of return. This obviously is unsatisfactory from the shareholder's point of view. From the viewpoint of the economist it is not only unsatisfactory but serious. Investment
funds are a scarce economic resource which should be directed by the economic system towards the project after the rate of return commensurate with the uncertainty involved.

Each year the directors of the firm make a dividend decision whereby they pay to the ordinary shareholders part, all or none of the profits earned during the year. Most firms do not pay out all their earnings all the time but prefer to keep some in the business either as reserves or for investment in projects.

In deciding on the dividend the board of directors is also deciding for the shareholders how much they should invest. The following explains the procedure. Tax complications are ignored.

<table>
<thead>
<tr>
<th>Net earnings</th>
<th>Rs 7,000</th>
<th>This belongs to the Shareholders.</th>
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<tbody>
<tr>
<td>Dividend Declared</td>
<td>Rs 2,000</td>
<td>The shareholders receive this in cash.</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>Rs 5,000</td>
<td>The directors have decided to keep this amount of shareholders' money in the business.</td>
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Had the Rs 5,000 retained earnings been paid to the shareholders they would have been able to use the money as they wished. The directors, by keeping the money in the business, have decided that the shareholders will derive greater benefit by increasing their investment in the firm. By retaining earnings the directors are providing funds for further investment. They should be quite certain that the return on the proposed investment will be higher than the return which the shareholders could achieve if they had received the funds.

Retained earnings provide industry with much of the funds needed for investment. Very often these funds are retained without considering the implications of the decision. In a private company the directors are normally the owners and consequently there is no possibility of affecting the interest of persons other than themselves by an incorrect decision being reached. In fact incorrect decisions are hardly taken by persons who are directly in control. In a public company, however, the directors may only represent a part of the total ownership and so they must be very careful to make decisions in the best financial interests of the shareholders.
as a whole.

The advantages of retained earnings as a source of funds are that:

(a) There is no change in the control pattern of the firm.

(b) Retained earnings, being equity capital, reduce the financial risk of the firm, i.e. lower the debt/equity ratio.

(c) The funds are readily available and do not involve expensive issuing costs.

(d) There is no fixed charges.

(e) There is no fixed maturity, as equity capital is a perpetuity.

(f) There is no increase in the number of shares, so even a small return on the investment of retained earnings will increase the earnings per share to all existing shareholders.

The disadvantages of retained earnings are that:

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(a) Management may not be as careful with retained earnings as they would be with an alternative source of capital.

(b) Retained earnings may not be the most suitable source of capital, i.e. a firm with no debt and stable earnings may be able to raise debt capital more efficiently than using retained earnings.

(c) The 'cost' of retained earnings may be high.

The last disadvantage is often difficult to explain to management who look on retained earnings as a costless source of funds. They point out that retained earnings have no issuing costs, and that no new dividends arise. This serious error has led many a management into a serious trap. If retained earnings are viewed as a costless source of finance management is tempted to reduce dividends. Paying out low dividends often causes share prices to remain low. High levels of retained earnings, if properly invested increase assets per share. Over time, assets per share may greatly exceed the share price. This makes the company vulnerable to a takeover bid which can result in management losing their jobs.
Since retained earnings are equity their cost is the same cost as that of raising new shares with the exception of the issuing costs attaching to new shares.

As stated already, the amount of earnings retained is a function of the dividend policy followed by a business. In practically every case the dividend is a cash payment to shareholders. A dividend payment reduces in actuality the value of the business. The power to declare a dividend rests with the board of directors of a company. Dividends are sometimes declared twice yearly. An 'interim' dividend is paid when the half-yearly results are announced and a 'final' is declared the annual results. The dividend decision is voted on at the annual general meeting. Dividends need not and cannot be declared unless profits have been made or unless reserves of undistributed profits exist. It is illegal to declare a dividend out of subscribed capital in terms of the provisions of Section 205 of the Companies Act, 1956.

In attempting to define a policy on dividends the
directors must remember that the objective of the business is the maximisation of the long-run wealth of the owner. In practice this means maximising the share price in the long term. The effect of dividends or the lack of dividends on the share price has been the subject of much theoretical debate. In the early 1960s Modigliani and Miller put forward a well-argued thesis that the value of a business was defined totally by the earning power of the firm. It therefore did not matter whether a firm paid dividends or not, in terms of net worth to shareholders, there could be no difference between paying dividends on the one hand or allowing retained earnings to reflect themselves in share price rises on the other. The model used by the individuals concerned assumed a world of perfect certainty and no taxes. Modigliani and Miller suggested further that investors would invest in firms with dividend policies which suited their own needs.

Other researchers take a very different view. In a world of uncertainty, dividends are relevant because investors are receiving cash now instead of making an uncertain gain in the future. The evidence available tends to support the view that firms
paying dividends are in general more highly valued than firms retaining all earnings.

Differing taxation policies also affect the issue. In some countries like Ireland capital gains tax at 30 per cent on inflation-deflated profits is lower than the average income tax rate paid by investors on dividend income. This suggests that many investors would prefer lower rather than higher dividends.Offsetting this to some extent is the tax relief available on dividends paid out by many companies.
## BIBLIOGRAPHY

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