CHAPTER - IV

PATTERN OF GROWTH - I
(Internal Sources)

As discussed earlier, growth assumes three forms, viz. (1) by internal growth or by the process of expansion through retained earnings; (2) by external finance or by sale of securities to the public and (3) by the process of combination.

In this and the subsequent two chapters, growth pattern through three methods has been analysed. The present chapter attempts to examine the growth pattern through internal sources. Among the internal sources, I have taken Free Reserve (Reserve and Surpluses) as growth stimulant. Provision for Taxation and Depreciation are used for specific liabilities.

ROLE OF INTERNAL SOURCES
IN THE PATTERN OF GROWTH

The corporate funds are drawn from internal and external sources. In a developing economy, corporations, at almost all stages of their development, have to rely on external finances. Most of the empirical studies both in India and abroad have shown that investment or rate of growth of corporations depends upon the volume of internal savings. But at the same time it is observed that big companies are in a position to save and for them accumulation is automatic. They have huge earnings which enable them to plough back a greater proportion of their earnings. This definitely helps them in maintaining a faster growth rate. Small companies, on the other hand, cannot accumulate adequate internal finance mainly because of their low profitability. Consequently, they have to look to the capital market which does not support much. It is interesting that the big companies have both the ability and willingness to save but have to approach the capital market to finance their capital requirements. It may be due to the fact that their own internal resources are inadequate to finance the rapid assets growth or expansion which these companies visualise. Big companies could get only 56.6 per cent of their needs for capital expenditure out of their internal savings. Small companies could attract only 15 per cent of their funds required by them to finance their capital.

development programme during 1968–69. It shows that neither the big companies nor the small companies wholly depend upon internal finance as the entire corporate sector meets 50 per cent of its requirements from external sources.

Business savings accumulate from a variety of sources. Some of them are provisions which are specially made to pay certain liabilities such as taxes or depreciation and other impending liabilities. These savings are also accumulated for the replacement of assets and expanding other capital equipments. The residual surplus for development purpose accumulate after making provision for taxation and depreciation. The net surplus reserve is imputed after the payment of dividend to the preference and ordinary share-holders. The reserve and surplus are classified into the following three groups:

(1) Capital Reserve, and
(2) Development Reserve Reserve, and
(3) Other Reserves.

A brief description each of these reserve is pertinent to this inquiry.

1. CAPITAL RESERVE

A capital reserve is one which is not available for distribution as dividend. It may be derived from one or more of the following sources:

(a) Capital profits which can not be distributed

as dividend such as profits earned prior to incorporation, profits made on the purchase of a business by a company, unrealised appreciation in the value of a fixed asset, premiums received on the issue of shares and debentures, or profit on redemption or conversion of debentures if their distribution is repugnant to the company's Articles.

(b) Any business remaining in the capital reduction account where the share capital of a company is reduced in accordance with the provisions of Section 55.

(c) Any general reserve standing in the books of a company where share capital has been reduced.

(d) Reserve profits which are not represented.

(e) Profits of an exceptional nature, which is not desired, should be available for distribution.

**TABLE - 30**

**PATTERN OF RESERVE & SURPLUS OF BIG COMPANIES**

**DURING 1965-66 - 1969-70**

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<tbody>
<tr>
<td>B</td>
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<td>S</td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

| 1. Capital Reserve as percentage of Reserve and Surplus | 8.9 17.8 9.7 33.1 9.4 38.4 9.2 38.9 8.2 MA |
| 2. Development Reserve as percentage of Reserve & Surplus | 25.0 18.0 30.5 24.0 33.7 21.2 34.3 23.9 35.1 MA |
| 3. Others as percentage of Reserve & Surplus | 64.2 65.1 59.8 45.7 56.7 39.8 56.4 37.0 56.6 MA |

**SOURCE:** Calculated from Reserve Bank of India's Bulletins

B = Big companies; and S = Small companies.
Table 30 shows that small companies retained a greater portion of capital reserve out of their reserves and surplus and it was 38.4 per cent and 38.9 per cent respectively, as against 9.4 per cent and 9.2 per cent respectively, of big companies during the period 1967-68 and 1968-69.

**DEVELOPMENT REBATE RESERVE:**

The purpose of this reserve is to tap the surplus account for a specified amount for improvements. It may be designated as a reserve for additions and constructions or other similar terminology may be used.

The creation of this reserve is accomplished by transferring the surplus. No new assets are obtained by setting up the reserve and, hence, it in no way assists in the immediate financing of construction activities. Indeed, it may be created after the means of making the improvements have actually been assembled.

The expansion, as provided, affected only the assets position of the company, and the individual equities were in no way changed. However, it is not decided that the corporation’s current financial position is not impaired by the expansion and that the addition be officially and permanently recorded as coming from accumulated earnings. Hence, the general surplus account will be decreased by the amount of expansion and a new reserve for development
account established.

In the establishment of this account, the expansion actually occurred first, but the procedure may be reversed. The principles are essentially the same, however, because:

(i) a reserve for improvement would be created by reducing the general surplus account by a like amount, and

(ii) upon the actual construction of the new plant, fixed assets would be increased and current assets decreased (assuming no new financing).

Although the creation of a reserve for development does not immediately provide the means of constructing the new additions, it does provide for the funds in an ultimate sense. By setting up a reserve for development, that amount is no longer available directly for dividend declaration; and hence, in an indirect way the retention of an equal amount of assets is assured automatically. Of course, the funds or assets could be retained by means of general policy; but the existence of a separate reserve account publicly announces the policy of permanent retention of assets on a legal as well as on economic basis. By the establishment of the account, the share-holders are informed to a certain extent of the expansion programme and the source of the funds for its financing. It is desirable for concerns that are expanding through the medium of earnings to adopt some specific procedure rather than blindly accumulate the funds through the

1. op.cit., p. 430.
Development rebate allowance is one of the most important, major, substantial and effective tax incentive allowed to industries under the provisions of the Income Tax Act, 1961. The Scheme was introduced for the first time by the Finance Act of 1955 on the recommendation of the Nathal Commission with a view to provide incentive for industrial development of the country.

**CONDITIONS FOR THE ALLOWANCE OF DEVELOPMENT REBATE:**

The allowance of development rebate shall be granted only if the following conditions are satisfied.

(i) The asset is owned by the assessee and is used wholly for the purpose of his business and not for profession;

(ii) The prescribed particulars have been furnished by the assessee in respect of the ship or machinery or plant;

(iii) An amount equal to 75 per cent of the development rebate to be actually allowed is debited to the profit and loss account of the relevant previous year and credited to a reserve account to be utilised by during a period of 8 years not following for the purposes of the business of the undertaking.
The reserve should not be used:

(i) for distribution by way of dividends of profits, or
(ii) for remittance outside India as profits or for the creation of any asset outside India.

This clause shall not apply when the assessee is a company being a licencsee within the meaning of the Electricity (supply) Act, 1948, or where the ship has been acquired or the machinery or plant has been installed before the 1st January, 1958.

In respect of the ships acquired after 28th Feb. 1966, the quantum of the development rebate reserve to be created by ship owners has been reduced from 75 per cent to 50 per cent.

Development rebate shall not be derived by reason only that the amount debited to the profit and loss account of the relevant year and credited to the reserve account aforesaid exceeds the amount of the profit such previous year as arrived at without making the debit as aforesaid in accordance with profit and loss account.

The machinery, plant or ship in respect of which development rebate has been claimed shall not be sold or otherwise transferred by the assessee to any person at any time before the expiry of 8 years from the end of the previous year in which it was acquired or installed and allowance made under Section 33 or under the corresponding provisions of the Indian Income Tax Act, 1922. Following
an exceptional case where this condition shall not apply:

(i) where the ship has been acquired or the machinery
or plant has been installed before the 1st Jan., 1958, or

(ii) where the ship, machinery or plant is sold or
otherwise transferred by the assessee to the Government,
a local authority, a corporation established by a central
State or Provisional Act or a Government company, or,

(iii) when the sale or transfer of the ship, machinery
or plant is made in connection with the amalgamation or
succession.

An infringement of any of the above conditions shall
attract the provisions under Section 156(5) regarding the
revision of assessment of the year in which the develop-
ment rebate was first allowed and now it shall be withdrawn
in revision.

It will be observed from Table-30 that big companies
recorded a higher percentage of development rebate reserve
out of their total reserves, and it was 37.7 per cent and
34.3 per cent respectively against this it was 21.2 per cent and
23.9 per cent respectively of small companies during the
years 1967-68 and 1968-69.

Big companies, as mentioned earlier, have set aside
a higher amount of development rebate, due to their urge
to expand their business units. Besides, big companies
reduced their tax burden, by creating a larger amount of
reserve for the purpose.
OTHER RESERVES:

This reserve is simply the total of the accumulated earnings allowed to remain in the business, which are not designated for any particular purposes. It includes profits retained in the form of various sinking funds and reserve and specific reserves (such as plant, repair reserve, building repair reserve, gratuity reserves, pension reserve).

Firstly, it is desirable to align surplus with some specific programme and a portion of the reserve is definitely tagged as being for that objective. If we refer to Table-30, it would be clear that big companies are making extensive use of other reserves. Table-31 shows that other reserves as percentage to reserve and surplus were 64.2 per cent in 1965-66, but declined to 59.8 per cent in 1966-67 and no substantial decrease is noticed during the subsequent years.

It would be significant to make size-wise study of the use of other reserve. The analysis of Table-30 reveals that big companies have set aside a greater portion of 'other reserve' out of their total reserve and surplus during the years 1965-66 and 1969-70, and it was 56.5 per cent, 56.6 per cent of big companies; against this it was only 39.8 per cent and 37 per cent of small companies during the period 1968-69 and 1969-70 respectively.
### TABLE - 31

Annual percentage increase (+) or decrease (-) of profits before tax, provision for taxation, profit after tax, provision for depreciation, distributed profit, reserve and surplus, gross fixed assets, of big companies during 1961-62 and 1969-70

<table>
<thead>
<tr>
<th>YEAR</th>
<th>Profits</th>
<th>Provision</th>
<th>Profits</th>
<th>Provision</th>
<th>Profits</th>
<th>Reserve</th>
<th>Gross Fixed Assets</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>before</td>
<td>for</td>
<td>after</td>
<td>for</td>
<td>distributed</td>
<td>and</td>
<td></td>
</tr>
<tr>
<td></td>
<td>tax</td>
<td>taxation</td>
<td>tax</td>
<td>depreciation</td>
<td>surplus</td>
<td>fixed assets</td>
<td></td>
</tr>
<tr>
<td>1961-62</td>
<td>14.1</td>
<td>9.4</td>
<td>9.4</td>
<td>7.9</td>
<td>10.3</td>
<td>-33.1</td>
<td>9.5</td>
</tr>
<tr>
<td>1962-63</td>
<td>11.7</td>
<td>36.9</td>
<td>-5.6</td>
<td>11.4</td>
<td>-2.7</td>
<td>10.9</td>
<td>9.9</td>
</tr>
<tr>
<td>1963-64</td>
<td>18.7</td>
<td>26.9</td>
<td>23.6</td>
<td>14.5</td>
<td>15.3</td>
<td>12.6</td>
<td>10.9</td>
</tr>
<tr>
<td>1964-65</td>
<td>10.8</td>
<td>11.8</td>
<td>9.9</td>
<td>27.9</td>
<td>19.9</td>
<td>14.5</td>
<td>8.6</td>
</tr>
<tr>
<td>1965-66</td>
<td>24.9</td>
<td>24.4</td>
<td>25.3</td>
<td>28.4</td>
<td>26.0</td>
<td>22.4</td>
<td>8.6</td>
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<tr>
<td>1966-67</td>
<td>3.4</td>
<td>-4.8</td>
<td>17.8</td>
<td>11.5</td>
<td>4.9</td>
<td>-0.7</td>
<td>11.5</td>
</tr>
<tr>
<td>1967-68</td>
<td>-10.8</td>
<td>-20.7</td>
<td>-9.9</td>
<td>6.0</td>
<td>1.1</td>
<td>6.2</td>
<td>9.7</td>
</tr>
<tr>
<td>1968-69</td>
<td>1.0</td>
<td>2.8</td>
<td>-0.4</td>
<td>7.2</td>
<td>2.9</td>
<td>8.0</td>
<td>8.1</td>
</tr>
<tr>
<td>1969-70</td>
<td>27.4</td>
<td>12.7</td>
<td>39.3</td>
<td>21.4</td>
<td>14.3</td>
<td>9.9</td>
<td>7.8</td>
</tr>
</tbody>
</table>

**Source:** Calculated from the R.B.I. Bulletins.
Another important feature which emerges from the study of the Table-30 is that there has been a steep decline in other reserve of small companies. It declined from 65.1 per cent in 1965-66 to 37.0 per cent in 1969-70. The main reason for this decline is that the rise in total expenditure was steeper than the rise in total income during 1968-69. As a result, small companies had to withdraw from reserves to the extent of Rs. 62 lakhs in 1968-69.¹

The accumulation of internal reserves is affected by the following factors:

1. Profitability of big companies;
2. Provision made to taxation and depreciation;
3. Dividend policy of the company.

PROFITABILITY AND ACCUMULATION OF SAVINGS:

Ability to save of a company is indicated by its rate of profit. The more prosperous the corporation, other things being equal, the more stronger will be its position to save. To what extent the accumulation of reserve and surplus depends upon the increase in the profit is indicated by the Table-31. It will be clear that in years where improvement in the profitability has been noted, reserve and surplus has been increased but not to the extent profit has increased. It may be that a greater proportion in profit has been used in the payment of dividend setting aside funds for provision.

say on account of higher taxes or depreciation allowances. A complete picture will be before us when we will compare the accumulation of reserves and surplus with provisions and dividends.

PROVISIONS OF TAXATION AND ACCUMULATION OF RESERVE AND SURPLUS

One of the characteristics feature of Indian corporate tax structure is its ever increasing rate. The corporate tax rate as percentage to profit before tax has increased from 38.6 per cent to 51 per cent in 1970-71. Profitability slightly reduced to 50 per cent in 1970-71. Profitability of the companies has not increased in the same proportion. Consequently, companies are deemed to pay this out of their revenue and surplus. This can be seen from Table-52.

To what extent reserve and surplus has been affected by increasing provision for taxation is at once made clear by the Table-51. Since the profits before tax have not witnessed the same increase as is reflected in the increase of tax provision, the accumulation of surplus and reserve has been affected. In this manner, big companies can not take full advantage of their increasing profitability. This relief even has not been provided by depreciation allowances.
TABLE - 32

INTERNAL SOURCES OF BIG COMPANIES AS PERCENTAGE TO TOTAL LIABILITIES

<table>
<thead>
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<tbody>
<tr>
<td>1. Reserve and Surplus</td>
<td>20.5</td>
<td>17.7</td>
<td>17.4</td>
<td>17.7</td>
<td>18.4</td>
<td>N.A</td>
</tr>
<tr>
<td>2. Provisions</td>
<td>5.8</td>
<td>5.0</td>
<td>4.3</td>
<td>4.2</td>
<td>3.9</td>
<td>N.A</td>
</tr>
<tr>
<td>3. Reserve and Surplus as %age to Net Fixed Assets</td>
<td>44.9</td>
<td>38.2</td>
<td>37.8</td>
<td>38.9</td>
<td>41.1</td>
<td>N.A</td>
</tr>
</tbody>
</table>


DEPRECIATION ALLOWANCE AND ACCUMULATION OF RESERVE AND SURPLUS:

Depreciation funds as it is well known, accumulates for the replacement of assets. The Indian tax system allows certain allowances in the accumulation of depreciation funds but it is tied down to the original cost of the assets. The depreciation can not exceed the original cost of the assets during its entirety.

Depreciation allowances, undoubtedly, facilitate internal accumulation of funds and without their provision the incidence of taxes would have been more severe on business. But depreciation provisions do not by themselves generate fresh funds. The cash flow secured through depreciation is mainly the return to liquidity of funds.
invested in fixed assets in business. The effect of the provision is to secure a tax free cash flow to the extent depreciation is admissible for tax purposes and to withhold distribution of the amount so secured as income. Accumulation of depreciation funds and depletion reserve, etc. are not necessarily available in the cash form; in that way, they do not increase the total resources of the companies. Re-investments of these funds, however, finances the capital demand and a stable price level may even permit some expansion in the equipment. This is true because the productive life of the asset exceeds the block life of depreciation and the new asset is generally made more productive through investment in technology.

The Table-31 shows that during the period 1961-62 to 1969-70, the tax provision and depreciation funds have persistently increased mainly at the cost of Reserve and surplus. This is due to the fact that corporate income tax does not strike the important source of internal financing, represented by depreciation. Over the ten-year period, accruals to depreciation have consistently increased while addition to surplus and reserves are nominal. The additions made to the depreciation funds are not admitted by the Income-tax authorities over and above the book value of the assets. But the
management regards depreciation in terms of replacement of values rather than merely accounting for the investment originally committed for its care.

PROFITS DISTRIBUTED AND RESERVE AND SURPLUS:

The annual increment in reserve and surplus is residual in the sense that it accumulates after the distribution of profits, and it bears the burden of taxes, depreciation provision. The Table shows that in recent years when the profits after tax have declined and the distributed profit did not bear the burden of taxes, the addition to the general reserve has diminished. Besides, it is estimated that on account of consistently increasing process of assets, the general reserve has been used to the extent of two-and-a-half times of the depreciation funds to preserve intact the capital invested in depreciable assets. The general reserve is thus employed as a sort of replacement fund for the cost replaced equipment and over and above its original cost. While this is equivalent to new investment, it is possible that it may not forge any addition in its capacity.
INTERNAL SOURCES AND RATE OF GROWTH OF BIG COMPANIES:

As pointed out earlier, internal savings are broadly divided into Reserve and Surplus and provision. It can be observed from Table-32 that the total internal savings as percentage to total liabilities have declined from 26.3 per cent to 22.5 per cent in 1969-70. The decline is mainly on account of tendencies of the companies to reduce their provisions for depreciation. It is also on account of certain reduction in tax rate specially in 1969-70. Consequently, provision for depreciation and taxation have declined from 5.8 per cent in 1965-66 to 3.9 per cent in 1969-70. The decline in internal sources is also affected by Reserve and Surplus. Both capital reserve and Development Rebate Reserve have been affected mainly on account of earning capacity of the companies, as a result of which reserve and surplus as percentage to total liabilities have declined from 20.5 per cent to 18.4 per cent in 1969-70. This decline in internal savings has lost some of its position in total assets formation. Thus, the percentage of internal sources, i.e. Reserve and surplus as percentages to net fixed assets formation has declined from 49.44 per cent in
1965-66 to 41.1 per cent in 1969-70. This decrease in the rate of internal finance has not arrested the growth of fixed assets formation. It has increased the reliance of big companies on external sources which is explained in the following chapter.

**CONCLUSION:**

It is observed in this chapter that business savings are motivated for a variety of purposes. These motives are distinctly illustrated in the balance sheet of companies. Depreciation funds do not serve any development as they accumulate to replace an asset. However, there are other types of savings which accumulate to finance the growth process, particularly the Development Rebate Reserve, which also enjoys some tax privilege. But the residual profit which is ploughed back for development is steadily declining.

Even though big companies are in a position to plough back a significant part of their profit, yet in recent years, on account of increasing rates of taxes, their ability to retain profit has declined. Stability in dividend rate has given more prominence to all size of companies, particularly big companies. Consequently, the share of internal savings to finance development has decreased. This is evident from the fact that percentage of internal sources as percentage of net capital formation has declined from 49.44 per cent in 1965-66 to 41.1
per cent in 1969-70. But this fall in internal
savings has not arrested the growth of big companies
which shows that growth is not dependent on these
savings. It may be that increasing facility in the
availability of capital which has been made possible
through direct and indirect government support, has
made the growth process of big companies independent
of the accumulation of internal savings. The analysis
in the following chapter will show the growing importance
of external sources in financing the growth of big
companies.