CHAPTER III
PROPRIETORSHIP FUNDS

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(A) EQUITY SHARE CAPITAL

(1) Nature of Equity Share as a Source of Finance

By 'Share' in a company is meant not any sum of money but an interest measured by a sum of money and made up of diverse rights conferred on its holder by the articles of the company, which constitutes a contract between him and the company. 'Share' means a share in the share capital of a company and includes stock except where the distinction between stock and shares is express or implied. 'Equity Share Capital' means, with reference to any such company, all share capital which is not preference share capital. Sections 85 to 90 of the Indian Companies Act, 1956, deal with kinds of share capital and voting rights. They do not apply to any private company unless when it is the subsidiary of a public company. The principles underlying these sections are (i) that voting rights are generally confined to holders of equity share capital, preference shareholders being given rights of voting only for certain purposes and under certain given conditions and (ii) that voting rights and other rights of shareholders are to be strictly proportional to their share of equity share capital.

A public limited company may raise funds from the promoters or from the investing public by way of equity shares. The equity shareholders are the owners of the company and they undertake the risks of business. They elect directors to run the company and have the largest
degree of control over the management of the company. Since equity shares can be paid off only in the event of liquidation this source has the least risk involved. This is more due to the fact that the equity shareholders can be paid dividend only when there are distributable profits. However, the cost of equity shares is usually the highest. This is due to the fact that such shareholders expect a higher rate of return on their funds. Further, the dividend payable on these shares is an appropriation of profits and not a charge against profits. This means that it has to be paid only out of after-tax profits. The equity share capital provides a security to the other suppliers of funds. In view of this, a company having substantial equity capital may find it easier to raise funds. The Indian Companies Act lays down a number of provisions regarding the issue and management of equity share capital.

It is a well known fact that equity shares are the base on which the superstructure of a company is erected. This is the primary and main source from which a public company obtains the base capital. All other sources are secondary. They are a charge on the assets of a company. The finance from these sources can be raised only when assets are acquired out of the finances raised through equities and charges have been created on them. Thus, finances from other sources are dependent on the equities. This makes the issue of equities a matter of fundamental importance to a company, and the very coming into being
of a company and its continued existence are dependent on the equities. The equities assume such an importance because, according to the Companies Act, dividend can be paid out of profit after tax and such a dividend does not cumulate. All other securities - ownership or creditorship - do not possess this characteristic and, therefore, the equities owe their importance as a source of finance to the corporate sector. Even if a company does not earn reasonable amount of profit for any number of years, it is not legally obliged to pay any dividend to the equity holders. However, in practice, if this happens, the equities will be quoted at a discount and the company cannot raise further capital either from rights issues or further issues to the general public. On the other hand, there may be a company which declares dividend at a reasonable rate, say 10%, but in this process may distribute a major portion of its earnings. This prevents the company from retaining a reasonable portion of its earnings for augmenting its capital to reduce its costs and to increase its surplus for lean years and for expansion, modernisation, etc. A running corporate undertaking, which does not generate sufficient internal resources, fails to instil confidence in the minds of equity holders and the general public, and therefore, may have to depend on borrowings entailing a burden of fixed charges on the already meagre resources of the undertaking. This is one of the causes of sickness amongst the concerns.
The basic factors responsible for emphasis in capital structure, on equity financing and the avoidance of fixed charges are: (i) High proportion of operating expenses in comparison to income from sale. (ii) Instability of prices of equity owing both to seasonal and cyclical causes. (iii) Dominance of generally non-mortgageable current assets in the figure of total assets.

Investors of equity shares in companies with more stable earning record are content with more secure but modest returns.

A study* was undertaken recently to assess the popularity of equity shares as an investment alternative. Interviews with 400 individual investors were held. Equity was the most attractive investment to 123 persons and it was least attractive to 78 persons. The other interviewees liked other forms of investment. The frequency distribution of the factors behind the preference for equity shares is presented in Table III.1.

<table>
<thead>
<tr>
<th>Factors</th>
<th>No. of persons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Higher returns</td>
<td>38</td>
</tr>
<tr>
<td>Capital appreciation</td>
<td>25</td>
</tr>
<tr>
<td>Liquidity of funds</td>
<td>18</td>
</tr>
<tr>
<td>Safety and security</td>
<td>16</td>
</tr>
<tr>
<td>Extra benefits-Bonus shares</td>
<td>17</td>
</tr>
<tr>
<td>Tax benefits</td>
<td>6</td>
</tr>
<tr>
<td>Regular dividend</td>
<td>3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>123</strong></td>
</tr>
</tbody>
</table>

Table III.2 shows the relative importance of factors leading to the belief that equity is the least attractive form of investment.

<table>
<thead>
<tr>
<th>Factors</th>
<th>No. of persons</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market fluctuations</td>
<td>56</td>
</tr>
<tr>
<td>Poor returns</td>
<td>10</td>
</tr>
<tr>
<td>Chances of market value being reduced</td>
<td>10</td>
</tr>
<tr>
<td>No tax advantage</td>
<td>--</td>
</tr>
<tr>
<td>High initial investment needed</td>
<td>2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>78</strong></td>
</tr>
</tbody>
</table>

The study concluded thus,

(i) The credentials of people behind the company are the single most important influence on the investors' evaluation of an investment.

(ii) Dividend record and Reserves position are the most important technical criteria.

(iii) Past performance is more important than the future prospects.

(iv) General reputation and popularity of a company is also important.

(v) A general idea about the soundness of the concern rather than specific returns and profitability is considered more important.
A public company must conform to certain prescribed criteria under the Capital Issues (Control) Act, 1947. A public limited company issuing capital exceeding Rs. 25 lacs during a period of twelve months is required to file a statement of the capital issues proposed with the Controller of Capital Issues at least 30 days before the date of the proposed offer of capital. Such proposals as conform to certain financial criteria including the following, are exempt from control:

(i) DER should not exceed 2 : 1.

(ii) Total paid-up preference share capital should not exceed one third of total paid-up equity share capital.

(iii) The issue of equity shares should be at par, and not at a premium or at a discount.

(iv) The value of equity share capital subscribed by promoters, directors and their friends should not be less than 15% of total issue capital, if it does not exceed Rs. 1.5 crores. It should not be less than 12.5%, if the total capital issued does not exceed Rs. 2 crores, and not less than 10%, if the total capital issued exceeds Rs. 2 crores.

(v) The rate of interest on debentures and the rate of preference share dividend does not exceed 8% and 9.5% respectively.

(vi) Such shares should be eligible for listing on recognised stock exchanges.
The exemptions are not applicable to the issue of securities by companies registered under section 26 of the MRTP Act.

The issue of equity shares as a source of finance is beneficial to the issuing company in many ways. It does not entail fixed charges. There is no legal obligation to pay dividend on equity shares. Regarding the capital, it does not carry any fixed maturity date. Since it provides cushion against losses for creditors, its sale increases the creditworthiness of the company. It may at times be sold more easily than debt. It carries a higher expected return than does a preference share or a debenture. It provides investors with better hedge against inflation than does a preference share or a debenture as it represents the ownership of the company.

However, equity share has its own limitations as a source of finance. Its sale extends the voting right and thereby a part of controlling power to additional equity shareholders. Hence, additional equity financing is avoided by new and small companies. The owner managers are not willing to share their control and incomes with others. The use of debt may enable a company to utilise funds at a low fixed cost. In the case of equity shares, the costs of underwriting are usually higher than those for preference shares or debentures for two reasons.

(i) Costs of investigating equity share investment are higher than those of investigating the feasibility of
comparable debenture security. (ii) Equity stocks are more risky. In addition to this, equity dividends are not deductible as an expenditure for calculating the company's income subject to tax, but debenture interest is tax-deductible. Equity share prices fall in recession and cause a rise in the cost of capital and in turn, reduce investment.

(2) Equity Share Financing in Cotton Textile Mills of Ahmedabad

As mentioned earlier, proprietorship funds refer to those funds which have been collected in the form of paid-up equity share capital, paid-up preference share capital and Reserves and surplus. It has also been made clear that the share of proprietorship funds in the total funds was around 30% during both the periods of study, i.e., 1966-70 and 1971-75. In this section, the intention is to study the role of equity share capital from two points of view: (a) Its share in total funds. (b) Its share in proprietorship funds.

This study reveals that out of a total 55 issues of equity shares, as many as 29 issues were having a face value of Rs. 100 per share. Table III.3 provides a break-up for all the 55 issues.
Table III.3  
Equity Share Issues

<table>
<thead>
<tr>
<th>Face value of equity share (Rs.)</th>
<th>No. of issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>1</td>
</tr>
<tr>
<td>50</td>
<td>2</td>
</tr>
<tr>
<td>100</td>
<td>29</td>
</tr>
<tr>
<td>125</td>
<td>7</td>
</tr>
<tr>
<td>200</td>
<td>6</td>
</tr>
<tr>
<td>250</td>
<td>9</td>
</tr>
<tr>
<td>500</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>55</td>
</tr>
</tbody>
</table>

A study of Table II along with Table No. XIX reveals the role of equity shares as a source of finance. The main findings are:

(i) The average share of total paid-up capital in total funds had declined from 13.50% during 1966-70 to 10.10% during 1971-75, i.e., by 25.20%, without any significant change in the variability factor.

(ii) The role of equity share capital in total funds had declined more than marginally from 11.30% during 1966-70 to 8.50% during 1971-75, i.e., by 24.78%. This was accompanied by a moderate change in the variability factor.

This means that the importance of equity share as a source of finance had fairly declined during the latter period.
Some of the exceptional cases in this regard are worth noting.

(i) In the case of cotton textile unit Nos. 9 and 37, the share of total paid-up capital in the total funds was far below the overall average during both the periods. However, this share had increased marginally during the latter period.

(ii) In the case of unit Nos. 40 and 47, the share of total paid-up capital in total funds was below the overall average during both the periods and, it had further declined marginally during the latter period.

(iii) In the case of unit No. 16, the share of total paid-up capital was quite above the overall average during the former period. However, it had declined notably during the latter period by 33%.

The exceptional cases in regard to equity share capital were as follows:

(i) In the case of cotton textile unit Nos. 8, 19, 21, 32, and 34, the share of paid-up equity capital in total funds was far below the overall average during both the periods, and had declined during the latter period.

(ii) In the case of textile unit Nos. 9 and 40, although the share of paid-up equity capital in total funds was far below the average during both the periods, it had increased marginally during the latter period.
A study of Table III and Table XIX regarding the equity shares as a part of the proprietorship funds leads to the following observations:

(i) The average share of total paid-up capital in proprietorship funds had declined by 18.95% during 1971-75 as compared to that during 1966-70. This was accompanied by a marginal change in variability factor.

(ii) The average share of paid-up equity share capital had declined during the latter period by 16.5%, and this was accompanied by a marginal change in variability factor. This means that the cotton textile mills were following fairly uniform policies in regard to this source of finance during both the periods of this study.

The exceptional cases in regard to the share of total paid-up capital were:

(i) The share in the case of unit Nos. 4, 17, 37, 41 and 43, was far below the overall average during both the periods, but had increased during the latter period.

(ii) In the case of unit No. 9, the share of total paid-up capital in proprietorship funds was below the overall average during both the periods and in addition to this, it had declined further during the latter.
(iii) In the case of unit Nos. 8, 18, 19 and 25, the share of paid-up capital in proprietorship funds was fairly above the overall average figure in both the periods. In the case of unit No. 18, this share had increased, whereas, in the case of the other units, had declined during the latter period.

In regard to the share of equity share capital in proprietorship funds, some cases are noteworthy:

(i) In the case of unit Nos. 37, 41 and 48, the share was below the overall average in both periods, i.e., 1966-70 and 1971-75. It had further declined during the latter period in the case of unit No. 47, whereas it had increased in case of unit Nos. 37 and 41.

(ii) The share was quite above the average in the case of unit Nos. 18, 27, 29 and 32, during both the periods. It had increased further in the case of unit No. 18 and had declined in the case of the other units during the latter period.

The share of equity capital in total paid-up capital is illustrated in Table IV.

It is clear from the study that the share of equity capital in the total paid-up capital of all the fifty textile units of Ahmedabad had increased very marginally by 1.80%, from 78.60% during 1966-70 to 80.00% during 1971-75. This was not accompanied by any significant change in the variability factor. This means that only
one fifth of the total paid-up capital was in the form of paid-up preference capital during both the periods.

It may be noted that there were some exceptional cases here, too:

(i) In the case of unit Nos. 4, 6, 9, 26 and 45, the share of equity capital in total share capital was far above the average during both the periods, but had declined only in the case of unit No. 45 during the latter period. Six units in 1966-70 and 5 units in 1971-75 had not issued any preference shares.

(ii) In the case of unit Nos. 28 and 35, the share was below the average during both the periods, but it had increased during the latter.

(iii) In the case of unit Nos. 8, 22, 25, 27, 29, 31, 33, 34 and 46, the share had not changed at all. In the case of unit Nos. 22, 27, 29, 31, and 46, no preference shares were issued and, in the other cases, although the share was below the average, it had remained unchanged during the latter period.

For the comparison of the role of equity shares in cotton textile mills of Ahmedabad with the other units of the cotton textile industry and other industries, a reference may be made to several studies undertaken by individuals and institutions:

(i) The study made by Rao* leads to the observation...

that the share of equity capital in total funds in large and medium public limited companies having a share capital exceeding Rs. 5 lacs had declined from 34% during 1966-67 to 1970-71 to 32% during 1971-72 to 1971-75. At the same time, the ratio of dividend to profit before tax had declined from 33% to 23% during the two periods. A possible explanation is that the role of equity shares and dividend pay out ratio are closely interconnected.

(ii) The studies made by RBI*, reveal that in the case of cotton textile industry as a whole, the role of paid-up capital had gradually declined. A study of 261 textile companies during 1966-67 to 1970-71 indicated that the share of paid-up capital was 8.5%. During 1971-72 to 1974-75, it had declined to 3.80% in the case of 271 textile companies studied. With respect to new issues of shares also, a declining trend was noticed.

This phenomenon can be explained in terms of payment of dividend. As is revealed by V.L.Mote in his study "Some Aspects of Textile Policy", the dividend to net worth had always been lower in the case of cotton textile industry. The ratio was 4.32% for the cotton textile industry and 5.38% for all industries in India put together during 1965-66 to 1970-71, and it was 4.45% for cotton textile industry and 5.25% for all industries put together during 1970-71 to 1973-74.

(iii) The study of the Research Bureau of the Economic Times* revealed that the share of paid-up capital in total funds had declined from 28.80% during 1972-73 to 10.70% during 1973-74 in the case of large industrial projects belonging to 30 Indian industries. Similarly, a declining trend in the role of new capital issues was marked from the Second Five Year Plan onwards as shown in Table III.4.

Table III.4

<table>
<thead>
<tr>
<th>Particulars</th>
<th>Second Plan</th>
<th>Third Plan</th>
<th>Annual</th>
<th>Fourth Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid-up capital of new issues: (%age share in total funds)</td>
<td>10.09</td>
<td>7.60</td>
<td>5.60</td>
<td>3.10</td>
</tr>
</tbody>
</table>

(iv) The study of the financing patterns in cotton textile industry made by Kothare and Menon** revealed that the role of paid-up capital had declined in all industries (vide: Table III.5).


Table III.5

<table>
<thead>
<tr>
<th>Paid-up capital (in Rs. crores)</th>
<th>1965-66 to 1971-72 to 1970-71</th>
<th>1974-75</th>
</tr>
</thead>
<tbody>
<tr>
<td>Textiles:</td>
<td>201 Companies</td>
<td>8.02</td>
</tr>
<tr>
<td>Other industries:</td>
<td>1240 Companies</td>
<td>66.26</td>
</tr>
<tr>
<td>Textiles:</td>
<td>271 Companies</td>
<td>7.70</td>
</tr>
<tr>
<td>Other industries:</td>
<td>1379 Companies</td>
<td>59.50</td>
</tr>
</tbody>
</table>

The above figures show that the role of total paid-up capital as well as equity share capital had declined in the cotton textile industry as a whole, as in the case of all the industries working in India. In other words, the decline in the importance of equity share and the total share capital in cotton textile mills of Ahmedabad was in no way different from the situation that prevailed in all industries including the entire cotton textile industry in the country.

(3) Protection to Shareholders

Lord Jenkins, Chairman, Company Law Board, U.K., had said, in unambiguous terms: "The illusory nature of the control theoretically exercised by shareholders over directors has been accentuated by the dispersion of capital amongst an increasing number of small shareholders who pay little attention to their investments.
so long as satisfactory dividends are forthcoming, who lack sufficient time, money and experience to make full use of their rights as occasion arises and who are, in many cases, too numerous and too widely dispersed to be able to organize themselves*. If this is the story of an advanced country like U.K., where people are much more conscious of their economic rights, no wonder that in the underdeveloped economy of India the illusory nature of the shareholders' control reaches its climax.

The shareholder, while acquiring, holding or disposing off his holdings requires protection from at least three groups. Firstly, he requires protection against the corporate management who might misuse his funds for their own purposes. Secondly, he is required to be protected against the Government who might enact laws and institute procedures affecting his interest. Thirdly, protection also is called for against the share brokers, whose level of integrity has often been questioned in the past not only in India, but also in all the stock exchanges in the world. If the shareholder happens to be a small shareholder holding an insignificant proportion of the total share capital of the company, he must also be provided protection against the majority shareholders who, having access to the funds as well as inside information of the company, may try to use them to the detriment of the former's interests.
The problem of this protection arises because the joint stock company organization has become indispensable for the growth of modern industry. The large capital requirements of modern industrial plants, as well as the probability and degree of risk involved are beyond the capacity of one or even a few persons to bear. The joint stock company form facilitates pooling of resources and sharing of risk by many persons. However, although this form can facilitate contribution to capital by many and scattered individuals, the management of its resources must necessarily be placed in the hands of a few. These few must take orders from the owners of capital, and the laws provide for democratic control of the managers by the shareholders. Democratic control sounds excellent in theory but is not found to work so smoothly in practice.

The situation in India had been aptly described by the Bhabha Committee, in its Report: "The comparatively low standards of business knowledge and experience of the average investor, the absence of any well-informed and reliable financial press, and long distances which make it difficult for the investors to combine for the exercise of their rights have rendered them practically inefficient."

Thus, the reasons for this 'illusory nature of control' are, broadly: (i) The shareholders are large in number. (ii) They have very small individual holdings. (iii) They are geographically scattered. (iv) They are ignorant of legal and economic facts. (v) They are
generally disinterested in the working of the company beyond the rate of dividend - or, at most capital appreciation over years.

Large Number: Although the total number of shareholders in India forms a very small fraction of the population; in absolute terms, it is quite large. The shareholding population in India was estimated at 2 million in 1968-69 and, today, it is roughly put around 3.2 million. The task of reaching them is a gigantic one. Even for individual companies, the number of shareholders is fast becoming larger and larger. With continuous increases in the prosperous units' activities, the issue of right and bonus shares has helped in accelerating this trend. Out of the thousands of part-owners, only very few attend the general meetings and, yet, the fact remains that the effective control over the management is supposed to be exercised through various resolutions passed at the general meetings.

Small Individual Holdings: The size of holdings shows a skewed pattern in India with a very small number of accounts holding bulk of share capital and a vast majority of small accounts holding a small percentage of share capital.

The surveys carried out by the Reserve Bank of India* in 1959 and 1965 indicate the magnitude of problems.

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of large numbers and small holdings. The 1965 survey covered 189 public limited companies with stock exchange quotations. Individuals held about 10,65 lakhs accounts in the companies, accounting for 99% of the total of 10,76 lakhs accounts. However, in terms of capital, individuals accounted for Rs. 193 crores or 46% of total paid-up capital of Rs. 423 crores. Another significant feature revealed by the survey was the predominance of small investors as 94% of the total number of shareholdings was found to be below Rs. 5,000, although they accounted for only 22 per cent of the total value of holdings. In the case of individuals, account holdings below Rs. 5,000 accounted for the paid-up value of Rs. 93 crores, or 99% of all holdings below Rs. 5,000. This shows that a majority of individual holdings were small holdings, giving rise to the problem of minority shareholders.

**Geographic dispersion:** The concentration of industrial activities in and around the metropolitan cities and the establishment of stock exchanges in them led to the concentration of shareholdings in four large urban complexes. However, in recent years, the geographic pattern of shareholding has changed substantially. Although no formal study of this aspect is available, it is believed that large numbers of applicants from smaller towns are being allotted increasingly higher number of shares. This geographic dispersion must be viewed against the fact that the major tool in the hands of the shareholders to control the
management is the various resolutions passed at the general meeting of the companies which are held at the Registered Office of the company.

Ignorance: The shareholders' ignorance is of three different types: ignorance of various laws, ignorance of basic financial theories and concepts, and ignorance regarding the working of corporate sector.

There are various laws seeking the protection of the shareholders and conferring upon them certain rights which they may exercise individually or collectively. Perhaps, the knowledge of these legal facts, combined with will to act, may prove a powerful deterrent to the malpractices and mismanagement.

The average shareholder does not understand the basic economic and financial theories that have a direct bearing on the worth of his investment. The percentage of shareholders who can read and understand the Profit and Loss Account and the Balance Sheet is distressingly low. Fewer still understand the economic concepts and the industrial sector's role etc., to make correct decisions about their own investments.

The absence of agencies that can keep the shareholder informed about the progress of various companies, of the industries, and also of malpractices, has added to the problem of ignorance. The Bhabha Committee's remark regarding well-informed and reliable financial press does not, fortunately, hold good today; but how many investors - and small investors in particular - can afford
Apathy: The small shareholder buys shares in order to get dividends and, so far as he is assured of this, he is completely disinterested in other matters like how the company is run, who are running it, and if they are deriving any personal profits through their connection with the company. It is unfortunate that some of the small shareholders have completely misunderstood this part of their role. It is true that this apathetic attitude comes partly due to the ignorance not only of the business of the company but also of the economic and legal framework. In part, it is also due to the lack of time on the part of the minority shareholders.

In spite of all these causes which lead to the lack of effective protection of shareholders, the fact stands that it is very much essential for the progress of our economy. For rapid industrial progress, the country has to tap the savings of her vast household sector and a direct investment of these savings in corporate securities through the organized capital market is the easiest and most desirable way to do so. Unless the potential investors are assured of safety and growth of their intended investments at the hands of corporate managements, their savings will continue to be frittered away in other undesirable channels. The shareholders' funds are significantly large to attract the attention of the parties concerned to provide them adequate protection.
The Government has provided substantial measures in the Companies Act, 1956 to protect the shareholders. In fact, the Indian provisions have been regarded by persons of authority abroad as a distinct advance on the laws as they are even in more advanced countries.

The Companies Act, 1956: The Companies Act provides measures as regards the capital structure of the companies, the general meetings, the accounts and audit, directors, inter-company investments, special provisions to check malpractices, etc., which directly or indirectly safeguard the interests of the shareholders. A brief summary of the relevant provisions is presented in this section.

Capital Structure: Capital can be raised either by an issue of shares or by an issue of debentures. The Memorandum of Association, the basic document which defines the nature and scope of the company's business, states the 'Authorised Capital' of a company, which is the maximum limit to which it can issue share capital. The Authorised Capital can be changed by a resolution passed at the General Meeting.

A company can issue only two types of share capital: preference and equity. The rights attached to each type of shares are detailed out in the Act. The important right that is relevant here is the right to vote. In general, only equity shares carry voting rights and such voting rights are proportional to the amounts paid-up. The preference shareholders have right to vote only on resolutions in matters that directly affect them, or when the dividend on cumulative preference shares is in arrears for a certain
number of years. The equity shareholders have a pre-
emptive right as regards any further issue of share capital,
in that any such new capital must be offered first to the
holders of equity shares. Further issues can be made to
other parties only if authorised by a special resolution
of the General Meeting of the Company.

The company may invite applications for shares by
the issue of a prospectus. Schedule II of the Act lists
down in detail the matters that must be disclosed in the
prospectus. The information given must be sufficient to
enable any prudent prospective investor to decide as to
whether or not he should subscribe to the shares or
debentures. It should further disclose whether any appli-
cation has been made or would be made to any recognised
stock exchange for listing of shares. It is illegal to
issue a form of application for shares of a company unless
it is accompanied by prospectus.

Only a natural person or a body corporate can
become a member of a company. The Act lays down rules
regarding application, allotment, calls on shares, etc.
Calls must be made on a uniform basis for all shares,
falling under the same class. Advance payment of call
does not entitle the member to any voting rights.

The Act also limits the commission to be paid to
brokers and/or underwriters in return for service to the
company in connection with the sale of securities to
5 per cent of the issue price and provides that details
of such commission must be disclosed in the prospectus.
The rights attached to any class of shares may be varied by consent in writing of the holders of that class of shares, or by passing a special resolution of holders of that class of shares in a separate meeting. Dissentients holding not less than 10 per cent of such shares have a right to move the Court to have such a proposal cancelled.

General meetings: A general meeting may be statutory meeting, annual general meeting, or extraordinary general meeting. A statutory meeting is held after the commencement of business by the company. An Annual General Meeting is to be held every year, and the interval between two annual general meetings should not normally exceed 15 months. Ordinary business transacted at the annual general meeting is as follows:

- Consideration of accounts, balance sheet and reports of the Board of Directors and Auditors.
- Declaration of dividend.
- Election of Directors in place of those retiring.
- Appointment of auditors and fixing their remuneration.

Any other business transacted at an annual general meeting is deemed to be special. An extraordinary general meeting is a general meeting other than a statutory meeting or an annual general meeting. The Board of Directors may call it on requisition of holders of a certain number of shares.
Notice of the general meeting must be given to the members at least 21 days in advance, specifying the place, date, time and agenda of the meeting. If a member wants to propose a change in the auditors or removal of a director and appointment of a substitute, he has to give a special notice to the company not less than 14 days in advance.

Two types of resolutions are passed in any general meeting. Ordinary resolutions are passed by a bare majority of votes of members present either in person or by proxy. Special resolutions require the consent of three fourths majority of members voting personally or through proxies. Voting is to be taken after discussion on the resolution, first by show of hands. Poll may be demanded by a prescribed number of members, whereupon votes are equal to the number of shares held. A member entitled to attend and vote in a general meeting is entitled to appoint a proxy to attend and vote on his behalf and the proxy need not be a member of the company. The proxy, however, does not have a right to take part in the proceedings of the meeting, except for voting on resolutions. The Act also provides for a minimum quorum necessary for the conduct of general meetings. The minutes of the general meeting must be recorded in a Minute Book within 14 days and initialled by the Chairman of the general meeting. Members are entitled to inspect the minutes and, on payment of prescribed fees, obtain copies.
Dividends: The directors can recommend the payment of dividend, but it is the general meeting alone which can declare the dividend. The dividend declared by the general meeting cannot exceed that recommended by the directors. Dividend can be paid only out of the profits of the company in the current or previous years, after providing for depreciation. Dividends are payable in cash except in case of capitalization of profits or reserves. Dividend warrants must be posted within 42 days from the date of declaration.

Accounts and Audit: Every company must maintain proper books of account in respect of receipts and disbursements, sales and purchases, assets and liabilities, etc. The Central Government may direct a certain class of companies to maintain cost records. Maintenance of books is the responsibility of those in charge of management.

The books of accounts are open for inspection by any member of the Board of Directors. It must be noted that the law does not give a similar right to the shareholders.

Duly audited copies of the Balance Sheet and the Profit and Loss Account must be sent to every member at least 21 days before the Annual General Meeting. Schedule VI of the Act lays down a standard format to which the company's final accounts must conform.
The Annual General Meeting appoints a qualified chartered accountant as the auditor of the company. The auditor holds office till the next annual general meeting and cannot be removed except by a general meeting, after the approval of the Central Government. To preserve the independence of the auditors, the following persons cannot be appointed auditors of the company:

- A body corporate.
- An officer or employee of the company.
- A partner or employee of an officer or employee of the company.
- A person indebted to the company for more than Rs. 1000/-.

The auditor has a right of access to books of accounts of the company, and also to all relevant vouchers. He can demand explanations from the officers of the company. The auditor is a watchdog of the shareholders, appointed for the purpose of reporting to them on the Balance Sheet and the Profit and Loss Account. The company can sue the auditors in respect of damages arising out of the breach of his duties. He is punishable if he wilfully makes a report or authenticates any document of the company otherwise than in conformity with the Act. He is also criminally liable if he knowingly omits any material fact.

Directors: Every company must have a Board of Directors. The Directors are responsible for direction, conduct, management and superintendence of the company's affairs. They are expected to exercise utmost good faith and care,
and their position resembles substantially to that both of agent and trustee.

The Directors are elected at the General Meeting. Two Thirds of the members of the Board are liable to retire by rotation. The Board may appoint persons to fill up casual vacancies and such appointees hold office up to the date to which the Director who caused vacancy would have held it in normal course.

Directors are elected by simple majority. The number of directorships held by any person at any time cannot exceed twenty, with certain exceptions. The office of the Directors cannot be assigned.

The Director may be removed by an ordinary resolution passed in a general meeting, provided special notice of such resolution is given.

The meeting of the Board must be held at least once in three calendar months and at least four such meetings must be held in a year. The Act prescribes the quorum for the Directors' meetings, which cannot be less than two. Directors who are interested in any resolution to be voted upon in the meeting are to be excluded in counting the quorum.

The Directors cannot do the following without the consent of the general meeting:

- Sell or lease the undertaking of the company, in part or full.
- Remit or give time for repayment of debt due by a Director.
- Invest money received as compensation on compulsory acquisition of the company's undertakings.
- Borrow in excess of paid-up capital and free reserves.
- Give charity of more than Rs. 25,000/- or 5 per cent of the average given by the company during the last three years, whichever is higher.
- Appoint sole selling agents.

**Inter-company loans**: To prevent mismanagement of shareholders' funds, the company cannot, in certain cases, extend loans to another company without prior approval of the Central Government, though such conditions do not apply to loans given to subsidiaries.

For companies not under the same management,
- a special resolution in the general meeting is necessary if, loan amount exceeds 10 per cent of subscribed capital plus free reserves, and
- a special resolution plus the permission of the Central Government is necessary, if this percentage is 30.

For companies under the same management,
- a special resolution in the general meeting of the lending company is necessary in all cases, and
- a prior approval of Central Government is necessary, if all such loans together amount for more than 20 per cent of the subscribed capital plus free reserves of the company.
Special Provisions: The Central Government and the Courts have the following special powers to prevent mismanagement and oppression:

(i) Special Audit: The Central Government may order special audit if, in its opinion
- the affairs of a company are not properly managed,
- the financial position of the company is not sound, and/or
- the affairs are being managed in a manner likely to cause serious injury or damage to the interests of trade or industry or business to which it pertains.

The Special Audit may be entrusted to the regular auditors or to any other qualified auditors. This audit is of a fact-finding nature and its expenses are to be borne by the company.

(ii) Inspection and Investigation: The Act empowers the Registrar of Companies, or any officer authorised by the Central Government in this respect, to inspect, without prior notice, the books of account and other books and papers of the company. It also empowers the Central Government to order an investigation in the affairs of a company at the instance of the members of the company. An investigation has to be ordered by the Central Government if the company itself, by a special resolution, or a court, by an order, declares that such an investigation is necessary. Investigation may be ordered by the Central
Government if it is of the opinion
- that the business is being conducted with an intent to defraud its members,
- that the promoters or persons concerned are guilty of fraud or misconduct towards the company or its members and/or,
- that there has been material suppression of information which ordinarily should be disclosed to the members.

The Central Government may appoint one or more inspectors with wide powers and the inspectors are make report to the Central Government.

(iii) **Prevention of Oppression of Minority**: If the majority shareholders act in oppression of the minority shareholders, the latter may apply to the Court under Section 397 or 398 of the Act. Such proceedings can be instituted by
- not less than one hundred members of the company or not less than one-tenth of the total number of its members, whichever is less, or any member or members holding not less than one-tenth of issued share capital of the company,
- by any member or members on obtaining consent in writing of the number of members required as per above clause, and
- any member or members authorised to apply by the Central Government.
The court has the following powers in this matter:

- The regulation of the conduct of the company's affairs in future.
- The purchase of shares and interest of oppressed members either by other members or by the company.
- The termination, modification or suppression of any agreement between the company and the managing director or any other director or the managers.
- The invalidation of transfer of property.
- Any other matter for which in the opinion of the court it is just and equitable that provision should be made.

The Central Government has powers to appoint two additional Directors on the Board of the company as a safeguard against oppression of minority or mismanagement. In such a case the Central Government may direct that any further change in the Board shall require its prior approval.

It may be concluded that the statutory measures contained in the Companies Act, although acclaimed to be distinctly advanced over their counterparts in other countries, are not enough to provide protection to the small and minority shareholders. The need exists for including some additional much demanded measures, and for helping the shareholders to stand on their own feet and assert themselves through their own associations.
But the protection of small shareholders is not an end in itself. It is important because it facilitates accelerated flow of money from households to industrial corporations. The other side of the coin of protecting the shareholders is to make shareholding more attractive for middle class savers.

**Low spread of shareholding**: In India, only one person out of 300 is a shareholder, as compared to one in 12 in U.K., or one in 3 in U.S.A.. There are several reasons advanced for the low spread of shareholding. Some of them are:

* India is not an industrially developed nation. The per capita industrial output in India is much below that in U.K. or U.S.A. Consequently, not many industrial firms have publicly owned capital.

* A large part of India's industrial development is in the public sector, which has not issued securities to the public. This reduces further the number of public owned industrial firms.

* Shareholding was, for years, equated to gambling and was avoided by the middle-income groups. Further, it was supposed to be an 'upper class' hobby and its correct significance either from the point of view of national economy or from the viewpoint of an individual investor was not understood.
The stock exchanges, prior to the passing of the Securities Contract (Regulation) Act, were not free from malpractices. Even after the passing of the Act, they have failed to project a proper image of themselves and, consequently, the brokers are still looked upon with suspicion by the middle class.

Heavy corporate and individual taxation has given the investors a raw deal. The performance of the Indian industrial sector in terms of Profits Before Taxes has been very satisfactory and comparable to that in U.S.A. and U.K., but in terms of Profits After Taxes and dividends, the trends have been downward.

Trading in shares on the stock exchanges is done in 'lots' and many times it is beyond the reach of the common man to have liquid cash to buy the 'marketable lot' of a particular scrip.

The major remedies that can be suggested are as follows:

The stock exchanges should project a better image of themselves. This, as already suggested, can be done by establishing high standards of integrity, by providing services to the investors and by educating consciously the public of their role - perhaps by establishing a Public Relations Department.
Tax concessions may be given to the investors. The trend is certainly in this direction and dividend income including bank interest to the extent of Rs. 3000 is free from income tax and the investment in equity shares to the extent of Rs. 1,50,000 are free of wealth tax. At present, tax is deducted at source from dividend income in the absence of a declaration from a shareholder that his total income is not taxable. Many middle class investors do not turn to shares for fear of losing this tax-deduction, since they do not want to file returns of income. Of course, refund is granted by the Income Tax Office.

There should be a separate provision for the deduction of dividend income out of the gross total income for the purpose of determining total taxable income of an assessee. Any dividend earned up to that limit should also be exempted from deduction of tax at source. The amount of dividend for the purpose of this deduction and exemption may be kept around Rs. 3000/-.

Trading in shares should be allowed in any number and the present system of 'marketable lots' should be abolished.
In conclusion, protection of shareholders on one hand and incentives to shareholding on the other will go a long way in the industrial development of the country and establishment of "peoples' capitalism".

It would be of interest to point out the recommendations made by the High Power Committee - the Sachar Committee appointed by the Government to review the Companies Act and the MRTP Act.

Recommendations of the Sachar Committee in connection with shareholders' protection

Proper balance between shareholders' rights and the right of management should be maintained. Shareholders' individual membership rights and corporate membership rights should be strengthened with a view to making their participation effective and meaningful. There should be better management at Board level and remedies against oppression by majority over minority shareholders and against acts of mismanagement should be improved and quickened. Powers of Courts to deal with such matters should be enlarged. Recognition of shareholders' associations needs to be encouraged. Vigilance over corporate activities and corrective measures over erring companies need to be strengthened.

A proxy holder should have a right both to take part in discussions and to cast a vote on show of hands. To facilitate this, the two-way proxy form with suitable modification should be a mandatory requirement for all public companies.
A legal right of intervention should be provided to shareholders in exercising control over and issuing directions to the Board without disturbance to their day-to-day managerial autonomy, by amending section 291.

The twin proof requirements in section 397, namely, a continuous course of oppressive conduct and circumstances justifying winding-up of companies is onerous. A single act of oppression should be sufficient. Provision for necessity of circumstances justifying winding-up of the company be deleteč.

Directors appointed by the Central Government under section 408 should report every three months on matters which the Government ought to know.

The power under section 409 presently exercised by the Central Government should be exercised by the Company Law Board (as re-constituted) in future. Prescribed percentage of shareholders also should have the right to complaint.

Interim orders under section 409 should be operative for a period of two months only, unless extended further. Final orders should be passed by Company Law Board within six months.

Any party aggrieved by the order of the Company Law Board should have a right of appeal to the High Court. The appeal should be decided by the High Court within six months. Meanwhile the order of the Company Law Board should remain undisturbed.
Shareholders' Associations should be recognised on the same lines as the recognising of Stock Exchanges. They should be entitled to avail the rights to apply to the Court/Central Government/Company Law Board in cases of oppression or mismanagement.

A single shareholder or shareholders' association (in the case of public companies) should be entitled to apply to the Court under sections 397 and 398 and not the Central Government, to move a petition regardless of the prescribed percentage of members under section 399(1)(a) & (1)(b).

None of the office-bearers of a shareholders' association should be concerned with the management of the company.

In order to ascertain how companies' funds are utilised, an inspecting officer should be empowered to inspect the accounts of partnership firms and joint ventures in which the company has an interest.

Inspection of companies under section 209A should be carried out only after giving prior notice, unless, for reasons to be recorded by the Regional Director, it is considered necessary.

The Company Law Board, like the Court under section 237(b), should have power to order investigation into the affairs of the companies.

Persistent default by the companies in complying with the statutory requirements should be an additional ground for investigation by the Central Government under section 237(b).
Investigation into the affairs of related companies should be carried out only after giving an opportunity to the concerned party to be heard.

As the provisions relating to Special Audit in section 233A have not been made use of frequently—and are consequently redundant—should be deleted.

The right of companies to refuse to register transfer or transmission of shares should be exercised within two months of the date of the lodging of the transfer deed or request for transmission, and only for reasons to be recorded in writing. Default should be punishable. Such order should be appealable to the Company Law Board.

An appeal should lie to the High Court on the grounds mentioned in section 100 of C.P.C. against the orders of Company Law Board.

In order that members may move any resolution, the additional requirement with regard to the value of their shares being not less than one lakh rupees as provided in section 188(2) should be removed.

A single member should also be entitled to give the special notice required under section 225, 261, or 284. Section 190 should be amended.

In case the minimum subscription is not received by a company within 120 days, all monies received from the applicants should be refunded forthwith with increased rate of interest at 12%.
The copies of the Minutes of the General Meeting of Companies should be supplied by companies on request to the shareholders and to recognised shareholders' association, free of cost.

A public company, other than section 25 companies, should be expressly prohibited by Statute from having any power to expel any of its members, notwithstanding its Articles or resolution of the Board.
(B) PREFERENCE SHARE CAPITAL

(1) Meaning and Characteristics

Share capital is of two kinds: preference share capital and equity share capital. A preference share must satisfy the following two dominant conditions:

(i) As regards dividends, it must carry a preferential right to a fixed amount,

(ii) As regards capital, in the event of a winding up or other arrangement, to repayment of capital, there must be a preferential right for the repayment of the amount of capital paid-up on such share.

In addition, a preference share may or may not carry such other rights as the following:

(i) A preferential right for payment of any arrears of dividend remaining due on such share.

(ii) A right to payment of a fixed premium as per the Memorandum or Articles.

(iii) A right to share in surplus assets in the event of a winding up, after all kinds of capital have been repaid.

The preference shares may be cumulative or non-cumulative. The holders of preference shares of both classes have a right to vote on any resolutions of the company directly affecting their voting rights. Where dividends are in arrear, holders of cumulative preference shares
have a right to vote on all resolutions of the company at any meeting, if their dividends are in arrear for an aggregate period of not less than two years on the date of the meeting. Holders of non-cumulative preference shares have a right to vote on all resolutions of the company, at any meeting, if their dividends are in arrear for the two financial years immediately preceding the meeting or for any three years during a period of six years ending with the financial year preceding the meeting. The voting right of a preference shareholder of either class will be in the proportion which the capital paid-up on his shares bears to the total paid-up equity share capital of the company.

**Definition**: "Preferred stock is a stock which, by the Certificate of Incorporation, or the by-laws, has been given a preference over the equity in respect to dividend. It is usually stipulated that preference holders will receive a certain rate of dividend before any dividend is paid on the equity stock. Preferred stock may be preferred also as regards distribution of assets on dissolution".*

The main features of a preference share are:

(i) Preference share is a hybrid form of financing, combining the features of debt and equity. In the event of liquidation, a preference shareholder’s claim on assets comes after that of creditors but

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before that of equity shareholders. Usually this claim is restricted to par value of the share.

(ii) Although, a preference share carries a stipulated dividend, the actual payment of dividend is discretionary rather than a fixed obligation of the company. The omission of a dividend will not result in a default of the obligation or insolvency of the company. The Board of Directors has full powers to omit a preference dividend, if it so chooses.

(iii) The maximum return to a preference shareholder usually is limited to the specific dividend and these preference shareholders ordinarily do not share the residual earnings of the company. This dividend is not tax-deductible, and this fact is a principal short-coming of preference share as a means of financing.

(iv) In view of the fact that interest payments on debt are deductible for tax purposes, the company that treats preference dividend as a fixed obligation, finds the explicit cost to be rather high.

Preference share is, in many respects, comparable to a debenture. Legally and in an accounting sense, preference share is an ownership security. Most managers, however, consider a preference share a debt, because of its fixed charge and leverage effect on equity share earnings. Equity shareholders also think of preference share as debt because of its superior claim for dividend and repayment of capital in the event of the winding up of
the company; but debenture holders consider it as equity because it supplies assets against their claims in case of liquidation. Debenture holders have to be paid off before anything can be paid to preference shareholders in the event of liquidation. The similarities between a preference share and a debenture exist on account of fixed payment obligation, claims superior to equity, (often) convertibility into equity and its utility as a long term source of finance. A preference share is dissimilar from a debenture on account of the difference between the treatment of preference dividend and that of interest on debentures. Interest on debentures is a charge against gross profits, whereas dividend on preference shares is an appropriation cut of net profits.

In regard to the nature of preference shares as a source of finance, the Sachar Committee has suggested that:

(i) Irredeemable preference shares as a class should be abolished. The existing irredeemable shares should be redeemable at the end of five years from the date of commencement of the Act with the option, to be exercised within six months from the date of commencement of the Act to redeem them within a period of twelve years and at the rate of interest of not less than 10%. No consent of the class of members should be necessary for such conversion.

(ii) No company, in future, should issue any preference

shares which are not redeemable within a period not exceeding 12 years. At the time of redemption, the shares may be either renewed or paid off in cash to those who do not agree to renewal. Shares may be redeemed by issue of fresh shares or debentures or by crediting an equivalent amount to Capital Redemption Reserve Fund from out of profit.

(iii) A company which has failed to redeem its preference shares shall be prohibited from declaring any dividend on equity shares or transfer any of its profits to reserves until such time, the preference shares are redeemed.

(iv) All preference shares issued in future must be cumulative preference shares. All existing preference shares which are non-cumulative will be deemed to be cumulative with effect from the date of the commencement of the Act.

The suggestions, as above, if accepted by the Government of India and incorporated in the Companies Act, will have some implications as regards the financial structures of public limited companies:

Firstly, if all preference shares are redeemable, the preference shares as a source of long term funds might lose its importance in case they are not renewed at the time of redemption. Of course, this provision will add to the safety of the repayment of capital from the viewpoint of preference shareholders.
Secondly, the restrictions suggested to be imposed on dividend distribution and transfer of profits to reserves will add to the safety of preference share investment. However, it might turn out to be a provision sometimes against the interests of equity shareholders. In addition to this, the process of ploughing back of profits, which is already slow, will be slower.

Thirdly, the management of a company can take advantage of these suggestions, i.e., it can build flexibility into its financial structure. Since the period of repayment is known in advance, it also knows definitely the period for which such funds are available to the company for the purpose of investment. Even the repayment can be better planned without creating any problems of liquidity.

(2) Benefits as a Source of Finance

The advantage of financing through preference share is that it is a flexible financing arrangement. The dividend is not a legal obligation on the part of the company issuing such securities. If earnings turn bad and the financial condition of the company deteriorates, dividend can be omitted. With debt financing, interest must be paid regardless of whether earnings are good or bad. To be sure, companies that are accustomed to paying dividend on their equity shares certainly regard preference dividend as a fixed obligation. Nevertheless, under dire circumstances, a company that omits its equity dividend also can omit its preference dividend.
Another advantage of a straight preference issue is that it has no final maturity. It is a perpetual loan. Also, the majority of preference issues do not require sinking fund obligations. Thus, a preference issue gives a company flexibility in allowing it not to make principal repayments or plan for refinancing. Moreover, from the viewpoint of creditors, preference shares add to the equity base of the company and thereby, strengthen its financial condition. The additional equity base enhances the ability of the company to borrow in future.

The dominant reason for the use of preference shares as a source of finance is the absence of any need to part with control of management. The other reason is the desire of the company to maintain a balance between prior charges to profits and the appropriations, which is reflected in their capital structure.

The excess cost of servicing preference shares as compared to debt may be thought of as a risk premium for not being burdened with any increased charge on profits by way of tax-deductible interest on debt.

Another incidental advantage is that the issue of preference shares goes to augment the equity base on which the borrowing power of the company is considered. The company which has already borrowed to its capacity can still borrow more, if there be a need, by first issuing preference shares.
From the viewpoint of the company, preference share financing is certainly costlier than debt financing, but companies adopt preference shares more with an eye on achieving a proper gearing of capital structure than on a comparison of monetary costs.

The use of preference shares to raise capital funds is a form of trading on equity with the investment of equity shareholders providing a base for earnings for the company and a degree of security that the fixed commitment can be kept.

The issue of preference shares instead of debentures carrying high fixed charges reduces the cost of capital to the company. Preference shares do not present a threat to solvency, whereas the failure to meet the fixed instalment payments due on debt may result in bankruptcy, reorganisation or liquidation. To avoid such a possible result, companies in 'risky' fields with fluctuating earnings may tend to favour the use of preference shares instead of debentures.

Preference shares have an appeal for a certain type of investors interested in securities giving more income than debentures, but with a greater certainty than is generally found in equity. They may, thus, broaden the source of capital funds for the company. A company may decide, that because of lack of marketable assets, it would be better to issue preference shares instead of debentures, which the capital market might regard as inferior in quality. A company may conclude that the issue of preference shares would be the best way to raise
long term capital funds owing to a condition of weak demand for equity in the capital market or the reluctance of investors to purchase equity shares of companies in this particular field.

The motivating feature of preference shares is that it helps in keeping voting control in the hands of equity holders. Sometimes non-commulative preference shares may be issued as a form of bonus share to equity holders.

Investors are interested in preference shares because of higher rate paid on them as compared to that payable on similar debentures, or because the rate of preference dividend may be higher than the rate of equity dividend. In addition to this, investors seek not only diversification among companies but also reduced risk. Preference shares are regarded as protective investment during an unstable or declining stock market. At times, a preference shareholder can expect to participate in the success of the company, if participating preference shares are issued to him. When debentures are substituted for preference shares, the former would have to be provided for through sinking fund appropriations.

(3) Limitations as a source of finance

As Venkat Ramani* has pointed out, preference shareholders providing operational and additional source of finance for the operations of the company fall into a

middle hopeless category between owned and owed funds. Despite cumulative right to dividend, the impact of even a year's postponement of dividend in the light of prevailing inflation and high interest rates can be a quite significant loss to them. The Board is usually dominated by the interest of equityholders and, perhaps, of creditors like financial institutions. Hence, the preference shareholders' interest is seldom protected. In times of prosperity, they are generally not entitled to anything more than the fixed rate of dividend; the residual profits go to equity holders. In this sense, they are treated on par with creditors.

In the matter of redemption, their position is worse. As per the provisions of law, an issue of preference capital can be redeemed only out of profits earned or by making a fresh issue. For a non-earning company, preference holders, who have not been paid their dividend also, are put to great loss. They do not enjoy the protection available to secured and unsecured creditors. The secured creditors can go to the court of law and can get security enforced. The unsecured creditors come next. As the preference shares are not treated as debt, they have no remedy, if capital is not redeemed. The management generally requests them to extend the redemption date, which they have to agree.

Another limitation is that, as preference shares form a part of the capital in Law, the dividends on such shares have to be paid out of after-tax profits and therefore, the rate of agreed dividend applicable to preference
shares should be grossed before tax, when the competing advantages of borrowed funds and funds from preference shares are being examined, as per the following formula:

\[
\text{Gross rate of dividend} = \frac{\text{agreed rate of dividend}}{1 - t}
\]

where, \( t \) = tax rate applicable.

The unsoundness of tax structure impedes the flow of risk capital to industries. The preference shares entitled to receiving a fixed rate of dividend are much less rewarding and attractive than the deposits in a company. Preference shareholders turn out to be worse off both in the matter of yield and of safety of funds than depositors. Again, preference share dividends are not tax-deductible and, therefore, their cost is very great in comparison with that of debentures. The after-tax cost of debt is approximately half the stated rate of interest for profitable companies. The cost of preference share is the percentage amount of preference dividend. This fact has greatly reduced the use of preference share in recent years. Moreover, investors in preference shares do not have any enforceable right to dividend. Accrued dividends have seldom been found settled comparable to the amount of obligation that had been incurred.
The studies made by the Reserve Bank of India show that the importance of preference shares as a source of finance had diminished during 1971-75 in comparison with that in 1966-70. The contribution of preference shares was studied with reference to its percentage in total issues of securities, namely, equity shares, preference shares, and debentures. The funds raised from the issue of preference shares were 8.40% of those raised through all securities during 1966-70 and 6.40% during 1971-75.

The study of Rao shows that in the case of large and medium companies with a capital exceeding Rs. 5 lacs, the share of preference capital in total funds had remained constant at 4% during both the periods, i.e., 1965-70 and 1971-75.

The main findings of Gupta's study on preference shares and corporate financing are:

(i) Over the years there had been a steady decline in the importance of preference shares in relation to


equity shares. Preference share capital as a %age of equity capital had declined from 25.50 in 1951-52 to 12.90 in 1970-71.

(ii) During 1965-66 to 1970-71, there was a decline in the importance of preference shares from 14.40% to 12.90%, though it had increased to 17.30% in 1974.

(iii) The bulk of preference issues were underwritten mostly by All-India and State level development banks and investment institutions like LIC and UTI. Nearly the whole of the underwritten amounts had to be taken up by the underwriters.

His conclusions can be stated as follows:

(i) The fact that the bulk of the new preference issues made during recent years, especially preference issues of new and young companies, were subscribed by the underwriting institutions themselves leads to the conclusion that:

(a) Preference share financing in the form of a public issue of capital used to be and was still supposed to be a method of raising industrial capital from the general public. It had, more or less ceased to score this purpose in the majority of preference issues. Rather, it became a method of raising money from underwriters themselves.

(b) The market for preference shares existed in name only. There were many quoted preference issues in which no trading was quoted for months, in
some cases for several years. In these cases, there was no convertibility of preference shareholding into cash through sale.

(ii) With redeemability feature, preference share is brought closer to debt financing as a form. In law, preference shareholder is an owner and not a creditor, but in equity shareholders' view, the preference shareholders are outsiders.

(iii) Preference dividend is not tax-deductible and therefore, the servicing cost is higher than that of debt capital.

(iv) In spite of high cost, preference share capital should be regarded as a soft loan, because of the "pay if and when you can" concept underlying all preference dividend payments as against rigid requirements insisted in loan arrangements. The same flexibility underlies the redeemability of preference shares, even when definite redemption dates are given because there are hardly any penalties for violation.

As Dewing observes*: "Preference share is an attempt to endow the investor with certain vague and often unenforceable rights against the earnings of the corporation without giving him any clearly defined lien on the earnings".

This study reveals that the mills had, in all, 70 issues of preference shares outstanding as detailed out in Table III.6

Table III.6

<table>
<thead>
<tr>
<th>Face value Rs.</th>
<th>No. of Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>12.50</td>
<td>1</td>
</tr>
<tr>
<td>25.00</td>
<td>1</td>
</tr>
<tr>
<td>50.00</td>
<td>8</td>
</tr>
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<tr>
<td>125.00</td>
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</tr>
<tr>
<td>200.00</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>70</td>
</tr>
</tbody>
</table>

As many as 65 issues of the 70 above were having a face value of Rs. 100 per share or less. More than ¾ths of the issues were having a face value of Rs. 100/- per preference share.

With regard to the rights to dividend, the classification of preference shares was:

(i) Only cumulative 33 Issues
(ii) Cumulative and Redeemable 37 Issues
This means that nearly one-half of the preference shares were made available for investment over a fairly long period of time.

The contractual rate of dividend on preference shares ranged between 4% and 10%. The record of dividend payment did not seem to be very fair, because more than half, (i.e., 47) of the issues had a dividend of less than 6%. There were only five issues which enjoyed a dividend between 8% to 10%.

The main findings regarding the preference shares as a part of the total funds based on the study of Table II and Table XIX, are:

(i) The average share of preference capital in total funds had been quite meagre in both the periods of study, i.e., 1966-70 and 1971-75. The share of 2.92% in the former period had declined to 2.08% during the latter. This was accompanied by a very marginal change in the variability factor. However, the variability factor indicated that financial policies and practices in regard to the issue of preference shares were not uniform during both the periods and this lack of uniformity had increased further during the latter.

(ii) Some cotton textile mills of Ahmedabad did not issue any preference shares throughout the period of this study, i.e., 1966-75. Such units were Nos. 22, 27, 29, 31, 45, and 46, in the list.
(iii) In some exceptional cases, the share of paid-up preference share capital in total funds was far below the overall average during both the periods. Further, it had declined in the latter period as compared to the former. Such units were Nos. 4, 6, 9, 26, 30, and 43, in the list. To quote one instance only, in case of unit No. 4, the share of preference capital was hardly 0.77% of total funds during the former period, and it had dwindled to just 0.25% of total funds during the latter.

(iv) In some cases, the share of preference capital in total funds was far above the overall average during both the periods, and it had declined during the latter. They were unit Nos. 8, 14, 23, 28, 33, 34, 35, and 48, in the list. In the case of unit No. 8, the share of preference capital was 8.33% of total funds during the former period, but it had declined to 5.72% during the latter.

The study of Table III along with Table XIX in regard to the preference shares as a part of proprietorship funds leads to the following observations:

(i) The average share of preference share capital in proprietorship funds had declined from 13.40% during 1956-70 to 10.20% during 1971-75. This was accompanied by a marginal increase in the variability factor. However, the variability factor, i.e., 94.31% during 1966-70 and 109.30% during 1971-75, indicated that the textile units of
Ahmedabad had adopted, absolutely dissimilar financial policies and practices with regard to the role of preference share as a source of proprietorship funds. This non-uniformity had increased further during the latter period.

(ii) The average share of cotton textile unit Nos. 6, 9, 26, and 43 was below the overall average throughout the period of this study, i.e., 1966 to 1975. It had declined further during the latter period in the case of unit No. 43, where the average share of preference capital was 1.94% of proprietorship funds during the former period and where it had declined to 1.44% of proprietorship funds during the latter. As against this, in the case of unit No. 4, the share of preference capital in proprietorship funds was below the overall average during both the periods but had increased from 1.82% to 2.07% in the latter.

(iii) In some units, the individual share was far above the overall average during both the periods. It had increased during the latter period in the case of unit No. 3. Its share had increased from 21.77% to 29.84%, whereas that of unit No. 33 had increased from 45.09% to 46.03%, both during the latter period. In case of unit Nos. 8, 14, 19, 23, and 25, the average share was far above the overall average during both the periods, but it had
declined during the latter. The largest reduction was from 47.35% to 20.15% in the case of unit No. 25.

Regarding the share of preference capital in total paid-up capital as illustrated in Table IV and Table XIX taken together, the following observations can be made:

(i) It had declined marginally during the latter period of study from 21.40% to 20.00%, taking all the fifty mills together. This was accompanied by a very marginal change in the variability factor.

(ii) In the case of unit Nos. 3, 15, 28, and 40, the share was far above the average during both the periods of study, but had declined during the latter.

(iii) In the case of unit Nos. 4, 6, 9, 16, 26, 30, and 32, the share was below the overall average during both the periods, and had declined further during the latter.

(iv) In one exceptional case of unit No. 44, the share was below the average during the former period, i.e., 12%, but had increased to 31% during the latter period and had crossed the overall average figure.

As mentioned earlier, the preference share as a source of finance seems to have played an insignificant role during both the periods of study. Also, its importance had diminished during the latter period of study. The reduction in terms of its share in total funds, proprietorship funds, and total paid-up capital supports this statement. This is a trend which is conformed by
the results of the RBI study, according to which, the share of preference capital in total funds had declined from 8.40% during 1966-70 to 6.40% during 1971-75 in the private corporate sector, whereas it differs from the results of the study made by Rao in which it is found that the average share of preference share capital had remained constant at 4% of total funds.

Thus, preference shares were not popular with the investors as well as managements throughout the period of ten years of this study. The appreciation in market prices of preference shares had not favoured the investors. The unpopularity may be traced to three factors:

(i) Lack of capital appreciation.
(ii) Poor public response to preference shares.
(iii) Absence of satisfactory record on dividend payments.

(1) Lack of capital appreciation is indicated by the indices of preference share prices exhibited in Table III.7.

<table>
<thead>
<tr>
<th></th>
<th>1966-70 (average)</th>
<th>1971-75 (average)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ahmedabad Cotton All-India Stock Exchange</td>
<td>85.94</td>
<td>84.67</td>
</tr>
<tr>
<td>Ahmedabad Cotton All-India Textile Industry</td>
<td>89.14</td>
<td>96.76</td>
</tr>
<tr>
<td>Ahmedabad Cotton All-India Exchange</td>
<td>98.10</td>
<td>92.62</td>
</tr>
</tbody>
</table>

Table III.7
The figures indicate that,

(a) In the case of preference shares quoted on the Ahmedabad Stock Exchange, a declining trend in the preference share prices was noticed. Unlike this, the preference share prices of the entire cotton textile industry and of the All-India All-Industries had increased during the latter period.

(b) In both the periods, preference share prices of Ahmedabad mills had been quoted lower than the other two put together.

(ii) Poor public response is reflected, in the capital raised through preference shares and the need for underwriting the same. Data* relating to the amount of capital raised by issuing preference shares through prospectus indicate that non-government companies had raised Rs. 9.60 crores during 1966-70 and Rs. 6.34 crores during 1971-75, on an average. This means that the role of preference shares as a source of finance had diminished during the latter period.

The data relating to the underwriting of preference shares is presented in Table III.8*.

Table III.8

<table>
<thead>
<tr>
<th>Year</th>
<th>Net amount offered to the public (Rs. crores)</th>
<th>Amount underwritten (Rs. crores)</th>
<th>Amount devolved on underwriters ( % )</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971</td>
<td>5.15</td>
<td>5.10</td>
<td>52.00</td>
</tr>
<tr>
<td>1972</td>
<td>7.19</td>
<td>7.19</td>
<td>58.00</td>
</tr>
<tr>
<td>1973</td>
<td>4.50</td>
<td>4.30</td>
<td>74.30</td>
</tr>
<tr>
<td>1974</td>
<td>3.30</td>
<td>3.20</td>
<td>57.20</td>
</tr>
<tr>
<td>1975</td>
<td>4.70</td>
<td>4.70</td>
<td>52.70</td>
</tr>
</tbody>
</table>

The following observations can be made:

(a) The public response to the issue of preference shares was very poor, since more than 90% of the amount of preference shares offered was underwritten. This might have been on account of the tendency of the managements to safeguard the companies under unforeseen circumstances.

(b) An amount between 50% and 75% of the total amount underwritten had to be paid by the underwriters themselves. This means that the investing public did not have confidence in the underwriters also.

The underwriting experience of the special financial institutions with respect to preference shares is

that they had to take up nearly 80.10% of the total amount underwritten by them during 1969-73.

(iii) Absence of satisfactory record on dividend payments

The findings with regard to payment of preference dividend or the basis of Gupta's study* of preference issues of all companies of public importance were: (vide: Table III.9).

Table III.9

<table>
<thead>
<tr>
<th></th>
<th>1961-66 (average)</th>
<th>1967-72 (average)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Companies paying no equity dividend and preference dividend, as a %age of total</td>
<td>13.3</td>
<td>28.2</td>
</tr>
<tr>
<td>2. Companies paying preference dividend, as a %age of total</td>
<td>9.7</td>
<td>10.1</td>
</tr>
<tr>
<td>3. Companies paying both preference and equity dividend as a %age of total</td>
<td>72.0</td>
<td>61.7</td>
</tr>
<tr>
<td>4. Total number of companies studied</td>
<td>2524</td>
<td>2415</td>
</tr>
</tbody>
</table>

(a) Dividend had been skipped over quite frequently. The yearly average of such companies had increased from 18.30% in 1966-70 to 28.20% in 1971-74.

(b) The vast majority of companies - 70% - which had skipped equity dividend in any year had also skipped over the preference dividend.

Out of 298 companies studied, 10% had skipped over preference dividend only once in 10 years (1961-72), 10% had done it for 3 years, 14% for more than 3 years, and one out of every ten companies paying dividend in 1961 did not pay at least once during 1961-72.

The conclusion is that the suspension of equity and preference dividend together was found in practice to be more common than the suspension of equity dividend alone.

The study points out that preference shares as a medium of investment are not beneficial as they do not satisfy the investment criteria, especially, of steady income and safety of capital. In the view of RBI, the issue of preference shares by companies should be discouraged in future as a matter of policy, and that, a wider use of convertible debentures in corporate financing should be promoted.

Suggestions were mooted that a ban should be imposed on preference shares, the legal protection to preference shareholders should be strengthened by giving a right of representation in the Boards of Directors, and that the creation of a sinking fund for redemption of preference shares in each case should be prescribed.

As per this study, these suggestions should not be acceptable as they would not be beneficial. The idea of a sinking fund will impose a fixed burden on company and a total ban on issue of preference shares may take

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away from companies, which are financially sound, a useful source of finance.

A compromise solution would be to provide for the issue of convertible preference shares as in the U.S.A. The Preference to Equity ratio of 1:3 now permitted might be reduced to 1:5 or 1:6. The fixed rate of dividend need not be raised as and when general interest rates go up. It will be useful gradually to widen the gap between the rate of interest on debentures and the rate of preference dividend by holding the latter constant.

In order that preference shares as a source of finance become more beneficial, the following be provided by law:

To ensure that preference dividends are paid, the auditors may be required to certify, in all cases where preference dividends have been skipped, that it was justified in the circumstances.
(C) RESERVES

(1) Nature of Reserves as a Source of Finance

The term "Reserve" is not defined in the Companies Act. The dictionary meaning of 'Reserve' is:

(i) To keep for future use of enjoyment: to store up for some time or occasion: refrain from using or enjoying at once.

(ii) To keep back or hold over to a later time or place or for further treatment.

(iii) To set apart for some purpose or with some end in view; to keep for some use.

The Institute of Chartered Accountants, England, has defined a 'reserve' as 'amount set aside out of profits and other surpluses which are not designed to meet any liability, contingency, commitment or diminution in value of assets known to exist as at the date of the balance sheet'.*

For the purposes of Balance Sheet and Profit and Loss Account, a negative definition is provided in Schedule VI of the Companies Act, namely, that the expression 'reserve' shall not include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any liability.**

* The Institute of Chartered Accountants, England: 'Recommendations on Accounting Principles No. VI, para 43.
** The Companies Act, 1956: Schedule VI, part III, para 7(1)(b).
For any business concern, liabilities are resources of funds for financing the assets. There are two types of liabilities: (1) Internal (2) External. Internal liabilities are the resources belonging to owners of the business, which are brought into the business by them. In a going concern, internal resources consist of owners' capital and reserves. The owners' equity is a constant factor and will remain as it is unless fresh capital is brought in or raised. But, what it earns by deployment along with external resources will be revenues and when all expenses are charged against them, what remains as surplus may be retained in the business as an item next to the share capital, as reserves. Thus, reserves are nothing but retained earnings or earned surplus and, in a going concern which is doing well, are an important financing component in the total liabilities. Further, as a source of internal finance, reserves are looked upon as a watermark of strength to the business as they reduce the need for depending on external borrowings, which will only add to the debt pressure of the undertaking. Where the reserves are rising year after year, it is an indication of improvement in the profitability of the concern and surplus earnings can be ploughed back in the business.

Reserves are important because they are as good as owned funds. Where they are progressively increasing, they will increase the tangible net worth of a concern. A rising trend of reserves along with a satisfactory record of dividend payment will speak well of the quality
of management. It will also reduce the need to have recourse to higher working capital finance as self-generated funds are ploughed back in the business. A higher reserves figure will also increase the owners' stake in the business.

Free reserves are general reserves and include items like dividend equalisation reserve, general reserves from retained earnings, and reserves created from share premium account. Revenue reserves are reserves created out of normal trading operations of the company. Reserves created out of profits of non-revenue nature are called capital reserves.

The term "Free Reserves" has not been defined anywhere in the Companies Act. The Sachar Committee has suggested this definition:

"Free Reserves" means all reserves by whatever name called including any statutory reserves created under any other law for the time being in force, and credit balance to profit and loss account, but shall not include any sums set aside for redemption of preference shares (till such time as preference shares are not redeemed) or reserves created on revaluation of fixed assets or reserves created to meet any other liability. Provided, however, the balance under the Miscellaneous Expenditure in part I of the Schedule VI of the Act including debit balance to profit and loss account, deferred revenue expenditure, statutory liabilities, arrears
of depreciation and provision for doubtful debts, loans and advances, excess if any of the book value of aggregate investments in shares and securities over the market value of such investments and other provisions required to be but not made in the books of account shall be deducted before determining the amount of free reserves.*

Merely because reserves are shown in a balance sheet, it does not mean that the concern is well off. The existence of such a reserve is of no use, if adequate depreciation is not provided or provision is not made for items like bad debts. Where there is no general reserve in a balance sheet it means one of these two things: One, that the management has not retained any part of the earnings in the business and has distributed 100% of its earnings in the form of dividend. Second, that the concern is not faring well and has only carried forward losses in the balance sheet. Where a concern has built up reserves, there can be little reservation about its financial position, working results and management's efficiency. Reserves increase the net worth of a concern and enable it to command more credit from the lending institutions. When reserves increase, the financial leverage is improved by setting a favourable DER.

As a financing component, reserves are at par with owned funds in a going concern. The more they are built up and deployed within the business as free reserves, the more will improve the intrinsic net worth of a concern and the less will be the need to resort to external funds for financing. It is for such a concern that banks and other financial institutions rush to lend; for their funds are deemed to be quite safe there.

Retained earnings as a source of finance do not entail any financial obligation in terms of interest or dividend. They are not to be repaid like redeemable preference shares or debentures. They do not have any flotation costs as in case of equity shares. They will always have a positive effect on the rate of return to shareholders.

Retained earnings are a very helpful source of finance for expansion. Loans from financial institutions, as an alternative, might prove to be delayed finance and might interfere with the financial working of the enterprise because of limits on DER, margin specifications, etc. Retained earnings when ploughed back may be considered, in effect, equal to a rights issue without any contingent dividend liability.

Retained earnings are very useful in financing activities during inflation, when costs of material, labour, machinery, etc. escalate. In those times a financial institution may not come forward to finance
the increasing gap for investment. At other times, management may have an option to over-invest in materials, and retained earnings might be the readily available source of finance.

A possible divergence between profitability and liquidity position of a company may enhance the importance of this source of finance. A Profit and Loss account may show net profit but finance may be available only when an asset is sold, creditors are added, inventory is cut down. The profit may have already been used to add to assets or repay liabilities.

If the management of a company wishes to have higher market prices for its shares, the payment of only reasonable dividend and ploughing back of a large part of profits is one of the best alternatives. If the management adopts a little conservative dividend policy, it can plough back the required amount of profits for investment in the company as a regular feature.

The flow of funds from outside the company, i.e., from banks and others, can never be fast and adequate enough to enable a company to secure promptly all funds it needs for its expansion and diversification. The capital market machinery is tending to become rigid not only in developing but also in some of the developed countries in the world. Under Planning, there is a fairly rigid control over the capital market in regard to the channelling of
funds. The requirements of the private sector get a low priority as compared to those of the public sector. In a country like India, it would be unwise for a company to distribute all profits as dividends.

(2) Studies on Dividend and Retention Policies

The dividend policies of 1650 large and medium public limited companies were studied by S.L.M. Sinha.* He made a separate study of profit making companies, apart from all companies. Table III.10 contains the relevant data:

<table>
<thead>
<tr>
<th>Particulars</th>
<th>1966-70 (Average)</th>
<th>1971-75 (Average)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(A) All Companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. No. of companies</td>
<td>1501</td>
<td>1650</td>
</tr>
<tr>
<td>2. Profits retained as %age of PBT</td>
<td>21.40</td>
<td>30.10</td>
</tr>
<tr>
<td>3. Profits retained as %age of PAT</td>
<td>40.05</td>
<td>56.04</td>
</tr>
<tr>
<td>(B) Profit-making Companies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. No. of companies</td>
<td>1283</td>
<td>1330</td>
</tr>
<tr>
<td>2. Profits retained as a %age of PBT</td>
<td>31.70</td>
<td>35.30</td>
</tr>
<tr>
<td>3. Profits retained as %age of PAT</td>
<td>55.50</td>
<td>66.37</td>
</tr>
</tbody>
</table>

In general, the profit making companies had retained larger portion of their earnings from PAT as well as PBT. However, the growth of retained earnings in the case of all companies seemed to be higher than that in the case of profit making companies. A large share of profits of these companies was consumed by taxes. According to him, the Indian corporate sector is exercising as much restraint as is desirable. The general practice of the Indian companies is to err on the safe side, i.e., under-distribute dividends rather than over-distribute them.

Section 205 of the Companies Act limits the transfer to reserves an amount equal to 10% of PAT to ensure payment of dividend at a rate equal to the average of rates during the last three preceding years. This, in fact, favours high distribution of dividends. A statutory ceiling on distribution of dividend equal to not more than 40% of PAT (after the past losses are set off) would be in the interests of shareholders as well as the company.

The study of RBI covering 1501 selected large and medium public companies during 1966-70 and 1650 such companies during 1971-72 to 1974-75 indicated that:

(i) Reserves and surplus had increased from Rs. 5 crores in 1966-67 to Rs. 307 crores in 1974-75. Its contribution to total funds was negligible during the year 1966-67 and it increased to 13.70% during 1970. As a whole, during 1966-70, their contribution to total funds was 7.93% and had almost doubled to 14.90% during 1971-74.

Another study of RBI* suggested that, in the case of cotton textiles industry, the share of reserves in total funds was negative during 1966-70, but had subsequently improved and was equal to 20.33% of total funds during 1971-75. On comparison one may conclude that the cotton textile industry as a whole fared very poor during the former period but was far better than the All-India All-Industries average during the latter.

Rao** points out that retained earnings as a % age of P3T had marginally improved from 19% during 1966-70 to 20% during 1971-75 in the case of the companies sample studied by him.

In a study of selected units of fast moving industries (Engineering and Chemicals), medium industries (sugar and cotton textiles) and slow-moving industries (Tobacco and Vegetable), Pandey*** concluded that "The retained earnings are generally found to be insignificant. The insignificant retained earning ratios do not imply that the companies distribute more of profits among shareholders but because, in the process of growth, they require more of capital beyond their internal capacity to save".

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The pattern of financing of large industrial projects in the private corporate sector during 1973-74 was studied by the Research Bureau of the Economic Times. It was found that the 'Reserves and Surplus' had increased from 17.30% of total funds in 1972-73 to 18.70% thereof in 1973-74. However, the trend of retained earnings was as follows (vide: Table III.11).

**Table III.11**

<table>
<thead>
<tr>
<th>Particulars</th>
<th>First Plan</th>
<th>Second Plan</th>
<th>Third Plan</th>
<th>Annual Plan</th>
<th>Fourth Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings as a % of total resources</td>
<td>24.20</td>
<td>17.50</td>
<td>17.40</td>
<td>12.70</td>
<td>23.20</td>
</tr>
</tbody>
</table>

The study by Kothare and Menon*, of 261 cotton textile companies from 1965-66 to 1970-71, 271 companies in 1971-72, and 249 companies during 1972-73 to 1974-75 revealed that on an average, retained earnings as a part of PAT had shot up briskly from 10.58% of PAT during 1966-70 to 36.30% during 1971-75.

The RBI study of finances of Medium and Large Public Limited companies shows that the companies were found to distribute 80% of net profits as dividend on an average. According to one RBI study on dividends and retained earnings of public and private limited companies during 1955-66:

(a) the dividend payout ratios differed widely between industries.

(b) the net profit was the significant factor in case of five industries, whereas cash flow was the important factor in the case of other industries.

The studies made by Krishna Murthi and Sastry* of Chemical industry from 1962 to 1967 and 60 non-government public limited companies from 1967 to 1970, conclude:

(a) Current profit explains the dividend behaviour.

(b) Dividend decisions are autonomous and there was no inter-dependence between dividend, investment and external finance except in jute industry.

The study of 366 companies from 1947 to 1961 made by Rajnigam and Joshi** shows that the dividends were found to vary with the rate of profit, size, age, growth and management of the companies, but liquidity and capital formation were not found to influence dividend distribution.

In his study of corporate dividend behaviour with special reference to 158 growth and controlled companies covering 19% of corporate sector from 1961 to 1972 Dhamejia *** concluded thus:

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(a) Companies were not observed to follow a policy of distributing a certain portion of their profits as dividend. The dividend payout ratio had increased from 55% in 1960 to 62% in 1972.

(b) Declaring a dividend rate on the face value of shares was observed to be a common practice among companies.

(c) Maintaining a dividend rate was the practice found in 41% of cases. In 33% cases dividend rate was generally increased. Only in 21% cases dividend was skipped or reduced.

(d) Directors seemed to follow a policy of non-decreasing dividend for longer periods and of avoiding any increases in dividend.

(e) Changes in dividend rates were associated with the changes in earnings rates. With an increase in the rate of earnings, nearly 53% companies had raised the rate of dividend and 36% companies had kept it constant. With reduction in the rate of earnings, 45% companies had kept the rate of dividend constant, whereas 33% companies had reduced it.

(f) Dividend payout ratios in textiles, food, chemicals and miscellaneous industries were about 60% and the engineering industry had a lower dividend payout ratio.

(g) Growth of a company was found to limit the dividend payment.
Financial institutions and dividend policy:

The dividend decisions are directly influenced by the restrictive provisions of loan agreements between financial institutions and borrowing companies restraining dividend rates to certain ceilings. For instance, the loan agreement (No.9) of IFCI, p.40, provides the following:

(i) The borrower shall not declare any dividend during any financial year unless it has paid instalments of principal and interest due on existing loans and on any additional loan.

(ii) The rate of dividend shall not exceed 10% on equity paid-up capital of the borrower without the prior written permission of IFCI.

(iii) While permitting any borrower to pay dividend above 12%, IFCI shall reserve the right to ask for repayment of the outstanding loan to the extent of additional dividend allowed to be paid beyond 12%.

The study of 101 companies selected at random from various industries made by Maheshwari* (based on the data collected from the Official Stock Exchange Directory, Bombay.) from 1970 to 1976 was divided into two parts:

(i) to analyse critically various facts of corporate dividend behaviour and infer some of the most prevalent dividend policies, and

(ii) to examine and assess the relative weights of various dividend decision variables which have caused corporate dividend behaviour in India in the recent past.

Table III.12 exhibits the relevant figures.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Zero payout Ratio</td>
<td>27</td>
<td>25</td>
<td>27</td>
<td>27</td>
<td>30</td>
<td>31</td>
</tr>
<tr>
<td>25% to 50%</td>
<td>30</td>
<td>31</td>
<td>26</td>
<td>41</td>
<td>35</td>
<td>33</td>
</tr>
<tr>
<td>50% to 75%</td>
<td>18</td>
<td>18</td>
<td>21</td>
<td>8</td>
<td>8</td>
<td>13</td>
</tr>
<tr>
<td>75% to 100%</td>
<td>12</td>
<td>12</td>
<td>10</td>
<td>5</td>
<td>2</td>
<td>7</td>
</tr>
<tr>
<td>More than 100%</td>
<td>2</td>
<td>8</td>
<td>10</td>
<td>2</td>
<td>-</td>
<td>1</td>
</tr>
</tbody>
</table>

The main findings are:

(i) Nearly 40% of the sample had a payout ratio between 25% and 50%.

(ii) The average ratio had declined by 2% from 1970 to 1976.

(iii) The number of companies having a dividend payout ratio exceeding 50% had declined from 38 in 1971 to 21 in 1975. A restraint on dividend distribution was notable.

(iv) Despite the increasing tendency in absolute dividend amounts paid to the shareholders, the dividend...
rate was more or less stagnant, ranging between 8.60% and 10.90% during 1970 to 1976.

(v) The sample companies which skipped dividend were predominantly those with poor liquidity position.

(vi) A high degree of correlation existed between dividend rate and earning rate.

(vii) Higher variation in earnings had compelled managements to maintain relatively lower dividend rates.

(viii) Younger and fast growing companies believed in distributing lesser and lesser portion of their earnings by way of dividend.

(ix) Loss was not the predominant factor to incline managements to skip dividend.

Kothare and Menon's study of financing cotton textile industry showed that whereas dividend to PAT on an average had declined from 128.84% during 1966-70 to 116.73% during 1971-75, the policy of distributing dividend with the help of past reserves had continued throughout the period of this study.

The RBI study of 1650 public limited companies showed that there were frequent variations in regard to dividend payout and retention of earnings from 1970-71 to 1974-75, as shown in Table III.13.
The records of ICICI* showed that, in the case of 417 public limited companies, a large portion of earnings was consumed by corporate income taxes. The tax provision to PBT was 66.34% in 1971-72; it had increased to 73.27% in 1974-75. It is interesting to note that these companies had increased their retention of profits from 25.20% of PBT in 1972-73 to 36.30% of PBT in 1974-75 by restraining dividend payout. The amount of dividend to PBT had declined from 30.40% during 1972-73 to 15.90% of PBT during 1974-75. They also seemed to be adopting gradually a less liberal policy on dividend payout.

The other study of 1501 selected large and medium public limited companies during 1966-70 and of 1650 companies from 1971-72 to 1974-75 made by RBI indicated that the retained earnings as a part of total funds had increased from 7.98% during 1966-70 to 14.90% during 1971-75. As against this, as per Kote's study of cotton textile industry, the contribution of retained earnings to total

funds was negligible during 1966-70, but had increased to 20.33% during 1971-75, and that inspite of decreasing returns on equity, the industry has continued to pay dividend.

Kumar and Manmohan* studied the relative importance of dividend and retained earnings by taking into consideration the data from the Directory of Bombay Stock Exchange relating to 54 engineering companies, 48 Electricals, 51 Chemicals, 66 Cotton textile companies and 33 companies engaged in the business of Tea during 1969, 1970 and 1971. Their conclusions were:

(i) In the case of growth industries—Electricals and Engineering—the dividend explained share price variations much more than retained earnings.

(ii) In the case of chemicals, the impact of both dividend and retained earnings was roughly the same, though that of retained earnings was marginally higher than that of dividend.

(iii) In the case of tea and textiles, retained earnings explained the price variations better than dividend. This was surprising as in less growth-oriented industries, dividend normally has more impact than retained earnings.

(iv) In well-established industries, like tea, cotton textiles and chemicals, investors attached a lower risk to their shares and so the market placed a premium on retained earnings.

A reference to Table II and Table XIX together exhibiting the contribution of reserves in the total funds makes it clear that:

(i) The average share of reserves in total funds had increased marginally from 16.20% during 1966-70 to 13% during 1971-75. This was also accompanied by a marginal change in the variability factor over the whole period of this study. It may be noted that the retention policies adopted by textile mills under study were not uniform during both the periods. However, a decline of variability factor from 66.11% to 51.22% indicated that the level of uniformity had increased during the latter period with reference to dividend and retention policies adopted by them.

(ii) The share of reserves in total funds in the case of unit Nos. 5, 14, 19, 25, 27, and 50, was below the overall average during both the periods. However, the increase was significantly higher in the latter period.

(iii) In the case of unit Nos. 3, 8, 18, 23, and 33, the individual average share of reserves in total funds was below the overall average during both the periods. However, in the case of unit Nos. 3, 18, and 33, it
had declined significantly, whereas in the case of unit Nos. 8, and 23, it had declined marginally during the latter period.

(iv) The share in the case of unit Nos. 4, 12, 13, 17, 37, 41, and 43, was above the overall average during both the periods, but had declined in the latter period, whereas in the case of unit Nos. 38, and 47, not only was their share above the overall average during both periods, but also had it further increased during the latter period.

A reference to Table No. III and Table XIX regarding the share of reserves in the proprietorship funds leads to the following observations:

(i) An increase of 17.60% in the average share of reserves in proprietorship funds could be noticed from 50.00% in the former period to 58.80% during the latter. It was accompanied by a marginal change in variability, which indicated that the financial policies with regard to the role of reserves in owned funds were not uniform. However, the level of non-uniformity had declined during the latter period. It seemed that the units had adopted less and less non-uniform policies and practices during the latter period.
(ii) In the case of unit Nos. 4, 9, 12, 17, 37, 43, and 47, the share was above the overall average during both the periods. Further, in the case of unit Nos. 9, 12, and 47, it had increased and in the remaining cases, it had declined during the latter period.

(iii) The share was below the overall average in the case of unit Nos. 3, and 18. The share in the case of unit No. 3 had increased from 5.34% to 5.76%, whereas that in the case of unit No. 18 had declined from 13.26% to 10.05% during the latter period.

(iv) Exceptionally, in the case of unit Nos. 5, 19, 25, and 32, the share was below the overall average during the former period only, though it had exceeded the overall average during the latter period.

Internal financing is mainly dependent on the adoption of a suitable dividend policy. The desirable aim of companies should be the establishment of a stable dividend rate as it aids in raising additional capital, enhances company reputation, and increases the value of securities. In doing so, it is necessary to consider the trend of profits, shareholders' reaction, requirements of retained earnings, government's economic and taxation policies, etc. The dividend Vs. retention decisions in the case of cotton textile mills of Ahmedabad were influenced, in general, by the following factors:
(i) The record of earnings over the past years.
(ii) Frequency of periods resulting in operating deficits.
(iii) Fluctuations in earnings during each phase of the business cycle.
(iv) Effect of dividend policy on the company's credit standing.
(v) Plans for expansion and need for fixed capital.
(vi) Working capital needs.
(vii) Attitude of the Board of Directors.
(viii) Expectations of the shareholders.
(ix) Burden of corporate income taxes.

The major factors affecting dividend Vs. retention decisions seemed to be: profitability position, burden of corporate taxes and dividend policy as adopted by the cotton textile managements.

(a) Profitability position

The study of Profit and Loss Account and the Balance Sheets of all the 50 cotton textile units of Ahmedabad has yielded the frequency distribution of Net profit to Net worth as exhibited in Table III.14.

**Table III.14**

<table>
<thead>
<tr>
<th>Net Profit to Net worth (%)</th>
<th>No. of companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 5.00</td>
<td>12</td>
</tr>
<tr>
<td>5.00 to 10.00</td>
<td>9</td>
</tr>
<tr>
<td>10.00 to 15.00</td>
<td>12</td>
</tr>
<tr>
<td>15.00 to 20.00</td>
<td>10</td>
</tr>
<tr>
<td>20.00 and above</td>
<td>7</td>
</tr>
<tr>
<td>Total</td>
<td>50</td>
</tr>
</tbody>
</table>
The other findings are:

(i) In the case of 10 units, the amount of PBT was negative during the former period, i.e., 1966-70, whereas, during 1971-75, the number of such units had fallen to 5.

(ii) As many as 12 units had a profitability of less than 5% of their net worth employed, throughout the 10 year period of this study.

(iii) In the case of other units, the performance was more than fair. As many as 29 out of 50 units had earned profits at the rate of 10% of net worth and more. This factor along with less liberal dividend policy adopted by the managements, particularly during the latter period, seemed to have helped them increase their reserves, despite heavy burden of corporate income taxes.

It may be noted that in the absence of very heavy taxation, the textile units of Ahmedabad could have added larger amounts to reserves and improved their role in financing.

(b) Tax provision as a part of PBT

The study of Profit and Loss Accounts and Balance Sheets of all the 50 units suggests that,

(i) The number of companies providing for taxes to the extent of more than 50% of their PBT had increased during 1971-75. Such companies were nine during 1966-70 and had increased to twelve during the
latter period. This means that increasing tax burden on these companies was one of the major factors which had disabled them from retaining and ploughing back larger profits.

(ii) The number of companies providing for taxes to the extent of less than 50% of PST had declined from 41 during the former period to 39 during the latter. This means that companies to which higher tax slabs were applicable had increased in number during the latter period.

(c) Dividend considerations

The analysis of Profit and Loss Accounts and Balance Sheets of the mills showed the distribution of cash as well as non-cash dividend as stated in Table III.15.

<table>
<thead>
<tr>
<th>Rate of dividend as %age of PAT</th>
<th>No. of companies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1966-70</td>
</tr>
<tr>
<td></td>
<td>1971-75</td>
</tr>
<tr>
<td>Nil</td>
<td>5</td>
</tr>
<tr>
<td>Below 50%</td>
<td>16</td>
</tr>
<tr>
<td>Above 50%</td>
<td>34</td>
</tr>
<tr>
<td>Above 100%</td>
<td>14</td>
</tr>
</tbody>
</table>

The main findings on the distribution of dividend on equity shares as well as preference shares are:

(i) The number of companies paying no dividend on equity as well as preference shares had increased
from 5 during 1966-70 to 6 during 1971-75. All these companies were having a negative PBT.

(ii) The number of companies distributing dividend of an amount below 50% of PAT had increased from 16 during 1966-70 to 23 during 1971-75.

(iii) The number of companies paying dividend of an amount exceeding 50% of PAT had declined from 34 during the former period to 27 during the latter.

(iv) The number of companies distributing the whole of PAT by way of dividends as well as transferring a portion from Reserves to pay dividends had declined from 14 during the former period to 10 during the latter.

From the above particulars, a conclusion can be drawn that the cotton textile mills of Ahmedabad, in general, had adopted a less liberal policy on dividend distribution during the latter period as compared to the former. This was a major factor contributing to their capacity to plough back profits, despite heavy burden of taxation.

The study of Profit and Loss Accounts and Balance Sheets of the fifty textile mills of Ahmedabad shows that they had issued bonus shares or non-cash dividend to the extent of Rs. 274.63 lacs during 1966-70, and to the extent of Rs. 762.24 lacs during 1971-75. This means that there was a rise of about 140.80% during the latter period as compared to the former. It may also be noted
that companies under group management had issued more bonus shares as against individual companies; Also, they had been more consistent on the issue of bonus shares than the latter.

**Dividend Vs. Retention decisions** are affected by fiscal as well as monetary measures pursued by the Government in furtherance of economic stability and development of the country. These policy variables may affect these decisions directly or indirectly through their impact on earnings and on the working of the company. The degree of influence will vary from company to company depending upon the importance of that policy variable at a point of time or depending upon the company which may be included in the priority list or a company managed and controlled by a large business group which may be subject to Government regulations.

Fiscal policy of tax on company or individual incomes influences dividend decisions. Progressive income tax, at rates higher than those in the case of capital gains tax, deter companies from their dividend declaration, where companies are controlled by directors representing shareholders in the high income groups.

According to the Finance Act, 1959-60, a company is a separate entity for tax purposes and shareholders cannot claim refund for tax paid by the company, i.e., the practice of grossing up of dividends in the hands of shareholders is abolished after this enactment. This abolition
was one of the considerations for the companies to increase the dividend so as to compensate the shareholders for the loss of benefit of grossing up and to enable them to maintain their dividend incomes.

The taxes levied on companies include corporate income tax, tax on dividend above a certain rate, excess profit tax and additional tax on closely held companies for not distributing required profits. All have different objectives. In general, the influence depends upon the incidence of tax which may be considered in two ways:

(1) For a company having a monopoly in the product market or having inelastic demand for products, the increase in corporate tax will be shifted to the consumers in the form of price rise and may not influence adversely profits and dividends. (2) For a company having a competitive market for its product, profits may be reduced with the increase in corporate tax. With a reduction in PAT, dividend rate may be maintained, for which past reserves may be drawn upon or the dividend rate may be curtailed by maintaining corporate surplus or reserves.

Monetary policy relating to bank rate or bank credit to industries - to combat inflation or to have a balanced growth of economy - will also affect corporate sector and influence dividend decisions. An increase in bank rate generally leads to a rise in market interest rates and in the cost of debt, and affects the liquidity of the company. This might add to the cost of borrowings and may encourage use of internal funds, resulting in a low dividend payout
ratio. On the other hand, the increase in interest rate may enable some companies to increase their dividend rate. Such a policy of dividend rate competitive to bond yield is followed in cases (i) where, the companies want to raise more funds from the capital market, or (ii) where investors having substantial interest in companies do not recognise potential capital gains and the tax advantage of high retention of profits.

In India, interest cost is hardly 5% of total cost of production and a slight increase does not have much importance. But, in cases, where increase in interest cost due to bank rates raises the cost of raw materials and cost of production, it does have a significant impact on the profits of the companies and dividend distribution. The policy of tight money and credit squeeze followed by RBI, particularly after 1973, to combat inflation affected the liquidity and working of a number of companies relying on banks for credit and a number of them skipped dividend.

Direct restrictions on dividend declaration may relate to individual companies or may, as a general measure, relate to all companies. The Companies (Temporary Restrictions on Dividend) Act, 1974, imposed the following main restrictions:

(i) The maximum distributable profits would be either one-third of the net profit of the company or an amount required to pay 12% dividend on equity shares and that on the preference shares whichever is less.
(ii) Payment of interim dividend is prohibited except with the previous approval of the Central Government and subject to terms and conditions as imposed by the Government.

(iii) Companies are prohibited from making any distribution out of their assets like the issue of bonus shares or the grant of loans to shareholders without the prior approval of the Central Government.

It was estimated that annual dividend restrictions would range between Rs. 50 lacs and Rs. 1 crore, RBI had estimated them to be Rs. 1 crore, whereas the Bombay Stock Exchange had estimated them to be between Rs. 60 lacs and Rs. 70 lacs. They have been criticised on a number of grounds:

(i) Restrictions on dividend might encourage companies to engage in speculative activities and use the surplus funds for inventory build up.

(ii) The limit of dividend at 12% increased bank rate to 9%, and bank advances were made available at 15% and above. These would serve as disincentive to investors in shares.

(iii) They would cause hardship to small investors. According to one RBI study, 90% of corporate shares are held by small and medium investors holding share capital of Rs. 5000 or less. Big investors gain in terms of reduced tax liability and reduction in wealth tax liability.
(iv) They would cause hardship also to institutional investors, who account for about 18% of total share capital of corporate sector e.g., the reduction in dividend of, say, Rs. 5 crores to LIC and Rs. 2 crores to UTI would be a loss to small policy and unit holders.

Compulsory transfer of profits to reserves is intended to impose a moral obligation on the company to retain more of earnings. After the amendment of section 205 (2A) of the Companies Act, 1956, the Central Government has framed rules called (i) the Companies (Transfer of profits to Reserve) Rules and (ii) the Companies (Declaration of Dividend out of Reserves) Rules, 1975. Under these rules a company has to transfer a stated proportion of profits to reserves before declaring dividend to shareholders as per the break-up in Table III.16.

Table III.16

<table>
<thead>
<tr>
<th>Dividend on paid-up capital to be declared(%)</th>
<th>Net profit after tax to be transferred to reserves before declaring dividend</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 10.00</td>
<td>Nil</td>
</tr>
<tr>
<td>10.00 to 12.50</td>
<td>2.5 %</td>
</tr>
<tr>
<td>12.50 to 15.00</td>
<td>5.0 %</td>
</tr>
<tr>
<td>15.00 to 20.00</td>
<td>7.5 %</td>
</tr>
<tr>
<td>Above 20.00</td>
<td>10 %</td>
</tr>
</tbody>
</table>
These rules provide for:

(1) Declaration of dividend as per the decision of the Board of Directors.

(2) Strengthening of reserves position.

It is stated in the Rules that a company is free to transfer more than 10% of PAT, (i) if it is maintaining or increasing dividend rate from the average of three years immediately preceding, and (ii) if the PAT is more than the average of two years immediately preceding.

A company may skip dividends if PAT amounts to less than the average amount of dividends over the immediately preceding three years. The ultimate effect would be

(i) that a company will not be able to reduce or skip dividend just for conserving resources,

(ii) that on account of restrictions, if a company wants to pay more dividend, deferred dividend warrants will have to be issued, and

(iii) that now the rate of dividend is crucial - and, not the amount of dividend, - as the companies have to maintain the average rate of 3 preceding years even on larger capital base, resulting from additional public issue or bonus issue, if PAT has not fallen by 20% or more than the average of two succeeding years.
The result may be that companies might issue less of bonus shares as the maintenance of dividend rate has to be taken care of.

Restrictions on declaration of dividends have not much affected the working of the fifty cotton textile mills of Ahmedabad. There were only two textile units which had issued deferred dividend warrants for the year 1974, and only three that had issued deferred dividend warrants during 1975.

Restrictions on the payment of dividend out of reserves have affected adversely those companies which had adopted a very liberal dividend policy during 1966-1970 and wanted to continue it even during 1971-75. The number of companies with a dividend payout ratio of over 100% of PAT had declined from 14 during 1966-70 to 10 during 1971-75. They had adopted a policy of maintaining the rate of dividend even when they had to draw some amount from past reserves. In order to do so, some of them had continued to rely more on external sources, particularly bank borrowings and institutional borrowings. As per the restrictions on the use of past reserves for declaration of dividend, a company can draw from reserves in a particular year up to 10% of the paid-up capital, provided the balance left in reserves and surplus is not less than 15% of paid-up capital and the loss of the current year is adjusted first from such withdrawal before paying the dividend.
A couple of typical cases are worth noting here:

In one case, the Chairman of the Company explained thus:*
"Your directors have recommended the dividend for the year at the rate of Rs. 25/- per share on 28,500 equity shares which will be paid for in the following manner as permitted under the Companies (Temporary Restrictions on Dividend) Act, 1975.

Rs. 15/- per share as immediate dividend,
Rs. 5/- per share as first instalment of deferred dividend payable from and after 6th July, 1976, and
Rs. 5/- per share as 2nd instalment of deferred dividend, payable after 6th July, 1977.

In another case, dividend was declared as follows:**

(1) Total dividend per share Rs. 18/-,
(2) Payable as immediate dividend Rs. 12/- per share,
(3) Payable as 1st deferred dividend instalment Rs. 3/-, per share on or after 6th July, 1976, and
(4) Payable as 2nd instalment Rs. 3/- per share on and from 6th July, 1977.

The Sachar Committee has opined that the rules regarding transfer of profits to reserves are unnecessarily cumbersome and lead to confusion and, also, cause hardship in some cases. It has suggested that the

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Companies (Transfer of Profits to Reserves) Rules, 1975, should be deleted, and that the Companies (Declaration of Dividends out of Reserves) Rules, 1975, should be dispensed with.

At present, proviso (b) to sub section (1) of section 205 of the Companies Act permits the company to pay dividend, leaving a part of the accumulated loss unadjusted. The Institute of Chartered Accountants of India in their memorandum has strongly suggested an amendment of this proviso to ensure that a company does not distribute the profit earned by it in a year, or in the previous years, unless the entire loss including depreciation is completely made good.

A comparison of dividend payment Vs. retention policy as adopted in general, by the cotton textile mills of Ahmedabad, the entire cotton textile industry and All-India All-Industries brings to light the following:

(i) The reduction in dividend payout ratio in the case of textile units of Ahmedabad was comparable to a similar finding of Maheshwari on the basis of a study 101 companies belonging to different industries. The number of such companies having a dividend payout ratio exceeding 50% had declined from 38 in 1971 to 21 in 1975. In the case of textile mills of Ahmedabad, the number of units with a dividend payout exceeding 50% had declined from
34 during 1966-70 to 27 during 1971-75. A restraint on dividend was notable. The number of companies not declaring any dividend had increased from 27 in 1970 to 31 in 1975 according Maheshwari's study. Similarly, five textile units of Ahmedabad did not pay any dividend during 1966-70 and the number of such units had swollen to six during 1971-75. Similarly, the companies having a dividend payout ratio exceeding 100% had declined as per the finding of both these studies.

(ii) A similar trend is observed in a study of 417 Public Limited Companies (ICICI Portfolio, 1975). The amount of dividend to PBT had declined from 30.47% during 1972-73 to 15.90% during 1974-75. These companies seem to be adopting gradually a less liberal dividend policy.

(iii) The increase in the contribution of reserves to total funds in the case of textile units of Ahmedabad from 16.20% during 1966-70 to 18% during 1971-75 was in keeping with the overall trend observed in other industries. However, the rate of growth was far less when compared with the position of cotton textile industry as a whole. The RBI study of 1501 selected large and medium companies during 1966-70 and 1650 companies during 1971-75 shows that the contribution of retained earnings to total funds was negligible during 1966-70 and had increased sharply to 20.33% of total funds during 1971-75.
The rate of growth of retained earnings in the case of all companies studied by RBI put together was also faster than the one seen in the cotton textile units of Ahmedabad. The contribution of retained earnings of all companies on an average was 7.98% of total funds during 1966-70 and had increased to 14.90% during 1971-75. Whereas the contribution of reserves to total funds in the case of cotton textile units of Ahmedabad had increased by 10% only, the same in the case of all industries put together had almost doubled during the latter period.