CHAPTER ONE

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1.1 Introduction

Retained earnings refer to that part of corporate’s net profit after tax which is not distributed to the shareholders as dividend but is reinvested in the business. Retained earnings is a technique of financial management under which all profit after tax is not distributed amongst the shareholders as dividend but a part of profits is retained or reinvested in the company.

Retained earnings therefore, are the sum of a company’s profits after dividend payments, since the company’s inception. They are also called earned surplus, retained capital or accumulated earnings.

Retained earnings are an important source of internal or self financing by a company. The savings generated internally by a company in the form of retained earnings are ploughed back into the company for diversification of its business. Retention of earnings by companies reduces their dependence on funds from external sources in order to finance their regular business needs.

In order for a company to grow, develop and expand, retained earnings have to be used for the accumulation of assets that generate income for the company. When income is generated it gives a company the means for expansion, as well as helps it in its research and development programmes. More income helps to improve the financial status of a company and also makes it more favourable in the eyes of investors.

Retained earnings are also called as ploughing back of profits as the retained profits are ploughed back into the business for its development. Retained earnings is also known as self financing, internal financing or inter financing. The need for retained earnings arises for the purpose of replacement of old assets which have become obsolete, for expansion of growth and business, for contributing towards the fixed as well as working capital needs of companies, for improving working efficiency of plants and equipments, to make companies self dependent of finance from external sources, for redemption of loans and debentures.
Retained earnings is favourable for companies as issuing of new capital is inconvenient as well as involve floatation costs also if company raises debt, the financial obligation and risk will increase. Retained earnings not only give rise to growth in the value of the firm but also appreciate the value of its shares.

The importance of retained earnings has been highlighted by a number of studies done on the subject. A brief view of some studies is presented here.

Harkavy (1953) propounded that retained earnings or corporate reinvestment is an important source of capital gain for companies.

In the view of Donaldson (1961) retained earnings were the funds available with companies over which management has complete and independent control regarding their utilisation.

Krishnamurthy and Sastry (1971) are of the opinion that retained earnings played a crucial and important part in exerting influence and getting finances for investments when supply of funds was limited on account of poor profits.

Ojha (1978) evaluated the justification of retained earnings retention by companies in terms of beneficial factors which it offered to companies such as to equalize dividend when there was low profits in current year, to withstand depression, to reduce cost of capital and formalities of financing, to enable gradual growth and to get easy finance.

Myers and Majluf (1984) propounded that profitable firms borrowed less because of their sufficient internal sources in the form of retained earnings which reduced their dependency on external sources of funds which involved heavy interest payment on the borrowed funds.

Van Horne (1985) defined retained earnings as company’s cumulative profits that have been retained or reinvested in the business.

Karak (1993) viewed retained earnings were important internal source for company’s to finance their expansion programmes as far as possible with the retained earnings.

Athey and Laumas (1994) found that internal funds in the form of retained earnings are important for large firms and firms that produced luxury goods.
Salvary (2004) professed that corporate retained earnings impact the regional flow of financial capital.

Mahakud (2005) found profit after tax, dividend policy, cost of borrowing, shareholding pattern, investment opportunities and availability of external funds to be important determinants of retained earnings which affected the retention of earnings decision of companies.

Kaushik (2007) propounded that there existed significant differences between domestic and multinational companies with regard to the manner in which retained earnings were managed and the factors which determined retained earnings.

Salvary (2007) favoured corporate earnings retention by means of dividend policy as it provided companies with an important means for mitigating risk.

Kamat (2008) found retained earnings to be an important internal source of financing by companies.

Bhayani (2009) favoured the retention of earnings by companies as earnings retained were better source of finance which were diverted to profitable investment opportunities earning a higher return thus increasing the value of the companies.

1.2 Advantages of Retained Earnings

Retained earnings benefits companies in the following ways:

- Companies which retain their earnings can face unforeseen contingencies, capital market crisis and other downturns.

- Retained earnings helps to stabilize the dividend policy of companies, improves companies relation with its shareholders.

- Appreciates the value of shares of company’s.

- Retained earnings is the most convenient and economical method of finance and involves no legal formalities.

- Retained earnings helps to keep the financial structure of company’s fully flexible and increase the credit worthiness of company’s.
• Due to retention of earnings the growth and modernization plans of companies don’t suffer due to lack of finance.

Though, retained earnings is an important and cheap source of finance as compared to external sources of finance available to companies and gives benefits and advantages to companies, shareholders and society but it also carry some dangers with it like the heavy reinvestments of such profits year after year by a company may cause dissatisfaction among shareholders as they may get lower dividends.

1.3 Disadvantages of Retained Earnings

Retention of earnings may tempt the management to raise bonus shares to the equity shareholders leading to over capitalization, the companies may not always use the retained earnings to promote the interests of shareholders. Instead, it may be invested in unprofitable avenues or misused by locking up them in those business concerns which are against the interests of shareholders, retained earnings can be used to manipulate the share prices of stock exchange. The company may keep the dividend rate very low so as to purchase the shares at very lower prices and later by increasing dividends rates, it may reap benefits from higher share prices.

1.4 Definition of Earnings Retention Ratio

Retention ratio is also called as Plough back Ratio. As per definition, Earning Retention Ratio or Plough back Ratio is the ratio that measures the amount of earnings retained after dividends have been paid out to the shareholders. The prime idea behind earnings retention ratio is that the more the company retains the faster it has chances of growing as a business. This is also known as retention rate or retention ratio. There is always a conflict when it comes to calculation of earnings retention ratio, the managers of the company want a higher earnings retention ratio or plough back ratio, while the shareholders of the company would think otherwise, as the higher the plough back ratio the uncertain their control over their shares and finances are.

1.5 Retention of Profits

Two schools of thoughts are available in financial literature regarding this aspect. One favours retained earnings and other against it. To draw a conclusion, each of them needs to be examined.
The school of thought, which favours retained earnings, argues that it acts as a cushion to absorb the shocks of business vicissitudes. It builds a resistance power to face depression and is a path to a stable dividend policy, which enhances the credit standing of a company. Moreover, given the lower cost of retained earnings in relation to the sale of common stock, it is not surprising to find that financial managers favour earnings as a source of equity funds.

Apart from this, as inflation deteriorates the purchasing power of money and creates a problem in replacing fixed assets, the views of Wright (1981) prove to be an appropriate solution. To him, just to remain in business, the company must usually retain some earnings over and above the depreciation provided on historical cost basis. The shareholders in the process are also provided an opportunity of having their investments secured against the business variations and the market price of shares also favours them as advocated by a school of thought.

The school of thought that is against retaining profits advocates that it invites dangers, such as the company grow into a monopoly, be over capitalized, creates dissatisfaction among shareholders, market price of share may also be manipulated, or the directors may also misuse the funds. Das (1965) expressed doubts if high volume of retained earnings may serve any useful purpose for a company’s growth.

In this regard Ohja (1976) is also of the same view that excessive retained earnings may be used for undesired inter company investments, over expansion, inventory accumulation, and hoarding, which not only increase the cost price to the consumers but also deprive other needs and concerns of capital.

Hence, the study of both the schools suggests that the role of retained earnings is vital in the growth of a company. Excessive retained earnings, in the absence of a sound retention policy, may however invite danger.

### 1.6 Retained Earnings and Valuation of Share

The present value of a share, in financial literature, is considered to be the sub total of the discounted present value of all the future receipts taking the form of dividend payments and capital gains. Both future dividend payments and capital gains are dependant on the expected future earnings of the concern. The discount rate brought
into use to find out their present value is a result of both the prevailing general market rate of interest and the risk (both business and financial) attached to the share. The appropriation of earnings between dividends and retention affects both the expected future earnings of the concern and the discount rate to be applied and hence the present value of the share. That is why investors give different weights to earnings that are distributed in the form of dividends and to earnings that are retained for reinvestment.

To explain the behavior of share prices, two different theories have been offered in the literature known as the dividend theory and the retained earnings theory.

1.7 Dividend Theory

The advocates of this theory recognize dividends as being more fundamental in regard to the determination of share price than retained earnings. They contend that an increased amount of retained earnings has much less weight in the valuation of shares than the dividend paid today. The required rate of return which represents a weighted average of the future period required rate rises with the proportion of earnings retained (Gordon, 1959). According to them, given two similar companies (earnings and risk being the same); the price of the shares of that company would be higher which has a higher payment ratio.

Most of the empirical findings show that share prices have been influenced more markedly by the dividend rate than by retained earnings. The earliest assertion of dividend theory was made by Graham and Dodd (1951) when they claimed that the average impact of a dollar of dividends on share prices is four time the impact of a dollar of retained earnings. Among the few outstanding statistical studies which favoured this theory are those of David Durand (1957), Walter (1956), Gordon (1959), Fried and Puckett (1964) and Porterfield (1959). All came to the same conclusion namely, that the proportional effect of dividends on share prices is greater than the corresponding proportional effect of retained earnings.

1.8 Retained Earnings Theory

The retained earnings theory supporters assert the validity of the proposition that higher share prices are a consequence of higher retained earnings especially in the long run. The effect of retained earnings on share prices is a result of the profitability
of corporate investment opportunities. If the rate of profit on new investments is more than the minimum rate required by the shareholders, it certainly has a positive effect on the share prices of the company.

Harkavy (1953) made the assertion, that if, from the investors point of view, the present value of future profitability of retained earnings is more than the rate of return which investors quite require, retained earnings would lead to a rise in the prices of shares. The crucial factor is the profitable utilization of the investor’s funds.

Another argument given in the favour of the retained earnings theory is the preferential treatment to capital gains, compared to dividend income under the income tax laws. Higgins (1974) concluded his observation regarding dividend policy, evidence also suggests that share prices are not a positive function of dividends as often suggested. In fact, if there is any correlation at all, it seems to be in the opposite direction, with dividend exerting a depressing effect on share prices. On the basis of statistics most of the studies made so far supported the dividend theory.

Retained earnings, having a value in the theoretical framework as to their effect on the market prices of shares, lose their weight when put to empirical test. Thus, share prices tend to be influenced more by dividends rather than retention.

1.9 Dividend, Dividend Decision, Dividend Policy and Retained Earnings

Retained earnings decision is itself not a complete decision, it is taken on the basis of dividend, dividend decision and dividend policy of company’s, and therefore it is important to have understanding of the concept of dividend, dividend decision and dividend policy.

1.9.1 Dividend

Dividends are payments made by a company to its shareholders. It is a portion of corporate profits paid out to the stockholders or shareholders. When a company earns a profit or surplus, that money can be put to two uses: it can either be reinvested in the business called retained earnings, or be paid to the shareholders as dividends.

Many companies retain a portion of their earnings as retained earnings and pay the remaining as dividends. For an equity investor, dividends are the most awaited
returns. For a joint stock company, a dividend is allocated as fixed amount per share. Therefore a shareholder receives a dividend in proportion of his shareholding.

Public companies usually pay dividends on a fixed schedule, but may declare dividend at any time, sometimes called a special dividend to distinguish it from a regular one. Dividends are usually settled on a cash basis, as a payment from the company to the shareholder. They can also take some other forms like such as store credits and shares in the company (either newly created shares or existing shares bought in the market).

Further, many public companies offer dividend reinvestment plans, which automatically use the cash dividend to purchase additional shares for the shareholders. Cash dividends which is the most common form of are paid in form of cash. Announcements of dividends is usually a good news for the investors. They consider it as a signal that the company is doing well and is rewarding its shareholders.

Dividends are usually paid to owners or shareholders of business at specific periods. This is apparently based on the declared earning of the company and the recommendations made by its creditors. Thus, if there are no profits made, dividends are not declared. But when profits are made, the companies are obliged to pay corporate tax including other statutory taxes to the government, this is an essential corporate responsibility particularly of profit making companies. The taxes no doubt reduce the profits available at the disposal of the companies which either can be retained or distributed as dividend to shareholders of the company’s.

1.9.2 Dividend Decision

Dividend decision has been a subject of enquiry for financial analysts, academicians and researchers for about five decades. The objective of the decision is to determine the extent to which the earnings of the company should be distributed as dividend. Dividend decision involve deciding how much dividend should be paid (payout ratio) and in what terms it should be paid.

Dividend payout ratio shows the percentage share of the net profit after tax which is paid as dividend to equity shareholders after paying dividend to preference...
shareholders. It is calculated by dividing the total dividend paid to equity shareholders by the total profits available for them. Dividend per share refers to the actual amount of dividend declared per share.

The dividend decision is an integral part of a company’s financial decision making as it explicitly related to two other major decisions namely the investment decision and the financing decision. In fact, the question why companies pay dividends and why do investors pay attention to dividends have puzzled both academicians and corporate managers for many years.

Dividend decision is one of the most difficult and controversial issues in modern corporate finance. This has resulted into a number of competing theoretical explanations for dividend policy.

Dividend decision involves deciding how much dividend should be paid (payout ratio) and in what form it should be paid to the shareholders. The decision is taken in the light of investment opportunities available and alternative financing options. As the underlying objective of all financial decisions is to maximize shareholders wealth, the structure of corporate tax is an important input for dividend decision making process.

However, companies may also be discouraged from paying higher dividends when these are doubly taxed, once in the hands of the company and again in the hands of the shareholders.

1.9.3 Dividend Policy

Dividend policy is one of the most controversial subject in finance. Dividend policy is one of the most important financial policies, not only from the view point of the company, but also from that of the shareholders, the customers, the workers, regulatory bodies and the government.

Historically dividend policy has been referred to as the firm’s choice of distribution of its profits either by way of dividend payments or through share buy back programme. The dividend policy affects the profits available for reinvestment. Retention of profits for reinvestment strengthens the shareholders equity position.
Dividend policy is the trade-off between retaining earning and paying out cash or issuing new shares to shareholders. The selection of optimal dividend policy is one of the most important questions in the company’s financial management.

A company’s dividend policy has the effect of dividing its net earnings into two parts: retained earnings and dividend. The retained earnings provide funds to finance company’s long term growth. It is the most significant source of financing a company’s investments in practice.

Dividend policy is concerned with the payment of dividends to the shareholders. The term dividend refers to that part of profits of company which is distributed by the company among shareholders. It is the reward of the shareholders for investments made by them in the shares of the company.

The investors are interested in earning a maximum return on their investments and to maximize their wealth. If a company pays out as dividend most of it earns, then for business requirements and further expansion it will have to depend on outside sources such as issue of debt and new shares.

Dividend policy of a company thus, affects both the long term financing and the wealth of shareholders, as a result a company’s decision to pay dividend must be reached in such a manner so as to equitably apportion the distributed profits and retained earnings. Since, dividends are a right of shareholders to participate in the profits and surplus of the company, they should receive fair amount of profits. The companies should therefore, distribute a reasonable amount as dividends to its members and retain rest for its growth and survival.

The management of a company while evolving a dividend policy, must strike a proper balance between payment of dividend and retention of its earnings, when the companies increases the retained portion of net earnings, shareholders current income in the form of dividend decreases.

But the use of retained earnings to finance profitable investments will increase the future earnings therefore management should develop a dividend policy in such a way that divides the net earnings into dividends and retained earnings in an optimum way to achieve the objective of maximising the wealth of shareholders. The
development of such a policy will be greatly influenced by investment opportunities available to the companies and the value of dividends as against capital gains to the shareholders.

The typical dividend policy of most companies is to retain one third to half of net earnings and distribute the remaining amount to shareholders. Retained earnings should be used as a source of finance only when the company has profitable investment opportunities.

If the shareholders have better investment opportunities, the earnings should be distributed to them so that they may be able to maximize their wealth, generally when the companies have an internal rate of return greater than the required rate of return required by shareholders, it would be to the advantage of shareholders to allow reinvestment of earnings by companies. When the companies does not have highly profitable opportunities and earns a rate on investment which is lower than the rate required by shareholders, it is not proper to retain earnings.

It is sometimes argued that, even if companies have highly profitable investment opportunities, earnings should be distributed and funds should be raised externally to finance the investment, this will exert a discipline on the company’s management in proper deployment of funds, but companies in practice prefer to retain earnings because issuing new share capital is inconvenient as well as involves flotation costs.

Thus, depending upon the needs to finance their investments opportunities, companies may follow different dividend policies. A high payout policy means more current dividends and less retained earnings which may consequently result in slower growth and perhaps lower market price of share, on the other hand a low payout policy means less current dividends, more retained earnings and higher capital gains and perhaps higher market price per share.

1.10 Dividend Decision and Valuation of Firm

On the relationship between dividend policy and the value of firm, different theories have been advanced which takes into account the role of retained earnings in relation with dividend decision or dividend policy.
These theories can be grouped into two categories: (a) theories which consider dividend decision to be irrelevant and (b) theories which consider dividend decision to be an active variable influencing the value of the firm. In the latter, there are two extreme views. first is that dividends are good as they increase the shareholder value and second considers that dividends are bad since they reduce the shareholder value, they are discussed below.

1.10.1 The Irrelevance Concept of Dividend or the Theory of Irrelevance:

According to this theory, dividend decision has no effect on the wealth of the shareholders or the prices, and hence, it is irrelevant so far as the valuation of the firm is concerned. This theory regards dividend decision merely as a part of financing decision because the earnings available may be retained in the business for re investment, but if the funds are not required in the business they may be distributed as dividends. Thus, the decision to pay dividends or retain the earnings may be taken as a residual decision.

This theory assumes that investors do not differentiate between dividends and retention by the firms. Their basic desire is to earn higher return on their investment. In case the company’s have profitable investment opportunities giving a higher rate of return than the cost of retained earnings, the investors would be content with the company retaining earnings to finance the same.

However, if the company is not in a position to find profitable investment opportunities, the investors would prefer to receive the earnings in the form of dividends. Thus, a company should retain the earnings if it has profitable investment opportunities otherwise it should pay them as dividend.

Modigliani and Miller (1961) have expressed in the most comprehensive manner in support of the theory of irrelevance, they maintained that dividend policy has no effect on the market price of the shares and the value of the firm is determined by the earning capacity of the firm or its investment policy. The splitting of earnings between retentions and dividends, may be in any manner the firm likes, does not affect the value of firm.
As observed by Modigliani and Miller “Under conditions of perfect capital markets, rational investors, absence of tax discrimination between dividend income and capital appreciation, given the firm’s investment policy, its dividend policy may have no influence on the market price of shares”. This theory of irrelevance is also called the residual approach.

1.10.2 The Relevance Concept of Dividend or the Theory of Relevance:

The other school of thought on dividend decision holds that the dividend decisions considerably affect the value of the firm. The advocates of this school of thought include Myron Gordon, John Lintner, James Walter and Richardson.

According to them dividends communicate information to the investors about the firms profitability and hence dividend decision becomes relevant thus, those companies which pay higher dividend, will have greater value as compared to those which do not pay dividends or have a lower payout ratio.

Walter’ approach supports the doctrine that dividend decision are relevant and affect the value of the firm, his approach is based on assumption like that all firms finance their investments through retained earnings that is debt or equity is not issued, the firms rate of return and cost of capital are constant and all earnings are either distributed as dividends or reinvested internally immediately.

Gordon’s approach in the theory of irrelevance also suggested that dividends are relevant and the dividend decision affects the value of the firm. He based his approach on assumptions like that the firm is an all equity firm, no external financing is used or available and retained earnings represent the only source of financing investment programme, the rate of return on firm’s investment is constant, corporate taxes do not exist, firm has perpetual life, retention ratio is constant and the cost of capital for the firms remains constant.

The justification of retained earnings may be evaluated in terms of the factors such as: to equalize dividend; to withstand depression; to reduce the cost of capital and formalities of financing; to enable gradual growth; and to get easy finance (Ohja, 1978). Retained earnings also provide self sufficiency in finance as they provide a good base to borrow additional funds.
1.10.3 Concluding Remarks

Hence, it is contended that to a great extent that retained earnings are compulsory in character. However excessive retained earnings are not an unmixed blessing and it does have its own drawbacks. The financial managers thus, need to wisely decide the extent of retentions to be made. The shareholder’s wealth in this process should not be put to any jeopardy.

In India and foreign, till date most of the studies have been done mainly confined to dividend decision, dividend policy, their behaviour, determinants in companies of India and foreign, not much has been undertaken with respect to retained earnings, its impact, importance in companies of India, how retained earnings impact or influence the companies dividend policy have not been studied.

Kaushik (2007) made a comparison of retention policies of domestic companies vis-a-vis foreign companies.

Thus, the present study is undertaken with a view to identify the factors or determinants on which the retained earnings of profitable companies of the selected sectors in India depend. The study tries to find out the most important variables or determinants of retained earnings and which have impact on the retained earnings of the selected sectors profitable companies of pharmaceutical sector, cement sector, petroleum sector, steel sector and textile sector.