C H A P T E R - VII

EARNINGS MANAGEMENT

The most crucial objective of every firm is to earn. Funds start flowing out of business in absence of the earnings. So, designing of a carefully thought out plan for the management of earning is a necessary condition. The earnings generated by the firm are the most significant internal source of financing. Where as the payment of earnings to residual claimants as dividend increases their current wealth, it involve the use of firm's funds. Thus the twin objectives of the management of earnings -- the distribution of earning as dividend and retention of the same being an important source of internal financing, though desirable, are in conflict. On the one hand a higher dividend rate means higher earning per share and thereby favourable reaction on its market prices; but on the other hand, a higher dividend rate results into less retained earnings leading to slow expected growth rate and thereby the lower market price per share.

The policy decision towards allocation of earnings between dividend and retention is a crucial one.(1) It affects the firm by influencing the cost of additional capital, its sale value and financial structure as well as the investors in equity in terms of the volume of dividend and the price of shares. At the same time other financial policies of the firm are also influenced by this vital issue.

While deciding the financial structure the dividend factor has to be assigned its due weightage. It is not to be treated merely as a cost item; it is to be treated as an investment item also. When an additional dividend investment is made, the price earning ratio has its reflections on it. However, the capitalisation of reserves by the issue of bonus shares though deemed to be a dividend element is a non-cost item.

Both the determination of the size of allocable funds to be distributed as dividend and the fixation of dividend rate are formidable tasks. A number of variables like legal constraints, earning power, taxation effect, cash flow, lagged dividend, growth of sales, market rate of interest etc. need be considered for a number of reasons like capital formation and growth, social responsibilities, holdings of interest-groups etc. However, as dividends are to be paid only out of profits earned,(2) the amount of profit in a given period stands as the basic determinant of dividend rate. Again, the liquidity of the firm also needs evaluation as payment of dividend will reduce the current working capital;(3) and if the latter is allowed to shrink considerably, it will affect the current operations. Thus declaration of dividend stands as the effect of profitability as well as a cause of illiquidity. The reasons for the latter is the transfer of a part of NW to current zone by the declaration of dividend resulting into inflated CL and thereby the shrinkage in WC.

The dividend paying firms in Terai region are significantly few (Table-VII.1). Out of 19 sample firms, only two firms paid dividends in 1980. (Though information conerning two firms could not be collected while data were compiled [Annexure I (xxviii)], later information disclosed that even these two firms did not declare dividend — CHANDMONI for the years 1979, 1980 and 1981, and KAMALA for the years 1980 and 1981). The number of dividend paying firms was largest in 1977 due to boom in tea market; even during that year also about one-third of sample units did not declare any dividend. Table VII.1 clearly shows that the number of firms paying dividend is both low and fluctuating.

TABLE - VII.1

Sample units paying dividends.

Year	1974	1975	1976	1977	1978	1979	1980	1981
No. of units	7	6	7	13	4	5	2	3

A further analysis clearly reveals (Table-VI.4 Page..112..) that during the octennium, six, companies never paid any dividend and the highest average rate of dividend (0.2691) was paid by one company only.

The dividend payment pattern is also casual in nature. Only two companies were paying dividend throughout the octennium and except these two, none followed any stable dividend policy (Table-VII.2). The dividend rates bear no relationship with their earnings [Annexure I (xxviii)].

TABLE - VII.2

Frequency in Dividend Payment

No. of years for which dividend was paid.	Nil	1	2	3	4	5	6	7	8
No. of units.	6	4	1	1	2	1	0	1	2

In Terai the rate of dividend varies widely and has little relevance with the size of investment in equity (Table-VII.2). The average yield on share comes to 0.0515 with a co-efficient of variation of 0.7931. Despite wide fluctuations in PAT/EQUITY ratio, the firms followed in general certain uniform policy of 'No profit, No dividend'. Deviation from such a policy is an exception that could be observed only in one case i.e. ASHAPUR.

TABLE - VII.3

Dividend Ratios

Year	DIV/EQUITY	DIV/PAT	PAT/EQUITY	DIV/NW
1974	0.0717	0.2026	0.3538	0.0476
1975	0.0564	0.5863	0.0961	0.0269
1976	0.0898	0.2064	0.4352	0.0447
1977	0.1296	0.2334	0.5554	0.0566
1978	0.0279	- 0.0526	- 0.5304	0.0181
1979	0.0176	- 0.0512	- 0.3417	0.0131
1980	0.0038	- 0.0031	- 1.2042	0.0061
1981	0.0150	- 0.0214	- 1.2035	0.0260
Mean	0.0515	0.1375	- 0.2299	0.0291

The wide fluctuations in DIV/EQUITY ratio reflect the earnings pattern of the firms. The highest value of this ratio (1977) was due to boom caused by market demand factor — the unusual profit-taking that induced the firms to pay dividend. The lowest figure in 1980 (0.0038) was because of severe draught leading to abnormal decrease in the volume of output and only one firm (SUKNA) earned profits and paid dividend. During 1977 though all the companies earned profits [Annexure I (xxx)] four companies paid nothing; these also did not pay any dividend during the octennium. Another four companies paid dividend only during this year (1977) — once only in the octennium under review.

The profit-equity ratio fluctuates widely and surpassed the unit value twice (1980 and 1981). The number of years during which profits were earned and losses were incurred are well balanced. As the ratio is, by and large, non-controllable, more so in tea industry, because of its subjugation to natural vagaries, the abnormal fall in this ratio during 1980 and 1981 had little to be controlled by the management. The aggravation can also be ascribed to the depressed market conditions. However, the increasing values of this ratio, in first-half of the octennium, save that of 1975 (excessive draught), was caused not by the managerial efficiency but by the demand factor itself leading to rise in prices.

The other ratio DIV/PAT is controllable one and is the direct outcome of the managerial decisions and is unlike that of PAT/EQUITY. The pay out ratio (DIV/PAT) values do not disclose any pattern and vary between 0.5863 to 0.2026 even when inflow of funds through operational activities are, more or less, regular. A conservative policy influenced by the lagged dividend can be observed amongst firms that paid dividends. Enquiry during survey revealed that the fluctuations in the rate of dividend with respect to individual firms are largely influenced by exogeneous factors of fraternity amongst the management groups and is not based on any financial principles. It was also not the out come of any formulated policy in this respect.

DIVIDEND POLICY.

The dividend policy of a firm affects the dividend-equity ratio, payout ratio and the cost of equity in terms of return provided and, thereby, the price of equity and the market value of the firm.

A number of factors have their bearing upon dividend policies of which the legal constraints, the firm's investment opportunities, the availability and cost of funds from other sources (new issues and debt), tax rates, share-holders' desire for current income, and the 'information effect' of dividend changes, are the most influential. The bearings of these factors, their relative importance and their changes over time and between firms make it difficult to arrive at a conclusion concerning the effect of a most appropriate dividend policy. The two schools of thought (4) on policy orientation of dividend ; one that treats 'internal investment needs as the prior active decision, with dividends, if any, as a residual distributions' and the other one that treats 'stable (slowly growing) dividends as an active decision variable with retentions as a residual'. Of the former school of thought, Modigliani and Miller, states that, "the irrelevance of dividend policy, given investment policy, 'is obvious, one you think of it'. It is after all, merely one more instance of the general principle that there are no 'financial illusions' in a rational and perfect economic environment. Values there are determined solely by 'real' considerations — in this case the earning power of the firm's assets and its investment policy — and not by how the fruits of the earnings power are 'packaged' for distribution," (5) and finally asserts that "the current valuation is unaffected by differences in dividend payments in any future period and thus that dividend policy is irrelevant for the determination of market prices, given investment policy." (6)

Amongst the notables in the latter school of thought, Ezra Solomon states that "By and large, the hypothesis (Dividends as an active variable) is consistent both with the financial objective of market value maximisation and with the behaviour of firms". (7) He contends that dividends may offer tangible evidence to the firm's ability to generate cash, and as a result, the dividend policy of the firm affects the share price. He states "... in an uncertain world in which verbal statements can be ignored or misinterpreted, dividend action does provide a clearcut means of 'making a statement' that 'speaks louder than a thousand words". (8) However, though a strong proponent of "dividend as an active policy variable and retention as residual", (9) Solomon admits that "firms with highly variable revenue flows and variable investment opportunities, shorter planning horizons and relatively costly access

access to external funds, cannot afford to treat dividends as an active decision variable and tends to treat dividends as residual."(10)

Any study on the effect of payout on the market prices of Terai tea shares is constrained, by the limitation that most of the Terai tea companies are not listed — only six out of twenty six tea companies are quoted. Our survey revealed that the shares of non-listed tea companies are also being privately quoted in an unauthorised and unorganised tea share market(11) having its own brokers. These brokers confirmed that dividend decisions affect the share prices of the so-called private tea share market and the selling prices are, in most cases, above the paid-up value of shares; they, however, declined to disclose the relationship between the book value of shares and their selling prices. As the market is limited to Jalpaiguri — a small township, the money value of shares do not reveal the true value of shares because of the conventional practices of paying dividend in kind (mentioned earlier). In most of the cases share transactions are held in very small lots - one to ten shares only. The fluctuations in the prices of shares of such companies and in such a market become much more prominent in cases of 'concerning', especially if closely held. No other information could be made available as brokers on this private tea share market treat the prices as most confidential. Thus a comparison between book-value and market value of shares of non-listed companies can not be made possible.

An analysis of the EPS of quoted companies(12) in Terai tea industry (ATAL, BELGACHI, NEW CHAMPTA, NEW TERAI ASSOCIATION, TIRRIHANNAH, and PAHARGOOMIA TEA ASSOCIATION) (Table-VII.4) reveals that earnings increased by degrees during 1974-77, reaching peak in 1977. Most of quoted companies, like that of all the sample units, reveal the same trend of earnings [Annexure I (xxx)]. During the octennium, the mean value of EPS of quoted companies (-2.225) disclose the same pattern as of the unquoted ones.

TABLE-VII.4

Earnings per share (Rs.)

Sample Code	1974	1975	1976	1977	1978	1979	1980	1981
T1	6.36	0.24	4.80	0.44	-8.07	-3.87	-21.24	-5.53
T3	2.85	0.63	2.76	3.73	1.11	-4.13	- 3.88	-5.00
T12	0.28	3.15	1.68	2.01	3.12	-13.74	0.35	-5.75
T14	2.14	2.56	1.47	7.22	2.61	- 1.50	-10.90	0.51
T18	- 6.69	8.23	9.14	18.95	-1.32	- 4.23	-22.86	2.32
T19	3.83	0.81	- 1.09	1.49	-5.09	0.53	-22.08	-54.45
Mean	1.46	2.60	3.13	5.52	-1.27	- 4.49	-13.44	-11.32

EARNING PRICE RATIO.

The market price of the equity representing a valuation of the future based on the earnings available per share and the risk factors involved in the business and in the industry to which it is engaged. The earnings price ratio of quoted companies (information is available with respect to quoted companies only because of the constraint noted earlier) show a great variation (Table-VII.5). The ratio reveals diversity between one company and another. Since share prices fluctuate widely from year to year (and even within the year), the ratio for a given company also varies correspondingly. The shares prices of Terai tea companies are at times higher because of attractive attractive earnings (1977). But sometimes though the EPS is poor (Table-VII.4) relatively a higher price is quoted for shares /Annexure I (xxxvi)_7. The share prices also soar up because of 'cornering' attempts. On the whole, shares seldom sell at the level of earning-price ratio. The stock market experts opine that "It is a common rule of the thumb that shares should sell at ten times earnings, i.e., the earnings-price ratio should be 10%, the percentage being lower and the multiplier being higher in the case of companies commanding investment prestige and showing a progressive increase in earnings power."(13) On the basis of this yeardstick it can be observed (Tables-VII.4 and VII.5) that shares of Terai tea companies are both under-priced as well as over-priced.

TABLE - VII.5

Earnings - Price Ratio (%)

Sample Code	1974	1975	1976	1977	1978	1979	1980	1981
T1	-	-	-	-	-	-	-	-
T3	16.76	0.04	21.94	0.07	0.07	-	-	-
T12	4.71	63.00	23.26	23.37	26.13	-	3.55	-
T14	-	-	9.48	12.47	16.45	-	-	-
T18	-	-	12.27	27.07	-	-	-	-
T19	-	-	-	18.63	-	8.03	-	-

'-' denotes that EPR could not be ascertained as either the quoted prices are not available or the EPS is negative.

MARKET PRICES TO BOOK VALUE.

The book value per share indicates the net assets available to share holders after off-setting the claims of external liabilities. The book value of shares of listed companies [Annexure I (xxxvi)] indicate a rising trend in all the six quoted companies upto 1977; only two companies maintained the trend during the octennium. The negative book values can also be observed (1979, 1980, 1981) in three cases (ATAL, NEW CHAMPTA and PAHARGOOMIAH) and the apparent reasons are the negative earnings (Table-VII.4). The declining trend in book values (1978-81) is the resultant effect of poor earnings because of depression in the market as well as decline in the volume of output. The former was because of market demand factor and the latter was effect of vagaries of the nature. The market price per share in relations to book value represents the market evaluation of every rupee of equity in the company. It indicates to what extent the market value of equity is protected by the assets of the company taken at their book value. The ratio value signifies the degree of protection to investors. The market prices of listed companies, from stock exchange sources,(14) reveal that in most of the cases the market prices are below the book value of shares [Annexure-I (xxxvi)]. The exceptions are for only one or two years and relate to 'NEW TERAI (1980, 1981), BELGACHI (1980 and 1981), PAHARGOOMIAH (1980) and NEW CHAMPTA (1980). The increase in the ratio values of market price of shares to book-value (Table-VII.6) are due to sharp decrease in net worth. However, the exceptional increase in NEW CHAMPTA (1980) is neither due to increase in the earnings nor due to future prospect of growth but for the very small value of the denominator.

TABLE-VII.6

Market Price of shares to Book Value.

Sample Code.	1974	1975	1976	1977	1978	1979	1980	1981
T1	-	-	-	-	0.66	-	-	-
T3	0.95	0.92	0.80	0.69	0.66	0.78	1.18	1.79
T_{12}	0.46	0.33	0.45	0.55	0.67	-	13.90	-
T14	-	-	0.73	0.65	0.57	-	1.05	1.06
T18	0.51	-	0.73	0.59	0.50	0.34	-	0.34
T19	-	-	0.50	0.48	0.82	1.46	-	-

'-' denotes that values cannot be ascertained as one of the variables, market price is not available from the Stock Exchange Sources.

STOCK DIVIDEND.

For the conservation of cash and, thereby, to protect the erosion of WC, preference to the issuance of bonus shares (15) instead of cash dividend is the general practice of corporate bodies and Terai tea industry is no exception to the practice. The benefit of tax-exemption induces this direct conversion of retained earning to equity capital. Though stock dividend represents nothing more than capitalisation of resources, without even altering the proportional ownership of share holders, its real impact is generally reflected on the market prices of shares. Mathematically it can be shown as:

If, $(N_a \times M_a) > (N_b \times M_b)$

it is gain to share holders,

Again, if $(N_a \times M_a) < (N_b \times M_b)$

this implies losses to the share-holders.

But, if $(N_a \times M_a) = (N_b \times M_b)$

There is neither gain nor losses to the share-holders who received bonus shares in lieu of cash dividend.

where,

N_a = Total number of shares including the bonus issue.

M_a = Market prices of shares after the bonus issue.

N_b = Total number of shares before the bonus issue.

M_b = Market price of shares before the bonus issue.

A special feature of the sample units in Terai tea is that, though majority of them are non-listed, 100 per cent of them had issued bonus shares, at least once, since their incorporation. During the octennium under review five companies of which two are listed (BELGACHI and NEW CHAMPTA), issued bonus share. After issue of bonus shares the market prices of shares of the former company did not reflect any impact (during 1980 or thereafter) and price of equities remained static throughout the octennium [Annexure I (xxxvi)]. In the case of latter it is difficult to ascertain the impact (of bonus issue in 1978) because of the effect of EPS which is much powerful to influence the market prices of shares. The EPS increased by 55.22 per cent (Table-VII.4) and market prices increased by 39.47 per cent [Annexure - I (xxxvi)].

It is difficult to measure the actual return on equity in terms of dividend other than cash or stock as dividend is also paid in kind. If benefit without consideration be defined as dividend, then dominant share-holders in Terai tea industry enjoy these returns which are indirect and available to them only. Information gathered during survey disclosed that under the garb of management and servicing charges the dominant share-holders manipulate the accounts and thereby take away a quite handsome amount of profit. The veracity of this generally accepted feeling is a big question mark.

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<u>References and notes</u>.

1. Of the most important corporate financial decisions, if arranged in order, the dividend decision is the third -- the financing decision (capital-mix) and the investment decision (asset - mix) are the first two.

2. Sec. 205 (I) of The Companies Act, 1956, provides that the payment of dividend can be made out of three sources only.

   (a) Profits of the company for the year for which dividends are to be paid,

   (b) Undistributed profits of the previous year,

   (c) Money provided by the Central or State Governments for the payment of dividend in pursuance of a guarantee provided by them.

3. Sec. 205 (3) lays down that the dividend is to be paid in cash.

4. There are two schools of opinions regarding impact of the dividend decision upon the value of the firm. The first

school of thought (James E. Walter and Modigliani and Miller) - hold the view that dividend payment is a passive 'residual' after a retention decision have been taken; and dividend policy, as a financing decision, is solely determined by the profitability of the investment opportunities. Hence, the value of the firm is determined by the earning power, firms assets and its investment policy and not how the fruits of earning power are distributed. And even under conditions of uncertainty and risk, share holders are indifferent between dividend and retained earnings, and hence dividend is a 'passive residual' in the financial decision making of the company.

The other school of thought - (John Lintner and Ezra Solomon) - opines that dividend represents a 'primary and active' decision variable in most of the situations, i.e. dividend decision is taken first and the amount to be retained is a product of the decision and, therefore, relevant for the valuation of shares. The investors are not indifferent between dividends and retained earnings.

(a) Modigliani, F. and Miller, M. H. "DIVIDEND POLICY, GROWTH AND THE VALUATION OF SHARES". Archer, Stephen H., and D' Ambrosio, Charles A., ed. "The Theory of Business Finance - A book of readings" second edition, Macmillan Publishing Co., Ind. New York 1976, Pp. 636-663.

(b) Walter, E. James., "DIVIDEND POLICY : ITS INFLUENCE ON THE VALUE OF THE ENTERPRISE", Stephen, H. Archer and Charles A. D'Ambrosio, ed. 2nd edition. op.cit., p. 618-628.

(c) Lintner, John., "Distribution of Incomes of corporations among Dividends, Retained Earnings and Taxes", American Economic Review, Vol. XLVI No. 2 (May, 1956) Pp. 97-113.

(d) Solomon, Ezra., "The Theory of Financial Management", Columbia University Press, New York, 1963, p. 143.

5. Modigliani and Miller, "Dividend policy, growth and valuation of shares". Quoted, from, ~~Archer~~, H. Stephen and D'Ambrosia, Charles A., ed. op.cit. p. 640.

6. Modigliani and Miller, op. cit., p. 658.

7. Solomon, Ezra, op. cit. p. 144.

8. Ibid., p. 142.

9. Ibid., p. 139.

10. Ibid., p. 144.

11. During survey it has been gathered that an unauthorised and unorganised tea share market operate at Jalpaiguri town (West Bengal), having its own self-appointed brokers. The reasons for the location of such a market at Jalpaiguri is the location of registered head offices of a large number of public limited tea companies - in Feb. 1984, 31 registered head offices were at Jalpaiguri town. Of them 11 companies have their all estates in Terai region.

12. The Stock Exchange Official Directory, WEEKLY REPLACEMENT SERVICE, Bombay Stock Exchange, Bombay, Vol. No. XVI, Section 34 (i) to (iv).

13. Ibid., Vol. No. I Section 4, (EXPLANATORY NOTES), p. 51.

14. Ibid., Vol. No. XVI, Section 34 (i) to (iv).

15. The Companies Act, 1956, Sections 96, 97 and 205 (3).