Ploughing Back of Profits

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Abstract*: *Like other stakeholders, shareholders will also anticipate a fair return on their investment in the shares of the company of course in the form of dividend in majority of the cases. Though, the payment of dividend on equity shares is not mandatory, but the companies will pay the dividend during the years of profits to their shareholders. The cash payment of dividend may affect the liquidity position of the companies. Hence, the companies will try to pay dividend in the form of issue of bonus shares by capitalizing the profits or by ploughing back of past profits. The purpose of writing this article is to elaborate on how the bonus issue will be served as an effective tool to manage liquid sources of a company.

Index Terms*: *capitalization of profits, issue of rights, Earnings per share and Employee Stock Option Plans.

I. INTRODUCTION

Companies who got large amounts of accumulated profits or who have large amount of revenue and capital reserves, they can pay stock dividends by plough back of such accumulated profits instead of paying cash dividend as the payment of cash dividend may adversely effect the working capital position of the company or the liquidity position of the company because of the outflows of cash through the payment of dividends. This process of paying stock dividends by ploughing back of the accumulated profits by a company is also called issue of bonus shares. In this process the shareholders will get additional shares from the company at free of cost. They need not pay anything like in case of rights issues. Rights issue is a process in which the new shares will be issued to the existing shares at a price on pro-rata basis before they are issued to the general public. The Companies Acts, 1956 and 2013 requires that when an existing company want to issue additional shares for mobilizing the capital, first such shares have to be offered to the existing shareholders on pro-rata basis, the main reason for such rights issue is to prevent a company from offering shares to the public at price subsequently below its worth, thus lessening the interest of old shareholders in the corporate Pie. The objective of issuing the rights shares either to reduce the existing debts of the company or to undertake an investment program. According to Sec.62 of the Companies Act, 2013 all the existing companies can issue right shares for the purpose of increasing their subscribed capital. However like in case of bonus issue, the companies should also follow the guidelines issued by the Securities Exchange Board of India(SEBI). However, the shareholders may or may not accept the right shares issued by the company which means some of the shareholders may renounce their shares to others, hence they will not get any additional shares from the company. As a result of renouncement, the other people in who's favour the rights were renounced, will purchase the shares. The bonus issue is also different from buy back of shares. As a result of bonus issue or ploughing back of profits the subscribed share capital of the company will be increased. But as a result of buy back the number of shares (ie., the subscribed share capital) of the company will be reduced. Since the Companies Acts 1956 as well as 2013 allows, the companies can repurchase their own shares either in the open market or through bids or tenders. Generally the management of the company will resort to buy back of shares either to reduce the number of shares or to eliminate any threats by shareholders who may be looking for a controlling interest. Here controlling interest means theoretically 51% of the subscribed share capital. Hence buy back is nothing but repurchase of the company's shares by the company itself in order to reduce the number of shares and also to protect it's controlling interest. However, at present the companies in India have to follow the procedure given by Sections 68, 69 and 70 of the Indian Companies Act, 2013 in order to buy back their own shares either through bids or tenders or through purchase in open market. The ploughing back of profits or issue of bonus shares is also different from employees stock option plans. In order to motivate the employees particularly Information Technology companies where the man power is the main asset will resort this Employee Stock option plans as tool. Under this plan, a right is granted to the employees to purchase the shares of the company at a predetermined price with in a certain period of time. The employee may or may not accept this option. However the main objective of this scheme is to motivate the employees and to make the employees as owners and also to create belongingness among the employees towards the organization. In order to satisfy the desires of the equity shareholders the companies have to declare the dividends in the annual general meetings every year irrespective of the quantum of profits earned by the companies during the year of declaration. The dividend that is declared by the company in the annual general meeting is called the final dividend. Some times the companies will also pay the dividend in various periodical intervals which are also called interim dividends.

Therefore, whether it is interim dividend or final dividend it can be defined as that part of the profits of the company which are distributed to shareholders. 'According to the Institute of Chartered Accountants of India (ICAI), a dividend is a distribution to shareholders out of profits or reserves available for this purpose'

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source: Guidance note on terms used in Financial Statements, issued by the ICAI . For the purpose of paying dividends the company should have accumulated divisible profits. Divisible profits refers to profits available to equity shareholders ie., these are the profits available to equity shareholders. if from the profit after tax, if we have deducted the dividend payable to preference share capital we will get earnings available to equity shareholders. Some companies will distribute all these earnings to the equity shareholders as dividends and some companies will not distribute anything, but some companies will distribute only a part of the earnings as dividends and the remaining part of the earnings will retain with them for future development and expansion programs. At this point we should also discuss about Earnings Per Share (EPS), which is nothing but the earnings of the company available per equity share and it will be calculated by dividing the earnings available to equity shareholders with the total number of equity shares outstanding. In India, all the listed companies have to follow the Accounting Standard 20, issued by the Institute of Chartered Accountants of India (ICAI) for computing the Earnings Per Share(EPS). Generally, out of the Earnings Per Share a portion will be paid as dividend which is called as Dividend Pay Out ratio and the remaining amount will be retained by the company with it for its future expansion and development which is called Retention ratio. Therefore, the formula to calculate the dividend pay-out ratio is ‘Dividend Per Share divided by Earnings Per Share’ and the formula to calculate the retention ratio is one minus dividend pay-out ratio.

II. ANALYSIS OF DIVIDEND PER SHARE

Dividend per share is nothing but the total dividends of the company that are attributable to a single share. It is calculated by dividing the total dividends of the company with the total number of shares subscribed. For example, if the total dividends to be distributed by the company is Rs.10,00,000 and the total number of shares outstanding are 1,00,000, then the dividend per share is Rs.10 ie., Rs.10,00,000/1,00,000 shares. If a shareholder hold 1,000 shares in that company, he would get Rs.10,000 as dividend ie., 1,000 shares x Rs.10 per share. The DPS would be a better indicator than EPS as the former shows what exactly is received by the owners. Like the EPS, the DPS may not be a reliable measure of profitability as the equity base may have increased due to increased retention without any change in the number of outstanding shares. Based on the secondary data obtained from the websites of the following banks and also from the money control.com, and taking the Dividend Per Share(DPS) as the financial tool and through Hypothesis testing ANOVA tables the dividends of the selected 10 data of the selected 10 banks for the past 15 years was analyzed as under in order to know whether the DPS of various banks is different or same.

Bank wise Dividend Per Share (Rs.) for the year ended 2003 to 2017

Bank	‘03	‘04	05	‘06	07	08	09	10	11	12	13	14	15	16	17	Average
HDFC	**3.0**	3.5	4.5	5.5	7.0	8.5	10.0	12.0	16.5	4.30	5.5	6.85	8.0	9.5	11.0	7.68
ICICI	**7.5**	7.5	8.5	8.5	10	11	11	12	14	16.5	20	23	5	5	2.5	10.13
AXIS	**2.2**	2.5	2.8	3.5	4.5	6	10	12	14	16	18	20	4.6	5	5	8.41
KOTAK	**2.1**	1.40	1.25	0.60	0.70	0.75	0.75	0.85	0.50	0.60	0.70	0.80	0.90	0.50	0.60	0.87
YES	**0**	0	0	0	0	0	0	1.5	2.5	4	6	8	9	10	12	3.53
FEDERAL	**4**	7	2.5	3.5	4	4	5	5	8.5	9	9	2	2.20	0.70	0.90	4.49
KVB	**7**	10	10	12	10	12	12	12	12	14	14	13	13	14	2.6	11.17
INDUSIND	**1.40**	2.25	1.80	0	0.6	0.6	1.2	1.8	2	2.2	3	3.5	4	4.5	6	2.32
J&K	**12**	10	8	8	11.5	15.5	16.9	22	26	33.5	50	50	2.10	1.75	0	17.82
CITY UNION	0.40	0.60	0.40	0.40	0.40	0.50	0.20	0.75	0.75	1	1	1	1.10	1.20	0.30	0.67

Source: Money control.com

Graphical Presentation of the above data:

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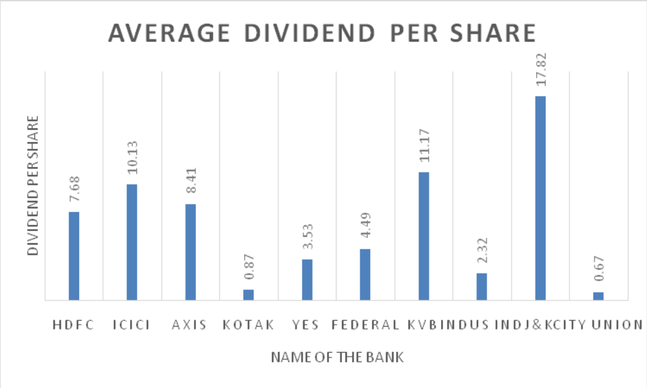

Result Analysis:

The above table describes the DPS of selected banks. In HDFC bank the highest DPS was Rs.16.50 during the year 2010-11 whereas the lowest Rs.3.00 during the year 2002-03. In ICICI bank highest DPS were Rs.23.00 during the year 2013-14 whereas the lowest Rs.2.50 during the year 2016-17. In AXIS bank the highest DPS were Rs.20.00 during the year 2013-14 whereas the lowest Rs.2.20 during the year 2002-03. In KOTAK highest DPS were Rs.2.10 during the year 2002-03 whereas the lowest Rs.0.50 during the years 2010-11 and 2015-16. In YES Bank highest DPS were Rs.12.00 during the year 2016-17whereas the lowest Rs.0.00 during the years 2002-03 to 2008-09. In Federal bank highest DPS were Rs.9.00 during the years 2011-12 & 2012-13 whereas the lowest Rs.2.50 during the year 2004-07. In Karur Vysya Bank highest DPS were Rs.14.00 during the years 2012-13, 2013-14 and 2015-16whereas the lowest Rs.2.60 during the year 2016-17. In IndusInd highest DPS were Rs.6.00 during the year 2016-17 whereas the lowest Rs.0.00 during the year 2005-06. In Jammu& Kashmir Bank highest DPS were Rs.50 during the years 2012-13 and 2013-14 whereas the lowest Rs.0.00 during the year 2016-17. In City Union Bank of India highest DPS were Rs.1.20 during the year 2015-16whereas the lowest Rs.0.30 during the year 2016-17.

Hypothesis Testing:

Hypothesis Testing based on F-Test at 5% level of significance.

H0: There is no significant difference between Dividend Per Share at selected banks during the study period.

H1: There is significant difference between the Dividend Per Share at selected banks during the study period.

ANOVA Table

Dividend_Per_Share:

	Sum of Squares	df	Mean Square	F	Sig.
Between Groups	4314.533	9	479.393	12.529	.000
Within Groups	5356.800	140	38.263		
Total	9671.333	149			

Table indicates the calculated value of ‘F’. The calculated value of ‘F’ is 12.529 which is higher than the table value of ‘F’. The table value of ‘F’ at 5 % level of significance is 1.99. It indicates that the null hypothesis is rejected and alternative hypothesis will remain. So, it indicates that Dividend per Share of the sampled banks is significantly different during the period of study.

However, in a particular year how much earnings have to be distributed and how much earnings have to be retained will be decided by the management of each and every company which is also called dividend policy or dividend decision of the company.

This dividend policy or dividend decision will differ from one company to another company and from one year to another year in the same company.

Each and every company will disclose its dividend policy for each and every year in its Annual Report. All the public limited companies in India have to comply with the relevant sections of the Indian Company Law ie., the Companies Act, 2013 for declaration, distribution and payment of dividends to their shareholders. The dividend need not necessarily be paid in cash alone. It can be paid in various other forms. That is the reason why the dividends may either cash dividends or scrip dividends or property dividends or stock dividends. if the dividend is paid in cash form it is called cash dividend where as instead of paying cash if the company has issued bonds to the extent of the amount of dividend payable, it will be called scrip dividend or bond dividend on such bonds the bond holder will get interest periodically at the rate stated on the bond. Similarly, if the company has distributed it’s products to the shareholders instead of paying cash, it will be called property dividend. In the same way companies can also issue its shares freely to their shareholders in lieu of paying dividends by utilizing their accumulated profits or retained earnings or free reserves. This process of issuing free shares to the existing shareholders by capitalizing the reserves or ploughing back of profits is called stock dividend or is also called issue of bonus shares. These various alternative forms of dividends will be used by companies for managing their liquid resources. If the available liquid resources have used for making cash payment in the form of dividend, the company has to seek bank loans or selling of its fixed assets for generating the required amount of liquid resources. Hence the companies will look over other forms of paying the dividends.

Even among other forms, most of the companies would prefer the capitalization of their reserves. As result they need not expend any liquid resources, at the same time they may satisfy the needs of their shareholders. However, the issue of bonus shares is possible only to those well established and well reputed and financially sound companies, because of their accumulated past profits. Hence, it can also be said that for newly established companies or companies having less reserves, the payment of stock dividend is not possible.

Like households who save their current earnings in banks or mutual funds or other financial intermediaries for the purpose of their future spending, the companies also save some of their current profits in the form of reserves. That is the reason why the reserves are also called retained earnings. They create reserves either for their business expansions or for paying dividends during the years of in sufficient profits or even to pay they dividends during the years of losses or for some other purposes. For the purpose of protecting the liquid funds with them, the companies will issue the bonus shares. As a result of capitalization of profits, the accumulated profits of the company will be reduced and the subscribed capital of the company will be increased and there will not be any change in the total assets of the company. The bonus shares may be issued either by converting partly paid shares as fully paid shares or by issuing fully paid shares at free of cost by capitalization of reserves and profits of the company in proportion to the total number of shares outstanding. For example, if a company has issued bonus shares in the ratio of 1:5, it means it gives one free share to the shareholder for every five shares owned by such shareholder. If Mr. S got 200 shares in the company he will get 40 free shares. Therefore, after the issue of bonus shares, Mr. S's holding will be increased from 200 shares to 240 shares without paying any cash. In the same way, if the total number of equity shares outstanding of the company before the bonus issue is say 2,00,000 equity shares of Rs.10 each, after the bonus issue with 1:5 ratio, the total number of shares outstanding would become 2,40,000 equity shares of Rs.10 each. There will not be any increase in the cash or bank balance of the company since the company has not received any cash from the issue of bonus shares. Here, the figures will be changed only on the liabilities side of the balance sheet of the company. To be clear, the balance in reserves will be decreased and the paid-up capital of the company will be increased as a result of the bonus issue, it as stated above. Hence, the bonus issue refers to the issuance of free additional shares to the existing shareholders based upon the number of shares that the shareholders already own. One more point to be remembered here is that the Companies Acts, 1956 and 2013 as well as SEBI both are salient on the ratio of bonus issue. Hence there is no bar on the ratio of bonus issue, which means a company can issue the bonus shares in any ratio. As demonstrated by Modigliani & Miller (1961), the bonus issue though increases the number of equity shares outstanding but they don't have any effect on shareholders proportional ownership of shares. This is because, if accumulated reserves of a company are distributed through a bonus issue, effectively it is just a transfer of retained earnings into paid up share capital of the company. Thus, relative claim on the assets of a company by the existing shareholders remain the same even though they now hold an increased number of equity shares.

The following are the list of reserves those can be used for the issue of bonus shares: (i) General reserve, (ii) Dividend equalization reserve, (iii) Capital reserve arising from sale of fixed assets received in cash, (iv) Profit and loss account, (v) Capital redemption reserve, (vi) Balance in debenture redemption reserve, and (vii) Securities premium collected in cash. However, in the above list, the capital redemption reserve and securities premium collected in cash can be utilized only for issuing fully paid bonus shares but not for issuing bonus shares by way of converting partly paid shares as fully paid shares. It has to be remembered that before issuing the bonus shares, the partly paid shares have to compulsorily be converted into fully paid shares. The following reserves cannot be used for the issue of bonus shares: (i) Capital reserves crated on revaluation of fixed assets, (ii) Share premium arising on the issue of shares at the time of amalgamation or acquisition of companies, (iii) Balance in debenture redemption reserve before the redemption take place, (iv) Investment Allowance reserve etc.,

Merits and demerits of bonus shares: The merits and demerits of bonus shares can be discussed from the point of view of investors and from the point of view of the company.

Merits and demerits of bonus shares to the shareholders:

Advantages: The following are various merits of bonus issue from the shareholders or investors point of view:

Bonus shares are completely tax free like dividends in the hands of the shareholders.

Bonus shares are particularly beneficial to the long term investors who wish to increase their investment over a long period of time.

Preserving cash for future expansion and issuing bonus shares will increase the confidence among the shareholders.

In the future periods, if the company want to distribute cash dividend, then the shareholders will be able to get huge dividends on their increased number of shares.

Disadvantages: The following are the various disadvantages from the view point of shareholders.

Not all investors may be interested in receiving the shares as a dividend; some may want liquidity for fulfilling other objectives. When such investors sell their bonus shares for generating liquidity, their stake in the company is reduced.

The shareholders will not get any capital gains after the bonus issue, since there will not be any increase in the market price per share

Advantages and disadvantages of bonus shares to the company:

Advantages:

- The company can prevent its cash outflows in the form of cash dividend because of bonus issue. Such liquid resources can be used in the growth and expansion activities.

- ➢ It has a signalling effect and gives a positive sign to the market that company believes in its long-term growth story.
- ➢ If the company itself is facing liquidity problems, then it can use the bonus issue as a tool of managing the liquidity to satisfy the shareholders desires related to dividends.
- ➢ Bonus issue increases the small shareholders proportion of stake in the company which in turn increases the liquidity of the stock.
- ➢ The Increase in the issued share capital increases the perception of company's size.

Disadvantages:

- ➢ Because of the increased number of shares as result of bonus issue, the EPS will be decreased in the future which intern have a negative impact on the market's perceived value of the company.
- ➢ Like rights issue, the bonus issue is not able to generate any cash inflows for the company. Hence, the company's ability to raise money by follow-on offerings is reduced.
- ➢ If the cost of administering bonus issue exceeds the cash dividend, the purpose of issuing bonus shares will give additional expenditure to the company.

The companies in India have to follow the guide lines issue by the Securities & Exchange Board of India (SEBI), in the year 2000 which are as under:

- ➢ The Articles of Association of the company should contain the provisions for issue of bonus shares. If there is no such provision in the Articles of Association, the company should pass a resolution to that effect at the general body meeting. The proposal of bonus issue should be completed within six months from the date of such approval by the Board of Directors.
- ➢ The bonus issue cannot dilute the rights of either fully convertible or partly convertible debenture holders of the company.
- ➢ As a result of bonus issue if the issued or subscribed capital exceeds the authorized capital of the company, then a resolution in the general body meeting has to be passed to increase the authorized capital.
- ➢ Bonus issue should be made out of free reserves created from genuine profits or securities premium collected in cash.
- ➢ Bonus shares cannot be issued out of the reserves which are created from the profit on revaluation of fixed assets.
- ➢ There should not be partly paid up shares at the time of issue of bonus shares.
- ➢ There should not be any default on the part of the company in payment of various statutory dues like provident fund, gratuity etc., Similarly, there cannot be any default in either the payment of interest or principal on fixed deposits accepted by the company.
- ➢ There should be a gap of at least 12months between the public or rights issue and the bonus issue.

Besides the above SEBI guide lines, the companies in India should also follow the provisions of Section 63 of Indian Companies Act, 2013 for issuing the bonus shares. The relevant provisions of Section 63 of the Companies Act, 2013 are as under:

(*1*) A company may issue fully paid-up bonus shares to its members, in any manner whatsoever, out of—

(*i*) its free reserves;

(*ii*) the securities premium account; or

(*iii*) the capital redemption reserve account:

Provided that no issue of bonus shares shall be made by capitalising reserves created by the revaluation of assets.

(*2*) No company shall capitalise its profits or reserves for the purpose of issuing fully paid-up bonus shares under sub-section (*1*), unless—

(*a*) it is authorised by its articles;

(*b*) it has, on the recommendation of the Board, been authorised in the general meeting of the company;

(*c*) it has not defaulted in payment of interest or principal in respect of fixed deposits or debt securities issued by it;

(*d*) it has not defaulted in respect of the payment of statutory dues of the employees, such as, contribution to provident fund, gratuity and bonus;

(*e*) the partly paid-up shares, if any outstanding on the date of allotment, are made fully paid-up;

(*f*) it complies with such conditions as may be prescribed.

(*3*) The bonus shares shall not be issued in lieu of dividend.

Source:
https://www.legalcrystal.com/act/62442/companies-act-2013-section-63

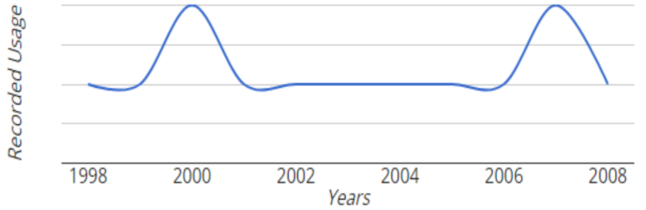

Fig: Trends of 'plough back'

List of Indian companies issued bonus shares recently:

S. No.	Name of the company	Bonus ratio	Date of announcement
1	TTK Prestige	1:5	29-03-2019
2	Kapashi Com	3:2	14-03-2019
3	Foods & Inns	2:1	11-03-2019

4	Nandani Creatio	3:2	18-03-2019
5	One Point One S	1:2	11-03-2019
6	Indo US Bio-Tech	1:4	07-03-2019
7	Airan	1:1	07-03-2019
8	Bajaj healthca	1:1	19-02-2019
9	South West Pin	1:1	22-02-2019
10	Inflame Applian	1:2	9-02-2019
11	Sukhjit Tarch	1:1	6-02-2019
12	NTPC	1:5	30-01-2019
13	Akash Infraproj	1:1	31-01-2019
14	WIPRO	1:3	18-01-2019
15	Vishal bearing	4:5	31-01-2019
16	Maximus Inter	1:1	16-01-2019
17	Indian Wood	1:1	02-01-2019
18	White Organic	1:1	17-12-2018
19	Container Corp	1:4	20-12-2018
20	Riddhi Corp	25:10	29-11-2018

Source: https://www.moneycontrol.com/stocks/marketinfo/bonus/index.php

III. CONCLUSION

Financially sound companies and companies having large amount of accumulated profits may suffer from liquidity problems. Such companies may have large amount of investments in the fixed assets like land and buildings, plant and machinery, furniture etc., but they may suffer from liquidity problems. Such companies if they have to pay cash dividends, it may be very difficult for them to expend the cash.

Such type of companies can use the ploughing back of profits or bonus issue of shares as an effective tool to manage their liquidity problems. Through the issue of bonus shares the companies need not expend their cash and cash equivalents for the purpose of payment of cash dividends. similarly they need not approach any bank or other financial institution for raising loan for payment of dividends. in the same way they need not sell any of their properties for the purpose of raising money.

Because, the stock dividend or bonus issue of shares is one of the non-cash forms of dividend particularly suitable to those companies who face the liquidity problems for payment of cash dividends, even though they are financially strong and highly profitable. Hence the company can preserve its liquidity funds with it and such funds can be used by the company for its future development activities, at the same time it can satisfy the desires of its shareholders by issuing free additional shares through the capitalisation of profits. Hence, it can be concluded that stock dividend or issue of bonus shares can be used as an effective tool to manage the liquidity problems by various companies, by ploughing back the past profits the companies can satisfy the shareholders desires relating to dividend and also preserve their liquid resources.Highlight a section that you want to designate with a certain style, and then select the appropriate name on the style menu. The style will adjust your fonts and line spacing. **Do not change the font sizes or line spacing to squeeze more text into a limited number of pages.** Use italics for emphasis; do not underline.

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