

# CAPITAL CONSERVATION AND DEVELOPMENT IN JOINT STOCK COMPANIES

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Capital conservation in enterprises is carried out in the process of using capital for business and production with the aim to protect various kinds of assets from damage before expiry date, loss and deduction, and to avoid making false profit and reducing capital. Meanwhile in the utilization process, capital must be regularly conserved by productive capacity of fixed assets, purchasing power of materials for reserve and other movable assets and payment capability. Therefore, in case of inflation, initial capital invested (or retained profits) must be increased to ensure the enterprise's productivity.

Enterprises, in addition to responsibility of preserving capital, also take account of developing capital, regularly increasing capital through retained profits for reinvestment, technological innovation in business and production.

Currently, the regime of capital conservation and development in state-owned enterprises is defined as follows:

- Capital conservation allows state enterprises to raise product prices; reduce pre-tax profits and thus pay less profits tax. This is a measure to conserve capital for state enterprises whereas non-state enterprises cannot enjoy this privilege.

- Capital development in state enterprises is mainly realized via the production development fund made by profits set aside yearly.

In reality, the mechanism of assigning, conserving and developing capital according to Directive 138/CT dated April 25, 1991 and Decision 332/HĐBT dated Oct 23, 1991 by the Ministerial Council was applied to state enterprises only. Non-state businesses do not perform this mechanism now. Can enterprises having State investment capital such as joint stock and limited companies apply this mechanism? To date, the Government has not given detailed guidelines yet. That means joint stock companies with or without State shares are not entitled to apply this mechanism.

## 1. Reality of joint stock companies' capital conservation and development

Do non-state enterprises currently carry out capital conservation or not? This must be put forward by non-state enterprises in the current business condition. The remaining problem is how to carry out capital conservation and development in these companies.

The following are figures about capital preservation of some joint stock companies in HCMC:

### - PHARIMEX Joint Stock Company

Established on June 30, 1981 with 4,000 shares issued whose nominal value is VNĐ500 each. It had initial capital of VNĐ2,000,000. Afterwards, to meet the requirement of development, the company had issued more shares and until April 1995 the company's number of

shares totalled 18,190, nominal value of each share was VNĐ600,000 and the company's capital reached VNĐ10,914,000,000.

### PHARIMEX'S CAPITAL CONSERVATION

	Nominal value of a share June 30, 1981	Nominal value of a share April 1, 1994	Estimated nominal value of a share Jan 1, 1995	Ratio
- In Vietnamese Đồng	VNĐ500	VNĐ280,000	VNĐ600,000	
- Converted to gold	0.027 tael	0.063 tael	0.116 tael	4.3 times
- Price of a tael of gold	18,000	4,425,000	5,145,000	

Source: Report of the company at the conference of the economic department affiliated to HCMC Party Committee in June 1995

Until Dec 31, 1995, according to the company's financial statement, the total capital was VNĐ17,077,767,873, of which VNĐ11,843,131,906 belonged to the owners. Thus, the value based on bookkeeping of each share was VNĐ651,079.

At the same time, shareholders also earned part of profits via dividends annually, that is an additional factor for the conservation of shareholders' stock.

The PHARIMEX's capital conservation was well performed and the funds for conservation were deducted from after-tax profits, that is part gained by shareholders via dividend and retained profits for conserving and developing stock capital.

### - MEKONG Pharmaceuticals Joint Stock Company

The company was established on July 11, 1992 with 10,400 shares issued, each share's nominal value was VNĐ500,000. The initial capital stock amounted to VNĐ5.2 billion. Every year the dividend distributed by the company represents 36% compared with the share face value. Until Dec 31, 1995, each shareholder had earned about 90% of the initial pooled capital as followed:

### PERCENTAGE OF PROFITS DISTRIBUTION IN THE MEKONG COMPANY

	1993	1994	1995
- Net profits (VNĐ)	3,739,606,879	3,187,299,061	1,606,003,616
- Dividend (VNĐ)	1,847,679,510	1,871,876,000	652,800,000
- Dividend/face value (%)	30-35%	36%	12.6%
- For one share (%)	50%	58%	40%

Source: The company's report at the HCMC Party Committee's Economic Conference

Until Dec 31, 1995 the company's capital totalled VNĐ38,595,882,680, of which VNĐ9,535,516,430 belonged to the owners. Therefore, the value based on bookkeeping of a share reached VNĐ916,876, up by 1.84 times over the face value.

As compared with the inflation rate in the last three



years, the company has made good business performance to secure reasonable profits and concurrently conserve the shareholders' capital stock and develop the company's working capital as well.

**- Vietnam Export-Import Joint Stock Bank (EXIMBANK)**

EXIMBANK was founded on May 24, 1989 with the capital stock of VNĐ53,314,800,000 and 133,287 shares nominally valued at VNĐ400,000 each (US\$100), after two years of operation until Oct 20, 1993 the Governor of the State Bank issued Decision 198-QĐ/NH5 to allow the bank to raise its registered capital to VNĐ125 billion, each share's face value was one million đồngs in spite of VNĐ400,000. Then the EXIMBANK has also increased the former shares' face value from VNĐ400,000 to VNĐ1,000,000 without additional contribution. After four years of operation, the bank has made such funds as reserve fund for addition to registered capital (US\$768,950), special reserve fund (US\$720,062), fund for skill improvement (US\$14,728). The capital for basic amortization and other capital reached VNĐ1.3 billion. Thus, the total self-accumulated capital of the bank soared to VNĐ155 billion. In addition, the bank also distributed profits to shareholders yearly.

As a result of this, the EXIMBANK has well realized capital conservation for shareholders.

**- Đông Á Joint Stock Bank**

Đông Á Bank started its operation on July 1, 1992 in compliance with law, the bank's registered capital initially reached VNĐ20 billion. Until the end of 1991, the total chartered capital had been raised to VNĐ30 billion with 15,000 shares nominally valued at VNĐ2 million each. In the two years of operation, the bank had distributed dividends as follows: 7.2%/year in 1993, 23%/year in 1994. Meanwhile in these two years, the bank has deducted from profits to contribute to capital conservation fund: VNĐ2 billion in 1993, VNĐ3 billion in 1994. In addition, the bank's funds had amounted to VNĐ3 billion until the end of 1995. In 1995, the bank's pre-tax profits reached VNĐ30,423 million, a twofold increase over 1994 (VNĐ14,342 million). These are figures proving the Đông Á Bank's effective business performance and its capability to conserve capital for shareholders.

Through above mentioned figures of some identical units, we can see that joint stock companies carry out capital conservation according to individual criteria, some conserves capital stock by increasing share face value (mostly), deducting for conservation fund, or distributing dividends...Joint stock companies in general conserve capital stock by various forms and can secure the value of shareholders' stocks, besides the market price of their stocks will certainly increase but since there is no stock market, so the market price of current shares can not be figured out in comparison with the share face value.

In brief, joint stock companies or other non-state enterprises carry out capital conservation by means of after-tax profits whereas state enterprises do it by pre-tax profits. This causes difference between joint stock compa-

nies and state enterprises in payment to the State budget via profits tax. This is a basic difference in the mechanism of capital conservation of state enterprises and non-state ones at present.

Based on the above analysis, we think the Government should re-examine current regulations on the mechanism of capital preservation and development for state enterprises. Since enterprises under different ownership forms all operate in the uniform economic environment, are affected by the same legal system and enjoy equality before law, financial institutions to overcome bad effects of inflation should be implemented uniformly.

Just because of this, non-state enterprises currently think the Government gives discriminatory treatments to various economic sectors, this is not compatible with the common viewpoints of the Party and Government in the process of developing multi-sectoral commodity economy and causes unfavourable concepts and do not encourage economic sectors' investment. Even joint stock companies having the state shares also request the Government to carry out the same mechanism of capital conservation as state enterprises.

This is a problem posed for the State management

agencies and necessary to be solved with the aim to create the equality in finance between economic sectors.

**2. Viewpoint on capital conservation and development in joint stock companies**

To survive and develop in the market economy, joint stock companies as well as enterprises under various ownership forms must compete against each other nationwide and worldwide. In that condition, they have to produce profits in their businesses, that means they have to make up for costs from turnover and gain

profits, capital conservation and development become subjective essential target for every enterprise. If a business makes no profits, suffers loss, cannot make payments and it cannot overcome its shortcomings to develop, then it will go bankrupt. Just because of this, the joint stock company has to pay real attention to using capital stock of shareholders and know how to use it most effectively. The higher the company's profits ratio, the more plentiful its dividends and the higher the market price of its stocks. However in case of inflation in the market economy, the purchasing power of money declines, besides attention to profits, joint stock companies must be concerned about proper accounting with a view to preventing false profits, real losses which happened in state enterprises previously. When inflation takes place, joint stock companies should re-evaluate their fixed assets so as to calculate right and sufficient amortization, recover enough capital stock, reflect properly costs of materials, commodities as input factors with the aim to determine profits and capital conservation for movable assets.

Through analysis of the above mentioned joint stock companies' capital conservation, we think in our market economy at present, the regime of capital conservation and development applied in state enterprises should be





economy at present, the regime of capital conservation and development applied in state enterprises should be abolished due to the following reasons:

- The reality of capital conservation and development in state enterprises is part of profits tax retained (tax reduction) to help them conserve capital. This can be done otherwise (if the Government permits), profits tax is still calculated as usual, then part of profits tax can be retained under the form of allocating additional capital to conserve initial capital.

- To make equality between economic sectors in business and production, that is, capital conservation and development are every enterprise's obligations, they have similar sources to conserve capital, these sources are deducted from after tax profits, they cannot enjoy tax reduction to conserve capital as current state enterprises.

- To create conditions for appraising properly and sufficiently state enterprises' operations, give no subsidy via the regime of capital conservation and development; that is responsibility of the enterprise's managers - those who are allocated capital - at the same time, to re-organize state enterprises, if the State need maintain and develop an enterprise, it can grant additional capital to help that enterprise conserve and develop capital.

Capital conservation in joint stock companies is really to conserve stock capital of shareholders. When a shareholder puts his/her money in stock investment of a company, he/she wants to gain profits and hopes profits generated by this share must be higher than profits produced by other businesses with the same risk. Thus, profits expected in capital stock secure the factor of capital conservation since expected profits rate is mainly return on capital stock.

The investors commonly indicates:

Profit rate expected on invested capital	>	lending interest rate	>	deposit interest rate	>	inflation rate
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Profit rate expected on invested capital	=	$\frac{\text{net profits expected in a year}}{\text{current share price}}$
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If a joint stock company can ensure expected profit rate, then the company will basically conserve capital stock for shareholders, at the same time secure a certain interest rate for them. Otherwise, it will not be able to conserve capital, the value of shareholders' capital stock will decrease. The remaining problem is how to conserve capital.

### 3. How to conserve and develop capital in the joint stock company

What does an investor expect when he/she puts his/her money in buying shares of a company? Suppose they keep and sell their shares after a year, they will gain dividends distributed at the year's end and they hope the selling price of their share will be higher than its buying price at the year's beginning. Therefore the investor can gain two sums of money: one from dividends and another from the increase in share price. These sums produce profit rate on invested capital, which can be calculated by the following formula:

$$K = \frac{D_1}{P_0} + \frac{P_1 - P_0}{P_0} = \frac{D_1}{P_0} + g$$

K: Profit rate expected on invested capital

D<sub>1</sub>: Dividend expected after a year

P<sub>0</sub>: Current share price

P<sub>1</sub>: Share price expected after a year

g: growth rate of share price

Thus, profit rate expected on invested capital depends upon two factors:

- Profit rate on invested capital is obtained from dividends distributed annually; this factor depends upon business efficiency and the company's dividend policy.

- The increase in share price at the year's end compared with the year's beginning; this factor depends upon profits retained annually for reinvestment, and the fluctuation of stock price in the stock market. When our country did not have the stock market yet, we can temporarily ignore the market factor and only use the dividend to determine, that is, to depend on stock price for determination.

Stock price = (capital stock + retained profits) : number of shares issued currently.

Therefore, stock price at the year end is equivalent to its price at the year beginning plus profits retained in the year. That is:

Price of a share at the year end = price of a share at the year beginning + profits retained in the year for a share

With the above mentioned viewpoints of an investor, we can understand the content of a joint stock company's capital conservation as follows:

- The joint stock company has to conserve its capital stock just in the process of business and production, and the most important factor is its financial decisions in a short (or long) term.

- Every month, quarter, year the joint stock company can depend on paid-up capital cost to determine the value of capital stock that it need conserve until the end of a period.

- The company's value of capital stock requiring annual conservation is calculated according to the following formula:

The value of capital stock conserved until the year end = The value of capital stock conserved at the year beginning x (1 + cost of capital paid-up)

- The loss or insufficient conservation of capital stock can be settled as followed: To compensate for it by retaining part of net profits after it is deducted for the establishment of obligatory reserve fund. If that's not enough, the company has to reduce the nominal value of capital stock.

Thus, based on combination of the company's distribution of profits and conservation of capital stock, we can see the company's net profits will be divided into two parts after they are deducted for reserve fund: dividends for shareholders and retained profits.

The retained profits can be used as follows: part for addition to capital stock but it is still profit but do not become part of capital stock, with the aim to secure business capacity of the company (its growth rate is zero); the rest is used for reinvestment funds in order to develop capital for the company.

It is worth noting that the above joint stock company's capital conservation and development is considered in terms of finance, not of accounting, that is, capital conservation and development based on shareholders' capital stock are reflected in the item of retained profits of the company's balance sheet.

In short, the joint stock company's capital conservation and development do not reduce current profits tax, that is, the funds for capital conservation and development are deducted from after-tax profits. This depends upon the company's business efficiency, profits rate on capital invested, policy on dividend and fluctuation of the company's stock in the securities market.