Retained Earnings

A new company can raise finance only from external sources such as shares, debentures, loans etc. But, an existing company can also generate finance through its internal sources, i.e., retained earnings or ploughing back of profits. When a company does not distribute whole of its profits as dividend but reinvests a part of it in the business, it is known as ploughing back of profits or retention of earnings. This method of financing is also known as self-financing or internal financing.

Ploughing back of profits is made by transferring a part of after tax profits to various reserves such as General Reserve, Reserve Fund, Replacement Fund, Dividend Equalization Fund etc. Such retained earnings may be utilized to fulfill the long-term, medium-term and short-term financial requirements of the firm.

Advantages

1. It is the cheapest method of raising capital

2. It has no specific cost of capital

3. It increases the net worth of business

4. There is no dilution of control of present owners

5. It does not require any pledge, mortgage etc. like other loans.

6. It provides required capital for expansion and development.

7. Firms do not need to depend on lenders or outsiders if retained earnings, are readily available.

8. It increases the reputation of the business.

Disadvantages

1. It may lead to cause of dissatisfaction among the shareholders as they receive-a low rate of dividend.

2. Management may fail to properly use the profits retained.

3. Ploughing back or reinvestment of profit means depriving the shareholders a portion of the earning of the company. As a result, share price may come down in the market.

4. It may lead to over-capitalization because of capitalization of profits.

Retained Earnings Formula

The RE formula is as follows:

RE = Beginning Period RE + Net Income/Loss – Cash Dividends – Stock Dividends

Where RE = Retained Earnings

At the end of each accounting period, retained earnings are reported on the balance sheet as the accumulated income from the prior year (including the current year's income), minus dividends paid to shareholders. In the next accounting cycle, the RE ending balance from the previous accounting period will now become the retained earnings beginning balance.

The RE balance may not always be a positive number as it may reflect that the current period's net loss is greater than that of the RE beginning balance. Alternatively, a large distribution of dividends that exceed the retained earnings balance can cause it to go negative.

How Net Income Impacts Retained Earnings

Any changes or movement with net income will directly impact the RE balance. Factors such as an increase or decrease in net income and incurrence of net loss will pave the way to either business profitability or deficit. The Retained Earnings account can be negative due to large, cumulative net losses. Naturally, the same items that effect net income effect RE.

Examples of these items include sales revenue, cost of goods sold, depreciation, and other operating expenses. Non-cash items such as write-downs or impairments and stock-based compensation also affect the account.

Financing of Short-Term Working Capital

1. Indigenous Bankers

Private money-lenders and other country bankers used to be the only source of finance prior to the establishment of commercial banks. They used to charge very high rates of interest and exploited the customers to the largest extent possible. Now-a-days with the development of commercial banks they have lost their monopoly.

But even today some business houses have to depend upon indigenous bankers for obtaining loans to meet their working capital requirements.

2. Advances

Some business houses get advances from their customers and agents against orders and this source is a short-term source of finance for them. It is a cheap source of finance and in order to minimize their investment in working capital, some firms having long production cycle, especially the firms manufacturing industrial products prefer to take advances from their customers.

3. Trade Credit

Trade credit refers to the credit extended by the suppliers of goods in the normal course of business. As present day commerce is built upon credit, the trade credit arrangement of a firm with its suppliers is an important source of short-term finance.

The credit-worthiness of a firm and the confidence of its suppliers are the main basis of securing trade credit. It is mostly granted on an open account basis whereby supplier sends goods to the buyer for the payment to be received in future as per terms of the sales invoice. It may also take the form of bills payable whereby the buyer signs a bill of exchange payable on a specified future date.

When a firm delays the payment beyond the due date as per the terms of sales invoice, it is called stretching accounts payable. A firm may generate additional short-term finances by stretching accounts payable, but it may have to pay penal interest charges as well as to forgo cash discount.

If a firm delays the payment frequently, it adversely affects the credit worthiness of the firm and it may not be allowed such credit facilities in future.

4. Accrued Expenses

Accrued expenses are the expenses which have been incurred but not yet due and hence not yet paid also. These simply represent a liability that a firm has to pay for the services already received by it. The most important items of accruals are wages and salaries, interest, and taxes.

Wages and salaries are usually paid on monthly, fortnightly or weekly basis for the services already rendered by employees. The longer the payment-period, the greater is the amount of liability towards employees or the funds provided by them. In the same manner, accrued interest and taxes also constitute a short-term source of finance.

Taxes are paid after collection and in the intervening period serve as a good source of finance. Even income-tax is paid periodically much after the profits have been earned. Like taxes, interest is also paid periodically while the funds are used continuously by a firm. Thus, all accrued expenses can be used as a source of finance.

The amount of accruals varies with the change in the level of activity of a firm. When the activity level expands, accruals also increase and hence they provide a spontaneous source of finance. Further, as no interest is payable on accrued expenses, they represent a free source of financing.

However, it must be noted that it may not be desirable or even possible to postpone these expenses for a long period. The payment period of wages and salaries is determined by provisions of law and practice in industry.

Similarly, the payment dates of taxes are governed by law and delays may attract penalties. Thus, we may conclude that frequency and magnitude of accruals is beyond the control of managements. Even then, they serve as a spontaneous, interest free, limited source of short-term financing.

5. Deferred Incomes

Deferred incomes are incomes received in advance before supplying goods or services. They represent funds received by a firm for which it has to supply goods or services in future. These funds increase the liquidity of a firm and constitute an important source of short-term finance. However, firms having great demand for its products and services, and those having good reputation in the market can demand deferred incomes.

6. Commercial Paper

Commercial paper represents unsecured promissory notes issued by firms to raise short-term funds. It is an important money market instrument in advanced countries like U.S.A. In India, the Reserve Bank of India introduced commercial paper in the Indian money market on the recommendations of the Working Group on Money Market (Vaghul Committee).

But only large companies enjoying high credit rating and sound financial health can issue commercial paper to raise short-term funds. The Reserve Bank of India has laid down a number of conditions to determine eligibility of a company for the issue of commercial paper. Only a company which is listed on the stock exchange, has a net worth of at least Rs 10 crores and a maximum permissible bank finance of Rs 25 crores can issue commercial paper not exceeding 30 per cent of its working capital limit.

The maturity period of commercial paper, in India, mostly ranges from 91 to 180 days. It is sold at a discount from its face value and redeemed at face value on its maturity. Hence, the cost of raising funds, through this source, is a function of the amount of discount and the period of maturity and no interest rate is provided by the Reserve Bank of India for this purpose.

Commercial paper is usually bought by investors including banks, insurance companies, unit trusts and firms to invest surplus funds for a short-period. A credit rating agency, called CRISIL, has been set up in India by ICICI and UTI to rate commercial papers.

Commercial paper is a cheaper source of raising short-term finance as compared to the bank credit and proves to be effective even during period of tight bank credit. However, it can be used as a source of finance only by large companies enjoying high credit rating and sound financial health. Another disadvantage of commercial paper is that it cannot be redeemed before the maturity date even if the issuing firm has surplus funds to pay back.

7. Working Capital Finance by Commercial Banks

Commercial banks are the most important source of short-term capital. The major portion of working capital loans are provided by commercial banks. They provide a wide variety of loans tailored to meet the specific requirements of a concern.

The different forms in which the banks normally provide loans and advances are as follows:

(a) Loans:

When a bank makes an advance in lump-sum against some security it is called a loan. In case of a loan, a specified amount is sanctioned by the bank to the customer. The entire loan amount is paid to the borrower either in cash or by credit to his account. The borrower is required to pay interest on the entire amount of the loan from the date of the sanction.

A loan may be repayable in lump sum or installments. Interest on loans is calculated at quarterly rests and where repayments are stipulated in installments, the interest is calculated at quarterly rests on the reduced balances. Commercial banks generally provide short-term loans up to one year for meeting working capital requirements. But now-a-days term loans exceeding one year are also provided by banks. The term loans may be either medium-term or long- term loans.

(b) Cash Credits:

A cash credit is an arrangement by which a bank allows his customer to borrow money up to a certain limit against some tangible securities or guarantees. The customer can withdraw from his cash credit limit according to his needs and he can also deposit any surplus amount with him.

The interest in case of cash credit is charged on the daily balance and not on the entire amount of the account. For these reasons, it is the most favourite mode of borrowing by industrial and commercial concerns. The Reserve Bank of India issued a directive to all scheduled commercial banks on 28th March 1970, prescribing a commitment charge which banks should levy on the unutilized portion of the credit limits.

(c) Overdrafts:

Overdraft means an agreement with a bank by which a current account-holder is allowed to withdraw more than the balance to his credit up to a certain limit. There are no restrictions for operation of overdraft limits. The interest is charged on daily overdrawn balances. The main difference between cash credit and overdraft is that overdraft is allowed for a short period and is a temporary accommodation whereas the cash credit is allowed for a longer period. Overdraft accounts can either be clean overdrafts, partly secured or fully secured.

(d) Purchasing and Discounting of Bills:

Purchasing and discounting of bills is the most important form in which a bank lends without any collateral security. Present day commerce is built upon credit. The seller draws a bill of exchange on the buyer of goods on credit. Such a bill may be either a clean bill or a documentary bill which is accompanied by documents of title to goods such as a railway receipt.

The bank purchases the bills payable on demand and credits the customer's account with the amount of bill less discount. At the maturity of the bills, bank presents the bill to its acceptor for payment. In case the bill discounted is dishonored by non-payment, the bank recovers the full amount of the bill from the customer along with expenses in that connection. In addition to the above mentioned forms of direct finance, commercial banks help their customers in obtaining credit from their suppliers through the letter of credit arrangement.