Course: BBA Part II
Paper: XII
Topic: Retained Earnings
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What Is Retained Earnings?

Retained earnings (RE) is the amount of net income left over for the business after it has paid out dividends to its shareholders. A business generates earnings that can be positive (profits) or negative (losses).

Positive profits give a lot of room to the business owner(s) or the company management to utilize the surplus money earned. Often this profit is paid out to shareholders, but it can also be re-invested back into the company for growth purposes. The money not paid to shareholders counts as retained earnings.

What Retained Earnings Tells You

Whenever a company generates surplus income, a portion of the long-term shareholders may expect some regular income in the form of dividends as a reward for putting their money in the company. Traders who look for short-term gains may also prefer getting dividend payments that offer instant gains.

Dividends are also preferred as many jurisdictions allow dividends as tax-free income, while gains on stocks are subject to taxes. On the other hand, company management may believe that they can better utilize the money if it is retained within the company. Similarly, there may be shareholders who trust the management potential and may prefer allowing them to retain the earnings in hopes of much higher returns (even with the taxes).

Using Retained Earnings

The following options broadly cover all possibilities on how the surplus money can be utilized:

- The income money can be distributed (fully or partially) among the business owners (shareholders) in the form of dividends.
- It can be invested to expand the existing business operations, like increasing the production capacity of the existing products or hiring more sales representatives.
- It can be invested to launch a new product/variant, like a refrigerator maker foraying into producing air conditioners, or a chocolate cookie manufacturer launching orange- or pineapple-flavored variants.
- The money can be utilized for any possible merger, acquisition, or partnership that leads to improved business prospects.
- It can also be used for share buybacks.
- The earnings can be used to repay any outstanding loan (debt) the business may have.

The first option leads to the earnings money going out of the books and accounts of the business forever because dividend payments are irreversible. However, all the other options retain the earnings money for use within the business, and such investments and funding activities constitute the retained earnings (RE).

By definition, retained earnings are the cumulative net earnings or profits of a company after accounting for dividend payments. It is also called earnings surplus and represents the reserve money, which is available to the company management for reinvesting back into the business. When expressed as a percentage of total earnings, it is also called retention ratio and is equal to (1 - dividend payout ratio).

While the last option of debt repayment also leads to the money going out, it still has an impact on the business accounts, like saving future interest payments, which qualifies it for inclusion in retained earnings.