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Research Article

Impact of retained earnings on the short-term solvency and liquidity: A case assessment of excessive profit ploughing through reduced dividend earnings leading to shareholder dissatisfaction

Abhay Sharad Kinikar
Senior Faculty in Financial Management at Neville Wadia Institute of Management Studies & Research, Pune

Abstract

The paper highlights how the concept of retained earnings can actually lead to lower volume of profit in the long run as excessive ploughing of profit may lead to reduced dividend earning among the shareholders and create a sense of dissatisfaction among them. The paper reviews how a proportionate balance must be struck between retaining profits for organizational growth and paying dividends to keep shareholders satisfied. The concept reviews that excessive profit ploughing may cause firms to lose investors who may decide to withdraw their investments from the organization in the long term. The paper also highlights the relation between the level of capital availability and long term solvency level which can impact the profit from operations for the organization.

Keywords: Retained earnings, solvency, liquidity, stakeholder dissatisfaction, goodwill etc.

1: Introduction

Solvency is a condition where the organization tries to clear up all the financial debts where liquidity is a condition that can convert any assets into readymade cash for any further purposes without affecting the market price (Baker *et al*., 2017). There is an impact of retained earnings on short-term solvency and liquidity. In this study, the effects of retained earnings on short-term solvency and liquidity will be discussed. The prime objective of the study is to assess the liquidity and solvency level of an organization in terms of retained earnings. The objective will focus on understanding the effects of retained earnings on solvency and liquidity for a short period. It has an aim to understand requirements of solvency and liquidity associated with retained earnings. At the same time, behind the study, the idea of the profitability of retained earnings is the main reason. The profitability of retained earnings reflects the satisfaction level of the stakeholders who have invested in the process (Borisovna, 2020). This will be an aim to find out the satisfaction level of the stakeholders. While conducting the study the probable gaps in the research will be discussed to find out the problematic zone. At the same time, the study will reflect the position of short-term solvency and liquidity associated with retained earnings as the goodwill of the society.

2: Review of literature

2.1: Impact of retained earnings on long term solvency

The ploughing back of profits is one of the most common ways of retaining organizational profit and using the same to aid future operations through investments. Ploughing back on profits is the opposite of paying out dividends. While collecting profits from the market, as a form of dividend a share of profits is given to the shareholders. Ploughing back or profits allows retaining the organizational profit and it is commonly used by various organizations. It also provides an overview of the factors such as the reasons why the use of internal profit of the firm would help it in gaining a significant degree of competitive advantage. The number of production units, direct costs, value per unit, etc are influencing the internal profit of the organization. Internal profit will increase significantly when internal production and sales will increase (Ojah *et al*., 2019). The use of retained earnings is useful as it can also enable the organization to ensure the availability of smooth working capital. Retained earning is something gained by the organization at the same time and it is used for further use. The entire profit will be distributed in various forms of dividends and this will help to operate the business more smoothly. The production capacity of the organization can run smoothly with the help of these profits. More money will be invested in hiring sales representatives and more units of machinery can be bought with the help of this fund (Silviana and Adi, 2021). It can be invested in possible mergers and partnerships to increase the growth of the organization. While clearing out the debts the internal profits can be used. The internal profits also can be used to invest in new products or services. This section highlights the different ways in which profit can be retained by the organization and how it can benefit the organization in the long term. Profits can be retained in several ways by the organization which will help the organization for a long time. When the organization tends to keep the maximum amount of profit from the net profit, it can be retained easily. At the same time, the stakeholders become infuriated about the retention of the profit. This creates an unstable situation for the organization (Zabolotnyy and Wasilewski, 2019). On the other hand, the organization can retain a good amount of profit by not investing it in the operational works for the organization. This will create a huge impact on the operations of the organization. At the same time, turbulence will be created in the organization for the retained amount of profit. When the profit is retained generally by the organization, it can create disbalance in the entire system. For this reason, there is a genuine need for retained profit in the long term solvency. With the help of retained profit, an adverse effect can be witnessed in the long-term solvency.

2.2: Impact of profit ploughing on dividend earning

The ploughing of excessive profits can also lead to the lower declaration of dividends by the organization. This often induces organizations to keep a greater share of the profits to themselves which in turn would cause the firms to reduce the volume of profit earned by the shareholders (Sukemi and Sinabutar, 2020). The excessive ploughing of profit can often cause the organizations to lose customers because it would induce the shareholders to withdraw their shares from the organizations and this would lead to a higher level of dissatisfaction among the clients. This section highlights how a proper capitalization method is crucial to ensure long-term stability in operations for organizations. The constant ploughing back of profits may be an indicator of the fact that an organization is more oriented towards earning profit rather than maximization of welfare. This in turn may impact the volume of growth due to reduced goodwill (Simanjuntak and Hutabarat, 2019). The section also highlights that it is important for individuals to evaluate how operations may be catalyzed and appropriate balance is struck between equity and debt to ensure proper solvency and long-term operations for the business. The section highlights that excess retained earnings may at times tend to create negative goodwill instead of a positive one as people would perceive that the organization does not pay adequate profit to its shareholders and thus can retain such high volumes of profit. Ploughing back of profits generally is a management policy taken by the organization where the earning is not equally divided amongst the stakeholders (Maji and Malik, 2021). A big share of profit is pulled back for the organization without notifying the stakeholders. From the point of view of the organization, for the short run, the organization stocks up the earnings for further use. When an economic depression is witnessed, then these earnings can help the organization to function fully. The organization requires no need to depend on outsiders for the funding. At the same time, the organization can spend this among earnings for the infrastructure which will help the organization to grow (Legesse and Guo, 2020). The retained profit can be used to clear out the old debts used for the operations of the organization. At the same time, profit ploughing has some adverse impact on the dividend earning. A monopoly is created with the help of dividend earning in the organization. Constant ploughing the money for the organization will create an opportunity for monopoly and using the money for the organization will help to stabilize the monopoly. Share values can be manipulated when the earnings are ploughing back by the organization (Hertina, 2021). This may result in the dissatisfaction of the shareholders because they do not receive their share of profit. A disbalance can be created in the organization and shareholders can leave the organization. This will disrupt the organizational functions and the organization will shut down when the shareholders are backed off. The freedom of the investors is highly manipulated when the earnings are ploughed back. The natural growth of the capital market thus can be hindered when the investors are given limited choices to invest.

2.3: Impact of excess retained earnings on low solvency

Organizations need to evaluate how the use of techniques involving the ploughing back of profit by a firm can cause a real decline in the value of current assets. Various techniques can be involved in the system while ploughing back profit from an organization. The retained earnings can be saved without distributing it amongst the shareholders or it can be saved by decreasing the investments in the operations of the organization (Kadim *et al*., 2020). This is because dissatisfied shareholders may often tend to withdraw their investment from the organization and this would cause the firm to incur lower levels of solvency in the long-term period. The excessive dissatisfaction among the shareholders may, in this manner, create a negative impression which would also tend to deprive the organization of future prospective investments. This withdrawal of investments can severely affect the brand image of the organization. Along with it, the operations are severely affected when there are no investments from the investors and the quality of services decreases immensely. The study discusses if retained earnings can be used by an organization and reinvested in profitable ventures to ensure sustainable operations (Safitri *et al*., 2020). The use of such profit may also lead to a lower degree of operations for the organization. The study can also be used to discuss components such as the high degree of retained earnings and its usefulness in redeeming the short-term liabilities of the firm. The liabilities of the firm can be overcome with the help of excess retained profits. While working with excess retained profits, the operations of the organizations can be monitored closely to give better performances to the market. Generally, excess retained earnings do not satisfy the shareholders at times because it can create an opportunity for a monopoly in the system. The cash and cash equivalents of an organization constitute the short-term working capital and the availability of retained earnings can boost the same leading to greater profitability. This section studies the degree of balance which should be struck while retaining profits and providing dividends to shareholders. Excess retained earnings can increase the chances of survival of the organization during the economic depression. It creates stability in the organization giving it enough funds to operate during the economic depression. At the same time, the organization requires no outside fundings for the operations (Yuningsih *et al*., 2019). The excess retained earnings are readily available for the organization which can be used at any time. Excess retained earnings can always work as internal funding for the organization while giving it more opportunities. Any explicit type of cost like interest, floatation cost does not require while using the excess retained earnings. While using the internal source of fundings, the organization can use it as per its own will. A sense of freedom works while working on low solvency. The debts can be cleared out while using the excess retained earnings and it can clear all the financial troubles of the organization.

3: Gaps in research

Previous literature studies have examined how a lower level of retained earnings is equivalent to lower financial stability for the organization. Lower levels of retained earnings can increase the disruption in the financial stability of the organization. The chances of disrupting the economic stability become higher when the retained earnings become very less in amount. Studies have also shown that retained earnings availability within an organization is also termed as an important indicator of growth metric. The studies have given enough knowledge to understand the requirements of the retained earnings for an organization. At the same time, the impacts of retained earnings on the shareholders, dividend earning and low solvency all are mentioned in these studies (Jordà *et al*., 2021). These studies have helped scholars immensely to understand the importance of retained earnings while operating an organization. However, this study has been used to evaluate the fact that the use of retained earnings may also create reduced goodwill for the organization if the firm relies solely on increasing retained earnings by ploughing back dividend returns of shareholders. As the shareholders receive less amount of profits they gradually lose interest to invest in the organization. At the same time, the investors are not given enough opportunities and freedom to invest in the organization. The opportunities and the level of freedom are not discussed anywhere in the studies. Along with it, it was very unclear the processes of investments in the organization that will help the investors. However, if the dividend payout is kept intact, and the excess retained earnings are through greater real profits, then it can positively expand the organization's goodwill. The effect of goodwill on the organization is not mentioned anywhere. When the dividend payout is used for the operational purpose of the organization and the investors receive their share of investment, then automatically goodwill spreads in the market about the organization. Thus it becomes essential for the upper hierarchies to best outline the future operations and directions to suit the best interest of the organizations. The role of hierarchies to maintain the operations with the dividend payout is not mentioned anywhere. The success of using the excess retained earnings for organizational purposes is not mentioned that much in any literature (De Bandt *et al*., 2021). The use of retained earnings by the organization is not mentioned anywhere as well. The dissatisfaction level of the stakeholders is discussed in the literature while how to overcome this situation is not discussed anywhere.

4: Discussion and findings

The study highlights how retained earnings can have both positive and negative impacts on the operation of an organization due to differences in planning future motives. Comparative case studies of organizations through analysis of balance sheets and income statements have been undertaken to assess how an increase in retained earnings at times may lead to reduced share capital. This may be due to the fact that the increase in retained earnings in some cases may be accompanied by lower levels of dividend pay-out (Hertina, 2021). This section highlights the extent to which dividend pay-out should be planned to ensure a suitable retaining of profits for maximizing the availability of internal funds. The study mainly focused on the use of retained earnings to resolve the disputes of short-term solvency and liquidity. While conducting the study, the differences between solvency and liquidity become clear to the researchers. At the same time, the effect of the retained earnings on the organization is mentioned in the study. Retained earnings have some merits and demerits as well while operating the functions of an organization. It deliberately creates opportunities for the organization. At the same time, it makes the financial foundation of the organization strong by giving enough funds during the time of crisis. Also, the retained earnings make the organization independent enough that it does not need to depend on outsiders. The internal functions of the organization can be done smoothly because the authority is given to the hierarchy of the organization (Simanjuntak and Hutabarat, 2019). The earnings can be saved and used for the future. The retained earnings also have some demerits. It can create an opportunity for the hierarchy to establish a monopoly in the organization. While working with the other investors, keeping enough profits will give the chance to manipulate the investors as per the requirements of the authority. While using the profit for the internal functions it will give more chances to establish the monopoly. Retained earnings surely have an impact on long-term solvency and low solvency. The long-term solvency can be easily omitted while using the money received from the retained earnings. At the same time, profit ploughing can increase the dissatisfaction level amongst the shareholders. This will have a negative impact on the brand image of the organization. The study gives us enough insights into the literature gaps. The exact use of retained earnings in the organization is not mentioned anywhere. There was no focus on how to overcome the dissatisfaction of the shareholders and how to encourage them to invest more while giving them the proper amount of profits. The study gives the idea of the good and bad impacts of retained earnings on short-term solvency and liquidity (De Bandt *et al*., 2021). The negative impacts of profit ploughing on the shareholders of the organization are also mentioned in the given study.

5: Conclusion

The above study has led to the establishment of the fact that there is a significant degree of relation between retained earnings and goodwill of an organization through the former may not create an impact on the latter directly. The effect may be a result of reduced profitability due to inefficient operations of the firm causing them to retain dividends of shareholders. The study mainly focused on the impacts of retained earnings on short-term solvency and liquidity. Solvency is a situation where the debts are cleared using the retained earnings. Retained earnings thus have a strong relationship with short-term solvency. At the same time, retained earnings also have a genuine impact on long-term solvency and dividend earnings. Long-term solvency generally refers to the financial obligations of the organization for a long period of time. While ploughing profits for the organization, the process has severe impacts on the solvency and also affects the shareholders. When the shareholders do not receive their desired amount of profit from the organization, dissatisfaction is created amongst them. There is a high chance of withdrawing their portion of investment from the organization. This will have a long-term impact on the internal functions of the organization. The dissatisfaction level of the shareholders will damage the brand image of the organization. Very few people will be interested in investing in the organization. A decrease in investment will disrupt the functions of the organization. To mitigate these problems, the investors should be given equal opportunities to provide their inputs to the organization. They should be motivated to invest more while giving them more benefits from the organization. Mitigating these problems will not be hard enough for the organization if the hierarchy of the organization tends to provide fair share profits to the shareholders. The organization should divide the profits equally so that there is enough funding for the internal operations and the shareholders. This way the shareholders will be motivated to make more investments in the organization. This way, brand awareness will be created and more people will show interest to invest their money in the organization. While operating the organizational works, it is also necessary to look after the solvency of the organization. Retained earnings will be helpful to clear out all the debts taken for the organization. At the same time, the negative impacts of profit ploughing are discussed here. This will give people insight to understand the relation between the retained earnings and goodwill of the organization.

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