Subject :- Financial Management(COMCC-7)

Class :- M.Com Semester 2

Unit :- 4(Management of Income)

Topic :- Retained Earnings – A Source of Internal Financing

Finance is a constant requirement for every growing business. There are several sources of finance from where a business can acquire finance or capital which it requires. But, the finance manager cannot just choose any of them indifferently. Every type of finance has different pros and cons in terms of cost, availability, eligibility, legal boundaries, etc.. So choosing the right source of finance is a challenge. Based on the source of generation, the following are the internal and external sources of Finance :

INTERNAL SOURCES	EXTERNAL SOURCES
• Retained profits • Reduction or controlling of working capital • Sale of assets etc.	• Equity • Debt • All others except mentioned in Internal sources

Internal sources of Finance are the sources of finance or capital which are generated by the business itself in its normal course of operations. There is no outside dependency for catering the need of capital.

Like an individual, companies too, set aside a part of their profit to meet future requirements. The portion of profits not distributed among the shareholders but retained and used in the business is called Retained Earnings. It is also known as ploughing back of profit, retained capital or accumulated earnings. In other words, Retained Earnings are the profits that have been reinvested in the business instead of being paid out as dividends.

The Retained Earnings are considered as the backbone of the financial structure of the corporate sector and it represents that portion of divisible profits which is not paid out as dividend.

Characteristics of Retained Earnings

The characteristics of Retained Earnings are as follows:-

1. **Long-term source of Finance**
   Retained Earnings are a long-term source of finance for a company because there is no compulsory maturity like term loans and debentures.

2. **Floatation cost**
   Unlike other sources of financing, the use of retained earnings helps avoid issue-related costs.
3. **Control**
   Use of retained earnings avoids the possibility of charge/dilution of the control of existing shareholders that results from issue of new issues.
4. **Legal Formalities**
   Use of retained earnings does not require compliance of any legal formalities. It just requires a resolution to be passed in the annual general meeting of the company.

Advantages of Retained Earnings

The advantages of Retained Earnings are as follows :

1. **Useful for expansion and diversification**
   Retained earnings are most useful to expansion and diversification of the business activities.
2. **Economical sources of finance**
   Retained earnings are one of the least costly sources of finance since it does not involve any flotation cost as in the case of raising of funds by issuing different types of securities.
3. **No fixed obligation**
   If the companies use equity finance they have to pay dividend and if the companies use debt finance, they have to pay interest. But if the company uses retained earnings as sources of finance, they need not pay any fixed obligation regarding the payment of dividend or interest.
4. **Increase the share value**
   When the company uses the retained earnings as the sources of finance for their financial requirements, the cost of capital is very cheaper than the other sources of finance. So, the value of the share will increase.

Disadvantages of Retained Earnings

Retained Earnings also have certain disadvantages which are as follows:-

1. **Improper utilization of funds**
   If the purpose for utilization of retained earnings is not clearly stated, it may lead to careless spending of funds.
2. **Over capitalization**
   Retained earnings lead to over capitalization, because if the company uses more and more retained earnings, it leads to insufficient source of finance.
3. **Leads to monopolies**
   Excessive use of retained earnings leads to monopolistic attitude of the company.

4. **Dissatisfaction among shareholders**
   Retained earnings do not allow shareholders to enjoy full benefit of the actual earnings of the company. This creates not only dissatisfaction among the shareholders but also adversely affect the market value of shares.

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