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RETAINED EARNINGS AND FINANCIAL PERFORMANCE OF QUOTED FIRMS IN NIGERIA: AN EMPIRICAL ANALYSIS

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Abstract
This study examines the impact of retained earnings on the financial performance of listed manufacturing companies in Nigeria. An ex post facto research design was utilized, employing panel data derived from the annual reports of ten (10) companies within conglomerates and consumer goods sectors over a five (5) year period (2019-2023). The research population consists of all 153 manufacturing enterprises listed in the Nigerian Exchange Group as of December 31, 2023. Purposive sampling technique was utilized to determine our sample size. This study utilized descriptive and inferential analysis methods. The descriptive analysis indicated that all variables are normally distributed and suitable for this investigation. Conversely, the inferential analytic methods utilized include Pearson's correlation analysis, Granger causality analysis, and panel fully modified least squares (FMOLS). The Granger causality test indicates a directional causal link among ROA, RE, and FZ. The outcome demonstrates a directional causal relationship between RE and ROA, with a p-value of 0.5131. The results indicate that ROA does not predict the future value of RE, with a p-value of 0.7431, which exceeds 0.05. The study also reveals a directional causal link between FZ and ROA with a p-value of 0.9019. The findings also suggest that ROA does not forecast the future value of FZ at a p-value of 0.4629, which is greater than 0.05. Furthermore, the data reveals a directional causal link between FZ and RE with a p-value of 0.9571. However, the findings reveal that RE considerably enhances the prediction of the future value of FZ at a p-value of 0.0160, which is less than 0.05. The outcome of the Panel Fully Modified Least Square (FMOLS) shows that retained earnings have no significant link with the return on assets of the quoted firms, with RE having a coefficient of -0.095 and a t-statistic of -0.574 with a p-value of 0.570, which is greater than the 5% threshold of significance. Furthermore, the result of the Kao integration test shows a p-value of 0.2791 for the Kao residual cointegration test, which is greater than 0.05. The study concludes that there is no significant relationship between retained earnings and the financial performance of the quoted firms.

Keywords: Financial Performance, Firm Size, Retained Earnings, Return on Assets, Manufacturing Firms

1. Introduction

Retained earnings (RE) is the amount of net income left over for the business after it has paid out dividends to its shareholders (Khan, 2013). Edmans (2014) remarked that the quantity of retained earnings has now become an important concern to investors and other stakeholders since it is another tool to measure the performance of management to bring improvement in the market value of their firms. That is, shareholders now examine as part of their investment criteria the amount to which enterprises use retained capital,

and they also consider this in determining how much value in terms of capital gain, business growth, and asset net worth has been added by the company's retention of capital over time. Before buying, investors generally question themselves not only if a firm can produce profits but also whether management can be trusted to develop growth with those profits (Edmans, 2014).

According to Kayode (2014), retention is a critical decision for any business organization for profit maximization and appropriate financial performance. The decision is not only because of the need to maximize returns to various organizational constituencies but also on an organization's ability to deal with its competitive environment. In Nigeria there is a rising development in understanding of the importance of financial management with emphasis on investment and retained earnings policies as a veritable instrument for effective financial performance of business organizations (Azeem & Ali, 2014). Achieving this aim has always been predicated on the obligation of the management to set corporate policies for effective and efficient internal control, performance evaluation, and reserve management. The goal of most organizations is to fulfill the expectations of the investors, and financial markets increasingly dominate reserve accumulation incentives, and this is prevalent among firms in both developed and developing countries (Azeem & Ali, 2014).

Many businesses have failed because little or no attention was given to retention policy. The retention policy of any business organization, especially the manufacturing companies, is informative, and the expectation is that the reinvested capital will generate future cash flow and subsequently increase firms' financial performance and ultimately maximize shareholders' wealth. Studies have been performed on the effect of retention policy on financial performance, but little or no attention has been devoted to production-based enterprises. The empirical literature offers various studies concerning the relationship between retained earnings and financial success (Aloys et al., 2022; Mulekano & Miroga, 2023; Agembe et al., 2024; Thuranira, 2014; Motanya, 2020).

2. Theoretical Background

2.1 Pecking Order Theory

The primary objection to trade-off theory is presented by this theory. Donaldson (1961) was the first to suggest that managers want to raise money internally in order to expand the business. When internal resources are unavailable, the theory supports asset conversion, debt issuance, and, as a last resort, external equity. The approach was later made popular by Myers & Majluf (1984), who confirmed that enterprises should choose their financing in a hierarchical manner: first, use internal sources such as retained earnings and reserves; next, take out loan; and finally, consider preferred stock and issue common stock. Companies will carefully choose the alternative that will expose them to the least amount of additional expense of asymmetric knowledge if they decide to obtain funding from other sources.

This argument is supported by Omollo et al. (2018) study on the impact of equity financing choices on financial performance, which found that the retention ratio has a favorable influence on ROA while the common stock ratio has a negative effect. The idea that company managers should look at retained earnings financing before any other source is supported by the favorable impact of retained earnings. As a financing option, the theory ranks common stock last. This is consistent with the finding that common stock has a negative impact on performance and supports the Myers and Majluf (1984) model, which states that managers can avoid this by not issuing equity to raise money.

Furthermore, taking Pecking Order Theory into consideration, Al-Najjar & Belghitar (2011) agreed that profitability and leverage have an impact on cash retentions. However, there are several issues with the theory since it fails to take into account the impact of taxes, the costs of financial distress, the costs of floating securities, agency charges, or the collection of investments that the organization can afford depending on its actual financing structure. The hypothesis also ignores the chances that are lost when a company accumulates large retentions and the immunity that a company has as a result of having so much financial wiggle room. The theory thus supplements the tradeoff theory rather than replacing it because of these drawbacks. Because retained earnings make up a sizable portion of funding, this idea was pertinent to the study, and as a result, its effect on performance was examined.

2.2 Retained earnings

Internally generated cash that represents a portion of a company's profit that has been withheld and not distributed as dividends to shareholders is known as retained profits. It is a component of the equity held by shareholders. Retained earnings are usually reinvested in a company through several means, such as debt repayment, expansion, R&D, and fixed asset replacement (Calson, 2020). By defining retained earnings as "retention ratio" or "retention surplus," which denotes "the percentage of net earnings not paid out as dividends but retained by the company to be reinvested in its core business or to pay debt," Akparhuere et al. (2015) also concurred with this suggestion. Retained earnings, according to Will (2020), are the remaining net income for the company after dividends have been distributed to shareholders. This profit is frequently distributed to shareholders, but it can also be reinvested in the business to support expansion. Formula for Retained Earnings is; RE = RE0 – NP – D

Where : RE represents Retained Earnings
RE0 represents Beginning retained earnings
NP represents Net Profit/Net Loss
D represents Dividend

2.3 Financial Performance

Financial performance according to Bamidele et al. (2024) is a key component of finance risk management and, in a broader sense, refers to the extent to which financial objectives are being or have been fulfilled. It is the process of putting a firm's operations and policies into monetary terms. It is used to assess a company's overall financial health over a certain time period and can also be used to aggregately compare different industries or sectors or to compare similar companies within the same industry. Return on Asset (ROA) is the metric used in this study to measure financial performance. Return on Asset (ROA) demonstrates management's capacity to purchase assets at a fair price and use them to make lucrative investments. Ahmed (2009). According to Ahmed (2009), the return on assets shows how profitable banks' assets are after all costs and taxes are deducted. It is a widely used metric to assess managerial effectiveness. Better management performance and efficient use of a company's assets are indicated by a high ROA ratio; wasteful use of assets is indicated by a low ratio. Increasing asset turnover or profit margins are two ways to raise ROA. The formula for Return on Assets is;

$$\text{ROA} = \frac{\text{Net Profi}}{\text{Total Asset}}$$

2.4 Retained earnings and financial performance

Mulekano and Miroga (2023) in their research attempted to analyze the influence of retained earnings on profitability of industrial firms listed at the Nairobi Securities Exchange. The study was directed by the following specific objective: finding out the influence of retained earnings on profitability of industrial enterprises listed at the Nairobi Securities Exchange. The study employed descriptive research design. The investigation addressed 8 listed manufacturing firms at the NSE. The sample size was 8 listed manufacturing enterprises registered at the Nairobi Securities Exchange. Secondary data was collected for period of 5 years (January 2016 to December 2020) annually. Descriptive and inferential statistics were examined using STATA 15. Descriptive statistics and inferential statistics were employed to determine both the nature and the strength of the link between the dependent and independent variables. The study indicated that, retained earnings had significant beneficial effect on profitability of manufacturing firms listed at the Nairobi Securities Exchange.

Ugwu et al. (2021) in their study analyzed the influence of retained earnings on the operational performances of oil and gas enterprises in Nigeria. The study employed the Simple Linear regression was adopted in assessing the secondary data derived from the financial statements and annual reports of the selected oil businesses. Retained earnings are the variable that measured the independent variable while operational performance (dependent variable) was represented using Return on Asset (ROA) and Return on Equity (ROE). The study covers a ten (10) year period, 2009- 2018. Four (4) oil businesses traded in Nigeria Stock Exchange were utilized as sample for the study. The study indicated that retained earnings had positive and insignificant influence on both the Return on Asset and Return on Equity of oil and gas enterprises in Nigeria. This effect was nonetheless modest for all the examined oil and gas corporations with the exception of Mobil Nigeria Plc in which the retained earnings have a positive and significant effect on the Return on Equity. Agembe et al. (2024) performed research among 42 non-financial enterprises listed on the exchange analyzes the association between retained earnings and financial performance from an econometrics perspective. The study was based on the Pecking Order Theory, and adopts the panel data research design founded in the positivist research paradigm, with data covering the period range 2016 to 2022 inclusive. Data is sourced purposively from the annual reports of the non-financial sector, including agricultural firms, automobiles and accessories, commercial & services, construction & allied, energy & petroleum, insurance, investment, investment services, manufacturing & allied, telecommunication, and real estate investment trust. The research uses the fixed effects model under panel regression to establish a positive and substantial association between retained earnings and financial success, and notably the ultimate direct influence that retained earnings have on financial performance of listed nonfinancial enterprises.

Aloys et al. (2022) conducted a study on analysis of retained profits financing on financial performance of listed manufacturing and affiliated firms: A dynamic panel method. The study employed Dynamic Unbalanced Panel analysis methodologies employing Secondary data for 10-year period (2010 - 2019) with the sample population consisted of 9 listed enterprises. Quantitative secondary data was extracted from the firms' financial statements by use of a document analysis guide. Focus was on retained earnings financing regulated by economic growth rate and earnings volatility on performance which was proxied by Tobin's Q. Pecking order theory led the investigation. Longitudinal study design was adopted as it is appropriate when dealing with panel data. Pearson correlation was employed to indicate the strength and direction of relationship

among the study variables. Retention ratio (RR) had a moderate positive association (r = 0.3197) with Tobin Q and a significant positive correlation (r = 0.5997) Ln EVA respectively. The regression coefficient was also positive and significant. The study recommended that Retained profits boost performance hence should be used.

Agembe (2024) in his study on granger causality model of retained earnings and financial performance of non-financial firms listed on the Nairobi securities exchange (NSE), Kenya focuses on addressing this paucity by modeling Granger causality between retained earnings and financial performance measured through Return on Assets (ROA) of non-financial firms listed on the NSE. The Wald tests demonstrated that the financial performance of non-financial enterprises Granger-causes retained earnings, but retained earnings do not Granger-cause financial performance. The conclusion gained from these data is that financial performance of non-financial enterprises listed on the NSE allows forecasting of future retained earnings.

A study on implications of retained profits on Profitability of Listed Firms in Ghana was conducted by Musah (2018) and the author found no conclusive evidence on what optimal capital mean. A regression study conducted to evaluate the association between retained earnings and profitability showed found a positive relationship between profitability.

A study was undertaken by Motanya (2020) on the influence of retained earned finance on profitability of Kenyan petroleum enterprises. The study employed cross-sectional survey design with criterion sampling being used to get at 35 firms between 2007- 2016. Primary data was acquired by use of questionnaires coupled with secondary data. Descriptive statistics and Univariate tests (t-test and Pearson correlation) were carried out. The results demonstrated an unfavorable and negligible link between retained earnings finance and profitability at 1% significance level.

In a study by Yemi and Seriki (2018) on the effects of retained earnings and manufacturing firms' market value: Nigeria stock market experience. Panel Data was taken from 75 manufacturing firms registered on the Nigeria stock Market throughout the period 2003 to 2014. The unbalanced panel data (cross-sectional and time series) used to analyze the link were gathered from the yearly financial statements of the individual enterprises. Two basic approaches descriptive and multiple regression models were employed to determine the relationship between the underlying variables. The results demonstrated a positive and substantial association between retained earnings, earnings per share, dividend payout and value of firms while market value was favorably but non-significant connected with financial leverage. The study reduced the dearth of previous research on dividend policy in emerging markets regarding the empirical relationship between retained earnings and market value of firms.

Thuranira (2014) studied the effect of retained earnings on the returns of firms listed at the N.S.E. Descriptive research design was used and secondary data for 5 years from 2009 – 2013 was used. The study variables were retained earnings, net asset value per share, price to book value, dividend yield and stock returns. The regression results revealed existence of a very weak, negative insignificant relationship between retained earnings and stock returns and recommended firms should not retain huge amounts of earnings and organizations should adopt dividend policies that have a positive contribution to the shareholders.

3. Methods

This study made use of an ex post facto research design. This type of design was employed because the research relied mainly on the panel data sourced from the firms' published annual reports. The study also considered ex post facto research design because it aims at measuring and establishing the relationship between one variable (dependent) and another (independent) or the impact of one variable on another, in which the variables are not manipulated by the researcher. (Onwumere, 2005). Panel data were collected through secondary sources, mainly from published annual reports of the quoted firms. In Nigeria. The population of this study comprises all the 153 listed manufacturing firms in the Nigeria Exchange Group. Purposive sampling was employed to select 10 manufacturing firms from two subsectors, conglomerates and consumer goods firms. The data were collected using panel or pooled series, which comprise time series and cross-sectional series. The population of this study comprises all the 153 listed manufacturing firms in the Nigeria Exchange Group. This study employed descriptive analysis and inferential analysis methods. The descriptive analysis techniques engaged were mean, standard deviation, minimum and maximum values, kurtosis, and skewness. On the other hand, the inferential analysis methods employed are Pearson's correlation analysis method and the panel fully modified least squares (FMOLS).

The model specification for this study is in line with Arellano & Bond (1991) Panel Data procedure. Panel data applies the only one-way error component model of the pooled OLS given by:

$Yit = \beta 0 + \beta Xit + \varepsilon it$ ……3.1

Yit represent the Dependent Variable (ROA) of the manufacturing company i at time t.
β denotes the slope of the explanatory variables.
X represents the Independent Variable

Therefor the functional model for the study is:

$ROA = f(RE, FZ)$ ……3.2

This regression model is

$ROAit = \beta 0it + \beta 1RE\ it + \beta 2FZ\ it + \varepsilon it$ ……3.3

Where:
ROA = Return on Assets
RE = Retained Earnings
FZ = Firm Size
β0 = Constant Terms
β1, β2, = Coefficients of the Predictable Variables
Ɛ = Error Term

4. Results and Discussion

4.1 Descriptive Analysis

Table 1. Descriptive analysis of the variables

	ROA	RE	FZ
Mean	16.72240	15.36100	118.2176
Median	14.86000	14.07000	77.96500
Maximum	45.08000	42.09000	444.0800
Minimum	3.090000	4.560000	16.67000
Std. Dev.	10.48918	7.261444	107.6589
Skewness	0.921426	1.530205	1.251336
Kurtosis	3.234890	6.436958	4.062547

Jarque-Bera	7.190164	44.12248	15.40078
Probability	0.027458	0.000000	0.000453
Sum	836.1200	768.0500	5910.880
Sum Sq. Dev.	5391.122	2583.700	567931.1
Observation	50	50	50

Source: Authors' Computation 2024

Table 1 shows the descriptive analysis of this study. The table shows the mean, median, maximum, minimum value, standard deviation, skewness, kurtosis, and Jarque-Bera of the observations collated across the selected firms (2019-2023). It was observed that during the period under review, the sampled firms have a positive financial performance. The result also shows that the variable has a positive standard deviation, which indicates that the variable is dispersed.

The descriptive analysis indicates an average return on assets of the quoted listed firms of 16.72, the median of 14.86, the minimum value of 3.09, and the maximum of 45.08. Also, the descriptive analysis shows that the average retained earnings of the quoted listed firms in Nigeria is 15.36, the median is 14.07, the minimum value is 4.56, and the maximum is 42.08. Further, the analysis shows an average firm size of 118.22, the median value of 77.96, the minimum value of 16.67, and the maximum of 444.08.

The result also shows that all the residuals are platykurtic and skewed to the right according to the coefficients of the skewness and kurtosis. This is hinged on the fact that ROA is platykurtic with a kurtosis value of 3.23. This variable is also skewed to the right with a positive value of 0.92. RE is also platykurtic with a kurtosis value of 6.44. This variable is also skewed to the right with a positive value of 1.53. Furthermore, FZ is platykurtic with a kurtosis value of 4.06. This variable is also skewed to the right with a positive value of 1.25. The kurtosis and skewness result indicates that the variables are normally distributed.

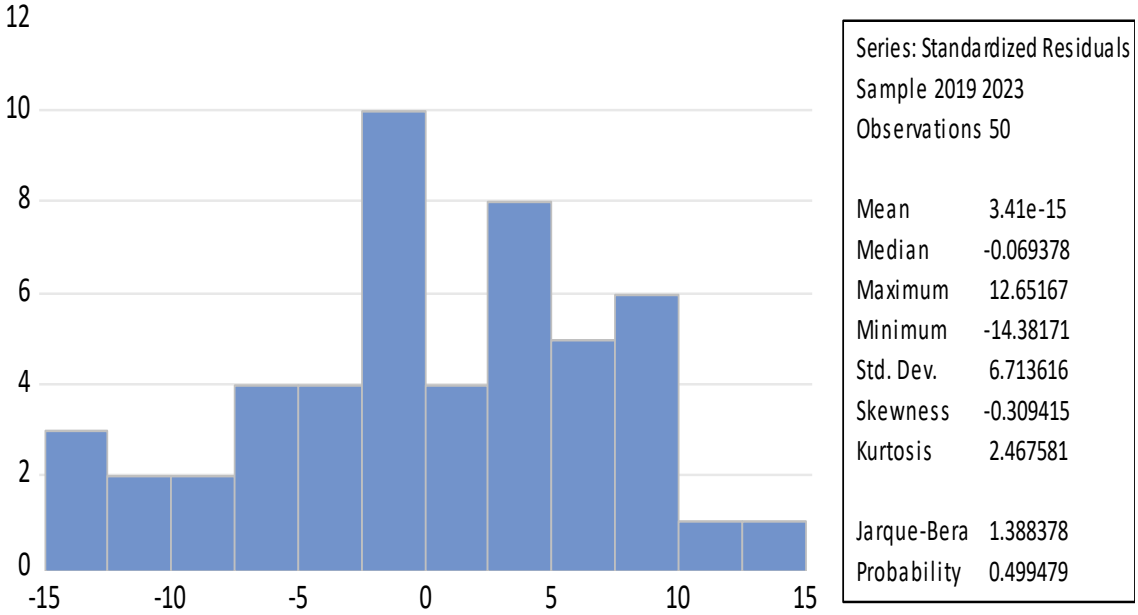

Figure 1. Normality Test

The result of the normality test in Table 4.2 shows that variables are normally distributed. This is hinged on the fact that the P-value of the Jaque-bera result of 0.499479 is greater than 0.05 (P > 0.05). Also, the bars in the histogram roughly followed a symmetrical bell or hill shape, which indicates a normal distribution.

Table 2. Pearson Correlation Analysis

	ROA	RE	FZ
ROA	1	0.44042078	0.76830788
RE	0.44042078	1	0.62203802
FZ	0.76830788	0.62203802	1

Source: Authors' Computation 2024

The Pearson correlation analysis in table 4.3 shows that return on assets has a positive correlation with retained earnings at an estimated value of 0.44. The analysis also shows that return on assets and firm size correlate at an estimated value of 0.77. The Pearson correlation analysis exerts a substantial correlation between the dependent variable ROA and the independent variables, RE and FZ.

4.2 Regression Analysis

Table 3. Panel Fully Modified Least Squares (FMOLS)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
RE	-0.094618	0.164796	-0.574155	0.5704
FZ	0.087439	0.039432	2.217462	0.0349
R-squared	0.920457	Mean dependent var		17.00750
Adjusted R-squared	0.889208	S.D. dependent var		10.10495
S.E. of regression	3.363477	Sum squared resid		316.7634
Long-run variance	8.643411			

Source: Authors' Computation 2024

The analysis in table 4.4 shows the result of the panel fully modified least square regression analysis. The result shows that retained earnings have no significant relationship with the return on assets of the quoted firms, with RE having a coefficient of -0.095 and t-statistic of -0.574 with a p-value of 0.570, which is greater than the 5% level of significance. This simply implies that a percentage increase in RE will reduce returns on assets by 9.5%. The result also indicates that there is a significant relationship between firm size and return on assets, with FZ having a coefficient of 0.087, a t-statistic value of 2.217, and a p-value of 0.035, which is less than the 5% level of significance. This result simply implies that a 1% increase in firm size can trigger an 8.7% increase in return on assets.

4.3 Granger Causality Test

Table 4. Pairwise Granger Causality Test

Null Hypothesis:	Obs	F-Statistic	Prob.
RE does not Granger Cause ROA	30	0.68527...	0.5131...
ROA does not Granger Cause RE		0.30047...	0.7431...
FZ does not Granger Cause ROA	30	0.10359...	0.9019...
ROA does not Granger Cause FZ		0.79442...	0.4629...
FZ does not Granger Cause RE	30	0.04386...	0.9571...
RE does not Granger Cause FZ		4.90035...	0.0160...

Source: Authors' Computation 2024

The pairwise Granger causality test in the analysis above reveals whether one time series variable Granger causes another and shows if there is a directional causal relationship between ROA, RE, and FZ. The result of the research above reveals that retained earnings do not considerably improve the projection of the future value of returns on assets. The finding reveals a directional causal association between RE and ROA. This is dependent on the fact that the p-value (0.5131) of the null hypothesis is greater than the significance level of 0.05. The findings also suggest that ROA does not predict the future value of RE at a p-value of 0.7431, which is greater than 0.05.

The findings in the analysis above also indicate that firm size does not considerably increase the projection of the future value of return on assets. The result reveals a directional causal association between FZ and ROA. This is dependent on the fact that the p-value (0.9019) of the null hypothesis is greater than the significant level of 0.05. The findings also suggest that ROA does not forecast the future value of FZ at a p-value of 0.4629, which is greater than 0.05.

Furthermore, the findings in the analysis above also indicate that firm size does not greatly increase the projection of the future value of retained earnings. The finding reveals a directional causal association between FZ and RE. This is dependent on the fact that the p-value (0.9571) of the null hypothesis is greater than the significance level of 0.05. However, the findings reveal that RE considerably enhances the prediction of the future value of FZ at a p-value of 0.0160, which is less than 0.05.

4.4 Cointegrations Test

Table 5. Kao Residual Cointegration.

	t-Statistic	Prob.
ADF	0.5853827...	0.27914...
Residual variance	14.76155781096031	
HAC variance	11.28333510049864	

In the table above, the p-value of the Kao residual cointegration test of 0.2791 is greater than 0.05. This simply shows that the deviation from the null hypothesis is not statistically significant; therefore, the null hypothesis is accepted. Therefore, it is fair to assume that there is no presence of a long-run panel relationship between the return of assets and retained earnings of the mentioned firms.

4.5 Discussion of Result

This study evaluated the effect of retained earnings on the financial performance of quoted manufacturing firms in Nigeria. The study focused on conglomerate and consumer goods firms. Panel Fully Modified Least Squares analysis was used to evaluate the data gathered from 10 sampled firms. The study made use of descriptive analysis and inferential analysis.

The descriptive analysis showed that all the variables are normally distributed and fit to be used for this study. The Pearson correlation analysis shows a positive and significant relationship between the independent variables (RE and FZ) and ROA, which was used as a proxy for financial performance.

The result of the panel fully modified least square (FMOLS) regression analysis shows that retained earnings have no significant relationship with return on assets of the quoted firms, as a percentage increase in RE will reduce return on assets by 9.5%. The results

also found that there is a significant relationship between firm size and return on assets (FZ). The result implies that a 1% increase in firm size can trigger an 8.7% increase in return on assets.

The Granger causality test shows a directional causal relationship between ROA, RE, and FZ. The result indicates a directional causal relationship between RE and ROA with a p-value (0.5131). The result also indicates that ROA does not predict the future value of RE at a p-value of 0.7431, which is greater than 0.05.

The result also indicates a directional causal relationship between FZ and ROA with a p-value (0.9019). The result also indicates that ROA does not predict the future value of FZ at a p-value of 0.4629, which is greater than 0.05.

Furthermore, the result indicates a directional causal relationship between FZ and RE. This is hinged on the fact that the p-value is 0.9571. However, the result indicates that RE significantly improves the prediction of the future value of FZ at a p-value of 0.0160, which is less than 0.05.

The p-value of the Kao residual cointegration test of 0.2791 is greater than 0.05. This simply shows that the deviation from the null hypothesis is not statistically significant.

5. Conclusion

This research work was carried out to show the effect of retained earnings on the financial performance of quoted manufacturing firms in Nigeria. The study posited that there is no significant relationship between retained earnings and financial performance of the quoted firms according to the result of the panel fully modified least square (FMOLS) in this study. Retained earnings provide insight into a company's financial health and serve as a crucial resource for reinvestment and emergency funding. As a result, high retained earnings are often associated with a high return on assets. The Kao cointegration analysis in this study also indicates that there is no existence of a long-run panel relationship between the return of assets and retained earnings of the quoted firms.

The study recommends that firms should consider maintaining good retained earnings, and one of the most effective ways to recover from negative retained earnings is to reduce expenses. This can involve cutting unnecessary costs, which may include negotiating lower prices with suppliers or outsourcing certain tasks to reduce labor costs. The study also recommends that since companies often use retained earnings to fund expansion projects, pay down debt, or enhance product development efforts. Firms should create more attention on revenue generation and dividend policies since they directly impact retained earnings. For instance, an increase in sales can cause an improved net income, which in turn boosts the retained earnings of the manufacturing companies.

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