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The Relationship between Retained Earnings and Financial Performance of Listed Non-Financial Firms: An Econometrics Examination

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Abstract

Internal funding sources such as retained earnings provide minimize information asymmetry in addition to being cheap and convenient for ailing firms such as listed non-financial firms trading at the Nairobi Securities Exchange (NSE). Research has however failed to do document precisely how the potential inherent in retained earnings can be exploited to improve financial performance of such firms in the long run. Therefore, this research conducted among 42 non-financial firms listed on the exchange explores the relationship between retained earnings and financial performance from an econometrics perspective. The study is anchored on the Pecking Order Theory, and employs the panel data research design founded in the positivist research paradigm, with data covering the time interval 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 show a

positive and significant relationship between retained earnings and financial performance, and particularly the ultimate direct influence that retained earnings have on financial performance of listed nonfinancial firms. Therefore nonfinancial sector stakeholders should seek to leverage retained earnings to enhance financial performance and achieve resilience in the volatile market conditions, while scholars should seek to enhance external validity of these findings by replicating them in other study contexts.

Keywords*: Information asymmetry, retained earnings, financial performance, nonfinancial firms, Securities exchange, Econometrics, Panel data.*

1.0 Introduction

Non-financial businesses, which cover a wide range of industries such as retail, manufacturing, and services, form the cradle of the global economy. Financial health impacts economic stability, employment rates and overall market confidence directly (Ghosh, 2022; Herranz González & Martínez-Carrascal, 2017; Valaskova et al., 2020). Therefore, analyzing the financial performance of companies illuminates their operational efficiency, strategic management and ability to sustain growth and innovation in today's business environment. Understanding financial performance of non-financial firms is particularly necessary following prior research that has documented vital grounds. Evidence shows that non-financial firms not only occasion the financialization of the real economy, but also provide a framework for well-being, broadening decision-making and economic stability policies, thus serving as gauges for the broader economy (Ganguly, 2021; Siegerink et al., 2020).

Kenya's economy is market-based, and is primarily driven by non-financial sectors including, agricultural, real estate, manufacturing, logistics, tourism, retail, and energy. According to the World Bank (2023), these non-financial sectors have propelled the Kenyan economy to a stronger and more stable position compared to its neighboring countries within East Africa. Yet, over the last decade (from 2006 to 2022), Kenya has witnessed a significant increase in the number of non-financial firms experiencing financial difficulties, resulting in regulatory supervision, suspensions, or delisting. Despite strict compliance laws and reporting structures, businesses face operational obstacles and financial distress. Previous studies have found a link between performance concerns in listed non-financial firms, such as being placed under statutory supervision, and insufficient debt financing, which has a direct influence on financial leverage (Mwangi et al., 2014). For example, the Capital Markets Authority placed Uchumi Supermarkets Limited in receivership from July 2006 to March 2010 due to its inability to meet supplier obligations (Muchira, 2015). Significant efforts have been spent at revitalizing financially distressed enterprises, frequently focusing financial restructuring (Ondari, 2019).

Retained earnings have been shown to be particularly important in the context of distressed non-financial public companies (Balasubramanian & Natarajan, 2019). Retained earnings are the portion of net income that is not distributed as dividends but reinvested in the company, reflecting the company's ability to self-finance its operations and growth (Fernando, 2024). For struggling enterprises, such as non-financial firms in Kenya, retained earnings might be viewed as a double-edged sword: According to Fernando (2024), retained earnings can be a valuable source of internal funding for enterprises that lack access to external capital. Internal finances are crucial for a company's operations, research and development, and important investments, ultimately leading

to recovery. As a result, how retained earnings are managed reveals a lot about the strategic decisions made by an organization's top executives.

A broad spectrum of industries, including manufacturing, technology, consumer products, healthcare, and services, are included in the category of non-financial firms. According to scholarly studies, these non-financial companies participate in cross-market arbitrage by switching between different types of securities when relative valuations fluctuate, leading to a negative correlation in finance flows across various markets exhibit (Ma, 2019). Non-financial enterprises, like other companies listed at the NSE, are currently dealing with the difficult circumstance of publicly traded companies suffering as a result of the ongoing economic crisis. Furthermore, investors don't seem to be as excited about stocks, which makes sense given their lower discretionary incomes and the rise of investment alternatives like real estate and private equity (Anyanzwa, 2023).

The performance and financial health of nonfinancial companies trading on Kenya's Nairobi Securities Exchange (NSE) are important factors that affect a range of stakeholders, such as managers, investors, and policymakers. But it is worth noting that a sizable portion of non-financial companies listed on the NSE have been seeing a downturn in their development and financial performance, which is detrimental to investment (Shikumo et al., 2023). According to Shikumo and colleagues, lenders don't seem to want to give money to non-financial businesses. As a result, these firms have trouble raising money for their ongoing operations. Thus, in order to make well-informed judgments about strategic financial management, it is essential to understand and assess these companies' long-term financial health.

One of the main elements affecting a company's financial health is retained earnings, which are important because they show how well-equipped the business is to reinvest earnings into its operations and maintain long-term growth. The amount of a business's net profit after taxes that is retained by the company instead of being paid out as dividends to shareholders is known as retained profits. These profits are not given out as dividends; instead, they are set aside for further investment in the business's operations. They are essential to increasing the ownership of the company's net assets by investors. Retained profits can have a significant effect on the firm's total worth (Dahmash et al. 2023).

Because they don't suffer further operating expenditures, retained earnings serve as a highly significant financial resource for organisations, improving financial performance and reducing risks. Retained earnings are often calculated using the plowback ratio, which is often referred to as the retention rate in organizational contexts (Koussis et al., 2017). Dahmash et al. (2023) states that the basic idea behind profits retention is that a company's growth chances are positively correlated with the amount of earnings it maintains. Since they don't require extra operating costs, retained earnings are viewed as an extremely important source of funding that improves financial performance and reduces risk. These profits are usually shown on the balance sheet under shareholders' equity (Fernando, 2024).

Yemi and Seriki (2014) underscore the importance of retained earnings, emphasizing their superior worth within companies. Through their research, they showed a direct relationship between firm size and a number of variables, including retained earnings, dividend payments, share repurchases, and an overall business valuation that was associated with higher profits. Furthermore, their research revealed that retained earnings play a significant role in elucidating the evaluation of market risk and financial leverage in these companies. The study specifically showed that retained

earnings had a major influence on both the firm's overall worth and its earnings per share. These findings highlight the significant contribution retained earnings make to trends aimed at optimizing financial performance.

To quantify economic phenomena, such as the nexus between retained earnings and financial performance over time, econometrics makes use of statistical inference, mathematics, and economic theory. Put differently, it transforms theoretical economic models into practical instruments for formulating economic policies. For instance, the aim of econometrics in a study relating retained earnings and financial performance is therefore to translate the declarative assertion that there is a positive correlation between retained earnings and financial performance into the declarative statement that the increase in financial performance is a specific proportion for every unit increase in retained earnings. Econometrics has enabled economic theorists' models to be transformed into forms that can be estimated by practitioners (Ouliaris, 2017). By using econometric methods, this paper recognizes that these methods have been used in disciplines of economics, including finance, labour economics, macroeconomics, microeconomics, and economic policy (Ouliaris, 2017).

1.1 Problem Statement

Research demonstrates that a considerable number of non-financial companies listed on the Nairobi Securities Exchange (NSE) continue to experience diminishing financial performance and growth, discouraging investors from investing in such companies (Shikumo et al., 2023). Yet, it is unclear if an ideal financial structure, measured through retained earnings stands to benefit financial performance and ultimate growth for such firms. Furthermore, variables such as retained earnings and financial performance are sensitive to temporal variations. However, scholars, company managers, investors, and other stakeholders particularly in the Kenyan business environment have hardly probed whether an optimal retained earnings can maximize the non-financial firm's financial growth from a temporal perspective.

1.2 Research Objective

This paper explores the econometric causal analysis of the relationship between retained earnings and financial performance in the context of non-financial firms listed at the Nairobi Securities Exchange (NSE). Our mission is to improve financial performance of such firms through evidence testing, synthesis, and interpretation that takes cognizance of the temporal and firm-specific variations. Econometrics enables the rigorous quantitative examination of economic data (Hill et al., 2018). It can therefore, handle complex relationships and provide accurate estimations of the impact of retained earnings on financial results. Moreover, econometric models can be customized to account for control factors such as sector type, firm size, and business environment that can easily affect financial performance extraneously.

2.0 Literature Review

2.1 Theoretical Literature

This research was grounded on the Pecking Order Theory, proposed by Donaldson in 1961, which suggests that company growth is best informed by funds raised internally. The theory suggests that if internal sources are unavailable, assets should be converted, debt issued, and finally, external equity as the last option. The idea communicated in this theory was that in seeking funds, firms ought to go for the option that minimizes the cost of asymmetric information (Povel & Raith, 2001). Therefore, this theory advocates for the consideration of retained earnings financing above

other sources. However, the theory has limitations, such as ignoring the impact of taxes, costs of financial distress, floating securities, agency costs, and the bundle of investments within an organization's reach. It also fails to consider lost opportunities and immunity gained due to financial slack (Bhama et al., 2016). Despite these limitations, the theory's suggestion that internal financing, which is a direct source of company income, minimizes information asymmetry and is the cheapest and most convenient financing option makes it suitable for this study.

2.2 Empirical Literature

Scholars have endeavored to explore the interrelations between retained earnings and financial performance of organization globally. For instance Okeke & Okeke (2018) conducted a study in Nigeria which examined the relationship between retained earnings and the financial success of listed companies. They used an ex post facto research methodology from 2010 to 2016, focusing on retained earnings (RE) as one of the independent variables, the results showed that RE positively and significantly impacted financial success of the listed firms. Businesses with more retained earnings typically had stronger financial results. However, the study acknowledged a flaw in its methodology, suggesting a potential reciprocal relationship between retained earnings and performance. Therefore, this paper used the panel data research design with the understanding that this design highlights prevailing stability.

Abebe (2016) conducted a study on privately held manufacturing firms in Ethiopia, and found that retained earnings significantly influenced financial performance (ROE) using the RE model. The research, based on annual reports and financial statements of ten companies, was conducted using the EViews programme. The findings suggest that a similar study involving listed non-financial organizations is needed to replicate these findings in a wider context, since Abebe's focus was on private corporations, typically for-profit purposes.

Oganda et al. (2022) conducted a study on nine listed manufacturing companies on the Nairobi Securities Exchange (NSE) to examine the impact of retained earnings financing on their financial performance. The study found that retained earnings significantly impacted the firms' financial performance using the dynamic unbalanced panel approach. However, the study needed to use an alternative proxy for financial performance other than Tobin's Q leading to ROE in this research. Besides, unbalanced panels as used by Ogada et al. (2022) comes with weaknesses such as reduced statistical power, presence of bias, and lack of robustness. Therefore, this research ensured that panels were balanced.

In another study, Omollo et al. (2018) examined the effect of equity financing on the financial performance of non-financial enterprises. The study involved 40 non-financial companies listed between 2009 and 2015 using panel econometric methodologies. The research used variables such as total assets, retained profits, and total equity as measures of financial success. The findings showed that the retained earnings significantly impacted Return on Assets (ROA), suggesting that holding onto earnings improved the company's asset-based financial performance. The study suggested that corporate finance managers should focus on using retained earnings more widely and rely less on issuing common shares to improve their company's performance. However, the retained earnings had no discernible impact on ROE, suggesting a more research focusing on ROE bearing in mind the temporal variations. Therefore, basing on the limitations of the reviewed empirical studies, we hypothesized that:

H_0: *Retained earnings have no significant temporal effect on financial performance of non-financial firms listed at the NSE.*

3.0 Methodology

This study employed the panel data research design anchored in the positivist research paradigm. This design combines cross-sectional and time series data, and allowed the observation of retained earnings and return on equity (ROE) over a period of time at a regular frequency. The study was conducted at the Nairobi Securities Exchange (NSE), the primary stock exchange in East Africa, to investigate the impact of retained earnings on non-financial companies' financial performance, utilizing the NSE's diverse portfolio of listed companies. The study targeted 51 non-financial sectors listed on the Nairobi Securities Exchange (NSE) in 2016, including agricultural firms, automobiles and accessories, commercial & services, construction & allied, energy & petroleum, insurance, investment, investment services, manufacturing & allied, telecommunication, and real estate investment trust. Data was sourced from the annual reports of these sectors from 2016 to 2022, providing a diverse representation of non-financial firms operating within the NSE during the specified time frame.

This research utilized a purposive sampling technique to identify annual reports of non-financial listed firms from 2015/2016 to 2021/2022. The sample size included 42 firms with complete and suitable financial reports from various sectors. After excluding companies lacking complete data, the actual sample size was determined to be 42 firms. The financial reports were downloaded from the NSE website, and unnecessary details were removed using key performance indicators (KPIs) and financial ratios. A thorough cross-verification process was conducted to verify the accuracy and reliability of the collected data. The audited financial statements of quoted companies were compared with the Security and Exchange Commission's NSE fact books, ensuring the data's integrity.

The data was analyzed using STATA version 15 software for econometrics, ensuring accuracy, consistency, and completeness. Descriptive statistics were generated to establish the data distribution for panel data regression. The analysis further used the fixed effects model to confirm the direct effects of retained earnings on financial performance by testing the hypothesis, establishing the suitability of the data distribution for panel data regression.

4.0 Results

4.1 Descriptive Statistics

Financial performance of non-financial firms was measured in percentage while retained earnings were measured earnings per share which was in level. Therefore, the two measures were transformed using natural logarithms to Ln FP and Ln ROE respectively prior to using them in analysis. The return on equity (ROE) percentage used as a measure of financial performance showed a negative mean of -19.1%, indicating that shareholders were not receiving positive returns on their investments (Table 1). The high standard deviation of 229.8 signifies significant variability in ROE values, indicating disparities in profitability among the companies. The distribution of ROE was highly skewed to the left, indicating that most companies had low ROE. The positive kurtosis of 184.6 suggests heavy tails and a sharp peak, indicating common negative ROE values.

Table 1: Descriptive Statistics for ROE

Percentiles	ROE	Smallest	Other Parameters	Value
1%	-550.6	-3489.7		
5%	-83.3	-1534.4		
10%	-36.1	-550.6	obs	294
25%	.32	-477.4	Sum of Wgt	294
50%	6.17		Mean	-19.1
		Largest	Std. Dev.	229.8
75%	13.1	74.5		
90%	29.5	75.1	Variance	52833.5
95%	49.9	95.3	Skewness	-12.8
99%	75.1	293.9	kurtosis	184.6

Source: Survey data 2023

The earnings per share of the non-financial firms showed a positive mean of 6.95, indicating average profitability (Table 2). The standard deviation was 18.3, suggesting moderate variability. A positive skewness of 2.87 suggests a long tail on the positive side, indicating high earnings per share values. A positive kurtosis of 12.1 indicates a distribution with heavy tails and a sharp peak, indicating common occurrences of extremely positive earnings per share values.

Table 2: Descriptive Statistics for Retained Earnings

Percentiles	EPS	Smallest	Other Parameters	Value
1%	-16.4	-37.4		
5%	-3.92	-30.8		
10%	-2.05	16.4	obs	294
25%	.05	-14.0	Sum of Wgt	294
50%	1.2		Mean	6.95
		Largest	Std. Dev.	18.3
75%	5.12	85.3		
90%	26.5	88.1	Variance	336
95%	49.1	89.9	Skewness	2.87
99%	88.1	91.3	Kurtosis	12.1

Source: Survey data 2023

Table 3 presents the results of the Breusch–Pagan/Cook-Weisberg test for retained earnings. These results show a significant chi-square statistic (13.51) and a low p-value (0.002), indicating strong evidence against the null hypothesis of homoskedasticity, and therefore confirming the presence of heteroskedasticity in the regression residuals.

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Table 3: Results of the Breusch-Pagan/ Cook-Weisberg Heteroskedasticity Test

Variable	Breusch-Pagan/ Cook-Weisberg Chi2(1) Statistics	Prob >Chi2
Retained Earnings	13.51	0.002

For each of the two variables, the Levin-Lin-Chu root tests produced strong evidence against the null hypothesis, as seen by the impressively low p-values for all test statistics (Table 4). The adjusted t* test result for financial performance was -27.3, with a p-value of.000. This suggests that there was at least one panel with consistent behaviour over time leaving financial performance stationary. Likewise, there was compelling evidence against the existence of unit roots in at least one panel according to the adjusted t* test statistic for retained earnings. The corrected t* test statistic of -10.3 yielded a p-value of.000, suggesting the presence of stationary behaviour in some panels.

Table 4: Levin-Lin-Chu unit-root test

H_0: Panels contain unit roots		Number of panes	= 42
Ha: Panels are stationary		Avg. number of periods	= 7
		Stat.	p-value
Ln ROE	Unadjusted t	-34.5	
	Adjusted t*	-27.3	.000
Ln RE	Unadjusted t	-14.3	
	Adjusted t*	-10.3	.000

4.2 Effect of retained earnings on financial performance of listed non-financial firms

The main aim of this study was to establish the relationship between retained earnings (Ln RE) and financial performance (Ln ROE) of non-financial firms listed at the NSE. Results of the Hausman test run to decide between the fixed effects (FE) and random effects (RE) models revealed a significant chi-square statistic ($\chi 2$ (1) = 30.1, $p<0.05$), an indication that the FE model was suitable. The regression analysis between the transformed values (Ln ROE on Ln RE) yielded a statistically significant coefficient ($\beta=0.702$, $p<0.001$) as demonstrated in Table 5. Therefore, these results that retained earnings related positively with financial performance in listed non-financial firms trading at the NSE, such that, a unit increase in retained earnings would result in a 2.02 units ($e^{0.702}$)in financial performance.

Table 5: Financial performance regressed on retained earnings

Ln FP	Coef.	Std. Err	t	p>|t|
Ln RE	.702	.057	12.30	0.000
Intercept	1.54	.067	23.10	0.000
Hausman test	Chi 2 (1) =30.08, p=0.000			

Therefore the postulated null hypothesis presupposing that retained earnings had no significant on financial performance of listed non-financial firm in an econometric framework was not supported, showing that retained earnings have the potential to offer direction on the future behaviour of financial performance in these firms.

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Discussions

The descriptive statistics for retained earnings, revealed a robust source of finding highlighted by a positive mean retained earnings that indicated overall profitability for the non-financial firms in question. Such a finding resonates well with Okechukwu and Ekweromu (2020) who in their investigation demonstrated financial health among firms posting positive retained earnings.Meanwhile, Fernando (2024) identifies retained earnings as the cumulative net earnings. Therefore, our results showing a positive retained earnings with moderate variability is indicative of the fact that by leveraging retained earnings, listed non-financial firms need not have financial performance constraints.

Indeed, the potential possessed by retained earnings to turn around financial performance in listed non-financial firms is underscored by the fixed effects model showing the positive and significant direct effect that retained earnings have on financial performance. Therefore, this study confirms that a unit increase in retained earnings potentially raises financial performance of listed nonfinanacial firms by 2.02 units. In documenting such a finding, this study mirrors previous findings (Okeke & Okeke, 2018; Yemi & Seriki, 2018), but more importantly, paves a way for exploiting retained earnings to spur the financial growth in nonfinancial companies listed on the NSE.

In essence, the finding of this study reinforces the findings of other studies that have, albeit using different proxies of retained earnings and financial performance shown the central contribution of retained earnings to the financial performance among firms (Kibor, 2018; Ochieng, 2018). However, this study scopes new dimensions by not only featuring nonfinancial firms but also exploring the cross-sectional and temporal perspectives of the variables. The use of the fixed effects model steers this study beyond its peers, conducted not only in Kenya but also in other contextual settings which only applied classical regression models (Dahmash et al., 2023; Nduati & Wepukhulu, 2020; Pibowei et al., 2021). The FE model under the econometrics framework enables this study to give a more accurate account of the effect of retained earnings by addressing the misnomers of unobserved heterogeneity among the firms (Breuer & deHaan, 2023), catering instead for time-invariant heterogeity and by extension, assuring robust results.

Summary

Through descriptive statistics, the study confirmed that listed non-financial firms covered a diverse landscape, with slightly more than a half of them posting profitability as demonstrated by a median earning per share of Ksh1.2. Skewness and Kurtosis values were high, indicating a concentration of firms with higher retained earnings and a few firms with exceptional profitability. The fixed effects model revealed robust results showing a positive and significant relationship between retained earnings and financial performance, and particularly the ultimate direct influence that retained earnings have on financial performance of listed nonfinancial firms.

5.0 Conclusion

The financial performance of NSE-listed non-financial firms is significantly influenced by retained earnings. The higher the level of retained earnings, the better the financial performance. Strategic earnings management can enhance financial performance by ensuring stability, growth and resilience in the market where competition prevails. It underscores how important sound financial management, together with prudent decision-making, is for long-term prosperity at the NSE. But

the differences in earnings per share reflect differences in the financial position of these firms justifying more temporal-oriented enquiries.

6.0 Recommendations

Following the findings and conclusions drawn, several recommendations are made. The Pecking Order Theory emphasizes the importance of internal financing sources in shaping a firm's financial architecture. Listed nonfinancial firms should therefore leverage this theoretical to prioritize retained earnings, in which case they may navigate volatile market conditions and economic uncertainties. Balancing accumulation allocation of retained earnings is crucial for sustainable growth and financial resilience in today's competitive business landscape. Stakeholders in the nonfinancial sector should seek to leverage retained earnings to enhance financial performance and achieve resilience in the volatile market conditions. Directing internal funding sources such as retained earnings towards sustainable initiatives can only guarantee long term growth and market positioning. Nonfinancial firms should aim to balance retained earnings and dividend payout to maximize financial performance in times of information asymmetry. Future research should therefore focus on replicating these findings in diverse nonfinancial firm contexts to enhance external validation.

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