Detailing Your Retained Earnings for EOFY

Companies can pay out shareholders with earned profit, but can also decide to retain a certain amount to reinvest within the company. This is known as Retained earnings. It is a cumulative amount generated by the company since its inception, after dividends are declared and is used for research and development, equipment replacement, debt reduction or cash savings. In publicly held companies, retained earnings reflects the profit a business has earned but not has distributed to its shareholders.

Retained earnings are listed as a line item on the company's balance sheet under shareholders equity, and are sometimes referred to as accumulated earnings, earning surplus or unappropriated profit.

Retained earnings are required for all financial statements when determining the future direction of a company at the end of financial year, and are used alongside the income profit and loss statement, balance sheet and statement of cash flow. Financial institutions, lenders, banks and other public companies require a retained earnings statement.

How Do You Calculate Retained Earnings?

Retained earnings are calculated using this formula:

Beginning Retained Earning + Net Income/Loss – Dividends Paid = Retained Earnings

To calculate your retained earnings, make sure you use the correct financial statements. These include your previous year's balance sheet or the opening balance from the general ledger. The balance can be found in the Owner's Equity section of the balance sheet.

Calculate your net income and loss, keeping accuracy a priority. Make sure you've included depreciation in the net income. Losses can also include negative shareholder equity and can be a serious indication of business health. If your business pays your shareholders dividends, the amount will need to be deducted from the net income to determine retained earnings. If your company is private, you will not need to necessarily pay dividends.

Calculate your beginning earnings, add the net income, subtract dividends paid to work out your retained earnings.

Retained earnings have four components.

Last year's reserves: Retained earnings are the cumulative net profit carried forward that has not yet been distributed

PAT: Retained earnings will grow with a high profit after tax

Dividend: The amount after tax that is distributed to shareholders after a portion of it is kept for the company to use

Depreciation: Depreciation is a non-cash expense for the company that is shown in the profit and loss section of the balance sheet

It is the company's responsibility to use the retained earnings in a wise and effective manner. There are several ways the company may proceed to invest:

Reduce debt: Debt is a company's liability. The more liability a company has, the less attractive it is to investors. A company with low liabilities will incur less associated risk.

Buy fixed assets: The company may use the retained earnings to buy assets in which to grow and expand the business with the aim to increase profits.

Purchase investments: Another way to grow the worth of the business is to invest in bonds, fixed deposits, mutual funds, stocks, takeovers, real estate, or funding start-ups. The company may also buy back its own stock, effectively making rarer stock more valuable.

Keep liquid cash: The company may opt to keep some cash to be ready to make investment purchases if they come up during the year.

Why Do You Need To Calculate Retained Earnings?

Calculating retained earnings is a helpful way to work out your cash projections or create your yearly budget for your business. Any changes or movement with net income will directly impact the retained earnings balance. This could include an increase or decrease in net income and will show if a company is genuinely profitable and can invest in itself. The reinvestments help boost future profits. If a company has negative retained earnings and shows an accumulated deficit, the company will have more debt than earned profits.

Investors want a financially stable company. Steady evidence of a business to prove it can earn profits as well as offer a steady increase in dividends will attract more investors, grow and build more wealth. Effective use of retained earnings will also show how the business is expanding.

Public companies need to satisfy their shareholders and keep their confidence and their investments. A combination of dividends and reinvestments will keep the company attractive and shareholders interested in keeping their funds and/or shares in the company.

For a small or new company, retained earnings will help bring in new investors. A new company that brings in dividends will keep investors pleasantly surprised.

Limitations of Retained Earnings

Retained earnings must be taken in context, as with any financial performance measure. A company's general situation must be taken into account before placing too much value on retained earnings. If a company has an accumulated deficit, it might also indicate need for financial assistance.

Correctly calculated retained earnings are a great way to determine a company's health and strength in the marketplace. The data is a director to be used for financial projections or creating a yearly budget for your business. Care needs to be taken when interpreting the data. Knowledgeable advice from a tax accountant will help steer your business towards future growth.

ITP Tax Accountants have helped Australia individuals and businesses for 50 years, and are highly trained in specialist areas of tax and investing. Speak with an ITP Tax Accountant today for business advice.