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# EFFECT OF RETAINED PROFITS ON PERFORMANCE OF SUPERMARKETS IN TRANS NZOIA COUNTY, KENYA

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***Abstract:*** **This study analyzed effects of financing structure on financial performance of supermarkets. The study aimed to specifically determine the effect of retained profits on performance of supermarkets. The study was informed by Pecking Order Theory and Tradeoff Theory. The study adopted an explanatory research design to show cause effect relationship. The target population of this study was 210 comprising of 4 supermarkets operating within Kitale central business district. The study used simple random sampling of 137 respondents that were used in the study. Five points like at scale questionnaire was used to collect data. SPSS version 20 aided to analyze Quantitative data using descriptive statistical methods such as mean. Inferential statistic such as Pearson correlation coefficients *r* and multiple regression models was used. The study findings indicated that there is a significant relationship between retained profits and performance of supermarkets, ($p<0.05$). The study concludes that retained profit affect performance of supermarket through reinvestment. The study recommends that; the supermarkets should prioritize on the use of retained profits to increase stock.**

***Keywords*: Effect, Performance, Profits, Supermarkets.**

## I. INTRODUCTION

Supermarkets are of great socio-economic significance. However, their long-term growth and competitiveness has been compromised by the chronic and often acute constraints on their access to formal-sector finance, among other systemic and institutional problems in developing countries (According to Abor and Quartey, 2010). One of the primary causes of large enterprises failure is non-availability of external sources of finance (Beck, 2007). A large percentage of large enterprises failure is attributed to inadequate financial structure or resource poverty and lack of managerial competency.Financial structure decision is the mix of debt and equity that a company uses to finance its business (Damodaran, 2001). Financial structure has been a major issue in financial economics ever since Modigliani and Miller showed in 1958 that given frictionless markets, homogeneous expectations, etc, the financial structure decision. This conclusion depends entirely on the assumptions made and analyzing their effects, the theory seeks to determine whether an optimal financial structure exists or not, and if so what could possibly be its determinants. Hence, the relationship between financial structure decisions and firm value has been extensively investigated in the past few decades. In Africa, financial access has been found to be critical for Small and medium enterprises (SMEs) growth and development, and the availability of external finance is positively associated with productivity and growth. However, access to financial services remains a key constraint to SME growth and development, especially in emerging economies (GFPI, 2011). One of the principal conclusions of modern economics is that finance is good for improving performance (Cecchetti & Kharroubi, 2012) of small and medium enterprises (SMEs) such as supermarkets (Beck & Demirguc-Kunt, 2006; Mohd Shariff et al. 2010; Mohd Shariff & Peou, 2008). In Kenya the supermarket is not a new concept in Kenya, having had the first store of its kind in the 1960s (Neven and Reardon, 2005). Some of the old players in the retail industry are Uchumi supermarkets, founded in the mid-70s and Nakumatt supermarkets, founded in 1987. However, much growth was not seen within the retail chains until the mid-90s when supermarkets grew from 5 to the current over 300 stores in Kenya (Kamau, 2008; Neven and Reardon, 2005). These range from well-established retail chains to independent one store supermarkets.

**Statement of the Problem:**

In Kenya, the performance of supermarkets has continued to decline over the years. GoK, (2014) indicate that virtually most small enterprises had collapsed leading to the closure of some of the enterprises that were producing 40% of the employment in Kenya. Others enterprises were auctioned while some were merged or acquired signifying questionable financial performance. Between 2001 and 2002, the enterprises performance dropped by 56% (Kenya Economic Survey, 2003). Despite supermarkets using different sources of financing some of them are still stagnated and others are failing, this is attributed to lack of knowledge on the best sources of financing. In addition, capital structure decision-making is even more complicated when it is examined in an international context, particularly in developing countries where markets are characterized by controls and institutional constraints (Boateng, 2004). Therefore, this study analyzed effects of financing structure on financial performance of supermarkets.

**General Objective:**

To determine the effect of financing strategies on performance of supermarkets in Trans-Nzoia County, Kenya.

**Specific Objectives:**

To determine the effect of retained profits on performance of supermarkets in Trans-Nzoia County, Kenya

**Hypotheses:**

There is no significant relationship between retained profits and performance of supermarkets in Trans-Nzoia County, Kenya

## II. LITERATURE REVIEW

**Pecking Order Theory:**

According to the pecking order theory (POT) (Donaldson, 1961; Myers and Majluf, 1984; Myers, 1984), asymmetries of information between insiders and outsiders will force the company to prefer financing by internal resources, then by debt and finally by stockholders' equity. Supermarkets are often opaque and have important adverse selection problems that are explained by credit rationing and therefore bear high information costs (Psillaki, 1995). These costs can be considered null for internal funds but are very high when issuing new capital. Supermarkets prefer debt to new equity mainly because debt means lower level of intrusion and lower risk of losing control and decision-making power than new equity.

The pecking order theory suggests that firms follow a certain hierarchical fashion in financing their operations. They initially use internally generated funds in the form of retained earnings, followed by debt, and finally external equity. The preference is a reflection of the relative cost of the available sources of funds, due to the problem of information asymmetries between the firm and potential finance providers. This means that it is more costly to use external debt finance than using internal funds (Myers and Majluf, 1984).

It is worth noting that the pecking order theory is criticized on the grounds of its underlying arguments and suggestions. Adedeji (1998) concludes that the suggestion of pecking order theory, that it is only the internal funds shortage that motivates firms to raise funds externally is questioned. This is because it ignores other theories and the effects of institutional factors that might affect the firm’s choice of financing instruments such as the level of interest rate, borrower-lender relations and finally, the government intervention. Cull and Xu (2005) argued that sometimes reinvestment of firm’s profits in the large scale projects is conditional by its ability to generate funds externally. He concludes that investment is lumpy, since internal and external funds are needed to finance the available profitable projects. Moreover, he argued that the government intervention through the monetary policy during the financial crisis may make the cost of borrowing lower than the cost of internal funds. Consequently, firms use debt before internal fund. This theory is therefore relevant to this study since helps in understanding why supermarkets use the financing strategies they do and therefore helping the study determine the effects of those choices on performance of supermarkets in Trans Nzoia County, Kenya

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**Conceptual Framework:**

The overall objective of this study was to determine the effect of financing strategies on performance of supermarkets in Trans-Nzoia County, Kenya. The retained profits which was measured by amount of money reinvested, pay-off debts, increase in stock and expanding in business. The dependent and independent variable were summarized in the conceptual frame work below:

**Conceptual Framework:**

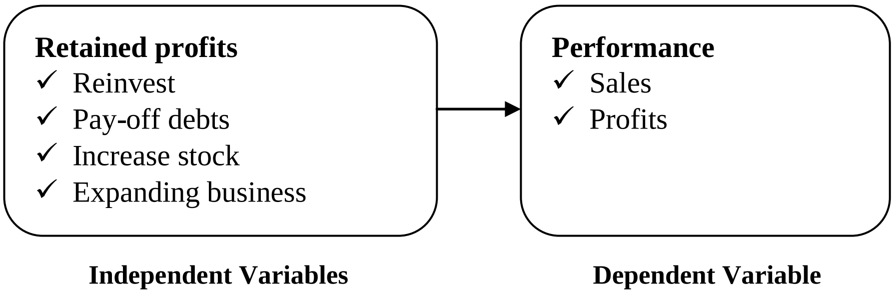


**Figure 2.1: Conceptual Framework**

**Effect of retained profits on performance:**

Revenue retentions also called retained earnings or retained surplus refer to the portion of a company's profits that is kept for reinvestment into the business or for debt payments, instead of being paid out rather as dividends to shareholders hence an improvement in firm performance (Chasan, 2012). Due to the fact that only few options are available for raising capital, most executives generally prefers cash from operations as a major source of capital for re-investment and firms' growth. Consequently, some organizations prefer to retain more earnings and plough it back into operations especially when they have viable investment opportunities (Campbell, 2012).

Whereas some investors may not be pleased if their organization increased amounts of earnings retentions, Ball (2013) postulates that retained earnings are one component of the corporation's net-worth and it increases the supply of cash that's available for acquisition and repurchase of outstanding shares. To this end, earning retentions can be utilized to create value for the shareholders (Hobson et al, 2012). However, Burgstahler & Dichev (1997) posited that misapplication of capital when a manager notes that they have a lot of cash at disposal may arise; which would instead destroy value.

Campbell, (2012) notes that the prime idea behind earnings retention is that the more the company retains the faster it has chances for growth and improved financial performance. Retained earnings are usually recorded under shareholders' equity on the balance sheet (Dinayak, 2014). Also related with periodically retained earnings are the accumulated retained earnings, which are computed by adding net income to or subtracting any net losses from beginning retained earnings and subtracting any dividends paid to shareholders (Dinayak, 2014).

Also, retained earnings can be expressed as a ratio, commonly known as retention ratio of plowback ratio. The retention ratio is also known as the retention rate of an organization (Orwel, 2010). Regarding earnings retentions Chasan (2012), stated that there is always a conflict in determining the ratio or earning to be retained. While the managers of the company want a higher earnings retention ratio, the shareholders of the company would think otherwise, as the higher the plowback ratio the more uncertain their control over their shares and finances are. Notably, retentions are a sacrifice made by equity shareholders and increase a firm's performance. According to Orwel(2010)they are internal sources of finance available to an organization and have got many advantages. As internal source, retained earnings are readily available for use. Also, retentions are cheaper than external equity, do not cause ownership dilution, and have got a positive connotation as the stakeholders perceive that the company has potential investment opportunities. However, they have demerits in that retained earnings is a limited source of financing, and the fact that they have a high opportunity cost since they are a foregone dividend by equity holders (Chasan, 2012). On the other hand, Khan &Zulfiqar (2012) states that growth of a company is not only influenced by earnings retention but, because of other sectors of the company. Furthermore, the dividend the dividend irrelevant theory - postulation that the dividend policy of a firm does not affect the net return of an investor assuming that unpaid dividends are reinvested by the company to generate more profits and higher stock returns (Choi, Kim, & Lee, 2011). In addition, Edmans et al. (2007) posits that, investors prefer to have a higher retention ratio in a fast growing business, and lower retention ratio in a slower growing business.

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## III. RESEARCH METHODOLOGY

In this study, descriptive design was used to describe facts in the field. The target population of this study comprised of 210 employees drawn from 4 supermarkets. Yamane (1973) sample size formula was used to select a sample size of 137 employees. The study used quantitative method to analyze data by use of SPSS by measures of central tendency such as mean, mode and standard deviation. Regression analysis was used to test the relationship between the independent variable and dependent variable. The multiple regression model was used is given as; $y_1 = a_i + b_1X_1 + \varepsilon$, Where $Y_1$= large firms performance, $a_i$ = constant, $\beta_1$ = the slope which represents the degree in which firm performance changes as the independent variable change by one unit variables, X1= Retained profits and ε = error term.

## IV. DATA PRESENTATIONS, ANALYSIS AND DISCUSSIONS

### Effect of Retained Profits on Performance of Supermarkets:

The study sought to determine the effect of retained profits on performance of supermarkets in Trans-Nzoia County, Kenya. The findings are presented in table 1.1

**Table 1.1: Effect of Retained Profits on Performance of Supermarkets**

| | | 5 | 4 | 3 | 2 | 1 | T | M |
|---|---|---|---|---|---|---|---|---|
| The company gets to keep retained earning | F | 55 | 43 | 9 | 4 | 1 | 112 | 4.31 |
| money to reinvest in the business. | % | 49.1 | 38.4 | 8.0 | 3.6 | 0.9 | 100 | 86.2 |
| The company gets to keep retained earning | F | 43 | 38 | 23 | 6 | 2 | 112 | 4.02 |
| money to pay off debts | % | 38.4 | 33.9 | 20.5 | 5.4 | 1.8 | 100 | 80.4 |
| The company uses retained earnings as it is free | F | 41 | 39 | 24 | 5 | 2 | 112 | 3.99 |
| to use for raising loans in future. | % | 36.6 | 34.8 | 21.4 | 5.4 | 1.8 | 100 | 79.8 |
| The use of retained earning has improved firm | F | 46 | 46 | 14 | 4 | 2 | 112 | 4.16 |
| performance | % | 41.4 | 41.4 | 12.5 | 3.6 | 1.8 | 100 | 83.2 |
| The firm prioritizing on use of retained profits | F | 38 | 39 | 25 | 7 | 3 | 112 | 3.91 |
| to increase stock | % | 33.9 | 34.8 | 22.3 | 8.2 | 2.7 | 100 | 78.2 |
| We prefer use of retained profit in expanding | F | 44 | 42 | 18 | 6 | 2 | 112 | 4.07 |
| our business because has no interest | % | 39.3 | 37.5 | 16.1 | 5.4 | 1.8 | 100 | 81.4 |

The findings on the effect of retained profits on performance of supermarkets indicate that a majority of the respondents 86.2% were of the opinion that the company gets to keep retained earning money to reinvest in the business, 83.2% held that the use of retained earning has improved firm performance, 81.4% held that they prefer use of retained profit in expanding our business because has no interest, 80.4% held the company gets to keep retained earning money to pay off debts, 79.8% held that the company uses retained earnings as it is free to use for raising loans in future while 78.2% held that the firm prioritizing on use of retained profits to increase stock. These findings indicate that the main effect of retained profits on performance of supermarkets was that the retained earnings was reinvested in the business. This is important for the business since it served as a source of funds which was easily available for the company, without interest enabling the company to expand its operations and business. These findings concur with Ball (2013) whose study postulates that retained earnings are one component of the corporation's net-worth and it increases the supply of cash that's available for acquisition and repurchase of outstanding shares. To this end, earning retentions can be utilized to create value for the shareholders. These findings also concur with Campbell, (2012) who notes that the prime idea behind earnings retention is that the more the company retains the faster it has chances for growth and improved financial performance. Retained earnings are usually recorded under shareholders' equity on the balance sheet. Jiang, Li, & Lin, (2014) also argued that retained profit provide crucial financial and operational performance indicators regarding a company's health. Fairfield & Jorratt Luis, (2016) noted that key line items, profit and retained profits, demonstrate a company's profitability level and how well it uses its own resources to grow. Profit appears on the income statement and cash flow statement. Retained profits show up on the balance sheet and cash flow statement. According to Hein, (2013) retained earnings or profit are either reinvested in the company to assist with stabilization and expansion or retained to strengthen the company's balance sheet. Profits retained by the company become equity and appear on the balance sheet as a component of owners' equity. Zucman, (2014) noted that retained earnings is one of the financial statements that any publicly traded company is required to publish on at least an annual basis. Retained earnings are essentially a company's bottom line net profit.

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**Performance of Supermarkets:**

The study sought to determine the performance of supermarkets in Trans-Nzoia County, Kenya. The findings are presented in table 1.2

**Table 1.2: Performance of Supermarkets**

| | | 5 | 4 | 3 | 2 | 1 | T | M |
|---|---|---|---|---|---|---|---|---|
| Growth in sales in relation to your | F | 38 | 50 | 10 | 10 | 4 | 112 | 3.96 |
| expectations | % | 33.9 | 44.6 | 8.9 | 8.9 | 3.6 | 100 | 79.2 |
| Growth in sales in relation to your | F | 37 | 50 | 11 | 10 | 4 | 112 | 3.94 |
| competitors | % | 33.0 | 44.6 | 9.8 | 8.9 | 3.6 | 100 | 78.8 |
| Growth in profits in relation to your | F | 67 | 33 | 8 | 3 | 1 | 112 | 4.44 |
| expectations | % | 59.8 | 29.5 | 7.1 | 2.7 | 0.9 | 100 | 88.8 |
| Growth in profit level in relation to | F | 43 | 47 | 13 | 7 | 2 | 112 | 4.09 |
| your Competitors | % | 38.4 | 42.0 | 11.6 | 6.2 | 1.8 | 100 | 81.8 |
| Increase in number of employees | F | 43 | 44 | 18 | 5 | 2 | 112 | 4.08 |
| | % | 38.4 | 39.3 | 16.1 | 4.5 | 1.8 | 100 | 81.6 |
| Increased market size in new markets in | F | 31 | 60 | 16 | 2 | 3 | 112 | 4.01 |
| relation to your | % | 27.7 | 53.6 | 14.3 | 1.8 | 2.7 | 100 | 80.2 |
| Increased market size in new markets in | F | 38 | 53 | 13 | 7 | 1 | 112 | 4.07 |
| relation to your competitors | % | 33.9 | 47.3 | 11.6 | 6.2 | 0.9 | 100 | 81.4 |
| Growth in capital from operations | F | 25 | 55 | 16 | 11 | 5 | 112 | 3.75 |
| | % | 22.3 | 49.1 | 14.3 | 9.8 | 4.5 | 100 | 75.0 |

The findings on the performance of the supermarkets indicate that 88.8% of the respondents were of the opinion that growth in profits in relation to your expectations, 81.8% said growth in profit level in relation to your Competitors, 81.6% said increase in number of employees, 81.4% said increased market size in new markets in relation to your competitors, 80.2% said increased market size in new markets in relation to your, 79.2% said growth in sales in relation to your expectations, 78.8% said growth in sales in relation to your competitors while 75.0% said growth in capital from operations. These findings indicate that the major indicator of performance in the supermarkets was growth in profits in relation to their expectations. These findings indicate that the major way the supermarkets were able to determine their performance was by looking at their profits in relations to their expectations. Every supermarket has set targets of performance therefore when a supermarket looks at their profit levels in relation to their expectations they are able to determine their performance.

**Correlation Analysis:**

The study carried out a correlation analysis to determine the relationship between the variables. The findings are presented in table

**Table 1.3: Correlation Analysis**

| | | Retained profits | Performance of supermarkets |
|---|---|---|---|
| Retained profits | Pearson Correlation | 1 | .352** |
| | Sig. (2-tailed) | | 0 |
| | N | 112 | 112 |
| Performance of supermarkets | Pearson Correlation | .352** | 1 |
| | Sig. (2-tailed) | 0 | |
| | N | 112 | 112 |
| **. Correlation is significant at the 0.01 level (2-tailed). | | | |
| *. Correlation is significant at the 0.05 level (2-tailed). | | | |

The results of the correlation analysis indicate that there is a significant relationship between retained profits and performance of supermarkets P= 0.000, and performance of supermarkets. This means that retained profits influence the performance of the supermarkets.

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**Regression Analysis:**

The study carried out a regression analysis to determine the relationship between the independent and dependent variable. These is presented in table 1.4 Table 1.4 Regression Analysis

| | | | | | | |
|---|---|---|---|---|---|---|
| | | | **Model Summary** | | | |
| | Model | R | R Square | Adjusted R Square | Std. Error of the Estimate | |
| | 1 | .448[a] | 0.2 | 0.17 | 0.4728 | |
| | a. Predictors: (Constant), Retained profits, | | | | | |
| | | | **ANOVA[b]** | | | |
| **Model** | | Sum of Squares | df | Mean Square | F | Sig. |
| **1** | Regression | 5.993 | 4 | 1.498 | 6.704 | .000[a] |
| | Residual | 23.913 | 107 | 0.223 | | |
| | Total | 29.906 | 111 | | | |
| **a. Predictors: (Constant), Retained profits** | | | | | | |
| **b. Dependent Variable: Performance of the supermarkets** | | | | | | |
| | | | **Coefficients[a]** | | | |
| **Model** | | Unstandardized Coefficients | | Standardized Coefficients | T | Sig. |
| | | B | Std. Error | Beta | | |
| **1** | (Constant) | 2.35 | 0.366 | | 6.422 | 0 |
| | Retained profits | 0.178 | 0.05 | 0.315 | 3.584 | 0.001 |
| **a. Dependent Variable: Performance of the supermarkets** | | | | | | |

The model summary indicated that about 44.8% of the regression model could be accounted for in the study. As shown from the table F= 6.704, p<0.000

The ANOVA table for the regression indicated that the results computed using the regression model were significant meaning that the regression model had been computed well and not by chance. Performance of supermarkets = 2.35 + 0.178 (Retained Profits) + 0.366 (Error Margin). Therefore, performance of supermarkets can be summed up as the sum total of retained profits plus the error margin.

**Hypothesis Testing using the Multiple Regression Model:**

The hypothesis stated that there is no significant relationship between retained profits and performance of supermarkets in Trans-Nzoia County, Kenya. The study rejected the hypothesis with a ($\beta = 3.584$, $p = 0.001$). These findings indicate that there retained profits significantly influenced the performance of the supermarkets. This could be attributed to the fact these retained earnings were ploughed back to the business giving the supermarkets more capital to work with expand their operation and increase their performance. These findings concur with Orwel (2010) whose study indicated that retained earnings are internal sources of finance available to an organization and have got many advantages. As internal source, retained earnings are readily available for use. Also, retentions are cheaper than external equity, do not cause ownership dilution, and have got a positive connotation as the stakeholders perceive that the company has potential investment opportunities improving performance.

## V. SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

**Summary of the Findings:**

**Effect of Retained Profits on Performance of Supermarkets:**

The findings on the effect of retained profits on performance of supermarkets indicate that a majority of the respondents 86.2% were of the opinion that the company gets to keep retained earning money to reinvest in the business, 83.2% held that the use of retained earning has improved firm performance, 81.4% held that they prefer use of retained profit in expanding our business because has no interest, 80.4% held the company gets to keep retained earning money to pay off debts, 79.8% held that the company uses retained earnings as it is free to use for raising loans in future while 78.2% held that the firm prioritizing on use of retained profits to increase stock. These findings indicate that the main effect of retained profits on performance of supermarkets was that the retained earnings was reinvested in the business. This is important for the business since it served as a source of funds which was easily available for the company, without interest enabling the company to expand its operations and business.

**Conclusion:**

On the effect of retained profits on performance of supermarkets, the study concluded that retained profits are reinvested to the business. The main effect of retained profits on performance of supermarkets was that the retained earnings are reinvested in the business. This is important for the business since it serve as a source of funds which was easily available for the company, without interest enabling the company to expand its operations and business.

**Recommendations:**

The supermarkets should prioritize on the use of retained profits to increase stock. This is because retained profit is a great source of funding for the supermarkets since the shareholders themselves determine their retention policy. These retained profits also finance the operations of the business effectively without encountering a lot of hustle to gain the capital

**Areas of further research:**

More research should be carried out to determine other factors that affect financing strategies on performance of supermarkets. Factors such as managerial competency and financing decisions in small and medium-sized enterprises (supermarkets) are recommended for future study. This would enable the researchers and investors to mitigate effects of such factors and hence enhance performance of supermarkets.

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