JMEE
Journal of Marketing and Emerging Economics
| e-ISSN: 2792-4009 | www.openaccessjournals.eu | Volume: 1 Issue: 5

Internal Financing in the Business Entities

Khotamkulova Madina Kizi, Zaynalov Jakhongir Rasulovich

Samarkand Institute of Economics and Service

Abstract:

This article analysis the internal sources of financing of the business entities, the differences between internal and external financing as well as, positive and negative aspects of the internal financing tools. Researches have been conducted based on the official information and statistics of both local and international organizations and scientific works in this sphere.

Key words: financing, business company, internal financing, external financing, funds.

Introduction:

All business organizations need finance to fund their operations as funds are required for almost all business activities. In the absence of money, it is not possible to utilize other resources. The amount may vary but all organizations need funds to run their business and they use either external or internal financing recourses to improve their activities. It should be noted that external and internal financing differ from each other based on the several aspects and we tried to deeply analyze the effects of both internal and external financing on the business process and made suggestions about when it is better to use internal financing instruments rather that external ones.

Literature Review

To begin with, it should be noted that several scientific works and literatures have been analyzed and referenced in order to make clear statements on this subject. Stam E. and Garnsey E.[1] refer that the funds can be raised for short term or for long time duration. The sources for finance for short term duration and for long term duration are different. Like, for long term duration the funds can be raised from equity shares, which is a perpetual source of finance. Long term loan can also be raised either from bank or from financial institutions. All these sources are external sources of finance. If an organization wants finance for short term, the external sources are overdraft facility from the bank or other short term credit facilities offered by banks and financial institution. Most of the time, the organizations resort to internal sources of finance for the purpose of meeting their short term financial needs. This is due to the ease of availability of funds and least involvement of cost. Internal sources of finance are trade credit, advance from customers, retained profits, undistributed dividend, depreciation charged on the fixed assets etc. Furthermore, it is stated that [2] the internal sources of finance are the short term sources of finance and the amount getting utilized need to be replaced for the purpose for which it is in the business. The business organization has access to these funds for short duration. These funds can be used by the organization for the duration for which these are available in the organization. A business organization can also sell off its assets which are of no further use, in order to release funds [3]. Moreover, scientists note that [4] the business can be started using either own money or borrowed money. In either case, once the business is established, it should generate profit. Once the business starts rolling, it meets up its own expenses. The operating cycle starts with cash and if it ends at cash, there is no issue, as the business always has cash to enter into next operating cycle. Finance is needed by all business organizations for n number of reasons. There can be numerous requirements for which a business organization may need funds. There can be business expansion, replacement of assets, non materialization of receivables, nonpayment from debtors, bulk purchase of raw material, receipt of large order, disturbance in cash cycle etc. To raise funds, a business organization has many choices, considering the amount required, the duration for which amount is required and the cost involved in raising and using this amount. Further, the risk involved in raising the funds, the degree of control management has to loose in a particular source of finance and the repayment schedule should also be considered, prior to raising funds from any source. The choice of the source of finance would depend on thought full consideration of all these factors and after thoroughly analyzing all the factors, the management of the business organization would select a specific source of finance to fulfill its requirements. If for any reason, a company needs cash or it needs finance, it can raise funds either through long term sources of finance of short term sources of finance.

Copyright (c) 2021 Author (s). This is an open-access article distributed under the terms of Creative Commons Attribution License (CC BY).To view a copy of this license, visit https://creativecommons.org/licenses/by/4.0/

JMEE Journal of Marketing and Emerging Economics
| e-ISSN: 2792-4009 | www.openaccessjournals.eu | Volume: 1 Issue: 5

Methodology of the research

The methodology includes historical analyzes, systematic analyzes, and graphic methods. Statistics have been made by the help of official statistics of Uzbekistan

Results

Following study has been conducted to identify main sources of internal financing in the business entities and followings have been revealed. One of the main sources of internal financing is asset sales. If you have machinery, computers, inventory or other assets you can sell quickly, you can raise cash to put out fires or expand your business. You might have to sell assets below market value to get cash in quickly. In some instances, you might eventually need an asset you're considering selling when you get back on your feet. Sometimes, it's worth it to sell an asset even if you have to replace it at a higher cost later. Depending on how old an asset you sell is, you might be able to depreciate the new asset enough to make the sale and new purchase less burdensome. Consider a sale-and-leaseback agreement that allows you to get cash for an asset but lets you continue to use it to make your product or operate your business. Your business is also an asset if necessary, considering selling part of your company to an investor or taking on a partner to get cash in.

The most obvious source of internal financing is using cash you've got on hand from the sale of your products or services. This doesn't include amounts you must set aside to pay your bills. In some cases, you can negotiate delayed payments with creditors to allow you to use that cash. If you don't depreciate your assets, talk to a tax accountant about doing so. This will help you reduce you income tax liability and let you use some money you've set aside for tax payments for financing needs. If your company has done well enough that you've invested your excess cash rather than let it sit in a checking account, you can use that money to fund business needs. Make sure you know what penalties you might have for early withdrawal of your funds. If you're seeking internal funding because you don't want to pay interest on outside loans, calculate how much potential gain you'll lose by liquidating an investment vs. how much interest you'll pay on a credit card purchase or loan.

If you have slow receivables, consider offering a discount to get them in quicker. If you have customers you know will be ordering from you in the future, offer them a discount on future purchases if they prepay. Contact a factor to discuss selling your receivables. Factors often buy receivables at a significant discount but are a viable option in an emergency situation. Following diagram 1 illustrates main sources of internal financing.

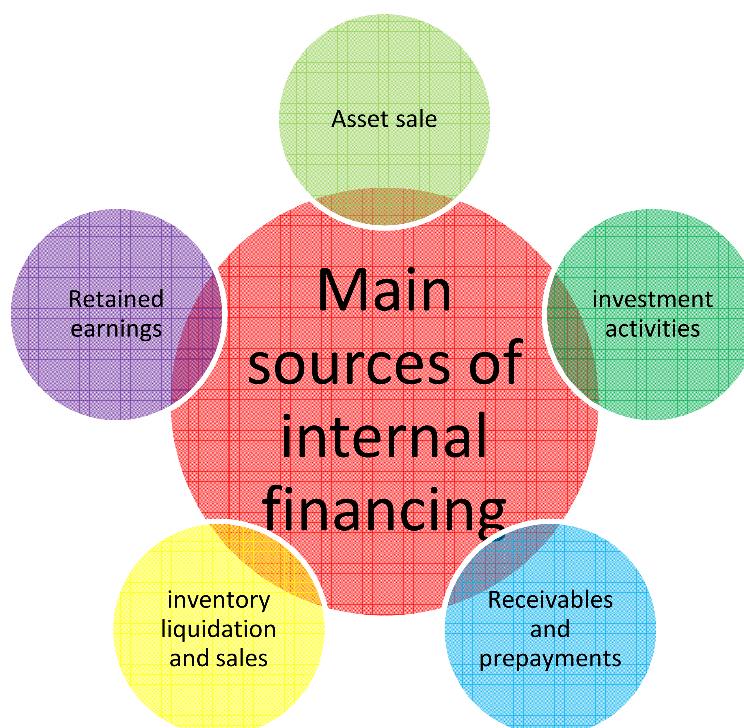

Diagram 1

ISSN 2792-4009 (online), Published under Volume: 1 Issue: 5 in October-2021
Copyright (c) 2021 Author (s). This is an open-access article distributed under the terms of Creative Commons Attribution License (CC BY).To view a copy of this license, visit https://creativecommons.org/licenses/by/4.0/

Main sources of internal financing[5]

Several studies have been conducted to analyze the differences between external and internal sources of financing and following table 1 illustrates the main differences between them.

Table 1 Differences of external and internal financing [6]

№	Internal financing	External financing
1	The finance is generated within the business	The finance is sourced from the outside of the business
2	Internal sources are used when the requirement of funding is limited	External sources are used when the requirement of funding is huge
3	Cost of capital is pretty low	Cost of capital is medium to pretty high
4	The idea is to limit the business within a boundary (may be not to grow so big)	The idea is to expand from local to national to global
5	The amount of capital is low to medium	The amount of capital is medium to huge
6	No collateral is required.	Most of the time, collateral is required (when especially the amount is huge)

As it can be seen from the above given table 1 there are several differences between internal and external financing sources of the business entities and it is can be concluded from that table that the method of the financing significantly influence on the performance of the company. For example, if the business entity wants to finance its short term activities financing it through external sources would have negative effects on the business as the interest rates and the required period for acquiring the fund are relatively high. The following research have been conducted to deeply analyze the merits and demerits of the financing the business with the help of internal funds.

It should be noted that internal sources of finance can have many advantages for a business but they come with some disadvantages as well. When it comes to the positive sides of the internal financing following can be referred.

1) No dilution of ownership and control. For example, if a business funds its finance through equity finance, the new equity holders will have to be given some form of control over the decisions of the business for the capital they have invested in the business. Generally, equity instruments also come with voting rights for companies. This means that new investors coming into the company will also get to make and contribute to the decision-making process of a business. This may prove bad for a business as it may cause conflicts between existing owners and new owners. New owners of the business may not share the same ideas and vision for the business as the old owners. This finance may come with some sort of restrictions on the use of the asset. This means the asset will no longer be in the full control of the business.

2) No Legal Obligations. Internal source of finance comes with no legal obligations to pay anyone. This is different from other sources of finance such as debt finance where the business is legally obliged to pay the debt providers. In case these obligations are not paid on time, the business may also have to face legal actions. Businesses also have to pay interest to the debt providers for the finance they have provided to the company. The same does not apply to internal financing.

3) Lower Cost . For example, if a company wants to obtain equity finance, it will have to comply with stock market regulations and also pay fees involved with issuing shares, etc. Similarly, the company has to pay interest fees and offer assets as security to obtain debt finance. Both of these costs are avoided when internal financing is used.

4) No Approvals Needed. When funds are generated internally, the business does not need permission of equity or debt holders to use these funds. This can also make the decision-making process of a business slower and vital opportunities might be missed waiting for approval.

5) Improves the Value of the Business

Internally generated funds also help improve the value of the business. These funds retained in the business help increase the value of the equity instruments of the business. Furthermore, internally generated finance, unlike debt finance, improve the gearing ratio of a business which makes investment in the business attractive for potential investors.

ISSN 2792-4009 (online), Published under Volume: 1 Issue: 5 in October-2021
Copyright (c) 2021 Author (s). This is an open-access article distributed under the terms of Creative Commons Attribution License (CC BY).To view a copy of this license, visit https://creativecommons.org/licenses/by/4.0/

6) Helps Improve Business Credit Rating. Financial institutions are more likely to give loans to a business that can show the potential to generate finance to repay the loan. Moreover, unlike debt finance, it does not adversely affect the credit rating of a business.

Internal financing can also have some disadvantages, as below:

1) Not Ideal for Long-term Projects. When internal finance is used to fund the activities of the business, the growth is limited by the rate at which the business can generate internal finance. A business is highly unlikely to generate enough internal finance to fund long-term projects at a constant rate. Therefore, external finance is always needed and preferred when investing in long-term projects. In addition, using internally generated funds to finance long-term projects needs proper planning and forecasting. This requires accurate forecasting to predict the exact returns and time of those returns for it to be effective. Once internal financing is used for a long-term project, the business also needs to keep tight control over the project to ensure the funds are recovered. If the spending is not closely controlled, the business might have to face bankruptcy threats.

2) Effects of Other Business Operations

If an internal source of finance is used to fund a long-term project, this may adversely affect the daily operations of the business. Using internal finance to fund a long-term project means the internal finance has to be generated from somewhere.

3) Loss of Tax Benefits

Debt financing comes with the benefit of tax deductions for the interest payments made by a business. When internal finance is used, this tax benefit is lost. For businesses that pay a high tax percentage based on their income, an internal source of finance may not be beneficial.

4) No External Expertise or Networks

External sources of finance may also bring expertise or networking opportunities to businesses. For example, when venture capitalists invest in a business, they bring expertise and networking to businesses, which is invaluable in itself for startups. When the internal source of finance is used, this advantage is lost.

In short, it can be said that businesses can choose between using internal or external sources of finance for their activities or upcoming projects. Using an internal source of finance can give the business many advantages such as avoiding dilution of ownership and control, lower costs, and improving the business value. However, it may come with some disadvantages such as not being ideal for long-term projects, loss of tax advantages, and loss of expertise and networking.

Conclusion

A business organization may need financial resources on many accounts. There may be regular need of money to run the business or there may arise special need for certain period. The regular requirement of funds is fulfilled using regular sources of finance like cash generation from business activities or working capital etc. Long term financial needs are taken care by perpetual source of finance that is equity or debt sources like loan from bank or financial institutions or bonds or debentures or even preference shares. All these are long or medium term sources of finance. For any urgent requirement, the business organization looks inside for funds. Outside the organization, there are sources like overdraft and short term loan from bank or financial institution, to raise funds for short term financial needs. Basically, there are four combinations of raising funds. Firstly, long term external, secondly, long term internal, thirdly, short term external and fourthly, short term internal. The internal sources of finance are company’s retained earnings, trade credit, advance from customers, accumulated reserves, unpaid liabilities or bills, unpaid interest or dividend etc. These sources are risk less sources of finance for the company. These sources do not involve any cost as these are company’s own funds. There is no risk of dilution of control or decision making while using internal sources of finance as these are companies own funds. Besides these advantages of internal sources of finance, there are certain limitations as well. Firstly, the amount is not really large and secondly, it is available for short time duration. The funds also have opportunity cost. Even then, the internal sources of finance remain the most attractive sources for the organization as these are organization’s own funds, in one or the other manner.

References:

1. Stam, E., & Garnsey, E. W. (2008). Entrepreneurship in the Knowledge Economy. Centre for Technology Management (CTM) Working Paper, No. 2007/04. http://dx.doi.org/10.2139/ssrn.1923098 viewed: 17/09/2014

ISSN 2792-4009 (online), Published under Volume: 1 Issue: 5 in October-2021
Copyright (c) 2021 Author (s). This is an open-access article distributed under the terms of Creative Commons Attribution License (CC BY).To view a copy of this license, visit https://creativecommons.org/licenses/by/4.0/

| e-ISSN: 2792-4009 | www.openaccessjournals.eu | Volume: 1 Issue: 5

2. Berk Jonathan and Peter Demarzo, Financial Management, 2016, Pearson India Education Services Pvt. Ltd., Noida.
3. Reynolds, P.D. (2011). Informal and Early Formal Financial Support in the Business Creation Process: Exploration with PSED II Data Set3. Journal of Small Business Management, 49(1), 27-54.
4. Babatunde, M. A., & Olaniran, O. (2009). The effects of internal and external mechanism on governance and performance of corporate firms in Nigeria. Corporate Ownership & Control, 7(2), 330-344.
5. Based on the information of https://smallbusiness.chron.com/internal-sources-finance-47552.html
6. Based on the information of https://www.wallstreetmojo.com/internal-vs-external-financing/

ISSN 2792-4009 (online), Published under Volume: 1 Issue: 5 in October-2021
Copyright (c) 2021 Author (s). This is an open-access article distributed under the terms of Creative Commons Attribution License (CC BY).To view a copy of this license, visit https://creativecommons.org/licenses/by/4.0/