Internal Sources of Finance for Business Organizations

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Abstract

All business organizations need finance to fund their operations. Funds are required for almost all business activities. Money has been identified as an important 'M' along with machines, material and manpower. 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. 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 (FIs). Debentures or bonds, which actually are loan from individual, can also be used for long or medium term finance. Preference share, which is a hybrid security to raise finance, can also be used as a source of long or medium term finance. 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 FIs. 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. 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. Financial resources are regularly required by the business organization. Business organizations acquire funds from several sources but the finance from internal sources is cheapest.

Keywords: Sources of finance, internal sources of finance.

Introduction

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. A further classification of these sources brings out another two classes viz. external sources of finance and internal sources of finance. Thus, there become four classes of sources of finance, long term external sources, long term internal sources, short term external sources and short term internal sources. All sources of finance can be categorized in at least one of these classes, assuming medium term sources to fall into the category of long term finance. Looking at the internal sources of finance, both long term and short term sources are included in this category. Internal sources of finance are used by the business organization usually when it requires funds for short time. Here, the choice of funds would depend upon the availability of fund in a particular head. Internal sources of finance are preferred by the companies due to the advantages these sources carry.

Sources of finance – An introduction

A business organization raises funds from many sources. As already mentioned these can be internal or external and long term or short term. Basic classification of finance sources is equity or debt. Equity is the perpetual source of finance for the company. The funds raised through equity shares always remain with the company and the company does not have to repay it to the equity share holders. In fact, equity share holders become owners of the company and are paid dividend. On the contrary, debt is to be repaid on a pre specified date along with interest charge. Almost all sources of finance can be classified broadly into these two categories. Funds through debt are raised by issuing debentures or bonds or by getting loan from bank or FIs. In between equity and debt, there is hybrid security called as preference share, having the feature of both debt and equity. Preference shares are medium term source of finance. Other long term or medium term sources of finance can be public deposits, corporate deposits etc. These sources are external to the company. For short term sources of finance, the company can opt for overdraft facility from its account or it can avail short term loan from bank or FIs. Besides these the company has other sources like retained earnings, undistributed dividend, trade credit, advance from customers, receivables, factoring etc. The choice of source of finance depends upon many factors such as amount, duration, cost etc. The business organization would first analyze its requirement and then would take decision regarding the source.

Internal sources of finance

A business organization has access to many sources of finance. These sources are external as well as internal sources. The sources of finance internal to the organization are as follows:

a. Retained earnings: The best source of finance for an organization is its retained earnings. Retained earnings are the part of profits which are not distributed as dividend to equity share holders. Retained earnings are the asset belonging to equity share holders, in the shape of reserves and surplus. Retained earnings is an easily available resource. The company has full access to its retained earnings. It is an easily available fund source. The cost of retained earnings is though treated as equivalent to the cost of equity but in actual, there is no cost involved as the funds are already with the company itself. From the viewpoint of risk also, retained earnings is a safer source for the company as it is company's own money.

b. Accumulated depreciation: All companies own fixed as well as current assets. The company charges depreciation on fixed assets. Depreciation is charged with the objective of funding the replacement of the fixed assets at the end of economic life of the asset. Till the asset comes to the end of its economic life, the accumulated depreciation amount can be used by the company. Accumulated depreciation amount is also risk less source of finance for the company as the accumulated amount is with the company itself.

c. Advance from customers: Advance received from customers can also serve as an internal source of finance for the business organization. Advance received from customers can serve as an important internal source of finance for large organizations. Large organizations when receive order from customers usually get advance payment. Smaller organizations may face problems in receiving advance payments. Advance payment is also received by the companies who are manufacturing special products. Any customer placing special order would also pay in advance to the company. Companies receiving order for tailor made or customized products may also receive advance payment from customers. It becomes really helpful in financing short term requirement of working capital. Advance payment from customers is thus a significant source of internal finance.

d. Trade credit: When a company receives goods, materials, equipments or services without making cash payment, it is called trade credit. Trade credit is a pseudo source of internal financing as no cash is available but there is the facility to pay cash to the supplier, at a later date. The benefit of trade credit is that the company does not have to arrange for cash to pay immediately but gets time for the payment. For this reason, trade credit is considered as a pseudo source of internal financing for the company.

e. Reserves: Another important source of internal finance for the company is the reserves maintained by the company. Many types of reserves can be maintained by the company and the amount contributed to the specific reserve can be used by the company till the date of use of that reserve for the specific purpose. Reserves also do not include cost as this are lying with the organization itself.

f. Unpaid liabilities: The organization has many liabilities, current as well as long term liabilities. All the liabilities are not payable immediately and the liability to be settled on a later date makes the funds available for another use. This way, unpaid liabilities can serve as the source of internal finance for the organization.

g. Unpaid dividend: The dividend is the part of profit which is paid to preference share holders and equity share holders. Rate of dividend for preference share holders is pre decided and fixed. The residual profit is distributed as dividend among equity share holders. Till the day dividend is not actually distributed, the amount can be used for another activity.

h. Unpaid interest on debentures etc.: Any unpaid interest on debentures or other debt instruments can also be used by the organization for other activities. There are specific dates on which such interest is payable and till that date the amount involved can be used for some other activity.

i. Cash generated from sale of assets: During the course of business, it may happen that the organization sells an asset not being used by it or if an asset is being replaced by new one and the old one is sold. In such cases, cash is generated which has no stipulated use. This cash can be used by the organization as an internal source of finance, in case of requirement.

j. Savings in transactions: this again may be treated as a pseudo source of internal finance. Savings in transactions can be done on account of availing cash discounts or better bargaining position. The amount thus saved can be used for some other activity by the organization.

Advantages of internal sources of finance

The companies have the choice of acquiring funds from external sources or to use the funds from the sources internal to them. If the company raises funds from external sources, it has many types risk to face. The first risk is of the dilution of control if the funds are raised from equity. As equity share holders are the ultimate owners of the company and also have voting right, the probability of loosing control increases if the funds are raised through equity. Second risk in the case of external sources is exertion of excess control if debt sources are used. Banks and financial institutions may exert unnecessary control over the functioning of the company and interfere in the decision making of the company if more amount of loan is taken from them. Third risk involved in the financing from external sources is of operational obligation of paying dividend to equity share holders or to pay interest to debt providers. Payment of interest on debt and repayment of debt amount is a legal obligation on the company. So the risk of bankruptcy also increases. Fourth issue involved with the external sources is the cost of procurement of the funds. In almost all the sources of external finance, there is acquisition cost involved and further the cost of that particular fund source is also to be borne by the company.

All the points mentioned above become the advantages of internal sources of finance for the company. First of all the funds are already in the company so there is no cost involved in the procurement of the funds. Internal sources of finance are risk less from the view point of the company, as these are company's own sources. There is no obligation of any type, regarding payment of dividend or interest, in case of internal financing. Thus, there is no probability of default in payments by the company. Another advantage of internal sources of finance is that there is no danger of lose or dilution or distribution of control over the company. As the sources are internal to the company and company is using its own funds, there is zero probability of loss of control or decision making power. Internal sources of finance are thus, advantageous to the organization in many ways.

Limitations of internal sources of finance

Internal sources of finance prove very beneficial to the organization but these also have certain limitations. These limitations are related to the amount, duration, misuse of funds etc. The first limitation of internal sources of finance is that the funds available are limited in the company and these funds do have multiple uses. The company has the obligation of prioritize the use of funds and accordingly the company has to deploy funds. Second limitation of internal sources of finance is the duration. These funds are available for short duration or maximum possible, for medium term. These funds cannot be employed for longer durations as these funds are already having another purpose of use and these are available till the time of their spent arrives. Since these funds are company's own funds, there is possibility of misuse of funds. As these funds do not involve cost, except opportunity cost, there may culminate a tendency to use these funds ineffectively. Prior to utilizing funds from internal sources, opportunity cost analysis may also be carried out. This would provide a clearer picture to the management of the organization regarding use of internal funds as money has multiple uses and it need to be utilized as per priority in its use. Even with these limitations, internal sources of finance are very lucrative for the business organizations, due to the advantage these sources offer.

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.

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