Course: PGDFM

Paper I

Topic: Internal Sources of Finance

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Internal Sources of Finance

The term internal sources of finance itself suggests the very nature of finance/capital. This is the finance or capital which is generated internally by the business unlike finances such as loan which is externally arranged by banks or financial institutions. The internal source of finance is retained profits, the sale of assets and reduction / controlling of working capital.

Finance is a constant requirement for every growing business. There are several sources of finance from where a business can acquire finance or capital which it requires. But, the finance manager cannot just choose any of them indifferently. Every type of finance has different pros and cons in terms of cost, availability, eligibility, legal boundaries, etc. Choosing the right source of finance is a challenge. We need to have an in-depth understanding of the characteristics of the source of finance. Let us focus first on the internal source of finance/capital.

RETAINED PROFITS / RETAINED EARNINGS

Retained profits/earnings are called the internal source of finance for a business for the simple reason that they are the end product of running a business. The phenomenon is also known as 'Ploughing Back of Profits'. Retained profits can be defined as the profit left after paying a dividend to the shareholders or drawings by the capital owners.

FORMULA FOR RETAINED PROFITS

It can be stated as below:

Retained Profits / Retained Earnings = Net Profits – Dividend / Drawings

CHARACTERISTICS OF RETAINED PROFITS

Retained earnings are a long-term source of finance for a company because there is no compulsory maturity like term loans and debentures.

Retained profits are also not characterized by the fixed burden of interest or installment payments like borrowed capital

Advantages and Disadvantages of Retained Profits as an Internal Source of Finance / Capital

ADVANTAGES OF RETAINED EARNINGS AS AN INTERNAL SOURCE OF FINANCE

The advantage of having retained profits/earnings is clearly seen in its characteristics.

1. First, they are long-term finance and nobody can ask for their payments.
2. Secondly, since there is no additional equity to be issued, there is no dilution of control and ownership in the business.
3. Thirdly, there is no fixed obligation of interest or installment payments.
4. Fourthly, retained earnings as an internal source of finance are cost-effective considering the fact that there is no issue cost attached to it which ranges between 2 – 3 %.
5. Lastly, investing retained earnings in the projects, with IRR better than ROI of the business, will directly have a positive impact on the shareholder’s wealth and thereby the core objective of management will be served.

DISADVANTAGES OF RETAINED EARNINGS AS AN INTERNAL SOURCE OF FINANCE

There is practically no disadvantage in generating or using retained earnings for financing the investments of the business. Assuming that the funds generated internally are not free as they are the funds belonging to the shareholders and the cost of these funds is equal to the cost of equity. There is only one alternative which can be explored i.e. debt financing sources. The purpose of exploring the option leads to thinking about two points. One, financial leverage that can be gained by introducing debt financing. Second, if the leverage is possible and practical, dividend decision regarding using the retained earnings to pay dividends to shareholders can be explored.