

**Organizational-economic  
mechanism of management  
innovative development of  
economic entities**

**Collective monograph edited by  
M. Bezpatochnyi**

Higher School of Social and Economic  
Przeworsk (Poland) 2019



**Mechanizm organizacyjno-  
ekonomiczny zarządzania  
innowacyjnym rozwojem  
podmiotów gospodarczych**

**Monografia zbiorowa  
pod redakcją naukową  
M. Bezpartochnego**

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Wyższa Szkoła Społeczno-Gospodarcza  
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The authors of the book have come to the conclusion that it is necessary to effectively use modern approaches the management of innovative development the economic entities in order to increase the efficiency of activity, to ensure competitiveness, to intensify innovation activity. Basic research focuses on assessing of the level competitiveness and economic security of enterprise, innovative ensuring of economic entities, analysis of human capital, estimation of alternative sources financing of innovation activity of economic entities. The research results have been implemented in the different models of formation the innovation policy of enterprise, mechanisms of innovative processes management of economic entities, introduction of crowdfunding, and improvement of the tax system for innovation development, integration of education, science and production. The results of the study can be used in decision-making at the level the economic entities in different areas of activity and organizational-legal forms of ownership, ministries and departments that promote of development the economic entities on an innovative basis. The results can also be used by students and young scientists in modern concepts and mechanisms for management of innovative development the economic entities in the context of efficient use the resource potential and improvement of innovation policy.

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### **Pakhnenko Olena**

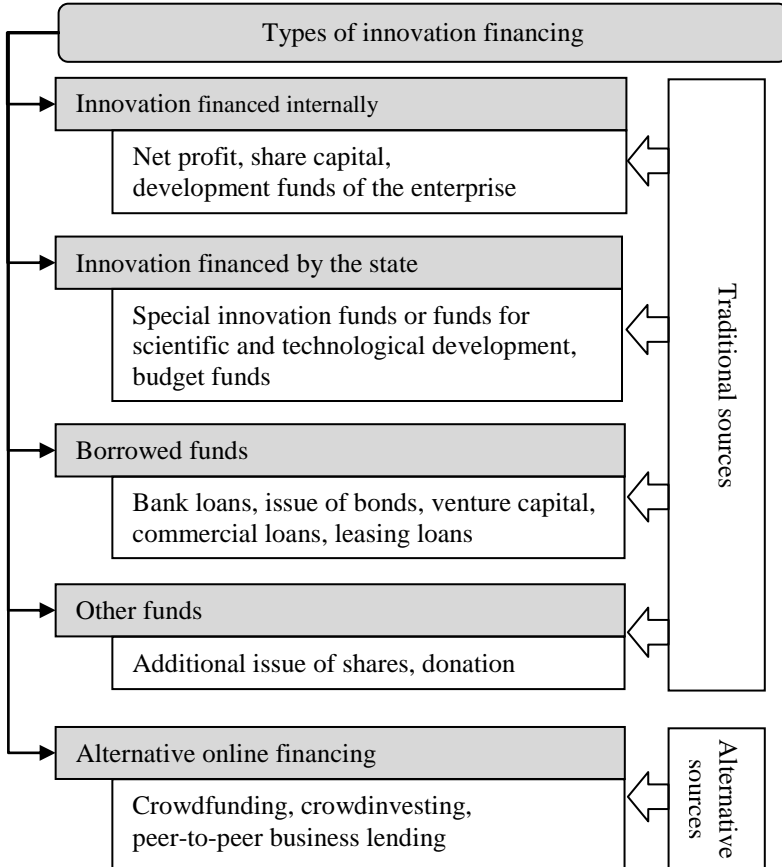
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### **ALTERNATIVE SOURCES OF FUNDING FOR INNOVATIVE ACTIVITIES OF BUSINESS ENTITIES**

The availability of financial resources is always one of the key issues for businesses. Business entities can use short-term bank loans (including overdraft, credit lines), commercial loans, factoring transactions, etc. to finance working capital. However, traditional sources of attracting financial resources are often not enough to finance innovation or their use is associated with difficulties.

The list of possible sources of financing for innovation activities, research and development is presented in Figure 4.1. In general, the main sources of financing of investment needs of enterprises are:

- self-financing (innovation financed internally);
- long-term bank loans;
- leasing loans;
- Issue of equity and debt securities.



**Figure 4.1 Traditional and alternative sources of innovation financing**

The normal situation for an enterprise is the predominance of internal financial resources. This is a sign of the autonomy of the business entity and a condition for maintaining its financial sustainability in the long run. The main source of internal financial

resources of the enterprise is net profit, and for new businesses - the authorized (share) capital.

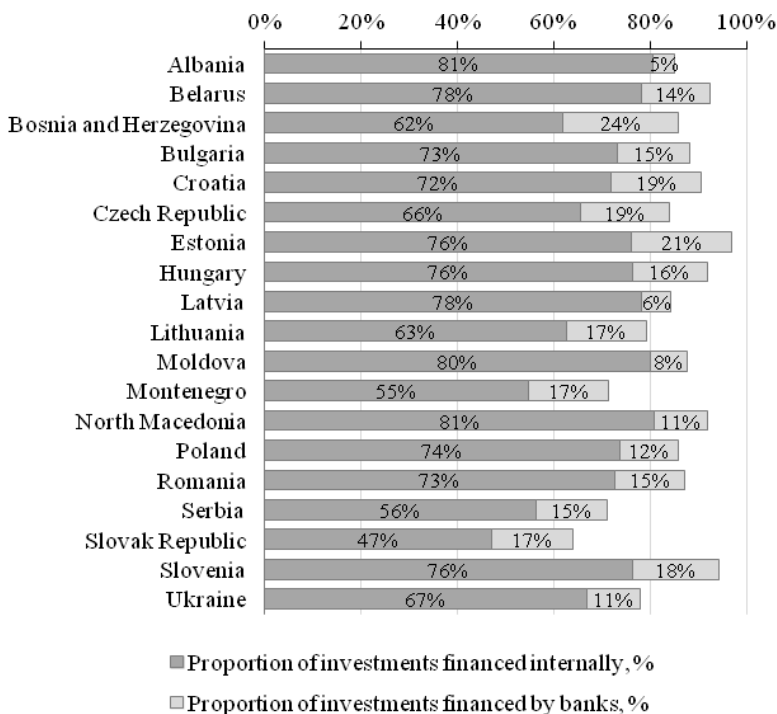
Given the riskiness of innovation and the long payback period of investments, innovative activity of enterprises is actively supported and co-funded by state specialized funds in many countries.

Nevertheless, the achievement of high rates of entrepreneurial activity and innovation activity, relying exclusively on internal business funds and government donations, seems impossible. Therefore, borrowed funds have an important role in financial support of innovation activity of enterprises. The provision of borrowed funds is based on terms of maturity, interest payment and repayment of the debt. Borrowed funds for innovation activities include bank loans; loans from non-bank financial and credit institutions (leasing loans, factoring, etc.); commercial loans and funds received from the issue and placement of debt securities (for example, corporate bonds), as well as venture capital – specific source of financing for innovation projects.

In European countries, as well as in the whole world, the greatest part of investments is financed internally from the own funds of the enterprises. The share of internal financing is about 60-70%. The actual structure of various sources of innovation financing depends on specific features of the enterprise, types of business activities, and on country profile in general. Based on data from the World Bank [2], we consider the structure of sources for investment activities financing in Eastern European countries (Figure 4.2).

The share of internal financial resources in the structure of investment activities financing of enterprises in Eastern Europe ranges from 47.2% to 80.9%. The largest share of internal sources in financing investments is inherent to North Macedonia (80.9%), Albania (80.9%), Moldova (80.0%) and Latvia (78.2%). The smallest share of self-financing of enterprises is in Slovakia (47.2%), Montenegro (54.8%) and Serbia (56.4%). These countries have the higher rate of leasing and equity financing (Montenegro), as well as a significant share of alternative sources of funding (Serbia, Slovakia).

The leaders of bank lending for investment activity in Eastern Europe are Bosnia and Herzegovina (23.9%), Estonia (20%), Croatia (18.6%) and the Czech Republic (18.5%). The share of bank lending in such countries as Latvia (6.2%) and Moldova (7.7%) is almost three times less than in leading countries of the region. The share of bank loans in providing the investment needs of business in Ukraine (11.0%), Macedonia (11.1%) and Poland (12.1%) are also low.



**Figure 4.2 Structure of sources for investment activities financing in the Eastern Europe**

*Source: [2]*

The remaining sources of external finance investments in Eastern Europe accounted for 3% (Estonia) to 36% (Slovakia) of the total investment. These sources include, first of all, leasing loans, irrevocable government and non-government donations, and debt securities issues.

Despite the diversity of traditional forms of external financing of innovation, most of them remain inaccessible to enterprises or are used restrictively, because they do not allow the attraction of funds on favorable terms or for the required period and do not always correspond to the goals and business opportunities.

Due to the development of information technologies, specialized online platforms have become a new alternative to traditional financing. Their use allows to raise funds for financing innovative business projects directly from the lender to the borrower without the financial

intermediation.

The types of alternative financing that can be used by enterprises to increase their investment funds and working capital are the following [6,7]:

- peer-to-peer business lending – borrowing from individuals and legal entities without the participation of a traditional financial intermediary through an online platform;

- reward-based crowdfunding – raising funds for an investment or other project in the absence of an obligation to pay an interest or other payment for the use of financial resources. Instead, it guarantees a non-financial remuneration to providers of funds, which may have different forms: the primary receipt of the product after its production, obtaining the goods for the better price or other benefits;

- donation-based crowdfunding – raising funds on a gratuitous and irrevocable basis, in which the recipients of financial resources do not bear any obligations to the donors;

- equity-based crowdfunding – obtaining funds from an investor in exchange for shares of an enterprise, dividends and the right to participate in management;

- profit sharing crowdfunding – raising funds from issuing securities, such as bonds and shares, with the obligation of paying out a part of company's income or profit in the form of dividends, royalties, etc. but the borrower has all control over the investment project (business);

- balance sheet business lending – business lending through an online platform, in which the loan amount is directly deducted from the account of the institution managing the platform;

- invoice trading – selling company's invoices or receivable notes to individuals and legal entities through an online platform at a discount;

- debt-based securities – selling the debt-based securities, typically bonds, to individual and institutional investors online.

Alternative business financing models are based on the use of specialized online platforms that provide a real and effective source of financial resources for enterprises. However, not all alternative financing models are eligible to finance innovation. We consider that two types of crowdfunding are best suited in order to finance innovation – reward-based crowdfunding and equity-based crowdfunding (or crowdinvesting).

Crowdfunding can provide financial resources for innovation projects in sufficient volume and on reasonable terms. This option of

financing innovation is available in both developed and developing countries. This is particularly important for many countries in Eastern Europe, where business entities significantly limited in the use of traditional sources of long-term debt, but can raise funds for their projects through crowdfunding platforms worldwide using the Internet.

Crowdfunding has several important characteristics that distinguish it favorably from the traditional channels of obtaining investment financial resources and traditional financial intermediaries (banks, stock market intermediaries), as well as from business angels and venture capitalists:

- unlike bank lending, crowdfunding platforms allow to raise funds by the start-ups and other companies at the stage of the appearance of a business idea and provide the required amount of funding on favorable terms;

- for both providers and recipients of financial resources, alternative online business financing provides such benefits as speed, simplicity and clarity of operations;

- unlike the issue of equity securities and venture financing, crowdfunding allows simultaneously obtaining the required amount of comparatively “cheap” financial resources from investors and maintaining control over the business;

- unlike all other types of financing, the availability of the crowdfunding platforms via the Internet allows for funding regardless of the geographical locations of the investor and recipient;

- crowdfunding can be applied to financing almost any kind of activity – startups, innovation, social projects, media projects and anything else that can be of interest to investors;

- crowdfunding platforms are simpler and more understandable for the recipient of financial resources, often the only requirement is to post information on the project online;

- as for investors (providers of capital), crowdfunding is not only a new area of investing and getting profit, but also an opportunity to support important and interesting business ideas and innovative projects.

However, crowdfunding also has its drawbacks and risks for both investors and borrowers. First of all, crowdfunding, as a type of alternative online finance, is implemented through the online platform and carried out without the mediation of professional financial market participants. Therefore, the functions of risk assessment and competent selection of projects rely on the investor himself, increasing his investment risks. Crowdfunding platforms can only carry out initial selection of projects that are allowed to be posted according to

predefined formal criteria.

Lack of investor control over the implementation of the project and the absence of accountability of the crowdfunding platforms to investors leads to frequent cases of fraud, the use of crowdfunding platforms and projects on the platforms for quick collection and withdrawal of funds, and not for stated purposes, innovations or other business ideas.

In addition, online crowdfunding platforms are vulnerable to cyber-attacks like any other information technology projects, which also increases the risk of losing money for crowdfunding participants.

The choice of crowdfunding projects for investing is carried out by investors on the basis of their personal preferences, values and interests [1]. Therefore, another risk for business entities when using crowdfunding is insufficient funding for the project as a result of the lack of investors interested in it.

In fact, only about one fifth of all projects receive the full funding through crowdfunding platforms. The ratio of fully funded and partially funded projects depends on their target orientation (Figure 4.3).

The most popular projects that are fully funded in 40-50% of cases are projects in the following categories: comics and graphic novels (52.1%), gaming (42.6%), charity (45.8%) and experimental (40.3%).

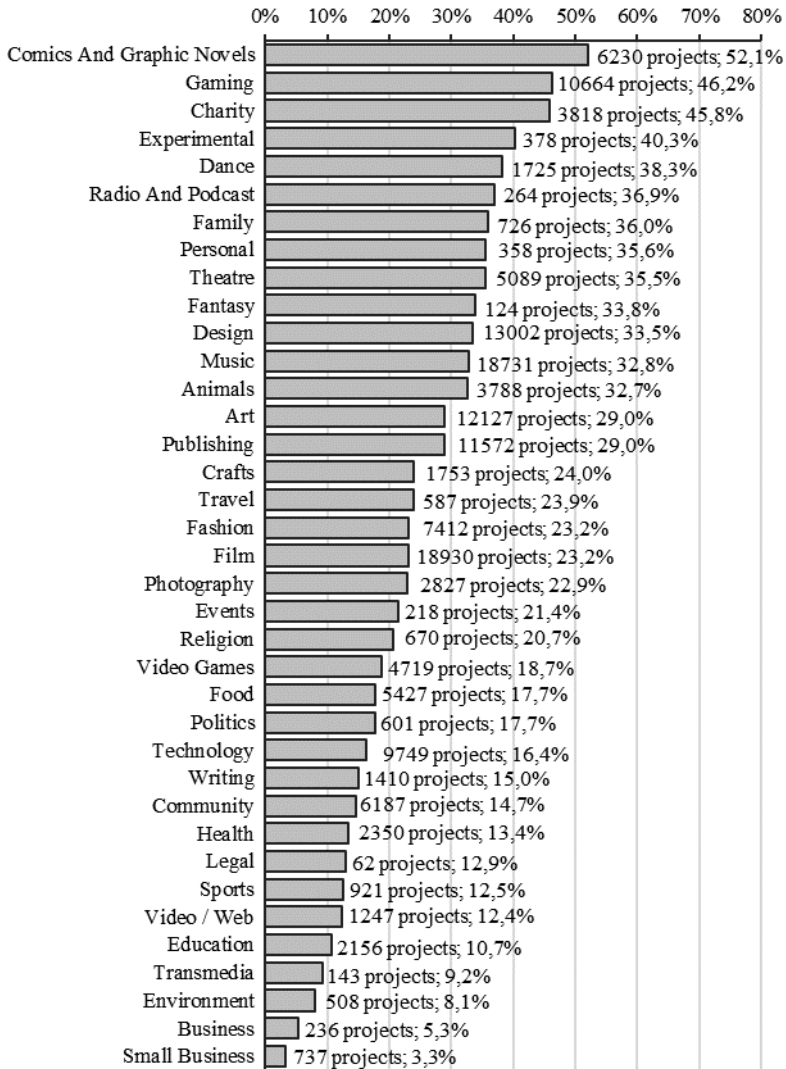
The following categories are leading in the number of projects that are fully funded through online platforms: film (18930 projects since 01/01/2014), music (18731 projects), design (13002 projects), art (12127 projects), publishing (11572 projects) and gaming (10664 projects).

The share of fully funded small business projects is the lowest compared to other categories and is only 3.2%. Business project proposals are also rarely collecting the required amount of funding through reward-based crowdfunding.

Despite the fact that 40% of experimental projects have received full funding and 9749 technology projects are already full funded through the crowdfunding platforms, reward-based crowdfunding is better suited to creative projects than to finance enterprise innovation. For these reasons, crowdfunding (equity-based crowdfunding) is often the most appropriate alternative finance option for businesses.

The key difference of crowdfunding is that investors get a stake in the company's equity and risk of losing investments. At the same time, the amount of possible profit is not fixed. Crowdfunding is an alternative financial instrument for financing new enterprises that do not have sufficient credit history or a convincing business plan for the bank.



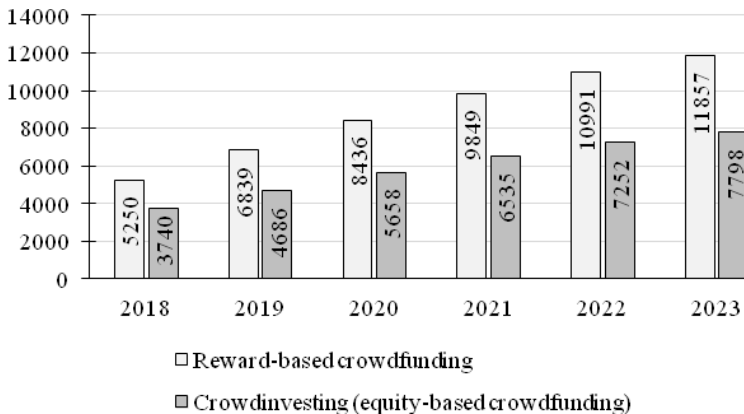


**Figure 4.3 Number and percentage of projects fully funded on crowdfunding platforms**

*Source: [5]. This figure shows the percentage and number of completed projects which ended or reached their target in each category between 01Jan2014 – 28May2019*

Equity-based crowdfunding is most attractive for non-technological enterprises that need investments to start or expand their business, but they are not interesting for venture funds and business angels specializing in investments in IT projects [3].

Despite the noted shortcomings of crowdfunding, in recent years, alternative online business financing has been developing at a very fast pace. According to Statista Digital Market Outlook the forecast value of alternative financing (including reward-based and equity-based crowdfunding) will increase on 17% in the next 5 years (Figure 4.4).



**Figure 4.4 Current and forecast value of alternative financing globally, million USD**

Source: [4]

Consequently, today the financing of investment and innovation needs of enterprises is mainly provided at the expense of internal sources (self-financing). The share of traditional sources of external financing, including bank loans and government donations, remains essential. However, the importance of alternative finance in the financial provision of innovation activity of enterprises is growing. Alternative finance is implemented through specialized online platforms without the participation of traditional financial intermediaries. The main types of alternative finance, which can be used to raise funds for innovative projects, are crowdfunding and crowdfunding. The dynamics of the European market for alternative business finance in recent years has shown the effectiveness of using such models and their benefits to finance the investment and innovation needs of businesses in comparison with traditional sources of funding.

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