ASSESSMENT OF THE COMPANY’S FINANCIAL SITUATION THROUGH LIQUIDITY AND ITS INDICATORS

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Abstract: The existence of each company is conditional on its ability to pay its liabilities. It must therefore have at its disposal a certain amount of money by which it can meet these liabilities. The ability to repay liabilities is referred to as liquidity. Assessing the financial situation through liquidity indicators and then managing it is extremely important for every company. If a company does not monitor and manage liquidity, it can lead to major problems with customers, states, employees, and other entities that are in certain relationship with the company.

Keywords: liquidity, solvency, liquidity indicators, liquidity management.

1 Introduction

Liquidity is an economic and financial term that expresses the ability of a company to pay its liabilities on time, i.e. within the maturity period. The liquid company is a beneficial business for the state economy because such a company does not cause financial problems to other entities in the economy. This means that the company pays the vendor an invoice within the maturity date, sends the payment to the bank in time for the loan repayment, pays salaries to their employees, pays the social insurance and pays the insurance premiums to the social insurance companies within the maturity date, and the tax office receives the tax payment from the company... The liquid company with the optimum amount of money ensures financial stability and a firm market position within the framework of the mutual competitiveness of companies.

2 Liquidity

Liquidity is one of the important indicators that interest the various stakeholders in the company’s interaction environment. In doing so, each entity requires a different level of liquidity. On one hand managers understand low liquidity as an untapped opportunity or a loss of control over a company. On the other hand, owners may consider this to be an inefficient tying of funds. Creditors will assume that low liquidity will be reflected in the deferral of interest collection, and customers with suppliers will expect the company to be unable to meet its liabilities, which can lead to a loss of supplier-customer relationships. For these reasons, it is necessary to manage liquidity so that the individual components of the asset acquire a cash flow in the course of their circulation before the liabilities that cover the assets in question are due.

A reliable statement of the financial situation of the company can be obtained by analysing its ability to pay its liabilities. It is true that a company that is financially stable is able to pay its liabilities and a company with financial difficulties has problems with it. The ability to pay liabilities is influenced by many factors, especially by the structure of assets and cash flow. When analysing this aspect of the company's financial situation, it is necessary to explain the terms liquidity in, liquidity and solvency, as they are often understood as synonyms.

Liquidity in is one of the characteristics of a particular type of assets. Indicates the degree of difficulty in transforming assets into cash. In the balance sheet, assets are ranked according to their degree of liquidity, i.e. according to how quickly and without major losses they can be transformed into cash. For example, inventories are generally more liquid components than components of fixed assets. Liquidity is the current ability to pay due liabilities. It depends on the structure of assets and in particular the proportion of liquid assets in it. It is considered as a criterion of short-term or immediate solvency. Solvency is the general ability of a company to obtain funds to pay its liabilities when they become due. It is one of the basic conditions for the company’s existence.

2.1 Liquidity analysis

Liquidity analysis consists of liquidity:

- vertical (liquidity of assets, liquidity of liabilities),
- horizontal (golden balance rule, liquidity ratios, liquidity differentials).

In the case of vertical liquidity, the individual components of assets and capital are assessed separately; the structure of assets and liabilities, i.e. their individual liquidity, is examined. Vertical liquidity consists of both liquidity of assets and liquidity of liabilities.

2.1.1 Liquidity of assets

The liquidity of assets is based on the differentiation of assets according to liquidity, i.e. the ability of individual components of assets to transfer their value into cash. It is characterized by the time of conversion of part of the assets into cash and the costs related to this conversion. The source base for asset liquidity is the asset side of the balance sheet. In it, the asset components are, as already mentioned, divided from the most liquid to the least liquid asset.

2.1.2 Liquidity of liabilities

Liquidity of liabilities can be characterized as the capital structure of the company. In its analysis it is necessary to monitor the ratio between foreign and own resources. Equity is a type of capital which belongs to the business owner. Foreign capital represents the debt that a company has to repay at a certain time. For the use of foreign capital, the company pays interest but also other expenses related to its acquisition. However, foreign capital is cheaper than own capital. When analysing the liquidity of liabilities, it is necessary to divide the liabilities into short and long-term. It is also necessary to monitor the ratio between foreign and equity and the ratio between foreign and total capital. The ratio between foreign and own capital reflects the debt ratio, which should not exceed 70%. The value of this indicator is of particular interest to banks, in the case of granting a bank loan.

The subject of horizontal liquidity is the analysis of the relationship between asset and liability components. The source of information is the balance sheet. Horizontal liquidity consists of a golden balance rule, liquidity ratios and liquidity differentials.

2.1.3 Golden balance rule

An important part of horizontal liquidity is the golden balance rule. Compliance with this requires that the sources of fixed assets coverage should be long-term resources (equity and long-term foreign capital), with the amount of long-term foreign capital at least equal to the value of fixed assets.

$$Fixed\ assets \leq equity + long\text{-}term\ foreign\ capital$$

The company should have as much capital as it needs. If the assets are still less than the sum of equity and long-term foreign capital, then the company is overcapitalised. This situation comes to the forefront when current assets are also covered by long-term capital. The opposite of overcapitalising a company is its undercapitalization, which is a situation where the value of fixed assets exceeds the volume of foreign resources. This other portion of fixed assets must be covered by short-term foreign capital. The case of undercapitalization occurs in the company at the time of expansion, when the company expands its production and sales, which is associated with an increase in assets not covered by financial resources. These are assets such as inventories, receivables and long-term assets.

The company is thus indebted at the suppliers and this causes the short-term foreign capital to be covered also by the long-term assets. This situation is considered unfavourable from the liquidity point of view.

$$Current\ assets \geq short\text{-}term\ foreign\ capital$$

Stated relationship relates to the ratio of current assets to short-term foreign capital. The optimal situation is when the current assets are larger than the short-term foreign capital. The difference arises from the net financial assets to the company if the current assets were acquired by the company from long-term foreign sources. Conversely, if the current assets are smaller than short-term foreign capital, the company incurs uncovered debt.

2.1.4 Liquidity ratios

The best-known liquidity indicators are liquidity ratios. Their essence is to determine the ratio between the various components of assets to short-term liabilities. “The liquidity ratios interpret the immediate, current and total liquidity of the business entity.

$$Immediate\ liquidity = \frac{finantial\ assets}{short\text{-}term\ liabilities}$$

The indicator shows the relationship between the most liquid part of assets and short-term liabilities. It is great when the indicator takes values in the range of 0.9 to 1.0, which actually means that 90 to 100% of short-term liabilities should be able to cover the company's own financial assets. For companies engaged in manufacturing activities, the range of values for this indicator is between 0.2 and 0.6.

$$Current\ liquidity = \frac{financial\ assets + short\text{-}term\ receivables}{short\text{-}term\ liabilities}$$

Current liquidity gives a partial concept of future developments in the payment situation. Short-term receivables should be receivables within maturity. We do not count on overdue receivables and bad receivables that distort the concept. Current liquidity should be in the range of 1.0 to 1.5.

$$Total\ liquidity = \frac{financial\ assets + short\text{-}term\ receivables + inventories}{short\text{-}term\ liabilities}$$

Total liquidity serves for long-term evaluation of the development of the company's solvency. The total current assets are taken into account in its calculation. When compiling the total liquidity, we do not take into consideration the degree of liquidity of individual types of inventories. A company showing an appropriate level of total liquidity may nevertheless find itself in an unfavourable situation when non-resale inventories form part of the current assets. Total liquidity should range from 2.0 to 2.5,” (Baran, 2006, p. 31 - 32).

Atypical ratios of liquidity include the insolvency indicator. “Insolvency is a ratio indicator that is calculated as the ratio of liabilities (in the strict sense) to receivables. It expresses the extent to which the receivables are covered by liabilities (in the strict sense) and indirectly suggests to what extent, in the event of immediate repayment of debts, liabilities (in the strict sense) could be settled by the receivables,” (Kotulič and collective, 2010, p. 62).

$$Insolvency = \frac{liabilities}{receivables}$$

2.1.5 Liquidity differentials

Differential liquidity ratios, together with net monetary assets and net available funds, include also net monetary capital. Net monetary capital can be calculated according to the relation:

$$Net\ monetary\ capital = current\ assets - short\text{-}term\ liabilities$$

This indicator is structurally closest to the total liquidity, which, however, puts the data in proportion, not the difference. Net monetary capital is the portion of current assets of short-term assets that is financed by long-term corporate resources. In carrying out its intentions, the company is thus free to dispose of it.

$$Net\ monetary\ assets = financial\ assets + short\text{-}term\ receivables - short\text{-}term\ liabilities$$

$$Net\ available\ funds = available\ funds - short\text{-}term\ liabilities$$

2.2 Degree of liquidity

In terms of the time when liquidity problems are examined, two basic levels of liquidity are distinguished:

- short-term liquidity,
- long-term resp. medium - term liquidity.

Short-term liquidity refers to immediate, current and total liquidity. Short-term liquidity is mainly influenced by the current status and structure of current assets and the status and structure of current liabilities. It is also influenced by the concept of the company's cash cycle and its normal operation. It can be influenced by short-term financial planning using tools with short-term financial impact.

These tools are:

- inventories management of materials, goods, semi-finished goods, work in progress and finished products so that the financial resources in these components of the assets are transformed as soon as possible into receivables and subsequently into cash,
- the management of receivables in such a way as to minimize the risk of default and to transform them into cash after the due date,
- management of cash in such a way that the undertaking has at its disposal sufficient amounts of cash or bank accounts at all times,
- management of short-term financing in the form of a fair balance of commercial liabilities and short-term bank loans.

On the contrary, long-term thus medium-term liquidity can only be influenced in the long term. The strategic financial plan is used and the following tools play a key role:

- overall business strategy aimed at expanding, attenuating, stabilizing or maintaining business activities,
- interconnection of individual business strategies,
- a thorough analysis of the effectiveness of investment projects,“ (Landa, 2007, p. 5).

3 Liquidity management

Liquidity management has a specific character and it is up to the financial managers of the company how to solve this problem. There are some general principles on how to manage a company's liquidity. They can be summarized as follows:

- avoid delays in the needs of liabilities,
- making optimal use of credit limits,

- prevent credit lines from being exceeded,
- avoiding financial sources inactivity losses;
- regulate the flow of funds,
- ensuring the availability of flexible short-term resources,
- build information systems supporting cash disposition.

The liquidity is conditioned by the volume of funds. Their condition is in turn conditioned by the cash flows that take place in the company. They are captured in cash flow statement, which also plays an important role in liquidity management. The analysis of past economic phenomena in the company are also very important. Information on these phenomena can be assessed in relation to liquidity, i.e. how they affected it. Thus, the company can plan cash flow, ensuring liquidity in the future.

At present, the understanding of liquidity management is different than in the past. Today it is not just about precise plans and cash flow forecasts. Rather, business finance managers focus on getting resources from customers and making suppliers deliver their services flawlessly. Liquidity management policy is a set of tools that improve liquidity, eliminate liquidity risk and reduce the need for net working capital. However, there are obstacles to such management. Liquidity problems and shortcomings can be summarized in two main areas:

- centralization of cash,
- control of the financial supply chain.

Cash centralization, as one of the activities for effective liquidity management, involves two tools by which cash can be centralized. The first is the real concentration of cash. In this tool, the money is kept in one master account. This creates a liquidity position across multiple side accounts. In this case, cash can be transferred from one account to the other in both directions. In the event of an excess of funds in the secondary account, the funds shall be transferred to the main account. Conversely, in the case of a negative sub-account balance, there will be a transfer of funds from the main account to the sub-account. The second tool for cash centralization is fictitious pooling. Credit and debit balances are only credited virtually, so there is no real money transfer.

The second critical area in liquidity management is business finance in the financial supply chain. While they are a critical factor, they provide an opportunity to improve risk management and process efficiency. Improving processes will ultimately help to optimize liquidity. Conversely, unmanaged commercial finance will result in reduced liquidity and cash drainage. Ultimately, managed liquidity will also lead to further improvement, not just in terms of process improvement.

Elements from the financial supply chain can also be considered as financial sources. They can also serve to increase liquidity. This form of financing is called financing secured by assets such as receivables or inventories. By selling receivables or by discounting bills of exchange, a company will receive finance for further use. Such an alternative financing option is mainly used in companies that have difficulty obtaining a traditional loan. Supply chain financing can also help improve business processes. The financial support of its suppliers is ultimately beneficial for both parties. Especially in recent years, the interest of companies in this type of financing has been increasing. However, many companies are skeptical about this type of funding. This is because financial managers do not know the benefits of this solution, companies have limited financial resources or companies overestimate their ability to extend the maturity of liabilities. However, this is an important opportunity for many companies to improve their liquidity.

"Liquidity stands and falls on the relationship between short-term assets and short-term liabilities. When managing it, it is necessary to keep in mind whether the company has sufficient funds at the moment to pay its liabilities. At any moment, each company has a certain mix of means of payment, composed of different forms of assets. They can be used immediately (cash or bank accounts) or in a short time (receivables, inventories). A company is liquid if it has sufficient amount of funds at a certain date to meet its liabilities," (Landa, 2007, p. 4).

4 Conclusion

Permanent and stable liquidity is a must for every company. If this condition is not fulfilled, it is likely that in the near future the company will encounter problems related to the inability to pay liabilities, which may lead not only to loss of competitiveness and reputation, but also to its existential problems. Insolvency entails a loss of confidence of suppliers, banks and customers. Therefore, ongoing liquidity assurance is essential for companies. This means having at its disposal the amount of funds available so that the company is able to pay its liabilities and at the same time not to commit the excess of financial resources, which then represent a loss of potential opportunities. Therefore, it is necessary for the company to balance its revenues and expenditures both in the short and in the long term. The solution to this issue is usually addressed in the financial plan and its control. The revenue and expenditure balancing process has a very specific character and is characterized by a certain degree of inaccuracy. A balanced financial plan is not always a guarantee of continuous and permanent liquidity. Deviations may occur due to different developments in actual and planned cash flow. Although the company's liquidity planning is not a 100% guarantee for continuing liquidity, it is important because it significantly increases the likelihood of achieving liquidity and helps to avoid predictable errors.

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