

THE DIAGNOSIS ANALYSIS OF FINANCIAL BALANCE BY USING LIQUIDITY

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Abstract

The financial analysis of company is the activity of diagnosing the company's state of performance the beginning to the end of the financial year, establishing the strengths and the weaknesses of the company's activity based on information provided by summary accounting documents (balance sheet, profit and loss and enclosures to the balance sheet).

The purpose of the diagnosis analysis is to identify the situation of the company at a certain time to prevent its insolvency and to adopt the appropriate measures for ensuring increased liquidity and debt payment settlement.

Keywords: financial balance, balance sheet, liquidity, cash availability, stocks, debts.

JEL Classification : M40, M41

1. Introduction

The financial statement represents the relationship between the great balance masses which should enable the firm to operate normally without treasury problems, to pay its debts at maturity and pay dividends to investors in equities.

In order to ensure the necessary liquidity and a healthy treasury, company management must take into account the financing activity to cover assets and power of attorney, it needs sources which remain available to the borrowed funds to at least the same period as the life of the assets.

Financial equilibrium can keep only if the company has availability at each maturity sufficient to extinguish the debt. As the profitability, liquidity is a necessary condition for the survival of the company. For the company not to enter into employment contracts must possess sufficient liquidity to meet short-term debts due or very short. Liquidity analysis is employed in the central financial situation of the company because the lenders are interested in its ability to fulfill its obligations of payment due dates.

Maintaining a financial balance and a better performance, must constitute a critical concern for further work in terms of profitability and liquidity.

2. The diagnosis analysis of company's liquidity

Given that balance sheet expresses truly and fairly the size of company's patrimony, presenting the image of shareholder's wealth registered by accounting, and at some point this wealth can be different if we consider the market value of the company. For this reason, in the financial analysis process emerged as necessity of elaboration the financial statement as the synthesis tool that allows assessing the wealth of the company to its real value.

The balance sheet is the document that provides those concerned information about developments of economic and financial indicators. The balance sheet summarizes the company's financial position at a particular time and income statement summarizes performance as a result of economic and financial flows during the analysis [4].

The financial statement allows verifying solvency on the short and long term providing valuable information to those interested mainly creditors to accurately assess opportunities to recover money and shareholders for the knowledge of real estate available [8].

The financial statement is that kind of balance sheet that starts to liquidity –chargeability optical, highlighting the risk of insolvency of the firm, more exactly the firm's inability to honor its commitments to third parties.

What does liquidity statement mean? It implies that current assets (less than one year) are superior to current liabilities (less than one year). For the company this means that the sale of inventories, collecting the claims and the available cash will allow paying the current debts in the coming months.

Overall, the company's financial liquidity means the ability to transform the assets from the patrimony in cash availability as the normal accomplishment of rotation funds [10].

In the specialty literature, the liquidity ratios are known as treasury ratios and are designed to measure a company's ability to pay or its solvency on the short term [9].

Liquidity measures the company's ability to deal with short-term obligations, representing the ability of the current assets to quickly turn into cash.

The analysis of the company's liquidity is achieved by using the ratios method.

The diagnosis made based on the balance sheet, in the optics of liquidity / chargeability (financial statement), is determined by ratios of liquidity, which are important primarily to see the real situation of the company, if it deals with maturing obligations on the short term and secondly because the company's management can realize comparisons of obtained results with results of other competitors [3].

Liquidity ratios used to measure the skills of the company to deal with short-term obligations and which reflect the extent to which current assets are transformed into cash are:

- a) overall liquidity ratio;
- b) intermediary liquidity ratio;
- c) immediate liquidity ratio.

To perform the diagnosis analysis I present the following information, based on the balance sheet:

Table no. 1.

The balance sheet of the firm in 2014

Active		Passive	
Permanent assets	75.316	Equity	61.103
Circulating assets, from which:	40.642	Total debts, from which:	54.855
Stocks	19.935	Debts on medium and long term	24.328
Claims	18.741	Debts on short term	30.527
Liquidities	1.966		
Total active assets	115.958	Total passive assets	115.958

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Data source: Annual financial statements as at 31 December 2014 submitted to the territorial units of the Ministry of public finance on the main issues related to the preparation and submission of annual financial statements.

Table no. 2.

The balance sheet of the firm in 2015

Active		Passive	
Permanent assets	58.759	Equity	74.282
Circulating assets, from which:	266.812	Total debts, from which:	251.289
Stocks	29.153	Debts on medium and long term	49.393
Claims	126.088	Debts on short term	201.896
Liquidities	111.571		
Total active assets	325.571	Total passive assets	325.571

Lei

Data source: Annual financial statements as at 31 December 2015 submitted to the territorial units of the Ministry of public finance on the main issues related to the preparation and submission of annual financial statements.

a) The overall liquidity ratio (R_{ol}) expresses the ability of circulating assets to turn into cash and to cover the debts of the company on short-term.

$$R_{ol} = \frac{\text{Floating assets}}{\text{Debts on short term}}$$

The overall liquidity reflects the current patrimonial components to transform into a short-term liquidity to accomplish the payment obligations due [5].

The overall liquidity is closely linked to the net working capital fund and is considered a good indicator of the firm's ability to pay its bills and repay loans [6].

To be considered a favorable situation for the company, the overall liquidity should be between 1.2 and 2, the minimum value being 1. The value higher than one unit of the ratio proves that, at least on the short term, the company has a net working capital fund positive that allows it to pay the outstanding liabilities.

A high ratio of the overall liquidity is not an effective activity because the value of the rate is influenced by the size of stocks that often is reflected by a reduced level of liquidity (slow moving inventories, inventories without movement etc.); the maximum acceptable value of overall liquidity rate is 2 [7]. When the ratio is below 1, the liquidities on short-term are less than the potential chargeabilities, the situation becomes risky, the company recording

outstanding payments, which it is equivalent to the risk of bankruptcy or insolvency. The state of short-term liquidity depends on the rotational speed of the claims and short-term obligations.

Table no. 3.

The overall liquidity ratio

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Indicators	The analyzed period		Δ	I	ΔI
	2014	2015			
Circulating assets	40.642	266.812	226.170	656,49%	556,49%
Debts on short term	201.389	449.246	247.857	223,08%	123,08%
The overall liquidity ratio	0,20	0,59	0,39	295%	195%

In the analyzed period we found that overall liquidity does not fall within accepted limits (1.2 and 2), this indicator being less than one unit (0.20 in 2014 and 0.59 in 2015) as circulating assets have the ability to cover debts on short term. Although from the analysis it is noted that in 2014 the ratio records a value of 0.20% and in 2015 a value of 0.59% which represents an increase of 0.39 in absolute value and 195% in relative value, the company is unable to honor its payment obligations due on the short term. Even though it is noted that circulating assets increased by 556.49%, in the same time increased also the debts on short-term with 123.08%, situation in which short-term funds are lower than current liabilities, the situation being critical for company. In this situation to escape from insolvency the company needs to borrow or sell some assets in order to repay debts.

b) The intermediary liquidity ratio (R_{il}) or the acid test ratio - reflects the company's ability to pay its obligations due on the short term from the circulating assets with the highest speed of rotation, other than stocks that generally are turning slower into cash. In this way the company honors its debts on the short term from claims and cash.

$$R_{il} = \frac{\text{Floating assets} - \text{Stocks}}{\text{Debts on short term}}$$

The optimal level of this ratio is 1, but is considered a value between 0.6 to 1, indicating a satisfactory situation. The value higher than one unit highlights that stocks are not financed by short-term debts but also reflects inefficient management of the claims being within the company difficulties in collecting them in the agreed terms.

Table no.4.

The intermediary liquidity ratio

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Indicators	The analyzed period		Δ	I	ΔI
	2014	2015			
Circulating assets	40.642	266.812	226.170	656,49%	556,49%
Stocks	19.935	29.153	9.218	146,24%	46,24%
Circulating assets - Stocks	20.707	237.659	216.952	1.147,72%	1047,72%
Debts on short term	201.389	449.246	247.857	223,07%	123,07%
The intermediary liquidity ratio	0,103	0,529	0,426	513,59%	413,59%

Also in the case of this indicator the value of the ratio in the analyzed period does not fall within the safe limits to ensure financial balance. Even if the intermediary liquidity ratio increased from 0.103% in 2014 to 0.529% in 2015, which represents an increase of 0.426 in absolute value and of 413.59% in relative value, the company does not have sufficient assets with high liquidity to cover the short-term liabilities, regardless of the actual value of the stocks. The inventories increased by 46.24% in 2015 affecting the company's liquidity as it grew difficult to sell stocks or with a slow rotational speed. Besides these weaknesses that affects the balance, debts on short term increased by 123.07% in 2015. Even in this situation, when the ratio is below 1, the company may not be in difficulty given that it has many stocks and with a high rotational speed. This means that the amount of money stuck in stocks is small, which improves its liquidity.

c) The immediate liquidity ratio (R_{iml}) is the company's capacity of immediate repayment of short-term debts using treasury cash, the availability of bank cash and short-term placements. This ratio reflects the company's ability to promptly honor its debts given only the available money [1].

$$R_{iml} = \frac{\text{Cash}}{\text{Debts on short term}}$$

In interpreting the ratio we must consider a range of information on the activity of the company. The optimal level of this ratio is between 0.2 and 0.3. A high value of this indicator does not represent the guarantee that the company can pay its short term debts, given that the other circulating asset have a reduced liquidity [2]. A reduced value of the ratio may lead to maintaining the financial balance if the company holds stocks and claims easily converted to cash.

The immediate liquidity ratio

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Indicators	The analyzed period		Δ	I	ΔI
	2014	2015			
Cash	1.966	111.571	109.605	5.675,02%	5.575,02%
Debts on short term	201.389	449.246	247.857	223,07%	123,07%
The immediate liquidity ratio	0,010	0,249	0,239	2.490%	2.390%

In the analyzed period the immediate liquidity ratio has experienced consistent growth. If in 2014 it was only 0.010% with an imminent insolvency due to increased cash availability of 5675.02%, it reached 0.249 ie an increase in absolute value of 0.239 and in relative sizes of 2.390%. The higher value of this ratio in 2015 does not represents a guarantee that the company can pay its debts on short term, given that other assets have a reduced liquidity. This ratio should be observed with reservations because as noted, the cash availabilities change significantly (1,966 lei in 2014 to 111 571 lei in 2015) in short periods of time due to the ratio of receipts and payments.

3. Conclusions

Although the company analyzed has ratios of liquidity reduced below safety limits, however due to cash flow high enough (in 2015, the cash availabilities are 111.571 lei), has a comfortably degree of liquidity that manage to deal with short term financial obligations.

Such a situation can have a probable recovery likely as renegotiating debt maturities, accelerating the speed of rotation of circulating assets in case of stocks would lead to increased liquidity of circulating assets to overtake debts chargeability.

To balance the liquidity ratios there are imposed several measures including:

- Increasing the operational efficiency by increasing sales, productivity and reducing fixed costs;
- Increasing debt collection;
- Increasing the speed of inventory turnover and better manage them;
- Renegotiation of short-term debt maturities;
- Accelerated depreciation of tangible assets that makes available financial resources to pay obligations;
- Increasing provisions for risks and spendings can be a real source of liquidity.

The liquidity indicators characterize the quality of financial-economic activity and depreciation of liquidity degree will affect the structure of temporary uses and thus the balance on short-term of the entity.

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