RELEVANCE OF FINANCIAL BALANCE INDICATORS FOR DIAGNOSING AN ENTITY'S FINANCIAL POSITION

GÂDOIU MIHAELA
LECTURER PH.D., FACULTY OF ECONOMIC SCIENCES AND LAW, NATIONAL UNIVERSITY OF SCIENCE AND TECHNOLOGY POLITEHNICA BUCHAREST, PITEȘTI UNIVERSITY CENTER, ROMANIA
e-mail: mihaela_gadoiu@yahoo.com

BĂNUȚĂ MARIANA
LECTURER PH.D., FACULTY OF ECONOMIC SCIENCES AND LAW, NATIONAL UNIVERSITY OF SCIENCE AND TECHNOLOGY POLITEHNICA BUCHAREST, PITEȘTI UNIVERSITY CENTER, ROMANIA
e-mail : mari.banuta@yahoo.com

Abstract

This paper is focused on identifying the economic-financial indicators necessary for the correct and complete diagnosis of the financial position of an entity. Specifically, it highlights the need to use financial balance indicators in knowing how the entity's management succeeds or fails to achieve its major objective, namely maximizing the entity's value. The consistent achievement of the major objective of an entity can only take place under the conditions of a profitable activity and maintenance of financial balance. So, starting from this aspect, the importance of analyzing the financial balance can be seen, as well as the correlation with the entity's performance. The analysis of the financial balance is obtained by means of indicators determined with the help of information from the balance sheet, namely the net position, the working capital, the need for working capital and the net treasury. Achieving financial balance can be achieved by adjusting the imbalances that manifest in the entity's current activity, more precisely between its financial sources and its resource needs. In order to ensure a state of perfect equilibrium, all the due dates of the payments or receipts should be perfectly correlated, which is very difficult to achieve in the practical activity of the entity because most of the time, the receipts precede the payments and thus are released a profitable activity.

Keywords: financial analysis, financial diagnosis, financial position, financial balance, economic and financial indicators

JEL Classification Codes: G17, G32, M10, M40

1. Introduction

Diagnosing the financial position of a company by knowing the financial balance, has as main objective to provide the necessary information to users of financial and accounting information, especially management, in order to adopt correct management decisions of the entity. In other words, it is about whether or not the entity's management succeeds in achieving its major objective, namely profit maximization, which can only occur under the condition of maintaining financial equilibrium. Starting from this aspect, the importance of financial balance is highlighted, as it is an essential condition for carrying out a profitable activity.

In a general sense, financial equilibrium conveys the idea of harmony between different elements of a system, but in the financial field it represents the harmonization of the financial resources necessary to achieve objectives with the actual possibilities of acquiring these resources, be they public or private funds, established definitively or reimbursably. Financial equilibrium can be evidenced by a system of correlations by which certain proportions are established between different financial flows. Balance is also a prerequisite and consequence of the entity's normal conduct of business in accordance with its business.

Ensuring and maintaining financial balance is, as we said above, the essential condition for carrying out a profitable activity, and its achievement can be achieved by regulating imbalances that manifest in the entity's activity, between its financial sources and its resource needs.

The purpose of this article is to emphasize the importance of diagnostic analysis of financial balance in correctly diagnosing the financial position of the company. In other words, it was highlighted that financial equilibrium is identified by the entity's ability to ensure the uninterrupted payment of previously contracted debts, including current liabilities generated by the achievement of the object of activity, or by tax legislation, from its receipts, so that it can avoid the risk of bankruptcy. In order to ensure a state of perfect equilibrium, it is necessary that all maturities of payments or receipts are perfectly correlated, which is very difficult to achieve in the practical activity of the entity, in most cases, receipts are ahead of payments.

This paper has been prepared in accordance with the provisions of the Accounting Law, the Accounting Regulations on annual financial statements and consolidated annual financial statements, as well as the legislation in force at national level. A methodological strategy was followed that can be framed in classical research patterns, by combining theoretical approach with empirical approach to the research problem. The approach achieved through this research activity is based on the general research problem, identified by the question: "How relevant are financial balance indicators for the diagnosis of financial position?"

The theoretical approach was based on the bibliographic study of the relationship created between financial balance indicators and financial management, in the sense of diagnostic analysis of financial position. The main sources of theoretical data were represented by the authors' scientific works and research, such as: Gomoi (2022); Grigorescu (2019); Rahman (2017); Sabău(2015) Todea & All (2014); Căruntu & All (2011), Stancu (2007).

The empirical approach is based on the quantitative and qualitative analysis of current studies and publications of professional bodies (publications of C.E.C.C.A.R., of A.N.E.V.A.R., etc.) on the analysis of financial equilibrium indicators and their effect on financial decision-making.

In order to achieve the purpose of this article, stated above, we also used other research methods such as the descriptive method for classifying financial equilibrium indicators and their effects in the process of diagnosing financial position, the synthesis method for establishing causal links between indicators characterizing financial equilibrium and financial position, analytical method to obtain an analysis of the theoretical approach to financial diagnosis, financial balance indicators and their role in the decision-making process.

2. Relevance of financial equilibrium analysis for the diagnosis of financial position

The financial position of an entity can be defined as all assets and capital over which it exercises control. According to paragraph 16 of the General Framework for the Preparation and Presentation of Financial Statements, developed by the International Accounting Standards Committee, several influencing factors act on the financial position, such as: the economic resources it controls, its financial structure, its liquidity and solvency, as well as its ability to adapt to changes in the environment in which it operates. The primary objective of analysing the entity's financial position is not limited only to determining net assets as a form of accounting valuation of shareholders' wealth, but also to determining the financial equilibrium of the company that is of primary interest to the entity's creditors.

Diagnostic analysis of financial equilibrium can be defined as a set of methods and techniques that operate with specific tools and transform data taken from summary accounting documents into information relevant to assessing the financial position of the entity. It is about how the management of the entity succeeds or fails to achieve its major objective, namely maximizing the value of the entity (Gâdoiu, 2015, page 26).

The analysis of financial equilibrium can be carried out on the basis of indicators determined with the help of balance sheet information, namely **net position, working capital, working capital need and net treasury.**

Starting from the legal approach to the balance sheet, **the net statement** (SN) measures the net worth of shareholders at a given point in time, i.e. assets unencumbered by liabilities. This indicator is also called net accounting assets (NCAs) and is determined as the difference between the total asset (excluding fictitious assets) and the total liabilities committed by the entity:

SN = Total assets - Liabilities

By excluding accrued income and provisions, the net statement (net accounting assets) becomes equal to equity and expresses the value of the realisable asset at a given point in time that is of interest to the owners, shareholders and creditors of the entity, especially in the event of its liquidation (Petrescu, 2008, page 193).

Since the net position reflects shareholders' actual equity, it is calculated by comparing assets and liabilities with the same maturity against each other and can be determined on the basis of the balance sheet used, as follows:

Net statement based on balance sheet:

SN = Total assets — Liabilities — Accruals — Provisions

Net statement based on balance sheet:

SN = (Total assets — Current liabilities) — Liabilities over one year – Provisions

Taking into account the ways of calculating the net position, we can meet in the practical activity of the entity three possible situations, as follows:

Table 1 — Comparison of net status statuses

SN > 0	***SN < 0***	***SN = 0***
Financial health well-being mirrored in positive financial management; *The rate of total assets exceeds the rate of liabilities incurred by the entity;* *Records the achievement of the entity's major objective, namely to maximize the value of equity and thus of the net asset financed from those capitals;* *Consequence of reinvestment of part of net profit and other accrual items, such as regulatory provisions, subsidies and reserves, reporting from the preceding financial year.*	*The entity's financial management is undesirable and will need to be improved as soon as possible;* *The level of liabilities incurred by the entity exceeds the amount of total assets;* *Consequence of losses in previous financial years above the value of other items of equity and reserves, reflecting an inefficient utilisation of net assets;* *Records a pre-bankruptcy status of the entity.*	*The amount of liabilities is equal to the value of total assets;* *A situation of perfect balance between assets and liabilities, being difficult to achieve in practice;* *Interpreted as constant financial management, to be improved as much as possible.*

Source: M. I. Pantea, Economic and financial analysis - tool of enterprise management, West University Publishing House, Timișoara, 2017, pag.. 363-364.

Working capital (FR), also known in the literature as financial working capital, permanent working capital or liquidity working capital, is an essential coordinate for the analysis of financial equilibrium that mirrors the ratio existing between balance sheets of the same duration, comparing the fixed asset ATL with permanent capital CPM, respectively the current asset AC with short-term resources DTS:

FR = CPM-ATL

FR= AC-DTS

If we refer to the first calculation relationship, we can see that a positive working capital can be obtained in case of permanent capital superior in value in relation to non-current assets. The

financial resources available to the entity on a long-term basis, whether own or borrowed, fulfil their mission and provide financing for current assets.

With respect to the second relationship, positive working capital is equivalent to a working asset larger than the firm's current liabilities, which is the same as a positive net working asset.

A relevant calculation of the indicators mentioned above also requires the adjustment of balance sheet items to better reflect their economic content.

Thus, the entity's equity includes equity and long-term liabilities, to which provisions are added, as well as deferred income, all of which have a term of more than one year. With regard to fixed assets, they should be adjusted by reducing them by fictitious fixed assets and financial fixed assets with a term of less than one year, and increasing them by current assets whose liquidity is greater than one year and by prepaid expenses whose settlement is medium or long-term.

Table 2 – Comparison of working capital status

FR > 0	***FR < 0***	***FR = 0***
normal situation of the entity, considering that it has achieved financial equilibrium; *the entity's safety margin, allowing it to secure a minimum level of current assets necessary to operate in optimal conditions;* *it should be considered whether this is not caused by an increase in the entity's indebtedness, which would be detrimental to its financial autonomy.*	*signifies a difficult financial situation of the entity, i.e. a state of financial imbalance;* *a red flag for the entity because it has current assets that are less than the short-term debt due that it will not be able to pay;* *it signifies a lower margin of safety, but if this is due to the financing of profitable new investments, in the long term they may contribute to increasing working capital.*	*the entity has stagnated in its growth for various reasons, this stagnation may be temporary or long-lasting and a profitability study is required.*

Source:M. Gâdoiu, Perfecting the financial diagnosis of the enterprise, Ed. Universitară, București, 2015, pag. 28

Operating operations lead to the formation of financing needs, but at the same time they also make it possible to build up the resources needed to finance these needs. It is therefore by comparing the two elements, i.e. the financing needs of the operating cycle with the corresponding financing resources, that the need or requirement for working capital can be assessed.

The working capital requirement (WCR) is an economic and financial indicator that highlights the entity's need for financing over a period of up to one year. This indicator can be determined on the basis of both the financial balance sheet and the functional balance sheet.

Working capital requirement based on the balance sheet:

The working capital requirement (WCR) is determined on the basis of current assets (CA) minus cash and cash equivalents (Db) minus total short-term liabilities (Dts) minus short-term bank loans (Cbs), i.e. **(**Radu at al., 2006, pag. 305):

NFR = (Ac – Db) – (Dts – Cbs)

The working capital requirement can also be determined by adding the entity's total inventories (St) to its receivables (Cr) and subtracting current short-term operating liabilities (Dce) as follows:

NFR = (St + Cr) – Dce

The increase in working capital requirement can occur either through an increase in receivables from customers or a reduction in payables to suppliers, and the decrease in working capital requirement can occur through an increase in payables to suppliers or a decrease in

inventories of raw materials and finished goods.

Depending on the outcome of the calculation of the working capital requirement, there are three possible states, namely:

Table 3 – Comparison of working capital requirements

NFR > 0	***NFR < 0***	***NFR = 0***
is the result of temporary financing needs of the entity's activity; *in such a situation there is a need to finance current assets which must be covered from stable resources controlled by the entity (to be repaid over a period of up to one year and incurring additional costs)*	*is synonymous with a surplus of temporary resources controlled by the entity over its current assets;* *it is favourable if it is the consequence of accelerating the rate of turnover of current assets, the urgency of receipts and the slowdown in payments*	*shows the existence of a balance between the assets used in the technological process and the sources of financing due in one year.*

Source: M. Gâdoiu, Perfecting the financial diagnosis of the enterprise, Editura Universitară, Bucureşti, 2015, pp. 40-41

This indicator shows the current balance of the entity, as opposed to working capital, which reflects long-term balance and is more fluctuating and unstable than the working capital indicator.

The size of the working capital requirement is influenced by: the nature of the business conducted, the length of the production cycle, the turnover of inventories and receivables, the volume of business conducted **(**Robu at al., 2014, page 442).

Working capital requirement based on the functional balance sheet:

Based on the functional balance sheet, the working capital requirement is calculated as the difference between cyclical needs (Nc) and cyclical resources (Rc), as follows:

NFR = Nc – Rc

The working capital requirement can also be divided into two component parts, namely the operating working capital requirement (NFRE) and the non-operating working capital requirement (NFRAE).

The operating working capital requirement (WCRR) arises because most balance sheet items relate to the operating activity of the entity and the size of inventories, receivables as well as operating payables vary in proportion to turnover.

This indicator is an asset item that characterises the entity's cyclical activity and is calculated as the difference between cyclical operating assets (Ace) and cyclical operating resources (Rce), as follows:

NFRE = Ace – Rce

The operating working capital requirement can also be determined according to the size of current assets, i.e. stocks (St) and operating receivables (Cr), less liabilities, i.e. liabilities to suppliers (Df), to personnel (Dp) and to the state budget (Dbs), as follows:

NFRE= (St + Cr) – (Df + Dp + Dbs)

It can be said that the need for operating working capital is seasonal in nature as it depends on the size of turnover. For these reasons, it is recommended that the interpretation of the working capital requirement for operations should be made with caution, taking into account this aspect of the entity's business, in order to know whether the working capital requirement corresponds to a minimum, average or maximum level.

Short-term financial balance analysis is performed by comparing working capital with working capital requirements, which is the **net cash analysis**. If, at a given point in time, the working capital exceeds the working capital requirement, the resulting surplus of funds constitutes

the net cash position (NCT), which is expressed in liquid assets. It plays an important role within an entity because it characterises the amount of cash available to the entity at any given time.

Net cash is also determined on the basis of both the financial and the operational balance sheet.

Net cash based on the balance sheet:

From the balance sheet equality between its assets and liabilities, we arrive at the confrontation of working capital with working capital needs. This comparison results in net cash, which is a result of transactions affecting all balance sheet items, resulting from the horizontal analysis of the balance sheet and can be determined in two ways:

a) Based on the upper part of the balance sheet as the difference between working capital (FR) and working capital requirement (NFR), thus:

TN = FR – NFR

b) Based on the lower part of the balance sheet as the difference between the entity's cash and cash equivalents (Db) and treasury or short-term bank loans (Cbs), thus:

TN = Db – Cbs

In the analysis of the entity's net cash, the following assessments can be made:

Table 4 – Comparison of net cash positions

TN > 0	***TN < 0***	***TN = 0***
FR > 0 and NFR > 0, it is the case of a working capital requirement financed entirely from permanent resources and releasing cash that may hide an underspending of capital; *FR > 0 and NFR < 0, then resources from the operating cycle are added to a surplus of permanent resources to release a large cash surplus, which may hide capital underutilisation;* *FR < 0 and NFR < 0, highlight that resources from operating activity cover a large cash surplus and only part of fixed assets, another part is financed from short-term debt, which requires an increase in permanent capital*	*FR > 0 and NFR > 0, when the working capital requirement is financed partly from permanent resources and partly from current bank loans in excess of liquid assets, in which case current bank risk analysis is required;* *FR < 0 and NFR > 0, when current bank loans cover part of the fixed assets, requiring a review of the funding structure;* *FR < 0 and NFR < 0, when permanent resources cover part of fixed assets, the rest being covered by short-term debts including current bank loans, which in this situation also requires a review of the funding structure.*	*FR =NFR, when net cash is perfectly balanced. In this case, working capital fully covers the working capital requirement and the entity no longer has to resort to short-term borrowing to finance its current activity;* *A net cash position of zero cannot limit the short-term financial autonomy of the entity.*

Source: S. Petrescu, Financial-accounting analysis and diagnosis , Theoretical-applicative guide, Ediția a III-a, Editura CECCAR, București, 2010, pag. 205-206

Net cash based on the functional balance sheet:

Based on the functional balance sheet, net cash (NT) is calculated as the difference between the overall net working capital (NWCR) and the operating and non-operating working capital requirement (NFR), as follows **(**Radu at al., 2006, pag. 307):

TN = FRNG - NFR

The size of net treasury can also be determined as the difference between active treasury (AT) and passive treasury (TP), according to the relationship:

TN = TA - TP

Depending on the size and direction of the change in these indicators, judgements can be made about the financial balance of the entity and the following situations may arise:

a) If FRNG > NFR, there is a positive net cash position, the overall net working capital is sufficient to cover the working capital requirement and to provide a cash position, allowing the use of the unused cash in the entity's current activity.

b) If FRNG < NFR, there is a negative net cash position and in this case the working capital requirement cannot be financed entirely from permanent resources and the entity will have to resort to bank loans to cover the financing needs of the operating cycle.

c) If FRNG = NFR, the cash balance is zero and may be the effect of a financial management policy designed to protect the entity from risks.

3. Conclusions

Following the completion of this paper, we can draw the following conclusions:

✓ it is important to calculate and interpret in their complexity, as a correlated system, all the indicators analysed, i.e. net position, working capital, working capital requirement and net cash, so that each one expresses a position of the entity from a certain point of view;

✓ the analysis of the net worth or net assets is important in that it allows us to draw some preliminary conclusions about the financial management of the entity (efficiency of financial management). This analysis must be supplemented by other investigations based on the accounting information provided by the summary accounting documents, such as the analysis of the indicators characterising the financial balance, i.e. working capital, working capital requirements and net cash;

✓ working capital is a necessity for most entities as it provides a safety margin for them and their creditors, a prerequisite for ensuring financial independence from third parties. The analysis of working capital must also be complemented by the study of another important indicator of the balance sheet, namely the need for working capital;

✓ working capital requirement is an indicator that shows the current balance of the entity and can be assessed by comparing the financing needs for the operating cycle with the corresponding financing resources, highlighting the entity's financing needs over a period of up to one year;

✓ a treasury without surplus or deficit is difficult to conceive in the practical activity of the entity; I consider that ensuring a perfect financial balance of the treasury is a hypothetical situation and can only be encountered if the working capital fully finances the need for working capital; an interpretation of the financial balance based on the functional analysis would lead us to the conclusion that an entity is not reliable if it has a negative treasury. However, expert practice has shown in many cases that entities with negative cash balances have not experienced serious financial difficulties because financial institutions have had confidence in the potential of these entities to improve their cash receipts in the future.

4. Bibliography

[1] Anghel, I., Robu V., Lala-Popa I., Ștefea P., Mironiuc M., Achim V., Siminică M., *Treaty on economic and financial analysis*, Academiei Române Publishing House, Bucharest, 2022;

[2] Căruntu C., Lăpăduși M. L., *Rentabilitatea și echilibrul financiar*, Analele Universității „Constantin Brâncuși" din Târgu Jiu, Seria Economie, Nr. 3/2011, pag. 196, disponibil online la adresa: http://www.utgjiu.ro/revista/ec/-pdf/2011-03/25_CONSTANTIN_-CARUNTU.pdf,

[3] Gâdoiu, M., *Improving the Financial Diagnosis of the Enterprise*, Bucharest, 2015;

[4] Grigorescu, L., *Model de analiza poziției financiare a întreprinderii*, Revista Română de

Statistică - Supliment nr. 8 / 2019, https://www.revistadestatistica.ro/supliment/wp-content/uploads/2019/08/rrss_08_2019_A04_RO.pdf,

[5] Gomoi B., *Analiza poziției financiare și a performanțelor unei entități din domeniul construcțiilor,* Ceccar Business Magazine, ISSN 2668-8921, 3/2022, https://www.ceccarbusinessmagazine.ro/analiza-pozitiei-financiare-si-a-performantelor-unei-entitati-din-domeniul-constructiilor-a9683/

[6] Pantea, M. I., *Economic and Financial Analysis – a Tool of the Company Management*, Publishing House of the West University of Timișoara, 2017;

[7] Petrescu, S., *Financial and Accounting Analysis and Diagnosis, Theoretical and Applicative Guide*, CECCAR Publishing House, Bucharest, 2008;

[8] Radu F., Cîrciumaru D., Bondoc D., *Analiza economico-financiară a societăților comerciale*, Editura Scrisul Românesc, Craiova, 2006;

[9] Rahman, A.A., *The relantionship between solvency ratios and profitability ratios: Analytical study in food industrial companies listed in Amman Bursa*, International Journal of Economics and Financial Issues, 7(2), 86- 93, 2017;

[10] Robu, V., Anghel, I., Șerban E. C., *Economic and Financial Analysis of the Company*, Editura Economică, Bucharest, 2014;

[11] Sabău C., *Financial Analysis – From option to necessity in the EU. Company diagnosis using financial equilibrium indicators*, Annals of the „Constantin Brâncuși" University of Târgu Jiu, Seria Economică, Ediția 1, Vol. II, 2015, p. 193, disponibil online la adresa: http://www.utgjiu.ro/revista/ec/pdf/2015-01.Volumul%202/30_Sabau%20Catalin.pdf;

[12] Stancu I., *Finanțe (Finance), 4th edition*, Editura Economică Publishing House, Bucharest, 2007;

[13] Stanciu F. G., Cioca R. G., *Fundamente ale analizei echilibrului financiar*, Revista Tribuna Economică – Supliment nr. 22/2018;

[14] Todea (Mariş), A., Bătrâncea, I., & Andone, D. (2014), *Financial equilibrium in Romanian tourism industry*, Proceedings of the IECS Conference, „Lucian Blaga University" of Sibiu, 224-231.

[15] Ţilică, E.V., Ciobanu, R., *Finance and Financial Management*, CECCAR Publishing House, Bucharest, 2019;

[16] Vasile, I., *Company Financial Management*, Meteor Press Publishing House, 2010;

[17] Vintilă, G., *Gestiunea financiară a întreprinderii*, Editura Didactică şi Pedagogică, Bucureşti, 2005

[18] *** *Order of the Minister of Public Finance no. 1802/2014* of 29 December 2014-Part 1 approving the Accounting Regulations concerning the individual annual financial statements and the consolidated annual financial statements .