

Corporate Financial Stability and its Liquidity: How Strong is the Connection?

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Abstract: The paper analyzes different approaches to evaluate corporate financial stability. Some of the approaches shift the emphasis of financial stability towards ensuring the liquidity of assets. More comprehensive approach towards evaluation of financial stability might be the evaluation based on the long-term solvency, cash flow and liquidity of assets.

Key words: Corporate Financial Stability • Liquidity of Assets • Liquidity Ratios • Solvency

INTRODUCTION

There is no a universal interpretation of corporate financial stability all researches may use in their works. In some studies the analysis of financial statements is oriented on improving financial stability as a major recommendation. The key task of this particular work is to find out whether or not the common interpretation of the corporate financial stability is substituted by estimation of liquidity of its assets.

Revising the concept and the idea of a system's stability we may start with its definition as "...an ability of a moving system to deviate from some motion under small variations of the initial system position in one way or another" [1].

Thinking of a more common interpretation of system's sustainability, we may emphasize not its "ability to deviate", but its ability to keep to the chosen direction, so the idea of stability of the system might be described as "the aptitude of a dynamic system to keep the planned route while in moving, to support the planned mode of operation despite the indignation applied" [2].

The core attributes of stability might be listed as *balance, homeostasis, steady-state mode*.

Economic stability is always considered in connection with the entire complex of sustainability. The conditions under which economic stability may have a chance could be described as flexibility in response to the changing market conditions, the competitiveness of products and production, innovative and investment

activity, liquidity and financial stability and the development of business structures and usage of innovative factors.

Highlighting active response to the changes in the external environment as the key factor, some researchers describe the economic sustainability as "a solid characteristic of the economic system based upon the basic trajectory of its development, resource support, built-in technological mechanism of reproductive cycles and the organic flexibility of administrative structures" [3], so the direction of the system's development and economic relationship with the static essence of the system are taken into consideration.

Nobody can deny the tight bonds between the values of *stability* and *sustainable development of the system*. The sustainable development of the system is commonly understood as a "consistent maintaining of its ability to reproduce purposeful operational outcome with the perspective of further improvement of those on each production cycle, meaning the industrial, economical, social, environmental and other parameters and minimizing their undesirable deviations resulted from any changes in production conditions" [4].

Rodionova and Fedotova describe the corporate financial stability as "a condition of financial resources and the way they're distributed and used that bring the corporation to growth and development based on its profits and capital maintenance with constant level of solvency and keeping the credit conditions at acceptable level of risk"[5].

Identifying funding sources in the production activity may also be a basis for estimation of financial stability [6], alternatively the financial stability of the enterprise might be described as an ability to manage successfully with own funds [7].

There is also a rather controversial interpretation of financial stability from a position of financial independence from external sources, although it is not considering the effect of financial leverage.

If the financial stability of a company is approached from the perspectives of its ability to cope with operational difficulties and to evaluate the ability of repayment in principal productive activity, that is most probably one of the financial researches that practice this type of approach.

There are various definitions of financial stability with their similarities (such as estimation of solvency, risk reduction, etc.) and differences (normally in intrinsic characteristics).

RESULTS AND DISCUSSION

The evaluation of corporate financial stability may be classified as following:

- Financial stability from the perspective of long-term solvency.
- Financial sustainability from the position of liquidity of assets.
- Financial stability from the position of long-term solvency, cash flow and liquidity of assets.

Financial Stability from the Perspective of Long-term Solvency: If the category considered has been demonstrating operational stability during a long-term period, this might be the point for examining its stability from the position of long-term solvency [8]. Although, its potential ability to meet its own obligations in the short term period, which is related to liquidity of its assets, is the key thing for long-term solvency. So, there are certain limitations in this consideration of financial stability from the standpoint of long-term solvency only.

The core characteristic of long-term solvency is the capital structure, as the value of the ratio and the sources of funds to finance the company activities-both own and borrowed-are the key in this case. A set of partial factors and integrated indicators (based on the expansion of financial ratios, discriminant analysis and regression [9, 10], etc.) are used for accessing the capital structure.

Although the ratios characterizing the structure of the capital have different names, they are of similar substantial load. Different sets of ratios may be used:

- Ratio of equity concentration (share of equity capital in the entire capital of the company), equity maneuverability (ratio of working capital to equity ratio), the ratio of borrowed capital to equity [8];
- Autonomy factors (concentration of equity) and maneuverability [11];
- Ratio of interest on loans coverage by profits, owner quota (the ratio of borrowed capital and equity) [10], etc.

Expanding the key financial indicators of the elements may be a part of a comprehensive assessment identifying the capital structure and other aspects of financial and economic activity. The well-known DuPont equation contains decomposition of return on equity through leveraged capital, operational efficiency and asset utilization [12, 9].

Financial Sustainability from the Position of Liquidity of Assets: A proper analysis of individual works accessing financial and economic stability of a company through the liquidity of its assets worth a separate consideration, although one will not come across this type of cited researches often.

An assumption that the core of a corporate financial stability is "the stocks secured and the costs sourced on formation" [13]. More general indicator of financial stability is a surplus or lack of funding sources for the formation of reserves and costs, resulting from the difference of funds' magnitude, the value of stocks and costs, as the quantitative assessment of financial stability asserts.

This interpretation of financial stability is based on the demand of compliance with the liquidity of assets (absolute, critical and current).

Assessing the corporate financial stability may be processed in two directions, resulting from the following condition:

$$FA + S \leq C + FL$$

where FA is fixed assets;
S is stock;
C is capital and reserves;
FL is fixed liabilities.

It comes from this inequality that a company has a current absolute financial stability, if:

$$CS \geq CL$$

A normal financial stability, if:

$$CSA \geq CL$$

And a minimal financial stability, if:

$$CSA + S \geq CL$$

where

CS is cash and securities,
 CL is current liabilities,
 CSA is cash, securities, accounts receivable,
 S is stock.

The indicators included into the last three inequalities are grouping the initial data for the evaluation of liquidity assets. The following three factors are suggested:

- Absolute liquidity ratio (AL) equal to the ratio value of the most liquid assets to current liabilities; recommended value - not less than 0.2-0.5;
- Critical liquidity ratio (acid test, AT) equal to the ratio of accounts receivable, liquid assets to current liabilities recommended value-not less than 1;
- Current ratio (CR) equal to the ratio of current assets to current liabilities (CT), recommended value-at least 2.

Formal usage of the data based on the notations as above may be represented as:

$$AL = \frac{CS}{CL};$$

$$AT = \frac{CSA}{CL};$$

$$CR = \frac{CSA + S}{CL};$$

where CS is cash and securities,
 CL is current liabilities,
 CSA is cash, securities, accounts receivable,
 S is stock,
 AL is absolute liquidity ratio,
 AT is acid test,
 CR is current ratio.

The proposed comparative analysis of recommended levels of financial stability and liquidity of assets normative values shows the following (Table 1).

Table 1: Comparison of financial stability levels and normative values of liquidity

Ratios	Liquidity or financial stability	Recommendedvalue
absolute liquidity ratio	liquidity	≥0.2-0.5
	financial stability	≥1
acid test	liquidity	≥1
	financial stability	≥1
current ratio	liquidity	≥2
	financial stability	≥1

The critical (minimum) requirement of corresponding figures' ratio for absolute financial stability (at least 1) is tighter than the standard value of asset liquidity (at least 0.2-0.5). This assumption is not sufficient, as it evidences that a stock of highly liquid assets must be owned by the company (in form of cash, securities, etc.) and it must be beyond the standard level required to maintain sufficient liquidity assets in order to achieve absolute financial stability. A significant amount of liquid assets becomes "frozen" under these conditions and it reduces the efficiency of the company.

In this case, the lower boundary of financial stability is twice lower than the standard value of the current liquidity coefficient, which cannot be sufficient and well-founded.

Normal level of financial stability corresponds to the normative values of prompt liquidity.

According to this approach, a bigger share of highly liquid assets and a smaller share of stocks than it is required to comply with the normative values of liquidity must be composing the current assets of a company to meet the requirements of the current financial stability.

Financial stability from the position of long-term solvency, cash flow and liquidity of assets. Revealing the essence of financial stability in a more competitive way is revising it through the long-term solvency, security of cash and liquidity of assets simultaneously.

According to this, the financial stability is characterized by both short-and long-term solvency, in static as well as in dynamic mode and this is the key advantage of this approach.

Although this approach has its limitations in estimating reliability of financial stability based on net cash flow (the difference between inflows and outflows), if significant amount of non-cash flows take place. Usage of cash flows data is quite reasonable in the absence or small amount of non-monetary transactions between the parties. In this case there is a more preferable approach based on a comprehensive and long-term liquidity and solvency characteristics.

When estimating the nature of financial and economic stability, in some studies also profitability, management efficiency and performance evaluation of the other sides of business may be taken into consideration together with liquidity, solvency and cash flows. With not adding any extra value to the matter of the case, they are rather irrelevant though.

CONCLUSION

Corporate financial stability could be defined as a system of financial relationship based on accumulation, allocation and appropriate management of corporate funds that ensure optimal financial risk and short-and long-term solvency.

More comprehensive approach towards essence of financial stability might be the evaluation basing on the long-term solvency, cash flow and liquidity of assets.

When considering the nature of financial stability from the availability of funds for the accumulation of reserves point of view (the second approach), a researcher may shift his focus on financial stability towards liquidity support for the company.

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