

THE REFLECTION OF THE COMPANY'S PROFITABILITY AND LIQUIDITY IN THE ACCOUNTING RESULT

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***Abstract:** An enterprise can have economic performance, but may end as a result of the financial deficit of liquidity. Between the beneficiary capacity and liquidity there is no mechanical relationship. In the practice of enterprises it is not sufficient to follow only the economic indicators but it is necessary to ensure the liquidity of the enterprise in its quality of particular dimension of financial management. Liquidity and treasury must be well defined and bounded as they represent the object of several accounting measurements.*

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The financial position of an enterprise is influenced by the economic resources that it controls, its financial structure, its solvency and liquidity and also its ability to adapt to changing the environment in which they operate. The information about economic resources controlled by the enterprise and its past capacity to modify these resources are useful to predict the ability of the enterprise to generate cash or cash equivalents in the future. The information about the financial structure- are useful to anticipate the future lending needs and how the profits and future flows of treasury will be divided between those who have an interest in business; these are useful to anticipate the opportunity to receive funding in the future. The information about liquidity and solvency are useful to anticipate the capacity of the enterprise to honor its financial commitments due.

Liquidity refers to the availability of cash in the near future, after taking into account the financial obligations related to this period.

Solvency concerns the availability of cash for more than they should honor the financial commitments due.

An enterprise that spends more on consumption and investment than it receives from the sale of products begins to deplete the different ways of credit. The cost of the credit is possible to cover temporary cash-flow needs, but it may become prohibitive when it comes to financing development.

The inability to regulate trade after the enterprise made use of all credit resources and improvement of liquidity, it may lead to cessation of payments and placing it in the recovery or wound up.

The **state of incapacity** may have three origins: the failure of economic profitability, errors of management structure and financial fragility.

A weak **economic profitability** limits the ability to renew its equipment, promote new products, to recruit qualified employees, etc. Progressively the business is deteriorating; the financial needs can not be covered only by excessive indebtedness, which cost is added to the

excessive expenditure and the falling spiral continues. In this case, the low performance of the enterprise is the cause of liquidity crisis.

The decreased profitability may be the consequence of economic and management errors. In this case, for example, the enterprise which supports important fixed costs, incurred in periods of favorable juncture and have not provided the opportunity for recovery in case of activity reduction when it occurs, it will be preserved a higher cost of business opportunities. The professional competence of the company has not been valued and it is the victim of some management errors by over dimension.

Also, a dependency of a very high customer places the supplier company at his attitude regarding the payment. This is commonly found in small companies. Diversification of customers allows the reduction of illiquid risk. But lack of payment is not only a consequence of a crisis of operating conditions. An enterprise may be destabilized in terms of financial structure without being simultaneously economically destabilized, but rapid growth can cause fragility in financial terms, if it was not provided the necessary increase in working capital, or was confronted with a variation of the waist of the enterprise under the growth in the capital. Such businesses, economically strong but financially fragile may seek to recover the treasury, but this must be done before the financial difficulties are passed over the economic performance.

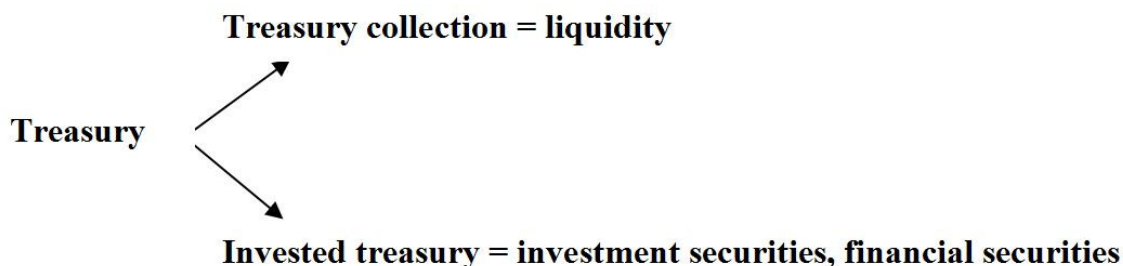
Therefore, **an enterprise may have economic performance, but it may end financially as result of the deficit of liquidity.**

The conclusion is that there **is no mechanical relationship between the beneficiary capacity and liquidity.** It is not enough to follow only the profitability of economic indicators, it is necessary to ensure the liquidity of the company in its quality of particular dimension if financial management.

Notions of liquidity and treasury must be well defined because they are the subject of many accounting measurements. On the one hand, certain liquid investments are not immediately available, but quickly mobilized, such as investment securities, shares and bonds. The questions that are raised are: can such values be included in the Treasury or should they be maintained in debt? Starting from what level of liquidity can a claim be treated as a fixed availability? On the other hand, there is a passive Treasury amended by the appropriations necessary to cover the bank's treasury agreed in various forms. These refundable credits have generated a treasury entry, and at the moment of refunding it changes to a potential levy on a short-term. If the bank renews the loans with a certain frequency, then it can be treated as a stable resource. Thus, the strict accounting of net cash is the subject to differences, bringing into discussion the borders of the treasury both in passive and active.

Seen in active, treasury is an investment. A slow collection of payment or placed shortly after a certain period offers a profit that is lower than the productive investment of the company. This brings into question two restrictions: first, the enterprise must provide the liquidity necessary for its transactions, on the other hand, it must also capitalize its assets.

From those presented it results the treasury scheme:



Often, there is a confusion between **treasury** and **liquidity**.

Treasury is calculated from the balance sheet between items that indicate the instantaneous value at the date of cost closure.

Liquidity is the result of the flow of entry and exit of money, delayed in time.

So, the treasury from day “d + 1” can vary greatly from the treasury from day “d”. For example, a seasonal activity is committed to spending money over a calendar year, but receives revenue, especially between November and January next year. The collection of amounts actually takes place next year, and it appears the activity resulted in a profit situation, but the company shows at the end of the year a liquidity risk.

In other vein, treasury calculated from the balance sheet items does not reveal its origins. We can not make the same diagnosis if the treasury is linked to a high degree of indebtedness, the external input of capital of self financing. The liquidity risk of an enterprise is evaluated differently by how the treasury is provided by recurring operating streams or external resources. From this point of view, the diagnosis takes into consideration, particularly, the treasury surplus resulted from the operation.

So, the notion of treasury varies, depending on the circumstances and the point of view from which is addressed. The account measures of the treasury correspond to particular definitions, seen as receipts, liquidity stable amounts and almost cash preserved to ensure transactions.

If we have the picture of funding, the **net treasury** represents the amount of deposits, less the current bank loans (credit balance of the current account), which means that securities investments are included in the claims of outside exploitation.

If we consider that securities investments, in terms of financial markets and capital, can be easily converted into currency and this conversion rate depending on the evolution of market liquidity, it means that the liquidity of securities investments may be greater than its registration, which gives a return. On the other hand the transfer of securities investments generates expenditure.

All these issues lead us to the idea that the definition of net cash must strive to overcome the concept and availability to take the form:

$$\text{Net availability} = \text{Treasury} + \text{Securities investment} - \text{Current bank loans}$$

Seen through the liabilities prism, we have that extensive concept of the treasury that requires a very careful analysis of the liquidities of the corporation, where:

$$\text{Treasury} = \text{Availability} + \text{Securities investment} - \text{Current bank loans} - \text{Effects expected and not achieved date of payment} - \text{Other financial liabilities of less than one year}$$

One can object that these loans are a permanent resource only if they are permanently renewed. Moreover, financial debts less than a year cover a part of short-term loans during the year, which is no longer a treasury debt. Finally, if all the financial debts of less than one year are treasury debts, why wouldn't we say so about other debts that are less than one year?

The different interpretations of cash can lead to the formulation of different diagnosis, and the analysis of firm liquidity should never lose sight of the substantive definition of the treasury.

The financial result of the company includes revenues and expenses, regardless their financial settlement. Besides the income there are also included the provisions and some transfers of expenditures, while alongside the costs there are included the amortisement and provisions setup, and also the value of ceased assets. If this result is an accountant economic result, it is interesting to calculate the result of the treasury or a **collected result**. This ability is the meaning of **Self Financing Capacity (SFC)**.

But the ability of self financing, as defined, is an expression of partial collected results. In essence, it does not include income from the disposal of assets which, although they are related to a financial flow, is extraordinary.

The ability of self financing is therefore calculated from the usual business of the company, such as:

$$SFC = \text{proceeds} - \text{expenses that are to be paid}$$

The ability of self financing can be calculated by two methods: either from intermediate management balances, or from the net accounting result.

The calculation of self financing capacity is based on the following:

$$\begin{aligned} SFC = & \text{GEE (Gross Excess of Exploiting)} \\ & (+) \text{ other unbreakable operating income} \\ & (-) \text{ other payable operating expenses} \\ & (+) \text{ unbreakable financial income} \\ & (-) \text{ paid financial expenses} \\ & (+) \text{ extraordinary unbreakable income} \\ & (-) \text{ payable extraordinary charges} \\ & (-) \text{ income tax} \\ & (-) \text{ participation in profit} \end{aligned}$$

The calculation of the ability of self financing starting from the result of net accounting is based on the following relationship:

$$SFC = \frac{\text{The net accounting result}}{\text{accounting result}} + \frac{\text{Expenses that were not paid}}{\text{paid}} - \frac{\text{Unearnable income}}{\text{income}} - \frac{\text{Income from transfers}}{\text{transfers}}$$

Which leads to the identification of calculation, namely:

$$\begin{aligned} SFC = & \text{net accounting result} \\ & (+) \text{ Expenses on almost cash and amortisement (exploiting, financial)} \\ & (-) \text{ Income from re-provisioning (exploiting, financial)} \\ & (+) \text{ Extraordinary expenses} \\ & (-) \text{ Extraordinary income} \end{aligned}$$

Regardless the method of calculation, its size is the same and represents a result partly cashingly because it includes stock changes (which is seen very well by the second method, since the net result is influenced more or less by the income of stored production), which is not a cash flow budget. In other words, measuring the flow of treasury shall differentiate revenue and expenditure from the receipts and payments, in addition to the variation of inventories, and when the self financing calculus is made starting from the net result which includes stock variation, this being corrected, where from:

$$\text{Unbreakable operating flux} = SFC - \text{stock variation}$$

The reasoning used for the stock variation can be applied even in the case of restrained production because the expenditure has already been registered during the year, their counterparty being found in the fixed assets account. It can be concluded that:

$$\text{Treasury flux} = SFC - \text{stock variation} - \text{restrained production}$$

In other vein, if for the same volume of sales, earnings are at a frequency less rapidly, we will see a simultaneous reduction of job availability and an equivalent increase of the post of claims. Conversely, all the increases in operating debt correspond to an increase in treasury.

To obtain a collectable flux, meaning the treasury variation called equally and global treasury over-balance by the **Overall Surplus of Treasury** (OST), it is sufficient to determine the balance variation (claims - liabilities). Taking into account all the variation (stocks debts and current debt) affecting the collectable operating flow, we have:

$$OST = SFC - \text{stock variations} - \text{balance variation (claims - liabilities)}$$

or

$$OST = SFC - \text{variations (stock + exploiting debts - exploiting liability)}$$

But in the expression (stocks+ claims of exploitation- debt of exploitation), the definition for the need for working capital (NFR) is recognized, where the final expression of global treasury is:

$$OST = SFC - \text{variation of the necessary working capital}$$

Therefore, the ability of self financing takes into account all the operations that are converged with the result: exploiting operations, financial and extraordinary, while global treasury surplus variation is related to treasury operations essential to continuing the operation.

Although one of the attributes of the new cost accounting is to determine when the cost is made in the moment of its employment, and the income in the delivery of goods or provision of services, making the circuits “purchase-sale” and “payment-receipts” have some disconnection, between the result and treasury is still a relationship, not being a value identity.

A product or a margin is in fact a difference between the output price and the cost of input factors in production of goods or providing services. It expresses the economic power of the company, meaning the ability to extricate itself over resources, its growth and financial compensation.

But the outcome is not immediately reflected in the company. It is not equal to the cash balance shown by all the operations leading to the payment and collection of input factors sold for the following reasons:

- The result takes account of certain expenses that are not part of the payment, but which are part of production costs such as depreciation and provisions;
- Unearned income influences the growth of result but without affecting the treasury;
- Operations are included in the result account as they are employed and not as they are on financial liquidation. For example, if a sale has not been paid by a customer, even if costs have been paid, the cash flow generated by this operation is negative, while the outcome is positive.

The interval between the date of employment and financial liquidation of payments are the source of differences between the result and cash flow.

In most practical cases, the operating expenses and operating income are not fully charged and paid. As such, the amount of accounting profit and depreciation does not exactly match to the net cash flow.

If we consider the fact that the gap commitments – receipts/payments are generally short and are offset by flows from the previous year gap, it can be considered that the capacity size of self-financing represents an almost exact assessment of the net cash flow released in the year. This approximation is more than satisfactory for financial analysts, but inadmissible in treasury management business.

Users of accounting information are not satisfied only with the information contained in the balance sheet, profit and loss sheets. On one hand because the evolution of financial market is a point of interest not as in the beginning of the year, and on the other hand because the use of accrual accounting generates the “hypothetical” size of business performance.

As noted above, the profit shown at the end is a somewhat abstract concept, as it is not the same, most times with the balance of the available cash at the same year-end. We rely on the principle of achieving the recording costs and revenues, but sooner or later, costs will be paid and revenues received.

CONCLUSIONS

In countries where performance is strongly influenced by financial market, the investors requirements are the most important and in the analysis of the financial situation the privileged concept is not the result but the cash-flow.

That is why in the last ten years the need to include in the financial situations of a document which could show the degree in which different activities of the corporation release cash flows, surpluses or deficits of cash has been felt.

Cash flow statement has been elevated to mandatory reporting document, first in the area of international capital markets and then in the International Accounting Standards.

But in the current context of economic crisis, we believe that small businesses which have faced with a lack of liquidity should complete the set of annual financial statements with the statement of cash flows.

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