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How to Manage The Liquidity and Fight The Firm Debt

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Abstract

The liquidity is one of the most popular and used financial indicators for solvency at enterprises. The present study attempts to identify the key factors of managing the liquidity in enterprises, and the ability of influence by financial managers on them in order to provide "fresh" money. The problem with the liquidity provision has always stayed open for most economic subjects, especially during the financial and economic crises of the 21st Century.

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INTRODUCTION

To meet the challenge of microeconomic instability financial managers should not only possess high organizational skills, a wide knowledge of economics, technology, production, finance, accounting, etc., but they should also have at their disposal a powerful and working set of tools enabling them to manage efficiently the financial and economic activities of the enterprise. That comprises documents, models, systems, etc., for the management of the financial processes. Therefore, in a market economy the managers of an enterprise should strive to run efficiently the flow of material and financial resources; the deliveries and distribute properly the working capital.

The problem with solvency is often connected with the pursuit of high profitability. The ensuring of emergency liquidity occurs regularly, but in most cases it is implemented through unprofitable working capital loans or, in the better scenario, financial managers have to undertake all kinds of actions for early claims. For a number of reasons, including this one, they have to be well acquainted with the possibilities for working capital management. The aim of the present article is to answer some of the most important questions connected with the working capital and assets turnover. The liquidity problems are connected with the management of the financial results. The pursuit of higher solvency and limitation of risk could provoke the taking of excess reserves out of the entity's turnover and could diminish its financial result. On the other hand, the drive for higher results could lead to liquidity deficiency. It is essential to achieve an acceptable financial result and good liquidity, which should not threat the turnover of the enterprise, otherwise the result achieved would be either low or the enterprise would head for a liquidity crisis. Liquidity is a function of the general correspondence between the disposable assets and the existing liabilities. The problem with liquidity is a problem of the correspondence between the size and the structure of assets and, as from today's point of view, planning in the long term could be estimated quite incorrectly, that is why short-term and medium-term planning outweighs the most. The annual liquidity plans should be drawn up and updated either every three months or monthly, thus providing solvency in time and being able to manage it with less available cash. Having in mind the existing and expected business processes, e.g., through an annual plan, the proper liquidity corresponding to the needs could be estimated[1].

The heaviest consequence of a liquidity crisis for an enterprise is connected with insolvency. In a state of insolvency the enterprise fails to meet its obligations towards counterparts, creditors and the budget. It is a difficult test on the managerial skills for every management. According to G. Breitkreuz[2] the most common reasons for liquidity crises are connected with the following basic points and factors:

First, the irrelevant or untimely reaction towards the current economic and market changes and the poor provision of information. The dynamics of the evolution of the markets and the competition can lull the enterprise out of their vigilance and the lack of up-to-date information can influence the adequate managerial decisions. Other reasons include: insufficient awareness of the responsibilities and liabilities for the planned activities, monitoring, coordination and control activities, poor accounting, lack of financial reporting or lack of proper financial reporting, lack of budgeting in the enterprise and monthly analyses of the reasons for the deviations between actual

[1] Ossola – Haring, C. 2006. *Die besten 150 Chicklisten zur Liquiditätssicherung.* München:Fachverlag

[2] Breitkreuz, G. 2007. *Ohne Liquidität keine Überlebenschance.* Marburg: Tecum Verlag

and estimated output, bad investments due to the lack of strategic planning and market underestimation, larger fixed asset investments with a source the working capital.

Secondly, cash and its incorrect management, which brings about the poor liquidity – inadequate use of attracted capital - bank credits, customers' and suppliers' loans, leasing, factoring, etc., cash outflow, caused by dividend payments, without the necessary working capital in the entity's turnover, a significant rise of expenses on the account of turnover, the lack of profitability or insufficient profitability, contraction of the owner's equity, indebtedness.

The competitiveness of the enterprise is a key factor among the reasons for a liquidity crisis and the drop leads to a downfall in customers' demands, non-performance of sales and deliveries, ignorance or poor management of the working capital, dissatisfaction and retreating of long-standing customers.

The policy of managing a company's working capital should take into account the influence of a large number of factors. Regardless of how the planning was made, the enterprise should be able to recognize the symptoms that signal for the liquidity deterioration and plan how to cope with the situation. Some of the most important symptoms for liquidity deterioration are:

- Unplanned creation of inventory (increase of the inventory turnover period);
- Increase of the level of the company's accounts receivable;
- Decrease in the diurnal or hebdomadal cash inflow of the enterprise;
- Incapability of the enterprise to transfer the increase of its expenses towards its consumers;
- Contraction of the net working capital of the enterprise or a rise of the debt ratio.

All of the aforementioned reasons arise from a single, major reason, namely – insufficient and untimely exercised control on the liquidity in the enterprise and lack of strategic decisions. One of the main tasks of the researcher is to outline the problems in managing liquidity by using a case study. The other two, no less important tasks, are: to find examples of good practices in managing liquidity and to define and justify recommendations. In such cases the following key questions should be raised at the enterprise:

- What are the crisis-response measures, approaches and policies that managers undertake under the limitations of financial, physical, information and time resources, conditioned by the crisis?
- Is the practice aware of the fact that to overcome the problems with liquidity, not only the standard classical company management needs to be replaced by anti-crisis management but also an in-depth analysis, estimation and the impact of the crisis on liquidity needs to be taken into account?
- What priorities in the area of anti-crisis management are the most essential; to what extent are they used by enterprises and do they correspond to the scientific requirements and the best practices?
- Does the management of the enterprise learn lessons from liquidity crises, do they develop into approaches, rules and practices, which make liquidity management more successful?

Finding the answers to the questions put above would facilitate to a great degree the management of this key financial indicator and would reduce the risks of insolvency. Liquidity management is a part of the financial planning and helps in maintaining the level of solvency of the enterprise. Financial and liquidity plans are set as short-term, medium-term and long-term plans in conformity with the goals. From the current perspective, long-term planning can be estimated quite inaccurately, therefore the burden rests upon short-term planning and medium-term planning. The annual liquidity plans should be made and changed quarterly or monthly. Thus solvency can be guaranteed in time and it can be maintained with less available cash. Due to the already-known and expected business processes, an annual plan could help, for instance, to define the secure, relevant need for good liquidity.[3]

A distinction between the cash inflows and outflows should be made in the process of planning. The cash outflows comprise mainly the current permanent expenses of the enterprise, staff costs and costs incurred for the purchase of goods and external services. Further, other public responsibilities and taxes have to be taken into consideration. The cash inflows essentially arise mainly through the sale of goods and services, through the disposal of assets or rights and through tax refunds. The following types of cash pertain to liquidity: available cash, daily maturity rates of bank credits, available credit lines.

These liquidity cash holdings are primary by means of securing a relatively fast liquidity. The secondary and tertiary liquidity comprise cash holdings whose availability is possible only in case of delays in time. These include: cash and short-term receivables, current assets or inventories[4].

A number of factors have an impact on liquidity. These factors have to be taken into serious consideration in order to manage this indicator and prepare anti-crisis measures. They could not only improve liquidity, but they can also secure the solvency of the enterprise.

In my opinion, the key instruments that can ensure the solvency of the enterprise and improve the liquidity can be divided into three groups:

Possibilities to increase the cash flow through actions towards the current assets

In relation to the factors listed above, which influence the liquidity in terms of assets, measures have to be applied in order to create additional cash flow. There are two possible actions for the first factor –**inventories**. Inventories are the tangible assets with the lowest liquidity. Therefore, investments in this type of assets are high risk investments. In addition, the delivery, storage and the preparation of inventory for its input in production is accompanied by extra expenses, which are not typical for other current assets. For that reason, among others, optimization of inventory is sometimes necessary. There are different methods to decrease the amount of available goods at stock – to process or reduce raw materials inventory, to disassemble finished goods and sell them as separate components. According to the majority of experts in this field, the inventory should be reduced but one of the basic market dogmas has to be taken into consideration, namely that the inventory is a function of turnover, these two are in direct proportion, i.e. without the necessary amount of current assets/stock-in-trade, the turnover will go down. Hence, it is essential to optimize the current assets to such levels that they do not jeopardize the main activity of the enterprise.

The first action - **shortening** of the period of turnover of current assets can be accomplished by:

- Increasing labour productivity;
- Improving work organisation;
- Introducing new techniques;
- Introducing new technologies;
- Retraining and raising the educational level of the employees;
- Other.

[3] Ossola – Haring, C. 2006. *Die besten 150 Chicklisten zur Liquiditätssicherung.* München:Fachverlag

[4] Uhlig S. 2000. *Immer zahlungsfähig*. Berlin: Printul Verlag

The second action - a **reduction** of the duration of stock rotation of current assets by:

- Reduction of the average level of current assets;
- Optimization of the deliveries of current assets;

The second factor are the **receivables.** The aim is **to reduce** the period for the receivables turnover. The instruments are:

- Providing better payment terms from customers;
- The shortest possible contracts in terms of payments;
- Offering stimuli as attractive discounts for clients, who pay their dues in time;
- Stricter terms in the contracts, which will disadvantage the client in case of late payment;
- Other.

Methods to increase cash through actions upon short-term liabilities

In the case of short-term **liabilities** the aim is to reschedule their payments for as long as possible without threatening the main activity of the enterprise and evading facing the risk of litigation. For the financial institutions such a change would not be a problem.

SHORT-TERM LIABILITIES	Measures to provide extra cash
SUPPLIERS	Overdue payments Renegotiating older terms and conditions Providing new suppliers
STAFF	Delayed payment of salaries Redundancies
STATE	Overdue payments to the budget, incurring the risk of interest penalties and fines
BANKING INSTITUTIONS	Overdue loan payments Renegotiating loans Refinancing loans

- Suppliers

In order to limit the cash outflow it is reasonable to differentiate suppliers and classify them into categories in accordance with their significance for the activity and profit of the enterprise, by strengthening the relationship with the important suppliers, thus enhancing mutual understanding and the desire for cooperation. Another measure that can be undertaken is to put proposals for different payment systems and persuade creditors that the new approach would be the best way for both parties to maintain mutually beneficial relations. Suppliers, especially suppliers with established long-term cooperation are willing, in case of skilled negotiating, to accept longer deferred payments of about 90 days. Diversification of the suppliers – it is possible to invite other suppliers who offer more flexible payment and pricing. In my opinion, in a challenging liquidity context, actions should be taken in this direction. In case the payments to less important suppliers are deferred by finding alternative suppliers, who offer more favourable conditions, the information from them could be used for further negotiations with the existing suppliers.

- Staff

In extreme liquidity situations it is possible to pay only a part of the due salaries. If employees are persuaded that the survival of the enterprise is threatened and the payments due to employees will continue at a later stage, in my opinion, in most cases they would show empathy. Another option is to make redundancies - in the most frequent cases auxiliary personnel or undertake a shift from full-time to part-time employment, as well as payment in accordance with the performance of the employee.

- Taxation

Using legitimate steps actions in handling tax obligations , tax payments are often deferred for long periods. In such cases tax consultants and accountants should be fully aware of the situation when planning liquidity and they should undertake the necessary measures.

- Banks

If credit relationships are established with banking institutions, it is possible to accomplish renegotiating. In most cases, that would lead to a rise in the interest rate of the credit but it would also lead to a reduction of the loans principal, at least at that stage, which is favourable for the solvency. Another alternative is refinancing the loan by another bank, which would allow the enterprise to heave a sigh of relief at this stage. Such a change would generally present no problem for the financial institutions, since the management of every bank "also carries the obligation to have plans in case unexpected circumstances arise", and subsequently," consider the alternative options to deal with these circumstances"[5].

Other possibilities for ensuring solvency

When choosing sources for extra cash, the managers of the enterprise have to take into account the purpose of the cash and also consider the financial state and risks, arising from raising debt capital. The following possibilities would increase the cash outflow and help the enterprise reduce problems with liquidity.

- Cash Management

Cash management is an essential tool for monitoring and control of liquidity reserves such as available cash, cash at banks, unutilized opportunities for debt capital, etc. These tools should be included in the planning and implementation phases and should constitute an integral part of the management information system.

- Organisation and management

The effective management is a prerequisite for the implementation of the objectives of the enterprise. In case every effort is made, costs will be saved which will be favourable for the liquidity. This is enhanced by the optimization of the work process, the rationalization of the information systems as well as reducing administrative expenses.

- Efficient research and development

Research and development in management are a strategically important area of management. The matter in hand is to invest money only when it is estimated as efficient and cost-effective. Enterprises should focus on the key points which guarantee success and fast profit.

- Potenital for product optimization

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[5] Asenov, E. 2009. *Osnovi na bankovia control.* Sofia: Stopanstvo

These are the main possibilities for reserves of enterprises:

- cost-saving measures;
- reducing the levels of hierarchy;
- more flexible working hours;
- stimulating motivation and efforts;
- reorganization of management, equipment and logistics;
- quality assurance, reducing reject rates;
- higher capacity utilisation;
- improving the quality of the services offered;
- reducing production time.

➢ Bank loans

When loans are used, the proper, timely negotiations with the banks under question are necessary, since most of the inevitable and necessary, required public guarantees have to be accounted for within a half year after the use of the capital. These requirements need comprehensive preparation such as writing a business plan and stipulating the estimate of the revenues and a liquidity forecast in the long run. In a situation of expansion and fast inventory turnover, many enterprises would prefer working capital loans in installments in order to plan their liability better. In a crisis situation forecasting the cash flow over time becomes difficult, which determines the use of another type of working capital financing - the most common is the overdraft or revolving credit. Fixed credit limits, for which banks require a step-by-step early decrease of credit lines as a condition for a future renewal, should be avoided. In the case of strong fluctuation of cash flow of the enterprise the ‘reduction’ of the liquidity could hamper its operation. An increase of short-term loans and long-term loans or the issued capital is also possible. Debt capital financing imposes the obligation not only to pay back the capital used after an agreed period of time, but also to pay a certain price for its use. The advantages of the use of debt capital are significant: retention of the property rights – there is not a new partner; expenses for the service of use of debt capital are deduced fully or partially from the amount of the taxable profit; in the case of short-term funding from external sources, the enterprise could adapt faster to the capital fluctuations than in the case of the use of own capital; debt capital financing often becomes necessary due to the fact that a number of practical obstacles occur in the case of mobilizing own capital.

Along with the positive sides of debt capital financing there are also disadvantages: the repayment of principal and interest rates is done on set dates; the provision of debt financing is also connected with securing guarantees; the use of large amounts of debt capital could block the operation of the enterprise, causing debt dependence and the management may lose their financial freedom; the financial dependence in the case of using external capital could hinder the access of the enterprise to the capital markets, etc. The debt capital can enter the enterprise in two ways: directly- in the form of operating lease and credit against goods or indirectly – as a bank loan, finance lease, debenture loans, etc.

➢ Bank guarantee

The bank guarantee can be the alternative of a working capital loan for many suppliers. The first-class bank guarantee covers the risk of non-payment to the agreed limit and it allows short-term deferred payment. On their behalf the institution, issuing the guarantee, has enough time to realize a part or the whole quantity of the product and it could facilitate the inventory turnover. From the financial point of view the bank guarantee is a tool several times cheaper than working capital financing which, in turn, leads to cost savings from interest rates. The disadvantage of this bank product is that it usually binds the payment to particular suppliers and it is difficult to apply in the case of replacement of a supplier or when the enterprise needs working capital, different from the payments to the suppliers.

- External capital financing or related entity funding

In some cases it might be an advantage when private capital providers finance their participation in enterprises. Through such participation liquidity can be covered for a short period. However, in order to attract such participants it is essential that the enterprise advocates their plan for development and future profits. Another possibility to attract capital is to provide funding from a related entity.

- Increase of own capital (Self-financing)

The own capital of an enterprise can be increased using several methods which would be favourable in a situation of cash deficit. The first method is to use contribution by a partner and the other method is the emission of ordinary or preferred shares. Additional cash can be provided using the two methods, thus increasing the functionally clear working capital of the enterprise. The own capital of the enterprise is provided by its owners- there is no fixed deadline for the availability of the capital and there is no obligation to pay a fee in cash for using these funds, either. For those who provide the enterprise's own capital there is greater risk of not receiving any remuneration from the capital invested, compared to those who invest loan capital. On the other hand, the more own capital is attracted free from a remuneration contract, the more advantages it has in case the business operates badly. The cash and the methods of self-financing are determined by the organizational and legal status of the enterprise. It is implemented on the basis of installments (in cash or property) agreed by contract. The share capital is personal and it serves as the partnership capital. The own balance capital of sole traders and partnerships is accounted for in the capital accounts of the enterprise. The effective own capital is formed by adding the amount of the so-called 'hidden' reserves. The secured own capital serves as a guarantee for external capital owners when providing that capital for the enterprise.

Self-financing can only be carried out if the profit of the enterprise, intended for this activity, has been transformed from inventory to liquid assets. We can distinguish between open and hidden self-financing. In the case of open self-financing, parts of the profit are accounted for in the capital accounts of the enterprise or are accounted as open reserves. Hidden self-financing comprises the forming of hidden reserves due to undervaluing of assets/property/ or overvaluing of liabilities. Open and hidden self-financing can also be triggered by the public finances through legislature, by introducing limits for the accumulation of reserves. One of the main differences between open and hidden reserves is their taxation. From the managers' point of view, self-financing provides different types of independence/freedom/ for decision making: independence in terms of property; production and economic independence; structural independence; financial independence. The state of self-financing of the enterprise is characterized by the feasible increase of the amount of the owner's equity as a result of economic activity. The advantages of self-financing are that, especially in the case of a company with share capital, it avoids the need to mobilize additional own and attracted capital; it is not necessary to attract new partners, which does not affect the structure of interests in the management of the enterprise; it is not necessary to give an account for the use of the capital; it is no longer necessary to pay for the service of using external capital; in the case of SMEs, which are unable to mobilize additional capital and seek new partners, self-financing is the only way to strengthen their own capital.

Self-financing also has its risks, due to the fact that the lack of external control could lead to unreasonable investment decisions, since no financial feasibility studies for the investment projects are required.

- Net earnings as a source of long-term financing[6]

The owners can decide whether to distribute the net earnings or to reinvest them. The reinvestment of a part of the net earnings is actually an additional new investment of the shareholders from the same enterprise, i.e. they refuse to be paid out dividends. The shareholders will expect from the reinvested capital the same rate of return that is required by the investors in the case of investments with the same level of risk.

- Subsidies

The subsidy is a contribution by an individual or an organisation (often the government) in the form of financial support or aid for establishing a certain enterprise. In most cases the subsidy is targeted, under certain terms and conditions and it is paid mainly in the economic sectors of public importance. Undoubtedly, this is a win-win option to provide cash.

- Leasing and (Sale Back Leasing)[7]

Leasing serves to finance fixed assets, not only regarding taxation, but also for the purpose to keep the liquidity levels. This form of financing of tangible assets does not often require payments in advance, which is a welcome development for the enterprises with liquidity problems at this stage.

In the case of Sale Back Leasing the enterprise sells certain tangible assets (buildings, equipment, factories, power stations, etc.) and then immediately leases them back. Thus, the enterprise raises cash and improves its liquidity situation. This is performed at the expense of the debt-to-capital ratio with all the unfavourable consequences.

The advantages of the leasing are as follows: you use your own capital to pay installments by expanding wisely the capacity of the enterprise; an opportunity to cover the leasing payments through additional profit; the leasing payments are eligible operating expenses of the enterprise; credit lines can be minimized; in some cases no expenses for insurance services are required, because the lessor becomes the owner of the asset; easier handling of questions connected with the liquidity load of the enterprise; better preconditions for a 'good' balance sheet, which would serve well for the lenders. The disadvantages refer to the fact that in most cases, the lease cannot be terminated prematurely, the expenses to serve the credit are sometimes higher, compared to other methods of financing;

- Selling tangible assets

Apart from the depreciation as a form of internal financing by releasing cash, the sale of tangible assets is another, not especially preferable method of providing fresh cash. It is used in the case of a liquidity crisis in an enterprise and using the received cash the payments to employees are also implemented or credits for working capital are paid off.

- Factoring

As we already know the factoring is a contract under which one of the parties transfers to the other party its receivables towards certain individuals and this organisation pays them, thus

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[6] Aleksandrova. M. 2012. *Finansirane i efektivnost na investiciite v realni aktivi.* Sofia: UNWE

[7] Petrov G. 2000. *Osnovi na finansite na firmata*. Sofia: Trakia - M

subrogating for their rights, taking the burden to return the amounts with a certain profit[8]. In the case of factoring, the entersprise sells its accounts receivable to a bank or another enterprise, dealing with factoring. The receivables are sold fully (not including the resources), thus the factor takes the whole credit risk, facing all dangers and loss resulting from the lack of payment on behalf of the clients, who fail to pay the enterprise. This method of finacing is often used when problems with the liquidity in the enterprise arise. It creates conditions to achive more up-to-date and timely management of capital. Practice has shown that the use of factoring is particularly useful in the cases of less than large, medium-sized enterprises or new-establised enterpises, suffering from lack of cash, with the prospect to enlarge the production scale. The factoring speeds up the capital turnover, which is important for such enterprises. The factoring simplifies to a great extent the terms agreed between partners. The seller can receive cash immediately after the delivery and the buyer is able to negotiate with the seller an acceptable period in time to defer payments. The seller has no responsibility for administrative payments, related to the control of repayment of the loan. He is granted the opportunity to actively deal with the production activities, to develop new production technologies and manage customer service.

- Litigation

Conducting or, respectively, avoiding litigation could have massive effect on liquidity. Litigation between the enterprise and the suppliers leads to delayed payments for months, sometimes even years. Litigation with clients is not recommendable, since it leads to delayed payments on behalf of the clients. In such cases the enterprise always has to compromise in order to keep its liquidity levels.

CONCLUSIONS

If all the above mentioned instruments or a part of them, are used by the enterprises which experience liquidity problems, in my opinion, they would have a positive effect on the factors and the financial cycle of the enterprise and they would improve its economic and financial indicators. Planning and ensuring a good liquidity is a complex process. The people responsible for this could implement this task only by having at hand all the reliable information and have the insight. A manager always has to check whether his decisions correspond to the possibilities for liquidity planning. The liquidity of an enterprise has to be estimated individually, in accordance with its specifics and the conditions that it operates in.

Managing liquidity is an essential part of company planning and management. This important financial indicator should be evaluated individually by the enterprise, in accordance with its specification and the environment that it operates in. The combination of tools that can influence all liquidity indicators – structural, functional and the financial cycle, is the most essential key point in liquidity monitoring.

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