University of Economics in Katowice

your place

your space

your future

FINANCIAL STABILITY IN THE EVENT OF A CHANGE OF AVAILABILITY OF CORPORATE EXTERNAL CAPITAL AS A RESULT OF A FORTUITOUS EVENT

Joanna Błach, Maria Gorczyńska,

Monika Wieczorek-Kosmala, Anna Doś

The research is funded by the National Science Centre in Poland, granted with the decision No. DEC-2011/01/D/HS4/04003

Wrocław, 26.05.2015 r.

Content

- **Introduction**
- **Definition of financial stability**
- **Parameters of financial stability**
- **Capital demand in case of loss event**
- **Changes in parameters of financial stability due to a loss event**
- **Conclusion**

Objective

- **To present parameters of financial stability of a company**
- **To show the direction of their potential changes as a result of a loss event**
  - **With their importance for ensuring access to capital necessary for covering negative effects of a loss event**

Thesis

- **Financial stability of a company determines the chance of constant undisturbed development**
  - **mainly by ensuring access to external capital in the case when it is necessary to cover the adverse effects of loss event**

Financial stability – macroperspective

Mainly related to financial system:

- **... condition of proper functioning of the economic system aiming at economic growth**
- **...absence of financial crises**
- **...condition where the financial system is able to withstand shocks...**
- **... condition of dynamic and constant balance...**
- **...healthy situation and harmonious interaction...**
- **...condition where economic activity is not disrupted by fluctuations in the market parameters**

Financial stability - microperspective

- **Re-definition**

  „stable = reacting with appropriate changes in behaviour towards changes in the business environment, capable of returning to the equilibrium, neutralising any arising deviations"

- ***Stable company*** **(descriptive definition):**
  - **operates in accordance with its goals despite disruptions**
  - **is capable of resisting shocks on a permanent basis**
  - **is maintaining its development strategy**
  - **is able to perform its economic functions**

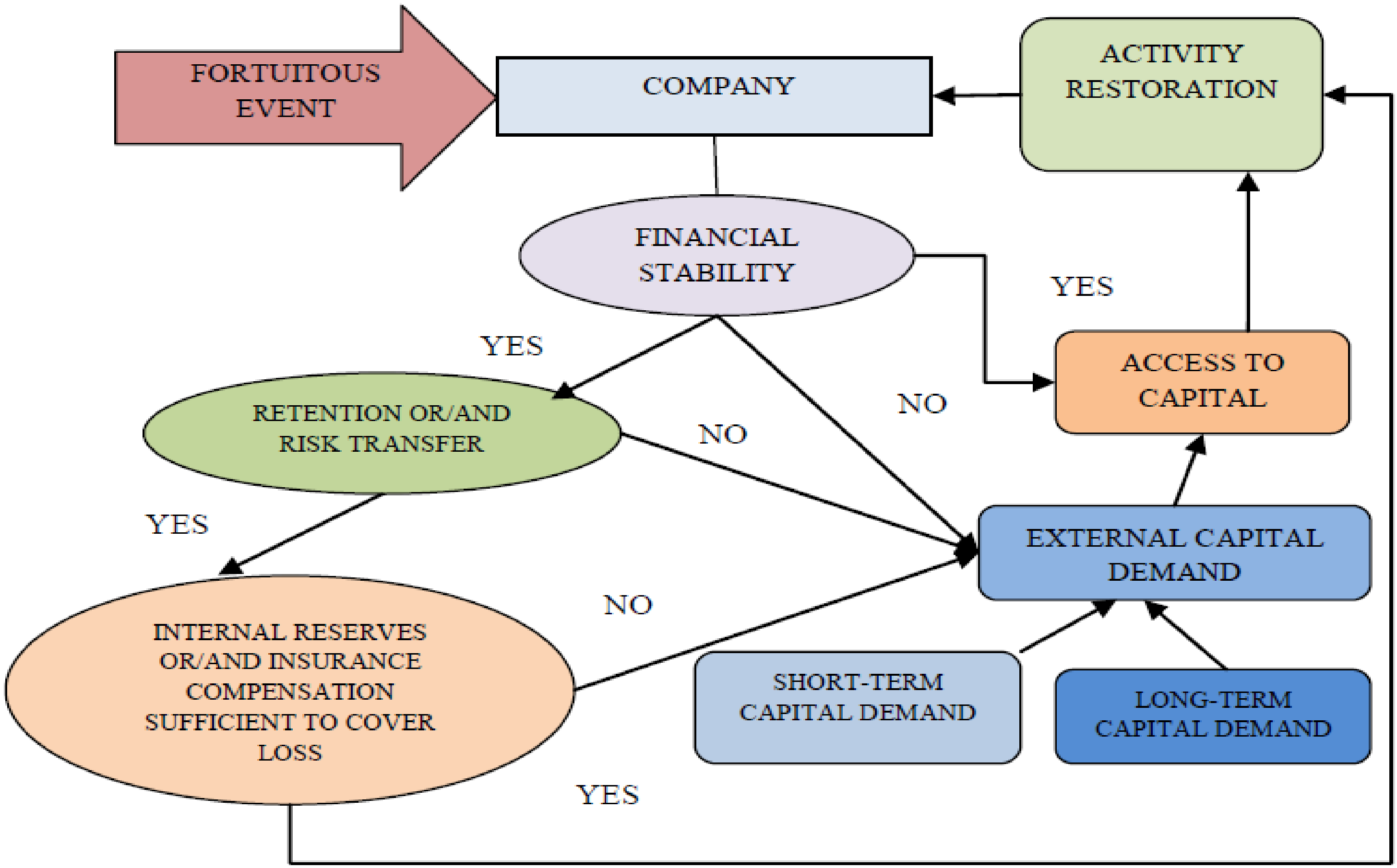
Financial stability of a company

- **Company demonstrates financial stability if despite internal disruptions and changes in its environment it is capable of maintaining:**
  - **financial liquidity, solvency, productivity and profitability within limits determined by the development strategy**
- **In the event of any deviations from the desired condition a company is able to udertake actions in order to restore the smooth functioning**
- **A fundament of financial stability is the possibility to raise and use capital to achieve the set goals**

Financial stability and its parameters

Financial Liquidity	Debt Management (Financial Leverage and Debt Coverage)	Efficiency (Assets Management)	Profitability
L.1. Current ratio (S)	D.1. Total debt to equity (D)	E.1. Total assets turnover (S)	P.1. Return on assets (S)
L.2. Quick ratio (S)	D.2. Total debt to assets (D)	E.2. Fixed assets turnover (S)	P.2. Return on equity (S)
L.3. Net working capital to assets (S)	D.3. Financial balance (fixed capital coverage) (S)	E.3. Receivables cycle (D)	P.3. Return on sales (S)
L.4. Cash productivity of assets (S)	D.4. Long-term debt coverage (S)	E.4. Inventory cycle (D)	P.4. Basic earnings power ratio (S)
L.5. General cash sufficiency (S)	D.5. Times interest earned (S)	E.5. Efficiency ratio (D)	

Feedback: loss event – financial stability – capital demand



Capital demand in case of loss event

$$CD_{(FE)} = CD_L + CD_S = L_D + L_I - R_R - C_I$$

- $CD_{(FE)}$ - **total capital demand of a company as a result of a fortuitous event**
- CD_L – **long-term capital demand**
- CD_S – **short-term capital demand**
- L_D – **direct losses**
- L_I – **indirect losses**
- R_R – **resources from internal reserves**
- C_I – **resources related to risk transfer**

Negative changes in parameters of financial stability as a result of loss event

Conseq.	Liquidity	Debt management	Efficiency	Profitability
S.1. (FA↓)	Decrease in cash flow ratios	D/A increases TIE decreases Long-term debt coverage decreases	Decrease in turnover ratios	Decrease in profitability ratios
S.2. (CA↓)	Decrease in balance sheet and cash flow ratios	D/A increases TIE decreases	Decrease in turnover ratios	Decrease in profitability ratios
s.3. (FA & CA ↓)	Decrease in balance sheet and cash flow ratios	D/A increases TIE decreases	Decrease in turnover ratios	Decrease in profitability ratios
s.4. (INV stop)	Changes are ambigous	Long-term debt coverage decreases	No changes	No changes

Negative change in parameters of financial stability - simulation

Parameters	O	Variant 1 Loss of 10% of TFA, IFA and Inventory	Variant 2 Loss of 50% of TFA, IFA and Inventory	Variant 3 Loss of 90% of TFA, IFA and Inventory
Liquidity	5	Decrease in current ratio	Decrease in current ratio and NWC/A	Decrease in all ratios
Debt management	2C 3F	Increase in financial leverage ratios Decrease in debt coverage ratios	Increase in financial leverage ratios Decrease in debt coverage ratios	Increase in financial leverage ratios Decrease in debt coverage ratios
Efficiency	4	Decrease in turnover ratios	Decrease in turnover ratios	Decrease in turnover ratios
Profitability	1	Decrease in all ratios	Decrease in all ratios	Decrease in all ratios

Conclusion

- **No sufficient evidence has been found to confirm the thesis:**
  - **that financial stability of a company is a necessary condition for constant, undisturbed development by ensuring access to capital allowing for covering negative effect of loss event**
- **However, financial stability is subject to the application of active approach to risk management**
  - **As ineffective risk management may result in permanent instability**
  - **Integrated approach to finance and risk management is required**

University
of Economics
in Katowice

www.ue.katowice.pl