THE IMPACT OF LIABILITIES ON A COMPANY'S FINANCIAL STABILITY

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Abstract: The aim of this article is to examine the impact of liabilities on selected financial indicators, which determine the financial stability of an accounting entity in accordance with the Accounting Act. Based on a theoretical perspective on liabilities, we present factual material drawn from a research project. In conclusion, we outline potential solutions that emerged from the analysis.

Keywords: short-term liabilities, long-term liabilities, liquidity, activity, indebtedness.

1 Introduction

Liabilities are more than simply figures on a balance sheet; they are essential to any company's or government agency's financial reporting and overall health. Investors, analysts, and other stakeholders who depend on financial statements to make choices must comprehend these responsibilities. In financial statements, liabilities play a crucial role in revealing the health of a business and assisting stakeholders in evaluating its liquidity, solvency, and general economic stability. Sustaining openness and confidence in financial reporting depends on accurate reporting and sound management of financial obligations. The Accounting Act defines liabilities as external sources of funding, and they play a significant role in assessing a company's financial health. Naturally, accounting entities are required to report liabilities in their financial statements, specifically in the balance sheet [5; 7; 8; 12]. When an asset or liability is related to more than one layout item, it must be reported under the item it occurs under or in the financial statements' notes, under the Accounting Directive 2013/34/EU. Liabilities differ in terms of their duration and kind. Specifically, as mandated by paragraph 39 of IFRS 7, IFRS Standards demand a maturity analysis that displays the remaining contractual maturities for non-derivative financial obligations. This article highlights the importance of evaluating liabilities in the context of company' financial stability.

2 Method

The methodological basis of the article included the works of scientists and specialists in the field of financial management and accounting, as well as the analysis and generalization of the best practices of a number of companies. The study used provisions of financial and strategic analysis, as well as methods of comparative analysis.

3 Results and discussion

Liabilities from an Accounting Perspective

Every business owner must navigate the complicated world of financial management and confront the difficult task of striking a balance between their company's assets and obligations in order to guarantee long-term stability and development. Comprehending the structure and influence of liabilities on a company's balance sheet is essential, regardless of the urgency of fulfilling immediate commitments or the need for strategic planning to handle long-term loans.

Liabilities are an important consideration when evaluating a company's financial health since they can be a "double-edged sword". On the one hand, they are necessary for capitalizing on opportunities, enabling companies to grow, finance new ventures, or just run their day-to-day operations without exhausting their cash flow. This clever use of debt may result in substantial development and profitability, demonstrating the advantages of responsibly handled obligations. Conversely, large or badly constructed liabilities can cause instability in the financial system, which in turn can cause problems with cash flow and solvency. Finding the right balance between leveraging liabilities for expansion and making sure they do not jeopardize the company's financial stability is crucial to preserving financial health. Therefore, comprehending the composition and consequences of liabilities is critical for any company hoping to prosper in the current competitive environment, underscoring the need of strategic financial management.

Understanding the structure of a company's balance sheet - especially the liabilities section - is crucial when it comes to corporate finance. This section provides a clear picture of the short- and long-term financial commitments that a business must meet. When evaluating a company's financial health, the two main categories - current liabilities and non-current liabilities - play crucial roles. Accounts payable, short-term loans, and accumulated costs are examples of current obligations that must be paid off within a year and are essential for running a business. However, non-current liabilities - such as bonds due, long-term loans, and deferred tax liabilities - offer information about a company's long-term financial obligations. To sustain financial stability and promote growth, a company's assets and liabilities must be proportionately balanced. A company's leverage and capacity to draw in investment can be greatly impacted by how strategically it manages these responsibilities.

The very term *liabilities* refers to external sources of asset funding for a company. According to the Accounting Act:

- A liability is an existing obligation of the accounting entity arising from past events.
- It is probable that this obligation will reduce the accounting entity's future economic benefits.
- The liability can be reliably measured.
- It is reported on the balance sheet or in the profit and loss statement.

According to International Financial Reporting Standards (IFRS), a liability is recognized in the accounting entity if it is measurable and meets the following three criteria [1-4]:

1. A liability is a current obligation that will likely require a future outflow of economic resources (transfer of cash, goods, or services) or the relinquishment of future income by the entity to settle its obligation at a specified or undetermined future date.
2. The accounting entity cannot avoid settling or discharging the liability.
3. The accounting event resulting in the creation of the liability has already occurred. An economic benefit is defined as the potential to contribute, directly or indirectly, to the flow of cash or cash equivalents.

The basic classification of an accounting entity's liabilities is based on time, dividing them into short-term and long-term ones. If specific liabilities cannot be categorized by time, the intention of the accounting entity at the time the liability arose becomes crucial for classification. For this division, the remaining maturity period is key. The remaining maturity period is the time between the agreed maturity date and the date on which the financial statements are prepared.

Even though they are necessary to finance operations and expansion, liabilities can have a big impact on a company's cash flow and liquidity. A company's liquidity may be strained by a significant amount of liabilities, particularly short-term ones, which can make it difficult for the business to satisfy its immediate financial commitments. This kind of situation frequently results in the need for further funding, which can burden the business even more. On the other hand, by guaranteeing that cash flows are enough for both debt repayment and development investments, efficient liability management may improve a company's financial stability. The secret is to strike a balance that satisfies operational requirements without endangering the company's financial stability.

The following ideas can help to understand how liabilities affect cash flow [11]:

Interest Expenses: Frequent loan interest payments lower the net cash available for other purposes, which may restrict investments in business expansion prospects or shareholder dividend payments.

Debt Covenants: Covenants mandating the corporation to maintain specific financial ratios are a common feature of loans. Cash flow may be further impacted by penalties or the requirement to return loans early if compliance is not maintained.

Refinancing Risk: High debt levels can make it difficult for businesses to refinance their debt, particularly in bad credit markets. Higher interest rates or the requirement to liquidate assets in order to satisfy debts are two outcomes that might have a detrimental impact on cash flow.

Short-term Liabilities

These liabilities are settled by the accounting entity within its operating cycle, typically measured in days [6; 9]. Short-term liabilities are classified by the degree of certainty as follows:

a) precisely determined liabilities,
b) provisions - liabilities that are estimated,
c) contingent liabilities.

The most numerous group of liabilities consists of trade payables. Companies generally encounter trade-related liabilities, which represent obligations to business partners. These arise from activities such as the purchase of goods, materials, or supplies intended for resale, use in production, or service provision. Other liabilities similar to trade payables include obligations for direct and indirect taxes, fees, or penalties. Loans represent financial borrowings provided by banks or financial institutions.

Provisions form a separate group of liabilities that are probable and estimated. Companies create provisions based on the principle of prudence for potential risks, losses, or business-related expenses. Since their exact amount and timing are uncertain, provisions are estimates of existing obligations arising from past events. They may be based on a percentage of a past base or an absolute amount, as defined by law, and they impact the company’s economic benefits.

Employee-related liabilities represent wage costs incurred for employees. Employing staff entails a legal obligation to pay contributions and taxes, creating liabilities toward social security institutions such as the Social Insurance Agency, health insurance companies, or the Financial Administration.

Miscellaneous liabilities are understood as transitory items, refer to expenses occurred during a given period but paid later. However, when preparing financial statements, companies must account for and allocate these liabilities over time. Examples include lease payments, unpaid rent, liabilities from complaints, etc. Short-term, precisely determined liabilities also include deferred income, liabilities from declared dividends, advances received, installments of long-term liabilities due the next year, and liabilities related to income tax, VAT, and other taxes.

Long-term Liabilities

Long-term liabilities are obligations with a maturity period or settlement term exceeding one year from the date of the accounting event. Long-term liabilities include:

- bank loans and mortgages;
- financial leases;
- obligations from the social fund;
- issued bonds, and others.

Loans can be classified as either short-term or long-term liabilities, depending on their maturity period. Through loans, a company acquires funds for business activities but incurs a liability in the form of principal which represents the borrowed money, and the interest that it commits to pay back. Loans are considered external sources and are recorded in the liabilities section of the balance sheet. Mortgage loans, often secured by real estate such as company buildings or land, also fall under long-term liabilities.

Leasing is a common method for acquiring assets. In a leasing arrangement, the lessor grants the lessee the right to use an asset for a specified period in exchange for payments, or installments. Leasing can be classified into two types: financial leasing and operational leasing.

Liabilities from the social fund are regulated by Act No. 152/1994 Coll. on the Social Fund, as amended. These are social obligations that can be used in future periods. Employers are legally required to create a social fund, with contributions ranging from 0.6% to 1% of the total gross wages paid to employees for the current year, as regulated by law.

Liabilities as Part of Selected Financial Ratios

To preserve and improve a company's financial position, effective liability management is essential. Businesses may maximize cash flow, lower interest costs, and enhance their debt-to-equity ratio by proactively managing both short- and long-term obligations. Refinancing high-interest debt to a lower interest rate is one practical tactic that may greatly lessen financial pressures. Additionally, businesses may take advantage of growth possibilities while limiting risks by preserving a balanced mix of debt and equity funding. Restructuring debt and extending terms of payment to creditors are two other doable strategies to increase operating flexibility and liquidity. The comparison table that follows shows how various liability management techniques affect a company's financial stability using fictitious data to highlight the possible advantages (see Table 1):

Table 1: The effect of various liability management techniques on the financial health of an organization, with fictitious data used to highlight the possible advantages

Strategy	**Interest Rate Reduction (%)**	**Debt-to-Equity Ratio Before**	**Debt-to-Equity Ratio After**	**Impact on Cash Flow**
High-Interest Debt Refinancing	3%	1.5	1.3	Positive
Debt Restructuring	N/A	2.0	1.8	Positive
Negotiating Longer Payment Terms	N/A	1.8	1.6	Moderate

Businesses frequently aim to finance their operations in a way that strikes a balance between debt and equity, which makes the debt-to-equity ratio a crucial statistic for analysts and investors. This ratio sheds light on a company's financial leverage and risk profile. It is computed by dividing its total liabilities by its shareholder equity. A greater percentage raises the possibility that a business is taking on excessive debt, which might raise its risk of bankruptcy during recessions. On the other hand, a smaller ratio suggests that a business may be underleveraging and so losing out on prospects for expansion. As an example, let us look at two technological companies: Company A, which has a debt-to-equity ratio of 0.5, and Company B, which has a ratio of 1.5. The lower ratio for Company A implies a cautious approach to leverage and may indicate a more solid financial situation. Company B, on the other hand, appears to be using debt more aggressively, which might raise financial risk but potentially lead to better profits [14].

A thorough examination of corporate finance reveals that a company's lifespan and financial stability are significantly

influenced by its strategic liability management practices. Prominent companies in a range of sectors have shown that competent management of liabilities may greatly improve their financial stability. For example, Apple Inc. has maintained a strong financial sheet to support its aggressive R&D and marketing strategy by managing its long-term debt and operating obligations well. This strategy has increased investor trust while also preserving its financial stability.

Microsoft Corporation is yet another prime example of effective liability management. In order to maximize tax savings and fund its strategic acquisitions, the computer giant carefully arranges its obligations, which supports development and expansion. Important tactics include of [11]:

- Lowering interest rates on corporate bonds to fund acquisitions without reducing shareholder value
- Optimizing the ratio of short-term to long-term obligations in order to preserve cash and financial flexibility
- Utilizing hedging strategies to control the foreign currency and interest rate risks related to its international operations.

By taking these steps, Microsoft has been able to successfully manage risks and sustain a solid financial position, which is in line with its ambitious growth plan.

The effects of strategic liability management on operational effectiveness and market leadership are demonstrated by Amazon.com, Inc. Amazon's growth is unmatched because it uses its liabilities to fund significant investments in technology, logistics, and market development. The business's strategy consists of [14]:

- Allowing for flexibility in its extensive logistical network by utilizing operational leases.
- Obtaining long-term debt on advantageous terms to finance its growth of infrastructure and technical advancements.
- Controlling supplier credit helps maximize cash flow and guarantee the prompt implementation of its ambitious plans.

Amazon's quick expansion and position as a dominant player in the worldwide market may be attributed to its strategic management of liabilities, demonstrating the significant influence that successful liability management can have on a company's success.

Liabilities significantly affect various financial ratios. In this article, we have selected the following ratios that are directly related to liabilities:

a) Liquidity. Liquidity ratios reflect a company's financial position and its ability to meet liabilities, which is assessed through analysis. Two key factors influence the ability to meet liabilities:

- Asset structure
- Regular cash inflow

The asset structure affects liability repayment because different assets have varying levels of liquidity. Liquidity refers to the ease with which assets can be converted into cash or cash equivalents and is determined by the time and cost required for conversion. Liquidity pertains to a company's ability to pay liabilities over the long term, while solvency refers to the immediate ability to settle liabilities. A company that is unable to pay its liabilities is considered permanently illiquid, indicating a breach of financial balance, or insolvency. Liquidity ratios, which are proportional indicators, help quantify a company's liquidity. Liquidity is typically divided into three levels: immediate, current, and total.

The amount of liquidity a company holds determines its ability to pay and cover its liabilities. As we have seen, various factors impact liquidity levels. Addressing low liquidity depends on the specific circumstances and can be challenging. To maintain liquidity, a company must ensure sufficient cash in its financial accounts, achieved through steady revenue, reduced investment expenditures, and cost-cutting measures. These steps may also result in reduced expenses, including payroll costs. Here is an example from the analyzed organization (see Table 2):

Table 2: Development of Liquidity Ratios from 2020-2022 (in euros)

Ratio	Years			Change	Index
	2020	2021	2022	22-20	22/20
Immediate Liquidity (0.2 – 0.8)	0.36	0.28	0.18	-0.18	0.50
Current Liquidity (1 – 1.5)	0.80	1.27	1.35	0.55	1.69
Total Liquidity (1.5 – 2.5)	0.81	1.27	1.36	0.55	1.68
Immediate Operating Liquidity (0.4 – 1.0)	0.5	0.41	0.23	-0.27	0.46
Current Operating Liquidity (1.2 – 1.7)	1.14	1.84	1.78	0.64	1.56
Total Operating Liquidity (1.7 – 2.7)	1.15	1.85	1.79	0.64	1.56

Source: financial statements; Balance Sheet section, own calculations

b) Activity Ratios

These ratios reflect the capital tied up in various forms of assets and quantify management efficiency, specifically the effectiveness of asset utilization. A key activity ratio is *days payable outstanding*, which measures the average time between the creation of a liability and its payment. This ratio relates liabilities to costs, particularly trade credit extended by suppliers. Higher days payable outstanding values may suggest the company's difficulty in settling its debts.

c) Leverage Ratios

Authors focused on:

- **Total Leverage:** This ratio indicates the extent to which external capital is used relative to total resources.
- **Self-Financing Ratio:** This ratio measures the extent of using own capital relative to the company's total resources.

Leverage ratios are used to assess the structure of financial resources, as the ratio of own to external sources affects financial stability. Proper balance between own and external sources is a result of effective financial management. Higher leverage increases the difficulty of obtaining external resources and raises business risk. The so-called "golden balance rule" for vertical capital structure suggests an approximate 1:1 ratio between own and external resources. Additionally, increasing own resources, often achieved through generating profits, is crucial for financial stability (see Table 3, 4).

Table 3: Development of Leverage Ratios from 2020-2022

Ratio	Years		
	2020	2021	2022
Total Leverage	114.04%	76.26%	72.91 %
Self- financing Ratio	-14.04%	23.74%	23.72 %
Insolvency Ratio	1.58	0.70	0.65
Financial Leverage	-7.12	4.21	4.22
Credit Burden Ratio	31.51%	22.76%	15.64%

Source: financial statements; Balance Sheet section, own calculations

Table 4: Structure of Funding Sources in the Balance Sheet from 2020-2022

Years / Passive accounts	2020 / €	%	2021/ €	%	2022 / €	%
Total Equity and Liabilities	317 502		403 929		519 877	
Equity	-44 573	100,00%	95 900	100.00%	123 296	100.00%
Share Capital	30 000	-67.31%	30 000	31.28%	30 000	24.33%
Other Capital Funds	19 000	-42.63%	19 000	19.81%	20 500	16.63%
Profit founds	0	0 %	0	0 %	0	0 %
The result of previous years' management	-198 975	446.40%	-93 572	-97.57%	45 400	36.82%
The result of the management of the current accounting period	105 402	-236.47%	140 472	146.48%	27 396	22.22%
Liabilities	362 075	100,00%	308 029	100.00%	379 019	100.00%
Reserves	3 107	0,86%	1 507	0.49%	8 122	2.14%
Long- term Liabilities	8 838	2.44%	9 095	2.95%	9 548	2.52%
Short- term Liabilities	250 072	69.07%	205 504	66.72%	280 030	73.88%
Short- term Financial Assistance	0	0.00%	0	0.00%	0	0.00%
Bank Loans	100 058	27.63%	91 923	29.84%	81 319	21.46%
Time distinction	0	100.00%	0	100.00	0	100.00 %

Source: financial statements; Balance Sheet section, own calculations

Conclusions, Framework Proposals, and Solutions

In analyzing the Balance Sheet and Income Statement for the period 2020-2022, as part of present research, authors observed the impact of liabilities on various financial indicators across many businesses. In most cases, the following conclusions are reached:

1. Higher levels of company indebtedness
2. Insufficient company liquidity
3. Reduced equity value

Framework Proposals and Solutions:

a) Proposal for Addressing Total Indebtedness and Insolvency

The recommended ratio of equity to debt is 50%, and generally, foreign capital should not exceed 70%. During the analyzed period, both companies had total indebtedness exceeding 70%, indicating higher financial risk. Reducing total indebtedness can be achieved by decreasing liabilities, particularly foreign sources. This can be facilitated by repaying bank loans and reducing liabilities, especially short-term ones, which often constitute the largest portion of liabilities. Identifying all liabilities, assessing their amounts and justifications, and subsequently eliminating unnecessary ones is essential.

Another key indicator of indebtedness is the degree of self-financing, which reflects a company's financial independence and is the inverse of total indebtedness. This ratio is calculated by comparing the company's equity to total capital and expressing it as a percentage. A higher degree of self-financing indicates greater financial stability and less reliance on external financing.

Maintaining a higher proportion of equity to total capital is crucial for any business. The recommended minimum for the share of own resources should not fall below 30%. Companies with a higher proportion of their own resources are considered less risky. Since our analyzed companies have a lower proportion of their own resources, they are more vulnerable, especially during external crises. However, the optimal degree of self-financing may vary among companies and is influenced by the industry in which they operate.

Increasing the value of own resources can be achieved through business profitability. Retained profits and reinvestment can enhance the self-financing ratio, potentially leading to expansion and internal growth. Effective cost management, which impacts cash flow, is also crucial. Reducing costs can improve overall business performance. Regular monitoring and analysis are vital for responding to changes in both internal and external environments. Effective management of own resources requires not only short-term monitoring but also long-term strategic planning. Strategic management and continuous attention are essential for maintaining the degree of self-financing.

Another important indicator of indebtedness is payment insolvency, which measures the extent to which receivables cover short-term liabilities and reflects the company's ability to meet liabilities with immediate repayment. Payment insolvency is calculated by comparing short-term liabilities to short-term receivables.

While payment insolvency provides a partial measure of a company's indebtedness, a high value does not always indicate an inability to pay liabilities - it may reflect a temporary situation [10; 15]. Finding a balance between liabilities and receivables is crucial. Solutions to address payment insolvency include regular monitoring of accounts receivable, tracking due dates, sending reminders for upcoming invoices, and issuing follow-up notices for overdue payments. Larger companies often have dedicated departments or employees managing receivables. To balance liabilities with receivables, companies should align the due dates of liabilities with the due dates of receivables.

b) Proposal for Addressing Credit Indebtedness

Credit indebtedness is not necessarily a negative aspect for businesses. Taking out a loan is a common practice in today's business world, with companies using loans to finance significant investments, development, material purchases, or new equipment. However, it is crucial for a company to assess all risks carefully.

Decisions regarding loan procurement should be well-considered and preceded by strategic planning. The range of credit products offered by banks is broad, so if a company needs to take out a loan, it is advisable to consult with a bank advisor who can collaborate closely with the company's financial department. This approach can lead to securing a loan that best aligns with the company's needs and financial capabilities.

c) Business Liquidity

Liquidity, as a key financial ratio indicator, was also part of the financial analysis for the businesses studied. We observed that liabilities impact this indicator, either independently or as part of external capital. In the analyzed companies, we calculated classic liquidity by comparing financial accounts, short-term receivables, and current assets (numerator) with short-term external capital (denominator). We also calculated operational liquidity using the same items as classic liquidity but with only short-term liabilities in the denominator.

Quick liquidity, which measures a company's ability to cover short-term external capital with cash on hand or in accounts, is another important indicator. Acceptable values for quick liquidity in a market economy typically range from 0.2 to 0.8.

The second liquidity indicator, current liquidity, should range from 1.0 to 1.5. This indicates whether the company can cover short-term external capital not only with financial accounts but also with short-term receivables.

The third calculation, total liquidity, has the highest acceptable range, from 1.5 to 2.5. This measure shows whether the company can cover short-term external capital, which represents a debt, through the monetization of short-term assets.

d) Structure of Liabilities

The evaluation of liabilities is crucial and depends on the type of liability. It may involve:

- Financial liabilities arising from trading,
- Liabilities not related to trading,
- Non-financial liabilities.

Models for valuing these liabilities will be discussed in further contributions.

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