Chapter 6

Liquidity as a basis for financial failure Risk in financial institutions

First: Basic concepts of financial failure.

1-Financial failure from an economic perspective:

This type of failure occurs when the return achieved on the invested funds is less than the average cost of these funds, i.e. if the return achieved on trading in ownership in the company is a negative number…

First: Basic concepts of financial failure.

Then the failed company can be viewed in the economic concept as those companies whose income is not sufficient to cover their expenses or in which the rate of return on investments - at their book cost - is less than the cost of capital.

First: Basic concepts of financial failure.

2-Financial failure from a legal perspective: The Egyptian Civil Code stipulates that the financial insolvency system assumes that the debtor's funds are insufficient to meet his due debts, and this refers to the increase in the obligations owed to others over the value of the company's assets..

First: Basic concepts of financial failure.

3-Financial failure from a banking perspective: The Central Bank of Egypt "the debt in which the client stops paying the principal or interest or both for a period of three months or more due to his inability to achieve cash flows from the results of his activities sufficient to pay those obligations and the bank does not have additional high-quality, liquid, short-term support guarantees that cover the full value of the debt and its return

First: Basic concepts of financial failure.

The soundness of the financial position in the short term is called liquidity and in the long term it is called solvency, and both mean maintaining the company's financial position, i.e. the company's ability to pay its obligations and provide the necessary funds to obtain the necessary needs in the short and long term.

Second: Stages of financial failure.

Financial failure is usually the result of accumulated errors and poor judgments in decision-making that may be completely far from real practices, but the natural result may be the loss of the company and then facing many financial problems that may lead to failure. **The stages of financial failure can be discussed as follows:**

Second: Stages of financial failure.

1-The first stage: Signs of financial failure: The stage before the emergence of the high default clearly. This stage is associated with many negative phenomena (indicators), the most important of which are:

- Decrease in demand for the project's products and an increase in inventory.
- Weakness of the project's competitive position.

Second: Stages of financial failure.

- Increase in the costs of products and services and lack of tight control and supervision over them.
- Low asset turnover rate.
- The project's inability to obtain sufficient credit facilities.
- Poor efficiency of production methods.

Second: Stages of financial failure.

- Adopting investment expansion policies without sufficient capital to meet them.
- Increasing the ratio of debt to the owners' rights over the safety ratio.

Second: Stages of financial failure.

At this stage, the project's current assets are sufficient to cover its current Liabilities, but they are unable to achieve an appropriate return to pay its other Liabilities - such as long-term loans - and the project also faces the problem of mismatch between its incoming and outgoing cash flows,

The following financial position statement can clarify this:

Second: Stages of financial failure.

Financial position statement of Tashell Financial and Investment Services Company On 31/12/2023 (value in millions of pounds)

Assets			liabilities and equity
	Current Assets		Current Liabilities
50	Cash	300	Short Term Bank Loans
900	Receivables, Notes Receivable	800	Notes Payable
250	Inventory		
1200		1100	
800	Fixed Assets	300	Long Term Liabilities
		600	Equity
2000		2000	

Second: Stages of financial failure.

The balance sheet shows a short-term shortage in liquidity, although current assets (1200) exceed current liabilities (1100), but the distribution of these assets is such that they cannot obtain production factors and meet their current liabilities due to the weakness of their cash position.

Second: Stages of financial failure.

2-The second stage: The stage of temporary financial difficulty or financial confusion: This stage is an extension of the first stage and has the same phenomena and causes, but due to the continuation of the same causes without addressing them and treating them financially and banking.

Second: Stages of financial failure.

This stage is related to the project's inability to meet its current Liabilities efficiently and is in dire need of cash despite owning tangible assets whose value exceeds the value of its total Liabilities towards others, which is reflected in the liabilities side of the balance sheet, The following balance sheet can clarify this:

Second: Stages of financial failure.

Financial position statement of Tashell Financial and Investment Services Company On 31/12/2023 (value in millions of pounds)

Assets		liabilities and equity	
	Current Assets		Current Liabilities
40	Cash	600	Bank Loans
460	Receivables, Notes Receivable	900	Creditors and Notes Payable
800	Inventory		
1300		1500	
700	Fixed Assets	500	Equity
2000		2000	

Second: Stages of financial failure.

The balance sheet shows that the total of its current liabilities (1500) exceeds its current assets (1300), which indicates the negativity of working capital and thus the company's inability to meet its due Liabilities.

Second: Stages of financial failure.

3-The third stage: The stage of technical financial difficulty: This stage is an extension of the previous two stages and is related to the project's inability to use normal financial and banking policies to obtain the required cash to be used in meeting its due Liabilities and meeting its required growth..

Second: Stages of financial failure.

and the difficulty of obtaining financing sources or converting part of its assets into cash to meet its current needs and pay its creditors' dues. This stage is related to several negative phenomena, the most important of which are:

Second: Stages of financial failure.

- Imbalance in the project's financial structure, and this imbalance is usually represented by the smallness of ownership rights compared to the obligations due with the continued increase in debts.
- Erosion of the project's capital because of its inability to recover the funds spent in its activity cycles (asset conversion cycles).

Second: Stages of financial failure.

- Using credit facilities for purposes other than those for which they were allocated, especially short-term loans, and thus the lack of working capital requirements necessary to manage the project activity.
- Inflating commodity inventory as a result of slowing down and stagnation of goods circulation.
- Increasing project debts to the banking system with no clear sources of repayment.

Second: Stages of financial failure.

Financial position statement of Tashell Financial and Investment Services Company On 31/12/2023 (value in millions of pounds)

Assets,		liabilities, and equity	
	Current Assets		Current Liabilities
20	Cash	900	Bank Loans
280	Receivables, Notes Receivable	600	Creditors and Notes Payable
600	Inventory		
900		1500	
700	Fixed Assets	500	Equity
400	Losses		
2000		2000	

Second: Stages of financial failure.

The balance sheet shows that current liabilities (1500) exceed current assets (900), which means negative working capital and thus the company’s inability to meet its due Liabilities, in addition to the company’s incurring losses that almost reach equity. Despite these negative phenomena, the project continues to operate despite facing many problems, whether related to liquidity and its inability to meet its current Liabilities or the stagnation of its sales and the severe shortage in its cash flows.

Second: Stages of financial failure.

4- The fourth stage: The legal insolvency stage: This stage refers to complete stumbling or financial failure, in which the project is suspended or almost suspended from activity and its market value is less than the total of its Liabilities. This usually occurs as a result of large and successive losses that lead to the erosion of capital.

Second: Stages of financial failure.

Financial position statement of Tashell Financial and Investment Services Company On 31/12/2023 (value in millions of pounds)

	Current Assets		Current Liabilities
40	Cash	900	Bank Loans
500	Receivables, Notes Receivable	600	Creditors and Notes Payable
360	Inventory		
900		1500	
600	Fixed Assets	500	Equity
500	Losses		
2000		2000	

Second: Stages of financial failure.

The balance sheet shows that current liabilities (1500) exceed current assets (900), which means that working capital is negative and thus the company is unable to meet its due obligations. In addition to the company incurring large and successive losses that led to the erosion of equity in addition to the decrease in the real value of its assets (1500) from the actual value of its liabilities (2000), which makes it fall within the circle of financial failure.

5 minute break.....

Tea Break

Third: Factors affecting the occurrence of financial hardship.

There are many reasons that lead to financial difficulty, and in general we can summarize them in one big title which is POOR MANEGEMENT.

- **Industry risks:**

- ✓ **The extent of the economic cycle's impact on the industry.**
- ✓ **The sensitivity of the company's profits to economic fluctuations.**

Third: Factors affecting the occurrence of financial hardship.

- ✓ Economic alternatives, inflation, energy factors, international competition.
- ✓ The extent of demand for the commodity and its relationship to economic indicators.
- ✓ The company's financial characteristics (fixed costs or high variable costs).

Third: Factors affecting the occurrence of financial hardship.

❑ Market risks:

- ✓ The extent of the company's ability to achieve sales.
- ✓ The extent of the company's market share stability.
- ✓ Weaknesses or strengths in the company's marketing strategy.
- ✓ The extent of reliance on a certain number of customers.
- ✓ Estimating sales in the long term.

Third: Factors affecting the occurrence of financial hardship.

❑ Risks of the company's operational efficiency:

- ✓ The ability to maintain and increase the profit margin.
- ✓ Price leadership.
- ✓ Integration of production processes.
- ✓ The extent of technological progress enjoyed by the company's operational capacity.
- ✓ Availability of raw materials.
- ✓ Availability of labor.

Third: Factors affecting the occurrence of financial hardship.

❑ Risks of accounting systems used:

- ✓ Methods used in inventory valuation.
- ✓ Revenue recording systems.
- ✓ Depreciation methods.
- ✓ Branch results recording systems.

Third: Factors affecting the occurrence of financial hardship.

❑ Profit adequacy:

- ✓ Return on capital.
- ✓ Profit margin.
- ✓ Sources of expected growth in profits.
- ✓ The impact of inflation on profits.

Third: Factors affecting the occurrence of financial hardship.

- **Financial flexibility:**

- ✓ The size of financial needs.
- ✓ Financial plans.
- ✓ The level of short-term debt.
- ✓ A comprehensive assessment of sources of funds.
- ✓ Payment structure.

Case study activity… Example page 177

- **Activity nature:** Case study.
- **Activity Time:** 30 minutes.
- **Skills:** creditworthiness assessment

The Next Lecture

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Liquidity as a basis for financial failure

Risk in financial institutions