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Key Mistakes and Delusions in Business Finance

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ABSTRACT: The author shows some fundamental shortcomings and weaknesses of modern corporate finance theory that affect the practice in enterprises and banks. Various theoretical areas of financial management are analyzed and their critical assessment is offered.New aspects of some relatively well-known information about the corporate's financial condition are depicted, particularly about net working capital, liquidity ratios, cash flow, optimal financial structure, and corporate's capital adequacy.The main purpose of the paper is to stress the need of reading professional literature with great caution and logical thinking. At the same time, there is a great risk in business decision-making that is based on some theoretical statements.

Key words: working capital,liquidity ratios, cash flow, financial structure, capital adequacy.

I. INTRODUCTION

This paper provides an overview of significant misconceptions and shortcomings in the professional literature and practice about dealing with certain economic categories in the context of business finance and accounting analysis, and consequently their inadequate explanation and formation of information.This mainly means inadequate creation of information for decision-making in the field of corporates' financial policy. The consequences in the lack of knowledge and wrong behavior of management are often reflected in difficulties in the operation of companies, especiallyat ensuring their solvency.

Due to a number of shortcomings, we will briefly point out them and cite the relevant literature for deepening and for a more detailed justification of the above.

Delusions about net working capital

The most common definition of net working capital (NWC) is the difference between short-term assets (STA) and short-term liabilities (STL) (e.g. Arnold, 1998, p. 543):

$$NWC = STA - STL. \quad (1)$$

The disadvantage of such a definition is the fact that it is otherwise accurate, but unfortunately purely computational and not substantive. The usual result of this is reflected in the wrong opinion that components (content) of net working capital are: inventories, trade receivables, marketable securities, cash, less current liabilities (e.g., Arnold, 1998, p. 543 and Brigham et al., 1999, pp. 595 and 596, and O'Reagan, 2002).

Many authors forget that net working capital cannot be influenced by short-term categories, although it can be calculated by using them. A causally consequential link between current assets and working capital does not exist.

Such an error is generated due to neglecting of the fact that net working capital can be calculated also as the difference between the long-term sources (LTS) and long-term assets (LTA):

$$NWC = LTS - LTA. \quad (2)$$

The equation 2 can be found already in Rao (1987, p. 517). The neglecting of the above equation enables the wrong belief that net working capital can be changed by current assets or current liabilities. Such a mistake is repeated by some authors (e. g., Arnold, 1998, p. 563 or Smart et al., 2004, p. 268).

Independent variables that affect the change in net working capital are just on the right side of the equation 2and the dependent variable is to the left side of the same equation. Net working capital is therefore a source of long-term financing of the organization. The consequence of not taking this fact into account is the inability to explain correctly the state and / orchanges of net working capital in the context of analyzing the financial statements.

Therefore, only equity and / or long-term debt can be actual components of net working capital.The structure of net working capital

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indicates its higher or lower quality. The important difference is, for example, if net working capital consists from long-term debt or equity. This structure has an important impact on company's solvency risk. Failure to consider this fact leads to a number of erroneous explanations, but also misleads decision-makers in business malicious actions.

Delusions about statement of cash flow

The next common mistake is misinterpretation of the statement of cash flow. Unfortunately, even International accounting standards (IAS 7, 2008, 18) recommend the direct method to report cash flow from operating activities as better information against the indirect method (IAS 7, 2008, 19).

This is somewhat reminiscent of the scholastic debate over whether the income statement has greater expressive power than the cash flow statement. At that time, Donleavy critically compared such discussions with those of greater utility of the left or right shoe (Donleavy, 1994, 162).

When comparing direct and indirect method of cash flow statement, the first question is, whether they are comparable at all. Two financial categories are in principle comparable only if they have exactly the same purpose.

Furthermore, it should be noted that it is possible to calculate each accounting category for at least two (but usually more) methods. Each of these methods does not demonstrate cause and effect relationship between categories, although the calculation result is the same. Therefore, due to the different method of calculating a category, as a rule, its expressive power changes, and its purpose changes as well. Such categories (information or indicators) are then not comparable.

The direct method of calculating cash flow does not reflect a causal relationship, while the indirect method allows it. In contrast, the direct method provides some more information related to the organization's current liquidity than the indirect method. Both methods are therefore complementary, but not exclusive.The recommendation of the International accounting standards is therefore incorrect and misleading. Even Miller and Bahnson make the same mistake when they favor the use of the direct method in reporting cash flow from operating activities over the indirect method (Miller, Bahnson, 2002, p. 87). Fortunately, it is very likely that the direct method will not be largely extended in practice, since its costs (taking into account the available information technology) and in the thoughts of managers today usually exceeds its expressive power.

Delusions about liquidity ratios

Important errors are related to the interpretation of liquidity ratios (current ratio, quick ratio and cash ratio). Many authors treat these indicators as important information about a company's solvency (e.g., Pinches, 1994, p. 640; and Brigham et al., 1999, p. 62). Unfortunately, the expressive power of these indicators is by no means sufficient to explain the evolution of a company's liquidity or solvency.[1] The consequencesare usually insufficient assessments of the solvency of the companies and their credit ratings in practice. This is especially important in several empirical researches, where the current ratio is often misused as a liquidity indicator of an organization.

So-called liquidity ratios are usually explained by comparing the numerator and the denominator (e.g. Friedlob, Schleifer, 2003, p. 75) because the indicator computationally represents a fraction. This approach assumes that the counter (directly proportional) and the denominator (inversely proportional) affect the indicator. Such an assumption in the case of these ratios is completely wrong. The equations, by which these indicators are usually calculated, do not reflect a causal relationship.

The nextshortcoming is the attempt to explain the individual coefficient and its movement without taking advantage of the possibilities of interrelation of the content and calculations of these indicators. This results in the fact that the analyst could not take full advantage of the expressive power of the indicators. For example, if we know all three indicators for two consecutive periods, we can make as many as 24 evaluated statements about the company based on them alone (Bergant, 2012, pp. 103-110).

Further fundamental errorsare the arbitrarily estimated optimal (desired) values of

[1] Although we may differentiate between these concepts in financial theory, we will not deal with this here. Both terms in principle explain the organization's ability to settle its liabilities.

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the coefficients, which have neither a theoretical nor an experiential basis (e.g. Fitzgerald, 2002, p. 138). Completely without foundation and wrong is, for example a wish to have a value of 2 for the currentratio and a value of 1 for the quick ratio. Inadequate business and financial policies of the company may result.

Current ratio

Bierman, for example, stated that the company can achieve a higher current ratio of surplus stock (Bierman, Drebin, 1978, p. 360). However, due to an increase in inventories, current ratio (CR) decreases rather than increases. We see that such inadequate explanation dates back for at least 30 years. A similar slip occurs even to Brigham, who believes that a low current ratio may indicates a small stock (Brigham, 1999, p. 62). Samuels et al. (1995, p. 56) wrongly suggest reducing the too high current ratio by reducing inventories and trade receivables, since such measures increase the ratio rather than decrease it.

This is due to the fact that only the following equation represents the causal effect relationship for current ratio (CR):

$$CR = \frac{1}{1 - \frac{NWC}{STA}} \quad (3)$$

The equation 3 shows that CR depends only on net working capital (in proportional way) and is inversely proportional on short-term assets (STA). Current ratio therefore depends on the ratio K = NWC/STA, which shows a part of short-term assets, which are the long-term financed (by NWC). Moreover, CR is another form of indicator K: (CR – 1)/CR. This is the maximum expressive power of CR.

Completely without theoretical basis is to want a value of 2 for the current ratio and a value of 1 for the quick ratio, which is still recommended by several professional authors (e.g. G. Westwick, 1989, p. 178).

Wrong explanation of current ratio can be found also in many contemporary authors (e.g. Mc Lure, 2004, p. 375, O Hare, 2013, p. 41 and Nuhu, 2014, p. 109), who these ratios explain very inadequately. They proceed from the wrong assumption that short-term assets or receivables with cash involved "cover" short-term liabilities.

Quick ratio

For the same reasons as in the current ratio, the common approach in the case of quick ratio is not appropriate. The quick ratio is usually calculated as short-term assets, reduced by inventories and divided by short-term liabilities. The real expressive power of quick ratio is the monitoring of short-term financial intermediary position (net short-term debt or net short-term claim) and the relationship between inventories and net working capital.

Cash ratio

The cash ratio is usually calculated as relationship between cash and short-term liabilities. The cash ratio is not discussed in detail in the recent literature or is not discussed at all, probably because it does not really say much about the company's solvency.Also, some proposals regarding its optimal value are only arbitrary, without proper justification (e.g., Samuels et al., 1995, p. 56). However, the search for cash ratio's expressive power only in the relationship between cash and short-term liabilities does not exhaust all possibilities of financial analysis.Its expressive power is shown especially in the comparison of the movement with the quick and currentratio.

Additional expressive power of cash ratio (CashR) is shown in the relation:

$$CashR = \frac{NWC_{act}}{STL} - \frac{NWC_{needed}}{STL} + \frac{NSTFD}{STL}.$$

The relationship above shows that the change of the cashratio can be explained by changes in three indicators. The first indicator shows the weight (percentage) of the change in actual net working capital (NWC_{act}), the second shows the weight of the change in the need for net working capital (NWC_{needed}), and the third shows the weight of the change in the net short-term financial debt (NSTFD). All of them are measured (divided) by short-term liabilities (STL). The first two indicators (fractions) can be combined to give weight changes in surplus or deficit of working capital or change capital adequacy as it will be explained in next section.

The absence of a theory about capital adequacy assessment of organizations

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An important shortcoming of contemporary financial analysis theory is a lack of an assumption of net working capital that is needed for safe operations regarding company's solvency. This is a consequence of a lack of common understanding of permanent current assets. It is important issue, because they represent long-term engaged money, so permanent current assets should be in principle long-term financed. This principle, however, is widely accepted in the context of feasibility studies about investment in fixed assets.

There is the lack of a definition of permanent working capital in various authors' texts. Brigham understands it as current assets at the lower end of the cycle (Brigham et al., 1999, p. 635). Smart et al. (2004, p. 777) speak only of a constant part of current assets. Arnold adds also cash to the minimum inventories and short-term receivables (Arnold, 1998, p. 549). Samuels defines permanent working capital indirectly through seasonal, fluctuating current assets (Samuels et al., 1995, p. 721). Cohen (1990, p. 146) and Kilig (2006, p. 366) understand that inventories and trade receivables present a long-term working capital.

Numerous and vague definitions of the permanent working capital are the cause of huge difficulties in designing useful information for decision-making about the solvency of the organization. This weakness can be reduced with an approach, which is typical for the idea of capital adequacy, but should apply to non-financial organizations. It will be proposed in next section.

It is important that some research suggest that the best approximation of permanent current assets is the difference between spontaneous short-term receivables with inventories included and spontaneous short-term payables (Bergant, 2019, p. 4).Such an approach is of course the approximation, because it is without an estimate of other risks in operations of an organization. They namely require additional reserve of long-term financing, on or off-balance sheet.An estimate of permanent current assets also means an estimate of the working capital needed, which, as a rule, is not equal to the actual working capital. Larger or smaller difference between the two indicates a better or worse capital adequacy of the organization and thus lower or higher insolvency risk.

Delusions about operating cash flow

The cash flow statement prepared in accordance with accounting standards has two disadvantages:
1. Does not separate short-term and long-term cash flows, which are important for monitoring the solvency of an organization.
2. Does not show the causes of changes in the cash balance.

Therefore, cash flow statement does not serve its primary purpose that is, reporting on changes in the liquidity or solvency of an organization. Likewise, an otherwise well-known operating cash flow does not serve sufficiently in managing the insolvency risk of the organization. Even more, cash flow statement is not and it cannot be a basis for assessing future cash flow of an organization though "financial analysts seek to prognosticate the risk attached to a firm's future cash flows" (Miller, Bahnson, 2002, p.103).

This weakness has been already noted by Sumner: "We can misunderstand and wrongly explain operating cash flow if we do not separate its two basic components: the part that comes from the profitability of the company and the other part that comes from the financing of the company" (Sumner, 1988, p. 530).

After all, the main cause of changing cash balance in the organization still remains unknown. The solution is simple, considering the capital adequacy of the organization. This is in principle indicated by the following equation:[2]

$$\Delta \text{ Cash} = \Delta \text{ NWC}_{act} — \Delta \text{ NWC}_{need} + \Delta \text{ NSTFD} \quad (4)$$

The equation 4 shows that changes of cash balance depend on changes in capital adequacy (the difference between net working capital actual and net working capital needed) and net short-term financial debt (the difference between short-term financial investments and short-term financial obligations). Any change in capital adequacy therefore directly affects the increase or decrease of cash, and thus the solvency of the organization. This also means that future cash flow cannot be estimated without anticipated changes in the organization's capital adequacy.

Given that the difference between actual and required working capital (NWC_{act}— NWC_{need}

[2] More about this equation in: Bergant, Manohin (2020).

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) represents a surplus or deficit of working capital ($OBK_{surplus}$ or OBK_{def}), equation 4 can also be used for the quickest assessment of the capital adequacy of an organization (Bergant, Manohin, 2020):

$$NWC_{def} = STFD - STFI - Cash. \quad (5)$$

In accordance with equation 5, NWCdeficit can be calculated by short-term financial debts (STFD), short-term financial investments (STFI) and cash, which includes also cash equivalents. When the result of equation 5 is negative, the company has NWC surplus. The weakness of equation 5 is that it does not show the causal relationship, however, it allows for continuous monitoring the changes of capital adequacy. The assumption of equation 5 is that the organization settles its business obligations within normal periods. Otherwise, it is necessary to adapt accordingly the data of STFD.

Optimal financial structure

The financing structure of the company in modern finance is addressed through a variety of theories, among them are: the theory of the costs of financial distress (trade-off theory), pecking order theory, signaling theory and market timing theory.[3] None of them has so far not received unequivocal confirmation of the empirical research, however a number of critical comments. At the heart of the debate is still trade-off theory. Its positive sides can be see particularly in:

- principled explanation of the company's behavior regarding it's fundamental objective;
- interpretation of the impact of borrowing (financial leverage) on the value of the company;
- theoretical proof of the existence of an optimal financing structure.

A general form for the optimal financing structure determination does not exist. The root cause of this "impotence" of the financial theory is in its numerous important shortcomings:

1. For each company the estimation of the costs of financial distress is extremely risky, because these costs are very difficult to calculate. The most difficult is the estimation of indirect costs which are generally higher than the direct costs of financial distress (Arnold, 1998, 797).
2. The summing up the different types of probability distributions about occurrence of costs and revenues when estimating the costs of financial distress, is professionally unacceptable. This is reflected in the fact that the companies which very likely get very small gains, are exposed to very high (although highly unlikely) risks whose likelihood cannot be reliably estimated.[4]
3. There is the question, on whose behalf? The complexity of the calculations (in particular the large number of assumptions and subjective assessments in the calculations) is the cause of relatively unreliable results (e.g. the recommended intervals for borrowing from 20 % to 40 % of total liabilities).
4. The theory is based on a "cost-benefit" approach which is a basic principle of economics. Such a view on the financial policy of the company could be in direct conflict with business ethics. Decision-making, information and implementation in the field of solvency is to be assessed through an ethical point of view as well. Long-term sustainable development of the company and individual performance depend not only on the legality and narrow professionalism of action, but also on ethical decision-making activities.[5]
5. The assumption of long-term growth of the value of a common equity includes also satisfied interests of other stakeholders. The company that operates immoral to internal and external stakeholders cannot be successful in the long term. Such an assumption is theoretically necessary for compliance and integrity of the model, but does not provide proper basis for the creation of information for decision-making. The common practice confirms such a statement.[6]
6. Entrepreneurial risk in relation to solvency significantly changes the dependance on the

[3] More on those theories in: Smart *et al*. (2003), Samuels *et al*. (1995), Arnold (1998), Bessler *et al*. (2011) and Brigham *et al*. (1999).

[4] More about the empirical problems of small probability in Taleb (2009, 748) and Taleb *et al.*, 2009, 78).

[5] Response that the costs of non-ethical conducting are included in the cost of financial distress, is the "shoot in the foot". Ethics does not allow weighting the cost-benefit as the sole criteria. The decision cannot be "half-ethical."

[6] Entrepreneurs and management are too often opt for short-term criteria and narrow interests.

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maturity structure of the debt, despite the unchanged ratio between foreign and own sources of financing. The risk increases if the share of short-term debt in all the company's debts increases and vice versa. The idea of the costs of financial distress does not take this fact into account. This significantly reduces the expressive power of information based only on the relationship between foreign and own liabilities (factor of financial leverage). Management can not sufficiently well decide about the company's solvency on such a basis.

The principles of managing current assets ("current asset management") and the principles of short-term financing try to reduce the disadvantage of trade-off theory regarding maturity. Both types of principles are covered in the literature with working capital management. The authors derive from the basic principles of finance, which requires consistency in maturity of liabilities with maturities of available sources of financing.In the literature, this principle is known as the "maturity matching principle" or "maturity matching approach" (eg. Walsh, 1996, 148; Brigham et al., 1999, 635) or the "matching policy" (Rao, 1987: 528). The simplification of this principle from an accounting perspective means a rule that permanent working capital (permanent current assets) should be financed on the long term basis.Deviations from this principle imply aggressive policy (aggressive approach) which means that also part of the permanent current assets is financed on the short term basis. Aggressive policy takes a greater risk of insolvency, but has lower financing costs due to cheaper short-term loans. Deviation in the other direction is conservative policy (conservative approach), which means that also a part of periodical current assets is financed on long-term basis. Conservative policy takes a lower risk of insolvency, but higher financing costs due to more expensive long-term liabilities (loans and equity).The modern theory of corporate finance therefore (in view of the selection of those policies) proposes trade-off approach between costs and benefits, in order to determine the best level of short-term financing (Smart et al., 2004, 798). Estimated costs of financial distress however remain an unsolved problem also in these casestogether with the lack of definition of permanent assets.At the same time trade-of theory remains at a dead end, with no hope of a final solution.

A different approach is as follows:

1. Management in its decision-making should not take into account the company's insolvency as useful option. Such an alternative is unethical assumption of the potential benefits of the company's insolvency. It follows that the short-term spontaneous liabilities (SL) in a given volume of business are relatively easy identifiable from payment deadlines in a particular industry known or contractually agreed. The company should respect them. A possible extension of payment deadlines in the best case represents a hidden liquidity reserve in case of force majeure.
2. If the company wants to timely meet its business obligations, it is necessary to take into account the maturity of debts, which means that it is not enough just to monitor the leverage factor (the vertical structure of financing).
3. It should be ensured that the permanent current assets are financed by long-term sources. Deviations must be carefully considered. This means that information for decision-making is based primarily on the estimation of the actual andneedednet working capital.

On above assumptions, a model of financial policy can be constructed (more about the model in: Bergant (2015).

II. CONCLUSION

From the above, it can be concluded that uncritical reading of textbooks and professional literature on business finance could be quite risky. Much greater risk is born by business decision-making based on some controversial theoretical statements.

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