A NEW APPROACH ON EVALUATION AND ACCOUNTING INFORMATION SPECIFIC TO BANKRUPTCY

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Abstract: An entity may experience minor difficulties, but it may face also crisis situations, which most often are the result of a long process of depreciation of their economic and financial condition. In specific circumstances (such as the financial crisis) all entities can face difficulties: the small or the big ones, entities that have a long history or young ones, entities that activate in developed economies or in emergent ones. Economic difficulties may be defined by structural or chronic losses. Thus, that organization is no longer profitable and generates an excess of expenditure over income. Therefore, it is not easy to delimitate the stages of a common and uniform process for all entities with a difficult economic-financial situation. These are the reasons for addressing degradation stages of economic and financial situation of the entity as an important criterion in the choice of diagnostic methods to entities in need, but also for the strategic orientation.

JEL Classification: G33, M41, O16

1. Introduction

Specialty literature has evolved in the evaluation field in the last decades, through elaboration of some models for prediction of bankruptcy, based on economic-financial indicators which form score-functions. In the same time, the methodology of the economic-financial analysis develops other more and more advanced methods and techniques for detection of the „health" status of the entities. In this context, should be settled up what determine the choice of one or another of the methods.

In general, the failure of an economic entity is a matter of time, even it can be the result of some random events against the entity has not provided. Taking into consideration the causes that produce the degradation of the economic and financial situation of an entity, it can be said that each of them has „its own way toward bankruptcy" (Pop, 1996) [1].

2. The stages of the financial degradation for an entity

The small entities can face difficulties, but also the big ones, entities that have a long history or young ones, entities that activate in stable economies or in emergent economies (developing, transition or recession). Therefore, it is not easy to delimitate the stages of a common and uniform process for all the entities with a difficult economic-financial situation.

These are the reasons for addressing degradation stages of economic and financial situation of the entity as an important criterion in the choice of diagnostic methods to entities in need, but also for the strategic orientation.

The ability of entrepreneurs and managers and the sustainability of economic environment in which it operates support the continuity of the entity to the fullest extent.

The bankruptcy is considered a function of three variables (Anghel, 2002)[2]:

- the individual capacity of owners and managers;

[1] Pop Atanasiu – Contabilitate comparată şi aprofundată, Editura Inlelcredo, Deva, 1996, pag. 142.
[2] I. Anghel - Faliment. Radiografie şi predicţie, Ed. Economică, 2002, pag. 12.

- the characteristics of the industry;
- the economic environment in which they operate.

Therefore, it can not be identified a single way towards bankruptcy for all entities. Thus, Argenti[3] presented *three typical alternatives* for the bankruptcy process, impacting on how to carry out the evaluative approach (Argenti, 1989), namely:

- first type of process is a very low profile which indicates that the performance of entities never grow before bankruptcy;
- the second type of bankruptcy process takes into consideration a high growth of indicators in comparison with the previous period, followed by a sudden bankruptcy;
- the third type of process is very common in economic reality: entity obtain higher performance for a long time, after recording a sharp depreciation of the situation, followed by a period in which record a constant level of financial indicators. After a number of years following a rapid decline and bankruptcy.

An entity may experience minor difficulties, but it may face crisis situations, which most often are the result of a long process of depreciation of their economic and financial condition.

Trying to distinguish the stages through which an entity when faced with difficulties, Hervé Chapaud[4] structured in three phases the life of an entity in need:

1. Degradation phase, which is often caused by errors in management, it can take on average 2-4 years and the measures that can be taken consist on the restructuring of the business entity;

2. Difficulty phase: during this period the entity reaches a high degree of vulnerability, the causes that gave rise to the economic and financial degradation generated multiple effects which in turn determined new effects. The situation is deteriorating rapidly, the period lasting only takes 2-6 months on average, maximum one year, and recovery measures are necessary because the degradation suffered is already evident;

3. Crisis phase (collapse): the entity is in that phase towards bankruptcy, the entity passes very quickly - about 3 weeks - the period of crisis and, therefore, necessary measures should be taken to rescue the situation quickly, that entity will not enter into insolvency in bankruptcy, which would lead to the total liquidation of the entity. This situation is presented in the figure 1.

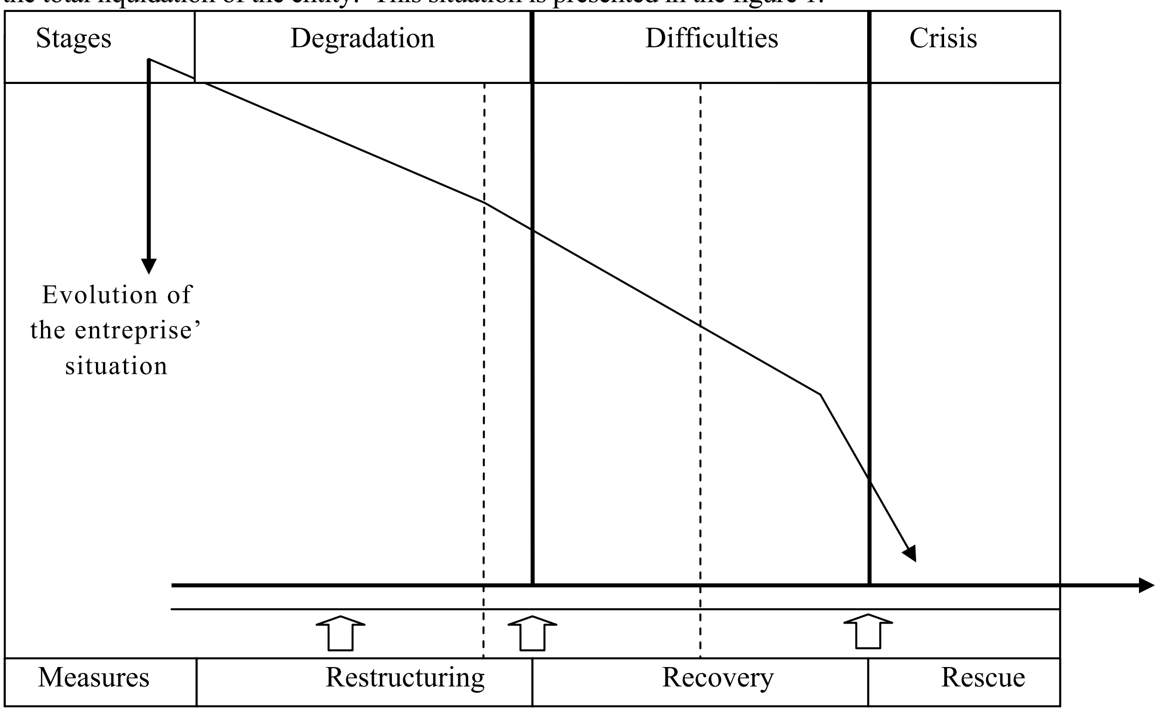

Figure 1. The stages of degradation process and appropriate measures

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Various other studies[5] on the economic and financial depreciation entity indicate relatively the same stages of degradation (Daigne, 1991).

A first phase it is characterized by the followings:

- stagnation or reduction in operating activity,
- diminishing results,
- increased production costs.

These symptoms can occur separately or simultaneously.

Consolidated financial statements begin to reflect adverse developments in indicators and in the exploitation field often happen that the entity is not able to maintain the manufacturing costs and product quality.

At this point, the entity either loses important market segments, maintaining the selling prices or decreases its profitability, decreasing prices. Analysis of the entity at this stage allows the economic and financial recovery.

The second phase is characterized by a growing number of „warning signals", as follows:

- to continue declining profitability,
- increase inventory variation in relation to trading activity,
- increase need for working capital,
- affecting more and more prominent the level of financial indicators.

Rotation of assets no longer provides necessary liquidity for debts payment during this phase and, in addition by reducing profitability, it leads to a reduction of the working capital.

Even if the entity remains at this level of activity, it begins to lose confidence in its ability to recover. The effects are immediate in this phase, the financial liabilities increasing largely and absorb most of the exploitation result. Often, at this stage, the entity needs to disinvest or to turn to shareholders for capital increase (Pop, 1996)[6].

In the third stage of degradation, the difficulties at the treasury level increases, due to the lack of working capital. As a result, the difficulties faced in operational activity lead gradually to exhausted funds. The survival of the entity depend on the period during it could support the reduction of profitability, a negative net treasury and the decrease of credibility to third parties.

In this phase, the entity could get into the situation of payments cessation and it is likely to initiate legal proceedings for recovery or for liquidation.

Starting from the finding that the process of degradation of an entity is progressive, at every stage entity registering an emphasis of the difficulties from the previous stages, but also new difficulties, it is appropriate the delimitation of three levels of depreciation of the entity, such as:

- an economic depreciation;
- a depreciation of the financial situation;
- a depreciation from the juridical point of view.

The bankruptcy risk of the entity, in legal terms, is only the result of economic and financial difficulties. It sanctions the inability of entity to generate a surplus of financial resources in order to pay for all stakeholders and to honor commitments to maturity.

Economic difficulties may be defined by structural or chronic losses. Thus, that organization is no longer profitable and generates an excess of expenditure over income. The easiest way to detect non-profitability of a business is to use an indicator which examines the operational activity, namely „gross operating surplus" (GOS).

The indicator does not take into account the financial and fiscal policies and it is based on the amount of added value got by the entity in the production process, in other words, the wealth created

[5] J.F. Daigne - Le management en periode de crise, Les editions d'organisation, 1991, pag. 72.
[6] Pop Atanasiu – Contabilitate comparată şi aprofundată, Editura Inlelcredo, Deva, 1996, pag. 166.

by the entity, being calculated as follows:

G.O.S. = Added Value + Subventions –
(Taxes + Staff Expenses)

In the case of economic degradation, the indicator may become negative, registering a gross operating deficit. Most advanced stage of economic degradation is achieved when the entity consumes resources without the ability to obtain production. In this case the added value is negative and induces an increased deficit of the operational activity.

In the case of a financial depreciation, the entity can not face the debt maturities; short-term liabilities are clearly superior to its realizable assets. The net negative treasury will put the entity in a position to meet payment incidents, leading to degradation of its image to business partners (suppliers, banks, etc.) even putting the problem of activity continuity, of its existence. By reaching the financial level of degradation for the entity's situation, this has to face the bankruptcy risk.

In such situation, on the way the evaluation of the structural elements included in the calculation of indicators is carried out it depends their relevance and reliability, as well as the microeconomic policy decisions that are required to be taken subsequently.

The financial dimension of the worsening situation of the entity is in the specialty literature, the basis for defining the concept of „entity in difficulty" (Matis, 2003)[7].

3. Entities in difficulty - financial and juridical dimensions

Legal aspect of depreciation has as premises the economic and financial depreciation, legal sanctioning the fact situation of the entity. Juridical depreciation supposes ascertaining, from the legal point of view of the insolvency of the entity, meaning, in many cases, short-time dissolution of the entity as a legal entity.

In legal terms, „an entity is considered in difficulty when it is in the condition of suspension of payments, that is when it can not meet its debt due to the amounts of available money", under the law on judicial reorganization and liquidation of entities (Law 85/2006 on insolvency proceedings of judicial reorganization and bankruptcy) [8].

The law provides in this case, the starting of proceedings for reorganization or juridical liquidation. In practice it is difficult to determine the most appropriate moment when the legal proceedings may be initiated to save the entity, as follows:

- if legal action is delayed, the entity no longer has sufficient assets, it will not be able to pay obligations, fact that draws its bankruptcy;
- if intervention is too early, it can generate a partial liquidation of assets, a reorganization of activity and in this case, it is involved a legal reorganization by converting debts into shares, merger with another entity, etc.

Crisis or shock phase was characterized by some authors (Joffre and Koenig, 1985)[9] as a point of inflection between two periods of the life cycle of the entity. The crisis can be defined as a rupture of relations, a disorganization structure and a paralysis of leadership.

Following the fundamental objective of continuing the operational activity, an entity has to develop, getting performance. On the background of its development, the entity becomes vulnerable, and it face a paradox: its style of administration and management generates a new phase of development for the entity, factors that hinder growth and may affect the effectiveness of the activity, the level of profitability, leading to bankruptcy.

The evaluation of the private entity in terms of its evolution determines two problems (Vargas, 1984)[10] :

- „How can be anticipated the problems, the nature and extent of their importance in order to prepare an appropriate response?"

[7] Matiş D.- Contabilitatea operațiunilor speciale, Editura Inlelcredo, Deva, 2003, pag. 141.
[8] Law 85/2006 on insolvency proceedings of judicial reorganization and bankruptcy.
[9] P. Joffre, G. Koenig - Strategie d'entreprise. Antimanuel, Ed. Economica Paris, 1985, pag. 75.
[10] G. Vargas - „Les crises de croissance de la PME-PMI", Revue francaise de gestion, ian.-febr. 1984, pag. 13.

- „Can you learn from past experiences in order to remedy the current crisis or through the analysis of difficult situations for similar entities in order „to borrow the taken measures"?

The first issue relates to the lifecycle of the entity. At each stage, the entity recorded general serious mutations, sometimes difficult to predict, which are also features compared with other entities in the same phase of development. So every difficulty that arises is „unique and difficult to generalize" (Vargas, 1984)[11]. Therefore, it can not be given a positive answer to the second problem.

The managers are faced with a contradictory situation pursuing business development:

- it should be developed a growth strategy and also to reduce the uncertainties involved by a new phase of development;
- it is difficult to predict, if not impossible, taking as a landmark the difficulties of past experiences for the analyzed entity or other entities.

Greiner[12] showed that the evolution of an entity can be analyzed on the 5 stages of its life, between each of them is manifested a time of crisis, as shown suggestively in figure 2.

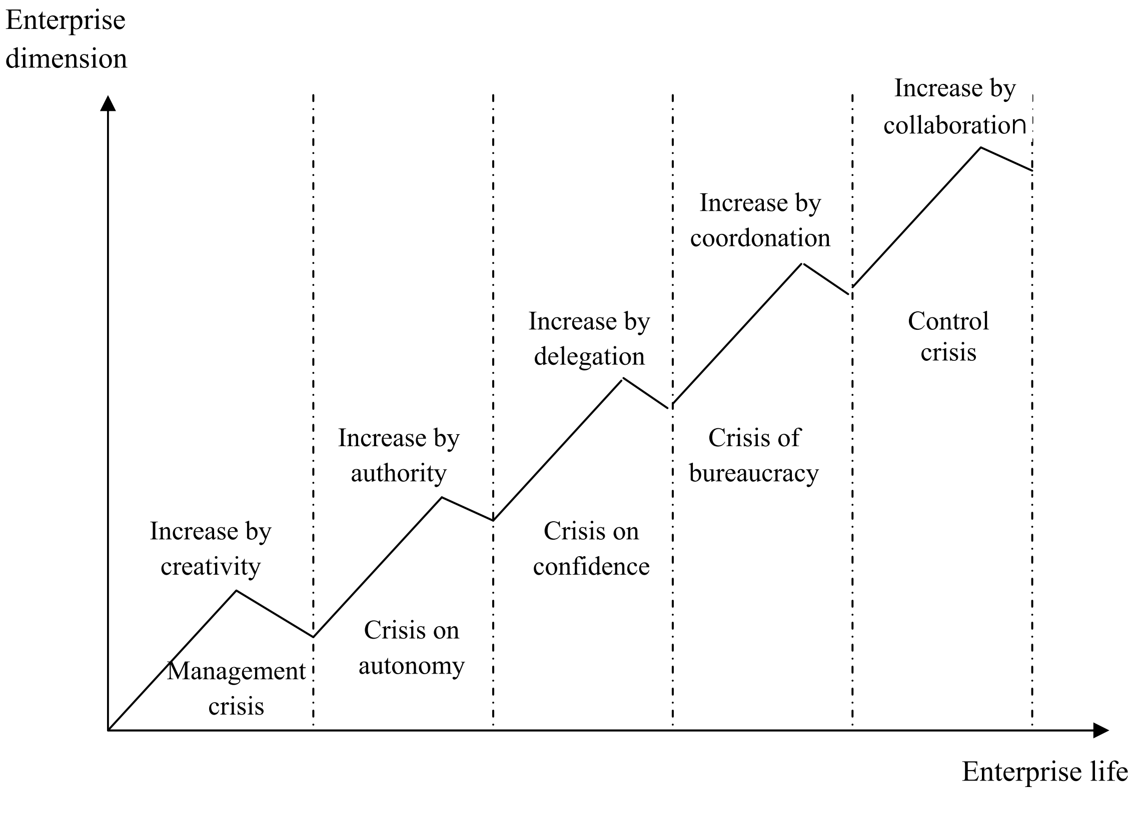

Figura 2. Life cycle of entity and the growth crisis

Source: H. Chapaud - „ Diagnostique de l'entreprise en situation de crise", coord. A. Marion, Ed. Economica, 1993, pag. 281

The business external environment conditions the development of the entity, which make necessary to adapt the entity's structures and especially the management style (another crucial factor in the evolution/decline of the entity).

The crisis is a moment when applied strategy does not allow the entity to respond satisfactorily to the „challenges" of its evolution and the operation requires major changes.

Even the time of crisis known objective manifestations, such as abrupt decrease in turnover or profits, the process that qualifies the crisis as given situation is a subjective one. For example, artificial crisis is possible if a member of the Administration Board who is established as opinion leader

[11] G. Vargas, op.cit., pag. 14.

[12] L.E.Greiner, „Evolution and Revolution as Organisations Grow", Harvard Business Review, iul-aug 1972.

expresses the feeling that the results of the entity, in fact prosperous, are not high enough to maintain its competitive position.

4. The role of accounting information on detecting the financial degradation of the entity

The economic and financial analysis allows, in general, highlighting the existing difficulties. But the financial analysis is based primarily on financial and accounting documents available after closing the financial year and this can generate difficulties and delays in identifying the degradation situation of the entity. This fact affects in a greater extent the third parties which are informed about the difficulties of the entity relatively late.

However, before closing the synthesis financial statements there are some „warnings signals”, that can be highlighted, in special, on the line of achieving a fair and efficient evaluation, which draw attention to issues which may be depth analysis to identify the state depreciation and take the appropriate action. These „warnings signals” can be searched in the main activities of the entity (production, commercial, administrative and organizational).

On the production level, can be observed the followings:

- a technical and technological inadaptation or a poor organization of the manufacturing process;
- existence of problems with product quality;
- a physical and moral wear of fixed assets or inadequate investment plans to the production structure;
- a high weight of staff compared with technical endowment;
- an inadequate technical equipment to the regulations regarding the work safety or environment protection.

The consequences of these issues are found in the level registered by the performance indicators.

On the commercial level can be identified:

- the emergence of competitors that produce at a lower cost or trade new products that reduce the market share of the entity;
- products in declining stage;
- there are not launched new products on the market,
- a downward trend of the activity sector;
- financial crisis registered by third parties (suppliers or customers);
- dependence on imported raw materials with high prices, which affects sales prices;
- an excessive specialization of production;
- dependence on a client or a reduced number of important clients, respectively suppliers.

The effects are, in general, the reduction of turnover and results, although there may be cases in which the turnover increases, registering concomitant a reduction of the results.

On the administrative and organizational level, the „warning signals” can be:

- a heavy flow of information between departments and performers-makers;
- an inefficient management control;
- inadaptation of organizational structure to the entity’s activity;
- poor leadership.

At the financial level can be underlined several "warning signals":

- the decrease of the performance indicators;
- the increase of the debt level;
- affect the financial equilibrium;
- difficulties related to the treasury level.

These signals at the level of financial statements are manifestations of the difficulties the entity have in the operating activity, which causes deeper analysis of financial imbalances through an economic analysis in terms of production, marketing, social or administrative.

5. Critical analysis of management for an entity in difficulty

Critical analysis of the management of an entity in difficulty, from the perspective of evaluation, indicate that, regardless of exogenous or endogenous causes of the worsening economic and financial situation of an entity, a state of difficulty may be exacerbated by the late and extremely slow response of the management team to changes, in conditions in which the adopted decisions are taken on the basis of information supplied by wrong or inappropriate evaluation.

Logically, an entity meets the criteria of operational continuity only if no information that would lead to a contrary conclusion (Anghel, 2002)[13].

The principle of operational continuity implies equilibrium of financial flows during the diagnosed period, an independent organization, without a significant reduction of the rate and level of activity.

The continuity of exploitation is a fundamental concept in financial-accounting theory and practice. IASC (International Accounting Standard Committee) believes that the establishment of the financial situation is based on the presumption that an entity will continue its work in the foreseeable future, having no intention or need to liquidate or significantly reduce its activity.

On other hand, the European Union of Accounting Experts (UEC) states that the entity which continues to operate should comply with the regulations on accounting records, otherwise have to book assets and depreciation provisions for risk and the expenses related to liquidation cost (Peyramaure, 2002)[14].

Therefore, UEC highlight the option of drawing up financial statements that take into account the values of liquidation indicators: liquidation prices, additional costs of liquidation, if the entity will reduce its activities in a meaningful manner or is liquidated (Toma and Chivulescu, 1994)[15].

The European Union of Accounting Experts underlines the following facts that can compromise the continuity of exploitation:

- The existence of a negative working capital or even a negative net income. The latter may result depending on the size of invested capital, a negative net position of the entity.
- Using of current credits for financing the investment.
- Failure renewal credits.
- Failure normal maturity adjustment of credits and use new loans to honor the old ones.
- Serious events in service, such as, for example, the finality of a contract that ensures continuity of production, bankruptcy of suppliers, customers, etc.
- Inefficient administration of the material, human resources.
- Problems related to organization and management of the entity (for instance, unavailability of a manager with expertise in strategic decisions).

Continuity of operating activity can be affected by the followings:

- voluntary dissolution of the entity, based on managerial decisions regarding the ending of activity for which was established the entity or the entity' sale;
- economic-financial difficulties, such as:
  - accumulation of debts to creditors;
  - obtaining of negative results;
  - reducing the operating capacity of the entity.

Most important, beside evaluation, it is the financial accounting auditing that play an important role in tracking of dysfunction for the entity's financial and economic activity in time. Second, it should be kept in mind that opinion of the analyst or auditor may increase the vulnerability of the entity and the possibilities to get bankrupt.

SAS (Statement on Auditing Standards) 34[16] consider that fundamentally there are two types of information that should be take into consideration:

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[13] Anghel I. - Falimentul. Radiografie şi predicție", Ed. Economică, 2002,pag. 127.
[14] P. Peyramaure, P. Sardet - L'entreprise en difficulte, Ed. Dalloz, Paris,2002, pag. 24.
[15] Toma M., Chivulescu M. – Ghid pentru diagnostic şi evaluare a întreprinderii, Editura Ceccar, 1994, pag. 145.
[16] AICPA - „The auditor's considerations when a question arise about an equity's continued existence", SAS 34, NY, 1981.

- information on solvency: negative evolution, operational losses or limit of the access to credit;
- internal information related to the possible loss of key managers and external information, such as legal proceedings.

Assessment of activity continuity may be very difficult and sensitive, and the analysis, the techniques and methods for diagnosing the health of the entity can bring a significant support to the effort of ensuring the continuity of activity.

The signal of an entity to its creditors, that their investment is in danger, is given when the entity no longer meets the contractual payment obligations. Of course, this is not the first clue of the entity's difficulties, but it is the situation that allows creditors to take steps to minimize loses.

Creditors must decide at this stage, namely:

- that the liquidation of the entity, in which case up bankruptcy proceedings as provided in Law 85/2006 on insolvency proceedings of judicial reorganization and bankruptcy,
- maintaining the entity alive by judicial reorganization.

According to Art. 29, par. 1 from the Bankruptcy Law, „any creditor who has a certain, liquid and eligible debt, can bring a claim at court against a debtor who, for at least 30 days, stopped payments"[17].

Creditors have been mentioned as originators of these decisions and not the syndic-judge, - person authorized by law to decide in some way or another - because they represent the people directly concerned in solving, through reorganization or bankruptcy, of the debtor's situation. In principle, this decision depends on determining the value of the entity in the conditions it is rehabilitated, against the value of its assets if they were individually valorized (liquidated). It will be adopted the procedure that promises the highest income to the creditors and owners.

If appropriate alternative from the economic view is the activity restructuring, the reorganization plan will indicate the prospects for recovery in relation to specific business possibilities of the debtor, with the financial resources available and the market demand to debtor's offer and it will include measures consistent with the interests of creditors and associations or shareholders and the public order, including the method of selection, appointment and replacement of managers and administrators.

Bankruptcy decision can be taken in the following cases:

- when the debtor declared the intention to go bankrupt or not declared its intention to reorganize;
- when none of the parties (debtors or creditors) have proposed a reorganization plan or they were not accepted;
- when the payment obligations and other undertaken tasks are not met accordingly the reorganization plan;
- when the activity of the debtor during the reorganization brings loss of its assets.

Through the new rules adopted, the Romanian insolvency law corrects a number of issues that were unclear or unfunctional.

6. Conclusions

The bankruptcy of entities is a natural process that ensures economic viability. However, entities with a high importance in the economy are in danger of bankruptcy, from different subjective or objective causes, fact that requires knowledge of the symptoms that can predict their failure symptoms and identify the risk factors.

Approaching this problem, numerous analysts have found that it is difficult to predict if and when it may produce the failure of an entity and to establish a strategy to avoid this.

Economic theory and practice have not solved all these problems, but have delimited possible means for identifying the difficulties.

Using as informational sources the financial situations elaborated by the entity, the events which may predict the failure can be grouped into three categories, namely: easily identifiable events; events difficult to be identified; unforeseen events.

[17] Law 85/2006 on insolvency proceedings of judicial reorganization and bankruptcy, consolidated in 2008.

In general, the economic and financial analysis allows, in general, highlighting the existing difficulties. Acceleration of degradation, particularly in the final phase, may cause difficulties identifying by the entity to be delayed because the financial analysis is based primarily on financial and accounting documents available after closing the financial year.

The legislation on the insolvency field at the national and international level were constantly renewed, the changes were driven by two major issues: the pressure to harmonize with the acquis communautaire and the adaptation to specific national regulations.

Also, the business external environment influences the development of the entity, which make necessary to adapt its structure and especially the management style.

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