

VALUATION OF BANCRIPT FIRMS IN CONTEXT OF ADHERENCE'S COUNTRIES TO THE EUROPEAN UNION

Monica ACHIM, Lecturer, PhD.
"Babes-Bolyai" University, Cluj-Napoca
Fănuța POP, Associate Professor, PhD.
"Babes-Bolyai" University, Cluj-Napoca
Sorin ACHIM, Lecturer, PhD.
"Babes-Bolyai" University, Cluj-Napoca

Key words: risk, failure, bankruptcy, insolvency, laws insolvency, comparison, Romania, UE.

Abstract: The firms and economic sectors that are in an advanced state of development and also have a good competitive position, have a lower degree of insolvency. But at the same time, new firms, the ones that activate in new sectors, are more exposed.

As well, in the new context of adherence's countries to the EU, increases the interest in the study of movements from the level of the maintenance of the performances of Central and East Europe entities on a competitive market and implicitly in the study of bankruptcy' risk.

We can notice a big increase in the number of bankruptcies from the commercial sector but must not be regarded as a negative aspect. The number of explosions of companies that was registered in all economies in transition from Central and Eastern Europe, made them represent the majority within the companies that were founded after 1989. This development has determined a strong competition, which was also triggered by the free access to the common market. In Romania, the number of bankruptcies in the last two years was strongly influenced by the positive effects of the new procedure which was simplified for the bankruptcy law.

The purpose of this paper is focus on the main factors that provoke the bankruptcy's entities by exemplify the insolvency level registered in Central and Eastern Europe countries, referring to Romania. Also, our paper offers comparison and explanation of movements in the level and structure of insolvency.

I. Introduction. General approaches regarding the bankruptcy risk

The bankruptcy risk of the enterprises is closely connected to the economical and financial risk . The financial risk depends upon the degree of indebtment, whereas the economical risk depends upon the ratio between the fixed expenses and the rate applied on variable costs. In a general way, the knowledge of some rates allows the calculation of the bankruptcy risk of an enterprise.

„The bankruptcy risk implies the assignment of a function that should estimate the probability for a firm to register losses and, consequently, to become unable to sustain its contracts with beneficiaries, pay its suppliers and return loans to banks.”

[Spătariu Elena Cerasela, 2005]

The bankruptcy risk is opposite to the profit probability and raises the issue of increasing the profitability of the firm, in the conditions of an assumed risk. In the case that there are permanent difficulties to pay obligations to third parties, we can speak of an economical and financial frailty of the firm, with negative influences upon its solvency.

The study of the enterprises that are in difficulty has a special importance for a large series of economic agents, of whom: banks, which are obviously preoccupied by the quality of the credit portfolios they constitute; different categories of shareholders, who are interested in protecting the capital invested and taking advantage of the benefices provided by the respective enterprise (obtaining dividends); investors, who wish to know the state of the enterprise before investing the capital held; creditors, who are interested in recovering the capital allotted in the form of loan; business partners (clients, suppliers), wish to close agreements with safe enterprises that are able to accomplish their contract obligations.

In Romania in the year 2006, the bankruptcy law was repealed and replaced with the insolvency law [Law 85 from the 5-st of April 2006, regarding the procedure of insolvency]. **The bankruptcy (or insolvency) risk**, is defined as the possibility of appearance of the inability to sustain the expiration obligations of the firm, resulted from previous engagements under contract, from current operations, determined factors for the continuation of the activity, mandatory prelevations.

Insolvency, on the other hand, is defined as that particular state of the patrimony of the debtor firm characterized by insufficiency of money funds available, for the payment of exigible debts.

The difficulties met by an economic agent have different causes. Most of these difficulties [Niculescu Maria, 1997] come from the **competitive and economical-social milieu** in which the firm develops its activity:

- the increase of internal and international competition;
- the appearance of substitution products;
- the bankruptcy of an important supplier which used to ensure certain materials, pieces, subensembles essential for the continuation of the activity of the enterprise;
- the loss of an important client or its bankruptcy;
- the bankruptcy of a bank with which the enterprise used to have dominant financial relations;
- the appearance of some regulations on the line of security and protection of environment, according to the new European regulations;
- the continuous fall of the rate of exchange.

Internal causes that lead to the alteration of the activity and especially to the sate of insolvency and implicitly of bankruptcy are:

- 1) of financial nature ;
- 2) of strategical nature ;
- 3) of organizational nature.

Causes of financial nature:

- the lack of control upon the way in which are used the financing sources;
- the financing of investments from current passives and the lack of immediate profits that should supply for the hole in the working capital;
- the case of not following the credit along its development;
- the continuous alteration of the indicator of financial stability
(*Total debts /Own capitals*) *100
- the continuous decrease of the fluxes of disponibilities, as a cause of the incapacity to recover the liquidity from debtors or the withdrawal of some loans, or even losses due to financial speculations;
- the maintenance of a negative working capital over a long period of time ;

- the continuous fall of the efficiency of the activity and the obtaining of more and more significant losses;
- the coverage of losses from previous years from the legal reserves of capital.

Causes of strategical nature:

- the lack of clear objectives in the future development of the activity or the misunderstanding of these objectives by the manager or the owners;
- the improper choice of sale markets or the lack of such markets;
- the faulty or inexistent marketing policy;
- the poor speed of reaction of the lead to circumstantial changes;
- the improper placement of the business or of some parts of it;
- future projects incompatible as size with the possibilities of development of the business;
- losses caused by the destruction of uninsured goods.

Causes of organizational nature:

- the lack of experience, of culture in business;
- the discrepancy between the abilities of the staff and the way they are applied in every working place;
- the deficient organizational structure;
- the lack of honesty and morality of leaders from all levels;
- faulty relations with the staff that holds public power, with the own clients and suppliers;
- political influences in the leading of the business.

The causes presented above have a certain resonance in the information provided by financial reports. In previsioning the state of alteration of the activity and appearance of bankruptcy one should also take into account other information besides the ones offered by the financial situations and reports, such as:

- the knowledge of the characteristics of the sector of activity in which acts the respective economic agent and of mean accomplishments obtained by the respective sector for the realization of comparisons;
- information regarding the frequent resignations of the leading staff and the fluctuation of the staff in general;
- the cumulation of important functions, especially when these functions are assigned to a significant role of actions;
- unexplainable transactions between different sub-units belonging to the same economic agent;
- the quality of financial analyses and auditings realized;
- the replacement of investments with leasing activities;
- the hasty sale of shares.

From the economical point of view, the enterprise in difficulty [Niculescu Maria, 1997] is mainly characterized by:

- Inadaptation to the environment. This inadaptation can become more and more important and can thus threaten the survival of the enterprise;
- Decrease of the volume of activity and profitableness;
- The use of unperformant techniques and instruments of management;
- Difficult financial situation;
- Low degree of usage in production facilities;
- Failure to ensure the concordance: man-method-machine.

From the juridical point of view, Romania, along with the adherence to the EU, has to harmonize in an adequate way its economical laws and also, to adjust an insolvency law. Likewise, in 2006, the bankruptcy law was replaced with the old solvency law.

The bankruptcy risk, can also be defined by: the possibility of appearance of the incapacity to sustain the past and present obligations of the company, resulted from previous contracts, from current operations, and which are very important for the continuation of the activity of the firm.

The insolvency, on the other hand, is defined as being that state of payment of the patrimony of the firm characterized by insufficiency of money funds available, necessary to pay due debts. According to new laws in action [Law 85 from the 5-st of April 2006, regarding the procedure of insolvency], if an economic agent cannot sustain its financial obligations, he is obliged within 30 days from the apparition of the state of insolvency to address a request to the court, in which to declare its intentions to enter a procedure of reorganization, or restructure the activity according to a plan, or total or partial liquidation of assets, in order to pay its debts. During the same time, if a creditor has an invoice to cash in, that has not yet been honoured, he can request the court to open the bankruptcy procedure against the insolvent firm. The insolvency law published in July 2006 is a very good one for the Romanian business environment because it clearly helps purifying the economic sector in Romania. The law number 85/2006 came as a natural change for the old law number 64/1995 required by the adherence to the EU, the new law being adapted to the European laws but not entirely conform to the insolvency laws from the other European countries. We have in view the long period necessary in Romania for this procedure which is, in average, close to 3 years as compared, for instance, to Austria where the average period for the insolvency procedure is close to 6 months.

Certainly the new law is adequate to creditors and protects them in their relations with the debtors. If behind the apparition of the new law, the principal purpose of law 64/1995 was the debtors' request for help in order to pay their debts, or the liquidation of patrimony, the new law has the main purpose to institutionalize a collective procedure to cover the debts of the debtor who is under insolvency.

As we have already said, the new law gives the creditors many possibilities to interfere in the procedure of liquidation and also gives them the possibility to control the steps of the procedure. The new law brings in different ways for the adoption of the plan of readjustment by the categories of debts so that no category of debt should be <<discriminated>>.

We believe that this new law is a positive one and we can observe the utility of this law by the increase of the number of cases sent in law courts, the use of this juridical procedure having an important role for the improvement of the Romanian business environment.

Statistically it was determined that *the hierarchy of the insolvency causes* [Maniu-Isaic Alexandru, 2005] is:

1. The incompetence and the managerial mistakes – close to 60 %;
2. The unfavourable evolution of the market – close to 20 %;
3. The natural phenomenon, fire etc. – close to 10 %
4. Other causes – close to 10 %.

II. Methods of evaluating the bankruptcy risk

The bankruptcy risk is determined on basis of a large series of indicators of which the most important are [after *International Accounting Group*]:

3. Indicators of the treasury difficulties:

- h. Relations with the suppliers
- i. Speed of rotation of stocks and time of recovering the creances that are placed under the mean of the respective branch or sector
- j. Financing investments by passives of exploitation
- k. Guarantees given
- l. Necessity to practise profit rates that are inferior to the mean of the respective branch or sector
- m. Intensification of exploitation losses
- n. Worsening of the ratio debts/own capital and surplus of debts compared to the net active

4. Indicators of difficulties in the management of the enterprise:

- e. Difficulties at the level of the lead
- f. Difficulties at the level of sale
- g. Difficulties regarding the process of production
- h. Exceptional difficulties, caused by a catastrophe, producing losses against which the enterprise has not been ensured

The analysis of the bankruptcy risk can be made through several methods, each of whom reveals distinct aspects:

1. Methods based on unfinancial-qualitative variables[Bătrâncea Maria, 2003]: managerial methods, methods of competition strategy;

2. Methods based on financial-quantitative variables [Achim Monica, 2007]: patrimony methods (using correlations between different rates), statistical methods (based on the function score);

3. Combined methods: Bank methods (of assesment of the bonity of clients - BCR, BRD, BT, Raiffeisen, BancPost model etc.) [Bătrâncea Ioan, 2007].

The analysis of bankruptcy risk can be made through several methods, each of whom reveals distinct aspects :

a) the static analysis of the patrimony situation; this type of analysis has represented for a long time in economic theory the only way of risk assesment. The main operational instruments standing on the basis of this analysis for the investigation of bankruptcy risk are the following:

- the working capital
- the method of rates of liquidity.

b) the functional analysis of bankruptcy risk on the basis of the functional balance sheet operating with stocks and fluxes of uses and resources;

c) the strategical analysis; the instruments used are the matrixes of strategical analysis (Matrix Boston Consulting Group - BCG, Matrix Arthur D. Little - ADL, Matrix McKinsey, SWOT Analysis etc.) that allow to approach the problematics of financial balance, of risk compared to the portfolio of activity of the firm, of its competition position ;

d) the analysis of bankruptcy risk through the method of scores .

III. Statistics of cases of insolvency in Eastern and Central Europe, referring to Romania

Romania's adherence to the EU increases the interest in the study of movements from the level of the maintenance of the performances of Romanian entities on a competitive market. In order to obtain a representative base of comparison, we have taken into consideration for the study the Central and Eastern Europe countries which are already part of the EU or are under negotiations for their adherence.

1. **From the point of view of the number**, the situations of failure of the 11 Central and East Europe countries, for 2005 and 2006, are presented in the following table:

Table 1

The statistics of failure numbers in Central an East Europe countries

No. of failures	Czech Rep.	Hungary	Poland	Slovenia	Slovakia	Estonia	Latvia
2005	1808	8126	793	733	1645	208	647
2006	1.028	4.655	307	368	878	70	269

No. of failures	Lithuania	Bulgaria	Croatia	Romania
2005	577	238	842	3582
2006	360	117	370	4661

Source: Coface Romania, after www.coface.ro

In order to draw more easily a comparison between the evolutions of bankruptcy in EU countries, it would be better to calculate some relative measures, namely the **insolvency rate**, as a balance for the companies that are under bankruptcy from the total of active companies on the market. In 2006, as compared to 2005, the **insolvency rate** differentiated by EU countries is presented as follows:

Table 2

The statistics of insolvency ratio in Central and East Europe countries(%)

Year	Czech Rep.	Hungary	Poland	Slovenia	Slovakia	Estonia	Latvia
2005	0,26	1,85	0,02	0,67	0,38	0,22	0,33
2006	0,1	1,0	0,0	0,2	0,2	0,1	0,1

Year	Lithuania	Bulgaria	Croatia	Romania	Average ratio
2005	0,35	0,07	1,32	0,68	0,30
2006	0,2	0,1	0,5	0,9	0,3

Source: Coface Romania, after www.coface.ro

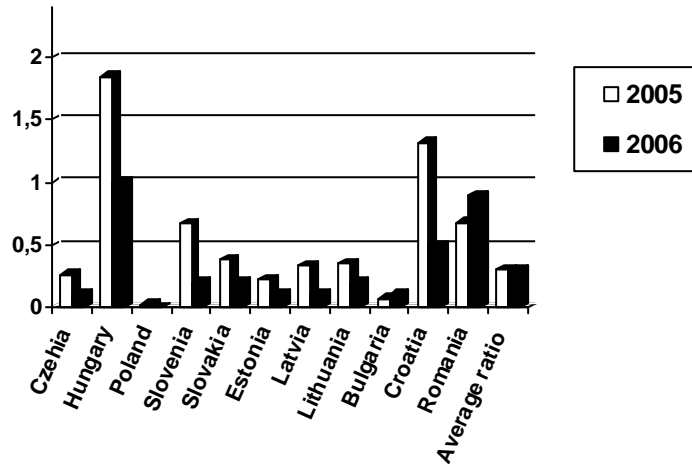


Fig. 1: The chart of insolvency rates by country in 2006 as compared to 2005 (%)

It can be seen that the highest bankruptcy rate in 2006 was in **Hungary** (1% in 2006 rapidly decreasing as compared to 2005). Second place goes to **Romania**, and in 2005 it was **Croatia**. In the case of Romania, an increase was registered in the number of companies being under bankruptcy with 45,9% in 2006 as compared to 2005, and this was primarily due to the issuing of the new insolvency law published in July 2006, a law that protects the lenders.

The large amount of insolvencies at the end of 2006 was also caused by the long period of time allotted to law suits, actually less than half of the total of insolvencies were lawsuits opened in 2006.

In 2007 the same type of evolution was expected, in terms of a rapid increase with 50% for the companies that would go bankrupt, mainly because of the new legislation combined with the EU one, which would destroy the small companies with an unstable financial situation. In **Poland**, the rate of insolvents registered is extremely low, but the number of bankruptcies reported does not reflect the real situation, because all cases of lack of actives are rejected by court and there are no official records concerning the number of cases rejected.

There is a small percentage of bankruptcy in **Bulgaria**, a fact which is primarily due to the complicated procedure and the duration of bankruptcy in this country. With the exception of Romania, the number of bankruptcies for the countries that have joined the EU in 2006 can be observed, fact which underlines the capacity of the new EU economies to overcome the competition on the unique market, invalidating the provisions regarding the number of bankruptcies, especially for the small and intermediate businesses.

2. From the point of view of structure by sector, the sector situation of the bankruptcies registered in the **Central and East European** economies, in percentage, is represented as follows:

Table 3

The statistics of insolvency structure by sector on Central and Eastern Europe countries

Area of Activity	% total 2005	% total 2006
Wholesale trade and commission trade	28,1	24,3
Retail trade	15,1	15,2
Construction	6,5	8,6
Company service	8,1	9,3
Transport	3,1	2,9
Agriculture and farming, forestry, fishing	3,4	3,3
Hotels and restaurants	4,3	4,3
Manufacture and processing of wood and wood products including .furniture	3,7	3,5
Manufacture of fabricated metal	3,4	2,8
Manufacture of textile and clothing	2,2	2,6
Manufacture of food products and beverages	2,6	2,7
Sale, maintenance and repair of motor vehicles	2,4	2,8
Travel agencies	1,6	1,9
Publishing and printing	1,9	1,6
Real estate activities	1,7	2,2
Manufacture of machinery	1,1	1,4
Data processing and data warehousing	0,9	1,0
Other sectors in total	9,9	9,6

Source: Coface Romania, after www.coface.ro

It can be observed from the data presented that the highest level of insolvency cases was registered in the **wholesale trade sector** with around 4% whereas in the **retail trade sector** the bankruptcy rate is of around 15%. The increase in the number of bankruptcies from the commercial sector must not be regarded as a negative aspect. The number of explosions of companies that was registered in all economies in transition from Central and Eastern Europe, made them represent the majority within the companies that were founded after 1989. This development has determined a strong competition, which was also triggered by the free access to the common market.

The changes of structure performed in the commercial sector in the past few years, namely the orientation of commerce towards supermarkets and hypermarkets has led to the disappearance of small businesses. So, it is only natural for this sector to register a large number of cases of insolvency.

Increases of bankruptcies were registered in the sector of constructions (around 2%), in the sector of administrative services (around 1%), in textile manufacture and clothing (0,4%), in sale, maintenance and repair of motor vehicles sector (0,4 %), in the sector of manufacture and machinery (0,3 %).

Decreases of bankruptcies were registered in the sectors of wholesale trade and commission trade (around 4%), followed by the sector of manufacture of fabricated metal (0,6 %), and sector of Publishing and printing (0,3 %).

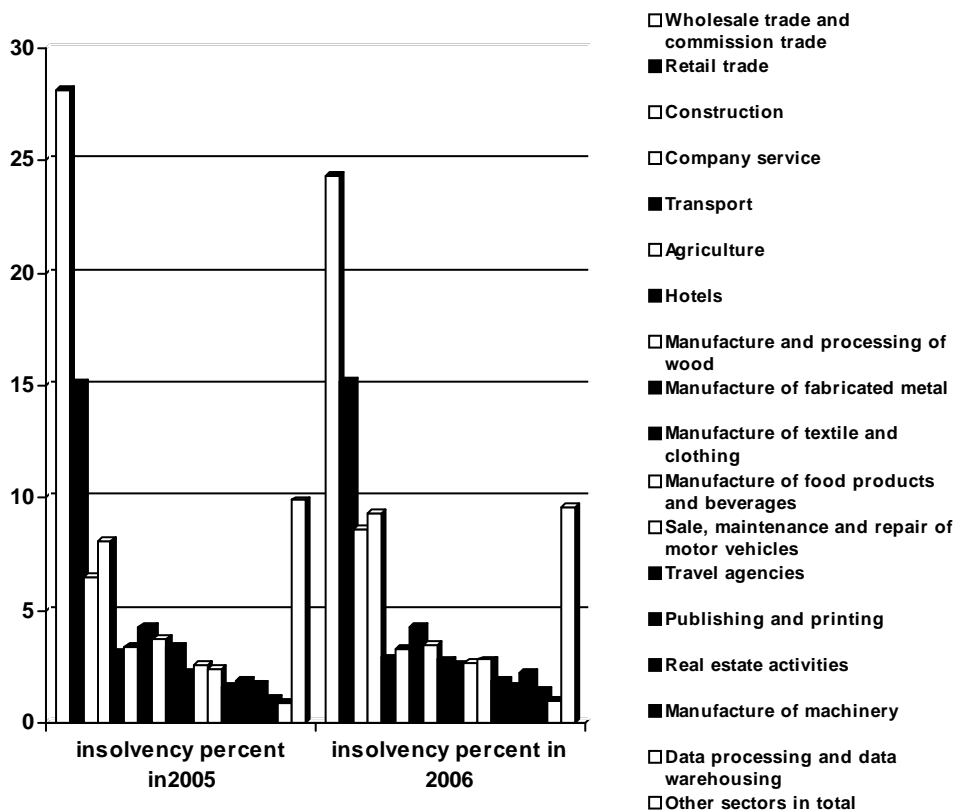


Fig. 2: The graphic of statistics of insolvency structure by sector in Central and Eastern Europe countries (%)

In **Romania**, from the point of view of the sector, the structure of bankruptcy between 2005-2006 is presented as follows:

Table 4

The statistics of structure of insolvency by sector in Romania

Area of Activity	% total 2006	%total 2005
Wholesale trade and distribution	18,3	22,6
Retail trade	18,5	12,3
Agriculture, silviculture, hunting and fishing	13,2	16,4
Food and beverages industry	10,8	11,6
Constructions	5,6	5,0
Wood and wood products fabrication	5,5	6,0
Textile, clothing and shoes factory	5,4	5,4
Transportation	3,6	3,2
Metallurgical Industry	3,4	3,4
Other activities mainly performed by companies	3,3	3,2
Hotels and restaurants	3,1	2,3

Other activities for personal services	1,4	0,9
Manufacturing of chemical substances and products	1,2	2,4
Drainage and removal of general wastes, sanitation and similar activities	1,1	0,6
Machines and equipments Industry	1,1	0,8
Recreational, cultural and sports activities	0,8	0,9
Extracting Industry	0,6	0,4
Real estate agencies	0,5	0,8
IT and related activities	0,5	0,5
Financial factoring	0,5	0,6
Post office and telecommunications	0,4	0,3
Post office and telecommunications	0,4	0,3
Production and supply of electrical, thermal energy, water and gases	0,1	0,2
TOTAL	100	100

Source: Coface Romania, after www.coface.ro

As in the previous years, the **commercial sector** has registered the largest number of bankruptcies. In 2006 **retail** over-passed the **en gross commerce** which was leading in 2005. The commercial sector registered 36,8 % from the total amount of bankruptcies in 2006, increasing as compared to 2005 even if the percentage was of 34,9%. This tendency confirms the evolution in the past years, so as the commerce is concentrated today on hyper markets, super markets, cash& carry retailers that continue to extend their business network, trying to occupy new markets, in small towns. Large retailers have increased the number of stores in 2006 with 40% as compared to 2005, at the end of January 2007; there were a number of 263 units all over Romania.

Agriculture is the third sector from the point of view of insolvency, whereas in 2005 it was on the second position, food and beverages industry occupying then the fourth place. The Romanian agriculture is still far from being a competitive sector.

However, by continuing the reforms in this domain and by absorbing EU agriculture funds, these can lead to an accelerated development in this sector and may attract new investors; there are some successful examples in this sector. On the regional plan, we have the example of Poland, where agriculture is a viable sector of the economy, with a high level of development, the farmers' benefit is a high price for export of meat and milk in EU countries registering high incomes.

The sector of constructions was in 2005 on the tenth place, and is now on the fifth place from the point of view of insolvents from the total registered in 2006. Although the sector of constructions continues to improve, being a developing sector which attracts a large number of investments, it is still a risky sector, where payments are done with difficulty, with a large number of insolvent companies, especially among the small and average ones which deliver materials of construction.

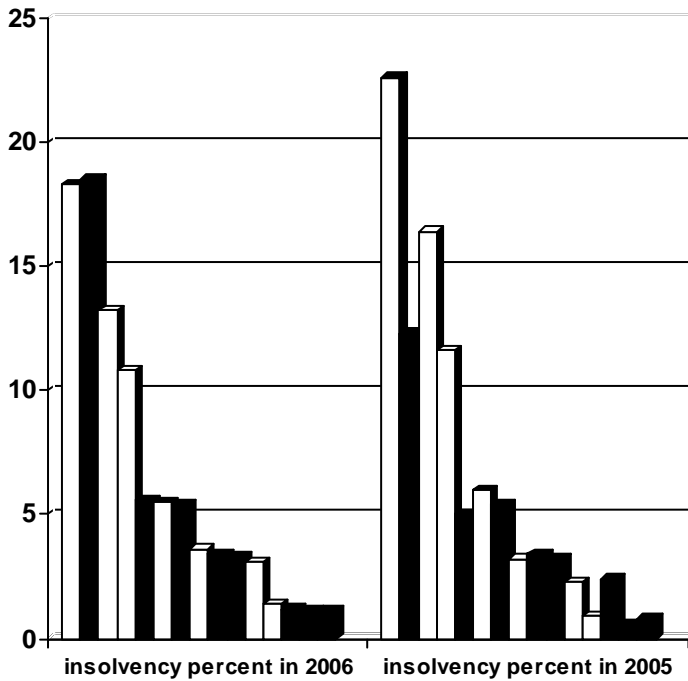


Fig. 3: The graphic of statistics of structure of insolvency by sector in Romania (%)

The insolvency rate remains the same in **textile, clothing and shoes factories**, and many companies from those that were working exclusively in loan, were closed because of the salary increase in this sector also. Many of them have problems due to the high costs of production as compared to other similar products from the Asian market, and many textile factories do not find the necessary resources to build an image, to enter in certain sectors of the market by opening own stores, by participating at exhibitions and fairs, etc.

On the other side, **the sectors which register the lowest rate of bankruptcy belong mainly to the sector of services.** The **IT sector, the financial department, post office and telecommunications, the energy sector** are under observance, since every year. Telecommunications keep on being a well- consolidated sector, and in the energy sector, although the market was opened, we cannot yet talk about competition.

Financial businesses, real estate trades, IT, are sectors with a high degree of development for the past few years and they are the least risky economical sectors at present. There is an increase observed in the insolvency rate in wholesale trade, in agriculture, food industry, in manufacturing chemical substances and products. The important increase of the number of bankruptcies in 2006 as compared to 2005, was strongly influenced by the positive effects of the new procedure which was simplified for the bankruptcy law, so that the creditor can more easily initiate the procedure of bankruptcy against a debtor.

It is estimated that under the new conditions of legislation, the number of bankruptcies in Romania will increase in the following years, because the debtors that could have until now “got away” because of the unclear legislation, will have fewer alternatives in case they don’t want to pay their debts.

REFERENCES

1. Achim Monica, Achim Sorin (2007) – *The analysis of bankruptcy risk base on non-financial factors*, article presented in the International Conference with the title, *Competitiveness and European Integration*, 26-27 October, Cluj-Napoca;
2. Bătrâncea Maria (2003) – *Risk and insolvency*, Ed. Dacia, Cluj-Napoca;
3. Bătrâncea Ioan (2007) – *Financial analysis of economic entities*, Ed. Risoprint, Cluj-Napoca;
4. Dichev Ilia D. (June 1998) – *Is the risk of Bankruptcy a Systematic risk ???*, Journal of finance, VOL LIII, No 3, after www.ebso.com;
5. Gilson Stuart C., Hotchkiss Edith S. Ruback Richard S (spring 2000) – *Valuation of Bankrupt Firms*, The Review of Financial Studies, vol 13. No.1, pp. 43-74, after www.jstor.org;
6. Larsen Stuart L. (March 2006) – *Preventive measures to avoid Bankruptcy risk*, Bussines Credit Revue, after www.ebso.com;
7. Maniu-Isaic Alexandru (2005) – *Mesure and statistic analysis of Romanian risk*”, Ed. Ase-on line, Bucuresti;
8. Moreno - Ternero Juan D., Villar Antonio (August 2006) – *New characterizations of a classical bankruptcy rule*, Rev. Economic Design, 10, pp. 73–84, after www.ebso.com;
9. Niculescu Maria (1997) – *Global strategic diagnosis*, Ed. Economică, București;
10. Reisz Alexander S., Perlich Claudia (2007) – *A market-based framework for bankruptcy prediction*, Journal of Financial Stability, no.3., pp.85-131, after www.sciencedirect.com;
11. Sherris M. (2006) – *Solvency, capital, allotement and fair rate or return in insurance*”, Journal of Risk & Insurance, vol. 73, no 1, pp. 71-96, after, www.ebso.com;

12. Spătariu, Elena Cerasela (2005) – *Theoretical elements of economical-financial analysis*, Ed. EX PONTO, Constanța;
13. *** Insolvency law, no.85/2006, published in M.Of.359/21.04 2006;
14. *** www.coface.com, www.coface.ro, www.worldreport.com, www.bankruptcydata.com, www.hud.ac.uk/finance/stufin/bankruptcy.htm.