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THE PROBLEM OF SOLVENCY OF COMPANIES EXEMPLIFIED BY CHOSEN COUNTRIES OF CENTRAL AND EASTERN EUROPE

Summary: One of the most important factors that affect integrated company management is the financial potential possessed by a given business entity. In the article there are characterized crucial factors connected with a loss of company's liquidity, i.e. its insolvency, which may lead to bankruptcy. The article also characterizes the phenomenon of bankruptcy in the economies of Poland, Czech Republic and Hungary in the years 1998 – 2004.

Key words: management of finance, financial liquidity, solvency, bankruptcy

Introduction

Integrated management of finance in a company "(...) can be treated as an overall concept, including the interconnected processes of operational, strategic and normative management. The management on particular levels varies according to the structure of functions (tasks), the level of complexity and management realization.

On the operational level management means the realization and control of activities performed in a company. Basic criteria of management on this level include financial potential (solvency) and the economic effectiveness of performed activities"[1].

The following article is devoted to the problems which arise in the sphere of processes involved in operational management, particularly to the problems connected with the solvency (financial liquidity) of companies.

1. Characteristics of the crucial aspects of insolvency of companies

Every activity performed or, in other words, all the decision-making processes that take place in a company entail financial consequences.

In the process of company management a very important role is played by financial resources. "Firstly – cash allows to cover the liabilities due to material supplies, provision of services, etc., according to the conditions of mercantile credit, tax liabilities to the state budget, Social Insurance, employees, and others. Secondly – the receivables, as well as the stock of ready-to-sell products turn into cash with a certain delay. The delay is even larger in the case of products sold on credit. Thus, even though cash is a peculiar form of company's current assets it is, at the same time, the form in which the changeable character of all its aspects is mirrored"[2].

Management of finance, especially the special care taken by the managers about the processes characterized by short-term financial decisions, determines the functioning of a company on the market.

"The increasing importance of finance in managing a business entity is vitally connected with maintaining financial liquidity. As a result, within a short period of time the status of a company on the market depends not on the level of its production or the amount of profit made, but rather on its

[1] Blaik, P., Logistyka, PWE, Warszawa 2001, p. 126
[2] Bury A., Zarządzanie kapitałem obrotowym. [in:] Wypych, M. (ed), Finanse przedsiębiorstwa z elementami zarządzania i analizy, ABSOLWENT, Łódź 2000, pp. 282-3

solvency"1. Thus, financial liquidity, i.e. the capability of a company to pay its current liabilities, is the most important factor in evaluating its solvency.

The decrease or loss of financial liquidity causes, among others, the increase of financial costs; difficulties in getting a credit connected with the lack of trust on the side of banks and contractors; limitation, or complete discontinuance of giving mercantile credits to the clients (only cash transactions are performed), which negatively affects further cooperation with them, resulting in the loss of regular contractors and difficulties with finding new ones. All of the above mentioned factors affect negatively further operation of a company, causing the limitation of its presence on the market, decrease of its profitability and the loss of opportunities for its further development. Therefore, bankruptcy petition is often the consequence of losing financial liquidity.

According to D. Wędzki, after W. Grabczan, there can be differentiated three stages leading to the bankruptcy of a company which are tightly connected with insolvency:

- "the first stage begins with the increase of concern about cash on the side of a company's management board. The expenses connected with remuneration of employees, board costs and sales are reduced, as well as the expenditure on research and development. At the same time there is a tendency to decrease the amount of receivables by their stricter recovery and to prolong the period of discharging liabilities due to supplies of materials and provision of services;
- the second stage is characterized by very serious problems with solvency. Acquiring cash is becoming the main aim of the management board. The expenses are reduced to the indispensable minimum. The expenditure on investment is discontinued and the liabilities due to suppliers are no longer discharged. Ultimately, some of the capital assets are sold. The board is trying to acquire a new source of financing and restructure the already existing one;
- the third stage is close to the insolvency proper. Drastic decisions are taken, such as laying off employees, selling part of the company's estate or the whole plant. If these extreme measures do not help, the company goes bankrupt"[2].

In order to limit the risk of losing financial liquidity by a company, it is advisable to conduct on a regular basis the evaluation of its payment capability and the possibility of its loss. Recognition, in due time, of the symptoms of insolvency provides greater chances for undertaking proper measures in order to impede, or wholly eliminate, the undesirable processes taking place in a company, which may lead to bankruptcy.

In general, it can be concluded that the direct reason for bankruptcy of a company is its insolvency, but the original reasons for bankruptcy can be of a diversified character and depend on many factors, both internal and external.

The external factors are very important from the microeconomic viewpoint, since the company has direct influence on them, i.e. the managers can control them and in the case of oncoming danger can act to directly improve the worsening situation. As far as the external factors are concerned, they are independent of the company's managers, since they are shaped by the macroeconomic situation of the country. Every company has to adjust itself to the rules of market economy in order to survive and operate successfully. However, it is not always possible, especially in the case of small and medium-sized businesses whose further operating can be easily affected in the negative way by the smallest changes in the economic situation.

The acquaintance with, and careful observation of external and internal reasons and syndromes of a company's bankruptcy is of crucial importance to the managers of a company, since they can appear in any area of the company's operation, as well as in its environment.

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[1] Pałczyńska-Gościniak, R., Ocena płynności przedsiębiorstwa, [in:] Jerzemowska, M. (ed.), Analiza ekonomiczna w przedsiębiorstwie, PWE, Warszawa 2004, p. 135

[2] Wędzki, D. Strategia płynności finansowej przedsiębiorstwa, Oficyna Ekonomiczna, Kraków 2002, p. 35

The factors causing bankruptcy of companies are the subject of many studies. In the literature on the subject there can be found many analyses of the factors, sources and symptoms of a financial crisis or bankruptcy of a company.

Among the most important factors causing bankruptcy of companies there can be counted, among others, the increase of competition, high interest rates, lack of capital, lack of knowledge and skill in company management, and difficulties with vindication of receivables.Analyzing the above mentioned factors causing bankruptcy and interpreting them – beginning with the increase of competition – we can create a model of a crisis that may lead to bankruptcy of a company.

The increase of competition causes that the companies which do not possess, among others, an effective marketing strategy, which is often due to the insufficient knowledge and skill in the field of management, and do not possess the capital for modernization and innovation of their estate due to large costs of bank credits, begin to have difficulties with selling their products, which initiates a chain of unfavorable events, i.e. the decrease in number of orders for ready-made products and services, and consequently the decrease of turnover. The decrease in sales affects the level of profitability and financial liquidity. In the area of profitability there takes place the increase of costs and the decrease of operational income, followed by losses and excessive indebtedness. In the area of financial liquidity the decrease of income causes difficulties with settling liabilities; there take place blockages of payment, and consequently, the loss of financial liquidity and insolvency[1].

The complex treatment of the first syndromes of a company's bankruptcy is presented in Table 1.

Table 1. First syndromes of a company's bankruptcy

Characteristics of a syndrome	Events causing anxiety
1	2
Financial syndromes	– lower income from sales, – unfavorable relation between steady costs and the income, – variable costs grow and the management board no longer has control over them, – the company is unable to remunerate employees on time, – the company does not cover current liabilities to Income Revenue Office, Social Insurance Services and banks, – the company has outstanding payments to the suppliers to settle, – Social Insurance Services and Income Revenue Office mortgage company's estate, – banks increase the security of the credits they have given through additional pledges of registration and mortgaged estates, – loss of liquidity, – no system of cost budgeting, – no conception of cost management, – no controlling department
Bad management of receivables	– too liberal a policy concerning mercantile credit, – prolonged cycle of receivables recovery, – allowing for the existence of outstanding debts, – increase in the amount of irrecoverable or doubtful receivables, – recovery of some receivables ends up in a court of law (which results in contentious receivables), – reserves for contentious receivables affect the financial result, – no specialized recovery department in a company, finance managers are unable to control the number and amount of outstanding debts,

[1] Prusak, B., Uwarunkowania upadłości przedsiębiorstw. [in:] Bławat, F. (ed.), Gospodarka Polski w okresie transformacji. Wydawnictwo Politechniki Gdańskiej, Gdańsk 2001, p. 85

End of Table 1

1	2
	– lack of knowledge which receivers are the ones who do not pay, – incompetence of the management board in the area of negotiating at least partial recovery of receivables, – sale and rise of receivables in the case of contractors that have been unknown so far, – dependency on one key receiver of goods, – no diversification of contractos
Bad management of a company	– incompetence of the management board, – no conception of company management (lack of mission, strategy and goals), – serious erroneous investment undertakings (e.g. underestimated ones), – wrong decisions in wrong moments, – frequent changes in the management board, – bad corporate image of a company results in the loss of receivers or favorable sources of financing
Bad management of human resources	– excessive employment of new workers or excessive dismissal of specialists, – lack of skill in motivating key specialists to stay with the company, – lack of motivation system in a company, – no training courses for workers

Source: Kadryś, M. *Pierwsze syndromy upadku firmy.* INFOR, Prawo Przedsiębiorcy 22/2003, p. 14

The best source of evaluation and verification of a company's financial situation are financial reports. Thanks to them, frequent and regular analyzing of balance data allows for the direct identification of symptoms signaling the worsening situation of a company. The symptoms of bankruptcy that can be identified by analyzing financial reports include:

- occurrence of a loss,
- decrease in profit (especially business profit gross or net),
- decrease in profit on sale,
- considerably increasing necessity of finding external sources of financing (such as, among others, credits and loans),
- increase of liabilities to suppliers (including outstanding debts),
- delays in payment of taxes and insurance fees (in spite of penalty interest),
- limitation of payment of national insurance benefits or even employees' salaries,
- the increase of reserves, especially as far as the ready-to-sell products and the unfinished production are concerned (the companies whose operation is of seasonal character and those operating under the conditions of high inflation may be an exception here,)
- problems with finishing the investments initiated,
- sale of some capital assets,
- negative cash flow from business activity (the companies that have just appeared on the market may be an exception here),
- positive cash flow from investing"[1].

The above mentioned reasons for, and symptoms of bankruptcy are real dangers to a company. It ought to be remembered, as has already been stated, that the worsening financial situation of a company, which may lead to bankruptcy, is often a result of the mutual influence of many endogenous and exogenous factors.

[1] Zaleska, M. Identyfikacja ryzyka i upadłości przedsiębiorstwa i banku. Systemy wczesnego ostrzegania. Difin, Warszawa 2002, pp. 22-3

2. Characteristics of the phenomenon of insolvency in Poland, Czech Republic and Hungary in the years 1998 – 2004

Bankruptcy of companies is tightly connected with the functioning of market economy. On the one hand, the phenomenon of bankruptcy is a positive factor, since it allows for elimination from the market economy the ineffective business entities and for productive allocation of the resources of the bankrupt entity to a prosperous entity. On the other hand, it may also happen that the companies which, in the course of their business dealings come across insolvent companies (i.e. debtors) begin to have financial difficulties themselves, which may lead to their own bankruptcy.

According to the studies conducted by Euler Hermes company on the phenomenon of bankruptcy all over the world, in the year 2004 "the considerable (-5%) decrease of the Euler Hermes Global Insolvency Index[1] was caused by a record, 4% boost in economy, propelled mainly by the USA and Japan. In the USA, where great domestic demand stimulated dynamic growth, the number of bankruptcies fell by 2%. The boom in Japanese economy, supported by strong industry, brought a 16% fall in the number of bankruptcies. In Europe, where the improvement of economic situation is rather insignificant, the number of bankruptcies remains high. The world economic growth was at its peak in 2004, and then came a noticeable slump caused by the growing prices of oil, the raising of interest rates in the USA and the growing price of Euro"[2].

The actual data concerning the bankruptcies of companies all over the world in the years 2005-2006 have not been published yet. However, it can be assumed on the basis of the prognoses developed by Euler Hermes that the slump in world economy expected to last towards the end of 2006 will aggravate the phenomenon of bankruptcy in Europe and Japan. However, even though there is supposed to be a growth in the number of bankruptcies throughout Europe, the prognoses say that the number of bankruptcies in Poland, Czech Republic and Hungary will remain the same[3].

Data concerning the number of bankruptcies in Poland, Czech Republic and Hungary in the years 1998-2004 is presented in Table 2.

Table 2. The number of bankruptcies in Poland, Czech Republic and Hungaryin the years 1998-2004

Year	1998	1999	2000	2001	2002	2003	2004
Poland							
Number of bankruptcies	864	1017	1289	1674	1863	1788	1025
Dynamics (%)	-	17,7	26,7	29,9	11,3	-4,0	-42,7
Czech Republic							
Number of bankruptcies	2022	2000	2491	2473	2155	1728	1600
Dynamics (%)	-	-1,1	24,6	-0,7	-12,9	-19,8	-7,4
Hungary							
Number of bankruptcies	4031	3391	4998	4795	6189	7693	8000
Dynamics (%)	-	3,4	19,9	17,9	5,0	24,3	4,0

Source: My own calculation based on Euler Hermes, *Bankructwa '04*, Manager Magazin 3/2005, pp. 79, 81

[1] In order to study the general risk of bankruptcy all over the world and limit the factors distorting the statistical data of bankruptcy in particular countries, Euler Hermes company developed a special indicator, i.e. Global Insolvency Index, where the absolute numbers were replaced by the change of the number of bankruptcies within a given period of time. The year 1997 was taken as a starting point (100%) and the countries were included in the overall statistics according to their share in the world GDP (judging by the current exchanges rates). Only those countries representing 80% of the world GDP were taken into account.

[2] Press information of 25th August 2005, issued by Euler Hermes Company, retrieved from www.eulerhermes.pl

[3] Ibidem and Euler Hermes, Bankructwa '04, Manager Magazin 3/2005, p. 76

According to data shown in Table 2, the number of insolvent companies in Poland in the years 1998-2004 has been growing steadily. In the year 2003 there was a slight, 4% decrease of the number of insolvent companies in comparison with the year 2002. Furthermore, in the year 2004 as many as 1025 Polish companies went bankrupt, i.e. 42.7% less than the year before.

From the analysis of bankruptcies of Polish companies in the period from January to June 2005, when 400 companies went bankrupt, it may be concluded that the number of insolvencies went down in comparison with the same months in the years 2000-2004, when the number of insolvent companies amounted respectively to 437, 590, 630, 576 and 636[1].

The positive phenomenon of decreasing number of bankruptcies is the result of economic revival and Poland's accession to the European Union, which gave Polish entrepreneurs the opportunity to initiate business activity on new markets. Euler Hermes emphasizes the fact that such a considerable fall in the number of bankruptcies in 2004 was possible also because of the fact that the earlier economic standstill had removed the weakest companies from the market, and only those remained, which were able to adjust to the existing economic conditions. Some of those companies underwent serious restructuring and thus were ready to conduct business activities under much more difficult economic conditions than those which actually existed in 2004[2].

The favorable decrease in the number of insolvent companies can also be observed in Czech Republic. Analyzing the bankruptcies of Czech companies in the years 1998-2004 as shown in Table 2, we arrive at the conclusion that the systematic decrease in the number of insolvencies began in 2001. Analyzing data for the year 2004, we can observe a fall of nearly 36% in the number of bankruptcies in comparison with the year 2000, and a fall of 7.4% in comparison with the year 2003.

For the decreasing number of bankruptcies in Czech Republic the increase of investment and consumer expenditure are to be held responsible, since the two factors provided a solid basis for the economic growth[3].

Out of the three countries of Central Europe taken into consideration, the least favorable situation concerning insolvencies can be observed in Hungary. In the period accounted for, i.e. the years 1998-2004, the number of bankrupt companies was growing (see Table 2). In comparison with 1998, in 2004 the number of insolvent Hungarian companies doubled. The dynamics of insolvencies was growing in 2002 in comparison with 2001 and amounted to 5%. It was also growing in 2004 in comparison with 2003, and amounted to 4%.

The persistently growing dynamics of insolvencies in Hungary was seemingly paradoxical since at the same time the economic growth of the country was very steady. After a year of membership in the European Union, Hungarian economic growth went up by 4% in 2004, mainly due to export and investments. In utmost probability, the reason for the persistently growing number of insolvencies in Hungary was a large number of newly set up companies, for whom to remain on the market during the initial period of their business activities was particularly difficult, thus they were often threatened by insolvency.[4]

As can be observed on the basis of comparative analysis of the phenomenon of bankruptcy in the years 1998-2004, out of the three countries considered, i.e. Czech Republic, Hungary and Poland, the most favorable situation exists in Poland.

Comparing the situation in Polish economy (see Table 2) with that of Hungary and Czech Republic, we may observe that in 2004 iin Hungary there were eight times more bankruptcies than in Poland,

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[1] Press information of 25th August 2005, issued by Euler Hermes, retrieved from www.eulerhermes.pl

[2] Euler Hermes, Bankructwa '04... , p. 79

[3] Press information of 25th August 2005, retrieved from www.eulerhermes.pl. and Euler Hermes, Bankructwa '04... , p.91

[4] Press information of 25th August 2005, issued by Euler Hermes, retrieved form www.eulerhermes.pl, and Euler Hermes, Bankructwa '04 , p. 91

while in the same year in Czech Republic 1600 companies went bankrupt. Even though there was a considerable decrease in the number of bankrupt companies in 2004 in Czech Republic, the situation in Poland, a five times bigger country, was still better with just 1025 bankruptcies.

Conclusions

As has already been stated, the phenomenon of bankruptcy is a common element of functioning of the market economy.

Early identification of the financial crisis is important not only for the company itself, but also for the business entities cooperating with it, since it provides an opportunity for limiting the costs connected with its supposed bankruptcy. Therefore, in order to limit the risk of a company going bankrupt, it is advisable to frequently control its solvency and estimate the probability of its loss. Recognition, in due time, of the symptoms of worsening financial situation provides greater chances for undertaking necessary measures that will deter or wholly eliminate the undesirable processes leading to insolvency.

"21st century is an era of fast communication resulting in prompt decision making, access to information and opportunity for data processing. (...)"[1]. Thus the development of information technology, especially data processing systems, allows for an implementation of very complicated mathematical and statistical methods, such as discrimination analysis or artificial neural networks, with the help of which it is possible to create very good systems of early warning against bankruptcy.

The analysis of the phenomenon of insolvency in Poland, Czech Republic and Hungary shows that, as far as the decreasing number of bankruptcies is concerned, the situation in Poland is the best (see Table 2).

Furthermore, Poland not only turned out to be the leader of the region in 2004, but also, according to the analysis of the bankruptcy rate all over the world, it was featured on the third place, after Finland and Japan, as a country where the rate of bankruptcies went down the fastest[2].

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10. www.eulerhermes.pl

[1] Urbańska, J. Procesy prywatyzacji przedsiębiorstw a rozwój przedsiębiorczości. [in:] Czachorowska, A., Kościelniak, H. (eds.) Ekonomiczne i pozaekonomiczne determinanty rozwoju. Wydawnictwo Wydziału Zarządzania Politechniki Częstochowskiej, Częstochowa 2003, p. 173

[2] Euler Hermes, Bankructwa '04... , p. 79