

CRITICAL ANALYSIS OF INCAPACITY OF PAYMENT RISK

Demetra LUPU VIȘĂNESCU, Ec. PhD. Student
University of Craiova

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1. General considerations regarding incapacity of payment risk and bankruptcy

In foreign specialized literature is made distinction between *incapacity of payment concept and insolvency*. In this way The bankruptcy risk (insolvency) can be definite representing possibility of appearance of honoring incapacity of reduced obligations (overcome to term) of firm, born by previous engagement contracted, from present operations, determinable for activity continuation, and the incapacity of payment represents this estate of debtor firm patrimony which is characterized through currency stocks available for the payment of exigible debts.

From economic-financial point of view analysis, the main indicators which are at the basis of incapacity of payment determination and implicitly of the bankruptcy are: lack of solvency and indebted degree. The estimation of solvency of an economic agent and implicitly of bankruptcy risk is influenced by a factors series like: activity sector, life cycle of production, economic, financial, fiscal, social, judicial and ecological characteristics of external average of economic entity, peculiarities of economic agent, season period, periodicity and activity fluctuations, frequency of difficulties in obligations payment, capitals structure, firm measurement.

As we mentioned before, *we consider* that economic agents who are in difficulty shouldn't look only from financial viewpoint, but through a certain angle of all its judicial, economic and social-politic implications. In this way, an economic agent who is in difficulty is characterized through decreasing of activity volume and advantageousness, owed to non-adapting at conditions imposed by market, of a deficient and non-performing management transposed in neutrality at optimum capacity of production factors which are at unit disposition.

From judicial point of view, as we mentioned before, an economic agent who is in payment impossibility and, in this way, he can't support all his exigible debts, he is obliged according to new legislation in term of 30 days from the appearance of incapacity of payment estate to address a requirement at the court , through which he shows his intention to enter in simplified or reorganization procedure, according to a plan, through activity reorganization or total or partial liquidation of his fortune, in consideration of his debts canceling.

The causes which action in situation of deterioration of an economic agent are different and we consider that, usually, they have their origin in economic-social and competitive average where he develops the activity.

In this way, accentuation of internal and international competition, the appearance of better new products, one important deliverer' bankruptcy who provided certain materials, pieces, ensemble essential for continuity of company activity, losing of an important customer or his bankruptcy, bankruptcy of a bank which the company had preponderant financial relationships, the appearance of some regulations on line of

security and environment protection, according to new European regulations, the decreasing of money market quotation *we consider* to be the main external causes which negatively mark the activity of any economic agent.

Besides external factors, an important role is played by internal financial, strategic and organizational factors, which is synthesized represented in the following two charts (table 1 and table 2).

From financial point of view difficulty estate of an economic agent can be evident by continuous diminishing of availabilities fluxes, because of recovering incapacity of debts from the debtors, retirement of some credit lines or even because of some financial losses. Also, the continuous deterioration of patrimonial solvency, maintaining of a negative bearing stock on a long period of time, continuous decreasing of activity efficiency and obtaining of losses more and more important *we consider* that the most important financial factors which, can we say that “betray” difficulty estate which is the economic agent subdued to analysis.

From strategic point of view lack of some clear objectives in the future development of activity or misunderstanding of these by administrator or owners and also the future projects incompatible as size with possibilities of business development have a negative influence over the future of the economic agent on the market. An inefficient marketing politics or even an inexistent one manifested through uninspired choosing of detachment markets as well as weak reaction speed at modifications imposed by market dynamics also have a negative impact over economic agent’s activity.

Finally, lack of experience, culture in business of leaders, non-correlation between staff’s abilities and their application mood at each working place, critical organizational structure, lack of leaders’ morality at all levels, critical relationships with staff who detain public power, with own customers and deliverers and not at least political influences in business leading are organizational causes which generate economic agent’s difficulty estate.

All these causes generate modifications in information offered by financial reports. Some modification appeared in financial reports can be easy identified and diagnosed and can be explained and correct.

In this way availabilities decreasing from economic agent’s accounts appears like result of debtors’ non-payments, important increasing of some costs elements, decreasing of physical volume production and reduction of sale price. The increasing of stocks can show the appearance of some market problems or non-correlated inadequate to these. The important increasing of debts is showed through the incapacity to maintain debt degree at previous level and the appealing at new loans, and the increasing of loan volume on short term can be justified through covering need of an idle of resources, but in the same time can hide a financing of investments from short time resources what can create big problems of liquidations in the future. The reduction of paid dividends warns about lack of trust in firm future.

Table 1

Exogenous factors which influence the increasing company vulnerability

<i>BUSINESS AVERAGE</i>						
MICROAVERAGE			MACROAVERAGE			
SUPPLY MARKET	DETACHMENT MARKET	FINANCIAL MARKET	BUSINESS CLIMATE	LEGISLATIVE CLIMATE		
				FISCAL	ECOLOGIC	SOCIO-ECONOMIC
EXOGENOUS FACTORS - business cycle in the respective branch - market instability - basical contractors' bankruptcy - competal type of market - increasing of suplying prices in the same time with the impossibility of sale	- business cycle in the respective branch - market instability - competal type of market - basical contractors' bankruptcy -requirement decreasing - increasing of competitive power of the competition - appearance of new products and technologies - appearance of substitution products	- accesss to teh capital - increasing of scholar course because of exogene causes - inflation - coin devalorization - instability of currency- banking market -worsening of the relation with the bank - bankruptcy of working bank of company - bankruptcy of assurance company	- economic macrocycle - group interests - govenmental politics of sustaining of respective domain - political instability - legislative instability -administrative inefficiency -substructure	- increasing of direct taxes - increasing of indirect taxes -increasing of taxes - evolution of customs taxes - instability - non-granting of reductions, exemptions, taxes, redispases of taxes	- increasing of standards of environmental protection - standards application - increasing of penalties severity	- reduction of possible subventions - increasing of minimum salary medium on economy - measurements with social character supported by company

Source: Negriță A., *Reorganization of companies which are in difficulty*, Ed. Mitron, Timișoara, 2003 pag. 22

Table 2

Endogenous factors which influence at increasing of company vulnerability

	STRATEGICAL REORIENTATION	TOP-MANAGEMENT QUALITY	ADMINISTRATION OF HUMAN RESOURCES	ADMINISTRATION OF FINANCIAL RESOURCES	RESEARCH-DEVELOPMENT ACTIVITY	TRADE ACTIVITY	PRODUCTION ACTIVITY
ENDOGENOUS FACTORS	<ul style="list-style-type: none"> - lack of strategic vision - mistakes in substantiation strategy - errors in strategy application - stiffness in strategic visions - exaggerated division - dependence by exogenous factors 	<ul style="list-style-type: none"> - preparing of management team - over dimensioning of team - lack of management team's cohesion - lack of coherence - deficiencies in management methodologies, adopting and delivery of decisions - deficiencies in information system - critical organizationic structure - accidents, deaths in management team - lack of preparing and training of inferior immediate echelon - correct unpracticing of control 	<ul style="list-style-type: none"> - inadequate paying politics - critical relations with trade union - appearance and administration of working conflicts - staff over dimensioning - critical selection - lack of preparing of perfecting - lack of motivation and training 	<ul style="list-style-type: none"> - financial administration of customer credit, deliverer of stocks, debts - deficiencies feasibility substantiation of investment programmes - lack of training in finding and valorification resources of exploitation and investments - deficiencies in according politics of trade reductions with trade character - deficiencies in practicing of financial control 	<ul style="list-style-type: none"> - lack of concern for introduction and landing of new products - lack of concern for introduction and making of new technologies - deficiencies in preparing and experience of the team - deficiencies in collaboration with other services - management of deficiatary projects 	<ul style="list-style-type: none"> - lack of information and market studies - deficiency in distribution system - non-revaluation of information about market - uncorrelation of supplying volume with production and market request volume - incapacity of promotional effort - stiff price politics - lack of care for finding of new supplying and detachment sources 	<ul style="list-style-type: none"> - uncorrelation of volume and production structure with the market requirement - organization and control deficiencies - deficiencies in maintenance activity - deficiencies in depositing and internal transport activity - increasing of specific expenditure - decreasing of working productivity - inobservance of working norms - inobservance of technology - frequently disciplinary deviations

Source: Negriță A., Reorganization of companies which are in difficulty, Ed. Mitron, Timișoara, 2003 pag. 23.

What I know through the acquisition of new assets and their mood of exploitation, so that the obtained incomes to be more over acquisition costs and in this way to obtain profit represents the reason of existence of each economic agent. But *we consider* that this increasing should achieve carefully, because there is the possibility of limitation of financial resources and the increasing of fix costs.

One of factors which negatively influenced the reorganization and individualization process of Romania, fact what brought to the bankruptcy of many public domain of companies, *we consider* to be revaluation of assets. In terms of a market economy characterized through an increased inflation – so it made in our country economy many consecutive years – can be considered a positive fact, which has as effect a increasing of own capitals. But this revaluation brings to a artificial improvement of financial situation because in fact the revaluated value of the assets can't be achieved on the market. In this way the repeated revaluations of transition brought to evidencing in accountancy of some economic goods at values far away of their value on the market- it is the case of used production equipments from physical point of view but especially moral.

Another element which generated unexpected changes in economic agents' financial situations was generated by inserting of debt for investments in fix mean value and its step by step recovering during all existence duration, through liquidation. At payment time the debt sum affected the payment capacity, and its non-emphasizing in profit and losing account mean a tax on increased profit.

To provision deterioration estate of the activity and appearance of the bankruptcy the analysts should to take into account and other information apart from those offered by financial situations and reports like:

- knowledge of activity sector characteristics which the respective economic agents action and achievement obtained by respective sector to comparisons achievement;
- information regarding frequently resignations of leading staff and the fluctuation of staff;
- holding of some important functions, especially when these functions associate an important role of actions;
- inexplicable transactions between different subunits belonging to the same economic agent;
- the quality of financial analyses and made accountable examinations;
- replacing of investments with leasing activities;
- precipitated sale of actions.

The analysis of bankruptcy risk is made through more methods, each of them emphasizing different aspects:

a) static analysis of patrimonial situation- this type of analysis represented long time in the economic theory the only one evaluation modality of the risk. The main operational instruments which are at the basis of this analysis for the investigation of bankruptcy risk: bearing stock and method of liquidity rates.

b) the functional analysis of bankruptcy risk on the basis of functional balance sheet which operates with stocks and usage fluxes and resources;

c) strategic analysis- the used instruments are strategic analysis matrixes (BCG, ADL etc) which allow the approach of financial equilibrium problem, comparison risk with activity portfolio of the firm, with its competitive position;

d) analysis of bankruptcy risk through scores method.

2. Application of scores method in financial analysis of bankruptcy risk

Scores method represents one of global investigation modalities of good estate of an economic agent with the purpose to establish the possibility of bankruptcy risk manifestation. This method occupies an important position in financial analysis domain and has on the basis discrimination analysis. "Scoring" technique has origin in USA, where, in 1950s' it searched placing into relationship of causes and manifestation modalities of some maladies, in medical researches. It is a static technique which helps at establishing of some characteristics on the basis of observations made about an object, phenomenon, process etc. Scores method was taken over by the other disciplines and one of them was economic-financial analysis, thus Americans used this method of risk evaluation which is exposed a company belonging of a certain activity domain. Scored method is a method of external diagnosis, which proposes to measure the risk which the investor exposes, the creditor and economic agent themselves in the future activity. In the context of financial analysis, the observations made on the basis of some achieved indicators, both in vulnerable companies and wealthy ones from financial point of view. The signification of indicators and combination mood of these depend on interest specific of each information user or each analyst.

This combination goes to construction of a linear function named "score function" which is a prevision instrument, both at leading disposition and external users.

$$z = a_1r_1 + a_2r_2 + \dots + a_n r_n$$

Where: r_i = financial indicators established by users

and a_i = balancing coefficients

To construction of an analysis model on the basis of scores method cross more stages:

1. choose financial indicators which reflect the best financial wealthy of an economic agent
2. compare the indicators evolution chosen on two categories by economic agents from the same activity domain, ones being in difficulty, and others wealthy from financial point of view
3. proceed at elaboration of Z predictive function through the combination of those financial indicators which had a powerful and permanent action;
4. establishing of intervals of Z function on the basis of observation made regarding manifestation or not, of bankruptcy risk.

Usage of efficiency, equilibrium, solvency and administration indicators in provision of bankruptcy risk are based on the fact that o systematic deterioration of these reflects difficulties in leading and administration of the respective activity.

The complexity of economic average which the economic agents develop the activity went to the constitution of other provisioning models of bankruptcy which don't have at their basis financial indicators.

In 1976 J. Argenti studied more manifestation modalities of bankruptcy risk and established that size of financial indicators is different from case to another. A part of companies which bankrupted, registered a continue decreasing of performances (of value of selected financial indicators), other firms suddenly bankrupted in conditions of some increased financial indicators, and other type of firms demonstrated the fact that are relevant the years which the activity developed normally for a period, without variations in value of financial indicators, pursuing then a rapid decline o indicators and bankruptcy.

The practice in this domain showed that accorded less importance to non-financial aspects, which represent one of major limits of national evaluation of bankruptcy. The concentration almost in exclusivity on information offered by financial indicators reduced a lot provision power of these models.

Keasey and Watson – made a study based on pattern of 146 small enterprises, from which 73 were bankrupted and 73 non-bankrupted, through which they showed including of non-financial variables increases predictive power of model against situation of exclusive usage of financial indicators.

Starting 1990s' a series of specialists- they centered the researches on analysis of non-financial factors and they had the purpose the creation of a model based on the analysis of 15 non- financial variables, observed on a equal number of viable and bankrupted firms.

From 15 variables, two are considered “key variables”, respective capital and experience of management. Each of variables taken into account offer to the user certain information about respective business in this way:

- starting of a business with an insufficient *capital* presents a big bankruptcy risk against business which were based on a size corresponding to the capital;
 - leading of some business by *managers without experience* have big chances of bankruptcy against these lead by experienced men;
 - economic agents who *didn't evidence correctly accountancy* the economic-financial operations and didn't organize an adequately internal control are exposed to bankruptcy risk;
 - *provision of business* activity represents a chance in business success;
 - engaging in business with *too old or too new products/services*, can represent a risk in the respective business;
 - economic agents *property of a single person* are more exposed at bankruptcy risk than those who have more shareholders;
 - lack of qualities in *marketing* domain of owners and managers can go to bankruptcy of respective business;
 - staff' s education and quality, staff and owners' age, business partners, belonging at some groups (religion, ethnical, sexual).
- each of these factors were distributed different importance coefficients.

Depending on different calculation methods of Z function, as well as value which can take this, economic agents join in the zone without bankruptcy threatening , zone with small bankruptcy risk, zone with uncertainty and bankruptcy zone in maximum a year.

After made researches achieved on a list with 10 major threatening in economic agents' survival, which contents: wrong placing, immobilization of one important capital part in fix assets, existence of some reduced reserves, appearance of some problems in debts payment, errors in stocks administration, un-controlled expansion of business, inadequately capitalization, lack of experience, staff' problems, bureaucracy.

3. Limits of application model based on score function in terms of Romanian economy

The importance of bankruptcy prediction and understanding of economic failure causes is finally an important problems. The direct costs of incapacity of payment or bankruptcy (legal taxes, accountants, auditors and lawyers' honorarium) are decreased in comparison with losses which shareholders/creditors can register as result of

decreasing of firm value. Also, the indirect costs like losses for managers, business partners, financial institutions, state, etc, are significant.

All these were felt on Romanian market in the least years. Any progress in causes identification and bankrupt prediction can diminish the costs above mentioned. Taking into account the present economic context it is a truly provocation to try the construction of a score function for provision Romanian companies bankruptcy, this firstly because of the fact that bankruptcy process has other different coordinates in Romanian comparatively with majority countries.

It considers that, the main limit of application by Romanian firms of diagnosis models based on score function developed in other countries is linked by national character of these "each country necessitate an own model". This thing owns the fact that models recognized on world plan were built in terms of a stabile economy at the same time, as a peculiar case, Romanian economy confronts with a transition extended period, characterized through an accentuated economic and political instability.

In specialized literature accorded a special attention to cash-show causes of incapacity of payment generator which economic agents confront. In financial practice is useful that cash-flow method to be applied both for the current situation analysis, and store strategy.

In Romania cash-flow analysis presents a peculiarities series which have the origin in transition specific to market economy. The peculiarities refer both specific economic phenomena which confront Romanian economy, and cash-flow determination methodology, respective at Romanian accountant system.

4. Incapacity of payment analysis and small and medium enterprises bankruptcy

Small and medium enterprises present a special interest, because they play an important role in new products and services offer, as well as occupation of working force.

These enterprises are characterized through the following aspects:

- micro enterprises and small enterprises have a products and services portfolio little diversified and depend on little customers. From this reason they are more vulnerable at economic cycles;

- financial structure of small and medium enterprises is influenced by the fact that they have a restricted access at loaned capital on long term, fact that makes many times in their passives to encounter beside shareholders' capitals only short time credits and obligations against deliverers;

- management of small and medium enterprises is different, in that way that in the best cases the management is assured by the unique associate and by his family, fact what determines personal or professional problems of this to be a cause of firm collapse;

- small and medium enterprises offer insufficient accountable-financial information, sometimes reduced enough can achieve the calculation of some financial parts payment and to determine the diagnosis of these firms. This fact owes to the mood in which they administrate the activity and mood which they show in accountancy.

- in most cases the offered information by accountancy of small firms are delivered behind time.

These enterprises have a very increased bankrupt rate, a study achieved by Coface Romania regarding bankruptcies situation in Romanian and a comparative analysis with

2004, emphasizes the fact that number of firms in bankruptcy in 2005 increased with 61% against 2004 (1969 firm in bankruptcy in 2004 and 3171 firms in 2005).

In the same time, companies number in judicial reorganization reduced at 1011 companies in 2005 at only 156 companies in 2005, meaning (minus)- 85%.

Regarding the sector evolution, as in 2004, remarques the fact that activity sector with the highest risk degree is the wholesale trade, being the most exposed economic activity sector, registering 811 companies in bankruptcy, meaning almost a quarter of incapacities of payment total in Romania (23%) in 2005.

If we add the wholesale trade and retail trade, we remark the fact that 45% of bankruptcies adherent to 2005 come from trade domain. This tendency confirm the evolution in 2004, the trade consolidate and being today more and more characterized by incomes concentration to type traders of hypermarket, supermarket, cash& carry and trade mall type complexes.

At small distance of wholesale trade, on the second place is the agriculture with a number of 587 firms in bankruptcy, meaning 16,4% of total. However, the agriculture succeeds in 2005 to reduce share in the firms total with (minus) +3,3% from 19,7% in 2004. Unfortunately Romanian agriculture stays far away to be a competitive one. The excessive deification of property, fix assets and own limited capitals which economic agents dispose of this domain, are the factors which brought to a big number of bankruptcy, especially of familial associates.

The sectors which registered the least bankruptcies, so with a decreased risk degree, belong especially to services. Among these we remark IT system, salubrity, post office and telecommunications and energetic sector with a share of 1%. It is naturally that in energetic and telecommunication sector to register a tiny number of bankruptcies and this because in energy delivering domain the market is practically closed, and in communications sector is extremely consolidated, a new competitor can enter on the market only with very big prices.

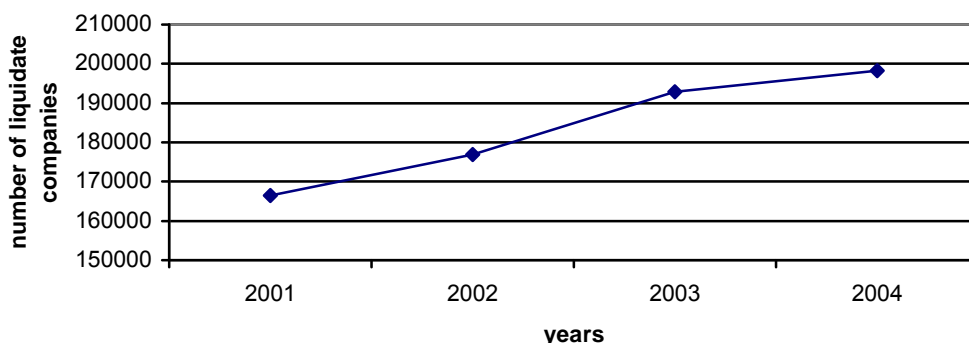
The evolution of bankruptcies in IT system reflects the development in dynamics of this sector in Romania, one of increasing motors in the last two years and which benefits by an ascending requirement, both in internal plan, and international markets.

As we observe from this study, the total number of incapacity of payment firms, which are in different stages of bankruptcy procedures or judicial reorganization is at country level of 6770. From geographic point of view, the biggest share detains Bucharest with 892 firms, of which 495 firms are in bankruptcy, and 43 firms are in judicial reorganization at national level only a reduced firms number, 156)meaning 2,3% of total(succeeded to sustain a judicial reorganization plan. The counties which pass 55 threshold of incapacity of payment companies total are: Bucharest 13%, Braşov 8%, Galaţi 6%, Olt 6% and Dolj 5%. The counties with the least bankruptcies are: Suceava, Călăraşi and Vaslui, registering only a case in bankruptcy procedure.

It is estimated that bankruptcies number in Romania will increase in the next years, mainly because of discipline strengthening regarding bankruptcy legislation, fact what happened in 2006, when bankruptcy law was abrogated and replaced with the incapacity of payment law, thus creating, those instruments which at state level, give the possibility of taking more rapid of those measurements which impose the procedure of starting of incapacity of payment and implicitly of bankruptcy, considered like a obligatory practice for those which are in similar situation.

We consider that in a competitive market, to which Romania goes to, the bankruptcy remains a barometer of economic system wealth, of its regeneration and elimination capacity of lack of balance and un-functionability.

Regarding evolution of companies liquidation in European Union between 2001-2004 records an increasing from year to year after results from the graphic and chart which is represent in succession.



Graph 1: Evolution of companies' liquidations in European Union in period 2001-2004

Source: Hermes

Table 3

Evolution of companies' liquidations in European Union in period 2001-2004

County	2001	2002	2003	2004
France	42036	42897	46000	46100
Italy	10767	10000	10000	10000
Great Britain	44747	46892	52300	54600
Germany	32278	37579	41300	43000
Other 11 contries	36681	39489	43200	44600
TOTAL	166509	176866	192800	198300
Increasing %	+3,80	+6,22	+9,00	+2,85

Source: Hermes

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