

## PROCESS-BASED ELIMINATION OF THE COMPANY CRISIS RISK ORIGINATION

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### ABSTRACT

*The definition of a business crisis in Slovakia has become formalized for its legislative definition in the context of the Commercial Code since the year 2016. This situation was by then perceived theoretically and solved solely by law governing bankruptcy and restructuring. However, practice has created the need to include this phase of company life into the formal legislative amendment. When entering into bankruptcy or restructuring, it turned out that the company/debtor fails to manage business risk, which is fully passed on to creditors. In most cases where it comes to the declaration of bankruptcy on the basis of the creditor's legal proposal, even the bankruptcy trustee finds that the company did not have any effort to cover this business risk, but on the contrary, its representatives took steps for the benefit of themselves, or related persons, which came to the multiplication of damage to the detriment of existing, possibly future creditors. Serious risk of loss of assets of the company, which may serve to satisfy creditors' claims, should be the driving force for corporate responsibility and responsibilities of the persons representing the company. The aim of this theme is the prevention of damage to the creditors and strengthening accountability for business.*

### KEY WORDS

*risk, business crisis, creditors' claims, bankruptcy, value of the company*

### INTRODUCTION

Company is considered to be a living organism, as its driving principle is human capital. Like other living organisms, as well as business goes through phases of their living - since its establishing (legislative requirement is the creation of Incorporation), through growth, culmination, degression, after a decline to extinction expressed deletion from the Commercial Register. Total over the life of company, its continuance or repetition of individual life phases depends on human potential, which should effectively manage and utilize tangible business page. This creates company value. The value of the company depends on its ability to use all the components and making a profit. Profit as such, today's practice is not considered a primary goal of the company. Thereby is maximizing the value of the company. The positive economic result is considered to be one of the motive and supporting corporate objectives pursued together with other objectives at lower levels. Also if a company makes a loss, it is still a continuing business, but with disappointing economic results, which reduces the amount of equity and the economic risk in relation to the threat of crisis is growing.

The main objective of the research is to state the procedures (methods) for establishing the boundaries of the threat of bankruptcy and to reduce business risk. Research is done in monitoring the behavior of enterprises in Slovakia, during the bankruptcy and restructuring proceedings. The research is intended to reflect legislative changes which reflect the drawbacks proceeding with additional objective of the research which is to implement these changes with a possible reference to its incompleteness or its insufficiency.

### 1 THE ANALYSIS OF LEGAL BASE: BANKRUPTCY OF THE COMPANY

The Commercial Code provides for the performance of business a number of conditions, among which also includes the implementation of its own responsibility for the entrepreneur. He fully bears the economic risk and for infringement of obligations incurred in connection with the performance of his activity corresponds to its entire business assets.

In case the company will not sustain this risk it enters the phase of degressivity, which can be dissolved without liquidation ending the transition to another legal entity or bankruptcy. Liquidation is excluded in this case because it is a process possible where the assets exceeds the liabilities of the company and can be expected realistic prospect of liquidation surplus for its distribution to the partners (shareholders) of the company.

Obligations of undertakings is to reduce business risk by preventing bankruptcy in order not to endanger the crisis and therefore must act with due diligence, that would act as another reasonably careful person in a similar position to overcome the crisis which consists in insolvencies or in liabilities in excess.

BALANCE SHEET (a)		BALANCE SHEET (b)	
long-term assets	equity capital	long-term assets	} *
current assets	liabilities (long/ short-term)	current assets	
$\Sigma$ ASSETS	$\Sigma$ CAPITAL	$\Sigma$ ASSETS	
			* (-) equity capital
			$\Sigma$ CAPITAL

**Fig. Nr. 1:** Healthy company balance sheet (a) a balance sheet of liabilities in excess (b)

Recognition of assets and sources of its coverage is always in accordance with balance rule, where assets are equal to the capital, which is divided into equity capital and liabilities. If the equity capital is negative, then the liabilities exceed the assets.

In the event of insolvency of monitoring we have available liquidity ratios, i.e. the ratio between liquid assets and liabilities, with the ratio at the time of bankruptcy of less than one to negative. The theory defines three levels of liquidity, the immediate use only funds available for the liquidity where readers already contains the full definition of current assets after deducting its low liquid components (medium- and long-term receivables, unsalable supplies, etc.). To determine the insolvency, this indicator is strictly defined so as not to be differences in interpretation in substantiation proceedings.

The conditions for determining the coverage of liabilities financial assets, i.e. if 30 days overdue are not financial liabilities are covered by these assets, which include cash, accounts receivable account (deposits redeemable at notice of less than three months), financial receivables and debt securities, which the payment period expires 30 days (there are also those which are overdue no more than 30 days), claims on money and debt securities that are repayable on demand (at sight) assuming repayment if they were on their repayment requested the next day.

The debtor is required to prevent bankruptcy. It follows that if the company risks bankruptcy, must also take appropriate and proportionate measures in order to continue his business, but not at the expense of its creditors. Price of liabilities generally is less than the cost of equity capital. Therefore,

companies seeking to participate in the financing of its activities by the external capital, which is not unlike equity capital fixed maturity along with its price in the form of interests. In case the borrower, which uses that foreign capital is not repaid on time, there is a creditor to claim additional accessories in the form of interest payments, interest and late fees, the potential costs of enforcement of the claim.

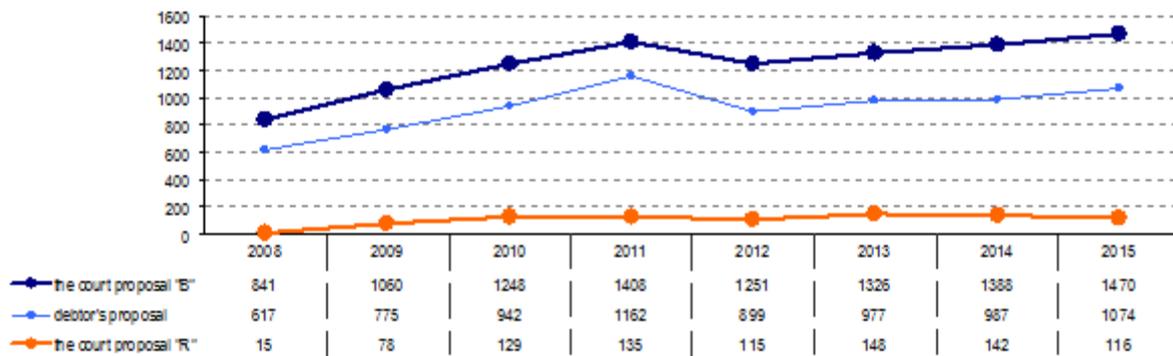
The function of a bankruptcy proceeding is to isolate the debtor by court-supervision without further damage for creditors such as employees, social and health insurance authorities, tax authorities, and not excluding business partners and others. In bankruptcy it occurs overlapping claims of creditors who signed them in one counterpart in a competent court and in one counterpart with the bankruptcy trustee who was appointed to this position on the basis of its listing administrators led by the Ministry of Justice of the Slovak Republic. Bankruptcy proceedings are regarded as mixed action that contains elements contentious, non-contentious and enforcement proceedings. It is a specific type of civil procedure (Ďurica, 2010).

Over the period from 2008 to 2015 inclusive, the Slovak courts have been given a total 9,992 applications for a declaration of bankruptcy, of which 7,433 proposals were made by the debtor himself (including liquidators), i.e. the degree of responsibility stood at 74.4%.

The highest degree of borrowers responsibility were in 2011 at a ratio of 82.5% and the lowest in 2014 at a ratio of 71.1%. The growth rate of proposals submitted is not copied the growth rate of proposals submitted debtor himself. This responsibility had worsen discipline in 2009, 2012 and 2014. At other

times the growth rate of debtors' proposals exceeded the growth rate of total proposals. These statistics need to be added as well as the proposals made on the authorization of restructuring on the years 2008-2015, when a total of 878 submitted proposals were realized, i.e. about 1.038% less than the application for a declaration of bankruptcy. Consequently borrowers opinion that the actual restructuring solution considered as unacceptable, respectively. They are of the opinion that this phase of life of the company may deter part of their customers and therefore choose more risky process in relation to

creditors and to maintain with all its strength in the market. This step may lead either to recovery or to the filing of the bankruptcy petition and even by the debtor, creditors or vice versa. And here arises the process of proving the degree of responsibility and guilt of the person liable for the debtor's filing of the proposal in a timely manner with regard to the proceedings with due diligence. If found guilty it occurs setting the record of responsible natural person in Disqualification Register and fined 12.500 euros.



**Fig. Nr. 2:** Statistics of court proposals in bankruptcy „B“ and restructuring „R“ in Slovakia since the year 2008 (Ref.: Ministry of Justice of SR, data provided by the District Courts of the Slovak Republic)

In relation to responsible business it means that the company (borrower) should precede its bankruptcy by all possible legal methods available such that business losses were borne by creditors. To satisfy them should be available all business assets up to the amount of creditors' claims. To avoid the reduction of these assets for the benefit of business owners, the legislation defined in the crisis ban restitution substitutes its own resources so as to fulfill the real purpose of bankruptcy and to satisfy claims of creditors to the greatest extent possible.

## 2 THE RESEARCH OUTPUTS FOR PROCESS OF ACCOUNTABILITY FOR RISK REDUCTION

Total research is aimed at establishing a methodology to help businesses to regard its position in relation to bankruptcy if they know that they have this condition threatens. In this case are indicators of financial analysis methods of classical or bankruptcies models predictive analysis useless. In this case, there is the need to address the situation in accordance with applicable legislation in the country, applying procedures focusing on indication of the threat of bankruptcy. As part of the research there were determined in order of importance the following procedures as follows: (1) The calculation of the equity ratio (2) The procedure

for determining the value of the company, (3) The risk measurement for the statistical variation and NPV and (4) Using the EVA.

### (1) The calculation of the equity ratio

Obligations of each entity within the meaning of the Act to monitor the rate of equity and liabilities, so that there is no violation of the law in time did not refer a proposal to resolve the crisis. For the year 2016 is marginal ratio of 100: 4, which by the year 2018 to stabilize at a ratio of 100: 8. The obligation of an entity is monitoring this ratio throughout the accounting period, despite official recognition of the state of management takes place once a year preparing the financial statements of the last day of the period of a calendar year (except for the economical year).

The financial statements are not consistent with respect to the accounting law that divides entities to big, small and micro sized entities. Into account in the survey was taken classical accounts of entrepreneurs in the double-entry bookkeeping, which is detailed in scope compared to the financial statements of micro entity.

Based on the principle of balance sheet assets (line 01) must be equal to the source of its financing (row 79), while equity capital is reported on line 80, and liabilities on the line 101, the first monitoring principle ratio is as follows:

line 101 acquires the ratio of 100 : line 80 acquires the minimum ratio of 8 resulting  $\Rightarrow$  line 80  $\geq$  7.41% of the value of line 01

In determining the boundaries of bankruptcy, it is necessary to avoid the accounting procedures and before the above calculations, it is necessary to apply a specific approach may not be accounted for in accordance with the state of the resource property coverage as follows:

1. is examined as a recognized contribution made by a member of the statutory body, employee reporting directly to the statutory body, company secretary, director of the branch company, a member of the Supervisory Board
2. examines how the recorded performance from the person who has a direct or indirect shareholding representing at least 5% of the company's share capital or voting rights in a company or has the ability to exercise influence over the management of the company, which is comparable with the influence corresponding to this share,
3. examines the performance as recognized by silent partner
4. exploration is recognized as the fulfillment of a loved person referred to in points 1st-3rd
5. it reviews the performance as recorded by a person acting on behalf of the persons in points 1st-3<sup>rd</sup> (Commercial Code, 2016)

These transactions referred to paragraphs 1 to 5 in accordance with the accounting practices and are recognized in equity as part of the liabilities of the accounts 249 Other short-term borrowings, 333 Other liabilities to employees, 361 Amounts owed to affiliated entity and entities within proportionate participation, 365 Other liabilities to partners and members, 471 long-term liabilities to affiliated entity and entities within participating interests, 479 Other long-term liabilities (possibly different depending on the selected accounting treatment) must be numerically subtracted from the line 101 and added to the line 80 although they are under the accounts placed on lines 108, 110, 130, 131, 140, i.e. the summary line 101. In case of the absence of transfer within accounting works, it is necessary to justify this calculation in the notes to the financial statements. It follows that the entity has no obligation to charge to the needs expressed by the ratio of 100: 8. This subsequently examining the bankruptcy trustee and in case of detection of an altered discharge the responsibilities consequences to the person of the debtor. This procedure is called compensation of own resources.

*(2) The procedure for determining the value of the company*

For an application, the first source is accounting as an information system that provides basic information. These may not be even those on which they received the final value of inputs because of the needs of their objectification for the method of valuation of assets and liabilities, input historic prices, overdue receivables, moral depreciation, failure to comply with accounting practices, compensation of own resources, the way the use of intangible assets and so on. Expert activities task is to provide the individual subjects in the form of his investigation findings that help in decision making.

Authoritative basis for the initial decision is stating interested in the company expiry or the continuation of its activities by business owners. Conditions to continue is that the company may not be in the state of liabilities in excess. If the conditions are met, the company may elect its debt relief of legal protection in the form of restructuring.

To determine the general value the expert methods are used, the use of which provides expert in the field of Business Economics in accordance with the form of purpose to assess either by equity method, business methods, combined method, liquidation method or comparative method, whereby it is enacted.

The goal of this research is the accuracy and objectivity of the inputs to the overall process of determining the value of a company. In order to determine the possible proceeds in the event of bankruptcy is the recommended equity method, which determines asset valuation on the date of valuation, and disregards the economic benefits arising from business activities, i.e. be determined by the value of an asset deal ( $V_A$ ), which will be deducted from the value of liabilities ( $V_L$ ). In determining the value of foreign resources must be excluded from the value of performance in place of their own funds, which do not enter into the evaluation as well as total equity. If necessary, entry of a company into bankruptcy, the company general value determined by the values of all items of assets multiplied by the ratio of converting into money ( $r$ ) be added general value of financial accounts, which are call money, valuables and cash in bank accounts ( $V_F$  funds). This approach to setting value will also be used separately for assets that are used to settle secured claims.

The convert into money coefficient is an important factor determining the potential framework of proceeds from the realization of assets of the company. It ranges of between 0 and 1. The coefficient for the licensed property is worth 0. It is determined by the expertise and experience of an expert, and its height must be justified and reviewable. The starting point is the expertise of market conditions for the type of property and assess

the current situation starting marketability of the property at the time of valuation. Account should be taken of the fact that monetization must take place as soon as possible for maximum yield, which is itself excluded. In case it is no realistic prospect of a high risk of loss of profit on the sale of this coefficient is reduced, such as overdue.

The formula that has been modified based on research of the following form:

$$V = ((r \times V_A) + V_F) - (V_L + V_E) \quad [€]$$

V	- value of the company
r	- convert into cash ratio
V <sub>A</sub>	- value of individual asset
V <sub>F</sub>	- value of funds
V <sub>L</sub>	- value of liabilities
V <sub>E</sub>	- value of future expenditures

The modification is based on the liquidation approach used in the case of liquidation of the company. What is the difference is that this modification takes into account the costs of financial distress, so called future expenses (V<sub>E</sub>), which can have an obvious nature concerning the solution in bankruptcy, such as the payment of court fee, reimbursement of lawyers' fees, payment of interests and etc. Costs of financial distress have a dual nature, in addition to the obvious sites, also have the character of the loss of opportunity which is reflected in the opposite coefficient (r).

The indicator of the company value should be observed as a trend indicator in terms of its development. In the event that will be in the timing of the decline, it is a degression and direction of bankruptcy. In the event that gives a negative value, the company is already in bankruptcy.

### (3) Risk measurement for the statistical variation and NPV

Business risk reflects the fact, provided there is a difference in the actual development of management than planned. It focuses in the future, when the company must make a qualified appraisal of future scenarios in which a negative scenario is the possibility of bankruptcy. This method of determining the risk consider only two scenarios - the expected planned and the threat of crisis. The company plans future expected cash flows are calculated using the indirect method and determines the probability distribution of these flows, with the probability of the occurrence must be considered on the basis of the current market position in relation to its segment surroundings and at the same time with respect to the general risks resulting from the macro environment of the company.

Indirect method of calculating cash flow is based on future incremental variables involved in generating profit, i.e. costs and revenues, and subsequently take into account changes in individual items of assets and capital, and again need to modify part of the commitments in case the nature of compensation of own resources. Costs must contain obvious future costs of financial distress, i.e. those that would be incurred in the event of bankruptcy.

Future expected cash flows of the individual variant entering the net present value (NPV) calculation is necessary to discount the same discount rate WACC either or opportunity cost of capital. Then, based on the product of the volume of the resulting individual net present values (NPV) and probability (p) they occur, determine the average net present value (ANPV), whereby the determined statistical standard deviation (δ) as the absolute level of risk. Deviation is monitored over time and the more variation in sequence the higher the risk and increases the threat of bankruptcy is more realistic. (Valach, 2001)

Chain calculation is as follows, where:

$$\begin{aligned} \text{ANPV} &= \sum (\text{NPV} \cdot p) \quad \rightarrow \delta^2 = \sum (\text{NPV} - \text{ANPV})^2 \cdot p \\ &\quad \rightarrow \delta = \sqrt{\delta^2} \quad [€] \end{aligned}$$

ANPV	- result average cash flow
NPV	- individual expected net present value according to individual scenarios
p	- origination probability of expected individual NPV according to individual scenarios
δ <sup>2</sup>	- dispersion of expected individual NPV
δ	- statistical NPV variance

In the case if we take into account the chronology of the period when the reference year is the year of "1" and the comparable period is the previous year "0", then this result indicated

$$\begin{aligned} \text{NPV}_0 &\geq \text{NPV}_1 \wedge \delta_0 < \delta_1 \vee \\ \text{NPV}_0 &> \text{NPV}_1 \wedge \delta_0 \leq \delta_1 \end{aligned}$$

that under these conditions the company in danger of bankruptcy threat of being at "1".

### (4) Using the EVA.

In principle, the economic value added indicators of economic profits and benefits to business owners in the form of excess ROE above the opportunity cost of capital market opportunities. Modification of the method is possible in the time observing highlight the threat of bankruptcy risk through its development so that the company will monitor the difference between the ROA and WACC. In this case, it should be noted that the aim in pursuit of EVA is not raising profits, because with him the same feelings indicator ROA, and thus in fact EVA change. The aim is to ensure that the employed capital does not exceed the overall earning power. Treatment method is that the WACC must include the costs of financial distress,

i.e. the threat of bankruptcy. In case that indicator has decline trend, the company is threatened by the crisis.

## CONCLUSION

The paper points to monitor the threat of bankruptcy in order to reduce business risk in relation to the company itself as well as in relation to creditors. This is the principle of corporate responsibility. The aim of the research is to provide subject to a procedure, which would have facilitated business inquiries in cases indication of the threat of bankruptcy.

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