

CONTROLLING CLAIMS AND LIABILITIES AND ITS USE FOR IDENTIFICATION OF BANKRUPTCY

CONTROLLING POHLEDÁVEK A ZÁVAZKŮ A JEHO VYUŽITÍ PŘI IDENTIFIKACI ÚPADKU PODNIKU

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Abstract

The article deals with controlling claims and liabilities, explains the concepts and principles used in practice. It also puts forward how the company's claims can be monitored according to time perspective as well as selected indicators of financial analysis. Following the example of a selected company in bankruptcy it shows how to apply methods for monitoring claims while tracking the structure of corporate liabilities. By analysing the balance sheet and notes to the financial statements the company's bankruptcy is identified.

Abstrakt

Článek se zabývá controllingem pohledávek a závazků, objasňuje jeho pojmy a principy využívané v praxi. Vysvětluje také, jak lze v podniku pohledávky monitorovat dle časového hlediska a také dle vybraných ukazatelů finanční analýzy. Následně na příkladu vybrané firmy v úpadku ukazuje, jak lze aplikovat metody monitoringu pohledávek při sledování struktury podnikových závazků. Analýzou rozvahy a přílohy účetní závěrky je identifikován úpadek firmy.

Key words: controlling, claims, liabilities, bankruptcy.

1 INTRODUCTION

The concept “controlling” came into European awareness from the USA. Many authors have tried to define this concept in professional literature as accurately as possible. The resulting definitions differ due to the authors' focus and different time-historical context as well. The obvious is the word base, i.e. “control”, or “to control”, in the meaning of check, handle, manage, have under control. Also F. Freiberg uses this at least double meaning in his publication “Financial Controlling” and therefore the concept of controlling can be agreed in the dual meaning as follows:

- manage, control, have under control
- check, examine.

If controlling is understood as the final stage of management only, i.e. as check, it is just a more fashionable name for a regular (standard) check of corporate activities. This is a quite frequent case, which does not represent any substantial change in the corporate management system. Innovative and useful is then the controlling especially in the meaning of a managerial function, where it represents *a specific concept of corporate governance based on comprehensive information and organizational interconnection of planning and control processes*.

In this way conceived innovative type of controlling as a management tool anticipates:

- system generation of controlling information systems,
- application of controlling tools, methods and techniques
- system communications between corporate organization divisions,
- changes in people's mind and attitude [1].

Ones of the areas, the controlling deals with, apply also to claims and liabilities. These areas are essential for the liquidity and overall health of a company. Omitting this area can result in business problems, leading usually to bankruptcy.

This article aims at outlining the use of controlling tools for the detection of insolvency and possible bankruptcy prevention.

2 CONTROLLING CLAIMS

From an economic point of view, sales of products and services represent practically the most important stage of the overall production process for each enterprise. Just here the transformation of inputs to outputs and consequently revenues takes place.

The effectiveness of this final stage depends, of course, on many factors, namely external and internal ones. Those can be e.g. development, research, production process, technology, competition, demand, advertising, etc.

The very company's business activities, or if you like stages, when a company makes all the steps to sell their output, mainly such that retains or improves the company's position even in future, are no less important part of the entire process. This phase of the realisation of business activities includes behaviours towards company's customers - buyers. Only few of companies can afford to dictate terms of payment (e.g., immediate payment or payment in advance). Most real businesses, even small and middle ones, must "respect" their customers and in contrary to treat them liberally. The manifestations of an active approach towards the customer (except for purely marketing tools) involve undoubtedly sales on credit, or granting a credit to a buyer.

When selling on credit, the accounting and monetary points of view of sales realization differ. This difference results in a claim occurrence. Such claims are therefore somehow funded before their extinction; during this time there is a real risk that their due date will not be observed, or that they will not be paid at all. This puts companies in the market environment into a problem, which is given by the necessity to grant a credit to the customers, while respecting the costs of such a credit; if we do not consider yet the risk of non-payment. If the company leaves the claim without substantial monitoring and management allowing its free development, at least costs could increase due to such crediting, which almost always happens, and the liquidity and thus the very existence of the company in future may be at risk. Such similar situation arises also in the case where the company respects only positive effects of claims. The positive and negative effects of claims may be as follows:

- a) positive impacts:
 - higher sales and thus higher profits,
 - acquiring new customers or markets,
 - maintaining the company's customers.
- b) positive impacts:
 - increase in costs due to growth in claims,
 - risk of default or failure to pay.

Just the evaluation of positive and negative impacts aiming at managing claims at an optimum level should be the contents of financial controlling. When controlling claims, or if you like, when managing claims, the subject of controlling tasks is primarily the assessment of the impact of credit (sales) policies on the following areas:

- sales,
- claims,
- cost of capital,
- risks of bad-debt-losses.

When controlling claims, each enterprise should decide how to proceed towards their customers, i.e. whether they provide them a trade credit (sales invoice), if so, for how long and with what level of discounts in the case of immediate payment. In making this assessment, the company should focus in particular on the following areas:

- Revenues (sales): the company has to consider the possibility that if they create more liberal conditions for customers, their sales will likely increase and vice versa.
- Cost of sales: one can assume that an increase in sales volume will induce also an increase in the cost of sales.

- Losses from unpaid debts: with the occurrence of claims the company must take into account the occurrence of losses from the non-payment of debts and to predict their amount.
- Discounts: in determining the discount for prompt payment the company should estimate the reaction of customers and accordingly determine the amount of discounts.
- Amount of claims: when providing a trade credit claims arise; the company should estimate the average turnover period and average amount of claims.
- Cost of tying up capital in claims: the average amount of claims must, of course, be covered by financial resources. In determining the cost the interest rate (in case of crediting) or the cost of lost opportunities (if it concerns own resources) should be considered.

The comparison of the results of different options of controlling claims should be in accordance with the specific goal of the company. A situation may arise, when an option results in lower profit margins, but higher turnover. In this case it is up to the company management to choose an option based on respecting the corporate objective.

2.1 Monitoring claims

This concept can be found in practice of small and medium businesses more often than the term of controlling claims, even though the very tracking of claims and their developments has, of course, the attribute of controlling tasks and the types of those tasks are almost always just the controlling tasks if introduced in the company.

Monitoring claims represents the controlling activity focused primarily on:

- records and check of claims,
- relation of claims to sales volume,
- due dates of claims.

In corporate practice, claims are monitored mainly using ratio indicators, i.e. using the claims turnover ratio and turnaround times. Those simple indicators can however be sometimes misleading with regard to their ratio composition. However, very often claims are tracked in volume and structure (age, individual debtors, etc.), or changes in development series and behaviours of individual customers are monitored.

- Claims turnover

This indicator measures the number of turnovers of claims during the period being assessed and its calculation is then as follows:

$$OP = \frac{\text{tržby (prodeje na úvěr)}}{\text{pohledávky}} \quad (1)$$

$$CT = \text{sales (sales on credit) / claims}$$

In fact, this is the ratio of the company's performance (credited) to the capital tied up in those sales (claim). If the company grants a trade credit to all customers, the sales as a whole can be considered. The tying up is then expressed in average or at the end of the period. An increasing value of the indicator then indicates positive developments in the field of claims.

- Claims turnaround time

This indicator represents the average number of days elapsed from issuance of an invoice and its payment. The indicator structure is as follows:

$$DOP = \frac{\text{pohledávky}}{\text{denní prodeje na úvěr (denní tržby)}} \quad (2)$$

$$CTT = \text{claims / sales on credit per day (daily sales)}$$

The positive development of this indicator, thus its reduction, improves logically the ratio between sales and claims, or it indicates faster transformation of claims into sales.

2.2 Age of claims

This represents another measurement of claims, or the level, which can be monitored, allowing capital tie-up in claims to be controlled and managed. This is actually the overview of the "age" structure of claims, mostly compiled in companies so that their claims are arranged according to the invoice date into the appropriate intervals representing their "age".

The notes to the financial statements of a company should give the information about claims overdue. Those claims are usually divided into classes according to the days passed since their due date. The most common breakdown is as follows:

- within 30 days,
- 30 - 60 days,
- 60 - 90 days,
- 90 - 180 days,
- 180 and more days

3 CONTROLLING SHORT-TERM FINANCIAL RESOURCES

Part of the short-term resources is acquired from company's operations more or less spontaneously, e.g. from suppliers (purchases on credit), staff (late payments of wages), customers (advance payments), etc.

The short-term resources can also take the form of short-term bank loans, discount loans, emitted short-term bonds and other short-term borrowings. The short-term resources can include factoring as well.

The main advantages of short-term resources versus long-term ones are generally lower costs and faster availability. In contrast to these advantages there is a higher risk of insolvency.

Creating an optimum mix of short-term financial resources is influenced by many factors, qualitative and quantitative ones. The main factors include as follows:

- cost of credit: it is important to distinguish between real and nominal interest rates and to include also fees, commissions, etc. into costs,
- availability of credit: may be limited by company's insolvency, inability to provide guarantees, poor economic results, etc.,
- time interval and size of resource needs: companies must know for how long and how much money needs [1].

Deciding on financial coverage of short-term capital needs is a common problem in business practice. The situation may arise when the company can choose from several competing alternatives. The primary goal is to ensure financial coverage while meeting the condition of minimizing the costs. The financial manager can suggest many options of financial coverage and recalculate the costs for each variant. The criterion of minimizing the costs should not be the only one in the decision-making. The risks arising from changing conditions should be considered as well.

4 POSSIBILITY TO USE THE MONITORING OF LIABILITIES IN IDENTIFYING BANKRUPTCY

In the same way as in claims monitoring and classification into groups by age, company's liabilities can be classified. Such classification facilitates timely identification of company's bankruptcy.

4.1 Definition of bankruptcy

Bankruptcy is defined in Act No. 182/2006 Coll. on insolvency and its resolution (Insolvency Act) in Article 3:

A debtor **goes bankrupt** if he/she has more creditors and liabilities for more than 30 days after their due dates and is unable to fulfill such obligations (insolvency) [3].

It is believed that the debtor **is unable to repay his/her liabilities**, if he/she stopped the payments for substantial part of his/her liabilities, or he/she is in default for a period exceeding 3 months after the due dates, or it is not possible to satisfy any of due liabilities to the debtor through enforcement of judicial decision or

distrain, or if he/she violated the duty to submit the lists stated in Article 104(1) imposed by the insolvency court [3].

The prerequisite of bankruptcy is the existence of more creditors, i.e. the debtor must have two or more creditors. If he/she has more claims of one creditor only, such a situation is not considered as bankruptcy. Another indication of bankruptcy is the period during which he/she does not pay his/her debts. Compared to the previous regulation a fixed term of 30 days is given. This relatively short period of time is intended to solve crisis situations as quickly as possible.

The third condition is that the debtor must be insolvent. It is important that there must be *substantial* parts thereof.

If the debtor is a legal entity or natural person - entrepreneur, he/she is bankrupt, even if he/she is heavily indebted. In determining heavy indebtedness the debtor's liabilities are considered (including the undue ones) in proportion to the value of his/her assets. If the liabilities exceed the assets, it is heavy indebtedness. In determining the value of assets further administration of the debtor's assets and further running his/her business must be taken into account as well (see Article 3(3)) [3].

Insolvency Act in **Article 98** imposes the obligation to debtors, who are a legal entity or natural person - entrepreneur, to submit insolvency proposal without undue delay just after he/she learns or with due care should learn of his/her bankrupt [3].

4.2 Assessment of insolvency, or heavy indebtedness

The data for this analysis were selected from Annexes and balance sheets of BDUM CORPORATION, a.s. for the years 2007 - 2009. With regard to insufficient information some amounts had to be "modelled up". The accounting unit gives overdue liabilities in an annexed table. According to time division it provides only current trade payables, other current liabilities are shown under the table regardless of the number of days overdue. The reason for inaccuracies and inconsistencies of information given in the financial statements may be an attempt to conceal the problems arisen in the company. Due to the nature and value of liabilities, it can be assumed that they are more than 30 days overdue (share in loss in another firm, liabilities to state institutions). The "modelling up" was set up so that the data listed in the Annex under the table were considered as liabilities overdue for 31 to 60 days, see *Tab. 1 Calculation of insolvency*.

Tab. 1 Calculation of insolvency (in thousands CZK)

Number of days overdue	As at 31 December 2007		As at 31 December 2008		As at 31 December 2009	
	trade	others	trade	others	trade	others
within 30 days	422	not specified	197		37	
31 - 60 days	318	not specified	0	21,685	0	27,390
61 - 90 days	100	not specified	66		29	
91 - 180 days	5,474	not specified	6,255		0	
180 and more	0	not specified	0		6,187	
Subtotal	6,314	0	6,518	21,685	6,253	27,390
Total		6,314		28,203		33,643
more than 30 days overdue		5,892		28,006		33,606
more than 90 days overdue		5,474		6,255		6,187
current liabilities - balance sheet, line 103		27,300		30,037		36,573
ratio (liabilities over 30 days overdue) / (total liabilities)		21.58%		93.24%		91.89%

Source: inherent processing

4.3 Evaluation

According to the above calculations we can assume that the debtor was bankrupt already at the end of the year 2008. The company has more creditors, liabilities for more than 30 days overdue and is insolvent (not fulfilling their liabilities for more than 3 months after due dates and most likely is not able to pay, because other liabilities between 2008 and 2009 have increased).

5 CONCLUSION

Controlling represents an effective tool for decision-making, evaluation and control of business activities of companies.

The controlling of claims is useful especially when deciding how to approach to customers and ensuring solvency. When managing claims in an incorrect way the company could be affected by secondary insolvency (being unable to pay their liabilities due to the lack of funds caused by the failure of customers to pay their debts), which could cause bankruptcy of the company.

Controlling short-term liabilities is looking for the ways how to ensure short-term capital and how to decide having several alternatives. Thanks to the monitoring of liabilities it is also possible to detect bankruptcy of a company in time.

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