WHAT CAUSES INSOLVENCY? A STUDY REGARDING BIG AND MEDIUM ROMANIAN ENTERPRISES GOING BANKRUPT IN 2013

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Abstract: *The failure of a company, whether insolvency or bankruptcy, has been a topic featured by countless researchers from various fields over time. In an attempt to counteract this negative phenomenon most of the studies focused on developing bankruptcy prediction models, omitting the actual reasons that caused the insolvency.*

In the present article we will try to determine the main reasons causing insolvency among the largest companies in Romania in 2013. In this purpose, we made a Top 10 Romanian companies which became insolvent in 2013 taking into consideration the report published by Euler Hermes in 2014 "Economic Outlook. Insolvency World Cup 2014: Who will score fewer insolvencies?". Subsequently, we examine "The Report on the causes and circumstances that led to the insolvency of the debtor" for each individual company from the proposed top. After analyzing the reports for all ten companies studied we found that an increasing of indebtedness and debt collection period, with disinvestment and poor management were the main causes that led to the insolvency in 2013 of the Romanian companies studied.

Keywords: insolvency; determinants of bankruptcy; Romania
JEL Classification: G33

Introduction

Most studies on insolvency and bankruptcy, like Beaver (1967) or Altman (1968), are focused on predicting this phenomenon on the basis of information provided by the annual financial statements of the companies included in the study (generally the researcher build statistical models using financial ratios). Although research findings converge on the importance of financial aspects in forecasting insolvency, several studies focused on non-financial factors such as poor management, membership of a group of companies (Baum and Mezias, 1992) or the size of companies (Hall, 1992).

Since the objective is to determine the causes of insolvency based on the reports of insolvency administrators for each company, in reviewing the literature and previous research conducted we will consider only those studies relevant to the topic addressed. In this respect, we eliminated the studies based on predictions, focusing on those using data related to actual insolvencies that took place over the years. The results of the most relevant studies show that insolvencies have being caused by a mix of factors, financial and non-financial, the difference being made by size criteria, specific economic sector and economic environment, in general.

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1. Literature review

The causes of insolvency were the subject of countless researchers. Some considered important non-financial factors (Baum and Mezias, 1992, Greening and Johnson, 1996, Swaminathan, 1996), while others focused on the financial ones (Santomero and Visno 1977, Myers and Majluf, 1984). In general, studies have taken into account criteria such as company size or sector to which they belong. Size of the companies was a particular concern in studies of Hall (1992) and Back (2005), who consider it a key factor in the insolvency of firms. Charan and Useem (2012) appreciated management as the main responsible of insolvencies, the results of their study indicating managerial errors as a major cause of firms' bankruptcy.

Considering both financial and non-financial factors, Ooghe and Waeyaert (2006) proposed a conceptual model in which they identified five main categories of causes of insolvency. They are presented as follows:

1. General environment refers to different factors (economic, political, social, and technological) or issues regarding government behavior, functioning of financial markets and institutions, National Bank policy.

2. Immediate environment involves the relationship with interested stakeholders as: customers, suppliers, competitors, banks, credit institutions or stockholders.

3. Characteristics of management or the entrepreneur include motivation, skills, qualities, and other personal characteristics of the managers. Usually, personal characteristics are considered to be the most critical factor in a company's failure.

4. Corporate policy covers adopted strategies regarding different activities within the firm as investments, marketing, sales but also day to day operations, administrative issues, financial and human resources, management and corporate governance.

5. Company's characteristics include the size, maturity or the industry that companies belong to.

When analyzing bankruptcy[*] usually the studies show that there are at least two or more factors contributing to insolvency.

[*] In this paper, we use either bankruptcy or insolvency when discussing companies' failure.

2. Analysis of Romanian studies on the causes of insolvencies in 2013

In Romania, insolvency cases were discussed in terms of forecasting, the studies up to date considering the companies not yet insolvent, but close to this stage. An analysis performed on companies already in insolvency was carried by Transylvania Insolvency House (2013). The sample used consisted of large and medium sized companies that became insolvent in 2011 and 2012 whose procedures were administered by the aforementioned company. Based on 650 insolvency procedures performed in 2011-2012 and analysis reports prepared in order to identify root causes of firms' insolvency, the results of Transylvania Insolvency House report indicate as the main cause of insolvencies in Romania, over-indebtedness. Other common causes that generated the imbalances of companies refer to a decrease in consumption, continued company losses, a degree of leverage over real ability to pay, and bad decisions of the management team. Although the drop in consumption is the main cause invoked by managers, a careful analysis shows that it only ranks No. 3 in a top of the real reasons, while on the second place are situated the wrong decisions of the management team.

The Top of insolvency causes detected by Transylvania Insolvency House is the following:

Table 1 - Causes of insolvency among Romanian firms in 2013

Top ranking	Causes	Percentage
1	Over indebtedness	49%
2	Wrong decisions of the management team	43,1
3	Decrease in consumption	43%
4	Continuous losses	31%
5	Membership to a group of companies	9%

Source: Transylvania Insolvency House (2013)

In this context, it is found that there are very few situations when the insolvency of a company has a single cause. In most cases it is a 2-3 aggregate factors that overlap and combine management decisions with external circumstances. But, more serious is that management teams do not detect or don't admit insolvency situations in time. From the analysis conducted by Transylvania Insolvency House it's revealed that over 90% of companies declared insolvent in at least 18 months after the appearance of this state, which decreased the chances of company recovery.

Decreased consumption is a cause specific to trade activity, while the lack of profitability affects frequently production. Other important reasons are continued losses in the current work (31% of cases), and the chain effects of imbalances, where the insolvency of a company has a direct impact on others (5%). In 4% of cases, losses of important contracts, unfair competition or main shareholder death were the main reasons that led to the insolvency of a company.

A study of Coface (2014) addressing what causes insolvency among firms in Romania in 2013 found comparable results with those of Transylvania Insolvency House. In general, in most of the cases studied, over indebtedness was the main cause of insolvency, but not the only one. Coface believes that a accumulation of factors is more appropriate when determining insolvency, loosing contracts or having important quantities of unsold merchandise being relevant in this matter.

Comparing the cases identified in the study of Transylvania Insolvency House (2012) and of Coface (2014) with those mentioned in the study of Ooghe and Waeyaert (2006) we found that they're consistent, each falling within one of the categories proposed by Ooghe and Waeyaert. In this respect we are going to analyze the 10 main insolvencies taking place among big firms in Romanian in 2013, framing them in the categories proposed by Ooghe and Waeyaert (2006).

3. Causes of insolvency for the largest Romanian companies in 2013

Taking as starting point the research of Ooghe and Waeyaert (2006), the studies of Transylvania Insolvency House (2013) and Coface (2014), the report of Euler Hermes (2014) we selected a number of 10 Romanian companies (big and medium) which became insolvent in 2013. The selection criteria was the turnover in the last year before declaring insolvency, meaning 2012.

For each of the companies selected we stated the month of declaring insolvency in 2013, the name of the company, the last turnover in the year before insolvency and the industry they belong to. The Top 10 was elaborated based on the Romanian companies mentioned in the Euler Hermes Report (2014). The results are shown in Table 2.

Table 2 - Top 10 Romanian companies going insolvent in 2013

Ranking	Month	Company's name		Turnover in 2012 (millions of euro)	Industry
1	February	Oltchim SA		341	Manufacturing of basic chemicals
2	February	Mechel Targoviste SA		244	Manufacturing of basic iron and steel
3	March	Ductil Steel SA		233	Manufacturing of basic iron and steel

4	February	Grup Romet SA		176	Manufacturing of other fabricated metal products; metal working service activities
5	November	Regia Autonoma Pentru Activitati Nucleare		142	Chemicals
6	February	Ecoforest SA		112	Manufacturing of basic iron and steel
7	February	Aromet SA		104	Manufacturing of basic iron and steel
8	September	Alpine SA		53	Building of complete constructions or parts thereof; civil engineering
9	February	Dobrogea Grup SA		51	Manufacturing of food products and beverages
10	March	Laminorul SA		43	Manufacturing of basic iron and steel

Source: authors' projection based on Romanian companies mentioned in Euler Hermes Report in 2014

For each of the aforementioned companies were considered "Report on the causes and circumstances that led to the insolvency of the debtor" drawn up by the insolvency administrator of the company and submitted to courts. The reports were accessed either from the National Trade Register Office or the official website of insolvency administrators of the companies.

After studying reports on the causes and circumstances of the insolvency we noticed that in 70% of cases indebtedness and difficult collection of receivables, or, in other words, increased debt collection period were the main reasons for recourse to insolvency in the analyzed companies. The difference is covered by disinvestment, represented by the decrease in assets held by large companies in Romania or loss or cancellation of contracts with certain customers, usually the big ones. The results of studying the related reports of the 10 companies are consistent with those of Coface and of Transylvania Insolvency House (2013) on insolvencies recorded among large and medium-sized firms in 2013.

Over 50% of companies analyzed reported in the annual financial statements for 2012 decreases in turnover of approx. 12%, reduction in deferred income of approx. 8% and reductions in inventories held by about 7%. Simultaneously, the level of indebtedness calculated as a percentage between total debt and total assets reported at the end of the financial year 2012 increased by about 25% compared to 2011. Since the debt in 2012 and increased investment in assets abated we can say that we are in the situation of mismanagement.

Loss of orders or cancellation of existing contracts with major customers was another reason that led to the opening of insolvency proceedings (over 60% of the analyzed companies lost contracts with major customers during 2012). Since the share of current assets increased in 2012, we can say that the products made by the companies studied have remained in stock, customers preferences directing toward cheaper similar products from foreign markets. To support this factor we viewed articles in the trade press during 2013 on the situation of certain companies (for example Romet SA). We found that the management company argued the loss of major contracts with domestic customers at the expense of similar products imported from China at lower prices. Therefore, we believe that market orientation towards products more affordable in most cases analyzed contributed to the degradation of the financial stability of enterprises, and finally, to insolvency.

Framing the obtained results after studying the reports on the causes and circumstances that led to the insolvency of the debtor in all of the 10 companies in the structure proposed by Ooghe and Waeyaert (2006) we identified factors from: immediate environment (interactions with diverse stakeholders as customers, suppliers, competitors, banks, credit institutions and stockholders); characteristics of management (motivation, skills, qualities, and other personal characteristics) and corporate policy (management style, adopted strategies regarding different activities within the firm as investments, marketing, sales but also day to day operations, administrative issues, financial and human resources, management and corporate governance). From categories as general environment and company's characteristics were not identified any factor, but we believe that future research could obtain relevant results in this respect. Even our study focused on the 10 biggest Romanian companies going bankrupt in 2013, we consider that a deeper analysis that would focus on the industry or size of the company could show there is a direct linkage between these criteria and the increased number of insolvencies in some economic sectors in Romania.

Conclusions

Seven Romanian companies with a turnover bigger than 100 million Euros in 2012 became insolvent during 2013. The last three from the Top 10 insolvent companies recorded in the previous year of insolvency a turnover between 60-30 million Euros. Most of them were from the industry of manufacturing basic iron and steel (Mechel Targoviste SA, Ductil Steel SA, Grup Romet SA, Ecoforest SA, Aromet SA), while another two belonged to chemicals industry (Oltchim SA, Regia Autonoma pentru Activitati Nucleare). Analyzing the reports submitted by insolvency administrators of the companies regarding the causes and circumstances that led to the insolvency of the debtor we found out a mix of causes, ranked as follows:

Table 3 - Causes of insolvency for Top 10 Romanian firms going bankrupt in 2013

Top ranking	Causes	Percentage
1	Over indebtedness	70%
2	Loss of contracts	64%
3	Decrease of turnover	55%
4	Continuous losses	43%
5	Membership to a group of companies	40%

Source: author calculations based on the analyzed reports regarding the causes and circumstances that led to the insolvency of the debtor of the Top 10 insolvent Romanian companies.

Our result is consistent of those of Coface (2014) and Transylvania Insolvency House (2013) showing that insolvency is the result of several factors, some of them incontrollable by management's company. Determining which contributed the most to this estate can be difficult for actors involved, and, usually, highly expensive. But as Romanian law imposes, the elaboration of the "Report regarding the causes and circumstances that led to the insolvency of the debtor" by the insolvency administrator is compulsory, although in the end there were cases when instances ruled against some reports and based their verdicts on other facts as well. How relevant remains the economic substance of some juridical aspects, or, in other words, if in a court the substance over form principles is applied is still questionable.

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