

# Bankruptcy and Forms of Their Solutions in SMEs in Czech Republic

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*Abstract:* - Corporate and personal entities, businesses or not, can find themselves in a situation where they are not able to fulfill their obligations. This condition is and insolvency, bankruptcy and the solution is determined by law. This article is explaining the principles and forms of bankruptcy proceedings by liquidation, restructuring, discharge from debts and special forms. Briefly it deals with bankruptcy register and questions regarding bankruptcy proceedings after 1<sup>st</sup> January 2008.

*Key-Words:* - Bankruptcy Process, Accounting, Financial Aspects, Czech Republic, Financial Crisis, SMEs

## 1 Introduction

The factors that lead a company to insolvency are always very different and sometimes, disperse. In the current economic crisis it is possible to distinguish some regularities, which are common on the bankrupt companies. Specifically, the building crisis and also the crunch of credit by financial institutions are, without a doubt, the two main reasons that commonly explain the current situation.

The onset of 2008 financial crises can safely be attributed to the collapse of US and European housing markets. Stimulated by sub-prime mortgage, housing sector enjoyed boom across USA and Europe during 1998 to 2006 [2]. [4] asserts that the worst part of the crisis is already over and the markets are suffering from what can be called “the aftershocks”. However, [5] argues that normalization of economic activities need “global and semantic” solution; do it and you are out of it.

In the Czech Republic bankruptcy conception is brought to reality by relatively new law, No.182/2006

regarding bankruptcy, as of its emendation act „Insolvency Law“. Bankruptcy law case was brought to life after original Liquidation and Settlement law was criticized for non-reflection Czech economy reality of the 90's.

By adoption of Bankruptcy law and its solutions (insolvency law), Czech Republic fully complies with developed countries standards. It is a completely new law, reflecting dynamic expansion of legal economic development not just in Czech Republic but Europe as a whole and other countries as well. Adopted modification of Bankruptcy law is a consistent re codification, containing bankruptcy proceedings, role of creditors and debtors but changing the rules of Bankruptcy Administrators. Bankruptcy law is replacing the Liquidation and Settlement law, where in temporary provisions is reservation made as of cases initiated prior to 31<sup>st</sup> December 2007.

Bankruptcy law is offering to those who cannot longer pay their creditors a new start by liquidating their assets to pay their debts or by creating a repayment plan.

Bankruptcy laws also protect troubled businesses and provide for orderly distributions to business creditors through reorganization or liquidation.

Bankruptcy proceedings are coming in four steps: Initiating step, Identifying step, and Approval and Liquidation plan.

Main source for insolvency proceedings is Bankruptcy Administrator (BA) resolving situations where the debtor is entering the bankruptcy phase and he is preparing a Liquidation Plan as well. His duty is to follow Liquidation and settlement law No. 328/1991 valid until 31.12.2007, regarding bankruptcy initiated until this date.

Bankruptcy Administrator is basically formulating possible court solutions for cases where the debtor is not having sufficient resources to cover his debts and since probably there are more creditors, it could lead to a dispute among them. Lack of resources can lead to situation where some creditors get more and other get nothing. This situation is solved by Bankruptcy Administrator the way that he is blocking those resources and debtor, so all creditors are treated equally, according to the nature of their claims. This law is offering how to keep the debtors businesses running and not divided, since if a business is kept in this condition, its value is higher than if it is sold-out fast. The main purpose is to satisfy creditors without liquidation of debtor.

Notice No.311/2007, is specifying the proceedings necessary for bankruptcy steps and forms to follow some Bankruptcy law Codes. This Notice is regulating requirements of request for Application for bankruptcy, Inventory list and requirements of Form of claims, Proposal for discharge and Reports, Restructuring plan.

## 2 Processing the Bankruptcy

During bankruptcy proceedings the following principles are applied:

- bankruptcy proceedings must be performed the way, no parties involved are treated unjustly or favored, and must lead to the fast, economical and as good as possible creditors satisfaction.
- creditors having, according to Bankruptcy Administrator basically the same or similar position are in the same position during the bankruptcy proceedings
- creditors rights acquired prior to the bankruptcy proceedings cannot be restricted by bankruptcy court and/or Bankruptcy Administrator, unless permitted by Bankruptcy law.
- creditors must refrain from actions leading to satisfaction of their claims outside of bankruptcy proceedings.

### *Bankruptcy and pending bankruptcy*

Debtor is bankrupt when he is in financial insolvency or in excess debts. He is in financial insolvency if there are many creditors and having fiscal liabilities with more than 30 days overdue, without possibility to repay them. Condition of many creditors is establishes two or more creditors, if there is just one creditor, he must than use other means than bankruptcy proceedings to satisfy his claims.

It is considered that the debtor cannot repay his fiscal liabilities when:

- he did stopped the payments of the majority of his fiscal liabilities or
- he is not paying his fiscal liabilities for more than 3 month period after their due-payment
- it is not possible to satisfy some of his fiscal liabilities toward creditor by enforcement of court decision or distraint or
- debtor did not presented his inventory sheet including his account receivables including the list of his debtors, list of his employees and documents supporting his bankruptcy or pending bankruptcy. This duty is designated to him by Bankruptcy Court.

If the debtor is a corporate entity or personal entity-business, it is under bankruptcy when is insolvent. Insolvency means if the debtor is having more creditors and his total debt is higher than his assets. Bankruptcy law is not specifying if there are claims that „can be paid“ as it was a case of Liquidation and settlement law, but about accounts payable, debtor must evaluate all those which can or cannot be paid.

Pending bankruptcy is specified in Bankruptcy law in connection to fiscal liabilities. The main sign of this is there reasonable assumption of debtors' readiness to pay his debts. This is valid for businesses or private citizens.

Bankruptcy or pending bankruptcy is solved by court, as bankruptcy proceedings.

### *Forms of bankruptcy solutions*

Forms of bankruptcy or pending bankruptcy solutions in bankruptcy proceedings are Liquidation, restructuring, discharge from debts and special solution of bankruptcy for insurance houses and banks.

### *Auditions*

It means that the debtors and creditors claims are resolved by court. Creditor claims are proportionately satisfied by selling debtor assets. Unsatisfied claims or their parts do not expire. This way of bankruptcy is the most used one.

Shortened and simple form of bankruptcy is Small bankruptcy. This is a form, when the debtor is private person without business, or debtor total turnover in fiscal

period preceding the bankruptcy filing is not bigger than 2 mil.CZK and no more than 50 creditors.

*Restructuring*

Goal of restructuring is not debtor liquidation but some recovery of his fiscal situation by means of special measures leading to the debtor business continuation. Claims are satisfied gradually and debtors business activities are kept running. Restructuring plan is prepared, continuously overseen by creditors. Restructuring is allowed by law if a total debtor turnover during the accounting period preceding the bankruptcy filing is 100 million CZK minimum or he is employing at least 100. If the debtor simultaneously with bankruptcy filing, or 15 days maximum after court decision, can submit the restructuring plan, agreed upon with at least 50% of creditors (calculated from their claims size) and at least 50% of unsecured debtors (calculated from their claims size), the number of debtor employees is not decisive.

Restructuring is not possible with personal entity business in liquidation.

*Discharge from debts*

This form of bankruptcy solution is intended, according to Bankruptcy law for debtors, for non-business persons capable of paying their unsecured creditors in lump-sum payment or installment during 5 years maximum period pay at least 30 % of their claims. Discharge from debts is giving him a chance that after 30% minimum of debt paid is discharged of debt remainder.

After the discharge of debt filling it is reviewed if the debtor has business activities and his debts are not from such an activity. Discharge of debt filling is filled by debtor. Discharge is performed by selling debtors assets or according to payment schedule. If the debtors' assets are sold, it is then preceded as in case of liquidation, assets are than not the ones acquired after the court discharge of debt approval. During the monthly installments for 5 years debtor is paying his creditors a certain sum.

After 5 years the court is issuing court decision releasing the debtor of his obligations. This release is not valid if during 3 years after his decision court shall find that this release was based on fraudulent conduct or creditor gives some of the creditors' unjust advantage.

Form of discharge of debt is better than small bankruptcy since during discharge of debt the fiscal obligations are finally erased.

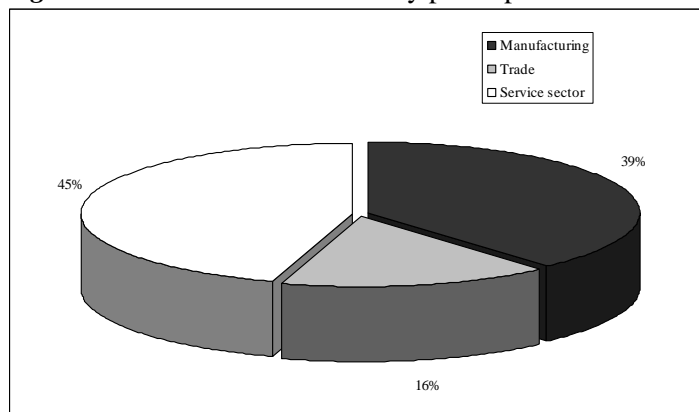
**3 Research Focused on Czech SMEs**

One of the biggest questions in bankruptcy proceedings is an insolvency certificate. This research goal is, by

using the questionnaire to assess the conditions signaling the imminent bankruptcy, especially account payable due and if there is more than one creditor.

It is summarizing the answers of 31 businesses with less than 250 employees. 12 of them are manufacturing, 5 are trading businesses and 14 are involved in service activities. Participants' structure is shown in Fig.1

**Fig 1.** Business structure of survey participants

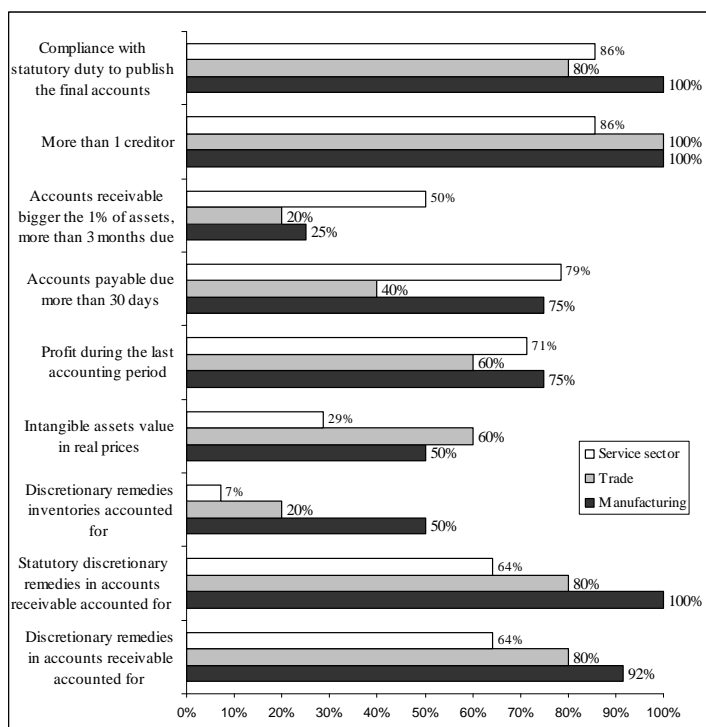


Source: authors' analysis

Questions used here were aimed to the signals connected with the bankruptcy risk factors in small and medium-sized businesses in Czech Republic.

Businesses answered 9 questions regarding discretionary remedies in accounts receivable and inventories and regarding files of accounts receivable and payable due. Summary of this research is shown in Fig.2.

**Fig. 2.** Occurrence of related events in businesses concerning their type of activity.



Source: authors' analysis

#### 4 Conclusion

Debtor can find himself in bankruptcy by financial insolvency or excess debt. Forms of solving the bankruptcy or pending bankruptcy are audits, restructuring, discharge of debts and special bankruptcy solutions for insurance houses and banks.

Bankruptcy proceedings are initiated by delivering the bankruptcy filing to the court. This bankruptcy filing can be entered by debtor or creditor. Bankruptcy court than shall publish the bankruptcy proceedings opening and appoint the Bankruptcy Administrator. Creditors can submit their claims from that moment. Each claim is than reviewed by Bankruptcy Administrator which shall publish their list. Bankruptcy court than decide about the form of bankruptcy solution.

In every business engagement there can arise the situation where one of the partners can find him in primary or secondary insolvency. Such situation shall be indicated on-time by information about possible delay or threatening bankruptcy. A best prevention against bankruptcy is a proper and exact evidence and dealing with debt. Other than conventional approach to the debtors' crisis and following disputes is there introduced by Bankruptcy law the institute of Pending bankruptcy.

Bankruptcy law is allowing the debtor to react even in time when the bankruptcy could be coming. Pending bankruptcy can be characterized as an incoming inability of debtor to pay on time and fully most of his obligations. Timely filing for bankruptcy and active cooperation with his creditors are increasing the chance of not entering the liquidation phase of bankruptcy and its solution.

[1] states that economic crisis and "downturns" provides good opportunities for medium-sized companies; they can "undertake counter-cyclical moves that strengthen their competitive position; lean enterprise campaigns; strategic acquisitions; hiring of talented employees released by downsizing companies" and etc. He further stated that current crisis offers the same opportunities. However, small firms are facing tightened credit term in contemporary financial conditions; moreover the entrepreneurs are showing noteworthy concern about access over credit.

When point comes to a financial crisis, it means a "poorly functioning financial markets" this inadequate performance of financial markets can lead to the limited entry of new firms, low production in the firms on hand and greater financial constraints from SMEs [3].

Considering the role of entrepreneurship in the crisis, due to its ability of innovation and growth of investment, entrepreneurship is able to play a vital role in the current financial scenario by creating job opportunities and economic growth.

Research results are showing that most of the businesses are observing the statutory requirement of publishing the financial statements and annual reports in Business Registry, this being observed by all manufacturing subjects.

Typical there is a situation where businesses are having more than one creditor. Such a situation is not necessarily leading to the assumption of insolvency. Deciding factor there is the existence of accounts receivables, due more than 3 months. In businesses researched here this situation existed by 20-50% of respondents.

Most of the businesses are accounting for statutory discretionary remedies in accounts receivable. Especially businesses with statutory audits must observe this field, since its documentation is required by law. Discretionary remedies in inventories are accounted for by relatively small portion of businesses in trading and services sectors, which is based on their business character. It is important that half of the participants is accounting for discretionary remedies in inventories. This is important to calculate real operational income. It is always lowering the accounting base results; reality is that good performance in this field is by businesses with mandatory audit. Overall the problems of discretionary remedies summarize in sense that if a business is not forming them at all and accounting accounts receivables due and inventories longer than one year, it can be concluded that its closing account is overvalued.

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