

DOCTRINAL AND FINANCIAL ACCOUNTING ASPECTS REGARDING INSOLVENT ECONOMIC ENTITIES

Dumbravă Partenie

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Abstract:

The restructuring of economic entities is a phenomenon specific to market economy but highly evidenced in the context of the economic-financial crisis, particularly when the effects of the crisis manifest at a global scale. Thus, the phenomenon became significant throughout the World and it did not elude the Romanian economy. In this context we bring to your attention some general aspects of the economic entities' insolvency process. Irrespectively to the positive and negative effects of the economic-financial crisis, the insolvency phenomenon is still a major concern for economy specialists and not only.

Keywords: restructuring, dissolution, liquidation, principles, accounts

Journal of Economic Literature (JEL) codes: Business Administration and Business Economics; Marketing; Accounting

1. Framework for insolvency

Nowadays there is a consensus among the majority of specialists in the economic field regarding the definition for insolvency according to which an economic entity is insolvent when it does not have enough available liquidity to pay off debts as they fall due.

From a juridical point of view, in Romania this situation is regulated through the means of Law no 31/1990 republished, Law no 85/2006 regarding the insolvency, GEO no 86/2006 regarding the organization of the activity of insolvency practitioners. Financial accounting and fiscal aspects can be found in the provisions of Law 82/1991 republished, OMPF no 1752/2005 for approval of accounting regulations in accordance with the European Economic Directives, OMEF no 2374/2007 for modifying and completing OMPF no 1752/2005 and explicitly OMPF no 1376/2004, along with the International Standards for Financial Reporting.

2. National and international statistics on insolvent economic entities

A study conducted by Coface Romania underlines the evolution of *Romanian insolvent economic entities* according to their activity sector as follows:

Activity sector	Year		
	2006	2007	June 30, 2008
Wholesale and distribution	1.935	3.431	1.770
Retail	1.909	2.371	1.501
Agriculture, silviculture and fishing	1.382	1.093	341
Construction	588	1.066	822
Food and beverages	1.133	1.064	391
Manufacture of wood and products of wood	575	810	412
Manufacture of textiles, clothing and footwear	570	731	355
Transporting	383	723	411

Other services rendered to legal entities	354	625	377
Hotels and restaurants	322	520	387
Metallurgical industry	355	338	17
Manufacture of chemicals and chemical products	129	302	77
Waste collection, treatment and other disposal activities	122	185	79
Machinery and equipment	118	136	71
Real estate activities	59	121	88
Sports, recreation and cultural activities	82	115	86
Informatics and connex activities	59	96	56
Mail and telecommunications	46	92	50
Other personal services activities	155	86	50
Financial intermediation services	54	83	50
Extraction industry	62	45	72
Manufacture and distribution of electric and thermal power, gas and water	12	45	13
Health care and social assistance	27	26	17
Total insolvent economic entities	10.431	14.104	7.493

Commercial sector

In 2006 retail surpassed wholesale which held the first position in 2005. 36.85% of the total bankruptcies from 2006 were filed in the commercial sector, an increase against 2005 when this sector had 34.9%. By the end of 2007 the commercial sector, including retail, wholesale and distribution, held 41.4% of the total bankruptcies filed, an increase against 2006. This proves the fact that small retailers find it harder and harder to compete with large retailers which yearly spread their network to smaller and smaller cities. The commercial sector holds the first position even in the first half of 2008. The bursting number of economic entities within the commercial sector from 10-15 years ago is now found in the shape of numerous bankruptcies.

Agricultural sector and food industry

Considering the insolvencies faced in 2006, agriculture is the third sector, on decline against 2005 when it held the second position and the food and beverages industry maintained its fourth position. In 2007 the third and fifth place in the hierarchy of bankruptcies were held by the two closely connected agricultural and food industry. Insolvent agriculture triggers insolvent food industry as the latter suffers from lack of raw material. Lack of inland raw material or its high cost as a result of poor efficiency, along with the highly competitive import products, lead to the increase in the number of bankruptcies filed within the food industry.

Construction sector

The construction sector, which in 2005 was placed in the tenth position, comes fifth in 2006 considering its percentage in the total amount of insolvencies filed in 2006. This is a risky sector, with a high number of small and medium insolvent enterprises. In 2007 the construction sector came forth in the hierarchy of bankruptcies. In Romania this sector had the fastest growth rate compared to all European countries and in 2007 constructions were the economy's growth engine. In order to undertake wide scope projects the majority of small enterprises resort to loans, and the lack of experience in what regards execution, limited technical endowment and labor shortages leads to the dalliance of projects' execution, thus creating financial blockages. The accumulated debts to suppliers and banks triggered the bankruptcy of many construction enterprises. In 2008 the third place in the bankruptcy hierarchy, the second if we take commerce as a whole, is held by the construction sector.

Internationally, a synthesis of the statistics on the evolution of insolvent enterprises in Western European countries goes as follows (Insolvency report 2007/2008, www.uc.se at the 1st of December 2008):

	2003	2004	2005	2006	2007	Insolvency rate per 10.000 companies
Austria	5.643	6.328	7.136	6.854	6.362	240
Belgium	7.593	7.836	7.878	7.617	7.690	110
Denmark	2.506	2.620	2.497	1.987	2.400	131
Finland	2.769	2.385	2.278	2.285	2.300	95
France	38.296	40.776	41.930	40.360	42.670	166
Germany	39.470	39.270	36.850	30.680	27.490	90
Great Britain	14.815	14.813	13.462	13.686	12.950	82
Greece	480	577	580	520	510	7
Ireland	346	321	327	304	310	31
Italy	16.000	17.500	17.150	8.827	5.410	13
Luxembourg	655	665	682	634	680	256
Holland	6.386	6.648	6.780	5.941	4.710	87
Norway	5.223	4.297	3.540	3.032	2.870	90
Portugal	2.980	3.123	3.300	3.400	3.350	27
Spain	646	561	869	853	830	3
Sweden	7.099	6.588	5.865	5.243	4.890	92
Switzerland	4.539	4.955	4.751	4.528	4.400	93
Total	155.446	157.263	155.875	136.751	129.822	x

On a general level, one can notice a slight decline in absolute values of insolvent economic entities from 155,446 to 129,822 as we come closer to 2007. This reduction tendency is specific to countries with a large number of insolvency cases and a relative high insolvency rate as: Denmark, Great Britain, Italy, Holland, Norway, Switzerland, and Sweden. This is not necessarily the case for countries included in the database of this period, in which there is an increase of the insolvency cases. Among the countries in this situation in what regards the absolute number of insolvent enterprises and a significant insolvency rate there are: Austria, France, Luxembourg. Portugal.

3. Discussions on doctrinal and financial-accounting aspects

3.1. Subjects of the insolvency procedure

Firstly, the actors involved in this process are the *shareholders* or *partners*, natural persons or legal entities, in their capacity as owners, which may willingly or under legal compulsion file for bankruptcy. Rationally, their positive attitude oriented towards profit should come first but, as this does not depend solely on their will, their partners' intentions have to be taken into account. Thus, *creditors* of different shape come forward and, if their interests are affected by imminent risks, they take actions in order to recover as much as possible of their receivables and therefore they play major roles in the opening of the insolvency procedure. In what regards voluntary liquidation, the main actor is the *liquidator*, insolvency practitioner, who becomes responsible along with managers and the members of the Board of Directors. The satisfaction of creditors and the content or discontent of shareholders or partners depends upon the liquidator's professionalism. The scope of involuntary liquidation is to pay off all the debts this being the reason why more actors are involved in the insolvency process. Thus there are: *court laws*, *syndic judge*, *juridical manager*, *liquidator*, *credit union*, *credit committee* and *special administrator*

with attributes and competences detailed in the provisions of Law 85/2006 regarding the insolvency.

3.2. The opening of the insolvency procedure and the accounting principles

Through the opening of the insolvency procedure the procurator of the syndic judge is responsible for the management of the operations implied by the liquidation of the economic entity along with the organization and monitoring of accounting. Accounting data is considered to be the main source of information within the economic entity, thus being used as the basis of the juridical manager's or liquidator's decisions along the whole liquidation process. Practically, in what regards the liquidation of an economic entity, the juridical manager or liquidator plays a double part, on the one hand he is *a user of information* and on the other hand he *makes decisions*. If the economic entity is being subject to reorganization, its activity continues without any modifications in what regards the implementation of accounting principles. In our opinion there are certain modifications of the accounting principles when the economic entity is subject to liquidation.

Going concern principle – the dissolution of an economic entity and its entering into insolvency have as a result the discontinuance of its normal economic activities, although in these processes the economic entity is still a legal entity. This implies that the going concern principle is given up. The activities are limited to winding down the current commercial operations at the moment of dissolution, selling the assets and paying off the debts. In the case of reorganization the going concern principle still applies. The consequences of not applying this principle affect the other accounting principles, the valuation of assets and liabilities and the disclosure of accounting information.

Conservation principle – this continues to be applied to a certain degree, but, if it is necessary to estimate liabilities and expenses in order to establish potential increases of value, these increases have to be recognized in the financial statements. Capitalizing the results of the stocktaking done at the opening of the liquidation triggers the need to reevaluate in order to establish negotiation bases when the goods are sold, in accordance with inflation, utility of the good, market situation and market price.

Consistency principle – this principle is not applied as the liquidation value of assets is different from their historical cost. The extraordinary situation of liquidation can lead to deflection from historical cost and necessity to reevaluate, as it is stipulated under IAS 8 “Accounting policies, changes in accounting estimates and errors”. The inversion of method does not imply the inversion of implementation.

Accrual basis principle – this principle is not applicable as the liquidation process does not take place within a calendar year but it starts at the date of opening liquidation balance sheet and ends at the date of closing liquidation balance sheet. The liquidation period is considered to be a single financial year regardless of its extension (Buglea, A., Butan R. and collaborators, 2006).

Opening balance sheet intangibility principle – the opening liquidation balance sheet is atypical, induced by the going concern principle. It is the first balance sheet of the final stage in the economic entity's lifespan.

No offset principle – according to the provisions of the insolvency law the opening of the insolvency procedure does not affect the right of a creditor to claim the offset of his receivables with the debtor's receivables held against the former, if the legal requirements in what regards the offset are complied with at the opening date of the procedure (Article 52 of Law no 85/2006 regarding the insolvency). A third party could be both a creditor and a debtor, before the draw up of the opening balance sheet and accounts receivable chart, thus being possible to offset individual receivables with individual liabilities of the same third party.

Separation principle – this principle maintains its applicability as the debtor’s patrimony is distinctively disclosed in the balance sheet. Assets are disclosed separately from liabilities which are reflected in the accounts receivable chart, thus separately valued.

Substance over form principle – this principle is desolated as the liquidator, under the supervision of the syndic judge, may give up certain contracts that vest.

Materiality principle – this could become complementary to other accounting principles while maintaining its applicability.

Economic entity principle – economic activity is conducted within enterprises (economic entities) with a distinction being made between the owners’ patrimony and the entity’s patrimony. In what regards the insolvency procedure, the implementation of this principle refers to the fact that the legislation requires the debtor, juridical manager and liquidator to mandatorily write on any correspondence, using discernible characters, in Romanian, English and French the term „în insolvență” („in insolvency”, „en procedure collective”), when the economic entity is under observation, and „în faliment” („bankruptcy”, „en faillite”), when the economic entity is bankrupt (Article 45 of Law no 85/2006 regarding the insolvency). The enterprise (economic entity) in liquidation is practically an entity with new objectives i.e. the transformation of assets into liquidity and payment of liabilities, an extension of the entity’s existence under a different shape, in insolvency, reorganization or bankruptcy.

Monetary unit principle – this implies the disclosure of incomes and expenses using a monetary unit. In the case of receivables determined at nominal value, in the accounts receivable chart they will be recognized at the nominal value from the opening process date, while receivables in foreign currencies will be converted into lei at the N.B.R. exchange rate from the opening process date.

3.3. The insolvency procedure, financial and accounting aspects

The recognition of economic-financial operations regarding insolvency makes use of the accounts system stipulated in the general chart of accounts. In this respect we bring to your attention the introduction of some synthetic accounts according to the order of classes and groups in the current chart of accounts.

Account 128 “Result of the liquidation” (Feleagă, N., 1998) is the result of the economic entities’ liquidation, insolvent economic entities, a bifunctional account, with the scope to reflect the result between the assets’ selling price and the net value of these assets, along with the expenses incurred by the liquidation and the ones triggered by the discharge of the unrealizable assets. Implementing this point of view would result in distinguishing between the financial results of the commercial activity and the financial results of the insolvency process of any economic entity.

Account 463 “Reimbursement with the liquidator” is a synthetic operational account, functioning as a liability account, which would reflect the relation between the liquidator and the economic entity during the insolvency procedure. The debts towards the liquidator for the liquidation activity of the insolvent economic entity would be recorded on the credit side of the account 463 “Reimbursement with the liquidator”, and on the debit side the cash or giro payment of these debts. Information available through the introduction of this account would empower a pertinent analysis of the liquidator’s activity, avoiding some uncertainty regarding his activity’s debit.

Account 6589 “Expenses of insolvency operations”, a synthetic operational account of level II, would account for expenses incurred by derecognizing assets either because they have been sold or because unrealizable assets have been discharged. The account would be closed through the debit of account 128 “Result of the liquidation”. Account 7589 “Incomes from insolvency operations”, a synthetic operational account of level II, that would reflect the incomes generated by the sales of the insolvent economic entity’s assets along with the incomes from provisions for risks and expenses or from impairment of the debtor’s patrimonial elements. The account would

be closed through the credit of account 128 “Result of the liquidation”. The fiscal approach of these amounts depends on the nature of 128 “Result of the liquidation” balance account and on the deductibility of expenses with provisions and impairment.

If patrimonial elements are measured at carrying value the accounts 891 “Opening balance sheet” and 892 “Closing balance sheet” become inapplicable as their role and function are undertaken by the accounts 456 “Capital reimbursement with shareholders” and 461 “Sundry debtors”.

4. Conclusions

Regardless of the insolvency’s nature, voluntary or juridical liquidation, the correct development of the insolvency procedure depends upon the liquidator’s professionalism, the accordance with the professional code of ethics. The implementation of accounting principles when the economic entity is the subject of an insolvency procedure must be correlated with professional judgment, going through doctrinal practice, and their integration with the economic entity and monetary unit principles proves the harmonization between Romanian regulations and European regulatory acquis. The harshness of these principles’ implementation in the case of an insolvent economic entity depends upon the juridical manager and liquidator’s professionalism and ethics.

There are no accounts specific to the liquidation operations within the chart of account. From our point of view new or analytical accounts could be developed within the current synthetic accounts in order to address this issue. We believe it is rational to develop new accounts in order to solve a significant problem of insolvent entities even if this implies the opening of legal demarche. The solution to reflect the insolvency operations does not involve legal demarche as this is up to the juridical manager or liquidator but, in our view, this alternative does not address the issue of an informational flow specific to this type of information.

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