

ANNUAL FINANCIAL STATEMENTS – A SOURCE FOR THE FINANCIAL DECISIONS OF INSOLVENT COMPANIES

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The paper presents the importance of financial statements in determining the insolvency of a company. The first part of the article presents a case study and the main signals of bankruptcy: negative working capital, negative equity capitals, losses, etc. In the end of the paper we detail issues that are not observable and that are related to the actual management of the company.

Key words: working capital, working capital need, treasury, equity capitals, annual financial statements

JEL classification: G33

In Romania, the structure of annual financial statements was regulated by OMFP no. 94/2000 and 306/2000, then by OMFP no. 1752/2005 and recently by OMFP no. 3055/2009 and includes:

- the balance sheet;
- the short balance;
- the profit and loss account;
- the statement of changes in equity capital;
- the statement of cash flows;
- Notes.

Economically, it is useful for the economic agents to determine those indicators that can prevent insolvency based on the analysis of the data in the annual financial statements. The specialized literature presents for this purpose models like: the Z score recommended by E. Altman, the Canon Holder model, the model of William Beaver, the model of the Central Bank of France and the Cematt model. More recently, commercial banks have bankruptcy risk assessment methods, such as: the method of the Romanian Commercial Bank, the method of the Romanian Development Bank – Groupe Societe Generale, the method of Transilvania Bank, the method of Raiffeisen Bank, which are methods tailored for Romanian economy, with obvious results in the diagnosis of bankruptcy.

Although the causes that determine bankruptcy are varied, we believe that some have decisive influences in this regard, such as:

- the lack of order contracts after 1990;
- outdated technology;
- inadequate legislation for privatization;
- persistence of strikes;
- low productivity;
- property claims;
- inadequate price policies;
- Stock production; etc.

Steve Robinson in the book “Financial Management”³⁷⁰ shows the easily identifiable problems based on annual financial statements, such as:

- the massive increase of the credit account (debts);

³⁷⁰ Steve Robinson, *Financial Management*, Teora Publishing, Bucharest, 2005, p. 147

- the substantial increase in stock (inventory);
- reduction in liquidity;
- increasing the amounts borrowed;
- cutting back on future investments;
- Reduction in paid dividends.

Next, we will present the balance sheet structure of an economic agent³⁷¹ for two consecutive reporting periods. Therefore:

		-lei-
The debit structure	N	N+1
Total fixed assets, of which:	365408,0	238526,5
- intangible assets	-	-
- tangible assets, of which:	365310,0	238428,5
- freehold land	105451,2	-
- buildings	248743,0	235212,8
- plant and machinery	4998,2	2591,0
- motor vehicles	4109,7	624,7
- other fixed assets	-	-
- tangible assets in progress	2007,9	-
- financial assets	-98,0	-98,0
Total current assets, of which:	52289,2	33929,7
Inventory:	11638,7	
- raw materials	5744,7	
- semi-finished goods	5004,6	
- goods purchased for resale	35,0	
- packaging materials	854,4	
Other current assets, of which:	40650,5	33929,7
- clients and similar accounts	38182,4	33741,7
- other claims	1829,2	-
- investment papers	100,0	100,0
- bank accounts	7,2	13,0
- petty cash in lei	531,7	74,1
- other values	-	0,9
Suspense account	13699,2	-
TOTAL ASSET	431396,4	272456,2
		lei
The credit structure	N	N+1
Equity capitals, of which:	-208005,6	-1030585,5
- social capital	733701,2	595000,0
- uncovered loss	-	-939968,3
- loss	-943123,8	-685617,2
- other funds	1417,0	-
Long-term loans	147526,4	181565,7
Suppliers and similar accounts	43627,3	28047,7
Creditor clients	2289,2	1155,0

³⁷¹ Data are real

Other debts	445959,1	1092273,3
TOTAL LIABILITIES	431396,4	272456,2

Based on the comparative data of the two consecutive balances, the following can be highlighted:

- regarding intangible assets, freehold lands in the year N+1 was missing because lands were retroceded to their owners;
- the inventory was exploited, so in the year N+1 the company had no stock;
- clients and similar accounts dropped from 40650,5 lei to 33929,7 lei;
- suspense accounts have not occurred in the year N+1;
- from -208005,6 lei in the year N, equity capitals reached -1030585,5 lei, so the net asset is negative;
- long-term loans increased from 147526,4 lei to 181565,7 lei;
- unpaid supplied recorded a drop from 43627,3 lei to 28047,7 lei;
- other debts grew 2.5 times.

By calculating the net working capital with the help of the two known methods, results:

a) $NWC = \text{Permanent capital} - \text{Assets}$

b) $NWC = \text{Assets} - \text{Short-term debts}$

For the year N, we have:

$$\text{a) } NWC_N = -208005,6 + 147526,4 - 365408,0 = -425887,2$$

$$\text{b) } NWC = 52289,2 + 13699,2 - (43627,3 + 2289,2 + 445959,1) = 65988,4 - 491875,6 = -425887,2$$

For the year N+1, we have:

$$\text{a) } NWC_{N+1} = -1030585,5 + 181565,7 - 238526,5 = -1087546,3$$

$$\text{b) } NWC_{N+1} = 33929,7 - 1121476 = -1087546,3$$

The working capital in the year N, as well as in the year N+1, is negative and represents a signal that the company is in difficulty, and the working capital, as the main financing source of the current assets, can't finance these assets.

Next, we'll determine the company's treasury in the two analyzed years. In order to do this, we'll determine:

The need for working capital = Stocks + Claims – Operating debts, and it will result:

$$\text{Year N: } 11638,7 + 38182,4 + 1829,2 + 13699,2 - (43627,3 + 2289,2 + 445959,1) = 65349,5 - 491875,6 = -426526,1$$

$$\text{Year N+1: } WC_{\text{Need}} = 0 + 33741,7 - (28047,1 + 1155,0 + 1092273,3) = 33741,7 - 1121476 = -1087734,3$$

The treasury has values in the two analyzed years:

Treasury = NetWC – WCNeed

$$\text{Year N: } T = -425887,2 + 426526,1 = 638,9$$

$$\text{Treasury} = \text{Availability} - \text{Treasury credits} = 100 + 7,2 + 531,7 = 638,9$$

$$\text{Year N+1: } T = -1087546,3 + 1087734,3 = 188,0$$

$$T = 100 + 13,0 + 74,1 + 0,9 = 188,0$$

The values of the treasury in year N, as well as in year N+1, are low. The companies used drawn-in sources for financing, meaning delaying the payment of short-term debts.

Indicator	Year N	Year N+1
TOTAL operating revenue, of which:	-257463,7	125015,5
- revenues from sale of goods	8567,1	782,9
- sold production	423442,2	53479,6
- turnover	432009,3	54262,5

- stored production income	-689473,0	37503,0
- revenue from tangible assets production		33250
Operating expenses, of which:	670195,9	531739,8
- goods for resale	7470,9	726,2
- total material expenses	182126,2	66415,9
- third party services expenses	13244,6	22600,7
- taxes, duties and similar expenses	5341,3	340564,8
- total personnel expenses	111175,5	88763,2
- other operating expenses	394776	-
- adjustment expenses for fixed assets (depreciation)	311359,8	12669,0
Operating loss:	927659,6	406724,3
Total financial revenues, of which:	11,5	77264,4
- interest income	11,5	46,8
- other financial revenues	-	77217,6
Financial expenses, of which:	73892,1	71740,5
- interest expenses	73892,1	48335,5
- other financial expenses		23405,0
Financial profit		5523,9
Financial loss	73880,6	
Extraordinary revenues	59436,6	12951,5
Extraordinary expenses	1020,2	297368,3
Extraordinary profit	58416,4	-
Extraordinary loss		284416,8
Total revenues	-198015,6	215231,4
Total expenses	745108,2	900848,6
Total loss	943123,8	685617,2

By analyzing the data in the profit and loss account, the following will result:

- the operating revenues in the year N were negative due to the income from the stored production (debit balance);
- the operating revenues in the year N+1 were 125015,5 lei, being influenced by the revenues from the tangible asset production of 33250 lei;
- the operating expenses were higher than revenues in the two analyzed years;
- personnel expenses in the year N+1 were higher than the turnover, which were economically unjustified;
- operating losses were recorded in both years;
- the financial activity recorded loss in the year N, but brought financial profit in the year N+1;
- the extraordinary activity brought profit in year N, and extraordinary loss in the year N+1.

Overall, loss was achieved in both years.

Mihaela Onofrei, in the book “Financial Management”³⁷² shows that “managers must identify early the signs of deteriorating financial statements of the enterprise, such as:

³⁷² Mihaela Onofrei, *Financial Management*, C.H. Beck Publishing, 2006, p. 115

- achieving negative financial results;
- the existence of negative working capital;
- the inability to reimburse credits at maturity;
- the bankruptcy of suppliers and clients important for the enterprise;
- reduced availability or unavailability of a manager;
- the persistence of strikes.”

Steve Robinson³⁷³ shows that “they are problems difficult to identify”, so these “accounts do not reveal everything” and he goes on to mention the list of events that announce bankruptcy:

- accounting norms and practices – other than the ones that are standard – compared to the norms of the competition and with the norms existent in the concerned sector;
- fast increase of the sales volume, of the main accounts, of the working capital;
- the inability to reimburse credits at maturity;
- the inability to draw-up in time the financial reports and the account statements;
- combining the functions of the chairmen and chief executive, especially when these functions are associated with a large package of own shares;
- leading and charming personalities that are acting as managers of the company;
- frequent resignations from the managing board;
- sale of shares belonging to the company director (in the *Financial Times* magazine, for the companies listed in the UK), especially right before „closing” (seven weeks before announcing the financial results of the company);
- transition from asset acquisition to leasing;
- predatory behaviour of the management;
- unexplained transactions between the subsidiaries of a company.

We believe that since the company recorded negative operating revenues, negative working capital, losses and unjustified values in the year N, bankruptcy was imminent.

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³⁷³ Steve Robinson, *Financial Management*, Teora Publishing, Bucharest, 1999, p. 150