Internal Causes of Albanian Enterprises Bankruptcy

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Abstract: Studies on the causes of enterprises bankruptcy have significantly increased due to the impact on several stakeholders (financial managers, shareholders, customers, suppliers and creditors, employees, etc., consequently causing a significant impact on the economic development of the country in which the enterprise operates) and due to the high direct and indirect costs incurred. Given that external causes (those related to the environment in which the enterprise operates) are out of the enterprise control, this paper will be focused only on internal causes of bankruptcy, which are directly influenced by the decisions made by management. In this regard, we have divided internal causes in two main groups: financial causes and non-financial causes. Financial causes are mainly linked to the decisions made by financial managers on cash and financial resources management, while non-financial causes mainly refer to the decisions made by management on the recruitment of staff (including senior managers and all other staff), and the lack of the planning activity as well.

Keywords: causes of bankruptcy; financial causes; non-financial causes.

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1. Introduction

The avoidance of bankruptcy is becoming an increasingly important field of study in enterprise financial management due to several reasons. First, due to the impact of enterprise bankruptcy on many stakeholders, such as financial managers, shareholders, customers, suppliers and creditors, employees of the enterprise and their families wealth etc., consequently causing a significant impact on the economic development of a country in general. Second, due to the high direct and indirect bankruptcy costs. Bhabra and Yao (2011) estimated the indirect bankruptcy costs of the US enterprises and found that indirect costs made up 2% of the value of enterprise three years before bankruptcy, while these costs constantly increased two years and one year before bankruptcy, comprising respectively 6.2% and 14.9% of the enterprise value. Whereas Altman (1984) estimated the direct costs of bankruptcy and concluded that direct costs amounted to 4.09% of the enterprise value before declaring bankruptcy. Third, due to the availability of data

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and development of quantitative techniques which have increased the possibilities and interest of researchers to build bankruptcy forecasting models.

Based on the literature review on this field, we can say that the success or failure of an enterprise is the result of interaction of the two groups of causes:

- First, the performance of an enterprise is affected by external causes which are not related to the management of the enterprise. The economic growth rate, inflation rate, exchange rate, interest rate, customer preferences and behavior are some of the external causes that have a significant impact on the performance of the enterprise (Sharma & Mahajan, 1980);
- Second, the performance of the enterprise is affected by internal causes, which are directly related to decisions made by management. Wrong decisions regarding the degree of financial leverage, dislocation of sales points, meeting the customers expectations, investments in fixed assets, etc. are some of the internal causes that can affect the performance of the enterprise.

The enterprise and the environment in which it operates are closely related to each other. Given that external causes (those related to the environment in which the enterprise operates) are out of the control of the enterprise, this paper will be focused only on internal causes. We have divided the internal causes in two main groups: financial and non-financial causes. Financial causes mainly refer to the decisions made by financial managers to manage cash and financial resources, while non - financial causes refer to the decisions made by management regarding recruitment of senior managers and all other staff, and lack of the planning activity as well.

The paper is structured as follows: the second section gives a detailed view of the financial causes of enterprise bankruptcy, while non-financial causes are explained in the third section. The fourth section summarizes the conclusions drawn from the paper.

2. Financial Causes

As explained above, the performance of the enterprise is affected by decisions made by financial managers, in addition to external causes, which do not depend on the management of the enterprise. This section represents the main financial causes affecting the continuation of the enterprise activity.

2.1. Liquidity Position

Liquidity is a major and growing problem for the enterprises. Liquidity is the ability of the enterprise to pay the short-term liabilities. Difficulties in payment of liabilities may lead initially to financial distress and then to bankruptcy. The

consequences of lack of liquidity are more sensitive especially during periods of economic downturn.

A bad situation of liquidity may increase the financial costs of the enterprise and may lead to the disability of paying bills. However, even the high liquidity is not good, because large amounts of cash mean that the enterprise is gaining a low rate of return. Refering to our country, construction is one of the sectors with the largest liquidity problems. As a result of the sharp decline in sales of apartments and delays in payment of bills for public works by public institutions and agencies, it has been caused a chain of debts in the construction sector. The global financial crisis of 2008 has further highlighted this problem, because many enterprises faced the decline in sales and purchasing power, partly due to the reduction of transfers from emigrants, who has been important investors in this sector in the pre-crisis period.

2.2. Cash Flow Management

If we consider the simplest situation, assuming that the enterprise can not access external financing, can not lose money and can not sell any of fixed assets, according to Walter (1957) cash inflows can be generated from the sale of products/services, where the amount of cash depends on the quantity and price of products sold and the change in accocunts receivable. On the other hand, cash outflows are caused by purchasing products/services, and the paid amount will depend on the quantity and price of the products purchased and the change in accounts payable. If cash outflows exceed cash inflows, the enterprise should withstand the shortage situation by using the available cash or should provide additional financial resources. In cases the latter does not happen, the enterprise can face insolvency situation.

2.3. Cash Flow Diversification

Diversification of cash flows, meaning the generation of cash from several product lines or market segments reduces the risk of the enterprise in the same way as stock portfolio diversification reduces the overall risk of the investor portfolio. If the enterprise operates in market segments that are not correlated to each-other, then the negative performance in one segment can be covered by the positive performance in other segments. In addition, geographical diversification, meaning the enterprise operates in several regions that are not correlated to each-other, positively affects the overall risk reduction and consequently the performance of the enterprise.

2.4. Financial Leverage

Financial leverage is an indicator of the extent of the enterprise debt financing. This indicator is measured by the degree of financial leverage (DFL), which is calculated as follows:

$$DFL = \frac{EBIT}{\mathrm{EBIT} - \mathrm{I} - \mathrm{Dp} * 1/(1 - \mathrm{t})}$$

or

$$\mathrm{DFL} = \frac{\text{EPS change in \%}}{\text{EBIT change in \%}}$$

As seen from the above formula, the enterprise that is financed only by ordinary shares has a degree of financial leverage equal to one. With the increase of debt and preferred shares financing, interest and dividend payments that the enterprise should pay to creditors and preferred shareholders respectively increase. Consequently, in both cases, this will lead to an increase in the volatility of both earnings per share and degree of financial leverage. This increase in financial leverage is an indicator of increased financial risk of enterprise, which indicates the ability of an enterprise to pay fixed financial expenses: interest expenses and preferred dividends.

2.5. Operating Leverage

Operating leverage is an indicator of the extent the enterprise uses the fixed operating costs (fixed production costs). This indicator is measured by the degree of operating leverage (DOL), which is calculated as follows:

$$DOL = \frac{Q * (P - VC)}{\mathrm{Q} * (\mathrm{P} - \mathrm{VC}) - \mathrm{FC}}$$

or

$$\mathrm{DOL} = \frac{\text{EBIT change in \%}}{\text{Sales change in \%}}$$

As seen from the above formula, an enterprise that has no fixed operating costs has a degree of operating leverage equal to one. As the fixed operating costs of the enterprise increase, the volatility of profit before interest and tax will increase as well, thus affecting the degree of operating leverage. The increased degree of operating leverage is an indicator of increased business risk (operational risk) of enterprise, which indicates the ability of the enterprise to pay fixed operating costs.

2.6. Delay in Tax Payments

Many enterprises consider delaying payments of taxes and fees as the most simple way to save money, which can be essential to their survival. This situation is considered as government borrowing. In order to gain benefits from such situation, it is not required to fill out forms or to make estimates of the enterprise; there are neither commissions nor time waste. And in the best scenario, due to the frequent

amnesties that are applied in our country, an enterprise can benefit also from the non-payment of interests. Nevertheless, in most of the cases enterprises do not pay taxes because they can not afford to pay. In this case, management should carefully assess and analyze the solvency of the enterprise.

2.7. Bad Working Capital Management

Enterprises usually purchase goods/services on credit, thus obtaining trade credit from suppliers. Likewise, enterprises sell goods/services on credit, thus offering commercial loans to customers. The difference in time between the moment of purchase of raw materials and manufacturing of the final product and the moment the enterprise collects cash from its customers creates a "time factor" (Platt, 1985).

The time factor can be influenced by management decisions regarding purchases and sales policies, manufacturing process and provision of trade discounts. An increase in sales or extention of the collection period accompanied with a reduction in the period of payment to suppliers will lead to increased "time factor". On the other hand, the improvement of manufacturing process, associated to the improved productivity and efficiency, and the application of trade discounts to customers in cases of immediate payment will result in reducing the "time factor". It should be mentioned that some enterprises can accept an increase in time factor if the overall increase in profit exceeds the additional cost of funding used for this purpose.

2.8. Asset-Liability Mismatch

One of the basic principles of corporate finance is that the term structure of assets should be equal to the term structure of liabilities. If there are differences between them, the future impact on the performance of the enterprise may be negative. In cases an enterprise uses long-term financing in making short-term investments, it is not efficiently using its sources, and this situation may lead to reducing profitability. On the other hand, if the enterprise uses short-term financing to make long-term investments, it will not only reduce the profitability, but soon may face a situation of insolvency, which may lead to bankruptcy.

2.9. Lack of Internal Financing

A very important concern for the future operating activity of an enterprise is the lack of internal funding sources. The reduction in profit reduces opportunities to support and finance enterprise growth and undertake potential investment projects as well. On the other hand, the reduction of economic result, makes it more difficult for an enterprise to get financing from financial intermediaries, and such situation could lead to the closure of enterprise.

Continuous losses not necessarily lead the enterprise to insolvency. An enterprise that faces such a situation, can have sufficient working capital to cover these losses, and as a result the enterprise may be able to afford its obligations, thereby

avoiding insolvency. Furthermore, special attention should be paid to the duration of these losses and also to the internal or external causes, which may have led enterprise to such a situation.

3. Non-Financial Causes

This section provides the key non - financial causes affecting the continuation of the enterprise operations.

3.1. Lack of Effective Management

Numerous studies indicate that a cause that could lead to enterprise insolvency is the lack of effective leadership and inadequate management, which is almost subjective and difficult to be measured. The personal characteristics of managers are generally considered the most important cause of enterprise failure (Ooghe & Waeyaert, 2004), including motivation, skills and other characteristics of them. Argenti (1976) in his paper identified some symptoms of an incompetent management. The autocratic leadership who controls the entire enterprise without any discussions with employees, the inability to respond to competitors, social and technological changes, are some of the reasons outlined in the paper of Argenti (1976). In addition, the inability to create value is the main cause of insolvency of the Hungarian enterprises (Palinko and Svoob, 2016), which start to face its first consequences 4-5 years before bankruptcy.

3.2. Lack of a Business Plan and Proper Vision

Another cause may be the business plan of the enterprise. According to Moyer (2005), an enterprise may fail even if there is enough product/service market demand. In this case bankruptcy could happen from unrealistic expectations of growth and inadequate planning. Consequently, the enterprise can be found in the situation of cash shortage, given that the current level of profitability is not able to support the previous capital structure, which was built based on the anticipated level of profitability.

In addition, many entrepreneurs are not aware of the importance of the enterprise ownership, especially entrepreneurs of small enterprises. They claim the business will be profitable since the first day. In general, many new enterprises make profits after one or more years of activity. Furthermore, new entrepreneurs do not reinvest profits in the business, although in the first years of activity it is a required action for the continuation of business. At the same time, many of them claim they will have more free time when leading their own business, while studies show that entrepreneurs, mostly those of small enterprises, work more than 60 hours a week.

3.3. Human Capital

One of the most important elements for long-term success, although not reflected in the balance sheets of enterprises, is the human capital. According to Bontis (1999) "Human capital represents the human factor in an organization; the combination of intelligence, skills and expertise that gives the organization its unique character. Human elements of an organization are those who are able to learn, change, be creative, and, if properly motivated, can ensure a long life in the market for the organization. Human capital should be considered as the main asset of the organization and the last must invest in human capital in order to survive and grow". Unfortunately, in Albania, enterprises invest too little in human capital. Enterprises that have established a training program (training and development) for their employees are not numerous and the wage still remains the only motivating element used by them. While other types of benefits almost do not apply.

3.4. Errors and Fraud

Employees are the main source of operational risk to the enterprise. Errors, cases of fraud or theft are not so rare. In order to eliminate or reduce them it is neccesary not only a very careful management, but a good system of internal control as well. The term "error" refers to the unintentional deficiencies in financial statements, such as errors in summarizing or processing data, interchange of data among some accounts, unreliable estimates, wrong applications of accounting principles and methods, etc. While the term "fraud" refers to the intentional actions and as such we can mention the falsification of financial statements values, the discrepancy between the actual assets and those reported in the balance sheet etc. The International Standard on Auditing ISA 240 defines the term fraud as "An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage".

3.5. Improper Accounting Procedures and full Cost Method

The accurate and detailed record of income, expenses and debt is vital for the survival of the enterprise. This is especially true for small enterprises. Keeping accounting records improperly and incorrectly makes it difficult for entrepreneurs to understand the real financial situation of their enterprise, and moreover affects the planning of both financial and investment activity, thus may lead to wrong decisions. The unawareness of accounting principles and procedures, and the misuse of methods for estimating the cost of production can bring a situation where actual costs exceed the anticipated costs, leading to loss of enterprise competitiveness.

3.6. Hird Party Liabilities

Each enterprise enters business relationships with third parties. It may happen that an enterprise, due to carelessness or negligence, harms a third party, such as a product of bad quality may harm customers, the lack of security conditions in the working environment may harm employees, environmental or noise pollution may damage society as a whole, etc. All these risks are related with higher costs for the enterprise, ranging from the loss of customers up to dealing with complex and costly legal issues.

3.7. Wrong Location

For many enterprises the choise of location is a critical decision, which will affect its future success or failure. Factors that should be considered in making such a decision are:

- population of the area;
- density;
- flow rate of pedestrians and vehicles;
- number of local competitors.

3.8. Size of the Enterprise

Many researchers agree on the argument that smaller enterprises have higher probability to fail. It is more difficult for small enterprises to find funding sources. Low profits, few assets that can serve as collateral and their operational risk make it difficult for the enterprise to gain the credibility of financial institutions.

Moreover, they face difficulties in recruiting qualified human resources given that the ability to professionally develop and grow is smaller than in the case of larger enterprises.

4. Conclusions

Studies on the causes of enterprises bankruptcy have significantly increased due to the impact it has on several stakeholders and due to the high direct and indirect costs incurred. Based on the literature review, the performance of the enterprise is affected by two groups of causes: external causes and internal causes. Given that external causes are out of the control of the enterprise, this paper was focused only on internal causes of bankruptcy. Internal causes of bankruptcy are divided into two main groups: financial causes and non-financial causes. Financial causes are mainly linked to the decisions made by financial managers on cash and financial management, while non-financial causes mainly refer to the decisions made by management of the enterprise regarding recruitment of senior managers and all

other staff, and lack of the planning activity as well. It can be said that the two groups of internal causes are interrelated. This means that both the skills and expertize of managers and employees, and the quality of planning and management affect the ability of the enterprise to generate cash inflows and to obtain financing. On the other hand, the generation of cash flows from daily activity and the financing decisions also affect the quality of leadership and other staff, and the quality of planning activit

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