FINANCIAL STATEMENT QUALITY PROBLEMS IN THE INSOLVENCY PROCESS

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Abstract

This paper examines financial statement quality problems in the insolvency process for limited liability companies according to the provisions of regulatory acts in Latvia. Empirical studies have been conducted from 2014 till 2017. The author conducted that regulatory acts do not regulate the procedure for financial statement preparing for insolvent limited liability companies in previous studies on accounting problems in the insolvency process. In 2015 Latvia developed new regulations governing the preparation of financial statements. The author researched the draft regulatory acts and found out that they did not consider the existing problems in the preparation of financial statements within the framework of the insolvency process and the author wrote proposals on the improvement of a regulatory act and submitted it to the Ministry of Finance. As a result, the Ministry of Finance acknowledged that the problems found by the author existed and made some improvements in regulatory acts in 2016.

Keywords: accounting, financial statement insolvency, company

JEL classification: G33, G38, K22, M41, M48

1 Introduction

The insolvency proceedings of a legal person are an aggregate of measures of a legal nature, within the scope of which the claims of creditors are settled from the property of a debtor, to promote the honouring of the debtor's obligations (Insolvency Law, 2010).
An insolvency process is one of the ways to eliminate the business in case a company does not have enough financial resources to pay its creditors. Started from 2010 the Latvian regulatory acts do not define exactly how a company should evaluate its property, claims and obligations in case the company has declared insolvency.

The regulatory acts determine the procedures how to evaluate claims, obligations and property in accounting reports and the presentation of financial reports in case the company or its structural unit is liquidated (Cabinet of Ministers, 2003).

For this reason, most of accounting specialists consider that in cases where a company has an insolvency process, its property, claims and obligations must be applied in the evaluation procedures and the conditions applicable to the company under which its economic activities have been suspended and the company has been closed have to be considered.

The author does not share this point of view and recommends to work on amendments in regulatory acts to improve the business environment, as well as to facilitate collecting correct budget revenue.

The author wrote proposals on the improvement of a regulatory act and submitted it to the Ministry of Finance. As a result, the Ministry of Finance acknowledged that the problems found by the author existed and made some improvements in regulatory acts in 2016.

The research aim is to identify the important problems in the preparation of financial statements of a company's insolvency process in accordance with the requirements of the regulatory enactments of Latvia and to draw attention to the amendments of regulatory enactments made by now and makes accounting and preparing of the financial statement more clearer and comprehensible.

Based on the aim, the following research tasks were set:

- to analyse the legislative and regulatory requirements for property and obligation evaluation in the liquidation process and insolvency proceedings in Latvia;
- to analyse the regulatory act requirements for accounting and financial reporting in the liquidation process and insolvency proceedings in Latvia.

2 Data and Methods

The following qualitative and quantitative methods were employed: the monographic method – in examining, assessing and analysing literatures and legal acts, selecting only the information related to the present research, describing findings and interpretations; logical analysis and synthesis; statistical methods, i.e.
statistical observation, compilation and grouping of information, calculation of statistical data, analysis of causal relationships and data generalisation. The logical construction method was used in analysing results and making judgements.

The present research used studies on the regulatory acts of the Republic of Latvia, statistics of the Register of Enterprises of the Republic of Latvia.

3 Results and Discussion

The existing legislation provides voluntary and forced termination of the activities of a company in Latvia.

According to the statistical data of the Register of Enterprises of the Republic of Latvia, the registration dynamics of limited liability companies (hereinafter the company) was declining in the period from 2008 to 2017 (see Figure 1).

Figure 1 Dynamics of registration and exclusion of limited liability companies by Latvia’s Register of Enterprises in the period from 01.01.2008.-31.12.2016.

Source: Author’s construction based on statistical data of the Register of Enterprises of the Republic of Latvia.

In 2011 were founded 16843 companies which is the highest number of newly registered companies during last seven years. The reason for this is that in the fourth quarter of 2010 entered into force Micro-enterprise Tax Law. By this law was reduced administrative and tax burden for micro-enterprises, especially in the period of commencement of economic activity, and also in the sectors with a low-income level (Micro-enterprise Tax Law, 2010). As of 1 January 2018,
a micro-enterprise turnover is reduced from 100’000 euro to 40’000 euro in a calendar year and a micro-enterprise tax increasing from 9% of turnover in 2010-2014 up to 15% from 2017 the part of micro-enterprises stopped their economic activity and where excluded from the Register of Enterprises. The number of excluded or liquidated companies constantly increased at the same time. The number of excluded companies accounted for 13.49% of the total founded companies in 2011, but in 2017 the number of excluded companies comprised 151.23% of the total new registered companies. The number of excluded companies includes companies which are closed through the ordinary procedure of the liquidation without using the instruments of insolvency proceedings and companies which are liquidated during insolvency and bankruptcy proceedings as well.

During the recent seven years, on average, 809 legal persons and 1399 natural persons were declared insolvent (see Table 1), which negatively affected tax collection in Latvia.

Table 1 Distribution of the number of insolvency cases registered in Latvia by characteristic of insolvency proceedings in the period of 01.01.2008.-31.12.2017.

<table>
<thead>
<tr>
<th>Year</th>
<th>Proclaimed insolvency cases (total)</th>
<th>Insolvency cases for natural persons</th>
<th>Insolvency cases for legal persons</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>number</td>
<td>%*</td>
<td>number</td>
</tr>
<tr>
<td>2008</td>
<td>1290</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td>2009</td>
<td>2202</td>
<td>71%</td>
<td>53</td>
</tr>
<tr>
<td>2010</td>
<td>2773</td>
<td>26%</td>
<td>199</td>
</tr>
<tr>
<td>2011</td>
<td>1729</td>
<td>-38%</td>
<td>850</td>
</tr>
<tr>
<td>2012</td>
<td>2256</td>
<td>30%</td>
<td>1375</td>
</tr>
<tr>
<td>2013</td>
<td>2392</td>
<td>6%</td>
<td>1572</td>
</tr>
<tr>
<td>2014</td>
<td>2256</td>
<td>-6%</td>
<td>1297</td>
</tr>
<tr>
<td>2015</td>
<td>2431</td>
<td>8%</td>
<td>1629</td>
</tr>
<tr>
<td>2016</td>
<td>2270</td>
<td>-7%</td>
<td>1539</td>
</tr>
<tr>
<td>2017</td>
<td>2118</td>
<td>-7%</td>
<td>1528</td>
</tr>
<tr>
<td>Total:</td>
<td>21717</td>
<td>-</td>
<td>10043</td>
</tr>
</tbody>
</table>

* Percentage change from the previous period

Source: Author’s calculations based on statistical data of the Register of Enterprises of the Republic of Latvia, Insolvency Register.
In 2008 Latvia passed a new insolvency law which allows for the first time financially distressed companies to continue operating by pursuing reorganisation. The reform also strengthened the qualification standards for bankruptcy administrators. In 2010 Latvia introduced a mechanism for out-of-court settlement of insolvencies to alleviate pressure on courts and tightened some procedural deadlines and adopted a new insolvency law that streamlines and expedites the insolvency process and introduces a reorganisation option for companies (World Bank, 2014). The legislature determined that the company which is being liquidated must prepare the closing financial statement to inform company’s creditors and other third parties on the process and the solution. But in the same time, the legislation does not define exactly how the company should evaluate its property, requirements and obligations in case the company has declared insolvency.

From 2003 laws determine the procedures how to evaluate claims, obligations and property in accounting reports and the presentation of financial reports in case the company or its structural unit is liquidated. For this reason, most of accounting specialists consider that in cases where a company has an insolvency process, its property, claim and obligations must be applied in the evaluation procedures and the conditions applicable to the company under which it economic activities have been suspended and the company has been closed have to be taken into consideration.

Analysing of the existing legislative and regulatory requirements, not only directly regulate the accounting and financial reporting, the author does not share this point of view, for the following reasons:

1. The legislature determine that the purpose is to promote the honouring of the obligations of a debtor in financial difficulties and, where possible, the renewal of solvency. So, the insolvency proceeding, by its very nature, does not mean that the company will be liquidated because the primary objective is to restore its solvency;

2. The Insolvency Law provides the right of the transition from legal persons’ insolvency process to legal protection process. Therefore, it is necessary to evaluate and understand whether the company’s activity within the insolvency proceedings from the accounting point of view conform or do not conform to the going concern principle. In addition, the legislator has established a procedure for suspension of the company’s economic activity of the insolvency proceedings;

3. In practice part of the companies after the day when the court has proclaimed insolvency proceedings continues economic activities for at least a year or for several more years, especially if the company owns property, which can be leased for rental revenue (Kelmere, 2016).
According to previous studies the author pointed below-listed problems in accounting and preparing the financial statement in the insolvency process if consider the regulatory acts for the companies that are liquidated in ordinary order (without insolvency):

1. The financial statement does not provide correct information about the company’s financial position and lucrative long-term investment. Therefore, the investors could make wrong decisions not to invest in this company and without investments the company must use the bankruptcy procedure;

2. Revenues and expenses are not harmonised within the reporting period. The property revaluation downwards up to the expected net proceeds of the sale, which is usually a forced sales value, make large expenses. If not reclassifying the property from long-term investments in current assets, then continue to calculate the depreciation and includes it in expenses and in the same period includes revenue from using long-term investment, for example, lease building or offices, and at the end of the period the financial report of the company should be correct - the profit or loss of the period according to real business situation;

3. As the one of the fundamental principles of the insolvency process is the principle of respect for the interests of creditors that it is particularly important to ensure legal certainty and security business environment (Insolvency Administration, 2012) and according to the special regulatory acts for insolvency the revaluation of liabilities during the insolvency process should be carried out at least twice and after each revaluation one should prepare a financial report for presentation of the financial position and financial performance of a company to third parties including creditors.

In 2015 Latvia developed new regulations governing the preparation of financial statements. The author examined the draft regulatory acts and found out that they did not consider the existing problems in the preparation of financial statements within the framework of the insolvency process and the author wrote proposals on the improvement of the regulatory act and submitted it to the Ministry of Finance. For example, to use correct terminology according to insolvency cases (the draft regulatory act was taken into account and corrected). The author drew the attention of the legislator to the fact that the new legislative act did not provide specific requirements how to evaluate a company’s property, claim and obligations and requirements for preparing its financial reports, including an annual report, within the framework of insolvency proceedings, as well as to the fact that
the new legislative act was not in line with the requirements of other regulatory acts (Kelmere, 2016).

As a result, the Ministry of Finance acknowledged that the author’s found problems existed and made some improvements in the regulatory acts but all of them were not accepted yet by other ministries, and at the end of 2015 the inter-institutional meeting decided to create a special working group in 2016, which would work on the legislative amendments to balance between the various requirements of the regulatory enactments regarding the preparation of financial statements of the insolvency process (Cabinet of Ministers, 2015).

In 25 October 2016 come in to force amendments regulatory acts in accounting and by them clarified the requirements for accounting and the financial statement preparation in the insolvency proceedings (Amendments to the Law on Accounting, 2016) like:

- In the insolvency proceeding if the administrator has taken a decision to stop the economic activity of the debtor then for preparing the financial report he should take into account the procedures how to evaluate claims, obligations and property in accounting like the company or its structural unit is liquidated;
- In the insolvency proceeding when the administrator has taken a decision to continue the economic activity of the debtor to full or restricted extent the financial statement shall be prepared by principle for continuing the activity – shall be assumed that undertaking will be operating also in the future. It should be used till insolvency administrator made decision to stop the economic activity of the debtor and start the bankruptcy procedure;
- While the insolvency process for debtor continues - for each accounting year shall draw up a balance sheet and a profit or loss account and an annex to the financial statement.

Some more improvements should be done in the future. For example, there are no unambiguously understandable should just be prepared a balance sheet, a profit or loss account and an annex to the financial statement for each accounting year or need to be prepared the financial statement and submitted to the State Revenue Service.

4 Conclusion

1. The registration dynamic of limited liability companies was declining in the period from 2011 to 2017, but at the same time the number of excluded or liquidated companies constantly increase. The number of excluded companies
comprised 13.49% of the total companies founded in 2011, but in 2017 the number of excluded companies comprised 151.23% of the total new registered companies. The number of excluded companies includes companies which are closed through the ordinary procedure of the liquidation and companies which are liquidated during insolvency and bankruptcy proceedings as well.

2. During the recent seven years, on average, 809 legal persons and 1399 natural persons were declared insolvent.

3. Till the end of the 2016 the Latvian legislation does not define exactly how a company should evaluate its property, claims and obligations in case the company has declared insolvency. But the regulatory acts determine the procedures how to evaluate claims, obligations and property in accounting reports and the presentation of financial reports in case the company or its structural unit is liquidated.

4. In 2015 Latvia developed new regulations governing the preparation of financial statements. The author examined the draft regulatory acts and found out that they did not take into account the existing problems in the preparation of financial statements within the framework of the insolvency process and wrote proposals on the improvement of the regulatory acts and submitted it to the Ministry of Finance.

5. As a result, the legislator made some important improvements in the regulatory acts and it is helps to do better accounting and financial statements during insolvency proceedings, but some more improvements should be done in the future (to determine that financial statement should be submitted to the State Revenue Service).

References


