

The Two Sides of the Coin – The Success and Failure of the Business

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Abstract

The role of economic entities in the ecosystem of the world's economies is widely recognized at all levels, due to their contribution to a country's economic growth and to generating new jobs and as a key factor for research, development and innovation. This is why the companies' financial decline is intensely studied, being one of the most analysed topics when it comes to economic enterprises, the impact of a company's bankruptcy propagating itself with a domino effect, which is difficult to quantify and to define in time. In the literature, studies and articles published by renowned analysts, when referring to enterprises in difficulty, we find a variety of attributes, insolvency, reorganization, bankruptcy, payment default, financial collapse, business collapse, decline or failure, respectively. In substance, all the terms used converge to a financially difficult situation, which makes it impossible to continue the economic activity and to meet financial obligations. In the last 20 years we have witnessed the collapse of several internationally renowned companies, and the bankruptcy of some of them has generated or amplified the great economic and financial crisis of 2008-2009. The COVID-19 pandemic created an unprecedented crisis, the economies of all countries in the world being affected, and many companies were expected to cease their business activity, but government support and funding measures paradoxically reduced the number of insolvent entities, contrary to the fundamental economic principles. The real impact of the current economic crisis after the cessation of liquidity infusions from the states should be tracked in the coming years.

Key terms: enterprises in difficulty, insolvency, high-profile bankruptcies, the COVID-19 pandemic

JEL Classification: A10, E00, E01, E60, E66, F01, F60, G01

To cite this article: Sorin Șomîtcă, Alina Șomîtcă, *The Two Sides of the Coin – The Success and Failure of the Business*, *CECCAR Business Review*, N° 8/2022, pp. 56-62, DOI: <http://dx.doi.org/10.37945/cbr.2022.08.06>

➔ Introduction

The situation of the economies of the countries of the world, of the European one, as well as of Romania in particular, depends fundamentally on the financial condition of the small and medium enterprises, as they have a vital contribution to the economic growth of the states, the economic development of a country, ensuring employment, while supporting innovation and free competition, at the same time.

The financial health of an enterprise is a situation in which the enterprise is financially at a given time, the life of an enterprise thus comprising a succession of circumstances that lead to various situations, many of

them difficult, which may or may not be avoided, some of them having a significant impact that can lead to the interruption of the activity, temporarily or permanently.

➔ **The financial collapse of some giants. Lessons to learn from past experiences**

Although at first glance it would seem that people are mortal and companies are not animated, it is still found that the life expectancy of enterprises is constantly decreasing, at least in recent times, while the life expectancy of mankind is increasing. But unlike natural death, failing companies can be brought back to life by applying various strategies to safeguard and rehabilitate them. Various studies show a decline in the life of European companies. For example, in Germany, it drops from 45 to 18 years, in France, to 9 years from 13 in the past and in the UK even more, to 4 years compared to 10 years ago (Sheth & Sisodia, 2005).

In the market economy, the line between success and failure is very fine, so that often many companies cross the barrier and enter the area of decline. We are constantly witnessing high-profile bankruptcies of giants, companies with world or national reputation and for which there were no such expectations in their glory years. Companies like Enron, Arthur Andersen, Parmalat, Lehman Brothers, Cisco, Polaroid, WorldCom, Carillion are some examples of global giants that, as a result of their collapse, have seriously shaken the global economy, with negative effects that have spread out, and have also generated global financial crises.

In Romania in recent years, the most high-profile bankruptcies can be considered those of Univers'All, Mic.ro, Domo, Poliano, Relad or Astra.

One of the biggest bankruptcies of the century is of Enron company, in 2001. Enron, one of the largest energy companies in the United States, owned more than \$ 60 billion in assets before its collapse, 29,000 employees and profits of over \$ 100 billion. Arthur Andersen, considered at the time one of the Big Five accounting and auditing companies with PricewaterhouseCoopers, Deloitte, Ernst & Young and KPMG, has been auditing and consulting for the company for many years. The company hid financial problems through various creative accounting means, using fair value accounting, and fraudulently marking its assets to the market, leading to the overestimation of profits and underestimation of debt and transfer of troubled assets to various special purpose entities. All these eventually led to the bankruptcy of Enron and of the Arthur Andersen audit firm, respectively, with the Enron case going down in history as the biggest audit failure.

Parmalat, the largest case of accounting fraud in history, is worth mentioning because it is probably the biggest bankruptcy on the European continent. Parmalat, with a history of more than half a century, the largest food distributor, the eighth largest Italian company, with more than 36,000 employees, was forced to file for bankruptcy in 2003. Its financial statements have been falsified for a long time, the audit firm Deloitte being the one to discover the accounting fraud and the lack of cash of € 4 billion. Having similarities with the Enron case, Parmalat hid the losses by means of specially created entities, wholly owned by it, some of them registered in tax havens. Assets and revenues were overvalued by various fictitious commercial and financial transactions, various non-existent assets were recorded, debts were undervalued, uncertain receivables with a low probability of collection were transferred to those specially created economic vehicles, thus creating a perfect financial picture that inoculated the investors, banks, partners and the economic environment the idea that Parmalat is a solid company.

The 2008 Lehman Brothers bankruptcy is the largest bankruptcy in American history, and its collapse has shaken the global financial system, eventually leading to an economic and financial crisis, the largest such crisis since the Great Recession of the 1930s. Before its collapse, Lehman Brothers was the fourth largest investment bank in the United States, with 25,000 employees, assets of \$ 639 billion and a history of over 150 years. The subprime loans crisis has created huge liquidity needs for the bank that could only be obtained by affecting

solvency, although the assets held were sufficient to cover debt. But the risks assumed by the bank were too high, and the liquidation of assets in a short time was impossible, so that after the failure of negotiations with creditors and potential buyers, it was decided for it to go bankrupt, with domino effect on the entire global economy, with devastating impact on the economies of the world states, that entered recession, of the banks, that had to apply for state aid, of the companies, that ceased their activity, and on the population, by increasing unemployment and deepening poverty.

⇒ Causes and symptoms of the decline of economic entities

In the analysis of the decline of an economic entity, a distinction must be made between the causes that determined the event and the symptoms, although these are often confused and overlapping, a cause of decline may become a symptom, as a symptom may also become a cause of the financial collapse at some point.

The symptoms can be detected by the company's stakeholders, mainly shareholders, investors, financial institutions, but also business partners, in the form of alarm signals sending messages that the economic entity is heading in the wrong direction and that without recovery measures, will lead to insolvency or even bankruptcy. In general, the symptoms are easier to identify than the causes, being only a manifestation of a difficult situation. We must react as quickly as possible and taking into account the underlying causes, so that their efficiency should be possible and with the best possible results.

Most of the time, the symptoms of a company's financial decline represent worsening financial indicators, such as a sharp drop in sales, declining profitability, accelerated debt growth, massive short-term balance sheet imbalance, impaired liquidity, cash flow constraints. At the same time, the non-financial indicators are also to be followed and have the same importance, namely changes of shareholders, management, massive staff rotations, deficiency in the accounting and control information system, managerial deficiencies.

The causes that trigger and favour the decline of a company are diverse, they can act individually or collectively, so recovery strategies must act mainly to counteract the causes, but also to alleviate the symptoms. If until recently the idea that mismanagement was by far the central cause of corporate bankruptcy, the COVID-19 crisis has shown that external factors are of the same significance, and may even state that they are decisive, acting independently of the other decisive factors, being difficult to counteract without the intervention of a superstructure.

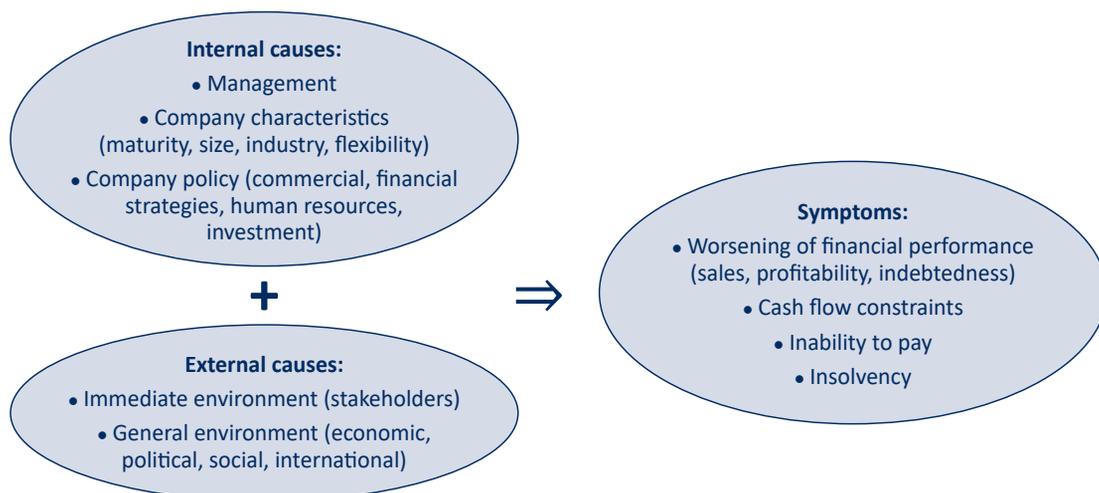


Figure 1. Causes and symptoms of the decline of economic entities

Source: Own processing.

➤ Economic measures of the states of the world in the context of the COVID-19 crisis

Various studies, including those of the largest commercial credit insurance company, namely Euler Hermes, mention that the number of insolvencies increased in 2019 for the third consecutive time, by 9% compared to the previous year, after previous significant decreases. Growth continued to be due to insolvency of companies in China, while in Western Europe there was growth in most countries and the United States and Canada entered for the first time in many years on an upward trend.

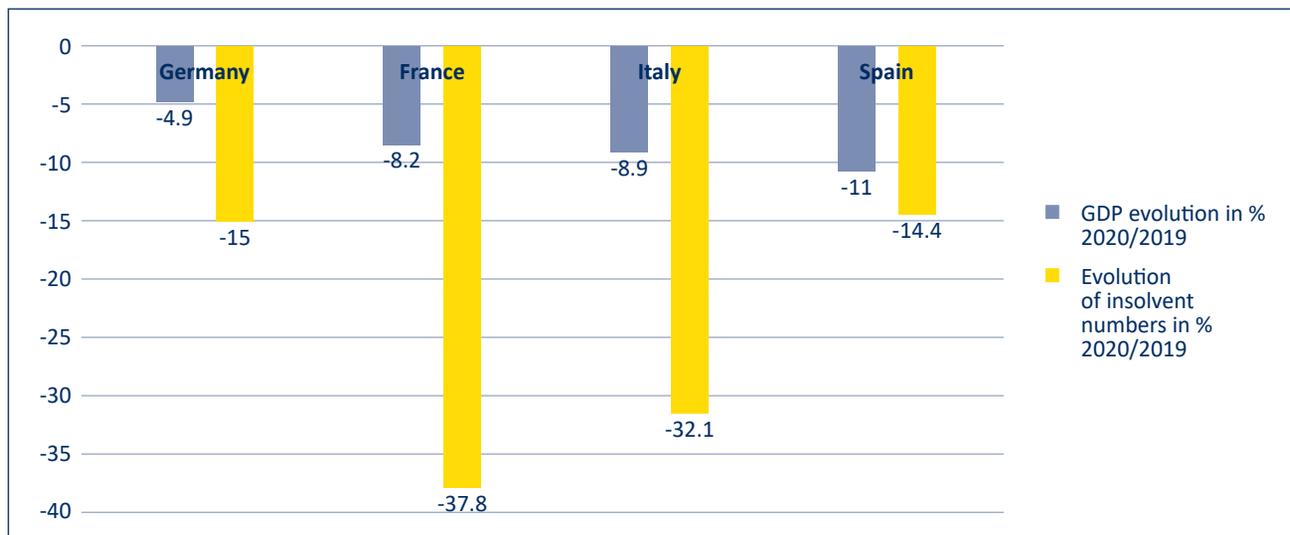


Figure 2. Evolution of GDP vs. insolvency evolution in 2020 compared to 2019

Source: Coface, 2021.

The current crisis caused by the COVID-19 pandemic will have a profound effect on the economy, although the number of bankruptcies has decreased, with government programs to support the savings delaying the closure of many businesses. Various analysts predict that there will be a wave of bankruptcies that was just delayed if the measures of stimulus, support and economic recovery do not continue. Thus, currently, the highest risks of insolvency or bankruptcy are assimilated to the sectors of activity that are based on the physical presence and social interaction, respectively the hospitality sector, the aeronautical industry, the automotive sector, the retail trade of non-food products. These were also the first and the most affected by the current crisis and their survival largely depends on how quickly they adapt their business operating model and control the costs.

Under normal circumstances, the number of companies in difficulty increases in close correlation with the contraction of a country's GDP. But, paradoxically, things were totally unexpected – while the economies of the eurozone countries contracted massively, some of them experiencing historical and short-term recessions unprecedented since the end of the Second World War, the number of companies that became insolvent has decreased. Here we are talking about the most developed European countries, Germany, France, Italy, Spain, whose economies have contracted substantially, but at the same time the number of insolvent companies has decreased at a much faster pace.

Romania's situation is no different from the rest of the European countries. While the country's GDP contracted by 3.9% in 2020 compared to 2019, the number of companies that became insolvent has reduced by more than 12%. In Romania, the number of insolvencies is following a decreasing trend after the peak in 2013,

the year 2020 marking the lowest level of the number of insolvent entities in the last decade (www.onrc.ro). The reality could be very different, given that many companies have been kept alive artificially, supported by government measures to mitigate the effects of the coronavirus pandemic.

In order to counteract the devastating effects of the current economic crisis caused by the health crisis, all countries of the world have taken economic measures to protect the population and the companies directly or indirectly impacted either by the measures imposed by the authorities regarding free movement or as a result of staff shortages, supply or distribution chain problems, and measures taken to revive the economy after the impact caused by the pandemic.



Figure 3. Evolution of the number of insolvent companies in Romania

Source: Own processing according to www.onrc.ro.

The European Union has launched the largest stimulus package in its history, totalling more than € 1.8 trillion, including the temporary recovery instrument NextGenerationEU, a mechanism that allocates € 750 billion for Europe’s recovery following the effects of the COVID-19 pandemic. It comes along with the impressive long-term budget of the European Union, mainly targeting the years 2021-2023. The amounts available by means of NextGenerationEU will be distributed to all European Union countries and cover various programs, either in the form of grants (€ 390 billion) or in the form of loans (€ 360 billion). Most of the funds will be directed to the Recovery and Resilience mechanism, and the allocation of funds to Member States is based on the respective country’s population level, gross domestic product per capita, unemployment rate, but closely related to the impact of the coronavirus crisis on the states’ economy. The funds of NextGenerationEU cover the following programs:

- Recovery and Resilience Facility;
- Rural Development;
- Just Transition Fund;
- REACT-EU;
- InvestEU Programme;
- RescEU;
- Horizon Europe.

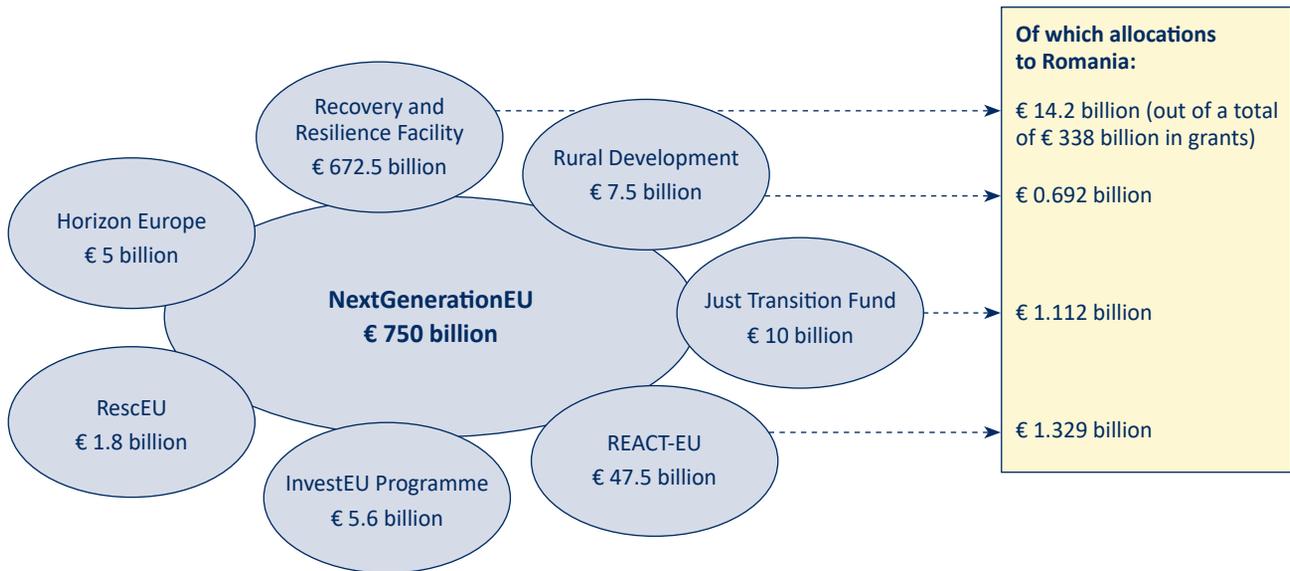


Figure 4. Breakdown of NextGenerationEU funds

Source: Own processing according to <https://ec.europa.eu>.

Romania will receive significant sums to mitigate the economic and social effects and to support the economy in order to become much stronger in the face of any dangers that might occur in the future.

As far as other states are concerned, the largest package of economic assistance measures to counteract the effects of the COVID-19 pandemic is the one adopted by the United States, the country most affected by the pandemic, with over 20% of the cases of illness worldwide (worldometers.info). The measures to stabilize the affected economy target impressive amounts of over \$ 2 trillion and are aimed at three major directions, namely: limiting the spread of the virus as much as possible, stabilizing the economy by supporting the population, the small and medium enterprises and the industries affected, such as the air transport of the population and goods, and funding of research in the medical field.

➔ Conclusions

The COVID-19 pandemic hit the global economy unexpectedly, generating an unprecedented crisis, being more an economic crisis than a health crisis, with effects on population health and huge psychological impact due to loss of life and measures imposed by authorities on isolation and free movement in order to prevent the spread of the virus. Unlike the previous crisis of 2008-2009, the world states have acted in the same direction, with measures specific for a pandemic, but also by allocating significant resources to support the economy and to help entities overcome the effects of the imposed restrictions. The companies, aided on the one hand by economic measures and on the other hand by learning from the experience of the previous crisis, have shown resilience and the ability to reinvent themselves, so we can say that most of them have successfully overcome the most difficult part of the crisis. This conclusion can be drawn by analyzing the figures on the number of companies that became insolvent during 2020, figures that are decreasing compared to previous years.

In the case of Romania, their number is at an all-time low, but the fear of all analysts is that government measures to support the economy just delayed the difficult moment and only in the coming years the real effects of the pandemic on the economy will be able to be accurately measured.

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✍ **Acknowledgment:** This paper is based on the results of the research co-financed through the project entitled "DECIDE – Development Through Entrepreneurial Education and Innovative Doctoral and Postdoctoral Research", code POCU/380/6/13/125031, project co-financed from the European Social Fund Through the Operational Programme Human Capital 2014-2020.