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A study of the causes leading to the liquidation of agricultural enterprises

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Summary: The viability of agricultural enterprises is of paramount importance. Their liquidation has harmful effects on broad strata of society. The aim of my research is therefore to analyze the leading causes of liquidation of agricultural enterprises. The research was led on 17 agricultural enterprises. This may help in the prevention and treatment of their insolvency.

The research results show that a long-term agricultural production is not sustainable with a low equity capital. For the long-term maintenance it is necessary that the investors establish the enterprise with a capital according to the type of the production. The loan can not replace the entrepreneurs own resources, it is only complementary to it. The owners of agricultural businesses should strive to ensure that the paid-up share capital is kept in the firm, because in case of payment difficulties, this can be an adequate financial provision.

Companies with financial problems can avoid liquidation if the crisis is detected in time by the leaders. However, the owners must organize the management of the enterprise so that it should have the necessary technical and economic knowledge.

With an appropriate management, and use of means of crisis management, the liquidation of the enterprise can be prevented.

Key words: agricultural enterprises, liquidation, capital lost, risk, crisis management

Introduction

In a market economy, legal regulation of winding up poorly performing, unviable companies is indispensable. The details of that regulation may vary from one country to another, but its aims are universal, namely to turn around companies that can continue in the long run despite temporary insolvency on the one hand, and to wind up those that are permanently insolvent on the other hand. Putting unviable and insolvent companies into liquidation makes it possible for other market players to use their assets more effectively and more profitably.

When Hungarian lawmakers passed the Bankruptcy Law (BL) in 1992, their primary aim was to put a quick end to the following problems that were starting to appear in the Hungarian economy and getting graver and graver in the early 1990s: chain debts among companies, liquidity problems increasing in severity and frequency, and permanent insolvency of companies (Erdős, 2007). Bankruptcy proceedings often failed to lead to agreement or to expedient reorganization and tended to result in liquidation (Erdős, 2005).

The 1993 amendment to the BL made it impossible for bankrupt companies to file for bankruptcy and changed the deadlines of the bankruptcy procedure in such a way that they became impossible to keep, consequently the proceedings could not be instituted. At the same time, the number of new bankruptcy proceedings initiated per year has been steadily growing. According to the surveys conducted by *Creditreform Magyarország* between 1996 and 2008,

more than 1,000 new bankruptcy procedures were initiated in 2008, which is over 250% of the 1996 numbers.

Widespread insolvency among companies is harmful for several reasons. The employees of companies that are wound up tend to become unemployed, which on the one hand increases state expenditure in the form of unemployment and social benefits, while the diminished incomes of unemployed people may lower demand, which in turn affects the earnings of other market players adversely, on the other hand. The wage subsidy that companies facing bankruptcy may be awarded by the *Labour Market Fund* is another state expenditure with a low rate of return. Of the 5.6 billion Forints paid out in 2006 for example, only 1.1 billion Forints were paid back. Companies going out of business further diminish the state's income from taxes.

Owing to the special position of agriculture in the Hungarian economy, companies liquidated in that sector impact the economy and society negatively in a number of other ways as well:

- Agriculture plays a prominent role in meeting consumers' food requirements.
- It is essential that agriculture should exploit Hungary's natural resources.
- About 400,000 people are employed in agriculture and food processing.
- By providing livelihood for rural communities, agriculture plays an important role in slowing the stream of rural population moving to cities.

Based on the above, the fundamental aim of this study has been to analyze the causes leading to the liquidation of

agricultural enterprises in order to help them avoid and manage bankruptcy. Of the 17 agricultural enterprises that were chosen for analysis, 13 were located in Hajdú-Bihar County, and 4 in Heves County; 15 of the 17 were cooperatives. The reason why cooperatives are over-represented in the present non-representative sample is that bankruptcy procedure often cannot be instituted in limited-liability or limited partnership companies (the two types most frequently affected by the BL) for lack of the necessary documentation and information. Of the 17 companies studied, one filed for bankruptcy in the first five-year period following the introduction of the BL in 1992. In 10 companies, bankruptcy proceedings were initiated between 1997 and 2001, in a further five between 2002 and 2006, and in one in 2007.

Materials and methods

Following the literature on bankruptcy forecasting, the study analyzed the following features of the 17 enterprises on the basis of their final accounts and their annual reports of the years preceding bankruptcy: liquidity quick rate, the current assets/ total assets ratio, the proceed/after-tax profit ratio, and the customer/supplier ratio.

In addition, the following data of the enterprises were also examined: the make-up of the liabilities reported in the final account, the degree of indebtedness, the ratio between equity capital and liabilities total and the make-up of accounts payable (the rate of long-term versus short-term liabilities within liabilities total).

Further analyses were made of the net earnings by sales, the profit and loss figures of operating/ business activity, the profits on financial transactions and, finally, changes of the balance sheet profit and loss figures over time, which can throw light on the causes leading to permanent insolvency.

Claims made by creditors in the bankruptcy procedure may differ from the value of accounts payable reported in the final accounts, because it is only claims that have been made in the period between the start of the bankruptcy procedure and the deadline set by the BL (either 40 days or a year from the start of the procedure) that are satisfied, provided the creditor has paid the registration fee, which amounts to 1% of the value of his claim. The study examines the make-up of the claims registered by creditors and listed in the asset division proposal submitted by the liquidator. The asset division proposal sets creditors' claims registered during liquidation against the assets that are available for the company in liquidation for satisfying those claims.

Causes leading to the liquidation of the studied enterprises

Based on the results of the analyses, it can be concluded that the liquidation of the studied agricultural enterprises were brought about by the following problems of Hungarian agriculture after the transition in 1989:

1. Agricultural cooperatives were converted without premeditation.

2. Agricultural cooperatives lost capital following economic conversion.
3. Their domestic and foreign markets narrowed.
4. The gap between the prices of agricultural and industrial products increased.
5. Lending rates increased and subsidies decreased.
6. Losses made agricultural enterprises less adaptable to economic change.
7. Following Hungary's accession to the EU, and as a result of increasing agricultural import, a number of market players e.g. dairy farmers or fruit and vegetable growers faced losses due to poor market organization.

Of the 17 agricultural enterprises in this study, 13 were successors of converted agricultural producers' cooperatives. Following conversion, 12 of them continued operating as cooperatives, and one was converted into a joint stock company. One of the enterprises that was set up as a cooperative was not the successor of one, but it had taken over an agricultural producers' cooperative with huge debts.

Prior to conversion, two of the studied enterprises had been stripped of assets to such a degree that their lack of farm equipment doomed them to failure from the outset. The management of one of the two cooperatives that were short of capital when they were set up opted for voluntary winding up, but had to face a compulsory winding-up order in the end.

Another agricultural enterprise used to get the bulk of its income from sales of wine products on the Soviet market prior to the transition of 1989. The loss of that market, however, made the company unviable and insolvent. It was characteristic of all the enterprises in this study that they did not have any income from exports in the years before their liquidation. That was a problem, because the higher prices achievable by exporting could have offset the increasing costs of imported raw materials.

The studied enterprises were forced to cut costs by not investing into development or the safety of production, which (combined with extreme weather conditions) led to significant yield losses in crop production between 1997 and 2000. In 1997, producers in Hajdú-Bihar county were struck by drought, whereas in the years 1998 and 2000 farmers in Hajdú-Bihar and Heves counties suffered water damage (due to too much precipitation) amounting to scores of billion Forints, which made it impossible to work the land or to harvest crops. The majority of the enterprises had financial difficulties due to the losses suffered earlier and had, by the time liquidation started, accumulated significant debts which were partly bank loans, partly tax arrears. In several agricultural enterprises bankruptcy was brought about by the drop in earnings caused by decreased yields. Of the 17 agricultural enterprises that went bankrupt, liquidation was initiated in 9 following drought and water damage. In order to finance production, all 9 enterprises were forced to take out loans secured by mortgage that could only be repaid by selling equipment or livestock, which further weakened their respective positions. At the end of that vicious circle or rather spiral, the enterprises lost their creditworthiness and became insolvent; liquidation could no longer be avoided.

Of the 17 liquidated enterprises in this study, one operated as a production and marketing cooperative, buying and selling vegetables. As a result of the unfavourable market situation of 2004, however, the cooperative made serious losses and, since it did not have enough capital, insolvency was unavoidable.

An analysis of the reports of the studied enterprises showed that the liquidity quick rate, the proceeds/after tax profit ratio, the equity capital/ total liabilities ratio and, finally, the rate of indebtedness had clearly indicated financial failure prior to and at the beginning of liquidation.

In the years preceding liquidation, the average liquidity quick rate of the enterprises in this study was significantly lower than the expected value of 1.00, what is more, it went on decreasing until the start of liquidation. (Figure 1)

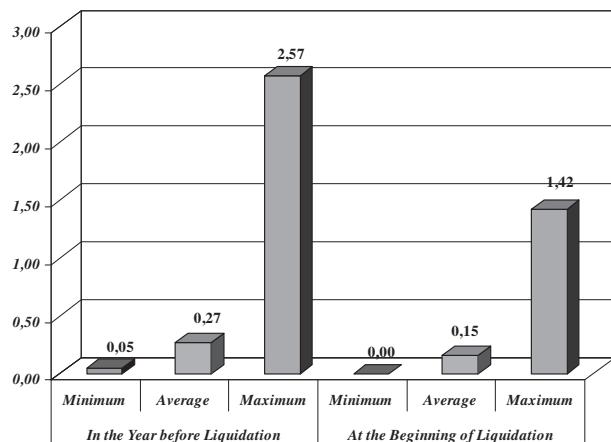


Figure 1. Changes of the liquidity quick rate prior to liquidation
(Source: the author's own calculations based on reports)

The average proceeds/profit ratio of the 17 enterprises was negative in the period immediately preceding liquidation, which means that the considerable losses suffered earlier played a decisive role in their insolvency. (Figure 2)

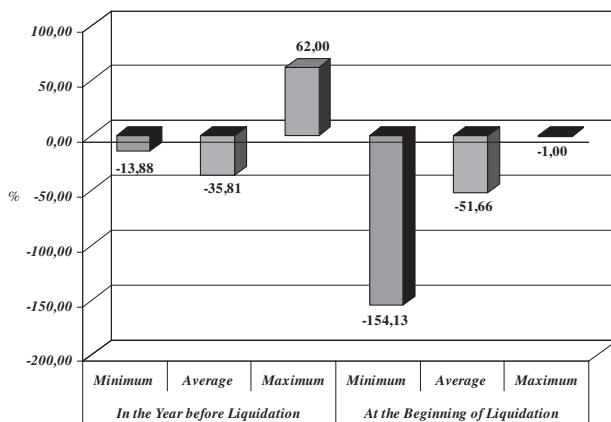


Figure 2. Changes of the proceeds/profit ratio before liquidation
(Source: the author's own calculations based on reports)

The enterprises had low levels of equity capital and a high degree of indebtedness due to the following two causes (Figures 3 and 4):

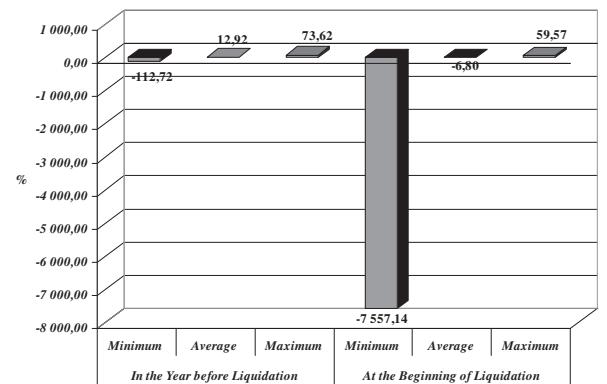


Figure 3. Changes of the rate of equity capital prior to liquidation
(Source: the author's own calculations based on reports)

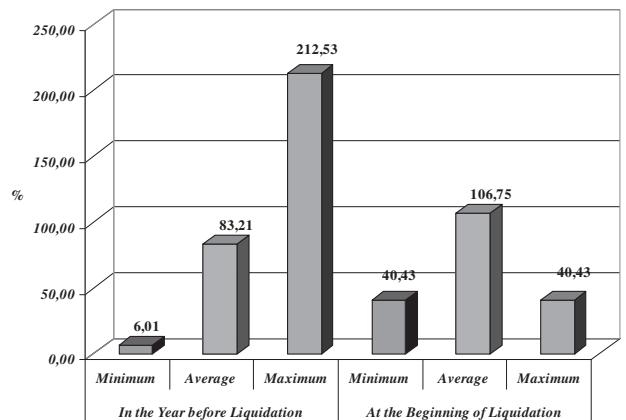


Figure 4. Changes of the degree of indebtedness before liquidation
(Source: the author's own calculations based on reports)

1. The majority of the enterprises had been making losses for years before liquidation, consequently their equity capital kept decreasing.
2. As most of the enterprises lacked the necessary income to cover operation costs, they had to take out loans which, however, did not cover tax liabilities.

In the enterprises in this study, accounts payable were mainly short-term debts, overwhelmingly tax arrears accumulated over the years.

An analysis of the indices has shown that the deterioration of the liquidity rate, the decrease of the equity capital, accompanied by the increase of the degree of indebtedness are warning signs of impending insolvency. The afore-mentioned indicators should be continuously monitored if bankruptcy is to be avoided.

Conclusion

Under Hungarian laws the minimum capital requirement to start a company is low, consequently a great many companies have been formed since the transition of 1989. The two most common types are limited partnerships — where there is no legal requirement of a minimum of issued capital — and limited-liability companies — which take no more than 500,000 Fts to form since 2007, and where the

owner's liability is limited. Those companies have often been formed out of necessity, in an attempt to escape unemployment. They tend to have a single source of income, with the loss of which the company becomes unviable. The enterprise that specialized in game management is a case in point. When the managing director fell ill, the business collapsed and had to be liquidated because of unpaid debts.

According to expert opinion enterprises most often go bankrupt over tax debts. This study has found that, in most of the studied agricultural enterprises, the Tax and Financial Audit Office was both the greatest creditor and the initiator of the bankruptcy procedure. Because of the high risks of agricultural production, suppliers sometimes secure their claims with the right of option. In two enterprises in this study that is what caused bankruptcy. The low earnings of the enterprises failed to cover their liabilities and, as a result, suppliers took possession of their implements of production.

Contrary to bankruptcy forecasting literature, which claims that bankrupt companies have characteristically low rates of current assets, this study has found that the opposite is the case in failed agricultural enterprises. The enterprises in the sample were characterized by a decrease in invested assets. As the fixed asset requirement of agricultural production is considerable, a steady decrease of those assets gradually makes their operation impossible.

An analysis of the causes of bankruptcy in the agricultural enterprises of this study has identified several problems the solution of which is the responsibility of both the state and the individual agricultural entrepreneur.

Producers to have safe market positions, they have to produce large quantities of consistently high quality products and that can only be done by forming big, capital intensive companies. The state can facilitate the formation of capital intensive agricultural enterprises with subsidies or tax incentives given to companies with high issued capital. Capital concentration could also be increased by setting a minimum requirement of issued capital for forming enterprises for certain business activities, the same way as law requires adequate qualifications for doing certain jobs.

Agriculture has always been a high risk business due to the special circumstances of agricultural production. A survey of the perception of risk factors conducted by Székely et al. in 2007 found that Hungarian farmers in a pilot study rated on a scale of 1 to 7 the weather as the number 1 risk factor, and that was followed by the fluctuation of prices in the second place. In order to manage the more and more frequent risk of extreme weather conditions, Parliament passed a bill in 2008 *on the national agricultural loss reduction plan and on the contribution to loss reduction*, putting it into effect with *Decree 32/2009 (III. 31) of the Ministry of Agriculture and Water Management on the procedure of agricultural loss reduction*. The plan consists of two parts: the contribution of individual framers on the one hand, and a state subsidy of matching funds of no less than the former amount. That "insurance plan" provides loss reduction in cases of frost, drought or water damage for farmers who have joined the plan. *** Participation in the loss reduction

plan is compulsory for agricultural companies and small and medium businesses, but optional for primary producers. Agricultural producers can get loss reduction only if the loss is/ damages are reported within 10 days of occurrence to the special administrative division of the competent Agricultural Office, while loss reduction claims must be handed in to the regional office of the special administrative division by October 20th of the year under review.

In 2009 crop producing enterprises have been estimated to suffer approximately 50% yield loss due to various disasters. Water damage in the first couple of months of the year, drought from March on and the situation has recently been exacerbated by storm damages. The expected price increase generated by demand exceeding supply can only partly offset the above losses. The loss reduction plan may serve as an interim solution. However, loss adjustment payments may well be deferred into 2010 because the payment schedule to be submitted by the Ministry of Agriculture and Regional Development by December 10th at the latest cannot be drawn up before the EU Committee has given its approval in the notification procedure. Since claims of yield losses will not be paid in 2009, the costs of agricultural production in that year will have to be covered by the producers. In that way, enterprises lacking the necessary assets may go under despite the introduction of the loss reduction plan.

In the author's experience, managers of small businesses especially find it difficult to interpret accounting data, and they also tend to be poorly informed about tax rules. Without that information, the annual business plan (if there is one) will not be well-founded, and the enterprise may go bankrupt even if its manager knows all the ins and outs of his special field. This can only be avoided by making sure that the managers of enterprises are well-versed in business management as well as their special fields.

Should an enterprise get into a critical situation, bankruptcy can still be avoided by employing the methods of crisis management, provided the situation is recognized in time. In that way the enterprise survives the crisis, creditors get paid, and jobs are saved. Unfortunately, crisis management is not widely used in Hungary partly due to the attitude of the enterprises in financial difficulty and partly due to the creditors' lack of confidence in the method, although the latter could play an important part in turning around the ailing enterprise. As an incentive for using crisis management methods, the state could subsidize companies the same way that it subsidizes consultation.

The wave of liquidations that started in 2009 has also been enhanced by the wide-spread practice of chain debts which makes a growing number of companies face bankruptcy. Claim management as well as customer rating is becoming more and more important because they are indispensable if marketing risks are to be lowered.

Crisis management and claim management, however, require ample capital, which again underlines the fact that enterprises that are short of capital are not viable in the long run.

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