

## **THE ESSENCE OF CRISIS IN AN ENTERPRISE**

*Various effects of crisis, drawing attention to opportunities of recovery proceedings appearing in the new Bankruptcy and Recovery Law have been presented in the article*

### **1. Introduction**

Nowadays, companies acting in the free-market economy, struggling with stiff competition, facing numerous barriers and trying to respond promptly to changes have become familiar with the phenomenon of crisis. Crisis does not emerge unexpectedly as many of managers running businesses used to suppose. At the beginning, it usually develops as a hidden crisis and can be unrecognized by managers and employees. This state does not last for a long time, though, and certain organizational disturbances start soon to disclose. The aim of this paper is, therefore, to show the essence of crisis in enterprises, its origin and impact on business activity.

### **2. From Mission to Crisis**

Each company, before starting business activity should determine the meaning of its existence and set a course of its action – in other words – formulate its mission. Mission is the basic and ultimate goal of an enterprise – distinguishing it from other companies functioning on a market and demonstrating philosophy on which its activity is based<sup>1</sup>.

Unfortunately companies far too often cannot realise their missions as a result of turbulences in economy and changeable conditions of business activity. A battle for survival and hard efforts towards adaptation to changes cause, that the mission becomes vague and realization of operational goals comes to the fore. Companies struck by economic and financial difficulties lose the basic sense of their existence. They try hard to change something but it is by no means linked with realization of their vocation. The companies enter a phase of stagnation characterized by ineffective management, inefficient use of resources or sponging off creditors and suppliers.

Theory and practice indicate that a strategic goal of each enterprise is to maximise its value. In order to achieve this there is a need of harmonious cooperation between internal and external stakeholders. However, such collaboration can be met quite seldom. Ruthless game of stakeholders triumphs over cooperation much more often. People are

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<sup>1</sup> See: *Zarządzanie przedsiębiorstwem*. Strużycki M. (ed.) Warszawa: Difin 2002, p. 108.

prone to being ruled egoism in order to reach assumed goals. The same happens to managers of companies what in consequence leads to internal organizational disturbances and problems with external business partners.

### **3. Greedy Games of Stakeholders**

The environment of a business is constituted by its internal and external stakeholders. Owners, managers and workers are the crucial players here.

Owners are particularly interested in financial situation of an enterprise, as they risk their own money invested in a business. They should also take into considerations possibilities of gaining desired rate of return on planned and taken decision<sup>2</sup>. Depending on their investing strategy – whether they are passive or active investors – particular situations are made advantageous to them. The virtual threat of a financial distress of joint-stock company will make passive investors sell shares, who this way want to save their profits. On the other hand active investors will be opt to buy shares at low prices and join recovery program counting on improvement of financial situation and eventual growth in share prices. To sum up, owners of an enterprise are interested mainly in its market position, financial standing and amount of profit achieved and dividend paid. They tend to assess boards' decisions on the basis these factors rather than others.

It is believed that an owner of a company should be capable of combining interests of employees and capital providers. However, there appears sometimes a situation when entrepreneurs completely disperse their own capital, as a reason of employing workers considering on the base of connections or securing interests of particular stakeholders only. When, additionally, there are no control bodies like supervisory or staff boards protests of aggrieved parties can be expected.

Managers have the biggest impact on activity of enterprises because they take the most important decisions influencing future standing of a company. Thus they need up-to-date information about symptoms of weakening financial situation in order to take remedial measures in case of virtual bankruptcy threat. S. Slatter and D. Lovett notice that an early application of restructuring strategies allows improving financial position of a company and avoiding troubles connected with crisis. Financial restructuring of a company conducted by a board of directors as an alternative to legal failure or winding up of an enterprise is the least painful way out from a crisis for stakeholders.

There are great expectations from managers – they should mitigate conflicts within the company and harmonise interests of various stakeholders so that a main goal of the enterprise can be achieved. Nevertheless, it is very difficult to meet expectations of all

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<sup>2</sup> See: Waśniewski T., Skoczylas W.: *Teoria i praktyka analizy finansowej w przedsiębiorstwie*. Warszawa: Fundacja Rozwoju Rachunkowości w Polsce 2002, p. 9.

interest groups in the company. The best example is when owners of capital demand payment of dividends while allocation of profits on research and development would be welcomed. Another problem is connected with entering into negotiation with creditors or outsiders, what, in certain cases, can only speed up bankruptcy.

Workers are the next interest group concerned with financial situation of a company since in case of failure they lose their jobs. The main interests of theirs' are stability of a company and its ability to pay remuneration. However, too high benefits to workers can lead an enterprise into financial troubles. The best example is when employees and trade unions fight for raise of salaries while financial distress plaguing the company does not allow satisfying such demands. In such case an internal conflict occurs, as a result of which common interest of the whole organization disappears. Board of directors may accommodate workers with what they demand but that implies two situations: a conflict is staved off and everything is back to normal or too high liabilities towards staff burden finance of a company to substantial extent what eventually leads to dismissals of personnel and corporate failure.

The above – mentioned arguments give right to claim that a financial distress – as a rule – has its origin in lack of internal concurrence of interests. This happens particularly when groups who have direct influence on functioning of an enterprise i.e. owners, board of directors or employees treat the business like a milk cow which is their inexhaustible source of prosperity. If harmonious cooperation between internal business groups becomes disrupted, the satisfaction of stakeholders i.e. banks, insurance agencies, clients, suppliers, local authorities and state will be endangered too.

Banks offer financial services to companies – but not without taking advantages of that. On one hand, they invest entrusted money, on the other give credits to companies and earn interest from that source. Their business can be in danger, however, when an enterprise becomes insolvent. For that reason in order to minimise default risk banks conduct systematic evaluation of financial credibility of their current and potential borrowers. The rating of a company reflects risk of inability to pay capital instalments and interest but – above all – it tells how expensive a credit for a company would be.

Insurance agencies take over a part of risk from companies in exchange for guaranty that in case of unfavourable circumstances or accidents the value of lost assets can be regained. This interest group is particularly interested in well functioning of an enterprise. Financial stability means no obligations to pay compensation and hence high profits.

Suppliers and clients are interested in an ability of a company to continue its activities. Each enterprise accounts for a particular share of the market for suppliers what influences a decision regarding advantageous choice of clients. Suppliers take into

consideration terms offered by customers in regard to form and a date of payment. Deferring payments for supplied goods increases risk of operations of suppliers. Therefore, suppliers analyse not only forms and dates of payment but also financial credibility of their clients<sup>3</sup>. Just as suppliers, clients – taking care of their business – choose contractors who meet their requirements in terms of quality of offered products or materials. Prices, forms of payment, punctuality of deliveries and quality of after-sales services are of great importance, as well.

Development of particular regions by the means of entrepreneurship and investments is in the interest of local authorities. Thanks to companies local authorities receive taxes accounting for significant share of local budgets. Moreover, the more enterprises are set up in a region, the more attractive for other investors it becomes. Companies that are concentrated around themselves attract attention of other investors even if it is considered only lower transport costs. Local authorities supportive of entrepreneurship and investments, solve also a problem of unemployment, what to some extent relieve tension in local community.

State, just as local authorities, is interested in promotion of entrepreneurship. Favourable investment conditions for enterprises stimulate:

- establishment of more workplaces what decreases unemployment resulting in extra social costs,
- growth of budgetary income in the form of taxes.

It is worth remembering, too, that state is a privileged stakeholder, when the claims are to be satisfied from assets of a bankrupt.

Recapitulating, crisis, in most cases, has its origin in conflicts between internal interest groups. It usually results from greed or egoism of individuals and stakeholder as a whole. D. Czajka<sup>4</sup> notices that the majority of companies which have gone bankrupt had encountered conflicting interests before. Deriving incomparable benefits by various stakeholders is an actual threat to a realization of mission and may lead an enterprise straight to failure. A dishonest game of interests consists in taking advantage of inept and ill-informed partners. If external stakeholders take up a strong position they usually exist at a cost of weaker business partners.

#### **4. Effects of Crisis**

There exists a prevalent conviction that a crisis of a company is only negative phenomenon as it entails different threats like bankruptcy or winding up among other things. However, one has to realize that a crisis is a mixed blessing. Facing a crisis

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<sup>3</sup> See: Gabrusewicz W.: *Podstawy analizy finansowej*. Warszawa: Polskie Wydawnictwo Ekonomiczne 2002, p. 24.

implies changes in an enterprise. Signals about coming financial distress may be a warning and simultaneously an inspiration for decision-makers to change something in management.

A crisis stimulates not only changes in management but also raises consciousness about the way an enterprise should not be governed. In principle financial distress should lead to recovery of a company in the end. It should definitely not trigger legal failure and winding up a company. The latter has to be a last resort in case there is no other possibility of satisfying creditors but winding up a company and sale of its assets. It was in fact, the aim of legislators passing the new Bankruptcy and Recovery Law which replaced old regulations dated back to the pre-war Poland<sup>5</sup>. The new Act established rules and legal proceedings for recovery with respect to enterprises at risk of insolvency. It is a *novum* considering previous regulations.

The legal instrument of recovery proceedings intends to minimise negative outcomes of insolvency and failure of enterprises by conducting effective restructuring of potential bankrupts.

The recovery proceeding encompasses realization of sanative plan which comprises restructuring of assets, liabilities and employment. While a restructuring process is being conducted the following issues, according to M. Kardyś, are of the greatest importance<sup>6</sup>:

• **appropriate moment of the beginning of the restructuring process** – It is a vital matter since postponing the decision may lead to a situation when sanative activities are no longer allowed by the law. The recovery proceedings is reserved entrepreneurs, who settle their current liabilities, however, their economic situation indicates virtual threat of insolvency in the nearest future. The recovery procedure must not be then instituted towards those entrepreneurs who<sup>7</sup>:

- ~ conducted such proceedings within previous 2 years,
- ~ entered a recovery arrangement within previous 5 years from the effective date of that arrangement,
- ~ were comprised under a decision of assets liquidation within the last 5 years from the date of the final decision in the proceedings,
- ~ during previous 5 years, were subject to a bankruptcy procedure concluded with a dismissal of the petition or with a discontinuance of the proceedings due to the lack of assets.

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<sup>4</sup> See: Czajka D.: *Przedsiębiorstwo w kryzysie. Upadłość lub układ*. Warszawa: Wydawnictwo Zrzeszenia Prawników Polskich 1999.

<sup>5</sup> The Act of 28 February 2003 – *Bankruptcy and Recovery Law*, Journal of Laws of 2003, No 60, item 535

<sup>6</sup> See.: Kardyś M.: *Jak uratować firmę od bankructwa*. [www.leszczyński.biz.pl](http://www.leszczyński.biz.pl)

<sup>7</sup> See.: *Report on the Condition of the Small and Medium-Sized Enterprise Sector in Poland in 2002-2003*. Warsaw: Ministry of the Economy and Labor, Polish Agency for Enterprise Development 2004, p. 115-116

• simultaneously conducting of restructuring process in whole company – Drawing up a sanative plan should encompass all areas of management – what, in particular, means that it should be carried out at all levels of management and in all department of a company. Consequently recovery process should be coordinated vertically and horizontally, since only then a revival of an enterprise is possible.

It is worth noticing that the new Bankruptcy and Recovery Law provides a declaration of bankruptcy with a possibility of concluding an arrangement with creditors at each stage of bankruptcy procedure. Declaration of bankruptcy in this form is accepted on the assumption that creditors are likely to gain more than in case of liquidation of debtor's company. Whenever there appears an actual prospect that a debtor, despite poor financial standing may satisfy creditors in a full a suspension of a liquidation procedure can be declared. One can make a judgement that Polish bankruptcy regulations are getting more sanative. However, they cannot be considered entirely comparable with the bankruptcy laws of France or the United States.

## **5. Conclusion**

Unexpected crisis does not have to turn into a failure. In case of careful observations of processes which take place inside and outside an enterprise, managers can react promptly and prevent from unfavourable effects of a crisis. Therefore observation of symptoms and determination of reasons of existing situation become so vital. Problems arise when managers and staff play alarming signals down and thus remain unaware of their mistakes. Deepening crisis can bring about a situation which is a point of no return and the only solution is a legal failure. Consciousness of emerging crisis can have a negative impact on employees. Fear of mutual accusations, mental pressure or guilty conscience release defence mechanism consisting in temporary lack of reaction and apathy towards appearing signals. As a result an attempt at overcoming difficulties begins at the moment in which chance for recovery is slender. Therefore, each enterprise should systematically monitor and register unfavourable trends or events. Creation of a catalogue of threats might contribute to avoidance of sore effects of crisis.

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**Summary**

Nowadays, business activity is characterised by continuous fight for a survival. Conflicts of interests and contradictions between interests of internal or external stakeholders appear very often. Some decisions which are taken by members of interest groups can have unfavourable impact on current business activity and realization of a mission of an enterprise in the end. The paper presents various effects of crisis, drawing attention to opportunities of recovery proceedings appearing in the new Bankruptcy and Recovery Law. This fact does not relieve managers from systematic monitoring of financial standing and external environment of an enterprise. An aim is a quick reaction to signals about possible threats.