

FINANCIAL REPORT QUALITY PROBLEMS WITHIN THE FRAMEWORK OF INSOLVENCY PROCEEDINGS IN LATVIA

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Abstract. The paper presents a more in-depth perspective on the concept and nature of financial report quality problems within the framework of insolvency proceedings for limited liability companies according to the provisions of regulatory enactments in Latvia. Empirical studies have been conducted in 2014 and 2015. In 2015, new regulations governing the preparation of the financial report were developed in Latvia. Author's research of the regulatory enactments drafts found that the new regulations do not take into account the existing problems in the preparation of financial reports within the framework of the insolvency process. The author wrote proposals for the improvement of a regulatory enactment and submitted them to the Ministry of Finance. As a result, the Ministry of Finance acknowledged that the problems identified by the author do exist and made some improvements in regulatory enactment. Although not all of them were accepted by other ministries at the time of writing. At the end of 2015, the inter-institutional meeting decided to create a special working group in 2016, which will work on legislative amendments to balance the various requirements of the regulatory enactments regarding the preparation of financial reports of the insolvency process.

Key words: limited liability company, financial report, insolvency, Latvia.

JEL code: G33, G38, M41, M48

Introduction

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.

Regulatory enactments of Latvia do not define exactly how a company should evaluate its property, claims and obligations in case the company has declared insolvency. However, the regulatory enactments determine the procedures for the evaluation of 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, the majority of accounting specialists consider that in cases when a company enters an insolvency process, to evaluate its property, claims and obligations must be taken into account the evaluation procedures and the conditions applicable to the company under which its economic activities have been suspended and the company has been closed.

The author does not share this point of view and recommends to work on amendments in regulatory enactments to improve the business environment as well as to facilitate collecting

correct budget revenue, because the existing legislative and regulatory requirements do not directly regulate accounting and financial reporting in the insolvency process.

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.

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

- to analyse changes in the number of registered and excluded limited liability companies in Latvia;
- 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 enactments requirements for accounting and financial reporting in the liquidation process and insolvency proceedings in Latvia.

The following qualitative and quantitative methods were employed: the monographic method – in examining, assessing and analysing literature and legal enactments, selecting only

the information related to the present research, describing findings and interpretations; statistical methods, i.e. statistical observation, compilation and grouping of information, calculation of statistical data, analysis of causal relationships and data generalisation; logical analysis and synthesis. The graphic method was employed to show the relationships identified and their nature and form. The logical construction method was used in analysing results and making judgements.

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

Research results and discussion

The existing legislation provides voluntary and forced termination of the activities of a company in Latvia as it can be seen in Table 1.

Table 1

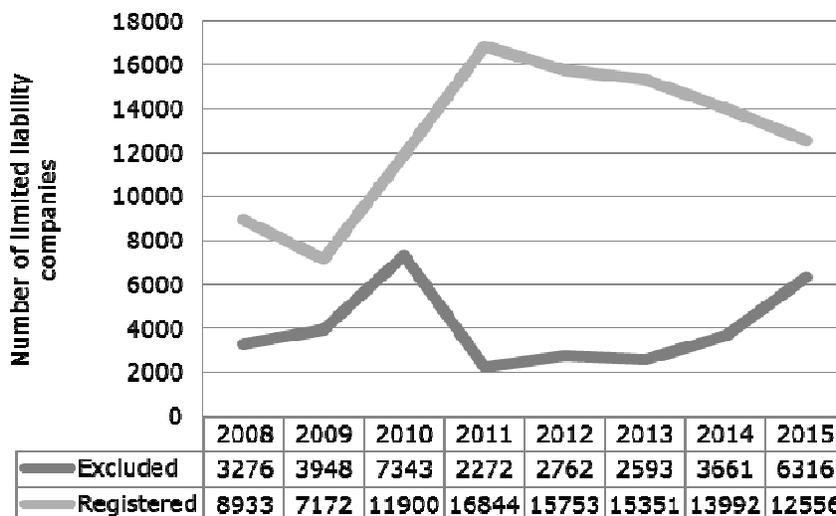
The legal basis of the termination of the company activities in Latvia

Legal acts	Grounds for terminating the activities of a capital company
Commercial Law	by a decision of shareholders
	by a court adjudication
	with the commencement of bankruptcy procedures
	with the termination of the time period specified in the articles of association (if the company was founded for a definite time period)
	having achieved the purposes specified in the articles of association (if the company was founded to achieve specified purposes)
	by a decision of the Commercial Register Office
	by a decision of the tax authority
Criminal Law	by a decision of a court or a public prosecutor regarding the application of a coercive measure

Source: author's construction based on Commercial Law (2000) and Criminal Law (1999)

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 2012 to 2015 (Figure 1). There has been a year-on-year reduction in the number of newly founded companies: in 2012 were 6.48% fewer companies founded than in 2011. In 2013 were 2.54% fewer companies founded than in 2012. In 2014 13992 companies were founded, which was by 8.86% less than in 2013. The number of registered companies continued decreasing also in 2015 when 12556 new companies were

registered, which was by 10.26% less than in 2014. The number of excluded or liquidated companies constantly increased at the same time. The number of excluded companies accounted for 17.53% of total number of founded companies in 2012. In 2015 the number of excluded companies comprised 50.31% of the total number of 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.



Source: author's construction based on statistical data of the Register of Enterprises of the Republic of Latvia

Fig. 1. Dynamics of registration and exclusion of limited liability companies by Latvia's Register of Enterprises in the period 2008-2015.

During the recent five years, on average, 868 legal persons and 1340 natural persons were declared insolvent (Table 2), which negatively affected tax collection in Latvia.

Table 2

Distribution of the number of insolvency cases registered in Latvia by characteristic of insolvency proceedings in the period 2008-2015.

Year	Proclaimed insolvency cases (total)		Insolvency cases for natural persons		Insolvency cases for legal persons	
	number	%*	number	%*	number	%*
2008	1290	-	1	-	1289	-
2009	2202	71%	53	5200%	2149	67%
2010	2773	26%	199	275%	2574	20%
2011	1728	-38%	849	327%	879	-66%
2012	2256	31%	1375	62%	881	0%
2013	2392	6%	1572	14%	820	-7%
2014	2251	-6%	1291	-18%	960	17%
2015	2417	7%	1615	25%	802	-16%
Total:	17309		6955		10354	

* 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

The State Revenue Service calculated that on 1 December 2015, according to Latvian regulatory enactments, the uncollectible tax debts of the companies to be liquidated until the liquidation procedure has been completed were a total of EUR 9.23 mln, which was approximately 0.13% of actual collected tax amount in eleven

months of 2015, and 0.98% of the total debt amount in the same period (State Revenue Service, 2015).

According to the Register of Enterprises of the Republic of Latvia statistical data, the insolvency proceedings were terminated by the bankruptcy procedure, on average, for 1173 legal persons

per year in 2010 and 2011, for 897 legal persons in 2012, 633 legal persons in 2013, while in 2014 and 2015, on average, for 396 legal persons per year (The Register of Enterprises of ..., 2015).

The company's solvency is one of the central problems, which deals with the management of the company throughout the life cycle of a company. The definition of company's insolvency in the economic literature indicates that it can be examined in conjunction with the concepts of "liquidity", "credit" and "financial stability" (Sneidere, 2009).

In general, in the world, research focuses on the causes of insolvency of a company, as the insolvency and bankruptcy of any company affects the following:

- the creditors of a company, including employees who, because of the insolvency of a cooperation partner, cannot recover their investments or regain them in a limited amount (only partially);
- the country in which the company is registered and the business takes place, as the government institutions are not able to collect the previously determined taxes or collect them in a limited amount (only partially);
- residents of the country – because of many insolvency cases that result in bankruptcies in which the government is not able to collect the previously determined taxes, thereby decreasing government budgetary revenues, the government might lack resources for implementing various important social projects, for instance, construction or renovation of infrastructures, which, in its turn, does not foster business development and increase tax revenues (Kelmere L., Jakusonoka I., 2014).

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.

The legislature has determined that the company which is being liquidated must prepare the closing financial report to inform company's creditors and other third parties on the process and the solution.

Financial reports are a structured representation of the financial position and financial performance of a company. The objective of financial report is to provide information about the financial position, financial performance and cash flows of a company that is useful to a wide range of users in making economic decisions (European Commission, 2008).

On the one hand, on the basis of a financial report, the company calculates the tax amount payable to the State Revenue Service and, on the other hand, the State Revenue Service can check whether the company has properly calculated the tax amount payable into the state budget.

At the moment, the Latvian legislation does not define exactly how the company should evaluate its property, requirements and obligations in case the company has declared insolvency. But the laws determine the procedures on evaluating 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, the majority of accountants consider that in cases when a company has an insolvency process, its property, claims and obligations must be taken into account the evaluation procedures and the conditions applicable to the company under whose economic activities have been suspended and the company closed.

Based on the analysis of the existing legislative and regulatory requirements, including those that do not directly relate to the regulation of the accounting and financial reporting in insolvency cases, the author disagrees with this point of view for the following reasons:

1) 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, in order to promote the honouring of the debtor's obligations (Insolvency Law, 2010). 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 for the transition from legal person insolvency process to legal protection process. Legal protection proceedings are an aggregate of measures of a legal nature, whose purpose is to renew the ability of a debtor to settle his debt obligations, if a debtor has come into financial difficulties or expects to do so (Insolvency Law, 2010). Therefore, it is necessary to evaluate and understand whether the company's economic activity within the insolvency proceedings from the accounting point of view conforms 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, after the court has proclaimed insolvency proceedings, a part of the companies continues economic activities for at least a year or for several more years, especially if the company owns property, which it can be leased for rental revenue.

If the company during the insolvency proceeding leases property and benefits from it with VAT taxable revenue and at the same time revalue its property to a value which corresponds to the expected net proceeds of the sale of this object and excludes its property from long-term

investments in current assets, the author considers that there are the following problems:

1) the financial reports do not provide correct information about the company's financial position and lucrative long-term investment. Therefore, the investors may be deterred from investing in this company and without investments the company must use the bankruptcy procedure;

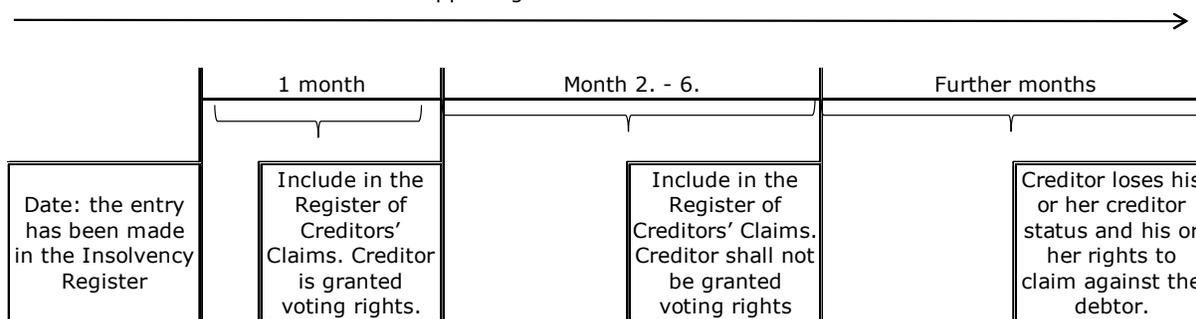
2) revenues and expenses are not harmonised within the reporting period. The property revaluation downwards up to the expected net proceeds of the sale, which is usually a forced sales value, make large expenses and, as a result, this constitutes a loss during the reporting period and the company is not obliged to pay corporate income tax to the state budget. If not reclassifying the property from long-term investments in current assets, then one calculates the depreciation and includes it in expenses and at the end of the period the financial report of the company should be correct - the profit or loss of the period of the lease. If there is a profit, the company has an obligation to pay the corporate income tax.

The obligations must be evaluated to an amount which has been agreed with creditors and there is an obligation to cover the amount if the company is closed through the ordinary procedure of the liquidation without using the instruments of insolvency proceedings (Cabinet of Ministers, 2003). The liquidator shall send a notice regarding the commencement of the liquidation to all known creditors of the company and the creditors of the company shall be invited to submit their claims within three months after the day of publication of the notice, if the company does not have known creditors, determine the term of not less than one month after the day of publication of the notice (Commercial Law, 2002).

The author's research of the Latvian regulatory enactments reveals that due to protection of creditors during the insolvency proceedings, the administrator has no duty to inform all known creditors of the company, except those creditors, whose place of residence or legal address is in another European Member

State, not in Latvia. Creditors' claims against a debtor shall be submitted to the administrator within six months from the day when the entry has been made in the Insolvency Register regarding the proclamation of the insolvency proceedings of a debtor (The Insolvency Law, 2010) (Figure 2).

Creditor submits creditors' claim with supporting documents



Source: author's construction based on Insolvency Law (2010)

Fig. 2. Submission of creditors' claims in the legal person insolvency proceeding

One of the fundamental principles of the insolvency process is the principle of respect for the interests of creditors. It is particularly important to ensure legal certainty and security business environment (Insolvency Administration, 2012).

Analysing the regulatory enactments, the author believes that 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.

The author believes that it is incorrect that in cases where the company has an insolvency process, its property, claims and obligations need to evaluate in the same way as the company which economic activities have been suspended and the company has been closed. The author believes that the fundamental principle of insolvency process has to be taken into consideration and recommends to work on amendments in regulatory acts to improve the business environment, as well as to facilitate collecting correct budget revenues.

In 2015, Latvia developed new regulations governing the preparation of financial reports. The author examined the draft regulatory enactments and found out that the new regulations do not take into account the existing problems in the preparation of financial reports within the framework of the insolvency process. The author wrote proposals for the improvement of the regulatory enactments. For example, to use correct terminology according to insolvency cases (at the time of writing this article, it was taken into account and regulatory enactment draft was corrected). The author drew the attention of the legislator to the fact that the new legislative act did not provide specific requirements for evaluating a company's property, claims 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 enactments.

As a result, the Ministry of Finance acknowledged that the author's found problems exist and made some improvements in the regulatory enactment draft. At the time of writing

this article not all of them were yet accepted by other ministries. At the end of 2015 it was decided at an inter-institutional meeting to create a special working group in 2016, which will work on the legislative amendments to balance the various requirements of the regulatory enactments regarding the preparation of financial reports in the insolvency process (Cabinet of Ministers, 2015).

Conclusions, proposals, recommendations

1) The registration dynamics of limited liability companies was declining in the period from 2012 to 2015. At the same time the number of excluded or liquidated companies constantly increased. The number of excluded companies comprised 50.31% of the total number of founded companies in 2015. 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.

2) Recent five years, 868 legal persons and 1340 natural persons, on average, were declared insolvent in Latvia. It's negatively affect tax collection in Latvia. On 1 December 2015, in accordance with Latvian regulatory enactment, the uncollectible tax debts in total is EUR 9.23 mln of the companies which are in the process of their liquidation.

3) The Latvian legislation does not define evaluating procedures for property, claims and obligations in case the company has declared insolvency. But the regulatory enactments determine the evaluation procedures and conditions for claims, obligations and property in accounting reports and the presentation of financial reports in case the company or its structural unit is liquidated.

4) As there are no direct regulatory requirements, the majority of accounting specialists consider that in cases where a company enter an insolvency process, its

property, claims and obligations must be evaluated in the same way as the company under which its economic activities have been suspended and the company has been closed. The author does not share this point of view for the following reasons: (1) 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 person insolvency process to legal protection process and (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.

5) In 2015, Latvia developed new regulations governing the preparation of financial reports. The author examined the regulatory enactment drafts and found out that the new regulations do not take into account the existing problems in the preparation of financial reports in the insolvency process. The author wrote proposals on the improvement of the regulatory enactment and submitted them to the Ministry of Finance. The author drew the attention of the legislator to the fact that the new regulatory enactment does not provide specific requirements for evaluation of a company's property, claims and obligations and requirements for preparing financial reports, including an annual report, within the framework of insolvency proceedings and to the fact that the new regulatory enactment was not in line with the requirements of other regulatory enactments.

6) As a result, the legislator made some improvements in the regulatory enactment. At the end of 2015, it was decided at an inter-institutional meeting to create a special

working group in 2016, which will work on the legislative amendments to develop and balance the various requirements regarding

accounting requirements and the preparation of financial reports in the insolvency process.

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