

DIFFERENT VIEWS ON DEFAULT RECEIVABLES IN THE CZECH REPUBLIC

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Abstract

The main aim of this contribution is an issue of default receivables. Most common default receivables in corporate life are created during classical trading with business partners when these partners pay late or do not pay at all. This paper discusses the default receivables from business and accounting perspectives. Some presented conclusions are universal but others are relevant only for the Czech Republic. That is especially connected with tax conditions. The value of default receivables could be adjusted for tax purposes. There has occurred a change in the legal framework in recent years and therefore the discussion is focused on these consequences. The issue of default receivables is also influenced on the way of enforcement (individual or collective). The way of enforcement has an impact on recovery rates gained by creditors at the end and also on possibilities of the value accounting adjustment. At the end the paper will summarize findings and specify ways of quantitative research which could be conducted in the future.

Key words: Receivables, Accounting, Tax View, Czech Republic

JEL Code: M21, M41, G33

Introduction

Receivables belong to a usual corporate life. Only small enterprises can avoid it because of receiving all transactions in cash. Receivables are enterprises' assets. They are a main item which is shown in a balance sheet. Receivables are created when clients do not pay immediately because they receive invoices and therefore payments can be realized within an agreed time frame. According to International Financial Reporting Standard (IFRS) 9 receivables are obviously a part of portfolio of financial assets measured at amortized costs (Strouhal et al., 2014). Not only IFRS are used in the Czech Republic because for SMEs it is more usual to work with national accounting standards. For tax purposes the Czech accounting standards have to be always applied. The definition from the Czech legal

framework is important because of tax purposes and especially related to receivables write-off. According to Act no. 563/1991 Coll., On Accounting receivables are measured at real value only in the case of receivables determined for trading because for classical receivables created as a part of business activities are measured at face value (Strouhal et al., 2012).

Receivables are connected with advantages as well as unfortunately with disadvantages (Brealey et al., 2011). The advantages stem from payment conditions which enable the postponed payment within the agreed time frame. The money transfer is not done directly during a “physical” transaction (product, good service etc.) that is on one side more comfortable and on the other hand it is a source of a competitive advantage. Clients are provided with an additional source for financing their business activities. The disadvantages of receivables come with a risk of non or late payment. The non or late payment causes a lack of financial sources which should be solved by other financial links continuing with enforcing of receivables.

The aim of this paper is to focus on receivables in default from business and accounting perspectives. First there are different ways of enforcing receivables. Second there are also accounting possibilities how to deal with problematic receivables. The accounting possibilities have strict rules defined by the Czech legal framework for tax purposes. The legal framework has changed recently. The paper discusses consequences of the aforementioned change and compares the state of the world before and after. Differences among different ways of receivables' enforcing are shown. There can be made a comparison of recovery rates and impact of accounting rules respecting the kind of enforcement.

1 Receivables' enforcing

Two main kinds of receivables enforcing are represented by individual and collective enforcement. Individual enforcing starts with communication as e-mail, phone call or letter and in the case of failure it finishes as forfeiture proceeding. The collective enforcing is mostly known as insolvency proceeding. Forfeiture as well as insolvency proceedings are enforcing of the last instance. The researches done in this field prove that the recovery rate (level of creditors' satisfaction) is low.

Official data are limited and there is a lack of related information for further decision making process in the Czech Republic (Čámská, 2013). First it is necessary to divide debtors into groups as enterprise entities and individuals. The results for these groups are different. In the case of personal bankruptcies individuals have effort to repay maximum of their debts or

at least legal minimum 30% defined by legal law for debt relief (Bokšová et al., 2015 or Paseková et al., 2015). The results for enterprise entities differ for individual and collective enforcement.

Level of satisfaction for collective enforcement is taken from the research done by the University of Economics, Prague (Kislingerová et al., 2013) and supported by other works as e.g. Plaček and Louda (2014). The further discussed sample contains over 3000 cases that represents over 20% of all possible insolvency proposals in the Czech Republic. Many cases finish without bankruptcy declaration and therefore their level of satisfaction is zero. The main reason is a lack of debtors' property accompanied by refused insolvency proposals because of mistakes or unmet requirements, further by unpaid deposit or taking proposal back. At the end bankruptcy is declared in less than 60% of cases. The final level of satisfaction depends on the kind of claim – secured, unsecured and priority covering especially employees' wages and charges of insolvency administrators. The secured creditors are satisfied at the level around 25% of the value of their registered and recognized receivables. The unsecured creditors are satisfied at the level lower than 5% of the value of their registered and recognized receivables. Unfortunately priority claims also do not reach full satisfaction and the recovery rate is less than 68% in average for all monitored cases.

It is difficult to evaluate the level of satisfaction of individual enforcement because the results of individual cases are not publicly available as in the case of the aforementioned insolvency cases. The available average results are not representative because they cover only cases of several systematic creditors. The research included one mobile provider, two banks and two consumer finance providers. The receivables are not divided according to groups of debtor (legal entities and individuals). The results show that there are significant differences in recovery rates among creditors (Arltová and Smrčka, 2015) and also differences among enforcement individual agents or offices (Smrčka and Plaček, 2015) hired by the creditors. The most successful cases occur in the case of mobile operators (recovery rate 80% for the best enforcement agents, recovery rate 40-60% on average). Recovery rate for the first bank reaches 15-25% based on the specific enforcement agent and for the second bank 25-40% depending on the specific enforcement agent. The worst results occur in the case of consumer finance providers who are satisfied only at the level 7-31%, respectively 5-16% for the second provider depending on the used enforcement agent or office.

We let aside the specific way of solving insolvency proposals functioning as reorganization procedure in the case of entrepreneurial entities. Proved by previous numbers

the results of enforcement are not high and they exceed 30% only for special cases as receivables of mobile operators and priority claims. The low level of satisfaction has a serious impact on business environment.

1.1 Business view

The default receivable has serious consequences for the affected enterprise and therefore it is necessary to pay attention to receivables at the beginning. The good receivable management starts as prevention when the enterprise decides about its business partners and contract's payment conditions (Brealey et al., 2011 or Smrčka and Čámská, 2016). This paper is focused on default receivables in whose case the prevention has not function fully. The enterprise has not received the payment during the agreed time frame and even not several weeks after maturity during a cheaper negotiation (reminds by phone calls or letters). The negotiation or enforcement in early phases does not have to be expensive but it can be very effective when the debtors are willing to pay and are able to generate money from their business or obtain additional financial sources (Emery et al., 2007). Later phases are more complicated because of failed early phases and getting worse the debtor's situation.

Individual as well as collective enforcement raises costs which are one consequence of default receivables. Other consequences are connected with corporate financing. The creditor has not received the agreed payment for which the creditor provided already goods or products. This money is missing in short term financial assets for further business functioning as payment of wages, utilities or material. If the enterprise does not have enough high reserve of short term financial assets the enterprise will have to search additional financial links (overdraft, short-term loan or change of payment conditions). Second receivables are the part of accounting and not only receivables but also default receivables have to be displayed in accounting statements.

1.2 Accounting view

The general objective of financial reporting ensured by accounting is to provide financial information about reporting entity that is useful to users of financial statements in making decisions about providing resources to the entity (IASB, 2013). The financial information should be relevant and faithful according IASB, 2013 as well as national rules set up by Act no. 563/1991 Coll., On Accounting. Respecting double entry-bookkeeping the selling of goods or products creates a receivable as a balance sheet item and a revenue as an income

statement item. The information about receivable's default has to be also included in financial reporting which should provide faithful information.

The default receivable (in this context also bad debt) has not been paid until maturity yet and therefore there is a high risk that it will never be paid, the full amount will not be paid or the transaction will raise the additional costs of enforcement (already discussed). The high risk or in other words lower probability of payment will be captured in reporting thanks to prudence principle. The value of receivable has to be decreased according to probability of successful enforcement. It is a case of value adjustment which decreases the receivable value in the balance sheet and creates an expense in the income statement. This task is closely tied to tax law. Although the receivables can be written off 100% they do not have to be fully accepted as an expense tax item decreasing the corporate tax base.

There are two possible methods how to adjust the receivable value. First it is direct write-off method and second it is allowance method. The direct write-off method allows to adjust the value only if it is certain that the bad debt will not be paid in future. It is consistent with the tax view. On the other hand the allowance method enables to adjust the value at the end of accounting period without certainty about nonpayment. The enterprise can write off the proportion of its bad debts coming from pervious experiences or depending on published industry averages. The value of adjustment depends on the corporate decision whose rules should be incorporated into internal corporate regulation in the Czech Republic.

1.3 Tax view

The tax task is difficult due to certainty mentioned in the previous part. The consequences of bad debts can be estimated but estimations and forecasts especially in nowadays turbulent entrepreneur environment never provide 100% reliable conclusion which will appear in the future. The tax law provides precise rules how receivables can be adjusted after a certain time period. From different perspectives it is seen that tax law combines direct write-off method and allowance method. The tax view will be introduced and discussed according to the Czech legal framework (Act no. 593/1992 Coll., on reserves for determining the income tax base) and therefore tax rules in other countries can differ.

The legal framework is usually revised and updated during years. The tax rules are not an exception and they have been changed in the Czech Republic in recent years. This paper discusses possibilities of value adjustment in the case of bad debts (or default receivables) and

therefore we focus only on the law change in this field. The previous as well as current versions will be introduced. The comparison and discussion will follow.

The previous version (valid till 2014) said that the value adjustment is possible at least 6 months after maturity. The maximal adjustment could be 20% of the face value and if the receivable value exceeds 200 000 CZK (for imagination slightly over 7 000 EUR) the receivable has to be enforced actively otherwise the adjustment cannot be processed. Higher tax adjustment can be realized in the case of active arbitration, court proceeding or administrative proceeding. Concrete values are shown in Table 1. Table 1 defines 5 time frames. The exception is insolvency proceeding whose recovery rates proved above are very low. In the case of recognized and agreed receivables during the insolvency proceeding the enterprise can write-off 100%.

It is visible that the law does not define certainty exactly connected with direct write-off method. We can come to conclusion that the used time intervals (frames) are an analogy of the allowance method. The time frames are set up by authorities and they have been chosen according to the development of entrepreneurial environment and respecting experiences with payments (enforcement) of bad debts.

Tab. 1: Time frame of receivables' value adjustment

Receivables in default	Previous legal rule	Current legal rule
12 months	33% of value	---
18 months	50% of value	50% of value
24 months	66% of value	---
30 months	80% of value	100% of value
36 months	100% of value	---

Source: Act no. 593/1992 Coll., on reserves for determining the income tax base – previous and current version

The changing economic environment has an impact on the change of legal framework. Since 2014 the number of time frames enabling receivables' write-off has been reduced. The new version worked only with two frames (50% and 100% write-off). There occurred also other modifications and therefore the paper will discuss detail only the current version. The last version is valid since 2015. As it is displayed in table 1 there are only two time frames, 18 months after maturity for 50% write-off and 30 months for 100% write-off. It can be used for

all receivables created during business trading operations. There is an exception for receivables over 200 000 CZK (for imagination slightly over 7 000 EUR) which have been transferred from the original creditor entity to another entity and therefore they function as short-term financial assets. These receivables have to be actively enforced via arbitration, court proceeding or administrative proceeding otherwise they cannot be written off at all. The receivables recognized and agreed at insolvency proceedings stay aside and they can be written off at their full face value. Special conditions are valid for small receivables not exceeding 30 000 CZK (for imagination slightly over 1 000 EUR) which can be adjusted at their full value 12 months after maturity.

The first comparison of previous and current version is provided by table 1. The reduction of number of time frames is crucial. It is a simplification which makes orientation in the value adjustments easier as first and as second it simplifies administration of receivable management. The time intervals are extended at the beginning when 12 months frontier disappears but on the other hand at the end there is shortening from 36 to 30 months. The change of influence of money time value is not significant on average because there is trade off between extension and shortening. On the other hand the absolute influence of money time value is high. 30 months after maturity are 2.5 years during which the enterprise does not have the money but also it does not have tax benefit although the enterprise has paid taxes from this equivalent revenue.

More serious impact comes from the condition of active enforcement. Classical business trading receivables do not have to be actively enforced for further value adjustment. It is only a case of receivables created as short-term financial assets. Previously enterprises were pushed into active enforcement otherwise they could not be processed the value adjustment. Nowadays they have a free choice. They can decide and respect actual conditions. Unfortunately active enforcement raises additional costs. The enterprise compares possible advantages of enforcement with its costs. Advantages depend on the probability of successful enforcement. Sometimes estimations of future payments from bad debts are equal zero or bellow costs of enforcement and therefore enforcement does not have an economic sense in this case. The kind of enforcement can be described as transaction costs. According to good decision making the enterprise will not start or will not continue the active enforcement process when transaction costs exceed future benefits. In practice this should be verified and be a part of corporate receivable management.

The receivables in the insolvency proceeding have exceptional unique position. In this case the value adjustment is 100%. The extra position of the insolvency proceedings should help the maximal effort of time shortening of proceeding and return of assets back into economic system accompanied by quicker tax benefit. On the other hand researches show that many enterprises come into the insolvency proceedings almost without any property (Čámská, 2013 or Kislingerová et al., 2013). It is possible that even majority of receivables has already been adjusted by 50% (18 months time frame). This assumption is very interesting idea which should be confirmed by further research. The research would or would not prove if the exceptional unique position has a sense or if receivables have already been partly adjusted because insolvency proceedings start to late in the Czech Republic.

Conclusion

This paper was focused on the default receivables (bad debt created by business trading transactions). The default receivables were described and discussed from different points of view. The entrepreneurial aspect complicated financing and further enterprise functioning was followed by the accounting perspective which is closely tied to tax view. The legal framework strictly defines the rules enabling the receivables value adjustment for tax purposes. The change of legal framework and conditions for the receivables in the insolvency proceedings opens new task which can be verified by further research. The receivables in the insolvency proceedings have on one side unique position for the value adjustment but maybe the consequences are not so serious because of late insolvency proposals and therefore 50% of the receivables' face value could be already written off using the expense item value adjustment.

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