

# Ways of identifying and addressing financial issues early (1) 2/35/21



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The year 2021 and the current macroeconomic cycle have brought a number of adjustments and uncertainty about the future to households (private consumers), businesses of various sizes, and policymakers. Covid-19 and related paradigm changes, the risk of recurrent pandemic, disrupted logistics and supply chains, and other factors create substantial risks affecting companies' ability to stay in business and grow. This article explores common causes of financial distress and debt restructuring tools, including how companies can reach an agreement with the State Revenue Service on paying taxes.

## Financial distress

Financial distress means a situation where a company is no longer able to settle its creditor claims. A company commonly faces this situation when its fixed costs are high, assets are illiquid, and/or cash flow sources are very sensitive to economic shocks.

For Latvian businesses – particularly small and medium companies that mainly provide services – it is crucial to find ways of detecting and preventing financial issues early. It takes considerably less time and money and the financial risks are easier to manage if a company puts in preventive work instead of waiting and seemingly economising in the hope that the circumstances will remain fundamentally unchanged and will not throw the company into financial difficulty. That is not what usually happens, so preventive investment pays off, and let us also remember the saying “buy cheap, buy twice.”

If the company still finds itself in financial difficulty, it should expect the following consequences:

- Prospective equity investors raise the risk premium;
- Creditors factor in a higher financial risk (i.e. higher interest charges and tighter conditions);
- It is difficult to retain staff and there is a risk of decreased productivity;
- A tighter and less advantageous supply chain flow;
- Corporate reputation risk.

## Mitigating the risk of financial distress

First of all, informed financial management decisions and properly set requirements for finance staff. The CEO should clearly separate areas of structural responsibility: regularly checking up on financial targets, identifying and attracting various types of financing, monitoring financial risk etc. Formal accounting services or the chief accountant formally performing the financial management function, or a lack of financial management strategy, are among the common risk factors in the context of financial distress.

A second key aspect is macroeconomic monitoring of the relevant business segment. To detect structural risks and changing business fortunes early, the CEO should monitor the current and the expected economic environment, including a clear picture of the closest rivals' issues and business development.

Third, liquidity management is key. The company's operations should be based on a sound liquidity management policy and strategy. This includes working capital and cash flow management and asset liquidity, as well as identifying ways to obtain new liquidity fast.

Finding itself in financial difficulty may create a number of painful restrictions on the company and put its long-term existence at risk. Early investment is needed to mitigate the future risk of financial distress. Boosting financial management with competent and experienced professionals and appropriate monitoring of financial and business risks is a vital task for companies operating under uncertain and changing conditions.

## Debt restructuring tools

### *An out-of-court settlement*

If a company already has or is at risk of having financial issues in the foreseeable future, Latvian legislation offers a number of solutions that companies can use to restore their financial health. First, we should use an out-of-court settlement with creditors but its content is not prescribed by law. To ensure that negotiations between the parties are successful, it is advisable to follow debt restructuring guidance jointly issued by the Ministry of Justice, the Insolvency Control Service, and social partners. The principles stated in the guidance should be put into practice, not only grasped theoretically.

One advantage of an out-of-court settlement is that it requires the lowest direct costs (practically zero, although we should certainly allocate more resources to pay for extra working hours put in by management and key employees). The process of reaching an out-of-court settlement also offers more scope for maintaining confidentiality, as the parties can address any problems without involving other creditors, which is often useful in terms of preventing other stakeholders from becoming concerned. Another benefit is that an out-of-court settlement does not impose any mandatory restrictions on handling the company's business. The only downside of an out-of-court settlement is that it does not offer a solution where the debtor is unable to agree with one of the creditors to be included in the debt restructuring agreement.

### *Legal protection proceedings and out-of-court legal protection proceedings*

In more complex cases (if no agreement is reached with the creditors, some will start enforcement action, such as demanding that the commercial charge be sold) we can use court protection through legal protection proceedings (LPP) or out-of-court LPP, a derivative. These cases still require approval from a statutory majority of creditors but do not require the consent of all creditors, so LPP or out-of-court LPP break a deadlock that may arise in the case of an out-of-court settlement if the company fails to agree with all the creditors necessary for debt restructuring. In other words, a court-approved plan for LPP or out-of-court LPP is binding on everyone, including the dissenting minority creditors. In the case of LPP or out-of-court LPP, the company should expect various restrictions on its activities because during these proceedings the debtor may carry out only the activities and payment obligations that are included in the LPP plan or approved by the person supervising the LPP in writing. The cost of LPP or out-of-court LPP is much higher, though. Initiating these proceedings is subject to a stamp duty of EUR 145, yet the bulk of expenses are incurred in drawing up a plan for LPP or out-of-court LPP, which may cost from a couple of hundred euros to upwards of 5,000.

(to be completed next week)