

# Discipline, Good Faith and Payment's Loyalty – Main Factors for Reducing the Corporate Indebtness in Bulgaria

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**Abstract** - As a member of the European Union Bulgaria is subject to monitoring, including in the field of economy. Our country complies with the rules and procedures imposed by the common European policy. Although recent analyses indicate a slight decline in corporate indebtedness, it also maintains the same high levels, thus it hides certain risks for businesses in all sectors of the economy. The delayed payment to a counterparty leads to an avalanche of delayed payments. The need for discipline, good faith and fair payments is tangible.

**Keywords** - payments, receivables, obligations, overdue receivables and obligations

## 1. Introduction

It is a fact that there are high levels of corporate debt in Bulgaria. According to a study of the Bulgarian Industrial Association [7] the increase of the liabilities of the nonfinancial sector for the period 2005 - 2012 has increased by 102 billion BGN - from 67 billion BGN in 2005 to over 169 billion BGN in 2012. The main part of the corporate liabilities are towards suppliers, related to companies and financial institutions. An increase in short-term liabilities is reported which grows with much higher rates than the long-term liabilities. The growth of short-term debt shows that the activity of non-financial enterprises is hampered by insufficient working capital with which they serve their production activities. Alarming is the growth of intercompany liabilities compared to 2011. It is increased by nearly 6 billion BGN, reaching 113 billion BGN. At the end of 2012 the total amount of enterprises' receivables of the non-financial sector is 71.5 billion BGN, of which 561 million BGN (0.8%) is past due (over 90 days). Long-term receivables (over 1 year) amounted to 8 billion BGN (12% of all), of which 7.6 billion BGN (95%) are commercial loans and leases. At the end of 2012, the state, the municipalities and enterprises with prevailing state and / or municipal property owed to companies 2.6 billion BGN, including 2.3 billion BGN a government debt and 360 million BGN a municipal debt.

The overdue liabilities at the end of 2012 amounted to 284 million BGN, including 111 million BGN from the state and 173 million BGN from municipalities and at the end of 2013 it was 152 million BGN state liabilities and 162 million BGN from the municipalities. The study reported persistent negative correlation between the amount of the liabilities of non-financial corporations and their sales' income.

The conclusion that we have based on the submitted information is that the debt of non-financial companies remains high. Growth in total liabilities and those in arrears increases the uncertainty among market participants. Risks are increased in payments between entities in commercial transactions leading to the delivery of goods or provision of services for remuneration.

## 2. Main characteristics of receivables and liabilities

In the process of carrying out its activities each enterprise enters into certain relationships with other companies - organizations other than public authority involved in the execution of its independent economic or professional activity even when it is carried by a single person [9]. In most of the given cases the relationship is related to purchase and sale of goods and/or services, therefore creates trade relations (commercial relations). By definition set out in Directive 2011/7/EC of the European Parliament and of the Council of 16 February 2011 on combating late payment in commercial transactions, *commercial transactions* means transactions between undertakings or between undertakings and public authorities which lead the supply of goods or provision of services for remuneration [9]. A similar definition is given by the Glossary of accounting terms, where it is stated that the deal is essential for the purchase or sale of assets or services [1]. We adhere to the definition of a commercial transaction in Directive 2011/7 / EC. Commercial transactions in turn give rise to receivables and payables. Trade receivables are one

of the most widespread financial assets. They are recognized as an asset in the company and thus become a carrier of information about the financial and property status. This makes them a factor, directly related to the accuracy of the financial statements. Usually receivables result in the normal course of operations and are of operational nature. Sometimes, however, they "linger" and collectability becomes questionable. The payment of one party is a receivable for the other party of the transaction. The obligation is a commitment of the debtor to give, to do or not something. Obligations may arise under law or under contract. Debtor (the debtor) can be both enterprise and a citizen. The late payments are liabilities, obligations on debtor reflected in its financial statements. They are reflected in the accounts of the other party (the lender) the asset side of the balance sheet as receivables, and in its own accounting - the liability side of the balance sheet as liabilities. Late payments are estimated and recorded as incurred at historical cost or other cost in accordance with applicable accounting standards [3], [5]. A late payment is considered a liquid one when it is determined by a reason and an amount. When the payment deadline of a late payment is extinguished, it becomes due. It should be noted that according to the *Law on Obligations and Contracts*, if the obligation is without limit, the creditor may demand its implementation immediately. [2] Liabilities are short-term - with a maturity of 12 months after the balance sheet date, and long-term - all the others. In accordance with applicable accounting standards [4], [5], the entity shall determine its interest-bearing liabilities as non-current, even when they should be settled within 12 months of the balance sheet date if:

- the initial period of settlement was more than 12 months;
- the entity intends to refinance the obligation on a long term basis;
- the intention is supported by an agreement to refinance or to reschedule payments, which is before the approval of the financial statements.

When the credit agreement provides immediate recoverability it is classified as short term if:

- prior to approval of the financial statements the debtor has agreed not to demand payment as a consequence of a breach of the conditions and
- unlikely to breaches of the requirement within 12 months of the balance sheet date. Timely payment (settlement) of the monetary obligations in commercial transactions, as agreed between the parties,

helps maintaining good liquidity and financial strength of counterparties and vice versa - late payments have a negative effect on the liquidity of companies and complicate the financial management. Because of the delay in payment the contractor (creditor) incurs losses and is forced to seek external funding. Competitiveness and profitability of the enterprise creditor get worse. The above described situation is typical not only for Bulgaria but for a number of member states of the European Union. A similar situation can be observed in countries outside the European Union.

In order to protect the interests of enterprises in the EU, the Council adopted Directive 2011/7 / EC of the European Parliament and of the Council of 16 February 2011 on Combating Late Payment in Commercial Transactions. The purpose of the introduction of *the Directive Combating Late Payment in Commercial Transactions* in terms of ensuring the proper functioning of the internal market by promoting the competitiveness of enterprises, in particular small and medium enterprises. In its Communication of 25 June 2008 entitled "Think Small First", the Commission stresses that the access of small and medium enterprises (SMEs) to finance should be facilitated and should develop a legal and business environment that is conducive to timely payments of commercial transactions [10].

State authorities have a particular responsibility. One of the priority actions in this direction is the reduction of administrative burdens and promotion of entrepreneurship. If it is possible the public authorities should ensure that, in general invoices for supplies and services, including SMEs, are paid within one month to ease liquidity constraints. It is clear that we should impose a "culture" of payments.

### **3. Payment deadlines of monetary obligations – positive and negative characteristics**

As a member of the EU Bulgaria should synchronize its legislation in accordance with the one adopted by the Commission's rules and procedures. In relation to the requirements of Directive 2011/7 / EU by introducing in the Trade Act of special rules on deadline limits for payment of monetary payments in commercial transactions and the consequences of failure to comply with the deadlines established for payment. These new rules apply to contracts signed after March 15, 2013 [6]. It is important to note that outside the scope of the Directive are transaction

deals with consumers, and therefore not included as settling time. There is no settlement and remain outside the scope, the interest in connection with other payments, i.e. payments under the laws on cheques and bills or payments made as compensation for damages including payments from insurance companies. Member States should also be able to exclude debts that are the subject of bankruptcy proceedings, including proceedings aimed at debt restructuring. The introduction of deadlines aims on the one hand to discipline parties to commercial transactions and on the other - to provide them with comfort and security of the customary activities. Legal deadlines for the payment of monetary obligations in commercial transactions are referred to in article 303a of the Commercial Code and are as follows [6]:

- no more than 60 days - the parties of a commercial transaction may agree on deadline of a payment but no more than 60 days, except as may be agreed and for a longer period if required by the nature of the goods or services or for another important reason, if it is not grossly unfair to the creditor's interest or good morals;
- no more than 30 days - when the debtor is a public contractor, the parties may agree on execution deadline for a payment no more than 30 days, except as may be agreed and for a longer period but not more than 60 days when required by the nature of the goods or services or another important reason, if it is not grossly unfair to the creditor's interest or good morals;
- 14 days from receipt of invoice or other request for payment – if there is no agreed payment period, a charge must be met within 14 days of receipt of invoice or other request for payment. When the day of receipt of the invoice or call for payment can not be established or when the invoice or the call is received before receipt of the goods or service, the period begins to run from the day following the day of receipt of goods or services, regardless of the fact that the invoice or call for payment are before that;
- where the contract or the law provides for review or approval of the product or service, the 14-day period begins to run from the adoption or the completion of the examination. If the invoice or call for payment is received before the deadline for review or approval that is 14 days of receipt

of goods or services, but a longer period for review or approval may exceptionally be agreed, where required by the nature of the goods or services or for any other important reason.

Despite the above written periods in some cases there is a delay of payment - payment is made later than specified in the contract or in the invoice. There is a damage to the creditor. Late payment is inherently a breach of contract. It (the delay) is possible and unfortunately it become "attractive" to the debtor due to lower interest rates on late payments and / or the absence thereof, and / or slow appealing procedure. Thoroughly studying the law of a Member State of the EU, and not only, and finding such "gaps" in the law the debtor in a commercial transaction starts to delay payment, which is unacceptable and risky for the creditor. In order to protect the creditor in the relevant legislation, respectively the law, there should be introduced texts which protect itof incurring such costs, protect their rights, and "compensate" for damages. In order to protect the creditor in line with the timing of the legislation with the European law, lawmakers have introduced certain passages in the Commercial Code. In article 309 of the code it is stated that if it is not otherwise agreed, if the debtor has delaying payment, the creditor is entitled to compensation at the statutory rate from the date of the delay, as well as compensation for recovery costs receivable in the amount of not less than 80 lev, without the need for an invitation. A compensation for incurred actual damage and expenses due to collect in a higher amount may be claimed under the general rules. Limitation of liability of the debtor may be agreed only if it is grossly unfair to the creditor's interest or good morals. [6]

The consequences of late payment can be dissuasive only if accompanied by a rapid and effective review procedures for the creditor. Judicial claims related to late payments are facilitated by the European Commission's regulations, namely Regulation (EC) № 44/2001 of 22 December 2000 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters Regulation (EC) № 805/2004 of the European Parliament and of the Council of 21 April 2004 creating a European Enforcement Order for uncontested claims, Regulation (EC) № 1896/2006 of the European Parliament and of the Council of 12 December 2006 establishing a European order for payment and Regulation (EC) № 861/2007 of the European Parliament and of the Council of 11 July 2007 establishing a European procedure for small claims interest.

#### 4. Advantages and disadvantages of affirmative actions to reduce the company's debt

In connection with the settlement of trade receivables and payables the mediation and other means of alternative dispute resolution are promoted. Directive 2008/52 / EC of the European Parliament and of the Council of 21 May 2008 on certain aspects of mediation in civil and commercial matters [11] sets a framework for systems of mediation at Union level, in particular in cross-border disputes without preventing its application to internal mediation systems. The advantages of the use of mediation as an alternative dispute resolution and the ability to reach an agreement on debt repayment are as follows:

- looking for and usually solving the conflict by an impartial (third) party such as the mediator;
- participation in the procedure is voluntary;
- tendency to arrangement is high;
- speed of the procedure and low cost;
- looking for a decision granting both sides.

A major disadvantage of mediation which can be specified as a risk on the collection of a receivable is the popularity of the method, which is negligible, and the lack of tradition in our country.

In Bulgaria over the past three years it's been practiced another extrajudicial debt recovery-recovery by assigning specialized enterprise - collector. Collection agencies professionally involved with recovery of debt. They have trained staff who knows the techniques of negotiation with the aim of realizing the claim. They use in the process of their activity a specific software.

The advantage of outsourcing the collection of receivables is that of an entity that has a claim and / or claims from a client, transferring it to another entity is not required to invest in their own infrastructure (phone central, specialized software and other necessary equipment) and staff training. The risks and disadvantages of the given method for settlement of receivables are as follows:

- Searching claim which has expired under the applicable law – we recall that according to Article 110 of the Law on Obligations and Contracts with the expiration of five years old period shall be extinguished all claims for which the law does not provide for another period [2]. As an additional argument pointing to the provisions of Article 111 of the above mentioned law that

the expiry of the three-year limitation period shall be extinguished: claims for compensation for work which is not provided for another prescription; claims for damages and penalties of unfulfilled contract; claims for rent, interest and other periodic payments [2];

- Initiating a procedure for unpaid claim without the debtor being notified of the assignment of the claim - according to art. 99 of the Law on Obligations and Contracts creditor may assign his claim, unless the law, the contract or the nature of the claim states otherwise. In that legislation is stated that assignment relates shall pass to the assignee privileges, collateral and its other accessories, including interest accruing, unless agreed otherwise. It is pointed out that previous creditor must notify the debtor transfer and to deliver to the assignee the relevant documents that establish the claim, as well as to confirm in writing the transfer that has happened. The transfer is effective against third parties and against the debtor on the date when it is announced on the last of the previous creditor. [2] It should be pointed out that the transfer is also known as cession. Under this contract a claim is transferred from one medium to another. The party that transfers the claim is called Cedant or the "old creditor". The party that accepts the claim is called the assignee or "new creditor". In the assignment, the third party, which in this case is the debtor, is not directly involved. Its role consists of the fact that after the transfer it must be informed by the cedant;
- Payment of the claim to the "old" creditor and the "new" creditor, which for lack of knowledge related to the transfer of the claim, ignorance or deliberate deception, the debtor pays twice;
- Sending letters and making phone calls between the collector and the debtor without complying with the terms and procedures for the notification;
- Implementation of unacceptable methods for the recovery of claims - wrongful acts against the personality of the debtor or his relatives through psychological pressure, pressure from employer threats.

Considering the possibilities for settlement of trade receivables and payables, we should present shortly, settlement of claims where the debtor is a public contractor. As already mentioned at the end of 2012, the state, the municipalities and enterprises with prevailing state and / or municipal property owe to companies 2.6 blnBGN, including 2.3 bln BGN government debt and 360 million BGN municipal. Arrears at the end of 2012 amounted to 284 million BGN, including 111 million BGN from the state and 173 million BGN from municipalities and at the end of 2013 were 152 million BGN state and 162 million BGN municipalities [7]. As set out in Directive 2011/7 / EC of the European Parliament and of the Council of 16 February 2011 on Combating Late Payment in Commercial Transactions, as a general rule the public authorities benefit from more secure, predictable and continuous revenue than businesses. In addition many public authorities can obtain financing at more attractive conditions than businesses. At the same time in achieving their goals the public authorities depend less than undertakings on building stable trade relations. Long payment periods and late payment for goods and services by public authorities incur unreasonable costs on businesses. It is therefore appropriate to introduce specific provisions in respect of commercial transactions for the supply of goods or provision of services by the State authorities, in particular, it should provide for payment periods normally not exceeding 30 calendar days, unless the contract otherwise agreed and provided it is objectively justified by the particular nature or features of the contract, and in any event does not exceed 60 calendar days. [8]

It is important to note that documentation in commercial transactions, and not only it, is of utmost importance. The fact that the invoices trigger requests for payment makes them important documents in the chain of transactions for goods and services. Invoices play an important role in determining the final date for payment. In this regard the European Union promotes systems that provide certainty as to the exact date of receipt by the debtor of the invoice, including in the field of e-invoicing, where the receipt of invoices could generate electronic evidence.

All these measures and deadlines are aimed toward procedures for recovery of unchallenged claims, related to late payment in commercial transactions completed within a short period, including through an expedited procedure and irrespective of the amount of debt. A key point here, and we believe that we should make efforts in this direction, is the dialogue between the parties and their awareness. Working with debts and arrears different organizations face every day on the one

hand with serious information deficits on the other - with a conscious (or not) failure of communication between the parties. From this situation, unfortunately, we all lose. Increasingly serious activity of creditors towards assigning receivables collection of specialized agencies or start legal proceedings is undoubtedly a positive sign, showing a willingness to tackle the problem of corporate indebtedness. Despite the efforts of creditors to collect their debts, risks relating to their settlement are there.

## **5. Major payments' risks in commercial transactions**

Based on the above written, without claiming that we are exhaustive, may be mentioned the following main risks in payments in commercial transactions:

- delay by the debtor to the statutory deadlines for repayment to the creditor;
- "gaps" in the law of a country allowing the debtor to delay payment;
- different interpretations of regulations and the possibility of abuse;
- late payment by public authorities;
- limiting the "freedom of contract", which could lead to harm to the creditor;
- assignment (cession) without notifying the debtor;
- extrajudicial debt recovery;
- different periods on the treatment of delay;
- passage of arrears in uncollectible and its deletion;
- relegation of the debtor in bankruptcy;
- lapse of time.

## **6. Conclusion**

There is hardly a company on the market which in recent years has not suffered trading losses because of delayed payments. Debt is accumulated. Products for which money is owed have long been sold. Trader refuses to pay its obligations. Creditor, i.e. manufacturing company, can not take the money through the courts, as it is possible that the debtor has no assets with which to meet its obligations. The wheel of indebtedness is spinning. Manufacturers delay salaries of their employees and can not pay suppliers, and assumes no new orders, because there is no money for materials. A similar fate is shared by businesses in the manufacturing and the businesses in the service sector. The described situation illustrates the alarming reality of high corporate indebtedness in

Bulgaria, which inevitably leads to risks in settlement of claims and liabilities. Where companies once "get hot", they begin to change the way of payment. If companies are in a strong position in the market, some of them use the opportunities provided by the advance course at the expense of price and market share. Other use bank tool to guarantee claims. Some companies attempt to exploit customers in advance to see if they can implement the mechanism of suspension. The conclusion to be made is that corporate debt requires and necessitates the development and implementation of a comprehensive system for managing the risks of a late payment. The key to reducing the arrears, we believe, is the imposition of discipline, integrity and loyalty in payments.

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