

## **The Economic Crisis and Working Capital Management of Companies**

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**Abstract.** *This article aims to highlight the impact of the economic crisis in the economy at the microeconomic level. The crisis that began in 2007 as a financial crisis, naturally grown into an economic one. Reduced availability of capital has reduced demand from vendors. It also worsened the possibility of rational adaptation, because the company had to deal with only short-term problems and there was not the opportunity and time for strategic management. The biggest problems hit the long inefficient firms (that survived only thanks to temporary excess demand) and growth-oriented businesses, which focused only on short-term time horizon. Paradoxically, firms that have had long-term ineffective conservative financing coped relatively well with the crisis by releasing detainee excessive working capital. At present there is uncertainty and companies are afraid of further development, which, as shown in the article, leads to further problems with working capital.*

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**Keywords:** crisis; corporate finance; working capital; strategic management; operating management.

**JEL Codes:** G30, M31.

**REL Code:** 14B.

## Introduction

The economic crisis was at first a shocking news, which hit the US and European countries were awaiting its direct impact, many politicians (certainly in the Czech Republic). Long after the outbreak of the crisis, many European politicians called the crisis a panic that the Czech and other European states do not need to concern about at the moment. For example, the Czech Finance Minister Miroslav Kalousek was talking along these lines (Kalousek, 2008: p. 4) even in October 2008 (once again awarded the prize for the best finance minister of Eastern Europe). The reason for optimism was the absence of the so-called "bad loans" because Czech banks went through the great credit crisis in 1997 and didn't have any major problems before the onset of the crisis. The volume of loans fell by 14%, which would not cause the liquidation of companies. Gradually, however, the situation showed that a small economy, whose industry is largely linked to the automotive sector, could not avoid problems. In 2007, capital base of companies was about a quarter higher than in 2000, as well as asset performance. What has also increased – though not so vastly – was the creation of added value in relation to performance. Although the equity capital of banks did not reinforce its position as much as equity capital of firms, the pre-crisis volume of bad loans was considerably lower in 2008 than in 2001. The strong corporate and financial sector allowed them to cope with the huge drop in foreign demand. According to Singer (Governor of the Czech National Bank) another positive aspect was the fact that Czech banks and companies were in many cases led by managers with valuable experience from previous crises.

### The impact of the crisis on the Czech economy in data on the macroeconomic level and other assumptions

When monitoring the impact of the crisis in each country in comparison with other countries, the most commonly used measure is the HPD development (Gross Domestic Product), Figure 1 shows the development of the crisis reflected using the GDP scale. It is evident that the Czech Republic, like most other states hit by the decline in 2009, then followed the process of economic recovery. The slowing growth rate, indicated by the interim results of 2011 raises many questions:

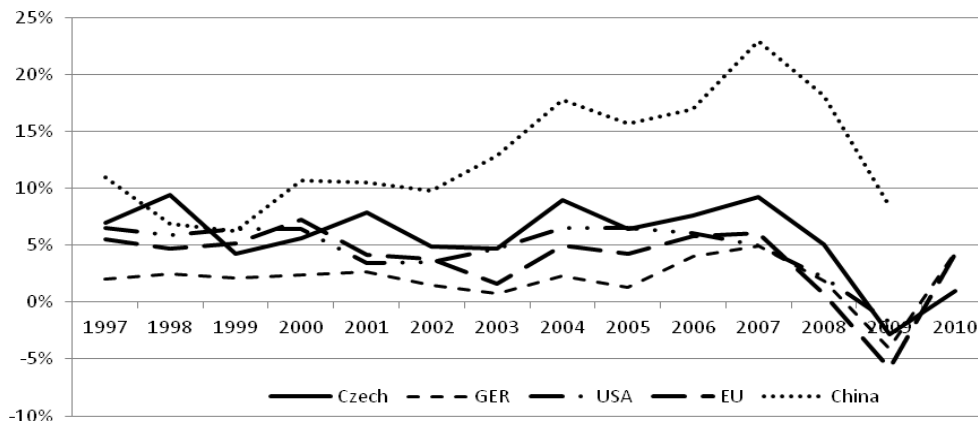
Should we expect another wave of crisis? (The "W" curve)

Will the second wave be any deeper or mild?

At the company level it is necessary to ask the following:

Are businesses ready for the crisis?

Do these businesses have the tools to continue to face adverse developments?



Source: own adaptation from OECD, 2011.

Figure 1. Development of GDP in recent years in selected countries

Czech Statistical Office tracks the so called confidence indicators in order to produce short-term predictions and analysis (Czech Statistical Organization, 2011).

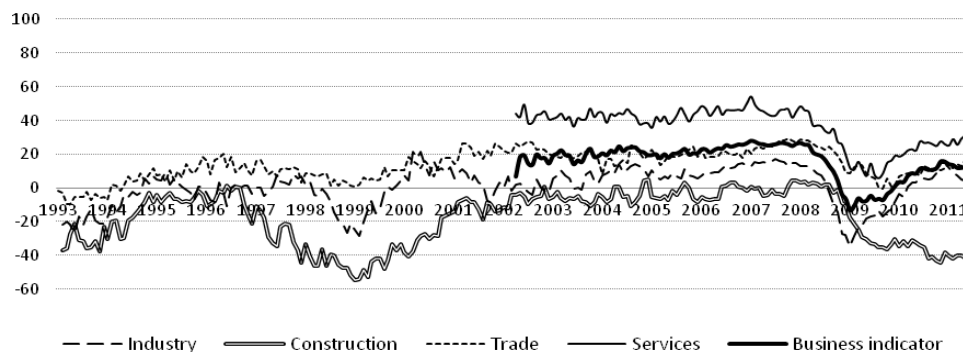
Business cycle surveys carried out in the enterprise sphere are an important source of information in the countries the economy of which is based on market relations; they provide information on expected tendencies in the development of main areas of enterprise economy in the nearest future. They are important especially because they show the atmosphere in enterprise environment and provide information well in advance and thus serve to identification of turning points in economy and provide information also for such areas that are difficult to describe by quantity data. In that sense business cycle surveys are organized and used in countries with developed market economy already for decades.

The branch confidence indicators are constructed as averages of seasonally adjusted weighted business cycle balances. The business cycle balance is the percentage difference between the responses “growth (+)” and “fall (-)”.

The confidence indicator for industry is the average of seasonally adjusted balances of three indicators (the assessment of total demand, assessment of stocks of final production, with inverted sign, and the expected development of production activity). The confidence indicator for construction is the average of two indicators (the assessment of total demand and the expected development of employment). The confidence indicator for trade is

the average of three indicators (the assessment of economic situation, assessment of stocks, with inverted sign, and the expected development of economic situation). The confidence indicator for selected services is the average of three indicators (the assessment of economic situation, the assessment of demand and expected demand).

The consumer confidence indicator is the average of four indicators (expected financial situation of consumers, expected total economic situation, expected total unemployment, with inverted sign, and savings expected in 12 months to come).



**Source:** own adaptation from Czech Statistical Organization, 2011.

**Figure 2.** *The development of confidence indicators in the Czech Republic*

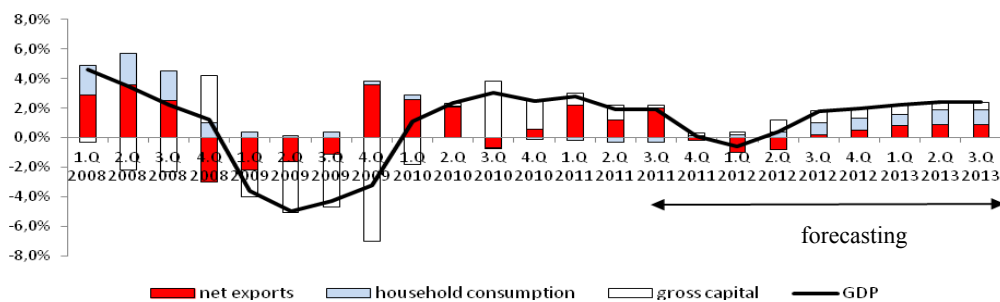
As we can see in Figure 2, the composite confidence indicator recorded stagnation and decline in recent months (the latest data is from September 2011). The reason for this is can be attributed to the stable pessimistic expectations in construction, but also a decrease in optimism in terms of Services, Trade and Industry. To illustrate the point, it is possible to point out the comparison how the expectations for the development of GDP in EU-27 are evolving (see Table 1). In addition to the OECD, which is lagging behind in their predictions, the table mirrors a clear pessimism of professional circles in comparison with previous predictions (data from September 2011).

Table 1

GDP forecasting				
Organization	Month/year of prediction	Predicted GDP growth for year 2011	Date of last prediction	Change from previous prediction
Consensual Forecast (CF)	9/11	1.7	8/11	-0.2
International monetary fund (IMF)	9/11	1.6	6/11	-0.4
Organisation for Economic Co-operation and Development (OECD)	5/11	2.0	11/10	0.3
Europe Commission (EC)	9/11	1.6	5/11	
European central Bank (ECB)	9/11	1.6	6/11	-0.3

**Source:** processed according to the sources stated in the table.

Predictions about future growth are quite sceptical. A good illustration of the Czech perspective may be provided using two options for further prediction: Figure 3 shows the prediction of GDP, according to Czech National Bank analysts, which expects a further decline in 2012, that the source of growth in 2013 will mainly be household consumption and net exports.



**Source:** own adaptation from Dubska, 2011 and Czech Central Bank, 2011, p.15.

**Figure 3.** GDP development – history and forecasting

It can be stated that the professional community and its predictions are definitely not optimistic and residents and businesses cannot expect a period of growth for another so-called post-crisis period, but rather a period of stagnation and decline.

### Companies and crisis

The empirical research making at Faculty of Business Administration of Economics in Prague in a form of questionnaire investigation was done in the terms of the solution of research intention MSM 6138439905 “New theory of

organizations' economy and management and their adaptation processes". This investigation was done before the period of economic and financial crisis at the edge of year 2007 in chosen Czech enterprises (in total 252 well filled questionnaires were gained and elaborated). Each questionnaire contained 77 basic questions focused on enterprise's economy and management and other 15 questions aimed specially at logistics. Most questions were conceived so as the examined one could answer by choosing one or more possibilities or by a particular value if you like.

Our survey has shown that (adapted from Kislingerova, 2007):

- 48% of companies expected, that the management in a global world would bring them more opportunities but also more threats;
- 60% of companies said the unpredictable market environment played a significant role in their decision making;
- 86% had a turnover of assets greater than 1;
- 78% of firms considered as significant or crucial to monitor the speed of technological change;
- 65% of firms were focused on the technological level of products to be very important and 71% expected that it will be even more important in the future. 85% valued the level of technology as a significant factor;
- 58% of firms reported that the price of their products has a vast influence on their productivity;
- 80% of firms were primarily focused on monitoring the increasing degree of competition;
- But only 12% of companies considered the international capital movements to be a key issue.

These data suggest that, before the crisis, Czech firms focused on competition, growth, but focused more on the monitoring of technical parameters and core business (which is undoubtedly the right way of dealing with business). However, Czech companies did expect the decrease of demand and availability of capital – which is exactly what happened.

The firms used capital resources to finance their available funds, 69% of companies used bank loans, 57% of companies used lease financing-uncertainty and short term fluctuations were attempted to be resolved by address overdraft surprisingly often (51% of firms). During the growing economy period, the impact of risky behaviour of firms was not shown.

The overall business climate has meant that firms:

- expected further growth;
- improved technology;
- expanded capacity and

all for the money of lenders.

In the next period, they often had problems not only with unused capacity, but also the repayment of interest. The negative effect of operating leverage associated with the negative effect of leverage caused financial problems that sought for operative solutions. Provisions were therefore often sought in working capital, which was often in a given amount unnecessarily detained, but it was very difficult to release it.

For further development it was positive that 35% of companies had excess liquidity ( $> 2.2$ ) and 32% of firms had high interest coverage ( $> 15$ ).

### **Firms during the crisis**

Within the research project MSM 6138439905 "New theory of organizations 'Economy and Management Processes and Their adaptation" in times of crisis we have repeatedly approached businesses with anonymous questionnaires, which should reflect their current situation and future prospects.

Questionnaires were filled in the second half of 2008, in the first half of 2009 and in the second half of 2009. (Kislingerová et al, 2009a, 2009b, 2010)

Respondents are not a representative sample of enterprises in the Czech Republic, the questionnaire concerns medium and large firms (Table 2).

Table 2

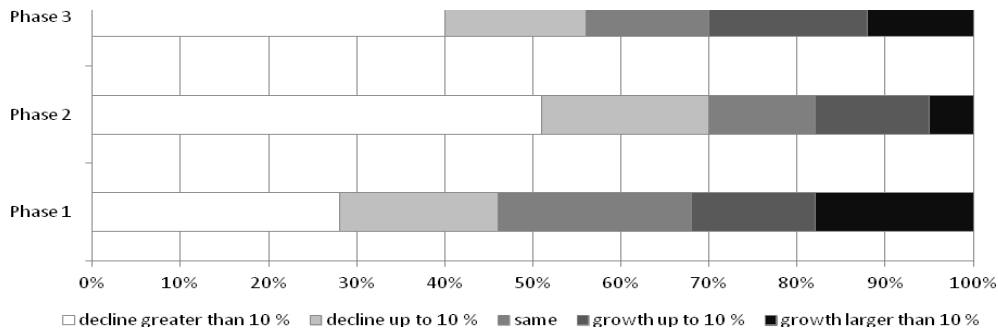
### **Structure of samples**

– % –

Amount of employees:	Group 2008 (Phase 1)	Group 2009/I (Phase 2)	Group 2009/II (Phase 3)
Up to 10	13.8	7.6	4.3
10-49	15.0	10.6	9.9
50-249	33.7	31.3	33.3
250-499	8.8	15.2	17.0
500 or more	28.7	35.3	35.5

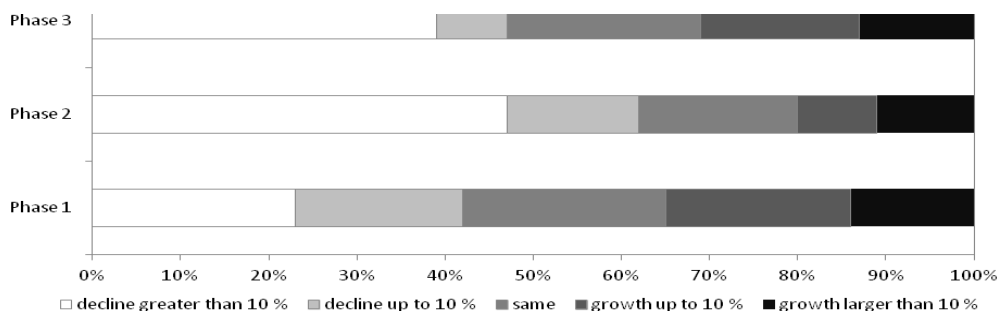
**Source:** own adaptation from Kislingerová et al, 2009a, 2009b, 2010.

Figure 4 and Figure 5 illustrate the impacts of the crisis on Czech firms using the indicators, which reflected the situation of demand and need for immediate solutions.



Source: own adaptation.

Figure 4. The Volume of sales in Czech firms 2008-2009



Source: own adaptation.

Figure 5. Volume of EBT in Czech firms 2008-2009

EBT in the first two phases decreases less than in the third one, because the company used the opportunity to sell unneeded assets – in the third stage, it probably did not have any more unnecessary assets.

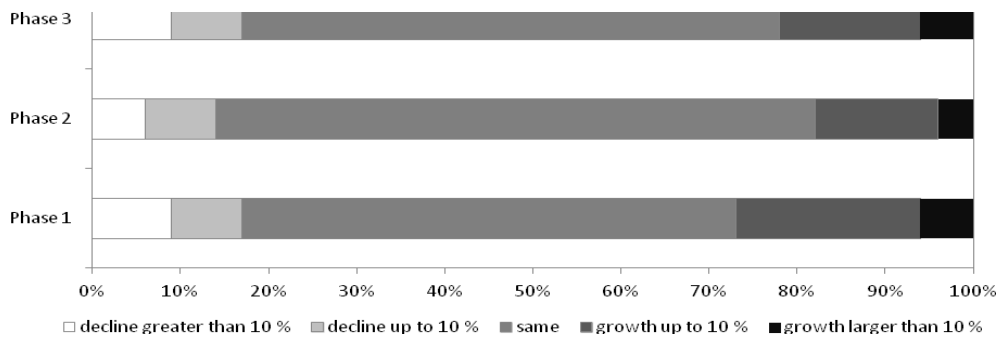
Figures 6 and 7 illustrate the impact, or the response of companies on changes resulting from the crisis in strategic areas of production factors – human capital and productive resources.

Large companies with management that has already dealt with a crisis, approached the issue of long-term impact more carefully. We see it in the investment in research and development, which usually maintain the same level (Figure 6).



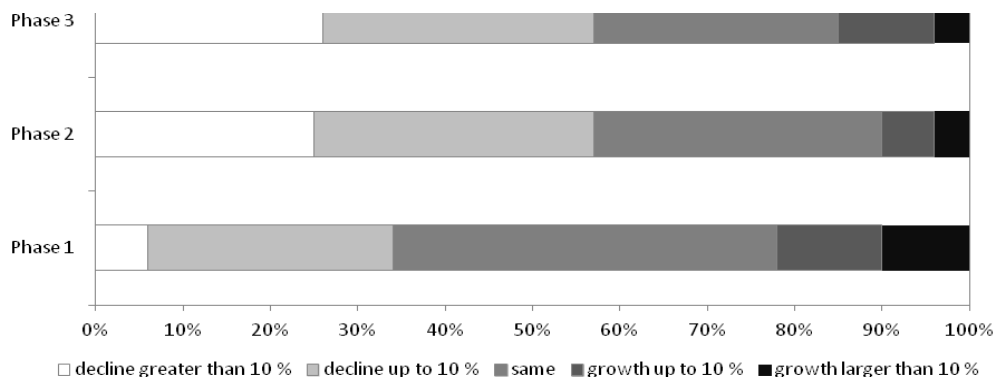
With similar responsibility, the companies addressed the issue of employees, where in the first stage the layoffs are probably related only to firms with a decline of more than 10% (up to 10% is a natural decrease – pension, maternity, etc.), i.e. 6% of firms. Unfortunately, in the second and third stage the situation was already untenable for the companies – they were also forced to reduce payroll costs.

They are still very careful in selecting appropriate employees.



Source: own adaptation.

Figure 6. Costs of research and development in the Czech companies 2008-2009



Source: own adaptation.

Figure 7. Number of employees in the Czech companies 2008-2009

The third phase included the question of how the situation has changed in the availability of finance.

Short-term resources (operational) and long-term resources (investment) were distinguished.

The opinions of companies are recorded in Table 3.

Table 3

**Change in the availability of sources**

– % –

Financing	Significant decline	Mild decline	No change	Mild improvement	Significant improvement
Short time	1	6	56	24	13
Long time	2	4	54	25	14

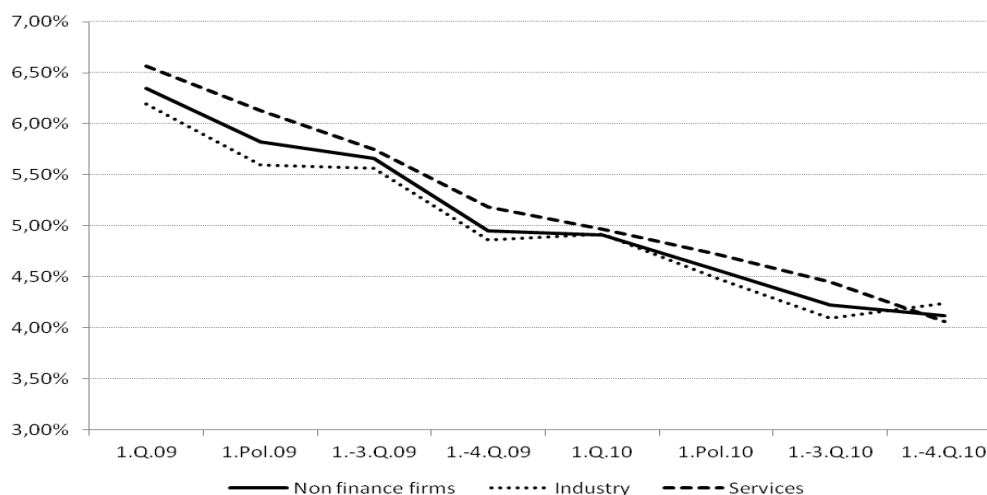
**Source:** own adaptation

It is very interesting, that:

- although in 2010 optimistic expectations no longer prevailed, opportunities to raise capital for funding are the same or worse,
- lenders do not see the difference between long term and short term finance.

This suggests that lenders (in the Czech Republic, mainly banks) still perceive a high risk and do not change their willingness to finance operating activities or businesses.

Figure 8 shows the change in the proportion of firms in the Czech short-term bank capital during the years 2009 and 2010.



**Source:** data from CZSO, 2010, 2011.

**Figure 8.** The share of short-term bank loans to finance the non-finance companies

Net working capital of firms decreases and they have no chance to escape from this situation.

The optimization of the financial assets and inventory has already occurred in the early stages of the crisis, short-term liabilities of the banking sector are still difficult to access, there is no other choice but to rely on supplier credits. However, because each firm wants to follow this process, the significant effect occurs only in terms of the constant increase in short-term liabilities and receivables due to distrust and pessimistic expectations.

Firms whose management was based on the use of their own resources, were previously described as conservative with inefficient financing, the crisis proved this attitude to be a significant competitive advantage because the old truths of cheaper foreign financing no longer apply. In case it is unavailable, it is not even cheap.

Banks have tightened their lending process, which is the reason for the unavailability of capital and the impact is especially felt by companies that do not have the capital provided by a strong parent company.

According to the KPMG survey from the year 2008 (Vojta, 2009, p. 59) 61% of companies reported that their top priority is active management of cash and 25% stated that a step towards improving the situation is the sale of unnecessary assets. However, this can be a long term solution.

In the survey (KPMG, 2008) CFOs of large European companies proposed to the firms during the credit crisis the following measures:

- Sale of unprofitable assets (37%);
- Reduction of credit limits to customers (43%);
- Negotiate longer payment of invoices (48%);
- Review the structure of liabilities (28%);
- Focus on ways to increase liquidity (32%).

Neither of the proposed action is effective in surface realization – there is no claim without debt.

The results of the survey were commented by the director of the legislative section chamber Boris Kucera: "The decline in moral causes secondary payment insolvency, will bring higher workload to courts, lesser success during insolvency proceedings and trade relations will return a few years back in time" (Vojta, 2009, p. 63).

The Chamber of Commerce survey conducted in October 2011 (Chamber of Commerce, 2011) indicates the current problems of enterprises and measures which will probably be forced to accept fewer orders and customer pressure on prices and maturity. Measures will influence the investments and personnel, hence will start to interfere with the strategic long-term prospects of companies.

I believe that this marks the cause or reason for concern about the future development (Table 4).

Table 4

<b>Impacts of the crisis and other measures of firms</b>				
<b>Impacts of crisis</b>	<b>% firms</b>		<b>Other necessary measures</b>	<b>% firms</b>
Decline in demand	50		Reduction of investment	48
Pressure on the prices from customers	19		layoffs	20
Worse payment morale of customers	19		Restriction on wage	31
Losses from financial operations	3		Restriction on fees	24
			Restrictions on employee benefits	15

**Source:** adapted from Chamber of Commerce, 2011.

Working Capital (WC) Share/ in 2009-2010 revenue was stable at nonfinance companies – 14%. This amount is approximately optimized, as the generally recommended value is 10-15%. Firms had no reserves for optimization and further development was difficult.

### **Empirical investigations 2010**

The survey took place at the website of the faculty between October 18 – November 1 2010.

The sample of respondents is not a representative match – the answers came from businesses that have passed the crisis actively and successfully: 96% expect that they might get into the process of insolvency proceedings and 55% expected production growth for 2011.

74% of monitored companies reduced costs, some (7%) by more than 30%. 19% of companies said they cannot afford or see no scope for further cost reductions.

17% strengthened equity capital through activity of the owner, most companies (60%) focused on the operation, monitoring flows of money in the company in order to avoid lack of capital due to the unavailability of credit.

General impact of the crisis also shows that even after the crisis 46% of the companies have the same share on the market as before and 37% of respondents indicate that the number of competitors remains the same.

The greatest importance for the negative change in the competitive position of the company was attributed to:

- Decline in demand (important for 73%);
- Customers' inability to pay (important for 43%);
- Exchange rate volatility (important for 43%).

At the end of 2010 the companies linked a worsening, important for their further development to:

- Acquisition and customer retention (49%) and
- Inability to raise funds for operating activities (38%).

The postponement of investments was marked as the most effective (42% of firms) measure of operating activities.

In the area of receivables and liabilities, companies indicated that their short-term overdue payables rose in case of 9% of firms, while overdue receivables grew in case of 40% of firms.

Experts (Kislingerová, 2009c, pp. 179-180) evaluated that Czech companies suffered in the crisis mainly because of poor assessment of risks and reaction to the postponement of important actions.

### Conclusion

Companies that survived during the economic recession have optimized the assets and increased the efficiency of financing through active management. The first stage dealt with a rapid response in the operative field including the production, sale and financing of working capital. If the crisis continues, or even if the pessimistic expectations keep damping the willingness of banks to participate in corporate finance, companies lose the possibility of starting a new development and the economy will be further hampered.

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