# RESTRUCTURING OF SMALL BUSINESSES IN THE REPUBLIC OF CROATIA DURING CRISIS

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***Abstract***

*Doing business in a modern environment exposes small companies to numerous risks. Due to changes in economy, which are primarily dictated by the global crisis, companies must adapt to changeable market conditions to continue their business operations. Therefore, their market survival depends on the timely conduct of certain activities by the company management, resulting in operational savings and ensuring their competitive advantage. This requires changes in the business strategy as well as the market, organisational and financial structure of these companies.*

*The paper will show an in-depth analysis of the market position taken up by small businesses using three practical examples, and indicating the pros and cons of restructuring which does not necessarily result in a desired effect.*

**Keywords**: *restructuring, small businesses, financial indicators*

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# 1 INTRODUCTION

Small businesses are a very dynamic part of the Croatian economy. They are more flexible and innovative than bigger companies and play an important role in the employment process. Fast changes occurring in the market, competition pressure and the recession force company management structures to adapt to newly emerged market conditions. A company faces a decreased operating volume, reduced liquidity, increased operating costs and employee surplus. It is important to conduct certain activities on time so as to retain a company's competitiveness. Company restructuring is a strategic decision made by the management, which leads to a change in the company's strategic management and operating policies.

This paper aims at exploring the restructuring process of small companies in the Republic of Croatia during the crisis. The research methodology is based on benchmarking financial data of observed companies in a three year period. The paper starts with the introduction of the said issue, and continues with a theoretical part listing characteristics of small companies in the Republic of Croatia, the restructuring process and types as well as various small company restructuring models. This is followed by the analysis of small company restructurings based on practical examples and ends with the final conclusion.

# 2 CHARACTERISTICS OF SMALL COMPANIES IN THE REPUBLIC OF CROATIA

According to the Financial Agency (FINA) data on company operations – corporate taxpayers, (http://rgfi.fina.hr), the number of operating businesses which submitted their 2013 annual financial statements in Croatia was 101,191, of which 99,573 or 98.4% were small and 1,618 or 1.6% middle-sized and large enterprises.

In the period between the start of the crisis in 2009 until 2013, the share of small businesses in a total number of the employed increased from 47.5% to 49.8%, accompanied by the increase of their share in pre-tax profit from 41.9% to 43.9%. This rise in the number of small businesses might be explained in light of the crisis during which many employees lost their jobs and subsequently rather tried to launch their own business than look for work with some other employer.

Pursuant to the Accountancy Act, small entrepreneurs are defined as those who comply with two out of the following three conditions: total assets and annual income not exceeding HRK 32.5 million and HRK 65 million, respectively, and an average number of the employed during the year limited to 50. Medium-sized businesses are those which numbers exceed two out of the previous three conditions, but comply with two out of the following three: assets and total annual income not exceeding HRK 130 million and HRK 260 million, respectively, and an average number of the employed during the year limited to 250.

# 3 RESTRUCTURING

Restructuring is a process of implementing large changes in the organizational structure, which often includes streamlining management tiers and the change of organizational components by transferring and outsourcing some activities or functions as well as frequent employee downsizing. An integral and essential part of the process is reducing the company depth and width also known as *downsizing*. (Bahtijarević Šiber F.&Sikavica P. 2001, 498-499). Worldwide companies opt for restructuring, primarily to improve their weak financial results in time of the crisis, which might jeopardize its very operations and lead the company into bankruptcy. Another reason for choosing restructuring is a new business opportunity which requires the unbundling of business parts or merging with other enterprises.

## 3.1. Types of restructuring

On principle, there are two types of restructuring in practice: defensive and strategic. Defensive restructuring includes two activities: reducing the number of employees and financial rehabilitation. This approach is conducted when business operations are bad, it is done quickly, the restructuring process is shorter and positive effects are maily short-term. Strategic restructuring is more complex and based on the two activity groups: activities connected with human resource management and activities connected with investments into assets, knowledge, products and services, development of new markets. This approach is conducted in times of a company's good operating result, accompanied by indepth due dilligence, a longer restructuring process and positive long-term effects, not immediately visible.

### 3.2. Restructuring phases

There are various restructuring phases which can, in general terms, be summarized into three basic ones: financial, operational-organizational and strategic restructuring. All of these should be preceded by a 'zero phase' i.e. an evaluation phase which represents a foundation for a quality implementation of the restructuring process (Benaković, 2012).

Financial restructuring includes the restructuring of the company's balance sheet i.e. the change in the structure of company's assets and liabilities. The basic goal of such restructuring is to increase company liquidity.

Operational-organizational restructuring or business restructuring includes changes in the company organization and management as well as operational restructuring based on marketing, production process, technology, cost, management system and staff restructuring. Its basic goal is to improve profitability, reduce costs and increase company liquidity.

The goal of strategic restructuring is to maintain long-term operating sustainability. It includes range reduction, identification of additional profit areas, innovative design for emerging markets, focusing on the most profitable value chain elements along with unbundling non-core business activities and introducing new business models (Benaković, 2012, 114).

To carry out quality restructuring, small company management must possess certain knowledge and management skills. It has to develop a restructuring plan including the analysis of company operations and the restructuring programme.

The operating analysis includes the legal status, financial statements (for the previous three years), production programme, facility and equipment characteristics, operational environmental impact, organizational structure, employment (the employee structure), funding, state aid, market analysis (for the previous three years), and the SWOT analysis before the restructuring.

The restructuring programme includes the restructuring period and the 2-year plan following the restructuring completion. It consists of the product range sales plan, raw material procurement plan (products, the plan of production and sales capacities, environmental protection programme, ownership and organizational structure restructuring programme, planned number and structure of the employed, financial plans for the restructuring period as well as for the two-year period after the completion of the said process, state aid, SWOT analysis after the restructuring (estimate) and the restructuring phased plan. (http:// www.mppr.hr/UserDocslmages/Prilog )

Results stemming from small business restructurings to-date have shown that the small business restructuring is conducted without a plan i.e. with no formal restructuring plans (http://europski- fondovi.eu/vijesti/).

### 3.3. Restructuring models

The restructuring of a company can be conducted by means of an outsourcing, downsizing, company liquidation, merger or acquisition as well as internal or in-house restructuring.

Outsourcing i.e. separating non-core activities as a restructuring model is a process of transferring activities which had been carried out in-house onto external partners, which will be entrusted to their conduct instead of the parent company (Galetić, L., 2011, 287). The decision on the activities which will be separated depends on the organizational strategic decision. A good business model is such which focuses on the organizational key processes i.e. on those which are most profitable and which represent the company's core operation.

There are two outsourcing types: the one which separates core value chain activities and the other which separates supporting ones (Galetić, L., 2011, 288). The most frequent examples of the first outsourcing type include the procurement, production and distribution chains, while the second type mostly includes research and development, business maintenance, legal affairs and others.

A question as to the reason why companies opt for outsourcing might be put forward. The implementation of outsourcing may improve business operations in terms of employees, reduce costs and enhance organizational financial and market aspects of its operation.

*Downsizing* often has various interpretations including enhanced productivity, reduced costs, restructuring, business process reengineering. It has been one of the most popular measures in the last two decades. It is not limited only to reducing the number of employees, despite it being its most frequent effect. For some, it represents the loss of work, for others a company survival. As costs are more easily planned than income, the focus on its decrease is the prevailing basis for efficiency increase. Reactive and proactive downsizing represent two various options in terms of employee reduction. Reactive downsizing is carried out as a response to already implemented changes in terms of losing a market share and weak business results while proactive downsizing occurs as soon as a first sign of change emerges on the market resulting in the management passing decisions for enhancing operations aimed at forestalling competition.

For achieving a successful downsizing process, it must be planned way in advance, during and after its implementation and it must be an integral part of the strategic business plan of all companies regardless whether they consider its implementation or not. If necessary, company management will be prepared to start dismissing employees. It must be emphasized that the initial phase requires large direct costs, which must be planned, such as severances or incentive programmes that should stimulate an employee to leave the company voluntarily. A disadvantage of such a programme is losing employees with key knowledge, abilities and skills necessary for company development.

Company liquidiation means the termination of company operations. It can be orderly as a result of the non-fulfillment of prescibed conditions for the performance of a business activity or forced (bankruptcy). Forced liquidation includes a court procedure over the assets of a debtor that is no longer in a possition to settle its obligations towards its creditors.

The Republic of Croatia has started paying large attention to the establishment of new companies by means of the simpliest way possible (simple limited liability companies), while on the other hand, there is a very expensive model of voluntary market exit. The fastest procedure of voluntary liquidation excluding any disputes with creditors is 12-18 months long and incurs large costs. A cheaper and faster process of a simple liquidation must be introduced for cases not burdened by any owner – creditor disputes.

Internal restructuring includes those activities which facilitate company's successful competition based on company's internal adjustability to its environment. The restructuring area is set on the basis of four underlying factors: environment, strategy, technology and company size. Restructuring might resolve the crisis occuring in-house or externally. Internal or in-house restructuring can be divided into physical, human resouce-related, IT and financial (Miletić, 2010, 59). Financial restructuring includes the optimal use of fixed assets necessary for conducting business operations, while the restructuring of human resources includes HR management. IT restructuring includes the optimal use of information regarding in-house as well as external changes, while accounting restructuring represents an in-depth analysis of financial statements i.e. a division of necessary and unnecessary company assets or income and expenses which may ensure its market survival.

## 4 EXAMPLES OF SMALL BUSINESS RESTRUCTURINGS

Restructuring models of three operating companies have been analysed in this chapter. Documentation used herein is available on the Financial Agency website (http://rgfi.fina.hr).

TROHA-DIL d.o.o. has been registered for the production of plastic products used in construction. The crisis which hit the construction sector affected the operating results of this company as well. In the period between 2011-2013, its operating income decreased by 21.4%, operating expenses by 22.9%, and the number of employees by 20. A lower number of employees in 2013 resulted in reduced staff costs by HRK 1.85 million compared to 2012, which, along with a decrease of material cost of HRK 6.11 million, led to increased profit before taxes. The 2013 current ratio was 1.6 compared to 0.85 in 2011. It should not be lower than 2, although the minimal current ratio of 1.5 is seen in some cases (Žager i Žager, 1999). The quick ratio also improved in 2013 to 1.6 compared to 0.10 in 2011.

The management conducted financial restructuring and decreased material and staff cost, in particular. As the staff cost decrease was conducted according to the reactive *downsizing* model, it enabled the company the achievement of its operating savings.

METALIND d.o.o. has been registered for the production and assembly of fire doors and metal constructions. Its business results were affected by the construction sector crisis as well. The 2011 income of HRK 76.5 million decreased to HRK 65.9 million in 2013. The 2011 expenses of HRK 57 million decreased to HRK 52.6 million in 2013. The number of employees was reduced from 125 to 121. In view of its small number of customers and suppliers, this company was facing another large risk in this operating segment. In line with the decision to sell made by the company management i.e. its owner, in

2011 it was acquired by the new owner Assa Abloy East Europe AB with its head office in Sweden.

This company was merged with the parent company and continued doing business recording bad performance indicators. The current  and quick ratios decreased from 2.64 to 1.65 and 2.15 to 1.42, respectively, while the debt ratio increased from 38.7% to 42%.

RIBA d.d. is a company engaged in fish and juvenile production and farming. Under the Commercial Court Decision, the company pre-bankruptcy settlement was granted in 2013 (http://predstečajnenagodbe.fina.hr).  In 2012, the company had 26 employees, the number it retained in 2013.

Actually,whole plan goes around measures of operative restructuring and calculation of their effects on positive business, which should lead to revitalization of solvency. This measures should be sort of turnaround in business; while old way of business have brought company into problems.

The 2012 income from sale of HRK 3.3 million decreased to HRK 2.49 million in 2013. Other operating income in 2013 included income from writing a debt portion off under the pre-bankruptcy settlement i.e. the loan of HRK 1.23 million, and state and trade liabilities of HRK 348,000.  The 2012 operating expenses amounted to HRK 16.76 million, compared to HRK 3.88 million in 2013.

In line with the Operating and Financial Restructuring Plan, short-term liabilities of HRK 1.22 million out of total HRK 2.93 m liabilities were written off. Liabilities to banks of 543,000 were converted into equity. In 2013, the company recorded profit of 18,000 compared to the 2012 loss of HRK 12.9 million.

## 5 CONCLUSION

Small businesses differ from medium-sized and large ones by their market presence and specific characteristics required for conducting such business operations.  Nevertheless, they have also been affected by the global economic crisis and experienced problems with product placement and the collection of receivables. Strategic restructuring of a company represents an important part of the restructuring process, which is often neglected by small companies as shown by concrete practical examples. This is caused by insufficient management experience of a company owner and insufficient decisiveness for carrying out radical operating changes. The first company example showed that the management had carried out financial restructuring and reduced costs. A staff cost decrease was carried out under the reactive downsizing model, which provided the company with its operating savings.

The crisis in the construction sector affected business results of the company, which restructuring model was described as example 2. Having changed its owners and management, this company became a part of a new parent company. As such, it continued its operations recording weaker operating results. The company management, described as example three, accepted the pre-bankruptcy settlement as its restructuring model. According to the operational and financial restructuring plan, 40% of the company's short-term liabilities as well as its liabilities towards banks of HRK 543,000 were written off. Following its 2012 losses of HRK 12.9 million, the company recorded profit of HRK 18,000 in 2013.

The basic shortcoming of small company management is its conduct of solely financial restructuring, followed by changes of its business organization with no detailed restructuring and indepth change.

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