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Evaluation of bankruptcy prevention tools : evidences from COSME programme

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Abstract

We apply propensity-score matching (PSM) in order to qualify the efficiency of SME bankruptcy's preventive rescue plan in a European perspective. PSM has a number of comparative advantages in such analysis, including the need to allow for heterogeneous impacts, while optimally weighting observed characteristics when forming a comparison group. The results show that firms asking for a rescue plan register 5.2% higher chance to survive compared to similar (on some pre-settled characteristics) firms that do not. Deepening our analysis to the specific case of COSME Programme's leading countries, our results show that these countries outperforms Europe, with a SMEs getting 7.7% more chance to remain active.

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1. Introduction

Small and medium-sized enterprises (SMEs) play an important role in most economies worldwide (Ayyagari *et al*. 2007, Burgstaller and Wagner 2015). In the European Union, around 99 percent of firms are SMEs, which account for two-thirds of all jobs in the private sector (Gama and Geraldes 2012). In 2015, nearly 23 million SMEs generated an added value of €3.9 trillion and employed 90 million workers. SMEs, therefore, form the backbone of the EU28 economy (European Commission 2016a).

This type of firm is frequently confronted with major challenges compared to larger ones, since they profit less often from economies of scale, fewer of them have access to a wide resource base, and they are relatively vulnerable to external events (Carter and Van Auken 2006, Altman *et al.* 2010, Lavia Lopez and Hiebl 2014). This highlights that the survival of SMEs is more easily threatened because of their smaller set of both financial and non-financial resources.

In Europe, in 2012, more than 600 bankruptcies[1] were declared each day (European Commission 2015). According to the European Commission (2016b), an average of 200,000 firms go bankrupt in Europe each year. These bankruptcies are bad for the economy because they lead to job losses and drops in the Gross National Product. They also lead to a lack of confidence in the small business sector. Bankruptcy does not only mean the closure of economic activities, but also that of human, technical, intangible and financial resources (Van Caillie and Dighaye 2002). It, therefore, creates dramatic social consequences for all stakeholders (Lussier and Pfeifer 2001).

This phenomenon, affecting all European countries, is however considered by the economic literature as a compatible element with economic development in a globalised economy (i.e. some firms "have to disappear"). That is, the creation of new enterprises is often seen as one of the key determinants of job creation and economic growth, and has to be compared with the number of bankruptcies. But, it should be noted that the number of bankruptcies outpaces the number of business creations, which confirms the economic scale of the bankruptcy phenomenon (Albessart and Duprez 2014).

Regarding the economic, financial and social consequences of bankruptcies on the global economy, it was clear that acting upstream of the process with preventive procedures may generate positive effects for all stakeholders in the economy (Van Caillie 2000, Bonnemason-Carrère and Recasens 2013, Camacho-Miñano et al. 2015).

Bankruptcy prevention procedures are currently governed in the EU by the insolvency law, but the practical rules are quite different from one member state to another. Each European country therefore developed its prevention tools dedicated to firms facing difficulties[2]. In 2016, and following the EU COSME programme (European Commission 2016c), seven European countries (*i.e.* Belgium, Denmark, Germany, Greece, Italy, Poland and Spain) formed the "Early Warning Europe" partnership that aims at preventing bankruptcy at a European level.

If bankruptcy prevention therefore seems to become increasingly important in the European framework, it is however noticeable that there exist actually no economic studies qualifying the effectiveness of such prevention tools. The aim of this paper is therefore to question the rescue process (referred to as a "rescue plan") for a firm facing difficulties. The motivation for carrying out this research comes from the relative scarcity of empirical studies on preventive procedures. Furthermore, the research in finance has largely ignored this aspect of the law by focusing on business failure prediction and its consequences. One of the main contribution of this paper also lies in the originality of the approach. We use a sample of

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1 Bankruptcy in the sense of firm disappearing in anyway (voluntarily or not).

2 For example "Early Warning" in Denmark, "TEAM U" in Germany and "Dyzo" of "Ced-W" in Belgium.

European SMEs that have voluntarily contacted the competent authority in order to activate the "rescue plan". The effectiveness of this approach is evaluated through Propensity Score Matching (PSM) method, with the Nearest Neighbour (NN) specification, in order to test whether being treated, that is applying for a rescue plan, increases the probability of being active compared to not being treated. To our knowledge, this method has never been used for such investigation. Then, we replicate this strategy to a group of countries particularly advanced in the prevention process, *i.e.* the COSME Programme's initiators, in order to compare the effectiveness or non-effectiveness of their rescue plan with other European countries.

The following Section 2, describes the data. Section 3, lays out the methodology and the empirical strategy employed. The results are presented in Section 4 and finally, the Section 5 concludes.

2. Data

The aim of this paper being to estimate the ability of a rescue plan to prevent firm bankruptcy, we selected a sample of European SMEs[3] (EU 28) from Amadeus database, covering the period 2006 – 2015, and we compared the binomial response outcome, that is the actual status, after applying for a rescue plan or not. We first had to restrict our analysis to so called "firms at high risk of bankruptcy" (Cultrera *et al.* 2020), since it would be senseless to assume that a healthy firm has the same opportunity to apply for a rescue plan as a riskier one. Practically, we restricted our data to SMEs operating in a risky environment, meaning they all have to register a lower position than the first quartile of the whole sample, for at least four of the five ratios selected by Cultrera *et al.* (2020):

- Liquidity ratio: current assets / current liabilities;
- Profitability ratio: earnings before interests and taxes / total assets;
- Solvability ratio: shareholder equity / total assets;
- Value added ratio: tax expenses / value added;
- Structure ratio (Beaver's Ratio): net cash-flow / total debts.

Our database therefore gathers 14,330 firm-year observations in the non-treated group (*i.e.* firms that do not apply for a rescue plan) and 20,755 firm-year observations in the treated group (*i.e.* firms that do apply), leading to a total sample of 35,085 firm-year observations. The econometric framework on which we rely on enforces to respect some critical assumptions (*i.e.* unconfoundedness and overlap assumptions, see Section 3 for detailed procedures), leading to data restriction. The final sample gathers 6,743 firm-year observations in the non-treated group and 3,710 firm-year observations in the treated group, giving a total sample of 10,453 firm-year observations.

Descriptive statistics of the 10,453 firms are presented in Appendix Table A1. As shown in the table, the average number of workers within firms is 19, whereas the average stock of capital is estimated at 196 thousand euros. The average amount of long term debt is 476 thousand euros, and the average tax amount is 4 thousand euros (this latter amount surely low due to the fact that some firms report their taxes when facing losses). Then, the average customer period of pay is 61 days, whereas the average supplier period of pay is 81 days, which can be seen as representative of the current situation. The net result is actually a loss of, on average, 13 thousand euros. This may be seen as a validation of the status of the firms in

[3] SMEs are defined by the European Commission as having less than 250 employees. They should also have an annual turnover of up to 50 million EUR, or a balance sheet total of no more than 43 million EUR (Commission Recommendation of 6 May 2003).

difficulty. Finally, the dispersion among countries and industrial sectors shows that firms are mostly gathered in France (22.89 percent), Italy (27.41 percent) and Spain (18.69 percent), and in the 'Wholesale and retail trade, repair of motor vehicles and motorcycles' (49.42 percent), 'Construction' (15.74 percent) and 'Accommodation and food services activities' (11.66 percent), which also seems representative of the current activities of SMEs.

3. Methodology

In order to empirically test whether applying for a rescue plan may improve bankruptcy prevention, we divide our sample into two specific groups. The treatment group including firms which applied for a rescue plan within the investigated period and the control group, including firms which are classified as "at high risk of bankruptcy" but which decided not to apply for such a plan. We rely on the Propensity Score Matching (PSM) method known as the Roy-Rubin model (Roy (1951), Rubin (1974)) and developed by Rosenbaum and Rubin (1983). Basically, the PSM aims at computing the mean difference in outcomes induced by the treatment, or, applied to our paper, the mean difference in the probability of being active induced by the recall to a rescue plan, given the firm *i*'s characteristics.

First, in order to avoid selection bias, arising for example when firms with better performance are less inclined to apply for rescue plan (even if they are considered as at "high-risk" of bankruptcy), we compute the propensity scores (PS), which provides the probability of receiving the treatment (*i.e.* applying for a rescue plan), given some pre-characteristics variables. These propensity scores are predicted with probit model.

$$p(X) = Pr[D_i=1 | X] = E[D_i | X] \quad (1)$$

where X is a vector of covariates not affected by the treatment: the size of the firm, computed using the number of workers (full time equivalent), the amount of capital vs total assets, the amount of long term debts vs total assets (financial strategy of the firm), the amount of taxes vs total assets (imposition strategy of the firm), the customer period of pay (in days), the supplier period of pay (in days), the stock rotation (in days), the net result, lagged by one year, the industrial sector (21 dummies, in NACE Rev_2), and the country of establishment (28 dummies); and D_i is a binary variable which is equal to 1 if the firm *i* receives the treatment (*i.e.* applies for the rescue plan), and 0 otherwise.

We may then compute the average treatment effect on the treated (ATT), which estimates the difference of potential outcomes between the treatment and the control groups:

$$\tau_{ATT}^{PSM} = E_{p(X)|D_i=1}\{E[Y_{1i}|D_i = 1, p(X)] - E[Y_{0i}|D_i = 0, p(X)]\} \quad (2)$$

where Y_{1i} and Y_{0i} represent the potential outcomes (*i.e.* being active) of the firm *i* in the treatment (1) and the control (0) groups, respectively.

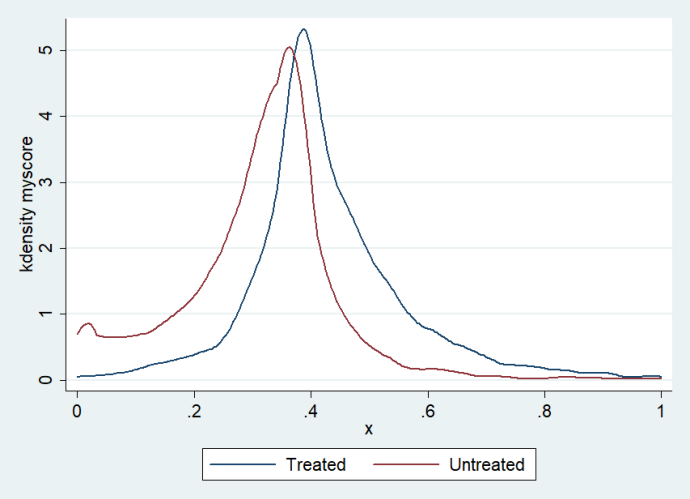
At this stage, we have to note that the ATT is identified only if we may assume that (i) the unconfoundedness assumption, (ii) the conditional independence assumption, and (iii) the common support assumption are holding.

With the unconfoundedness assumption, we can postulate that the fact of applying for a rescue plan is only based on observable characteristics, and that all variables influencing both the treatment assignment and potential outcomes are observed. This is a strong assumption and we will accept it in this paper. It should also be clear that conditioning on all relevant covariates is limited in case of a high dimensional vector X. The conditional independence assumption, based on the propensity score, can be written as:

$$Y_{1i}, Y_{0i} \perp\!\!\!\perp D \mid p(X), \forall X \quad (3)$$

Finally, the common support assumption, also known as the overlap condition, ensures that individuals with the same X values have a positive probability of being both treated and non-treated (*i.e.* applying or not for the rescue plan). ATT is therefore only defined in the region of common support. That is, an important step is to check the overlap between treated and non-treated groups (Bryson et al. 2002). As shown on Figure 1, this overlap assumption is validated for our data.

Figure 1 – Verification of the Common Support Assumption



As such, we cannot estimate the ATT directly using (2) even if we compute the propensity scores of each firm *i*. That is, *p(X)* is a continuous variable, and it is therefore impossible to match two firms with identical PS, and we have to rely on a matching method, allowing us to combine observations. Nearest Neighbour (NN) Matching can be seen as the most straightforward matching estimator. With this method, we search the closest control sample, both backward and forward, from the estimated PS values of the treated group. An individual from the non-treated group is chosen as a matching pair for a treated individual that is similar in terms of PS. Although several variants of NN Matching are available, we rely on the NN Matching with replacement, where an non-treated firm can be used more than once as a match. Allowing replacement increases the average quality of matching and decreases the bias (Caliendo and Kopeining 2008).

4. Results

4.1 Overall Specification

Table 2 focuses on the relationship between applying for a rescue plan and the probability of being active. As shown in the table, 3,710 and 2,106 firm-year observations overcome both the common support assumption and the nearest neighbour specification. The results from the Average Treatment on the Treated (ATT) demonstrates that, from a European perspective, applying for a rescue plan increases the probability of being active on the market by 5.2% compared to a similar firm that does not rely on such a program.

Table 1 – Nearest Neighbour Estimates of ATT – Outcome: Being Active

Number of Treated[(a)]	Number of Controls[(a)]	ATT (t values)
3,710	2,106	0.052** (4.832)

(a) The numbers of treated and controls refer to actual nearest neighbour matches
**meaning significant at a 5% level.

4.2 What about COSME Programme initiators?

As mentioned above, one major insight of the paper is to test whether the initiators of the COSME Programme, seen as leaders in rescue processes, perform better in recovering firms' health than European countries as a whole.

To carry out this analysis, we replicated the previous strategy on the 1,929 and 1,065 firm-year observations for the treated and non-treated groups.

Table 3 therefore shows that applying for a rescue plan increases the probability of being active by 7.7% in these seven countries. This means that a firm which applies for a rescue plan may increase its probability of getting better by 7.7%, compared to a similar firm which did not apply. It therefore seems that COSME Programme initiators outperforms Europe in helping firms to recover, providing some legitimacy to such Programme.

Table 2 – Nearest Neighbour Estimates of ATT – Outcome: Being Active

Number of Treated[(a)]	Number of Controls[(a)]	ATT (t values)
1,929	1,065	0.077** (5.015)

(a) The numbers of treated and controls refer to actual nearest neighbour matches
** meaning significant at a 5% level.

4.3 Robustness Tests

Although the NN Matching technique is the most popular matching technique, it faces the risk of imprecise matches if the closest neighbour is numerically distant. Other methods may be used to overcome this bias (Heinrich et al. 2010). As robustness tests, we therefore replicate our analysis on the overall sample with three other matching techniques: Radius Matching, Kernel Matching and Stratification Matching.

The basic idea of the Radius Matching is to use the NN within each caliper, a firm from the control group is chosen as a matching partner for a treated firm that lies within the caliper (propensity range) but also to use all of the comparison firms within the caliper. The benefit of this approach is that it uses only the number of comparison firms available within a predefined radius, thereby allowing for use of extra (fewer) firms when good matches are (not) available (Baser 2006).

With the nonparametric Kernel Matching estimator, all treated firms are matched with a weighted average of all controls, with weights inversely proportional to the distance between the propensity scores of the treated and control groups. Because all control firms contribute to the weights, lower variance is achieved (Garrido *et al.* 2014).

Finally, the idea of Stratification Matching is to partition the common support of the PS into a set of intervals (strata) and to calculate the impact within each interval by taking the mean

difference in outcomes between treated and control observations. This method is also known as interval matching, blocking and subclassification (Rosenbaum and Rubin 1984).

The results, presented in Table 3, globally show that applying for a rescue plan increases the probability of being active, with a range between 6.3% and 6.5%, providing support to the initial NN Matching.

Table 3 – Robustness tests – Estimates of ATT with Radius, Kernel and Stratification Matching – Overall Specification – Outcome: Being Active

Number of Treated	Number of Controls	ATT (t values)
	Radius Matching	
3,710[(a)]	6,743[(a)]	0.063*** (9.209)
	Kernel Matching	
3,710[(b)]	6,743[(b)]	0.065*** (8.027)
	Stratification Matching	
3,709[(c)]	6,744[(c)]	0.065*** (8.320)

(a) The numbers of treated and controls refer to actual radius matches
(b) The numbers of treated and controls refer to actual kernel matches
(c) The numbers of treated and controls refer to actual stratification matches
*** meaning significant at a 1% level.

5. Conclusion

This study examines the benefits of applying for a rescue plan compared to a random walk of firms facing difficulties and operating in a risky environment. Due to the non-experimental nature of the data used in this analysis, a propensity score matching model was used to account for the selectivity bias.

The empirical analysis was conducted on a European dataset covering the period 2006-2015. The results, robust to several matching methods, indicate that applying for a rescue plan is helpful for firms, since it increases the probability of being active in future, compared to equivalent firms that do not.

However, and focusing on COSME Programme's initiator countries, we have to note that, even if such results are encouraging since they show higher performance of their rescue plan compared to Europe as a whole, they also show that rescue plan procedures under COSME Programme would not be highly efficient, since they could "only add" a 7.7% higher chance of rescue.

Prevention procedures for these firms must be revitalised, and the reforms in place should contribute to this revitalisation. However, current practice reveals the inadequacy of the use of this type of procedure, and the shortcomings of its implementation. It is, therefore, necessary to consider the unsatisfactory results of these bankruptcy prevention practices. The success of this mechanism is linked to the target audience knowing of its existence, which does not yet seem to be the case[4]. The future of firm failure prevention presupposes a reflection on the power of the various actors, and on the creation of a favourable environment that is in line with the needs of firms. This would require the use of means to identify firms that are beginning to have

4 The UCM's survey of Francophone entrepreneurs in February 2015 reveals 43.9 percent of business managers do not know the existence of initiatives aiming at rescuing firms in difficulties (Lesceux et al. 2015).

difficulties. Means should also be made available for commercial investigations, so that more firms are contacted upstream on the process.

The major element that could according to us influence the use of prevention tools is public communication. These preventive measures can only be effective if an information and prevention network is put in place. A quasi-compulsory preventive procedure should be introduced as soon as the first signs of difficulties appear. Also, at the end of the procedure, an announcement should be made indicating that a recovery plan has been correctly applied and that the given firm is no longer confronted with the mistrust of suppliers and potential creditors.

Another point on which it is essential to insist on with entrepreneurs is the need to act early, when the firm is facing its first difficulties. Intended measures can only be effective if the entrepreneur reacts quickly, that is to say "as soon as a number of indicators are red, or even just orange" (Bonhomme 2010). Given all the measures put in place to help firms in difficulty, it is up to the entrepreneur to take the first step if they want the procedure to be effective (Bourrié-Quennillet, and Stephany 2001).

The best way to prevent bankruptcy is for the entrepreneur to be aware of the difficulties they are experiencing and to share them with others in order to receive help. Either the entrepreneur is aware of difficulties too late, at a stage where bankruptcy is inevitable, the entrepreneur does not want to admit to entrepreneurial failure, or else they are aware of it but do not want to share it with others because of the shame it brings. This would explain the notion of delayed introduction of safeguard procedures, which could be associated with this entrepreneurial failure, which is itself negative according to the European mentality (Danaux 2016). That is, the attitude in EU countries is to consider bankruptcy as a result of mistakes committed by the entrepreneur, and this is something which stays with them. As a result, in Europe, debtors consider the bankruptcy of their firm as personal failure, and the fear of failure impedes them from manifesting themselves as early as possible. Unfortunately, this early request is a major factor determining the probability of success of this "rescue plan".

This study provides evidence of the need for specific assistance programmes for firms facing difficulties. Even if further studies should confirm our preliminary results, the present study confirms the hypothesis that external advice may be found to be essential in the rescue of a firm, and should be developed.

Finally, it worth mentioning that even if such results may appear to be satisfactory, they may be highly improved with policies oriented through managers themselves. That is, would it be possible to save other groups of firms simply by applying for a rescue plan earlier?

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Appendix Table A1 – Descriptive Statistics of Selected Variables

	Mean	Std. Dev.
Number of workers (FTE)	18.53	38.34
Amount of capital (k€)	196.07	986.86
Long term debts (k€)	475.95	2658.07
Average taxes (k€)	4.07	132.06
Customer period of pay (in days)	61.17	88.91
Supplier period of pay (in days)	80.89	110.30
Stock rotation (in days)	42.26	104.35
Net result (k€)	-13.072	159.869
Country (%)		
Belgium	0.57	
France	22.89	
Latvia	1.17	
Lithuania	0.01	
Luxembourg	0.07	
Germany	0.78	
Austria	0.11	
Bulgaria	3.86	
Cyprus	0.02	
Croatia	1.39	
Denmark	0.00	
Spain	18.69	
Estonia	0.29	
Finland	1.71	
Greece	1.00	
Hungary	0.38	
Ireland	0.02	
Italy	27.41	
Malta	0.01	
The Netherlands	0.00	
Poland	0.42	
Portugal	4.20	
Czech Republic	4.70	
Romania	0.72	
Slovakia	3.51	
Slovenia	0.34	
Sweden	4.82	
United Kingdom	0.91	
Sector (%)		
Agriculture, forestry and fishing (A)	3.20	
Mining and quarrying (B)	0.34	
Manufacturing (C)	0.00	
Electricity, gas, steam and air conditioning supply; Water supply, sewerage, waste management and remediation activities (D+E)	0.71	
Construction (F)	15.74	
Wholesale and retail trade, repair of motor vehicles and motorcycles (G)	49.42	
Accommodation and food services activities (I)	11.66	
Transport and storage; Information and communication (H+J)	5.49	
Financial and insurance activities (K)	0.33	
Real estate activities; Professional, scientific and technical activities; Administrative and support service activities (L+M+N)	7.73	
Public administration and defence; compulsory social security (O)	0.00	
Education (P)	0.58	
Human health and social work activities (Q)	1.72	
Arts, entertainment and recreation; Other service activities (R+S)	3.07	
Activities of households as employers; undifferentiated goods- and services-producing activities of households for own use (T)	0.00	
Activities of extraterritorial organisations and bodies (U)	0.01	
Number of firms	10,453	