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The Credit Position of a Firm and the Risk of Bankruptcy

1. Introduction

Maintaining financial liquidity is the basic aim companies strive at in their ongoing activities. It conditions the functioning of entities on the market, achieving economic benefits and the growth of value in the longer term. Undoubtedly, that it is a complex problem for company managers. It requires broad knowledge about all areas of the management or enterprise activity, and at the same time it combines/joins decisions taken. It should be emphasised that it is particularly difficult to maintain financial liquidity when there is a slowdown or a crisis in economy, which changes the conditions of the functioning of numerous firms. Therefore, financial liquidity of a firm is a result of both the macro-economic situation and the decisions made, among others within the implemented credit policy, which are compliant with the implemented strategy of a firm, and which concern trade credit management in ongoing activities, especially in trade contacts.

2. The problem of shaping the credit policy in an enterprise

A credit policy conducted in a firm to a great extent concerns the management of receivables but an important fact should be stressed, namely that its shape is also influenced by the situation connected with the use of trade credit to finance the activity. Receivables are a substantial and practically constantly occurring component of current assets in companies, just like trade liabilities in liabilities. Without a doubt, in the current economic reality, the moment of sales and the moment of payment have been separated. Thus, trade credit is a commonly used instrument in trade contacts between counterparties. Clients, making a purchase with deterred payment term are often able to offer such payment conditions themselves, owing to which trade exchange becomes brisk and the company turnover is going up.

Thus, on the one hand, the use of trade credit dynamises sales, and on the other hand it is the reason for which the risk of not obtaining receivables grows. With an increase in sales conducted with deferred payment term and the overall prolongation of payment terms offered to counterparties, the risk of the occurrence of doubtful or bad debts rises. The execution of this type of receivables is connected with additional costs and it is frequently ineffective (Dankiewicz, Markusiewicz i Tompalska 2017, p. 50).

Thus, conducting an effective credit policy towards customers requires to work out a system of crediting principles and the procedures of the assessment of payment credibility of counterparties. The forms of a credit policy are created based on various criteria (Kowalik 2009, pp. 56 - 60). The most popular approach from the point of view of the character of this policy distinguishes the following policies (Sierpińska, Wędzki 1990, pp. 146 - 147): conservative, aggressive and flexible. On the other hand, according to the criterion of the method of financing receivables, a credit policy can be divided into so-called the position of a credit "provider" and the position of a "recipient". It is a significant approach generally referring to the management of financial liquidity in the firm, indicating the problems and the scope of granting a trade credit, but also self-financing with this credit.

In this context, it seems that an important tool used for the control of crediting recipients is the firm's credit position ratio. It is calculated as the ratio of (Sierpińska, Wędzki 1990, p. 135):

$\text{Credit position ratio} = \frac{\text{Receivables from recipients}}{\text{Liabilities towards suppliers}}$
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The ratio higher than 1 means that the firm grants more credits to counterparties than it uses itself. On the other hand, the credit position ratio lower than 1 shows that the company is in the position of the credit recipient.

In the economic practice, in addition to the fact that enterprises grant a trade credit, they just as often use it for the temporary financing of its operating cycle. It increases the risk of maintaining financial liquidity, but taking into consideration an easy access and a low cost of this source of financing, its use influences the improvement of profitability. Therefore, it seems that the crucial issue in the use of and granting trade credit is the timely settlement of liabilities and collection of receivables, which allows to avoid problems with the loss of financial liquidity.

Unfortunately, the reality within that scope is uncertain and complicated. The findings of the research carried out by the Association of Financial Companies in Poland and the National Debt Register (Portfel należności polskich przedsiębiorstw 2019) presents the situation in the portfolios of Polish companies in the third quarter 2019 and indicates another worsening in the subjective assessment of the dynamics of the portfolio of receivables. Again, there was an increase in the share of enterprises which declare the occurrence and simultaneous growth of the scale of problems with timely enforcement of receivables from clients - from 21.5% (July 2019) to 23.9% (October 2019). In the third quarter 2019, the percentage of bad receivables in the portfolio of Polish firms also increased slightly and was 22.2%. For the purpose of comparison, it is worth noting that such a level of bad receivables has stayed the same for more than 5 years, where, with small changes, it was as follows in the same periods of the previous years: in October 2018 – 22%, in October 2017 – 21.5%, in October 2016 – 21%, in October 2015 – 22.9% (Portfel należności polskich przedsiębiorstw 2015 - 2019).

There is no doubt that the lower the percentage of bad receivables accumulated in the portfolio, the lower probability of the occurrence of payment gridlocks, especially in such industries as construction and in micro and small enterprises, and the lower probability of the loss of financial liquidity in the case of an economic slowdown.

From the analysed consequences of the occurrence of receivables which are not paid on time for conducting business activity the studied enterprises marked the growth of the scale of the translation of delayed receivables into the lack of firms' ability to pay their own liabilities timely (from 26.4% in 2017, 29.2% in 2018, to 33.2% in 2019). As cyclic research shows, it is the most negative consequence of delays, in addition to the necessity to limit investment.

The lack of the possibility to maintain own timeliness in paying invoices worsens the image of the firm and results in worse financial conditions of supplies from counterparties. It should be remembered that if the scale of this translation grows, it may mean that in the area of receivables the snowball effect will occur (Portfel należności polskich przedsiębiorstw 2015 - 2019).

Therefore, one of the biggest internal threats for enterprises are payment gridlocks. The changes described suggest the occurrence of negative trends, whose staying in the period of the expected economic slowdown may translate into bankruptcies of firms, micro and small ones in particular, as well as those in portfolios of which delayed receivables are a considerable part of payments, and in firms conducting activities in

industries particularly susceptible to the snowball effect in the event of delays in receivables (e.g. the construction industry).

3. The bankruptcy of firms and its causes

The phenomenon of bankruptcy is an important element of economic life, which appeared in Poland after 1989, following the introduction of acts on business activity and restructuring (The Act of 23.12.1988 on Business Activity...) within the monetary policy implemented by L. Balcerowicz (Korol, Prusak 2005, p. 5). Regulations within that scope were introduced by means of the Act on Bankruptcy and Rehabilitation (the Act on Bankruptcy and Rehabilitation... of 28.02.2003) valid in Poland since 1 October, 2003.

The **bankruptcy** of companies is an inseparable feature of market economy, playing a function of cleaning the market from entities affected by the problem of insolvency. It quite often happens that bankruptcy takes place, the reasons of which can be seen in the socio-economic system and its mismatch to the coming civilisation transformations, including technological ones (Mączyńska 2015, p. 29). This market selection aims at the shaping of the development of individual countries and the whole world economy. The bankruptcy of companies is a phenomenon occurring particularly in the phases of crisis and depression, but it is seen on each stage of the business cycle. Moreover, in the phases of an economic crisis, during recession an unwanted domino effect may appear. It is related to the situation when the bankruptcy of one entity implies the insolvency of another one (Prusak 2011, p. 7).

Therefore, bankruptcy can be studied considering the **macroeconomic** and **microeconomic** scale. In the macroeconomic scale the number and the dynamics of the bankruptcies of firms with regard to the level of the prosperity in economy, as well as the problem of the insolvency of countries are considered in the first place. Within the analysis of micro-economic bankruptcy the problem of bankruptcy of individual business entities and natural persons not conducting business activity is most often discussed (Prusak 2011, p. 19).

The term of bankruptcy is perceived in various ways and there is no uniform, generally applicable definition of bankruptcy. Most often, in the process of defining bankruptcy two approaches to it are proposed (Prusak 2011, p. 21) – from the point of view of **economy and finance** (so-called economic bankruptcy) and the **law** (so-called legal bankruptcy). **Economic bankruptcy** is related to the financial standing of an enterprise and is described as the state in which a firm "does not have a capability of

continuing its activity independently so that an ability to compete on the market, and at the same time profitability, as well as liquidity and solvency (...) could be restored to it (...) without providing help from the outside" (Prusak 2011, p. 23). External help can consist of, for example, remitting some of the debts, changing repayment dates, reaching a settlement, decapitalisation or takeover of the entity by other business entities, or equity contributions made by shareholders (partners). In this approach a significant role is played by the term of insolvency of an enterprise. On the other hand, **legal bankruptcy**, on the basis of S. Gurgul, P. R. Wood and J. Płoch's deliberations, is defined as "regulated by bankruptcy law set of rules and procedures including, e.g., declaring bankruptcy of a business entity, conducting and completing bankruptcy proceedings, including, among others, valuating and selling the debtor's assets, compensating creditors". The aims of these actions include, among others, a fair division of the debtor's assets among creditors and compensating them to the greatest possible extent, as well as the liquidation of entities in the case of which it is impossible to restore the ability to compete on the market (Prusak 2011, p. 25).

Thus, in the legal terminology bankruptcy is defined as " a procedure defined by the law, initiated in the event of the debtor's insolvency, consisting mainly in joint pursuit of claims by all its creditors" (Lewandowski, Wołowski 2011, p. 7). The condition of initiating such a procedure is the **debtor's** insolvency.

Insolvency is a criterion inseparably connected with bankruptcy. In this context insolvency occurs when the market value of the assets possessed by the company is lower than the total amount of its liabilities (Altman, Hotchkiss 2007, p. 19). Due to referring to the asset-capital related situation, insolvency is not equal to the lack of financial liquidity, the assessment of which is based on operations related to cash. E. Altman calls the lack of financial liquidity "technical insolvency" and stresses the fact that it can be both a temporary state and also lead directly to the state of bankruptcy. A firm can be simultaneously solvent and not maintain solvency, as well as maintain solvency with the simultaneous insolvency (Prusak 2011, p. 24).

Insolvency leads to economic bankruptcy which, as it is emphasised by B. Prusak (2011, p. 25), is not always related to legal bankruptcy, whereas the majority of the occurrences of legal bankruptcy are equal to economic bankruptcy (as legal bankruptcy is its natural consequence).

To distinguish the legal and economic levels we can add that **bankruptcy in the economic sense** is simply called **bankruptcy** (Świerk, Banach 2013, pp. 441 – 452).

Bankruptcy is defined as the situation in which a firm does not have assets, thus, the level of its resources makes it even impossible to conduct bankruptcy proceedings. The entity is liquidated and creditors make a full loss and can only pursue their claims by means of civil law proceedings (Górka 2011). A bankrupt is also considered to be a company which has no ability to continue its activity independently and needs external help (Prusak 2011, p. 23). Such help can take different forms, e.g. an arrangement with the bank in order to restructure the debt, remitting some of the debts or prolonging the dates of their repayment, assistance of the state (recapitalisation of the firm, takeover of the management, granting guarantees), takeover of the entity or recapitalisation by other entities. Thus, bankruptcy does not have to mean bankruptcy in the legal sense but almost every bankruptcy in the legal sense is equal to bankruptcy (Hamrol, Chodakowski 2008, pp. 17 – 32).

S. Nahotko (2003, p. 43) perceives bankruptcy in two aspects: **static and dynamic**. The first of them refers to the state in which the firm stops paying debts, as the assets are not sufficient to cover them in full. Therefore, it is an approach identical with the definition of insolvency. On the other hand, the **dynamic aspect** was shown as the process of worsening financial results, concerning financial liquidity, profitability and the speed of the allocation of cash. The author emphasises its special significance from the point of view of management as such understanding of bankruptcy enables to take decisions which can protect the entity from the worst consequences (Nahotko 2003, p. 45).

Bankruptcy jest not synonymous to the end of the functioning of an entity. Arrangement proceedings can be conducted, in which as a result of a well prepared curative plan creditors agree for the delay of repaying their receivables. The regulations of the bankruptcy law allow for arrangement and curative proceedings owing to which an enterprise can avoid liquidation (Górka 2011). Therefore, among the **types of the legal bankruptcy** we can indicate: **liquidation bankruptcy and arrangement bankruptcy** (combined with taking away assets and not combined with taking away assets) (Tokarski 2012).

Bankruptcy is not a phenomenon which occurs suddenly, a lot of its **causes and symptoms** can be noticed well in advance, which creates conditions for the use of proper remedial actions (Hadasik 1998, p. 36).

Among the reasons for bankruptcy, considering its most general classification, we can distinguish two main groups: **exogenic reasons** (usually identified with

macroeconomic or external ones) and **endogenous** (in other words, microeconomic or internal ones). Quite often we can observe a situation when exogenic reasons influence the occurrence of internal factors. As A. Hołda (2006, p. 55) observes, the macroeconomic situation affects the ability of the company to stay on the market, and at the same time determines the intensity of the occurrence of the bankruptcy phenomenon with regard to the whole economy.

Exogenic reasons come from the entity's environment. They include phenomena associated with the economic situation and the fiscal, monetary and exchange rate policy dependent on authorities. Thus, they influence the firm, at the same time being beyond its impact (Korol 2010, p. 40). T. Korol (2010) distinguishes here three categories of phenomena: those influencing all entities (or by far the majority of them) in the same direction (e.g. changeability of exchange rates) and those affecting various groups of entities in opposite directions. J. Sułowska (2018, pp. 380 – 381) as subcategories mentions groups of macroeconomic and sectoral factors. In the first one she continues the division into foreign, domestic and regional factors.

With regard to this classification, L. Bednarski (1999, p. 167) distinguishes external and internal symptoms of bankruptcy in a similar way. He divides **external symptoms** coming from the environment of a business entity into: foreign, domestic and industry-related ones. **Internal symptoms** refer to the possessed resources of the firm and can be grouped into **financial and non-financial** ones. In the **financial symptoms** group the biggest role is played by a quantitative decrease in sales, which often evokes such consequences as a drop in turnover, operating profit, as well as problems with maintaining financial liquidity (an increase in receivables, often overdue ones, the growth of demand for credits and loans, and then difficulties with their repayment; the growth of liabilities towards suppliers and public law institutions (including also overdue liabilities) (Nahotko 2003, p. 63).

Among **non-financial symptoms** we can indicate mistakes in the organization and management, mistakes in human resources management, behavioural factors, as well as mistakes in the financial policy and marketing policy. Mistakes in the area of management which may be related to the organizational, strategic and tactic sphere, are, according to J. Sułowska (2018, s. 381 – 383) the main internal impulse for the occurrence of a crisis.

We cannot certainly talk about the existence of a closed "catalogue" of factors which cause crisis situations, and in the course of further events are a source of bankruptcy. However, P. Antonowicz (2015, p. 110) draws a conclusion that almost always specific causes of bankruptcies arise from mistakes in the management sphere and they include the lack of a proper reaction to negative stimuli from the internal and external environment.

Returning to the superior division of the cause of bankruptcies, S. Nahotko (2003, pp. 48 – 51) suggests their division according to two criteria: place and time. In accordance with the first of them also external and internal factors are isolated, whereas in accordance with the time criterion we can determine short-term and long-term factors, which, after putting together these two criteria, enables to obtain external short-term factors, external long-term factors, internal short-term and external short-term factors (Gabrusewicz 1998, pp. 75 – 76). External short-term factors appear as a surprise for the firm, but they operate for a short time, e.g. the withdrawal of a cooperating entity or a change in the demand for a specific product (group of products). External long-term factors are easier to observe. They result from the conditions of the macro-environment with regard to systemic solutions. As for short-term factors, the internal factor group is first of all the effect of the shaping of the volume and structure of sales revenues, enforcement of receivables, as well as the impact on costs, expenses or stock. On the other hand, internal long-term factors are related to the processes of creating assets, their restructuring, as well as shaping the capital structure.

As it was pointed, there are a lot of causes of bankruptcies of companies, both internal and external ones. They differ with the chance of predicting them, prevention and the intensity of results.

Causes occurring inside the organisation exert large influence on it, but they are easier to identify and redress. External causes influence the firm in a similar way that internal ones do, however, they are more difficult to predict and have very acute consequences (Świerk, Banach 2013, pp. 441 – 452).

4. The analysis of the credit position in the context of bankruptcies of firms in Poland

The identification of the symptoms of bankruptcy in Poland is possible through continuous monitoring of the financial, operating sphere and studying changes occurring on the market. It is emphasised in the literature that the results of the conducted economic

analysis deserve special attention. Owing to it, we can find out whether the situation in the firm has improved or perhaps it has worsened. As research shows, most often the beginning of a crisis is manifested in a decrease in the share of sales in the market. It can be often caused by the lack of marketing strategy or carrying out marketing research incompetently. Then, financial symptoms occur. A drop in revenues negatively affects the shaping of cash proceeds, and what follows, there are problems with the settlement of liabilities on time. The need for cash increases. Therefore, alternative solutions are sought - a strive for obtaining a foreign capital, e.g. a credit is obtained, however, the cost of obtaining it is high due to the risk of the firm's activity. The lack of the possibility to obtain a credit, or high cost of credit servicing may lead to the sale of stock at a lower price, and then the sale of all fixed assets. All these events present so-called domino effect. Unless they are stopped, it can brought about insolvency, and consequently the declaration of bankruptcy. As research shows, most symptoms of bankruptcy come from the financial sphere, which in spite of complex results of their occurrence are relatively easy to capture because they are measurable (Korol, Prusak 2005, pp. 49 – 50).

On the basis of the presented deliberations it seems that one of many significant parameters or measures signalling the threat of the firm's bankruptcy may be the company credit policy ratio. It synthetically presents the situation regarding the trade credit management in the context of both granting and using it. An analysis of the symptoms of the threat of bankruptcy, as well as the published research findings definitely show that one of the basic causes of bankruptcy is the loss of financial liquidity caused by the inability to pay due liabilities on time. Therefore, we can conclude by determining the credit position of the firm in the time preceding the moment of the declaration of bankruptcy that the entity should be rather in the position of the recipient of trade credit. Therefore, the credit position ratio reflecting the situation should take values lower than one.

In order to verify the **hypothesis** made, a few companies from different industries which declared bankruptcy in the past were analysed. Based on the available financial statements and reports of the analysed companies, the values of the credit position ratio over a few years preceding the declaration of bankruptcy by those entities were established. Attention was also paid to the shaping of the current liquidity ratio in that period in order to obtain additional information about the financial standing of those entities.

The following companies were analysed: Advadis SA, Ampli SA, Drewex SA, Krośnieńskie Huty Szkła Krosno SA, Próchnik SA, VRG SA.

Table 1 presents values achieved by the credit position ratio in the individual companies over a few years preceding the bankruptcy of the analysed companies. The last analysed year in the Table is the one when the studied enterprise declared bankruptcy.

Table 1

Values of the credit position ratio in the companies in the period preceding their bankruptcy

Companies	Values of the credit position ratio in the subsequent years					
Advadis SA	2009	2010	2011	2012	2013	2014
	0.76	0.66	0.34	0.05	0.03	0.02
Ampli SA	2009	2010	2011	2012	2013	2014
	(.)	0.83	0.87	> 1*	> 1	0.31
Drewex SA	2008	2009	2010	2011	2012	2013
	0.81	0.58	0.33	0.06	11.8	> 1
Krośnieńskie Huty Szkła Krosno SA	2003	2004	2005	2006	2007	2008
	(.)	(.)	3.83	2.57	2.61	0.83
Próchnik SA	2013	2014	2015	2016	2017	2018
	0.33	0.4	0.53	18.85	8.75	0.33
VRG SA	2003	2004	2005	2006	2007	2008
	(.)	0.80	0.71	1.05	0.79	0.70

*the value of the ratio >1 stands for the situation when in a given year in the company trade liabilities in the balance sheet are presented on the zero level.

Source: own study based on statements and reports available on websites of the companies and in the Emis base/service

When attempting to draw conclusions from the conducted research we can see that in the year in which bankruptcy was declared the companies were rather in the situation of the recipients of trade credit (except for Drewex SA). When analysing and generalising the conducted study we can indicate that in the previous years the firms had the position of the giver of trade credit, and actually only in the year of declaring bankruptcy or in the year preceding the bankruptcy (VRG SA), the firm achieved the position of the recipient of trade credit as a result of the considerable growth of the liability level. The situation is confirmed by the values of the current liquidity ratio achieved by the companies (Table 2).

Table 2

Values of the current liquidity ratio in the companies in period preceding their bankruptcy

Companies	Values of the current liquidity ratio in the subsequent years					
Advadis SA	2009	2010	2011	2012	2013	2014
	1.05	0.74	0.78	0.03	0.07	0.01
Ampli SA	2009	2010	2011	2012	2013	2014
	(.)	1.16	1.17	1.19	0.99	0.60
Drewex SA	2008	2009	2010	2011	2012	2013
	1.47	1.15	0.92	0.21	0.11	0.09
Krośnieńskie Huty Szkła „Krosno” S.A.	2003	2004	2005	2006	2007	2008
	(.)	1.86	1.96	1.55	1.48	0.34
Próchnik SA	2013	2014	2015	2016	2017	2018
	2.95	0.66	2.44	0.82	0.46	0.30
VRG SA	2003	2004	2005	2006	2007	2008
	(.)	2.1	2.7	4.1	3.5	0.7

Source: own study based on statements and reports available on websites of the companies and in the Emis base/service

In the analysed companies we can notice considerable fluctuations of financial liquidity expressed in values which the current liquidity ratio achieved. Generally, in all the companies analysed we can observe a drop of financial liquidity in the period preceding bankruptcy to adopt the lowest values in the year of its declaration.

5. Conclusions

It seems that the analysis of the financial liquidity of an enterprise, including also its credit position, is becoming more and more important in the context of the increasing problem of bankruptcies of firms in Poland. According to the statistics (BIG Info Monitor ..., 2020) in 2019 bankruptcy was declared by over a thousand of companies, and nearly every third entrepreneur has a problem with liquidity. As BIG Info Monitor study shows, for 16 percent of enterprises these are big or regularly repeating problems. The most threatened entities are those from transport and trade industries. Liquidity problems can translate into business relations and, in the worst case, they lead to bankruptcy.

Problems with maintaining financial liquidity in enterprises are manifested, among others, in difficulties with timely settlement of their trade liabilities, and on the other hand, often too high a level of receivables, which unfortunately favours the growth of doubtful or lost receivables. When conducting activities, enterprises adapt to changes in the environment, market requirements and also want to be up to their competition, the

effect of which is often a change in the previously conducted policy on trade credit, as well as on using this credit (Borowiecki, Wysocka 2012, pp. 30 – 42). therefore, it is necessary, which is emphasised in this article, to analyse and control parameters of the company credit policy.

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Abstract

This article discusses a problem which is really topical in the times of the current economic crisis, namely the problem of financial liquidity management in the context of the bankruptcy of enterprises. Attention is paid to basic causes leading to the bankruptcy of enterprises. Among them, the most important one is the mentioned loss of financial liquidity. It is manifested in the macro-economic approach - an increase in payment

gridlocks in companies, resulting both in the growth of liabilities and, on the other hand, the lack of the possibility of timely settlement of due liabilities. In this context, the problem of shaping credit policy, the effect of which is the credit position of the firm, becomes particularly important.

The analysis of the credit position is conducted on the example of a few companies which declared their bankruptcy in the past, based on their financial statements and reports. Research findings confirmed the hypothesis formulated in this article, as well as the conclusions drawn indicated that the position of the trade credit recipient was prevailing in the situations of the bankruptcies of companies, and the problems regarding the maintenance of financial liquidity were significant causes of declaring their bankruptcies.

Key words: bankruptcy of the enterprise, company credit policy, financial liquidity in company, credit position of the enterprise,

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