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Corporate Governance in Downturn Times: Detection and Alert – The New Italian Insolvency and Crisis Code

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Additional information is available at the end of the chapter

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Abstract

In its life cycle, an enterprise may experience periods of crisis. If the crisis is monitored promptly and appropriate measures are taken, not only may the enterprise continue to operate but it may also be able to seize opportunities for growth. The Italian legislator is introducing a procedure aimed at supporting companies to detect the very first warning signs of a crisis. The supervisory board of auditors, the audit firm, and certain qualified creditors will have the right and duty to start the early warning procedure (“allerta”). The board of statutory auditors (Collegio Sindacale) plays a fundamental role: its ex-ante supervisory and control activities over management allow it to effectively play an important role as main recipient of any crisis warning signs. The new regulatory framework lays down certain indicators and critical thresholds, which may trigger the alert process. Initially, the Delegated Legislation (Bill No.3671-bis) sets forth certain specific financial indicators. The new bill (Crisis and Insolvency Code) on the contrary refers to a more complex and sector-specific system of indicators. The findings of an empirical research conducted by analysing a sample of more than 600 enterprises and testing the discriminating capacity of the indicators initially considered are presented herein.

Keywords: crisis, insolvency, alert measures, board of statutory auditors (*Collegio Sindacale*), audit firm, *crisis settlement body for companies* (OCRI from its Italian initials), performance measurement, crisis indicators, Italian crisis and insolvency legislation, crisis thresholds, European directive on preventive restructuring frameworks and insolvency (COM (2016) 723), UNCITRAL

1. The business crisis as an opportunity for growth

The crisis is a stage in which the company can find itself during its life cycle. If well managed, but above all identified in time, it can also represent an opportunity for growth. In fact, the crisis (from the Greek κρίσις, decision) translates into change, the need for a turnaround and represents, at the same time, an event from which to derive a strengthening of the company with evolutionary perspectives that would not have occurred, without the manifestation of the state of difficulties [1].

The crisis-opportunity binomial [2] could appear to be a contradiction; it is normal to think that a company experiencing difficulties does not have the resources to grow, but it is instead fundamental that the crisis be faced also by investing in internal resources and skills, guiding them towards the achievement of new balances [3]. A crisis promptly diagnosed and managed with a view to growth will bring with it not only an improvement of the members' skills in the organisation and the introduction of management innovations, but including the increase of the cohesion level of the entrepreneurial group and the gaining of experience for preventing future crises.

The concept of crisis, for entrepreneurs, is complex to deal with, many of them take an attitude of rejection towards this event and have substantial difficulties in admitting the downfall, even when they are already involved, at least as long as it does not assume size such as to be diagnosed as a real overt crisis.¹ Crises, in fact, are preceded by stages of decline [4], which if promptly diagnosed and addressed, can stop the degenerative process, and even trigger a total reversal process [1]. Situations of decline or crisis may arise from inefficiency, overcapacity or structural rigidity [1] from decay of products, from shortcomings and marketing errors, from the inability to programme, from errors in strategy, from a lack of innovation or from others [4]. Crises often occur, therefore, not because they are unavoidable, but because companies are unable to perceive the warning signs; they are not able to limit the harmful effects and above all to monitor the threats to prevent them [5]. Often the degenerative process is due to the inadequacy of entrepreneurial and managerial resources with respect to the complexity of the issues to be managed [6].

2. Crisis stages and warnings: the role of actors involved in corporate governance and external parties

When a company goes into crisis, imbalances and inefficiencies start to appear, productivity and turnover are reduced, with the consequent creation—in the case of an industrial company—of stock surpluses and, more generally, of an inadequate coverage of financial needs.

¹Please refer to the following paragraph for the classification of the various stages of crises, the benchmarking of possible interventions consistent with new legislation and the identification of the role of actors involved in corporate governance and external parties.

This provokes during a period of greater or lesser duration, a contraction of profits or even losses with the consequent gradual impoverishment of the available shareholders' equity. The persistence of this situation can lead, if timely measures are not taken, to more significant difficulties and to the inability to cope on a regular basis, with the obligations assumed. This can be followed by damages to the company's image and credibility and consequently, the loss of customers and a decline in confidence in the financial system which translates into, in the Italian context, primarily as the loss of bank credit facilities.

A number of authors studied the typical timetable of situations that usually occur when a company goes into crisis and, if it fails to carry out an effective and prompt *turnaround* action, it becomes insolvent [4, 7, 8]. During each stage, it is possible and relevant that persons in charge of the corporate governance—both with a management role as with the role of supervision and control—must carry out associate actions as the difficulties arise and therefore, the management of the crisis stages. In accordance with the European Directive (COM (2016) 723)—on preventive restructuring frameworks and insolvency—Italy has implemented the Directive by introducing the “enabling act” first and then the “crisis and insolvency code”. In the following paragraphs, we try to provide a systemic reading that takes into account the indications of the new Italian “crisis and insolvency code” published as a draft in December 2017. The stated goal of the new regulatory framework is to achieve a better satisfaction of creditors safeguarding the rights of debtors, as well as encouraging the overcoming of the crisis by ensuring business continuity.²

2.1. First stage: incubation of the crisis and “informal” internal alert

At the beginning, an incubation stage develops which can be considered normal as can occur to any company on structural grounds. It manifests itself with the identification of management or production inefficiencies. Its severity and evolution must be assessed by the administrators also with the aid of forecasting tools such as the business plan to assess the progress of management and intervene with specific corrective actions. Corporate supervisory bodies will analyse the behaviour of administrative bodies ensuring that an adequate organisational system is implemented with particular reference to the presence, structure and functioning of an adequate system of internal control and having a reliable and effective dashboard of indicators that monitors all the parameters and thresholds identified in the new “insolvency crisis code”. Reference is made to Section 4 in which more information is provided on the subject of “crisis indicators”. The new Italian legislative framework provides that when “serious indications” of a crisis are detected, control bodies must immediately notify the board of directors of the appropriate measures.

The current critical situation is absolutely evident and requires the exercise of a high degree of professionalism and experience by all the players involved. It is only necessary to observe that

²It is worth highlighting that the new crisis and insolvency code provides a judicially relevant definition of the two concepts of “crisis” and “insolvency”. More specifically, the “economic crisis” must be understood as the state of economic and financial difficulties that makes a debtor's insolvency probable and that for companies, it manifests as an inadequacy of prospective cash flows to *regularly* meet planned obligations. On the contrary, a debtor is defined as “insolvent”, when it is no longer able to meet its obligations on a regular basis, and this manifests itself as defaults or other external factors.

at this stage, the intervention of the corporate supervisory bodies must be balanced and must take into account the fact that the company is facing difficulties, but that these are likely to prove reversible. Only an understanding of the features that characterise the situation being faced will therefore allow weighing lines of conduct appropriately. Measures that are too invasive and disproportionate, due, for example, to errors in classifying the situation that lead to anticipating behaviour, and therefore, reports, foreseen for the subsequent stages, could themselves constitute causes of a worsening and stiffening of the situation, which is clearly undesired, risking taking the form of self-fulfilling prophecies.

On the other hand, directors must learn to understand the importance of the role of the board of statutory auditors (*Collegio Sindacale*) and new duties, but, it is good to underline, including the new powers that the new code has objectively acknowledged, further legitimising their work. Especially in smaller companies, it will therefore be necessary for directors—to avoid unnecessary conflicts and therefore, risks of repeated reports—to develop, on the one hand, a better ability to listen to the indications of supervisory bodies, and on the other hand, a better capacity for reporting which must be systematic, formalised and timely on the measures undertaken and their impact.

2.2. Second stage: maturity of the crisis and “formal” internal alert

If a solution is not found, the company may slip into a second stage of maturity of the crisis. The inefficiencies that during incubation were not promptly dealt with produce more consistent effects and begin to affect company resources. The first financial difficulties are beginning to be encountered, which can result in worsening of the economic results achieved and also in terms of assets with a reduction of the available shareholders' equity, affected by the unsatisfactory results of the period. The reading of official financial statements can lead to the first, probably weak, reactions from stakeholders, which, while continuing to have confidence to the company, can however start to show concern. At this stage, it is even more essential for the intervention of administrative bodies to be decisive and focused as they must assess the severity of the most probable evolution of the situation and the effects of the latter on business continuity.

In order to make the alert more timely and, in consideration of the importance of banks, especially in the Italian context, as main lenders, or only lenders to smaller-sized companies, the new regulatory framework has introduced direct disclosure obligations between these parties and the corporate supervisory bodies. More specifically, banks, when they notify changes or revisions in credit lines to the customer, must also inform the corporate supervisory bodies, if any.

Supervisory bodies, in particular, as we will see better in next paragraphs, the board of statutory auditors, which constantly monitors a series of corporate performance indicators, are called at this stage to assess whether to implement an “internal alert” system. They must ensure that directors are aware of the existence of a more identified and relevant criticality than in the previous stage and of the need to undertake a well-identified path to avoid the consolidation of a crisis situation.

To this end, the board of statutory auditors and the other controllers may decide to take some further steps, this time more formal. Once the situation has been classified as significant

and, of course, in the event of inertia of the directors, that is, only in the case where adequate measures have not already been implemented by the directors as a result of less invasive interactions with the supervisory bodies themselves, they may decide to implement a specific “reporting procedure”. The latter consists of sending, with reason for its own decision, an official written notice—therefore, with proof of receipt—to the directors with whom an appropriate, but short time limit not exceeding 1 month is set—within which the board of directors must report on the solutions identified and the initiatives undertaken.

The risk that, in the absence of timely intervention, the thresholds that may lead to automatic reporting by qualified public creditors, better described later, may be exceeded must be duly taken into consideration by both the directors and the control bodies.

2.3. Third stage: reversible full crisis, internal alert “to external entities” and external alert

If the intervention described in the previous stage does not occur in a timely manner or if it does not produce a positive outcome, the company may however enter a full-blown crisis stage. The latter is characterised by the emergence of more significant financial imbalances that, once again, if not actively managed, can seriously compromise business continuity. We arrive at the “crisis” in a judicial sense, or in other words, as mentioned earlier, to the “inadequacy of future cash flows to meet regularly planned obligations”. During this stage, the relationship with the lenders to the business activity becomes fundamental. In respect to the latter, they must be provided with the opportunity of having access to detailed and prospective information in order to allow them to assess the company’s situation and a shared and rational strategy must be agreed upon with them. The risk of losing the trust of corporate stakeholders is, however, more general during this stage and not limited to this category. Even customers, suppliers and employees, to cite the main stakeholders, need to have access to the same information; otherwise, the company can lose fundamental resources for its own survival [9, 10]. The company and, therefore, the directors must demonstrate in a transparent and convincing manner the existence of strength elements—of an industrial or commercial type—and/or that extraordinary interventions have been planned—such as internal reorganisation, cost restructuring, strategic repositioning, partnership with new entities, recapitalisation by the shareholders themselves or by third parties—such as to make it possible to classify imbalances identified as temporary.

The corporate supervisory bodies monitor the correct setting up of a dialogue process with the parties that are strategically relevant for company’s survival. They must also assess whether the company can still emerge from the crisis independently, under the guidance of solely the directors or if, in order to secure the company’s business, it is necessary to trigger an “internal alert to external entities” process. With this regard, the new legislative framework provides that, in the event that planned interventions, including possibly following the first informal and then formal “internal alert” referred to in the previous stages, are considered inadequate or in the event of inertia, that is, failure to take sufficient measures, the corporate supervisory bodies must report the situation identified to a specific third party called OCRI (from its Italian initials, “*Organismo di composizione della crisi di impresa*”) or crisis settlement body for companies. It is necessary to highlight that: (1) on the one hand, the timely reporting to the

body responsible for the settlement of the crisis constitutes a cause for exemption from joint and several liability for the corporate supervisory bodies due to the detrimental consequences of the omissions or actions subsequently implemented by the board of directors in contrast to the requirements received, which are not a direct consequence of decisions taken before the report; (2) on the other hand, and in the same way, reward measures are foreseen for entrepreneurs who provide a timely remedy to the crisis situation.

As already mentioned, the new code also identifies a specific category of parties considered to be particularly relevant for the timely emergence of the crisis which are defined as “qualified public creditors” and which are given very significant powers in the alert process. The parties are IRS (*Agenzia delle Entrate*), the national insurance institution and the tax collection agent. They are given the power to send an additional alert to the “crisis settlement body for companies” (OCRI). This alert is a “totally external alert” or, better, an “external alert to external entities” as it is brought forth by a third party with “opposing interests” with respect to the company and is addressed to another external entity. The envisaged procedure is totally objectified as it operates in accordance with specific automatisms, based on overcoming the identified thresholds of doubtful debts,³ it is necessary to understand that it could therefore already be triggered even in previous stages. The above-mentioned is a modality of introducing the alert which is completely independent and concurrent with respect to that entrusted to the corporate supervisory bodies: an exchange of direct and preliminary information between the two parties does not seem in fact to be coordinated nor explicitly required. External alerting requested by institutions can be divided from a timing standpoint into two phases. First of all, they are required to give immediate notice to the debtor—and therefore, directly to the directors and not to the corporate supervisory bodies—of the fact that the debt exposure has exceeded the critical threshold identified by the legislation as relevant.⁴ Then, they must wait the short term of 3 months to allow the debtor to resolve the situation subject to notification by one of the following actions: (1) the extinction per se of his/her/its debt; (2) or reaching an agreement with the reporting body; (3) or again, the company’s submission of application for settlement assisted by the crisis or the application for access to an agreed procedure for resolving the crisis. In the event of the directors’ inactivity, at the end of the 3 months, they are again required within the short term of 30 days to: on the one hand, send a specific report to the supervisory bodies of the company, and on the other hand, contextually, to send a specific report directly to the crisis settlement body for companies.

³The debt exposure is considered to be of a significant amount: (1) for the revenue agency, when the total amount of debt expired for value added tax is equal to at least half of the total value added tax due for the previous year and is in any case higher than 100,000 Euro; (2) for national insurance, when the debtor is overdue by more than 6 months in the payment of national insurance contributions of an amount greater than half of those due in the previous year, and in any case, higher than the threshold of 10,000 Euro; (3) for the tax collection agency, when the sum of the receivables assigned for collection by the debtor exceeds the amount of 5% of the volume of business resulting from the taxpayer’s last tax return, provided it exceeds the threshold of 30,000 Euro, or in any case, when it exceeds the amount of 5000 Euro; in the case of exclusively value added tax debts, the reference threshold is that indicated in t and (4) If the debtor documents that it is the holder of tax credits or other receivables from public administrations for which 90 days have elapsed since the formal notice, for a total amount that, brought in correspondence with the debts, determines the failure to exceed the thresholds identified by the legislator. In this case, qualified public creditors shall refrain from reporting.

⁴The notice to the debtor must be made by certified electronic mail or, in the absence, by registered mail with acknowledgement of receipt which must be sent by the revenue agency together with the reporting of irregularities. The national insurance institution and the tax collection agent must notify the notice within 30 days of the threshold being exceeded.

The notice from “qualified public creditors” to “corporate supervisory bodies”, envisaged only subsequently—after the terms granted—and not at the beginning of the process, seems to confirm that already noted, namely the fact that the two alerts are concurrent. It is quite clear indeed that when the first parties turn their attention to the latter to inform them, they are not carrying out an action aimed at finding a shared solution, but in fact, they notify one-sidedly what is now considered a concrete state of affairs that one can only note. It seems that this notice has more than anything else the function of providing a certain date at the time when the first of the alerts was also triggered for the purpose of applying exemptions and incentives to the corporate supervisory bodies on the one hand, and on the other hand, penalties from the institutions. It must be noted that while corporate supervisory bodies are expected to provide incentive mechanisms for emerging from a state of crisis, in the case of “qualified public creditors”, the new legislative framework provides for penalties in the event of inertia of the institution and therefore, potential delays in reporting. In particular, for the IRS (*Agenzia delle Entrate*) and the national insurance institution, it is envisaged that the right of pre-emption will have no effect on the receivables held by them, while for the tax collection agent, the unenforceability of the receivable is envisaged for collection costs and charges.

The effects of the operation of the OCRI or of the crisis settlement body for companies are immediate. It is expected that the body appoints a board of three independent professionals (henceforth also known as the Triad), bound—among other things—by the obligation of confidentiality on all information acquired during the performance of their duties and who must keep secret facts and documents of which they may become aware in connection with their office.⁵ The Triad promptly convenes the directors to identify with them the possible measures to be taken to remedy the crisis and sets a deadline by which the directors must report with regard to their implementation. If the company proves to have identified a specific route and to have undertaken initiatives deemed useful to follow it, a deadline of not more than 3 months is set, which can be extended up to a maximum of 6 months in the event of positive results of the negotiations, in order to search for an agreed solution to the crisis. In most cases, the route proposed by the company must be out of court based on substantial agreements undersigned with the creditors and filed with the body, and they cannot be shown to parties other than those who have signed them. These agreements assume significant legal value as they are not subject to the revocation action exactly as would happen in the event of implementing a recovery and resolution planning (“*piano attestato*” pursuant to art. 67 of the bankruptcy law—see below). The new code does not exclude the direct recourse to procedures for regulating the crisis—characterising the next stage—see below—without a prior attempt to settle out of court, also providing in these cases for the possibility of a more invasive intervention by the Triad.

⁵Once the report has been received, the contact person of the Body appoints without delay a panel of three experts from those registered in the register of crisis and insolvency managers, of which: (1) one is appointed by the chairman of the specialised section with regard to insolvency proceedings by the court in the place where the company’s registered office is located or by a representative of the company; (2) one is appointed by the president of the chamber of commerce, industry, crafts and agriculture or by his/her representative, and must be different from that appointed by the contact person and (3) one is appointed by the local representatives of the business associations of each category, each of which forwards to the body, a list containing a number of experts registered in the aforementioned register, among which the contact person identifies the one appointed by the representative association of the sector to which the debtor belongs.

2.4. Fourth stage: reversible insolvency and use of crisis and insolvency procedures

In the event of the failure of out-of-court negotiations, assisted or not by the Triad appointed by the OCRI, the company structurally enters into a stage classified as reversible insolvency. The new code recognises “insolvency” as the status of a debtor who is no longer able to meet its obligations on a regular basis. During this stage, this situation is known and manifests itself in the company, both outside of third parties for the failures incurred and for attempts—which have been proved unsuccessful—to reach individual or collective free agreements with creditors. In the event that the external alert has already been triggered in the previous stage, and by the assigned or extended deadline, it has not been possible to reach an out-of-court agreement with the creditors involved, the Triad requests the debtor to apply for access to a procedure for regulating the crisis or insolvency within a very short time (maximum 30 days).

In the first instance, the directors must verify that the situation is still reversible, that there are specific possibilities for carrying out a turnaround in direct or indirect continuity or the implementation of a liquidation intervention plan beneficial to creditors. The tools provided for this from the new crisis and insolvency code⁶ are, in substance, even if subject to some significant changes, those already introduced in 2005 in Italian legislation following less invasive reforms, but that undoubtedly have had a significant cultural and behavioural impact⁷ [11–16].

To counter the difficulties of the crisis, the Italian government has indeed already introduced during the last decade some specific instruments: (1) recovery and resolution planning (“*piano attestato*” pursuant to art. 67 of the bankruptcy law); (2) restructuring agreement (“*accordo di ristrutturazione*” pursuant to art. 182 bis of the bankruptcy law) and (3) PAC-preventive arrangement with creditors (“*concordato preventivo*” pursuant to art. 160 of the bankruptcy law).

In the PACs, the proposal extends along one of the following alternatives [15, 16]: (1) restructuring of debts and satisfaction of credits through any form, including the sale of assets and the allocation of shares or other financial instruments (“*concordato liquidatorio*”); (2) ongoing business managed by the debtor (“*continuità diretta*”); (3) business or part of the ongoing business transferring the property thereof to one or more different companies (“*continuità indiretta*”). In the first case—liquidation agreement—the debtor must “ensure” payment of secured creditors and a minimum payment of at least 20% of the corresponding original unsecured debt. More than this, the debtor must provide new funds to be able to add at least a 10% to the sums allocated to unsecured creditors.

These techniques form a continuum based on the degree of judicial intervention and the degree of formality in general [21]. Ideas to shape them come from the US Chapter 11

⁶Procedures for settling the over-indebtedness crisis which essentially concerns consumers, professionals and minor entrepreneurs are here ignored.

⁷The reform of Italian Bankruptcy and Business Recovery Law was introduced in 2005 and then reviewed more than once [11, 17–19]. It has fundamentally changed the philosophy and the basics of the country’s business recovery procedures. The new regulations has been introduced to the maintenance and recovery of the company by estimation of agreements between creditors and entrepreneur, with a greater involvement of the former in management of the crisis [12, 20].

tradition [22–25] and from United Nations Commission on International Trade Laws [26], Legislative Guide to the Insolvency Law. The focal point is that restructuring can help to preserve the business value of debtor enterprises, the interests of other stakeholders and the benefit of creditors as a whole [4]. According to the UNCITRAL Legislative Guide (2005)¹, all debtors that falter or experience serious financial difficulties in a competitive marketplace should not necessarily be liquidated; a debtor with a reasonable survival prospect (such as one with a potentially profitable business) should be given the opportunity to demonstrate that there is a greater value (and, by deduction, greater benefit for creditors in the long term) in maintaining the essential business and other component parts of the debtor. Restructuring and reorganisation proceedings are designed to give to the debtor some breathing space to recover from its temporary liquidity difficulties or more permanent over-indebtedness and, as necessary, provides the debtor with an opportunity to restructure its debt and its relations with creditors. If reorganisation is possible, generally, it will be preferred by creditors if the value derived from the continued operation of the debtor's business will enhance the value of its claims [11, 12].

The success of any restructuring technique is related to the quality of operations that the company has planned to implement. This is the reason why, no matter which of the three instruments the company chooses, the law requires that more than one independent expert should analyse the potentially prospective financial data produced by the recovery strategy. Different specific opinions are required about the feasibility of the project and the fairness of the expected figures. In recovery and resolution planning and in restructuring agreement, they are expressed by an independent expert indicated by the company, while in PACs, a second opinion is needed from the Trustee indicated by the Court.

In addition, the situation is continuously monitored by the Board of Statutory Auditors (*Collegio Sindacale*) [27]. In fact, at this stage, the corporate supervisory bodies—after contributing to the alert process that led to structuring the solution chosen by the company—continue to perform their supervisory and auditing activities. To this end, they monitor, in compliance with the documents issued by the Italian Board of Certified Public Accountants (Rules of Conduct of the Board of Statutory Auditors, December 2015), the conduct of the directors, the economic and financial performance and the company's financial statements, assessing, in carrying out their periodic checks, the sustainability of the choices made and the methods for actually implementing the latter. The results of this activity are noted in their minutes and reports.

2.5. Fifth stage: full insolvency and application for judicial liquidation

If directors do not consider the possibility of applying one of the procedures for regulating the crisis and insolvency or the latter have not had the desired outcome, the company finds itself in the final stage of the process called overt insolvency. The situation is now irreversible, financial reconstruction goals are no longer usefully pursued, nor are there sufficient fresh financial resources available to implement an agreed settlement. In fact, it is only necessary to remember that the new code provides for the possibility of setting up a settlement agreement only if there is an insufficient contribution to increase the satisfaction of unsecured creditors by at least 10%. The only viable way therefore, remains that which the new code calls “judicial

liquidation”, with this expression meaning the procedure currently known as “bankruptcy”.⁸ It is important to highlight that among the persons entitled to file a petition for the opening of the proceedings, the code envisaged alongside the debtor himself, creditors, the public prosecutor and the corporate supervisory bodies and therefore, first of all, the board of statutory auditors.

2.6. Summary table

Table 1 provides a summary that highlights planned initiatives and who is actively involved in the various stages of the crisis, distinguishing between bodies that operate in the corporate *governance* sphere with management roles or supervisory roles and external entities.

2.7. A short comparison with the French “Alerte”

The Italian system to detect business crisis can be compared with the French “Alerte”. The Italian law actually was inspired by this prior model.

Two roles are similar. As soon as the entrepreneur understands that sooner or later the company will get into a crisis, he can undertake a preventive and objective diagnostic process. This helps him to identify the causes of the situation and to be able to remove them as quickly as possible. The entrepreneur evaluates the severity degree of his difficulties so that the “Alerte” process helps him to properly manage the situation. If the entrepreneur is not able to do the job by himself, auditors are asked to notify the alert as soon as they identify facts that could compromise the continuity of the business. If the entrepreneur, once informed, does not give a satisfactory answer or even when the decisions taken by the “assemblée générale” do not guarantee the business continuity, auditors can ask to be heard by Court President.

Some other roles are different. On the one hand, as already pointed out, the Italian new code identifies a specific category of parties considered to be particularly relevant for the timely detection of the crisis which are defined as “qualified public creditors” and which are given very significant powers in the alert process. The parties are IRS (Agenzia delle Entrate), the national insurance institution and the tax collection agent as already explained. On the other hand, in France: (1) a specific power is given to employees through the “comité d’entreprise”. When they get aware of the facts that may affect the company’s economic situation, they can request explanation to the employer. If the answer confirms the situation detected, they may decide to send a report to the entrepreneur and to the auditors and (2) then, shareholders informed of events that may compromise the business continuity, can notify the facts to management through a written question. The answer must also be communicated to the auditors who can notify it to the Court President if they consider it useful and (3) at last, the

⁸The desire to impose a change of name is not only a lexical whim, but brings with it the desire to eliminate the very negative connotation unquestionably linked—in the Italian context—to the concept of “failure” and consequently of “loser” when addressed to individuals. This decision was probably also influenced by the detection during the years of crisis of an important increase in the number of suicides among Italian entrepreneurs. According to the Link Lab Social Research Laboratory of Link Campus University, “suicides due to financial reasons” were over 800 from 2012 to date. From the above-mentioned, about 43% are entrepreneurs, of which more than 30% are in the North-East alone. <http://linklab.unilink.it/suicidi-motivazioni-economiche-dati-1-semester-2017>

Stage	Business situation	Planned initiative	Parties involved	
			Within Corporate Governance (with management or supervisory roles)	External parties
1	Incubation of the crisis	Informal internal alert	<ul style="list-style-type: none"> • Directors • Corporate supervisory bodies: Board of statutory auditors (<i>Collegio Sindacale</i>), Audit Firm 	---
2	Maturity of the crisis	Formal internal alert	<ul style="list-style-type: none"> • Directors • Corporate supervisory bodies: Board of statutory auditors (<i>Collegio Sindacale</i>), Audit firm • Legal advisor, Financial advisor 	<ul style="list-style-type: none"> • Credit institutions, Banks • Independent expert, I.E. (<i>Attestatore</i>) • Possibly: Court, Judicial Commissioner J.C. in the event of a PAC
3	Reversible overt crisis	Internal alert to external entities (corporate supervisory bodies). External alert to external entities (qualified public creditors)	<ul style="list-style-type: none"> • Directors • Corporate supervisory bodies: Board of statutory auditors (<i>Collegio Sindacale</i>), Audit firm • Legal advisor, Financial advisor 	<ul style="list-style-type: none"> • Qualified public creditors • Crisis settlement body for companies (OCRI) • Triad of independent professionals appointed by the OCRI • Independent expert, I.E. (<i>Attestatore</i>) • Possibly: Court, Judicial Commissioner J.C. in the event of a PAC
4	Reversible insolvency	Crisis and insolvency regulation procedures	<ul style="list-style-type: none"> • Directors • Corporate supervisory bodies: Board of statutory auditors (<i>Collegio Sindacale</i>), Audit firm • Legal advisor and Financial advisor 	<ul style="list-style-type: none"> • Crisis settlement body for companies (OCRI) • Triad of independent professionals appointed by the OCRI • Independent expert, I.E. (<i>Attestatore</i>) • Court • Judicial Commissioner J.C. in the event of a PAC
5	Full insolvency	Judicial liquidation	<ul style="list-style-type: none"> • Directors • Corporate supervisory bodies: Board of statutory auditors (<i>Collegio Sindacale</i>), Audit firm • Administrative authorities that exercise supervision and control over the company 	<ul style="list-style-type: none"> • Creditors • Public prosecutor • Court • Trustee

Table 1. Parties involved in the crisis governance and actions needed during the various stages.

most remarkable role, in France context, is the one reserved directly for the Court President. When he has knowledge of the difficulties of a company, he shall convene the entrepreneur to an interview, so that this last is provided with measures to correct his situation. He may,

if necessary, obtain from the auditors, the administrations, the social organisations and the “Banque de France”, information on the situation of the company.

3. A change from the revolutionary scope: the extension of the range of corporate bodies obliged to legal forms of control as a condition for the success of the alert procedure

The real revolutionary scope of the new code is, in the authors' opinion, the enhancement of the corporate supervisory function with the extension of the range of corporate bodies obliged to legal forms of control. The appointment of the corporate supervisory body—board of statutory auditors (*Collegio Sindacale*) or maybe single statutory auditor—becomes mandatory if the company has exceeded for at least two consecutive years; one of the following⁹: (1) total assets in the financial statements: 2 million Euro (equal to less than 50% of the previous limit of 4.4 million Euro); (2) revenues from sales and services: 2 million Euro (equal to less than 25% of the previous limit of 8.8 million Euro); (3) employees employed on average during the financial year: 10 employees (equal to 20% of the previous limit of 50 employees). The obligation to appoint the control body or auditor ceases when, for three consecutive financial years, none of the aforementioned limits have been exceeded. Size of the company becomes crucial for the appointment of the Board of statutory auditors. The lowering of the threshold beyond which is required to appoint the Board of statutory auditors is expected to carry positive effect.

The scale of this cultural change is indeed likely to be much greater and more invasive than the introduction of OCRI itself, as well as the identification of automatic crisis detection mechanisms for qualified public creditors.

The introduction of these new thresholds represents a very important recognition of the usefulness of corporate supervisory functions for the correct functioning of the system, when carried out according to the ethical and professional standards of reference [28]. The Board of statutory auditors (*Collegio Sindacale*) is the specific watchdog distinguishing the Italian corporate governance traditional system¹⁰ [12]. The abovementioned change intends to modify the behaviour of directors of medium-sized companies, but especially of small- and micro-sized companies that are very numerous in Italy¹¹ and today have escaped the obligation to equip themselves with appropriate control systems, or even with appropriate accounting and management systems. Infrequently, in these small businesses, the administrative functions are still perceived as an obligation related only to tax obligations and are delegated in full by outsourcing, losing

⁹Furthermore, companies required to draft consolidated financial statements and who control a company obliged to audit the accounts are required to appoint the board of statutory auditors.

¹⁰With the enactment of the Commercial Code in 1882, it was introduced a supervisory organ for the compliance control to the law, to the Constitution and to the Statute of the company because after the abolition of Government Supervision, it was necessary to entrust the fate of a company not entirely to administrators, whose activity in reality should be controlled to protect the interests of the company, its shareholders and all the stakeholders.

¹¹For a breakdown of the company situation and in particular, the composition of the type of businesses affected by the crisis in the last period, please refer to paragraph 5 where the empirical analysis is presented.

sight of the scope and relevance of tools such as the drawing up of frequent periodic financial statements and of business units and dashboards of significant indicators for management control and specifically for corporate governance. One only needs, in fact, to recall the Rule of Conduct 1.1 issued by the Italian National Council of Chartered Accountants and Accounting Experts (CNDCEC) [29] for the Board of statutory auditors (*Collegio Sindacale*), which establishes that the latter, in carrying out the function recognised by the law, supervises that the control system and the organisational structures adopted by the company are adequate to promptly detect signals that raise significant doubts about the company's ability to continue operating as an operating entity. The Board can request clarifications from the board of directors and request the latter to take appropriate measures.

Size is relevant because the smaller it is: (1) the less structured usually appears to be the general accounting systems; (2) the less implemented typically result in management systems and consequently, the capabilities to produce both short-term and long-term projections and forecast; (3) the weaker are expected to turn out to be internal auditors' procedures. In this context, reducing the threshold beyond which it is required to appoint the Board of statutory auditors introduces some useful and healthy routines.

In fact, among the functions of the Board of statutory auditors (*Collegio Sindacale*), the protection of all the interests must be emphasised. The administration and control system called "Traditional", as an alternative to the one-tier and two-tier corporate governance model, is the prevalent one in the Italian context. According to article 2380 of the Civil Code, the "Traditional" model constitutes the natural system of corporate governance for the management of Italian firms, the application of the two alternative models must be indeed expressly provided in a special provision of the company's statute. The structure of this model provides an administrative board appointed by shareholders, which is responsible for the management of the company, the Board of statutory auditors (*Collegio Sindacale*) again appointed by shareholders that carries out the control over the administration and the external audit firm also appointed by shareholders, which is responsible for the auditing. This model allows a precise division of roles: the administrative function is clearly separated from the control function. The Board of statutory auditors (*Collegio Sindacale*) appointed by shareholders is made up of three or five effective members (and two temporary auditors). One effective member and one substitute should be enrolled in the register of auditors. Since the introduction of the Reform of Company (Legislative Decree N. 6, January 17, 2003), the Board of statutory auditors (*Collegio Sindacale*) is responsible to supervise¹²: (1) the observance of the law and the statute, it should verify the compliance of acts and resolutions to the provisions of both law and statute; (2) the conformity of the management decisions to criteria of rationality (efficiency and effectiveness of choices) and if management has considered all the information necessary for taking operational decisions and (3) the adequacies of the organisational structure that must be suitable to the size, to the nature of the operations and to the strategies planned to achieve corporate purposes.

¹²According to Art. 2403 Civil Code, "The Supervisory Board oversees compliance to the law, to the company's Statute to the principles of good management and the adequacy of the organisational, administrative and accounting procedures adopted by the company during its functioning".

There is no doubt that the Board of statutory auditors (*Collegio Sindacale*) represents an important element of the Italian experience that should be emphasised in international contexts. The great crisis that has hit the world economy since 2008 could have been avoided if more companies would have adopted an adequate internal control system to ensure the protection of the social interest performing their duties. Even Joseph Stiglitz – who won Nobel Prize for economics, 2001 – highlighted the criticality and riskiness of governance models based only on external auditor (typical of Anglo-Saxon models) praising the Italian model based on the structural presence of a typical totally independent internal control body, that is, the Board of statutory auditors (*Collegio Sindacale*) [27]. The members of the latter attend the assembly of the Board of Directors assisting directly to the decision-making processes and stepping in meanwhile things happen. On the contrary, external auditors operate when everything has already been decided or even implemented. The peculiarity of the Italian System Controls is the joint existence of two levels of controls. A “downstream” control carried out by auditors in charge of the accounting control and an “upstream” control carried out by the Supervisory Board in charge for the surveillance of management’s behaviour. In small companies, the Supervisory Board usually undertakes both roles. With the new code, this will become the most widespread instance.

4. Dashboard of indicators and thresholds that trigger alerts: “Deterministic” approach and business economic approach

The extent of the changes introduced has made it essential to identify parameters that allow to understand as objectively as possible if the company is entering the crisis and what is the severity already reached by it in order to classify the situation. Only in this way, it is indeed possible not to delay (although it is important to underline that they must not be anticipated), the interventions envisaged by the new regulatory framework by the various stakeholders involved. This is a crucial issue which, if not duly addressed in corporate economic terms, risks not only to render the new mechanism for emerging from the crisis ineffective but also makes it very risky to issue alerts in advance. In fact, there are many elements that must be considered in order to form an opinion on a company’s situation. Many authors [26, 27] have long indicated that it is not correct to base its evaluations on the exclusive reading of some specific indices, but that it is essential to adopt a systemic approach, certainly more complex, less efficient and less objective, but more effective and with substantial and not only formal discriminative capacity.

We here describe the changes made in the legislative texts currently made available that bear witness to the current debate and the important and positive interventions occurring during the course of the work, to then propose empirical research aimed at highlighting the degree of effectiveness of the various solutions.

The issue was in fact addressed first of all in the Government Enabling Act approved on 11 October, 2017 which identified more than a systemic dashboard of economic-financial and equity indicators, literally “four” financial indicators that the corporate supervisory bodies

must take into consideration and assess in order to classify the company situation and consequently, to decide on which actions to take. These are the following parameters: (1) debt ratio; (2) credit rotation index; (3) inventory turnover index and (4) liquidity index. It is worth pointing out that in companies without a warehouse, the parameters identified are reduced to three.

The draft of the crisis and insolvency code, which has been followed up by the Enabling Act in order to implement the latter, no single indicators are recalled, but, taking in substantial terms the indications provided in the Enabling Act, it is less deterministic. It refers to a dashboard of indexes which need to be designed taking into consideration the specific characteristics of the entrepreneurial activity carried out by the debtor. Focus is on the sustainability of debts in the following 6 months and prospects of business continuity, as well as the existence of significant and repeated delays in making payments. The code then makes an explicit and strong reference to *specific standards* on the matter that will be issued by the professional category of reference, in other words, the Italian National Council of Chartered Accountants and Accounting Experts (CNDCEC). The latter is in fact indicated as the only entity required to draw up, on a 3-year basis, those indices which, assessed as a complete dashboard, reasonably assume the existence of a state of crisis in the company. It is important to highlight that the Code specifies that the choice of the indicators must not be formulated in a general way for all companies, but that specific indicators must be considered for each type of economic activity according to the National Statistical Institute (Istat) classifications. In formulating the reference documents, the Board is invited to consider national and international best practices.

The draft Code, however, continues to identify, along with the indices developed by the CNDCEC, some parameters and some thresholds of the values assumed by the latter, which give rise in certain situations to unique elements to be considered for the automatic occurrence of some effects. These are the parameters that are deliberately measurable in an “objective” way and this of course implies that readings of the latter are not acceptable in the context of a more systemic view of the business situation.

The “deterministic” approach remains in two cases: firstly, to qualify the debtor’s initiative as to promptly trigger the alert and, therefore, to assess the applicability of reward measures for the debtor company and of the liability for the Board of statutory auditors (*Collegio Sindacale*). In fact, requests for access to one of the insolvency procedures after the 6-month deadline, or the request to the OCRI following the end of 3 months, to be counted from the moment of verifying the occurrence of the following, are considered timely: (1) the existence of debts for wages and salaries expired for at least 60 days for an amount equal to more than half of the total salary; (2) the existence of payables to suppliers expired for at least 120 days for an amount higher than that of unexpired debts. Secondly, as already described above, determine the moment in which qualified public creditors must serve their own notifications first to the debtor and therefore, in the event that no solution is found, to the OCRI and at the same time as the Board of statutory auditors.

The method based on a dashboard of indicators is only one of the different approaches. Inductive approach is the simplest method—based on non-financial indicators—to detect business crisis. This last—that uses external indicators such as an extraordinary staff turnover or the loss in market share—normally used by small and unstructured companies—requires

not only the ability of the entrepreneur to detect the business crisis but also the courage of the entrepreneur to bring out his situation. More challenging is the use of multivariate approaches— such as the linear discriminant analysis— which constitutes the benchmark for our empirical research above described (see Section 5)—or the logistic models. The aim of these approaches is to detect business crisis through the use of statistical methods to encapsulate all different financial indicators.

5. Verification of the effectiveness of the financial statement indices required by the enabling act: an empirical analysis

It has been proposed to verify whether the four financial indicators indicated explicitly, as mentioned earlier, in the Enabling Act (Ddl 3671bis) can be considered alone sufficient to form a reasonably acceptable opinion on the existence and severity of the crisis. It must be noted that this refers to the debt ratio, the credit rotation index, the inventory turnover index and the liquidity index. The tested research assumption can therefore be summarised as follows: *the use of only the four indicators identified in the Enabling Act is sufficient to correctly and reasonably differentiate the situations in which it is necessary to trigger the alert procedure.*

The analysis was conducted on a sample of 677 companies that requested access to the PAC before the Court of Milan during the years 2008–2014 (out of a total population of 1299 companies, with a coverage of 52%). Financial statements for the three financial years preceding the application were analysed. The sample was almost entirely composed of 98% capital companies, of which 61% were limited liability companies and 22% public limited companies. The analysis of the distribution of the companies in the sample shows that 47% belong to the secondary sector and 51% to the tertiary sector. With reference to the size, adopting the definition of the European Commission (Recommendation No. 2003/361/EC), the sample was distributed in four macro-classes based on the number of employees of the year preceding the presentation of the application for a settlement with creditors. The companies are mostly micro and small, or in other words, with a number of employees less than 50 (**Figure 1**).

The analysis is carried out considering the values assumed by the indicators provided for by the Enabling Act (henceforth also “Indices of 3671bis”) and setting a comparison between the results

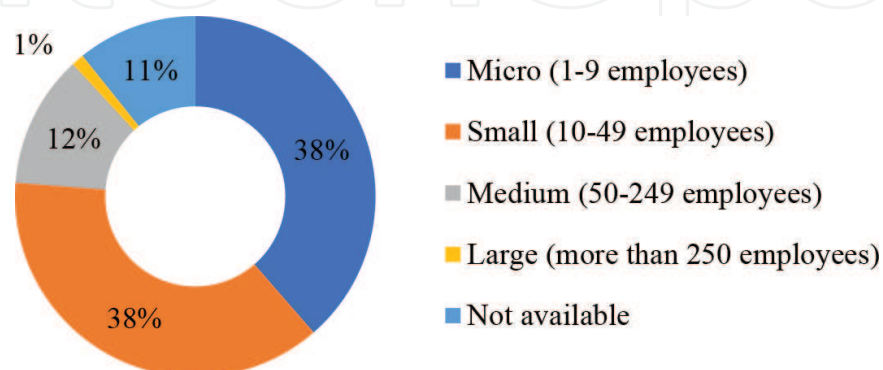


Figure 1. Size of companies.

achieved and those that would be obtained by applying the different model of the Altman Z'-score (Altman 1993) proposing a more systemic approach to the issue of corporate performance assessment. More specifically, Z'-score best suited to the Italian entrepreneurial network is used [28–30]. This expression of the well-known model is based on the use of a function that identifies the health status of each company (y), whose dependent variables (x) are represented by five financial statement indices. The indices in question are as follows: working capital/total assets (x_1); net profit/total assets (x_2); EBIT/total assets (x_3); book value of equity/book value of total debt (x_4); sales/total assets (x_5). The model is therefore composed as follows:

$$Z' \text{ score} = (x_1 \cdot 0.717) + (x_2 \cdot 0.847) + (x_3 \cdot 3.107) + (x_4 \cdot 0.420) + (x_5 \cdot 0.998) \quad (1)$$

Based on the value assumed by the dependent variable Z', three different “zones” are identified:

- safe zone: for results greater than 2.90; it includes those companies for which the probability of default is low;
- grey areas: for results between 1.23 and 2.90; it includes those companies for which the probability of insolvency is possible. It is a situation of uncertainty;
- distress zones: for results lower than 1.23; it includes companies for which the probability of default is high.

For each company in the sample, the “Indices Ddl3671bis” have been calculated on the financial statements for the 3 years preceding the application, verifying when they assumed values that are reasonably acceptable (positive) and when, on the contrary, they assumed significant values of the existence of a (negative) corporate crisis. Each of the four variables was therefore made measurable and classifiable in a dichotomous manner, identifying, in essence, reasonable thresholds of alert for each of the indices. To this end, significant values of high indebtedness, slow credit rotation, a slow turnover of the warehouse and a strong financial imbalance qualified as negative. This analysis allowed to identify a five-point measurement scale depending on the values assumed by the indices and the companies reclassified in the three typical index-zones of the analyses that can be obtained with the Z-score in order to make the results comparable:

- safe zone: companies in which there are no negative indices (zero negative) or that have only one (negative) index are included in this zone;
- grey zones: companies in this zone have recorded two negative indices;
- distress zone: companies which have recorded three or four negative indices are included in this zone.

The percentage of companies that fall into the grey area is very high, in fact these are percentages that vary from 60% of the year ($x-1$) to 49% of the year ($x-3$) which attest to the fact that in essence at least in half of the cases the indices are not able to provide unambiguous indications deemed useful to be able to differentiate between the various situations in an objective way.

The Z score was then calculated with reference to the same sample of companies and therefore on the financial statements themselves. The results seem to be much more significant. By analysing the zone in which the results can be found, it is noted that the percentage of companies that are included in the distress zone on getting closer to the year in which an application for a settlement with creditors has been submitted (65, 74, 87%); the opposite trend is assumed by the grey areas (31, 23, 11%) and the safe zone (4, 3, 3%) for which the percentage of companies included in them correctly decreases on approaching the year in which an application for a settlement with creditors was submitted.

Table 2 summarises the results obtained.

For purposes of the early emergence from the crisis, the positioning in the grey zone is the most critical since it does not allow to classify the situation with reasonable certainty. The percentage of companies located in the safe zone and in the grey zone is much lower if we consider the Z-score instead of Indices of Law Decree 3671bis, while the opposite trend is recorded with reference to the distress zone.

A weakness of the “Indices of Ddl 3671bis” is undoubtedly represented by the inclusion of the inventory rotation index. It is not always possible to apply the above indicator, in addition, different types of activities involve different warehouses and consequently turnaround days. The indicator can therefore be of complex interpretation if it is not inserted into part of a system with other data and other variables. Companies, for example, of the sample carry out, as mentioned earlier, very different activities from one another, from food to manufacturing, from metallurgy to building and services. The food sector needs a faster turnaround of the warehouse compared to the metallurgical sector due to the nature of processed products; it is not possible to generalise. To sum up, the main features of companies that can be considered to have an impact on the indicator significance are the specific sector and the size of the companies. Each sector has its own particular feature: size, maturity, number and size of competitors, level of technology and speed of innovation.

The non-systemic analysis of the four indicators proposed by the Enabling Act is therefore not sufficient to express a correct opinion on the existence of the business crisis. In more than half of the cases, in fact, it does not allow correctly and reasonably to differentiate the situations in which it is necessary to trigger the alert procedure.

Therefore, the choice of the new “Crisis and insolvency code” to broaden the spectrum of indicators to be considered referring to company economic practice and therefore to standards to

	Safe zone (%)			Grey zone (%)			Distress zone (%)		
	Ddl 3671bis	Z' score	Δ	Ddl 3671bis	Z' score	Δ	Ddl 3671bis	Z' score	Δ
X-1	16	3	13	60	11	50	24	87	-63
X-2	28	3	25	53	23	29	19	74	-54
X-3	36	4	32	49	31	18	15	65	-50

Table 2. Comparison of the results of the Enabling Act and of the Z-score.

be issued by the Italian National Council of Chartered Accountants and Accounting Experts (CNDCEC) is noteworthy in order to identify dashboards of significant and differentiated indices by sector as well as the indication that the latter need to be reviewed and updated every 3 years to take into account the changes occurred during the period, with particular reference to evidence of technical and scientific evolution.

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