

Business Insolvencies *in* LATVIA

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Business Insolvencies in Latvia

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Foreword

This is the seventh of the TeliaSonera Institute Discussion Papers. The Institute, which is located at the Stockholm School of Economics in Riga is generously supported by TeliaSonera and aims to promote applied economic research in the fields of entrepreneurship and telecommunication – the latter with a focus on regulatory issues.

The current discussion paper on Business Insolvencies in Latvia is written by two of the Institute's researchers, Friederike Welter and Arnis Sauka. This as well as the previous six discussion papers can be downloaded from the SSE Riga website, www.sseriga.edu.lv. Hard copies can be ordered from office@sseriga.edu.lv.

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1. Introduction

Performance and growth of firms have been topics of increasing interest among entrepreneurship researchers for the past two decades (e.g. Davidsson, 2004). Only recently, however, have entrepreneurship scholars started to pay attention to factors determining the failure of firms, which comes as a surprise considering the fact that a high proportion of both new and already established companies choose or are forced to exit business activity every year (e.g. Shepherd, 2004; Schror, 2005). Moreover, the long term survival of new ventures has been acknowledged to be one of the biggest challenges for entrepreneurs (e.g. Simon, 1996). In this light, it is thus reasonable to believe that much can be learned from firms that exit businesses in order to increase the chance of survival and growth of other companies (Pasanen, 2005). Although the topic has recently gained interest in entrepreneurship research, still no comprehensive explanation of what constitutes business failure exists (e.g. Pasanen, 2005; Ciavarella et al. 2004). The complexity of the failure process, involving various internal and external factors which are often difficult to identify and understand by the entrepreneurs themselves as well as a lack of appropriate data because ex-entrepreneurs are often reluctant to discuss 'their' failure are among the main challenges in this regard.

In the small business and management literature, business failure is defined in a number of ways, including closure, exit, insolvency, bankruptcy and discontinuance (e.g. Storey, 1994). Pointing to the overlap between these terms as well as different interpretations in various countries, the literature suggests distinguishing between companies which do not continue their business activities as a result of failure (for example, bankruptcy or insolvency) and firms which exit entrepreneurship deliberately (for example, in cases where the business is sold) (Pasanen, 2005). This explorative study focuses on firms that exit the market as a result of insolvency, that is they are unable to pay their debts³. The rest of the paper is structured as follows: Chapter 2 introduces the topic by reviewing reasons for business failure. In Chapter 3, the methodology and datasets are briefly introduced. Section 4 explores business insolvencies in Latvia drawing on existing official statistics. More specifically, by providing an overview of the legal framework for business insolvencies in Latvia, topics such as liabilities of smallness and newness and regional differences are covered there. The results from in-depth (2007) and phone interviews (2009) with insolvency administrators in Latvia are further presented and discussed in Section 5. The report concludes with conclusions and implications.

2. Why businesses fail – the state of research

In terms of factors influencing failure, we can distinguish between factors related to the entrepreneur, his/her business venture and the environment for explaining business failures, although complex causal relationships involving different levels and time periods of the failure process exist between these factors.

³ See Chapter 3.1 for more on the definition of insolvencies in Latvia.

Previous research on business failures has emphasized the role of the *background of the entrepreneur and characteristics of the business* such as its age, size, or the resource base, in particular finance (e.g. Zacharakis et al., 1999; Davidsson and Honig, 2003, Pasanen, 2005). For example, research has demonstrated that the human capital background and experiences of the entrepreneur as reflected in, for example, previous management experiences, are negatively associated with higher rates of failure among SMEs (e.g., Vesper, 1990; Gimeno et al., 1997; Zacharakis et al., 1999; Davidsson and Honig, 2003). Interestingly, however, some studies have also found a negative effect of higher education on business failure (e.g. Burke et al., 2005; Bruce, 2002). In this light it can be argued that although highly educated people may be more aware of business opportunities and possess better knowledge to exploit them as well as have better networks and access to capital, they also have more opportunities to work as employees in well established companies. Furthermore, age is usually negatively associated with business exit, that is, younger entrepreneurs are more likely to exit business than older people (Blanchflower and Meyer 1994; Taylor 1999; Van Praag 2003). This, however, is shaped not only by a lack of previous management and overall professional experience which might result in overconfidence (e.g. Forbes, 2005), thus contributing to business failure, but it could also be due to the fact that younger persons have better access to alternative job opportunities (Stam et al., 2007).

Entrepreneurial behaviour is another factor influencing failure. For example, tensions and disagreement between owners of the company where a team is involved in ownership and management and a lack of managerial skills are often named as factors increasing the risk of business failure (O'Neil and Duker, 1986; Hall and Young, 1991). Here, the literature on entrepreneurship cognition emphasizes the necessity to consider both the quantity and quality of partners involved in venture creation as well as the necessity to employ adequate motivation schemes in order to maintain the quantity and quality of employment within the company (e.g. Baron, 2004; McMullen and Shepherd, 2006). Recent surveys have also found that entrepreneurial personality variables, such as risk tolerance and internal locus of control, have a minimal impact on a firm's exit (Stam et al., 2007). Cognitive biases, however, especially overconfidence of entrepreneurs, may increase the risk of failure (Cooper, Woo and Dunkelberg, 1988; Busenitz and Barney, 1997).

On enterprise level, firm age and size, stylized as liabilities of newness, adolescence and smallness (Aldrich and Auster, 1986; Brüderl and Schüßler, 1990, Van Praag, 2003) influence business survival: the older and larger the business, the less likely its failure and the more likely the probability of its survival. Partly, this can be explained by a bigger product range more frequently to be found in larger companies, and a broader diversification of the customer base (e.g. Reid, 1991); partly, this is due to legitimacy gained throughout the process of setting and developing the business (idea).

Finally, the *external environment* plays a role in either triggering business failures or in generally accelerating the failure process. For example, unfavourable economic conditions might result in a slump in demand, consequently resulting in fluctuating sales which are associated with a higher probability of failure (e.g., Cressy, 1996). Therefore, companies started during economic recession are more likely to fail. Furthermore, relatively poor market conditions and a small market size are also negatively associated with firms' failure (Bruno et al., 1987; Lussier, 1996).

In light of the latter arguments, the entrepreneurship literature suggests that it is not appropriate to analyze business processes without considering the environment within which these activities take place (Karlsson and Dahlberg, 2003). In this light, most of the existing research has explored business failures in well-advanced economies and countries characterized by relatively stable institutional environments. Little, if any attention, however, has been paid to business failures in transition countries, including new European Union member states in Central and Eastern Europe. Due to the various specific features of entrepreneurship in Central and Eastern European Countries (e.g. Smallbone and Welter, 2001, 2006), we might reasonably expect '*liabilities of the transition context*' playing an important role in business failures in these countries. This report addresses this issue by focusing on the reasons of business failure within the context of Latvia.

3. Methodology

Arguably, one of the main reasons behind the lack of research on business failure in general is the lack of appropriate data (Pasanen, 2005). It is not only difficult to identify and access entrepreneurs who have failed to continue their business activity. Business owner-managers can be reluctant to talk about their business failure or they might provide very subjective and biased information. In order to avoid such shortcomings, this paper uses two sets of data to explore business failure. Firstly, we draw on official statistics from the company register of Latvia. As for most of the transition countries (e.g. Aidis, 2006), exact data on the nature and extent of entrepreneurship in Latvia for the whole period from the 'beginning of transition' are, of course, somewhat limited. Even if the data exist, the major problem in this regard is accuracy of the data set, meaning that, for example, a number of firms which have already exited business activity still appear in the databases as active businesses or incorrect contact information is often provided by such data sets. Especially when it comes to the earlier stages of transition, arguably, the most accurate data can be acquired either through EBRD, World Bank reports or official statistics of the country. Unfortunately the two former sources do not provide data on business insolvencies. Therefore, we rely on the official statistics of the Latvian Company Register, compiled in the Lursoft database, taking into account that for the periods of early stages of transition (e.g. up to the end of 1990s) these statistics are but a very general indicator for entrepreneurship development, including business failure.

Statistical data are complemented by interviews with business insolvency administrators working for the Insolvency Agency in Latvia. The Insolvency Agency in Latvia deals with the liquidation process and normally one administrator is assigned to each company facing the insolvency process. In this case, using a 'secondary' data source is justified because insolvency administrators have a considerable amount of information, yet they are not reluctant to share it as they are not directly involved in the failure of a given business. Moreover, by interviewing business insolvency administrators, we hope to obtain more objective data on the reasons behind the insolvency of firms. Therefore, a total of 15 in-depth, semi-structured and strictly confidential interviews with business insolvency administrators in Latvia was conducted in February 2007. In order to get more up-to-date information on business insolvencies in Latvia, 15 phone interviews were conducted with

business insolvency administrators during February-March 2009. This is important, since Latvia experienced a rapid development during 2007 with +12% of real GDP growth, whereas a serious economic downturn was experienced during 2008, leading to the decrease of real GDP to -10% in the fourth quarter of 2008, and also a continuing decrease in 2009 (CSB, 2009). Furthermore, a new law on business insolvencies was introduced in January 2008⁴. Needless to say, these processes might have an impact on the reasons why companies are forced to exit the business.

Drawing on the findings from existing studies exploring business failure within more advanced economies, the main guidelines for questions to insolvency administrators included identification of the typical symptoms of business insolvency, the main factors for positive or negative outcomes and the role of human capital in running the business. Furthermore differences among regions, industries, size and age of firms, and specific reasons for the respective business insolvency because of the infrastructure, legal system or ethics in the Latvian context were addressed.

4. Business start-ups and terminations in Latvia: an overview of the legal framework and available statistics

4.1. An overview of the legal framework of business insolvency in Latvia

In 1991 Latvia declared its independence from the Soviet Union and transition started with legal and market reforms, including the introduction of a legal framework for entrepreneurship. Along with the 'Law on Entrepreneurship' (1991), a number of related laws regulating the entrepreneurship climate were introduced. These include the 'Law on Individual (Family) Business, Farms or Fishing Companies and Individual Work' (1992.), the 'Law on Limited Liability Companies' (1991), the 'Law on Joint Stock Companies' (1993), the 'Law on Co-operatives' (1991), the 'Law on Government Companies' (end of 1990), the 'Law on Company Registration' (end of 1990) and several others.

In 2005 the 'Law on Entrepreneurship' together with related laws mentioned above was replaced by the 'Commercial Law'. This reduced the number of entrepreneurship forms from thirteen to five, which is important because there were almost no differences between many of the legal business forms. Furthermore, due to the fact that different entrepreneurship regulating laws were developed at different times and by different authors, no common terminology was used, which caused interpretation problems in courts. In addition to this, numerous changes made in the 'Enterprise Law' as well as related laws during recent years made it very difficult even for qualified lawyers to follow the relationship between various laws regulating entrepreneurship (Strupiss, 2009).

Alongside the development of 'Commercial Law', numerous changes have also occurred with regard to legal rules dealing with the insolvency process in Latvia. The first law directly linked to the regulation of insolvency in Latvia, the 'Law on Company Insolvency and Bankruptcy' was introduced in 1992. In 1996 this law was replaced by the 'Law on Company Insolvency', which again

⁴ See Chapter 3.1 for more information on the development of the legal framework for business insolvencies in Latvia.

was replaced by a new law 'Law on Insolvency' in January, 2008. Although there are many reasons why a new law on insolvencies had to be introduced, the main ones can be summarised as follows (Kveska, 2007):

- Requirements of the EU Accession process.
- Necessity to regulate the insolvency process internationally.
- Necessity to include the term 'insolvency of a natural person' in insolvency law as well as to better define the scope of those legal persons who are subjects of the insolvency process.

And finally, and perhaps most importantly, previous legislation on insolvency allowed for the use of the insolvency process as the primary tool to collect debts, without considering other legislation tools available for this purpose. Furthermore, previously the legislation did not foster the renewal of companies' solvency, but instead allowed for the submission of precarious insolvency claims. The 'Law on Insolvency' as introduced in 2008, offers solutions to all of the abovementioned challenges by improving the insolvency process as such while at the same time protecting the rights of companies against which the insolvency process has been started (Kveska, 2007). In this light, before we continue with providing an overall picture on business insolvencies in Latvia, a few important terms covered by previous and existing insolvency laws have to be briefly introduced.

According to the 'Law on Insolvency' (2008), the insolvency process is defined as the set of legal processes used for the renewal of companies' solvency, by using reconciliation or rehabilitation, or, if the solvency renewal is impossible, by applying the bankruptcy procedure. Thus the insolvency process can have three outcomes (Law on Insolvency, 2008):

- Reconciliation, which means that the situation of insolvency is solved by agreement among creditors and debtors regarding the return of the debt. Reconciliation is possible at all stages of the insolvency process, up to the beginning of the debtors' property auctions.
- Rehabilitation, meaning that the insolvency situation is solved by applying a set of activities in order to avoid debtors' possible bankruptcy, renew solvency and satisfy creditors' requirements.
- Bankruptcy, meaning that the insolvency situation is solved with debtors' liquidation and satisfaction of creditors' requirements from the funds acquired during the liquidation process by alienating debtors' properties.

The decision regarding the necessity to start the insolvency process is taken by the court, and the following natural and legal persons have the right to apply for the insolvency process by submitting a claim to the court (Law of Insolvency, 2008):

- The company experiencing debt itself, provided that there is evidence of the circumstances behind why the company cannot cover the debt. Furthermore, the company is obliged to submit the insolvency claim to the court in case it cannot cover the debt in 3 weeks' time and there is no written agreement with the creditor on the return of the debt. Companies are also obliged to submit the insolvency claim to the court in case their debt exceeds their assets.

- Insolvency Administrators.
- The creditor or group of creditors. Before initiating the insolvency process, however, creditors are obliged to send the debtor a written statement of claim, allowing for 2 weeks to cover the debt. If the debt is not covered by that time, the creditor should inform the debtor about the intention to submit the claim for insolvency to the court, allowing for another 1 week to cover the debt.
- State institutions, such as Public Prosecution, the State Revenue Service, the Privatization Agency, the City Municipality, the Regional Council or the Ministry of Agriculture.

4.2. Dynamics of business start-ups and terminations in Latvia

The development of legal and market reforms in Latvia started with the regaining of independence in the 1991, initially bringing steady decline to the economic development of the country. As illustrated in Figure 1, for example, growth of real GDP in Latvia reached a maximum of -34.9% in 1992, becoming positive only in 1994, again decreasing below the 0.0 level in 1995 (as a result of the banking crisis in Latvia), decreasing from 8.6% in 1997 to only 2.8% in 1999 (due to the financial crisis in Russia), and (up to 2008) remaining positive only after 1996.

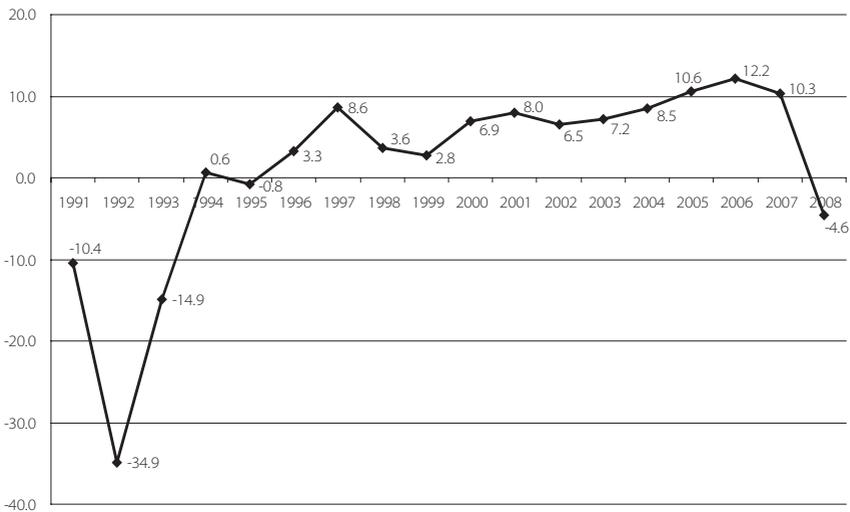
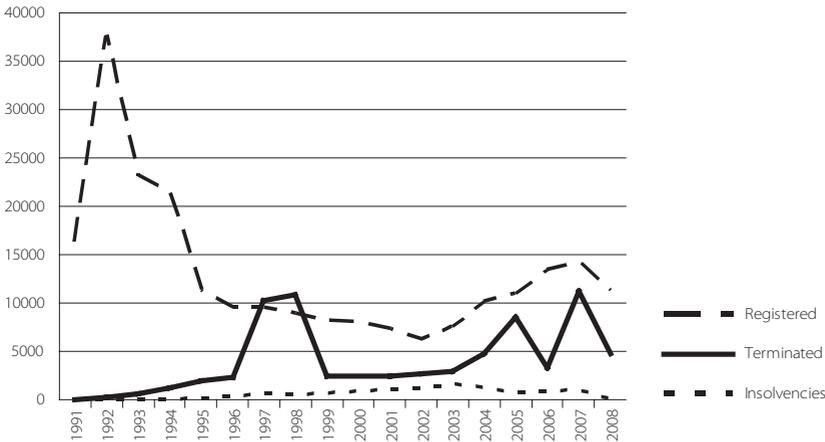


Figure 1. Growth of real GDP in Latvia (% , 1991-2008)

Source: CSB (2009)

Regardless of the steady decline in real GDP, processes initiated as a result of independence in the early 1990s, including the liberalization of purchase prices and privatization, as well as other reforms caused the mushrooming effect on entrepreneurship start-up rates. Figure 2⁵ illustrates the development of entrepreneurship activity in Latvia from 1991 to 2008 measured by the yearly number of registered start-ups, terminations and insolvencies of companies. As in other transition countries, the first years of transition were characterised by a 'boost' in entrepreneurship, reflected in a high number of business start-ups. During Soviet times entrepreneurship was officially not allowed, even though illegal or 'second economy' activities were tolerated⁶. Although co-operative enterprises were legalised in the late 1980s, many companies established during that time existed 'illegally' and were registered only when the legal framework allowed for this.



Note: According to Lursoft, no year is available for 1,086 insolvencies (e.g. each of these 1,086 insolvencies occurred between 1991-2008). These insolvency cases are thus not included in the chart.

Figure 2. Number of companies registered, terminated, and insolvent (1991-2008)

Source: Lursoft (2009)

Along with high start-up rates at the very beginning of the transition process, however, Figure 2 also shows a steady decline of entrepreneurship start-up activity until 2001. Furthermore, there have been increased levels of business termination during 1996-1999, which, similarly to the dynamics of the real GDP, were influenced by external events, including the Banking Crisis of 1995 in Latvia, when the bankruptcy of several leading banks led to a considerable proportion of people losing both their money and their trust in the banking system as such, as well as the Russian financial crisis in 1998, which resulted in declining rates for start-ups and higher exit rates in Latvia. Furthermore, a lack of entrepreneurial skills, i.e., many firms had to close down because

⁵ As for most transition countries, exact data on the entrepreneurship processes in Latvia for the whole period from the 'beginning of transition' is, of course, somewhat limited. Arguably, the most accurate data can be acquired either through EBRD, World Bank reports or official statistics of the country. Unfortunately two previously mentioned sources do not provide data on business insolvencies, which is why the authors have chosen to rely on the official statistics of the Latvian Company Register, compiled in the Lursoft database.

⁶ Through the legalisation of co-operatives in the late 1980s, private sector development in Latvia started with reforms instigated by the Soviet Union's leader M. Gorbachev while Latvia was still under the centrally planned system.

the ‘new entrepreneurs’ did not know how to deal with business management issues, the steady increase in competition, flow of financial assets and other such factors fostered both the decline of start-up activity and increasing rates of business activity termination up until 2002. Moreover, frequent changes in the legal framework, often highlighted as one of the major constraints to SME development in the early stages of transition, contributed to business closures.

Since 2002 and up until 2008, a positive trend in the growth of real GDP and business start-ups can be observed (see Figure 1 and Figure 2 accordingly). As a result of this development, Latvia, with a population of 2.4 million inhabitants, had more than 80 000 legally registered and *active* companies in 2007, creating more than 65% of GDP (CSB 2008). Furthermore, it should be noted that due to the steady growth from 2002 until the middle of 2008 Latvia had the fastest growing economy among European Union countries, with low inflation and unemployment rates. It should be noted, however, that development of entrepreneurship activity, together with GDP figures, significantly differed in the capital city of Latvia, Riga as compared with other regions of Latvia. As illustrated by Figure 3, for example, there were as many as 58 active companies per 1000 inhabitants in the Riga region in 2005 (41 in Riga City and 17 in other parts of the Riga region), whereas the number of entrepreneurs in provincial regions reached only 11-15 enterprises per 1000 inhabitants. Altogether, this pattern reveals the important role of the capital city of Latvia, Riga, and the Riga region and highlights comparably low economic activity in other regions of Latvia.

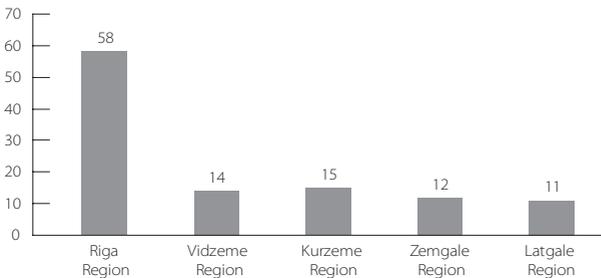


Figure 3. Active companies per 1000 inhabitants in regions of Latvia (2005)

Source: CSB, 2005

The growth of the economy slowed sharply from late 2007 (see Figure 4) as a consequence of deceleration in credit growth and high inflation. Furthermore, due to credit growth being tightened by banks and measures undertaken by the Latvian government in the spring of 2007, the average price of housing decreased by approximately 30% in one year, causing a very steady decline in construction activity (-10%) (EBRD, 2008). The decrease in GDP from late 2007 until early 2009 was also fostered by the sharp downturn of trade volumes (-17.2%), processing manufacturing (-11.5%) as well as financial intermediary services (-18%) (CSB, 2008). To sum up, the development of the economy in Latvia from 2002-2008, reflected by real GDP dynamics, also reflects the trends of the dynamics of enterprise start-ups and terminations during this period of time (see Figure 1 and Figure 2 accordingly).



Figure 4. Dynamics of real GDP in Latvia 2007-2008 (%)

Source: CSB (2009)

As a result of these processes, as illustrated by Figure 2, entrepreneurship activity in Latvia has decreased considerably in the first quarter of 2009 as compared with the situation in early 2008. To be more specific, 155,658 companies were registered in the company registry in January 2008 (CSB, 2008). According to provisional data provided by the State Revenue Service and Lursoft, however, only slightly more than 50% of all registered companies were active, which amounts to approximately 80 000 active companies out of 155,658 registered firms in the official company register in January 2008⁷. The data for early 2009 is 162,408 and 63,241 accordingly, meaning that although the number of registered companies has actually increased, there is a substantial decrease in active firms (see Figure 5)⁸.

Regarding insolvency in Latvia, as highlighted in the previous section, the insolvency process can have various outcomes, including reconciliation, rehabilitation and bankruptcy. According to the Central Statistical Bureau of Latvia (2009), there were 11,500 insolvency processes registered during the period from January, 1991 - February, 2009. Out of those 11,500, as many as 9912 insolvency processes were finished until February, 2009. Table 1 presents the outcome of all registered insolvency processes within the mentioned period of time, showing that most of the insolvency processes have ended in bankruptcy (9178 companies out of 9912 completed insolvency processes), whereas in 478 cases the claim to start the insolvency process was rejected by the court.

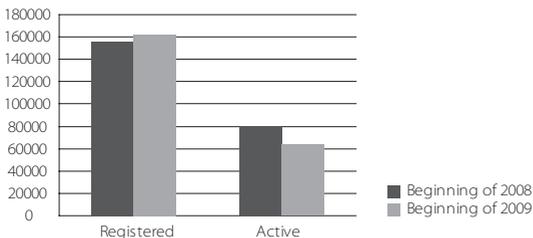


Figure 5. Number of registered and active companies in Latvia: provisional data (early 2008 compared to early 2009)

Source: CSB (2008) and Lursoft (2009)

⁷ A company is considered to be active if annual reports and/or financial reports are submitted to the State Revenue Service or other appropriate institutions, see <http://www.lursoft.lv/index.php?a=9&z=476> for more information.

⁸ See Section 3.3 and Figure 10 for more discussion on this issue.

Outcome of the insolvency process	Count	%
Insolvency process resulted in bankruptcy of the firm	9178	92,6
Claim to initiate insolvency process rejected by the court (e.g. company can return to business)	478	4,8
Insolvency process initiated but later on rejected by the court (e.g. company can return to business)	142	1,4
Debtor has covered all the debts (e.g. company can return to business)	84	0,9
No creditors have claimed their rights after the insolvency process was initiated (e.g. company can return to business)	16	0,2
Rehabilitation process completed (e.g. company returns to business)	14	0,1

Table 1: Outcome of the insolvency process

Source: Lursoft (2009)

And finally, Figure 6 presents business start-ups, termination and insolvency by company type during the years 1991-2008⁹. The data show that the highest proportion of the companies registered in Latvia are Limited Liability Companies (LLCs) (approximately 60% of total companies founded), while farms, individual companies and individual merchants make up approximately 16%, 10% and 6% respectively. Limited companies also constitute the biggest number of closures and, specifically, insolvencies: 33% and 6% of all registered limited companies have been closed down and become insolvent respectively from 1991 until 2008, compared to 15% and 1% of all farms, for example.

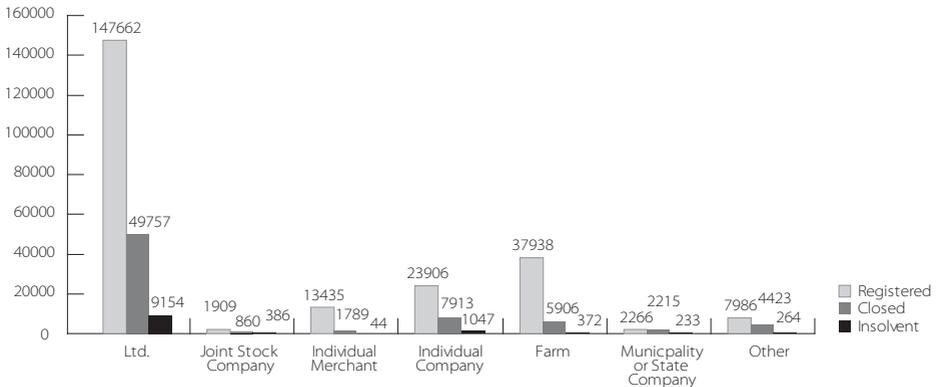


Figure 6. Registered, closed and insolvent companies by type (summary of the period 1991-2008)

Source: Lursoft (2009)

Regarding the firm dynamics according to company type, the data suggest that the number of Ltds. has constantly increased from 2002 to 2007, with a decline in 2008, which, in general, reflects the major trends in company dynamics in Latvia. In this light it is, however, important to note that although Ltds. constitute the biggest number of closures and, specifically, insolvencies, more Ltds. are created than exit the business (see Figure 7).

⁹ As stated above, here and further in the report, it is important to note once again that only approximately 50% of all registered companies are active.

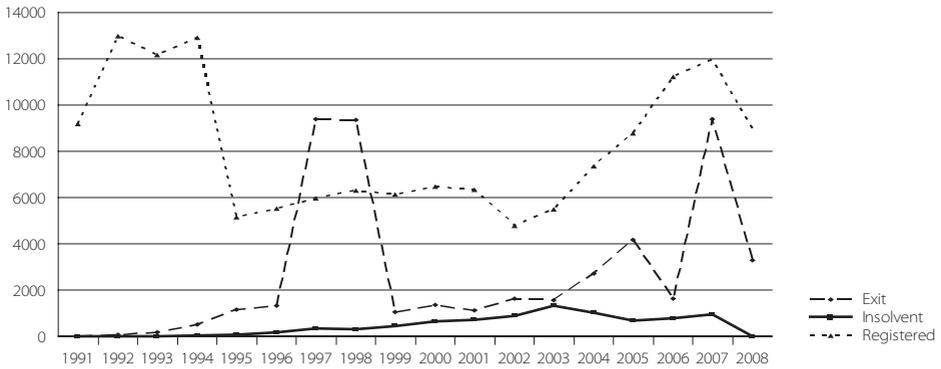


Figure 7. Dynamics of LLCs in Latvia (1991-2008)

Source: Lursoft (2009)

As illustrated by Figure 8, however, a different pattern in this regard is observed for Joint Stock Companies (JSC). More specifically, two main trends can be observed in the dynamics of JSC during the period of 1991-2008. First, JSC have obviously become even 'less popular', dropping from 400 to 40 registered JSC in 1991 and 2008 accordingly. This pattern can be explained by the fact that mostly only big companies choose to register as JSC, but as many as 98% of the companies in Latvia are small and medium-sized companies. Moreover, even relatively large companies still prefer to register as LLCs because of the comparatively easy regulations, having an impact on the management of the company among other things. The second trend is that, in contrary to LLCs, almost the same number of JSCs exited business than were registered in 2008.

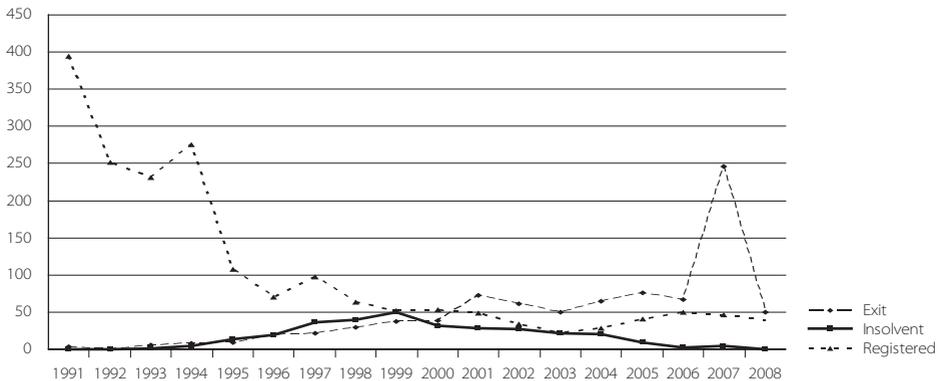


Figure 8. Dynamics of JSC in Latvia (1991-2008)

Source: Lursoft (2009)

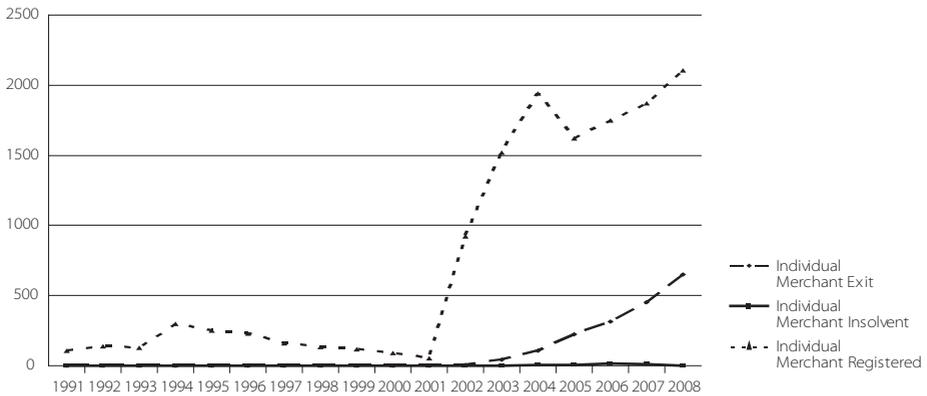


Figure 9. Dynamics of IM in Latvia (1991-2008)

Source: Lursoft (2009)

As the number of registered Ltds. and JSCs is tending to decrease, the opposite trend can be observed with regard to individual merchants (see Figure 9). Being an individual merchant (IM) is the easiest, fastest and also least expensive way to become self-employed and/or enter entrepreneurship activity in Latvia. According to the legislation, in contrast to all other types of business (except individual companies), individual merchants are natural persons (e.g. not legal persons) with the right to perform business activities and many employees in Latvia prefer to register themselves as individual merchants and self-employed due to the more favourable income tax rules.

4.3. Liabilities of newness and smallness, and business failure in Latvia

Figure 10 provides a look at the *liability of newness*, presenting an overview of firm survival according to company age over the period from 1992 – April 2009. According to the data, and in line with the liabilities of newness hypothesis, the highest number of exits is observed for relatively young companies, e.g. firms which are 3-6 years old. The number of exits for 1-2-year-old firms is also comparably high, whereas more experienced companies which have managed to survive for 14 years and more show a very positive survival rate. Very similar trends are present also in the provincial regions of Latvia, where firms aged 3-6 years are more likely to exit, whereas older and more experienced companies are less likely to fail (Table 2).

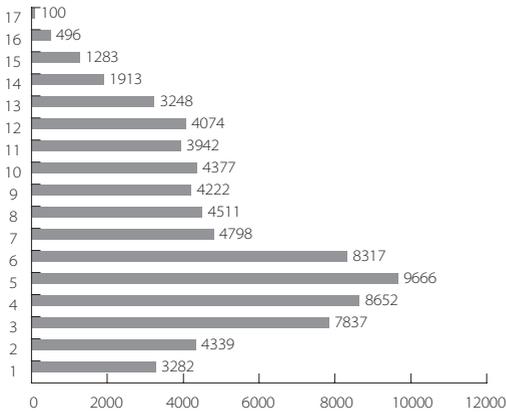


Figure 10. Number of exits of firms aged 1 to 17 years over the period from 1992 - April 2009

Source: Lursoft (2009)

Years	Kurzeme Region	Vidzeme Region	Zemgale Region	Latgale Region
1	427	374	343	323
2	477	531	432	429
3	706	698	620	597
4	647	838	749	792
5	702	784	792	785
6	627	698	748	717
7	480	564	495	569
8	450	519	437	482
9	404	475	398	490
10	444	430	453	525
11	422	367	422	547
12	386	380	512	592
13	326	317	444	553
14	183	193	201	131
15	108	116	115	80
16	65	71	57	24
17	15	12	10	4

Table 2. Exits of firms aged 1 to 17 years, in numbers over the period from 1992 - April 2009

Source: Lursoft (2009)

Regarding the liabilities of smallness, although they are easier to manage and adapt to changes in the market, smaller firms tend to be more sensitive to financial and other constraints brought on by an uncertain environment and are more likely to fail than comparably bigger counterparts (references). The liability of smallness could thus be one of the explanations for the high termination rates during the economic downturn since 2008 (see Figure 2), since the majority of companies in Latvia indeed fall into the category of ‘micro company’ (see Figure 11).

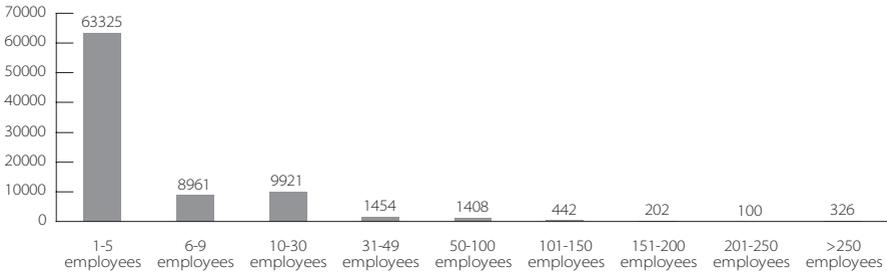


Figure 11. Distribution of firms in Latvia according to their size (data from April, 2009)

Source: Lursoft

Overall, the statistical data appear to suggest that besides liabilities of newness and smallness liabilities of the transition context also influence business failures. This will be explored further in the next section, drawing on interviews with business insolvency administrators.

5. Exploring business failures in Latvia from the perspective of insolvency administrators

5.1. Reasons for business failure during ‘good times’

In line with the conceptual review, the interviews with insolvency administrators suggest that an inability to cope with increasing competition, a lack of adaptability and overconfidence are main *factors on individual level* causing insolvencies in Latvia. This indicates liabilities of newness and smallness which are similar to stable environments such as mature market economies. Small retailers, especially in the food and construction material business, or cafeterias which are not able to compete with big shop chains that offer better prices and product assortments are mentioned as the most sensitive groups in this regard. Thus, the size of the company, along with access to financial and human capital and also management skills, plays a crucial role in the ability to survive. As one of the interviewees explains: “The reason why many companies fail is that they are not able to diversify their activities and adapt to changes in the market. Companies have minimal capital,

which is mostly tied in their fixed assets with a comparatively small proportion in current assets, which could then be used for the diversification of operations. As a result, firms have to exit, often through insolvency.”

The ability to learn and adapt to a changing environment came up as another reason why companies fail to continue with their business activities. This is caused by a lack of previous management experience as well as an inability to ‘see things in perspective’ and to plan for the future. One of the insolvency administrators explains: “In some cases, entrepreneurs are so satisfied about what they have that they forget to think about tomorrow. They do not understand that success in the past is not the best ‘predictor’ for success in the future. What happens is that being satisfied with the existing situation, instead of investing in new technologies or methods of operating the business, firms tend to spend all their assets and thus have nothing to work with. Realizing what has happened as a result of all that often comes too late, often in the form of the letter from authorities with news firm owners are not willing to read....”

Regarding overconfidence, our interviewees drew attention to individual liabilities of newness, in particular the age of entrepreneurs. “...It happens quite often that companies too optimistic in their plans tend to become involved in high leverage. In many cases, however, over-optimism results in a situation where owners are not able to pay their debts and are thus subjected to the insolvency procedure. In general, older and more experienced entrepreneurs are more cautious towards credits, while the younger generation has a quite different, often too optimistic, attitude.”

We now turn to the *transition context* in Latvia. By law, it is considered a criminal act in Latvia if companies facing major problems with paying their debts do not apply for insolvency. It is also stated by law that in such cases company owners should apply for the insolvency themselves. Nevertheless, according to our respondents, most of the insolvency cases in the country (approximately 90%) are initiated by the State Revenue Service (SRS), with the non-ability to cover (tax) debt to the SRS mentioned as one of the main reasons for the insolvency in this regard. More specifically, debts occur because of mistakes in financial reports, including financial results and tax amounts, submitted by companies to SRS, which then result in penalties companies often are not able to cover.

In this context, our interviewees emphasized several shortcomings in the operation of the State Revenue Service which they consider as external impediments for business survival in Latvia, thus pointing to a transition-specific problem with regard to the insolvency process: “Currently the SRS is dealing with consequences and thinking less about eliminating causes. Most of the insolvencies are initiated long after any errors have been identified; therefore penalties are accumulated to enormous amounts, which usually makes saving companies impossible.” Another respondent claimed that “... instead of providing entrepreneurs with advice and consultations, the SRS follows the regulations, and, often having no clue about the ‘real’ situation, it acts as a ‘repressive’ organization.” However, it is, of course, also the responsibility of the entrepreneurs to closely monitor business development, taking ‘the right decisions at the right time’, even if this means applying for insolvency. Nevertheless, there appears to be a communication gap between the SRS and entrepreneurs.

Another transition-specific reason is company fraud, which can further be highlighted as one of the major reasons behind business insolvency. Although the insolvency administrators emphasized that the number of companies going insolvent because of fraud has decreased with progress made in institutional reforms, nearly half of the firms administered by insolvency administrators had been set up with the intention to cheat. A typical example includes registration of a company in the name of a homeless person who has no idea that he or she is the owner of the firm, making a few big deals, earning quick money and disappearing. The underlying reasons as mentioned by our respondents include poor enforcement of (criminal) law (an indicator generally seen in early stages of transition, but coming as a surprise for Latvia which recently joined the European Union) as well as too much bureaucracy in general (Smallbone and Welter, 2001), but this also points to the difficulties of changing mindsets and establishing business ethics (Welter, 2006).

Regionally, the rates of insolvencies within different regions of Latvia reflect the general situation of economic development and business activity within these regions. That is, most business activities, and thus most business failures, take place in the capital city of Latvia, Riga, where more than 60% of the total number of companies are registered. As one of our interviewees remarked, "Riga is the place most of the cheaters come from, whereas poor individual merchants, those who often lose family property as a consequence of their business activities, mostly come from provincial regions and rural areas."

Apart from the reasons behind insolvency as described above, the specific type of insolvent company has to be emphasized. That is, according to one of the interviews, "... there are a number of companies that are no longer active in their business activity - often because for some reason owners are not interested in continuing business activity". "What happens with these firms...", continues the administrator, "... is that after spending some time sending letters with reminders about debts, etc., the State Revenue Service initiates the insolvency process. In most cases the insolvency process is initiated as a result, but in almost all, if not all cases, however, this is a waste of time and resources as there is nothing you can get from this company or its owners to cover the debts anymore". Furthermore, when the new Commercial Law was applied in 2002, many companies had to re-register, but those who did not were considered as having ended their operations and thus were closed. In many such cases, however, SRS applied as a creditor, which rendered closure impossible simply by excluding them from the company register.

What is interesting is that this type of firms, i.e., those that are not interested in conducting business anymore but have not properly closed the business and leave some minor debts, are more common in provincial regions of Latvia than the capital city Riga. As argued by one of the interviewees, "...if something like that happens in Riga, in most cases these are firms that register business with only a short term intention to work on a particular project, but for some reason fail in their activities. Then the only way out is often the insolvency process, although, again, nobody really benefits from that since the company itself is not interested in rehabilitation and there are no resources to cover any debts anyway".

5.2. What changed with the 2008 crisis and the new law?

When it comes to understanding the determinants of firms' insolvency from the beginning of 2008 onwards, two main influences have to be considered. The first one, as highlighted in section 3.2., is the introduction of a new insolvency law. The second: recent downturn in the economic situation in Latvia is influenced by the financial crisis in the United States and the 'old' European Union. In order to capture these influences, and explore what consequences there are with regard to business insolvency in Latvia, as mentioned in the methodology section, another 15 business insolvency administrators were contacted in early 2009. The findings from these interviews are as follows:

According to the interviews, no important changes have occurred as an outcome of the introduction of the new insolvency law - perhaps one year is not enough time for this. Unfortunately insolvency processes are still most often used as the main tool and initiated in very late stages. In this light, insolvency administrators use the term 'practical insolvency', i.e., the situation when, according to the new insolvency law, the company, although still operating, is not able to cover their debts in 3 weeks' time. In many cases, this is the right situation to start the insolvency process, without waiting until the situation gets worse and when it is already too late to avoid bankruptcy. To sum up, as emphasized by one of the interviewees, "In most cases the legislative framework is neither the influence nor cause for business solvency or insolvency. Most often these are problems within the organization or inability to cope with external influences".

Regarding the recent trends in companies insolvencies (2008 and early 2009 as compared with 2007 and previously), the influence of the financial crisis, is of course, considerable. More specifically, it has been emphasized that even those companies that operate exclusively in local markets (e.g. do not export and even do not import products from abroad) have been hit hard by the unstable situation in global economy. As highlighted by one of the interviewees: "Following trends of economic growth during recent years, many companies have gone as far as forgetting how to work efficiently. Even worse - some cannot continue to do that any longer as, for example, manufacturing costs are simply too high to compete in the market due to the fact that firms have bought equipment, real estate, etc. for too high prices, which certainly influence production costs."

In this light, the lack of appropriate strategies, causing the insolvency of firms, is often emphasized by insolvency administrators: "One of the major problems of those companies that go bankrupt these days is the 'blind willingness' to stick to things they used to have. That is, many firms do not understand that due to the situation in the market, they cannot remain as big as they were in terms of market share, profits, number of employees and other indicators." "These days are gone!", continues the administrator, "Firms simply have to live with the fact and adapt the strategies, by 'getting rid of unnecessary' market shares, profit margins and in some cases also product assortment as cheaply as they possibly can. In my view inability to cope with this is the major reason why companies went bankrupt".

Moreover, according to the interviewees, the economic downturn from 2007 onwards has led to a number of other challenges. To summarize, demand for almost all products has substantially decreased during the last year¹⁰, which for business in general means a dramatic decrease in the quantity and quality of customers. As a consequence, although medium and large companies might have enough resources to cope with such situations, this differs for smaller firms as emphasized by one of the interviewees, "... small firms cannot control the cash flows any longer and are pushed out of business as the consequence of market shrinkage". "Furthermore, in some sectors, such as construction and real estate, this is no more a question of company size", continues the insolvency administrator, highlighting that demand in some sectors is decreasing so much that even big companies face increasing debts and are forced to exit the business, often through insolvency.

In the context of this discussion, the 'psychological aspect of experiencing crisis in Latvia' has been put forward by some interviewees. Namely, as argued by one of the business insolvency administrators, "... the situation that companies cannot control their financial flow and run out of funds is not only caused by the dramatic decrease in demand for the products and service". In addition to this, these are also new behavioural patterns, becoming increasingly popular during the last year or so. "That is, knowing that nobody has money due to the economic crisis", continues the administrator, "... many entrepreneurs tend to postpone payments for goods and services they receive from their suppliers, even though they possess enough resources to cover such debts".

As emphasized by administrators, in many cases there is no 'bad intention' underlying such behaviour: "When asked, entrepreneurs truly believe that they are acting in accordance with the unwritten norms in the market - in a word, they behave exactly the same way as other entrepreneurs", emphasizes one of the interviewees. "The tricky issue here is that such behaviour, if repeated by many entrepreneurs, which is often the case, reduces the speed of cash flow", she continues, "... but especially during a downturn of economic activity, the speed of cash flow is a very important prerequisite to successfully conduct business activity". The conclusion from this, as also confirmed by insolvency administrators, is rather obvious: for a number of companies, especially small firms, such behaviour in the market means lack of funds for operating their businesses, which in many cases is the major reason for the start of the insolvency process.

Insolvency administrators further highlight that due to the downturn in the economic situation, companies tend to become involved in 'informal business activities and adapt "... different forms of cheating" to a greater extent as compared to 'good years'. While being reluctant to talk about specific types of 'cheating', interviewees emphasize that in some cases companies begin the insolvency process deliberately. More specifically, as shared by one of the interviewees, "... thinking that there is no way to continue successful business anyway, firms tend to use their often good reputation to get the maximum out of their companies and disappear leaving many debts". The insolvency process is, of course initiated as a consequence, but, "... in almost all cases this is only a waste of time as these firms are not interested in rehabilitation, nor is there anything you can get from

¹⁰ To illustrate the changes for product demand in the market, the decrease in amounts of retail for groceries has reached -12%, other goods (non-food) by -18%, and sales of cars, motorbikes and their spare parts decreased by as much as -38%. Processing industry amounts have decreased by -9.2%, the financial intermediation sector has decreased by -18%, and building and reconstruction by -10.9%. All changes are shown in comparative prices for the IV quarter of 2008 in comparison to the same period in 2007 (CSB, 2009).

them to cover the debts - all the financial resources, real estate, equipment, etc. of these firms has been 'sold to spouses, relatives, etc.' and although they in fact still belong to the owners of these companies, they are not accessible", concludes one insolvency administrator.

6. Conclusions and Implications

In general, our findings suggest that, besides factors influencing business failures regardless of the context, a number of environment- and transition- specific factors exist, even within an advanced transition setting. Both during steady economic growth and especially after the 2008 economic crisis, a relatively high proportion of business insolvencies in Latvia, for instance, take place due to illegal or at least unethical entrepreneurial behaviour. To be more specific: the main reason behind business insolvency mentioned by most of our interviewees is company fraud. Thus, among other things, this study confirms findings from previous research on the often illegal or unethical behaviour of entrepreneurs within a transition setting (Aidis and van Praag, 2007), albeit at the same time highlighting the disadvantageous nature of such behaviour for entrepreneurs themselves.

Other transition-specific reasons for business failure include the ability to adapt to frequently changing business regulations and an unstable business environment that characterises transition economies as such, although this changes over time. In terms of implications for policy makers, it is thus of crucial importance to ensure a stable business environment even in an advanced transition setting without introducing too much bureaucracy. By suggesting the necessity to further investigate the link between illegal behaviour and business failure, we also propose that policy makers should develop mechanisms which restrain entrepreneurs from involvement in illegal business activities and further support those involved in legal business.

In line with studies on business failures conducted within more advanced economies (Storey, 1994; Pasanen, 2005), non-transition-specific factors related to entrepreneurs and enterprises as indicated by a lack of working capital, knowledge and experience, or overconfidence of the business owners, also play a role in explaining business failures. Not surprisingly, our data also show liabilities of smallness and newness as reflected in the size and age of the company influencing business failure, especially when it comes to the context of the growing economy prior to 2008 in Latvia. The situation seems to differ, however, considering the changes brought about by the 2008 crisis, when factors such as lack of efficiency in conducting business activities, an inability to change strategies to adapt to new 'rules of the game' as well as various psychological aspects of entrepreneurial thinking play a decisive role in the business insolvency process.

In this light, it is thus not only important to reduce all possible constraints (including tax issues, bureaucracy, the work of the State Revenue Service, etc.) to entrepreneurship activity in order to minimize potential exits. During an economic downturn it is, perhaps, even more important to invest in both potential and already experienced entrepreneurs, aiming to enhance entrepreneurial

spirit as well as increasing their knowledge of tools, such as marketing, finance and strategies, to run businesses effectively. Also, supporting a generally favourable business climate assists potential entrepreneurs both in Riga and regions.

Apart from this, reducing the barriers to enter business is another important issue to consider for policy makers. One possible way of doing that, especially during ‘bad times’ in the ‘bad regions’ when potential entrepreneurs have a product but possess only very limited resources, would be to decrease or cancel registration fees for business start-ups. However, this needs to be considered together with programmes to train potential and existing entrepreneurs so that they are able to stay in business. In short, in times of economic recession, it is very important to *invest* in all types of activities and in all possible ways to foster entrepreneurship activities in Riga and all regions of Latvia.

In terms of future research, we recognize the limitations of our qualitative study and our narrow definition of business failure, restricting it to insolvencies, suggesting that there is scope for larger-scale research into business failures in different contexts, with a particular emphasis on ‘learning from failure’ of entrepreneurs.

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