

## **SPECIFICKÉ FAKTORY OVLIVŇUJÍCÍ NÁKLADY CIZÍHO KAPITÁLU: ČESKÉ PROFESIONÁLNÍ FOTBALOVÉ KLUBY<sup>1</sup>**

### **Some Factors Influencing Cost of Capital of Creditors: A Case of Czech Professional Football Clubs**

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#### **Introduction**

Sport is an important phenomenon of a human's life. In the last decades, the importance of sport has been steadily increasing both in social and economic terms. Independently on amateur level, professional sport has become a stable part in profit-oriented economic structures. Sport clubs and other sport events are driven by the same principles like other profit-seeking enterprises. The key factor for economic success is a tight identification of fans with a particular sport club and/or athlete. First of all, high-quality sport products bring benefits directly from the fans in a form of day-match revenues and souvenirs. Sponsorship, advertisement or broadcasting rights fees are examples of other significant sources of revenues. On the other side, sport events and competitions are often connected with adverse or even illegal behaviour (such as betting, money laundering, corruption, etc.).

#### **Literature overview**

Eurobarometer survey from November 2004 estimated that approximately 60% of the European citizens exercise regularly various sporting activities, either individually or within organised structures of around 700,000 clubs. Dimitrov et al. (2006) analysed the macro-economic consequences and they found out that sport activities, which took place in the EU in 2004, created value added at amount of 407 billion EUR, i.e. 3.7% of the EU gross domestic product. In addition, sport offers labour opportunities for 15 millions of the EU inhabitants (i.e. 5.4% of total EU labour force). Growing importance of sport has been also reflected in the official statements of the European Union, e.g. in the White Book on Sport from 2007.

Professional sport and its economics is a subject of research for more than 60 years. Rottenberg (1956) analysed economic consequences of players' reserve clause in the U.S. baseball leagues. A more general view on sport economics was worked out by Neale (1964), who dealt with the desirability of competitive balance from the point of view of the profitability of sports teams. Economically, professional sport can be considered as a joint production, when a league's supervising body regulates schedules of matches, players' transfers, salaries, etc. Rather than separate clubs, a whole league should be conceived as an economic firm consisting of more entities (i.e. clubs), for which decisions are implemented collectively similarly as in cartel structures (Filing, 2008, p. 8-9). Sloane (1971, p. 128) challenges the Neale's argument about a joint product as too exaggerated. To analyse an entire league as a firm is not sufficient, as clubs are always independent economic subjects. Referring to economic theories on non-profit maximising firms, Sloane proposes to broaden the scope of objectives and to focus on multifactor utility function. He identifies several objectives of professional sport clubs, such as playing success, attendance, revenue, profit, survival, etc.

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## Research design and data description

The paper analyses financial health of Czech professional football clubs with the emphasis on possible risks taken by providers of debt financing. Football clubs were chosen for three reasons. Firstly, (together with ice hockey) football is the most popular sport among Czech supporters and relatively large sums of money are concentrated in the football industry. Secondly, the first and second league satisfies Neale's description of a jointly produced market good. Thirdly, a professional licence from the Football Association of the Czech Republic is a necessary condition for the participation in the first or second division. The licence sets many prerequisites; e.g. legal status of football club. Only a share company established pursuant to Czech Commercial Code is allowed. Therefore, professional clubs have to comply with all legal requirements on enterprises, including financial reporting (e.g. annual financial statements have to be submitted to the Business Register).

Based on the last fact, the research can be carried out in two ways. It could be checked whether football clubs meet their information duties. The non-compliance (failure to submit annual financial statements or delayed submission) can be considered as a proxy measure of risk for providers of capital as they lose an access to financial information on their debtors (i.e. football clubs). Creditors are then unable to assess their risk exposition from independent resources. Therefore, the rate and speed of submission of financial statements to the Business Register will be used for the assessment of the creditors' risk.

Furthermore, data will be extracted from submitted financial statements in order to evaluate overall financial position and performance of Czech professional football clubs. Financial figures may help to reveal the specifics, which influence the financial health of football clubs negatively. Thus, we may evaluate whether the economics of Czech football clubs are in the line with the generally accepted financial restrictions. Breaching of financial constraints in the long run increases risks for creditors once again.

The sample consists of 36 football clubs, playing the first or second football league at least for one of five football seasons covering periods from 2005/2006 till 2009/2010. Financial statements are gathered only from the Business Register, an official source of publicly available financial information.

## Research results

### Level of informativeness

Theoretically, 180 sets of financial statements should be available, but it comprises only 97 sets, which makes difference of 83 missing sets. The discrepancy arises because clubs do not fulfil their information duty (73 cases in total); some clubs became business entities later than in the season 2005/2006 (8 cases in total); and two clubs changed the accounting period from calendar to fiscal year respecting the course of football season.

**Tab. 1:** *The rate and delay of submission of financial statements to the Business Register*

	09/10	08/09	07/08	06/07	05/06
Max. number of financial statements	36	36	35	34	29
Number of non-submissions	25	15	12	12	9
Number of submitted financial statements	11	21	23	22	20
Submitted fin. statements in %	31%	58%	66%	65%	69%
Average length of submission (in days)	181	245	296	453	447
Number of late submissions – soft criterion	0	4	7	9	5
Number of late submissions – hard criterion	5	10	14	17	15

Source: authorial survey

As it can be seen from the *Tab. 1*, a significant number of clubs fulfils their information duty with delay or they do not fulfil it at all. An average rate of submission of statements is slightly above 60 %. The rate is relatively low provided that submission is mandatory for all business entities operating in the Czech Republic and the non-compliance is a subject to be fined pursuant to Act on Accounting. However, the findings of this study are similar to a more extensive research carried out by Tomis (2007, p. 48), who found out that only 53 % of share companies complied with requirements of Act on Accounting and Commercial Code on submissions of financial statements and annual reports during years 2003–2005.

The Register enables to assess timeliness of financial statements submission; 2 criteria for measurement of delay in the submission of financial statements are used in this study.

1) *Soft criterion* refers to the provisions of Act on Accounting, pursuant to which entities shall publish their financial statements within 30 days after being approved by the management, but not later than 12 months after the end of accounting period. Statements submitted later than after 12 months are considered to be deposited with a delay.

2) *Hard criterion* refers to the provisions of §184a of Commercial Code, which requires the share companies to hold the General Meeting at least once a year, but not later than 6 months after the end of latest accounting period. Financial statements and annual reports are subject of an approval by shareholders at the General Meeting. Financial statements submitted later than after 6 months are supposed to be submitted with a delay.

*Tab. 1* confirms that the level and timeliness of mandatory disclosure is considerably low. All parties interested in doing business with entities not fulfilling their informational duties are unable to assess financial health of a company from independent and reliable resources. Creditors may be exposed to a higher risk, as far as repayment of their receivables concerns. To evaluate the possible negative economic impacts for creditors if sport clubs do not fulfil their information duty, a financial health of sport clubs in general is analysed.

### **Analysis of financial health**

Totally 103 annual data sets were extracted from submitted statements (in 6 cases data for comparative periods were used instead of some missing sets of financial statements). All data sets are subdivided into two groups according to the accounting period used by entities. Football clubs utilised a calendar year as reporting basis in 54 and a fiscal year in 49 cases. The division was made to obtain more comparable data, as volume of accruals and deferrals is significantly higher when an accounting period is on a calendar year basis, as majority of advertisement and sponsorship contracts are concluded with respect to a course of football season. For the purpose of this survey, each set of financial statements consists of information on total assets, equity, subscribed capital, and earnings before interest and taxation.

Descriptive statistics in *Tab. 2* reveal interesting inferences regarding the profitability and indebtedness of the Czech football clubs. In six of ten subgroups, an average for earnings before interests and taxation is negative, which signals possible problems with profitability. The annual earnings before interests and taxation (EBIT) of a club reached amount of – 4,952 thousands CZK over analysed period on average. This fact gives an empirical evidence of validity of Sloane's theory rather than Neale's one in case of Czech professional football. A long-term stability is broken down and further economic survival is questionable, which steps up a risk for creditors, because long-term losses reduce funds available for the pay-offs of liabilities.

**Tab. 2:** Selected information from financial statements – descriptive statistics

Year 2006	Maximum		Minimum		Average		Standard deviation	
	Calendar	Fiscal	Calendar	Fiscal	Calendar	Fiscal	Calendar	Fiscal
Total assets	211,804	600,203	2,227	7,756	51,048	137,017	69,001	192,192
Equity	148,680	164,643	-51,953	-154,861	12,986	20,434	45,389	96,063
Subscribed capital	133,440	422,476	620	1,000	24,853	104,716	44,583	152,214
EBIT	21,212	32,521	-12,397	-54,168	13	-12,454	7,733	25,326
Year 2007	Calendar	Fiscal	Calendar	Fiscal	Calendar	Fiscal	Calendar	Fiscal
Total assets	257,928	668,046	3,345	7,104	67,392	123,526	85,197	198,179
Equity	166,865	158,436	-10,962	-215,373	19,109	7,011	48,759	95,178
Subscribed capital	198,705	422,476	620	2,000	31,973	87,495	61,541	141,466
EBIT	32,828	6,379	-22,083	-53,288	1,094	-10,042	14,384	17,249
Year 2008	Calendar	Fiscal	Calendar	Fiscal	Calendar	Fiscal	Calendar	Fiscal
Total assets	286,724	857,626	799	8,290	73,008	182,362	91,912	279,974
Equity	187,481	640,358	-15,491	-20,966	29,934	79,918	58,501	192,845
Subscribed capital	198,705	1,040,476	620	2,000	35,334	148,131	62,543	317,765
EBIT	93,442	247,593	-20,297	-127,165	9,013	8,367	30,447	88,260
Year 2009	Calendar	Fiscal	Calendar	Fiscal	Calendar	Fiscal	Calendar	Fiscal
Total assets	322,881	535,829	2,204	5,273	67,919	138,076	107,772	178,192
Equity	182,620	288,138	-13,257	-57,059	20,619	43,153	59,285	105,115
Subscribed capital	133,440	494,970	620	2,000	24,864	102,270	43,970	169,806
EBIT	9,859	16,217	-18,104	-123,339	-2,634	-19,020	7,490	38,357
Year 2010	Calendar	Fiscal	Calendar	Fiscal	Calendar	Fiscal	Calendar	Fiscal
Total assets	207,223	516,547	3,176	16,369	64,622	218,519	96,763	191,880
Equity	181,835	277,794	3	-167,977	46,355	36,750	90,324	164,032
Subscribed capital	142,440	610,170	620	2,000	40,365	171,510	68,423	232,385
EBIT	13,452	3,625	-15,754	-157,992	-10	-39,356	12,011	63,441

Source: authorial survey. Amounts are expressed in thousands CZK.

As averages may be distorted by extreme values, additional analysis of financial health and capital stability was performed. Firstly, a total number of reported negative EBIT figures were counted for each year. In each year, more than 60% of clubs reported a negative amount of EBIT, which supports a previous conclusion about an overall poor financial performance of the Czech professional football clubs.

The importance of these findings is confirmed by two additional tests referring to the provisions of Commercial Code on capital adequacy. Pursuant to §193, the managing board of a company, which accumulated losses exceed 50% of subscribed capital, is obliged to announce the General Meeting of shareholders, who shall undertake measures to improve the state of business affairs. According to *Tab. 3*, a failure in the *Equity Test No. 1* is shown in 54 cases out of 103. In other words, more than half of football clubs have to solve drops in capital adequacy each year. The problem is usually ignored and solved insufficiently or even not solved at all as it can be proved by *Equity Test No 2*.

**Tab. 3:** Analytical tests on profitability and capital adequacy

Season	Test	Calendar	Fiscal	Total cases
	Negative EBIT	8	7	<b>15</b>
<b>2006</b>	Equity Test No. 1	8	6	<b>14</b>
	Equity Test No. 2	6	3	<b>9</b>
	Negative EBIT	8	7	<b>15</b>
<b>2007</b>	Equity Test No. 1	9	6	<b>15</b>
	Equity Test No. 2	6	4	<b>10</b>
	Negative EBIT	6	6	<b>12</b>
<b>2008</b>	Equity Test No. 1	8	3	<b>11</b>
	Equity Test No. 2	4	3	<b>7</b>
	Negative EBIT	7	8	<b>15</b>
<b>2009</b>	Equity Test No. 1	6	4	<b>10</b>
	Equity Test No. 2	4	4	<b>8</b>
	Negative EBIT	1	5	<b>6</b>
<b>2010</b>	Equity Test No. 1	2	2	<b>4</b>
	Equity Test No. 2	0	2	<b>2</b>
<b>Negative EBIT – total count</b>		<b>30</b>	<b>33</b>	<b>63</b>
<b>Equity test No. 1 – total count</b>		<b>33</b>	<b>21</b>	<b>54</b>
<b>Equity test No. 2 – total count</b>		<b>20</b>	<b>16</b>	<b>36</b>

Source: authorial survey

Furthermore, §193 of Commercial Code establishes the duty to call the General Meeting provided that results of business operations indicate the default of a company. A company is in the default, if it has more creditors, its liabilities are more than 30 days after due date, and the company is unable to settle its liabilities (§3 of Insolvency Act). The symptoms of a default as defined by Insolvency Act are known only to managers; therefore it is impossible for outsiders to detect directly, whether a company is defaulted or not. For the purpose of this study, it is presumed that a football club is in a default, if two conditions are met simultaneously. Firstly, a football club reports negative equity. Secondly, the club discloses information on liabilities over their maturity.

In 36 of 103 observations, the negative equity is reported. All 36 cases are accompanied with liabilities after due date. As a result, one third of Czech professional football clubs are permanently in a default position, which may turn into bankruptcy. Such a state of affairs boosts the risk of making business with football clubs rapidly. To make the situation even worse, the findings on non-compliance with information duty shall be recalled. Basically, Czech professional football clubs are generally in a very poor financial shape.

### Conclusions

Paper analysed financial health of Czech professional football clubs. An empirical study has revealed several important features relating to level of informativeness and financial health of Czech football clubs playing the first and second league. Firstly, the rate of submission of financial statements to the Business Register is rather low (about 60%), even though delivery of statements to the Register is legally mandatory. Secondly, majority of those clubs, which do submit their financials, does it with a considerable delay. Thirdly, Czech football suffers from a poor economic performance. Majority of clubs reports regularly

losses. Annual loss (up to almost 5 million CZK) is incurred by an “average” club each year. Equity is often negative and football clubs are unable to meet their liabilities on time. Consequently, one third of clubs appears virtually in a permanent default. In some cases, the virtual defaults turned to real ones and other clubs have survived just on the edge (and even the clubs with a long tradition are not immune to economic problems).

All mentioned factors lead to a situation that Czech football scene represents a very risky environment for all parties, which do not have any other access to financial information than to those contained in financial statements. The decision whether to conclude any contract to deliver goods or service to Czech professional football clubs needs a higher alertness, with the impact on cost of capital provided by creditors. Creditors may lose their money as significant risk of default and/or bankruptcy exists. This scenario is not only hypothetical. Over analysed five seasons, three clubs became bankrupted. It is indeed symptomatic that two of those three clubs did not fulfil their information duty at all.

The future research should address several topics. Firstly, a comparison with football clubs from other European countries should be performed to find out the similarities and differences. A more detailed analysis is required to address the cardinal unclear issue arising from the findings of this preliminary survey. How is it possible that a relatively high number of football clubs survives even though they conduct their business with long-term losses? Is this a specific of Czech professional football, or is it a common feature around Europe? Furthermore, impacts of the new UEFA Regulation on Financial Fair Play (setting restrictions on indebtedness of football clubs participating in the European cups) shall be assessed.

Finally, the research shall also provide answers whether and how the cost of capital of football clubs can be reduced. I presume that it depends crucially on transparency of football clubs and attractiveness of the football league. The latter factor is under a looser control of a football club as a product for football fans is supplied jointly by all clubs. However, the transparency is fully controllable by each club. Not only transparency of ownership, but also availability of maximum information on financial position and financial performance may be very helpful. Detailed information on key financials relating to the core of sporting business, such as revenue sources (tickets, merchandising, sponsors, transfers, advertisement, etc.) or on players' salaries, can present a valuable input into the creditors' risk assessment models.

## Abstrakt

Článek se zabývá plněním informační povinnosti českých profesionálních fotbalových klubů hrajících první a druhou ligu. Empirická analýza prokázala, že významná část klubů vkládá účetní závěrky či výroční zprávy do Sbírký listin se značným zpožděním, případně je vůbec nekládá. Neexistence veřejně dostupných informací o finančním zdraví zvyšuje riziko pro věřitele fotbalových klubů. Tato skutečnost je znásobena neuspokojivou finanční situací českého profesionálního fotbalu, jak vyplývá z druhé části empirického výzkumu.

**Klíčová slova:** ekonomika sportu; české fotbalové kluby; informační povinnost; finanční zdraví.

## Summary

The paper scrutinises some factors influencing the risks taken by providers of debt financing to Czech professional football clubs. The research is carried out in two ways. Firstly, the compliance with information duties set up by legislation is analysed. According to empirical survey, a significant number of football clubs submit their financial statements to the Register with a delay or do not submit them at all. This unsatisfactory state of affairs boosts the risk of

making business with football clubs rapidly taking into account an overall poor financial health of Czech football clubs, which was revealed in the second part of empirical study.

**Key words:** Economics of sport; Czech football clubs; Information duty; Financial health.

**JEL klasifikace:** L83, M41, M21, G30

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