Financial policy for an insolvent company

Alla Aleksandrovna Elakova

Kazan (Volga Region) Federal University, Branch in Naberezhnye Chelny, Sujumbike avenue, 10A, Naberezhnye Chelny, 423812, Republic of Tatarstan, Russia

Abstract. The article is devoted to the up-to-date issue of insolvency and possible bankruptcy of an enterprise. Insolvency of the enterprise can be considered from two perspectives: insolvency by formal criteria established by the legislation; insolvency defined as the assumed inability to fulfill its obligations in due time. In the first case, the possibility of active management of the enterprise to influence the situation is severely limited. In the second situation, this enterprise is in a position of pre-bankruptcy, when no one of the creditors has filed a claim in an arbitration court on the matured obligations due for payment. The main goal of the company on the verge of bankruptcy is to ensure financial stability and balanced budget cash flow. The author of the article shows a practical example of how a manufacturing enterprise on the verge of bankruptcy can ensure financial stability and deficit-free cash.
[Elakova A.A. **Financial policy for an insolvent company.** *Life Sci J* 2014;11(10s):349-351] (ISSN:1097-8135). http://www.lifesciencesite.com. 65

Keywords: insolvency, pre-bankruptcy, product life cycle, cash turnover

Introduction

The development objective of the financial policy of the company is to build an effective financial management system designed to achieve strategic and tactical goals of its activities. These goals are specific to each business entity [1, 2, 3, 4, 5]. For example, strengthening the position at the merchandise (services) market, achieving an acceptable level of sales, profits and return on assets and home equity, maintaining solvency and liquidity of the balance.

Insolvency of the enterprise can be considered from two perspectives:

1) insolvency by formal criteria established by the legislation;

2) insolvency, defined as the assumed inability to fulfill its obligations in due time

The first situation is governed by the Federal Law "On Insolvency (Bankruptcy)" dated 26.10.2002, № 127-FZ (as amended on 12.03.2014) [6]. Under this law, insolvency is a stop of executing the monetary liabilities or obligations under the mandatory payments due to insufficient funds, while insufficiency is presumed, unless proven otherwise. Insolvency can go into bankruptcy, which is a recognized by an arbitration court the debtor's inability to fully satisfy the claims of creditors on monetary obligations and (or) to fulfill the obligation to pay the required fees. In this article, this situation is not considered, since the activities of the enterprise, which is subject to this law, goes through a series of legal procedures:

- observation;
- financial recovery;
- external control;
- bankruptcy proceedings;
- settlement.
- observation;

Thus, the possibility of active management of the enterprise to influence the situation is severely limited.

In the second situation, enterprises are on the verge of bankruptcy, when no one of the creditors has filed a claim in an arbitration court on the matured obligations due for payment. But it is already clear that available cash and budgeted revenue for shipped products (completed works, rendered services) won't be sufficient to fulfill all existing and planned obligations [7].

The main goal of the company on the verge of bankruptcy is to ensure financial stability and balanced budget cash flow.

The main part

For example, let us consider a manufacturing enterprise with a sufficiently long production cycle (more than 1 month), which uses a per-order method of production (each product is different from others, there are no small series), and with a standard set of services – design, technology, procurement, sales, production.

Given the lack of funds, the management of the enterprise faces a problem of how to better manage existing cash resources to ensure balanced budget cash flow in the near future [8]. In this situation, the main tool of analysis will be an assessment of the effectiveness of the payments through the assessment of the future impact of these payments.

The enterprise, producing more than one product, has always a choice of where exactly to send the available funds to get the utmost benefits. From a mathematical point of view, this analysis does not present any difficulty. All calculation formulas for the current net value are known and available.

One of the drawbacks of calculating the current net value is the lack of consideration of the probability of occurrence. In order to evaluate the draft decisions on the expenditure of funds, taking into account the probability of events, proceed as follows. Allocate key parameters, set a number of amounts, indicating the probability of occurrence, to each parameter. For each set of parameters probability of occurrence and the current net value are calculated. Then we calculate the mathematical expectation and, finally, we obtain the most probable current net value [9, 10]. In all mathematical formulas where there is probability estimation, the quality of the original information is the most important in terms of influencing the result.

In conditions of limited available funds, the company's management has to make a choice between investment into WIP (work-in-process) of existing products or into starting to produce new orders.

Often the decision about the direction of funds is made to maintain the continuity of the production process. Sometimes it is a partially right decision, if the funds are directed towards the acceleration of production, which results in releasing frozen funds in WIP or in warehouses.

Under limited solvency, a necessary factor of choice is the amount of product-generated cash per unit time. Nevertheless, considering only this indicator is not enough, as there may be a situation where there is a high-performance product that can generate the greatest amount of cash [11, 12]. As a rule, it generates it at the point when one of the creditors has already filed his claims in an arbitration court and the company is subject to the federal law "On Insolvency (Bankruptcy)". Therefore, another important indicator is the product's ability to generate funds to a certain date.

On this basis, in order to avoid insolvency, when considering a product, we should take into account not only its ability to generate maximum cash flow per unit time, but also its ability to bring this money flow to a specific point of time. Thus, it is necessary to calculate the entire product life cycle in the enterprise, from concluding a contract and to designing and implementing the product to the buyer and receiving money.

At each stage of the products life cycle at the enterprise, each product has its own peculiarities and differences [13, 14]. For a full comparison between several products, it is necessary to calculate the impact of each stage on the current net value during the entire business process of motion (not only during the production cycle). The basic rule of dividing the product life cycle into stages at the enterprise is as follows: a stage should be singled out and gotten into the analysis if at least one of the products has different terms or costs.

Theoretically, since the moment of concluding the contract, the entire production cycle consists of the following stages:

1) preparation of design documentation;

2) purchase of raw products, materials and components;

3) production of the machine;

4) delivery of the equipment to the place of installation;

5) installation and commissioning.

To simplify the calculations, we take the whole cycle as a single value, although it should be borne in mind that in real production activity phases will overlap in some places and won't be only sequential, but parallel. Another assumption is that the timing of payments for purchases is the same for all options. In fact, they will be different, depending on the configuration of the machine. And this fact also must be taken into account in the calculations.

Key indicators for the calculations in this example will be profitability of an order, time of the assets of the enterprise being in circulation, terms of in payments.

Let's assume that the enterprise faces a question of priority for starting the production of three types of machines with the following conditions (Table 1):

Table 1. Terms of three types of the machines

Product	Contract price (without VAT), RUB.	Target prime cost, RUB.	Target profit, RUB.	Time of performance, days	Terms of payment
Machine 1	2,800,000	2,600,000	200,000	90	Upon manufacture
Machine 2	3,200,000	2,800,000	400,000	80	30 days upon installation
Machine 3	8,000,000	7,000,000	1,000,000	120	45 days upon installation

Thus, the first machine will bring us profits (and thus free cash): 200 000 roubles within 90 days, the second machine – 400 000 roubles in 110 days (80 + 30), the third machine – 1 000 000 roubles in 165 days (120 + 45).

Next, we calculate the rate of return on each machine per unit time of the funds of the enterprise being in circulation:

Machine 1: 200,000 RUB / 90 days = 2,222.22 RUB / 1day

Machine 2: 400,000 RUB / 110 days = 3,636.36 RUB / 1 day

Machine 3: 1,000,000 RUB / 165 days = 6,060.60 RUB / 1 day

Conclusion

This implies that using the calculation of earnings per one day of funds being in circulation, it will be the most beneficial to run these machines in production in the following sequence: 3, 2, 1. But in a pre-bankruptcy state indicators of receiving funds according to the calendar become of paramount importance in comparison with profitability. If there is a possibility of deferred payments on the most risky debts, we must compare this delay with the moment of receiving the payment for the machines and choose to launch the most profitable of the machines that fall into this range in the first place. Therefore, the sequence of the start of production should be correlated with the existing repayment schedule, taking into account the company's debts.

Corresponding Author:
Dr.Elakova Alla Aleksandrovna
Kazan (Volga Region) Federal University
Branch in Naberezhnye Chelny
Sujumbike avenue, 10A, Naberezhnye Chelny, 423812, Republic of Tatarstan, Russia

References

1. Vakulenko, T.G., L.F. Fomina, 2003. Analysis of financial (accounting) reports for management decision making. Saint-Petersburg: Gerda, pp: 288.
2. Altman, E.I., 1993. Corporate Financial Distress and Bankruptcy. New York: John Wiley & Sons, Inc., pp: 19-22.
3. Argenti, J., 1976. Corporate Collapse: the causes and symptoms. McGraw-Hill Book Co. Ltd, pp: 15-18.
4. Beaver, W.H., 1996. Financial Rations and Predictions of Failure. Empirical Research in Accounting Selected Studies. Supplement to Journal of Accounting Research, pp: 28-33.
5. Etheridge, H.L. and R.S. Sriram, 1995. A Neural Network Approach to Financial Distress Analysis. Advances in Accounting Information Systems, pp: 36-39.
6. Law of the Russian Federation “On Insolvency (Bankruptcy)” of 26.10.2002 #127-FZ, Legal reference system “Consultant Plus”.
7. Elakova, A.A., 2012. Development of management accounting and analysis during the economic crisis of the enterprise, PhD Thesis abstract, Yoshkar-Ola, pp: 20.
8. Bragg, S.M., 2005. The New CFO Financial Leadership Manual. Moscow: Alpina Business Books, pp: 532.
9. Gershun, A. and M. Gorskiy, 2006. Technology of balanced management. 2nd edition, Moscow: ZAO “Olimp-Biznes”, pp: 416.
10. Lutz, R.A., 2003. Guts: The Seven Laws of Business That Made Chrysler the World's Hottest Car Company. Moscow: Alpina Publisher, pp: 447.
11. Drury, C., 2008. Management and Cost Accounting: study guide for universities. Edited by Eriashvili N.D.; foreword by Prof. Bezrukih P.S. Moscow: Audit, UNITY, pp: 783.
12. Ivashkevich, V.B., 2008. Accountant’s management accounting: a study guide. 2nd edition. Moscow: Magistr, pp: 574.
13. Olve, N.-G., J. Roy and M. Wetter, 2006. Performance Drivers: A Practical Guide to Using the Balanced Scorecard: translated to Russian. Moscow: Publishing House “Williams”, pp: 304.
14. Groot, T. and K. Lucca, 2004. Cases in Management Accounting: Current Practices in European Companies. Minsk: Novoye znaniye, pp: 416.

6/27/2014