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Investments for a Bankruptcy as the Optimization of the Financial Architecture

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Investments for a Bankruptcy as the Optimization of the Financial Architecture

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1. INTRODUCTION

The financial crisis tested insolvency frameworks around the world. In Western Europe corporate insolvency filings rose of 22% between 2008 and 2009, with the biggest increases in Ireland (81%) and Spain (77%). Western Europe is still far from returning to its pre-crisis numbers. At the end of 2011 corporate insolvency filings were still 17% higher than in 2008. Between 2008 and 2012 Spain recorded one of the biggest increases – 182%.

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Weaknesses of insolvency regimes become apparent during crises. When a weak insolvency framework does not provide effective formal and out-of-court mechanisms to address financial distress, more debts remain unresolved and more companies become unprofitable, with their assets unavailable to their creditors and little chance of turnaround. An insolvency framework that allows debtors and creditors to find solutions through fast, inexpensive, transparent procedures can facilitate debt repayment, encourage lending and lead to a higher survival rate for viable enterprises.

As it was mentioned in a new report by the World Bank Group, the regulatory reform rates remained high in Europe and Central Asia. 19 countries of the region made all together 65 reforms, aimed at improving the business regulation standards in the previous year.

The report “Doing Business in 2014: Understanding the regulation of activities of the small and medium-sized enterprises” notes that the efforts of the European and Central Asia countries to strengthen legal institutions, as well as to simplify the regulation procedures and to reduce the associated financial costs have borne fruit for the local entrepreneurs. Europe and Central Asia was ahead of East Asia and the Pacific Rim and took the second place in the world after the member countries of the Organization for Economic Cooperation and Development (OECD) with high-income by a degree of the most favored regulatory base for the business environment.

Considering this report, 92 % of the European and Central Asia countries have been simplifying the business registration procedures since 2009. It was the highest rate in comparison with the countries in the other regions of the world. Nowadays, as a result of these efforts, it is easier to establish a business in the countries of Europe and Central Asia than in any other region of the world, and is even easier than in the OECD high-income countries. During the same period, 73% of Europe and Central Asia the countries have made changes to the process of solving the problems of insolvency responding to challenges arising from the financial crisis, while 85% have simplified the process of taxation.

For example, Ukraine adopted a new insolvency framework that strengthened protections of secured creditors, introduced debt-equity swaps and streamlined the insolvency process. And Poland, having simplified the process of business registration and obtaining building permits for the last year, was ranked the 45th out of 189 in the world rankings on the favorable business conditions.

However, it should be noted that in spite of the half-year effect of innovations introduced in the bankruptcy regulatory procedures (promulgation of the LU “On Resumption of a Debtor’s Solvency or Bankruptcy Declaration”) in Ukraine, a position on the criterion of “bankruptcy procedure and resolving insolvency” could not be improved due to the persistence of significant time and financial costs associated with the solvency recovery procedures or insolvency of business entities, as well as a downward change in the recovery index in these procedures. For example, if you have about the same average duration of cases and bankruptcy procedure in Ukraine, Poland and Hungary (about 3 years), the average cost of judicial procedures (calculated as a percentage of value of the debtor’s property) in Ukraine is significantly higher (42% against 15% in Poland and Hungary), and the collection rate is much lower than 8,2% (Poland - 54,8%, Hungary - 38,3%). Some data on resolving insolvency are given in Table 1.

Table 1 : Resolving Insolvency Rank

- 1 The average time to close a business. Information is collected on the sequence of procedures and on whether any procedures can be carried out simultaneously. Time for creditors to recover their credit is recorded in calendar years
- 2 The average cost of bankruptcy proceedings. The cost of the proceedings is recorded as a percentage of the estate's value.
- 3 Whether business continues operating as a going concern or business assets are sold piecemeal (0 as piecemeal sale and 1 as going concern)
- 4 The recovery rate calculates how many cents on the dollar claimants (creditors, tax authorities, and employees) recover from an insolvent firm.

When analyzing this data we can generalize that despite problems being common to many countries and associated with the financial crisis impact the success of implementation of the procedures for resumption of solvency of companies or reorganization of really inefficient companies to a large extent is determined by ability of the company's management to find a way out of the current critical situation.

It should be clearly understood that any problem, faced by the company during its life cycle, is literally a matter requiring urgent solutions (in Greek). Thus, if a head of the company, being on the verge of bankruptcy, will not be able to reject his thoughts, associated with the fear of losing job/money due to removal from office, at such a critical moment then the company's prospects really loom quite unsightly. If the fear dominates over the rationality such scenarios can be implemented:

1. A head may agree to attract the required number of borrowed funds to cover debts at such interests that the company would be unable to pay in the future. A so-called "effect of mole" appears when the active involvement of additional debt leads to "deepening" into a debt pit.
2. First of all, the frightened head will engage unscrupulous partners as the investor-partners, who later will impose their vision of business development aimed at gaining the maximum short-term returns.
3. The head may unknowingly agree to known illegal schemes to raise funds at the attractive interest rates that may eventually cause criminal cases of money laundering.
4. The head-fear monger will agree to cooperate with the companies-"butterflies", which will provide overvaluation of the company's costs for a certain percentage in order to conceal income for the real taxation and payment of taxes and other obligatory payments to the budget. Despite the short-term improvement of health and well-being of the head, such an operation is often completed with the preparation of a report by a tax inspection and then transfer of the inspection report and decision of the tax inspection to the tax police, and then according to the Article 212 of the Criminal Code of Ukraine "Tax Evasion", "Bringing to Bankruptcy" etc.

Obviously, the above options for an owner of the company (or rational manager) are not attractive. From another perspective, a correct way out of insolvency (when the court has already accepted a statement of the creditors about initiation of bankruptcy proceedings) shall be optimization of the debtor's structural characteristics, which form the basis of his financial architecture and a key influence on the possibility of resuming its solvency.

The company's financial architecture concept has been proposed for use in the corporate finance sphere by S. Myers, an American economist, who identified financial architecture as a changing financial design or financial organization of the company, including such structural characteristics as the legal form of the company (public or private), ownership structure (concentrated or dispersed), capital structure (the ratio of funding sources) and corporate governance system. Different combinations of parameters of the financial architecture determines aspects of the operating, financing and investing activities of an entity and actively influence on the financial performance formation.

Considering that the aim of the debtor's financial architecture optimization is the renewal of its solvency and financial standing stabilization, the problems of organizational and financial restructuring of the company are:

- maximization of the potential financial resource level by sources with the minimal cost and minimal transaction costs of attraction;
- effective redistribution of property rights and monitoring of the company's activities in order to minimize the risks of a hostile takeover;
- optimization of the capital structure for rapid reduce in the debt burden;
- protection of the owners' property rights and resolution of a conflict of interests between them and other stakeholders (Fig. 1).

Figure 1 : Objectives of the organizational and financial reorganization of the debtor company

Considering directions of the debtor's financial architecture optimization by its individual components, one can undo the following methods of the process. Optimization of the organizational-legal form of the

company and ownership structure involves the implementation of measures to change the legal status and structure of the company in the corporate reorganization context, namely:

- 1) attraction of new members to replenish the authorized capital to control the statutory limit for a number of members of the company;
- 2) splitting the company in order to separate those departments that operate inefficiently. Thus, the problems are clearly localized and way of their solution will be apparent (modernization, change of personnel, strengthening of security measures to prevent theft and embezzlement, etc.);
- 3) the most innovative ways of corporate reorganizations are:
 - modification and / or improvement of the brand / company logo;
 - change in the company's registered address in order to find the region with the most favorable tax climate;
 - patenting a new technology that will change the range of products, modify the company's brand (up to the introduction of new clothes for the new production), modify the color scheme of corporate colors and present a major new advertising campaign at the market.

The company management can implement the following activities in the process of optimization the debtor's structure of capital and assets:

- 1) replacement of the morally obsolete equipment with the new one;
- 2) revaluation of all the company's assets not in accordance with the carrying amount and depreciation rate, but under the commercial prices for the equipment, buildings, etc., which, despite an increase in the tax burden, will provide cost increase and improve its creditworthiness potential and investment attractiveness in the future;
- 3) sale of all the unsold inventories of raw materials and uncompetitive finished products, which will provide additional cash flow and vacation of warehouse premises;
- 4) installation of the high-tech equipment of a whole production and / or service department of the company;
- 5) complete dismantling of obsolete equipment with termination of the old production of the old product range and full conversion of the company, operating with the old industrial areas, with a focus on high-tech equipment;
- 6) conduction of an unexpected inventory, selective and continuous audit that will help you to find unrealized sources for collection of accounts receivable;

- 7) optimization of the debt capital structure in order to identify those loans that require priority repayment;
- 8) increase in the share of equity capital through the issue of securities;
- 9) development and implementation of an absolutely new investment project with attraction of new investors.

Thereby, optimization of the system of corporate governance and control is designed to ensure the settlement of relations among the company's owners and managers, as well as decreasing the probability of a conflict of interests between other stakeholders that under unfavorable circumstances can lead to a deterioration of corporate security of the company.

It should be noted that the corporate governance is not only the organization of activities of the Supervisory Board (the Board of Directors) and system of relationships between the company and its owners to enforce their rights. Taking into consideration that the investors have increased their attention to the assessment of the company as an investee, the corporate governance system is an integrated approach to the construction of foundations and mechanisms for business administration, including strategic planning, risk management, compliance with the legislative requirements, which would allow it to overcome crises at the macro- and micro-level with minimal losses. Thus, improving quality of the corporate governance is an important task of organizational and financial reconstruction of the debtor, which involves the following activities:

- 1) change of management and publication of identification data on the top managers, general director, accountants, who unprofessionally perform their duties at the highest positions in the management bodies, causing financial crisis in the company;
- 2) provision of the staff turnover (excluding dismissal of senior officials), which will reveal unscrupulous members of the staff and will allow to find the staff, who will be ready for the minimum wage to deal with new responsibilities with a view to the subsequent salary increase;
- 3) to ensure independence of the internal financial audit by the members of the Supervisory Council through mandatory acceptance of independent directors with an impeccable reputation and experience to the Board of Directors and to withdraw working shareholders from the Board of Representatives;
- 4) to send the company's top managers for retraining, to organize the language courses at different levels of complexity and for different categories and to organize permanent computer literacy classes;

- 5) to engage a life-coach to work with the top management, business and life coaching, as the removal of personal barriers in life of each of the top managers allow them to take a fresh look at the company's problems;
- 6) to hold a number of negotiations with creditors and debtors in the presence of a facilitator company (negotiator, mediator), who will teach techniques of negotiations, allowing to transform a conflict smoothly into a plane for the construction of both a debt repayment algorithm and to build long-term cooperation, being mutually beneficial to both the debtor and creditor;
- 7) to develop and implement a distance work system (working with freelancers), what will save money on maintenance and equipment of the work space and provide employment for certain categories of employees, who are due to certain circumstance in a remote access to the company (women on maternity leave and / or children of employees, who wish to earn money between classes in the higher educational institutions (being great on the new technologies), the people close to the retirement age and retired people, who are well aware of their responsibilities at the company, but which maintenance is economically inefficient for the company);
- 8) to establish a regular practice of corporate events (with family members, with departure out of the city, with the competitions, art contests, etc.) at the company and to equip rooms for catering and joint recreation at the company;
- 9) to improve / create standards and norms of corporate culture, starting with the meeting of the personnel together with the administration of the company for the revision of a collective agreement, particularly in terms of bonuses, cancellation of bonuses and the annual performance appraisal. To establish rules of conduct and approve them at the General Meeting as a part of the collective agreement.

Definitely, implementation of the above activities will take a lot of human efforts and financial costs, which is especially difficult under the threat of bankruptcy. However, at the time of financial crisis it is important to focus on implementation of the rational actions, throwing the panic and fear away. Moreover, it should be noted that any optimization measures do not give any effect if they are inadequate for an appropriate development stage. Therefore, when determining specific areas of organizational and financial reconstruction of the debtor company, the company's life cycle and its financial standing must be taken into account and foremost it is necessary to monitor implementation and economic benefits from the use of various optimization measures.

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