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THE SYSTEM OF BANKRUPTCY IN RUSSIA AND ITS EVOLUTION
Alexey Makarov [1]

1. The history of the development of bankruptcy system in Russia

The history of bankruptcy in Russia has long roots. Though the word "bankruptcy" appeared in Russian law much later there are articles concerning bankruptcy in the "Russian Pravda", which is one of the first legislative acts that operated in ancient Russia in XI—XII centuries.

Before the revolution of 1917 the legislation about bankruptcy was revised several times and the practice of commercial courts dealing with the cases of bankruptcy was constantly improved as well. The results of the research of the legal regulation of bankruptcy before 1917 show it's high level of development even in comparison with foreign systems of bankruptcy. At that time legal regulation of bankruptcy was considered as one of the key elements of regulating market economy.

The revolution of 1917 introduced its changes into the law-making process. Major modifications were made in the area of state law. However, the issues of bankruptcy were reflected in the reform of legal relationships envisaged by the state law.

Since 1930-s legal relations concerning bankruptcy of enterprises were not regulated. Official doctrine did not recognize the system of bankruptcy. It was argued that bankruptcy can not exist in the command economy. Moreover, the rules of bankruptcy were completely excluded from the USSR legislation.

After a long period of time started the process of restoring legal relations concerning bankruptcy of the debtor. The first to be adopted was the law of the Russian Federation "About bankruptcy of enterprises" dated November 19, 1992. The Law of 1992 was an attempt to unite in an eclectic way the elements of various systems of bankruptcy acting in different countries. Law-makers offered parties the possibility of applying elements of various systems of bankruptcy to the debtor, without providing any details.

[1] Alexey Makarov is associate professor of the Higher School of Economics in Nizhny Novgorod, Head of the Department of Financial Management at the Faculty of Economics.

Later some other acts were passed to fulfill the Law of bankruptcy of 1992. The latter defined the criteria for recognizing the organization of the debtor as bankrupt and envisaged measures aimed at financial support provided to the organization before termination, as well as the procedure of termination.

The national Law №6-ФЗ "About bankruptcy" dated February 8, 1998 was to a greater extent aimed at defending the interests of creditors. One of the key innovations of the second Law about bankruptcy was the requirement to the arbitration manager to have a special license.

New national Law "About bankruptcy" passed by the state Duma on September 27, 2002 and signed by the President of the RF on October 26, 2002, represents the third stage in the development of the legal settlement of relations connected with bankruptcy of organizations and citizens, which can be characterized as the continuation and development of the reform of legislation about bankruptcy started in 1998.

The new Law about bankruptcy of 2002 differs from its predecessors by a greater number of articles. The Law of 1992 consisted of 51 articles, the Law of 1998 – of 189 articles, while the new Law includes 213 articles. It is more detailed and has some conceptual changes in the legal settlement of bankruptcy.

To be more exact, the approach to defining criteria and external features of bankruptcy remained the same, while some procedures of bankruptcy were clarified, such as surveillance, external management, competitive production, and out-of-court settlement.

New systems appeared, such as the procedure of financial revival, self-regulating organizations of arbitration managers, checking at the hearing whether the claimed requirements have grounds so that the procedure of supervision could be introduced, transfer from competitive production to external management, and bankruptcy of strategic organizations.

According to the new Law competition creditors and authorized bodies. In fact, authorized bodies, as well as competition creditors, are the third to get the satisfaction of their demands, and authorized bodies take part in voting on the issue of settling the lawsuit out of court. The amount of claims of creditors to debtors – juridical persons has been increased as the condition of taking legal action about bankruptcy. At present bankruptcy lawsuit can be initiated by arbitration court on condition that the claims to debtor, who is a juridical person, are not less than 100 000 rubles.

The procedures of holding the meeting of creditors and the committee of creditors, authorities of arbitration managers, and the way of hearing bankruptcy cases have been described in more detail. This, no doubt, increases the guarantees and legal interests of all sides participating in a bankruptcy case.

The law contains a number of other novelties and upon the whole can be assessed as a high-quality legislative product.

At present the system of bankruptcy is developing and is to a great extent focused on preventing the termination of an enterprise by undertaking certain economic and organizational measures.

But as practice shows, there are cases of competition selling implying termination. Previous procedures aimed at financial revival of the enterprise are often inefficient. Experts maintain that the basic reason for this is that bankruptcy system does not include the component responsible for the collection and analyses of information about the enterprises that are likely to go bankrupt. The development of this element can significantly improve the efficiency of the financial revival procedure, which nowadays is introduced too late to be able to save the enterprise.

2. Modern methodology for evaluating bankruptcy

According to the first version of the Law about bankruptcy the government of the RF adopted a Decree № 498 "About some measures aimed at implementing the Law of about bankruptcy of enterprises" dated May 20, 1994. Next, Resolution of the National Board on bankruptcy № 31-p dated August 12, 1994 approved methodological provisions for evaluating financial condition of enterprises and establishing unsatisfactory balance structure. The given documents identified criteria for evaluating unsatisfactory balance sheet structure and bankruptcy of a company, defined the order of indices calculation. In spite of the fact that these indices for evaluating bankruptcy of organizations are not used at the moment, this methodology is and will be of interest both historically and logically.

Documents containing financial reports of a company serve as key sources of information for calculating indices and evaluating bankruptcy. Without giving peculiarities of Russian financial reports we would maintain that upon the whole their structure, format and content meet international requirements to a great extent. These requirements have been implemented in RF since 1998.

The system of criteria, which allow to define companies with either satisfactory or unsatisfactory balance sheet structure, includes the following indices:

1. Current ratio (CR);
2. Percentage of current assets coverage by equity (CACE);
3. Coefficient of restoring (loss) of solvency SR(L)C.

CR is calculated as the current assets divided by current liabilities. It is one of standard criteria, which shows the situation with liquidity.

CACE shows to what extent active assets of a company are provided with owner's sources. CACE is calculated as the ratio of difference between equity and fixed assets to the total current assets.

Coefficient of restoring (loss) of solvency SR(L)C is indices that characterize the capability of a company either to restore or to lose solvency during a certain period of time are coefficients of restoring or losing solvency.

Solvency restoring coefficient (SRC) for the period of six months is calculated in case one of the following conditions is true by the end of accounting period:

* Current ratio is less than two (CR < 2);

* Percentage of current assets coverage by equity is less than 0,1 (CACE < 0,1).

Solvency restoring coefficient (SRC) indicates the possibility that an insolvent company will be able to restore solvency during six months after the analysed period.

In case CR exceeds or equals 2, and CACE exceeds or equals 0,1, coefficient of losing solvency (SLC) is calculated for the period of three months. SLC characterizes the relativity of losing solvency by a solvent company during three months after the period under analyses.

Below are formulas for calculating SRC and SLC:

$$SRC = \frac{C\,Re + \frac{6}{T}(C\,Re - CRb)}{2}$$

$$SLC = \frac{C\,Re + \frac{3}{T}(C\,Re - CRb)}{2}$$

where:

CRe/b – current ratio at the end/beginning of the period under analysis;

T - is the duration of the period under analyses (in months).

It is noteworthy that the period under analyses can include several accounting periods.

If SRC < 1, it indicates that there is no real possibility to restore solvency in the coming six months. If SRC >= 1, it is believed that a company has possibility to restore solvency in the coming six months.

If SLC >= 1, this indicates that there is possibility for a company not to lose solvency in the coming three months.

Decision whether the balance structure is unsatisfactory and the company insolvent, is made according to the conditions given in Table 1.

The given methodology was widely used in 1994-96 when making decisions about bankruptcy. Its main drawbacks were insufficient flexibility, limited criteria, and tough norms. From our point of view due to these factors it was replaced by another methodology. Development of bankruptcy system contributed to it to a great extent.

According to the Decree № 33-p of the Russian National Service dealing with bankruptcy and financial revival dated October 8, 1999 criteria of presence or absence of signs of fictitious and deliberate bankruptcy were introduced.

In order to evaluate fictitious bankruptcy it is necessary to find out the coverage of short-term liabilities of a debtor with his current assets, which is calculated as the ratio of current assets to the amount of short-term liabilities (similar to CR). If this index equals or exceeds one, it indicates the signs of fictitious bankruptcy, and if it is less that one, the signs of fictitious bankruptcy are absent.

For revealing the signs of deliberate bankruptcy progression of the following indices should be studied:

- Coverage of liabilities by all types of assets;
- Coverage of short-term liabilities by current assets;
- Net assets.

Table 1. Decisions for Unsatisfactory Balance Structure

		Rules					
		Yes	Yes	Yes	Yes	Yes	Yes
CONDITIONS	1. CR> =2; CACE> =0,1; SLC<> =1						
	2. CR> =2; CACE> =0,1; SLC< 1						
	3. CR< 2; CACE< 0,1; SRC<> =1						
	4. CR< 2; CACE< 0,1; SRC< 1						
	5. CR> =2; CACE< 0,1; SRC<> =1						
	6. CR< 2; CACE> =0,1; SRC<> =1						
ACTIONS	1. Recognising balance structure as unsatisfactory and company as insolvent is postponed for the period up to six months	x					
	2. Decision about recognizing balance structure as unsatisfactory and company as insolvent can't be made				x		
	3. Decision about recognizing balance structure as unsatisfactory and company as insolvent is not made, but the company is registered in the federal bankruptcy Board			x			
	4. Balance structure is recognized as unsatisfactory and company as insolvent					X	X

When the indices deteriorate considerably the evaluation of all the deals of a debtor should be carried out. The purpose of evaluation is to reveal (uncover) unfavourable conditions for concluding them that eventually resulted in bankruptcy.

It is possible to speak about the signs of fictitious bankruptcy when there are grounds to suppose that actions of debtor's management such as concluding deals on unfavourable conditions have lead to significant deterioration in the indices under analyses as well as to debtor's bankruptcy.

The Federal Service of Russia dealing with financial revival and bankruptcy passed Order № 16 dated January 23, 2001, which ratified "Methodological guidelines for conducting analyses of financial condition of a company". These guidelines were recommended for carrying out evaluation and making conclusions, for monitoring financial state of organizations aimed at getting real assessment of their solvency, financial stability, business and investment activity, and operation efficiency. Criteria for evaluating financial condition of a company recommended by methodological guidelines are presented in Table 2.

It is important not only to determine bankruptcy, but also to predict it. In Russia in order to evaluate and predict bankruptcy such well-known multifunctional criteria as Altman's Z-score is used. The efficiency of evaluation and prediction is limited due to the weakness of the Russian security market, and insufficient transparency of financial reports of many companies.

3. Bankruptcy procedures and measures aimed at financial revival of a company.

According to the Bankruptcy Law when the case about bankruptcy of a debtor the following bankruptcy procedures can be used:

- Monitoring (observation);
- Financial revival;
- External management;
- Competition production;
- Out of court settlement.

The Law about bankruptcy describes the contents and use of each procedure mentioned above, as well as the actions of people applying these procedures. Financial re-

vival is one of bankruptcy procedures that are used for restoring debtor's solvency according to the schedule of liquidating debt.

Table 2

Financial Statement Analysis Criteria

Criteria Group	Criterion
1	2
1. Common Criteria	1.1. Average revenue per month
	1.2. Cash revenue percentage
	1.3. Average number of employers
2. Solvency and Sustainability Criteria	2.1. Common range of solvency
	2.2. Bank debt ratio
	2.3. Other organization debt ratio
	2.4. Fiscal system debt ratio
	2.5. Internal debt ratio
	2.6. Current liabilities coverage by revenue
	2.7. Current ratio
	2.8. Current assets financed by owners
	2.9. Percentage of current assets coverage by equity
	2.10. Finance independence ratio
3. Effectiveness of current assets using	3.1. Current assets turnover
	3.2. Inventories turnover
	3.3. Receivables turnover
	3.4. Return on current assets
	3.5. Return on Sales
	3.6. Revenue by employer
4. PPE effectiveness and investment activity Criteria	4.1. PPE turnover
	4.2. Ratio of Investment Activity
5. Taxes and other state fund payments criteria	5.1. Taxes payments ratio
	5.2. Other state fund payments ratio
	5.3. Pension fund payments ratio

Basic measures aimed at restoring debtor's solvency envisaged by the Law include the following:

- Changing the production profile;
- Terminating unprofitable production lines;
- Collecting accounts receivable;
- Selling debtor's enterprise or part of his possessions;
- Transfer of rights for claims on liabilities;
- Carrying out debtor's liabilities by property owner, founders (participants) of a debtor or by a third party;
- Increasing shareholders' capital of a debtor due to payments made by participants or third parties, issuing additional ordinary shares of a debtor;
- Replacement of debtor's assets;
- Other measures.

Selling debtor's property must not result in his impossibility to conduct economic activity. In order to restore debtor's solvency the plan of an external manager can envisage increase in the shareholders capital of a debtor, who is a joint stock company (JSC) by issuing additional ordinary shares. Replacement of debtor's assets is carried out by setting up one or several joint stock companies on the basis of debtor's property.

4. Examples of practical evaluation of the signs of fictitious and deliberate bankruptcy of companies

Let's consider the examples of evaluation of signs of fictitious and deliberate bankruptcy using the examples of Russian companies.

Company 1 operates in the sphere of constructing and servicing motorways. Its activities have certain peculiarities that caused further bankruptcy of the company:

For a long time payments for motorways construction were made in the natural form, i.e. by supplying materials, clearing of mutual claims. Thus, for getting financial resources the company had to resort to selling of assets that were not always high-liquidity ones. Road-constructing works have a strongly pronounced seasonal character and must be completed before winter. Financing company usually made payments at the end of the year.

Coefficients characterizing debtor's solvency are the grounds for initiating the first stage of determining bankruptcy indicators. (see table 3).

Table 4 presents the results of how significant deterioration of financial coefficients is. As it can be seen from table 4, there is significant deterioration of two and more coefficients in the following periods:

- Since January 1, 2003 till March 31, 2003
- Since July 1, 2003 till September 30, 2003
- Since January 1, 2004 till March 31, 2004
- Since July 1, 2004 till September 30, 2004C
- Since January 1, 2005 till December 31, 2005

The analysis has not revealed any deals that were concluded being aware of the conditions unfavourable for the debtor.

According to the analyses of progression of coefficients that characterize debtor's solvency and debtor's deals, it can be concluded that there are no signs of deliberate bankruptcy.

Indices of current liquidity in the analysed period are less than one (Table 5). This also points at the absence of signs of fictitious bankruptcy. Actual insolvency of a debtor stipulates the choice of competition selling procedure. Selling available assets can satisfy creditors' demands.

According to Definition of Arbitration court of Nizhny Novgorod region dated December 13, 2005, the Claim about recognizing Company 2 (JSC Ltd.) as bankrupt was received from one of the creditors of this company. It should be noted that in this example there are no grounds for carrying out evaluation aimed at revealing signs fictitious bankruptcy.

Calculation of indices essential for deliberate bankruptcy evaluation is presented below in tables and charts.

Table 3

Liquidity and Solvency Ratios (Company 1)

Ratio title / Date	01.01.03	31.03.03	30.06.03	30.09.03	31.12.03	31.03.04	30.06.04	30.09.04	31.12.04	31.03.05	30.06.05	30.09.05	31.12.05
Quick ratio	0,01	0,00	0,01	0,01	0,01	0,01	0,00	0,00	0,01	0,01	0,01	0,01	0,01
Current ratio	0,65	0,63	0,97	0,70	0,89	0,69	0,71	0,00	0,81	0,74	0,18	0,11	0,04
Current ratio (included long-term debt)	0,74	0,69	1,03	0,76	0,94	0,74	0,76	0,05	0,86	0,80	0,24	0,17	0,15
Current liabilities coverage by revenue	3,18	3,78	2,84	3,50	3,59	6,05	7,32	7,72	6,65	9,57	15,30	22,55	28,47

Table 4. Ratios growth rate

№	Ratio title	Average quarter growth rate	31.12.05	30.09.05	30.06.05	31.03.05	31.12.04	30.09.04	30.06.04	31.03.04	31.12.03	30.09.03	30.06.03	31.03.03	01.01.03
	(trend)		X	—	—	—	—	—	—	—	—	—	—	—	—
1	Quick ratio	0,001	0,006	0,006	0,006	0,007	0,006	0,004	0,005	0,009	0,006	0,006	0,011	0,000	0,014
	Decreasing		X	0,001	0,000	0,000	-0,001	-0,001	0,000	0,004	-0,003	0,000	0,05	-0,011	0,014
2	Current ratio	0,051	0,036	0,113	0,179	0,740	0,814	0,004	0,711	0,692	0,889	0,699	0,975	0,628	0,653
	Decreasing		X	0,077	0,066	0,561	0,074	-0,810	0,707	-0,019	0,197	-0,189	0,276	-0,347	0,025
3	Current ratio (included long-term debt)	0,049	0,149	0,175	0,241	0,797	0,861	0,048	0,760	0,736	0,942	0,763	1,035	0,688	0,741
	Decreasing		X	0,026	0,066	0,556	0,064	-0,812	0,712	-0,024	0,205	-0,179	0,272	-0,347	0,053
4	Current liabilities coverage by revenue	2,108	28,474	22,545	15,304	9,570	6,650	7,722	7,323	6,051	3,595	3,499	2,836	3,778	3,180
	Decreasing		X	5,93	7,24	5,73	2,92	-1,07	0,40	1,27	2,46	0,10	0,66	-0,94	0,60

1) Coverage of debtor's liabilities with all his assets

By the end of 2005 balance cost of debtor's assets becomes less than the sum of his liabilities (Table 5).

Table 5

Liabilities coverage ratios 2004 – 2005

Ratio title	2004			
	Q1	Q2	Q3	Q4
Liabilities coverage by all type of assets	1,81	1,42	1,88	1,99
Ratio title	2005			
	Q1	Q2	Q3	Q4
Liabilities coverage by all type of assets	2,04	2,02	1,32	0,96

According to accounting reports dated January 1, 2006, debtor's assets cover only 96 % of accounts payable (debt to creditors).

2) Coverage of debtor's short-term liabilities with current assets (Table 6)

Table 6

Liabilities coverage ratios 2004 – 2005

Ratio title	2004			
	Q1	Q2	Q3	Q4
Liabilities coverage by current assets	0,99	0,89	1,00	1,11
Ratio title	2005 год			
	Q1	Q2	Q3	Q4
Liabilities coverage by current assets	1,20	1,17	0,78	0,54

The reduction of the index under consideration is caused by the increase in accounts payable.

3) Amount of net assets

A company is on the verge of financial bankruptcy. All key financial indices (liquidity, financial stability, profitability) prove this. During the period 2004-2005 the amount of net assets dropped by more than 13 mln.rubles (Table 7).

Table 7

Net assets 2004 – 2005, thousand roubles

Ratio title	2004			
	Q1	Q2	Q3	Q4
Net assets	12 050	9 509	11 985	14 912
Ratio title	2005			
	Q1	Q2	Q3	Q4
Net assets	16 648	18 531	8 035	-1 270

Analysis of debtor's deals has revealed the following:

1. Prices of material values are artificially high and exceed market prices. For example, in 2004 lime road stone was supplied at the price of 501,01 rub. per ton. At the same time other firms supplied the same stone at the market price of 267,91 rub. per ton.

2. Starting with the middle of 2004 bitumen, oven fuel and petrol were supplied by an external company, while Debtor has his own fuel station. The prices of the supplied products exceed average market prices by 25-30% in the same time period.

3. A debtor has leased two cars, but they are used by another company without any agreement with the debtor. The Head of this other company is also deputy to the General Manager on financial issues in the company which is debtor.

All the facts mentioned above make it possible to speak about malfunctions of Debtor's management. According to the results of financial analysis it can be concluded that the signs of deliberate bankruptcy of Company № 2 are present. Decision was made to apply to it some of the considered measures of financial revival.

To conclude, calculation of potential payments without giving any details of the scheme of financial revival, designed according to acting legislation, is presented in Table 8.

As the result of implementing measures aimed at restoring solvency considerable increase in financial flow and improvement of financial condition of the company upon the whole should be expected.

Table 8

Cash inflows and outflows forecasting (Company 2), th.rbl.

	2006	2007 (six month)	Sum
Cash inflows (all sources):	54 941,8	23 446,6	78 388,4
From sales	52 941,8	23 446,6	76 388,4
From banks (credit)	2 000,0	-	2 000,0
Cash outflows (all sources):	48 553,5	22 943,0	71 496,4
Inventory purchasing	15 830,4	8 909,0	24 739,4
Electricity	5 859,3	3 019,5	8 878,9
Repairment	1 290,0	-	1 290,0
Transportation	765,0	355,0	1 120,0
General and administrative payments	6 000,0	2 352,0	8 352,0
Wages	10 015,8	4 947,7	14 963,5
Social payment (from wages)	3 697,9	1 639,7	5 337,6
Tax payments	2 810,1	1 720,0	4 530,1
Payments on credit and interests payments	2 284,9	-	2 284,9
Net cash inflow	6 388,3	503,6	6 892,0