

# HOW TO INVEST IN RUSSIA

Guide to theory and practical advice for making  
an investment in Russia in 2009



ASSOCIATION OF EUROPEAN BUSINESSES



AEB



## **Foreword by Elvira S. Nabiullina, Minister for Economic Development of the Russian Federation**

**Elvira S. Nabiullina**

On behalf of the Ministry for Economic Development of the Russian Federation, greetings to all of you who are about to read *How to Invest in Russia in 2009!*

For years, *How to Invest in Russia* has served as a reliable guide to Russia's economy and investment opportunities for all interested readers, offering independent, professional analysis of the country's economic realities and a fair view of its foreign investment climate.

Today, when talking about the condition of the Russian economy, it is important to note that being truly involved in international economic relations this country has not remained insulated from the global financial crisis. GDP growth has decelerated, investment in the Russian economy has slowed down, and the country's international reserves have declined. However, in spite of external shocks and domestic challenges, Russia has everything it needs to avoid serious losses.

The Russian government's efforts with regard to the financial and banking systems, and the real sector of the economy give us strong reasons to believe that the macroeconomic fundamentals will remain stable, and investment activity in key sectors will be preserved at a normal level.

Creating a favorable investment climate in Russia is one of our key priorities. Special attention is being paid to the elimination in Russia of excessive administrative barriers for existing and new businesses, and protection of investors' rights, especially in the field of intellectual property. The required changes are underway in relation to tax, customs and tariff policy. Transparent rules have been introduced regulating foreign investment in strategic sectors of the Russian economy; new mechanisms and institutions are being put in place to stimulate investment and encourage innovation. I would like to thank the European Business Association for its assistance and for its significant contribution towards bringing international investors to Russia and improving the business climate in this country.

I trust that this publication will be received with interest and, hopefully, spark the desire to invest in Russia.

*E.S. Nabiullina,  
Minister for Economic Development  
of the Russian Federation*



**Statement from Vladimir Ismailov,  
Chairman of AEB Finance & Investment Committee**

**Vladimir Ismailov**

Dear readers of this publication,

The Finance & Investment Committee of the Association of European Businesses in the Russian Federation (“FIC AEB”) is proud to present to you “How to invest in Russia in 2009”.

This edition of the brochure is the latest addition to an annual series of practical guides for those who are considering investing in Russia or would like to expand their business in Russia. Since last year’s edition significant changes have taken place in the world and Russian markets. We are in the middle of a global crisis and how long it will last and the legacy it will leave are currently unclear. However, our committee members strongly believe that Russia is still a good place for investing. The articles in this guide provide insight into avoiding difficulties while doing this.

We also received a number of comments and suggestions from readers since the last edition that have been taken into account in the preparation of this edition. As a result, we decided to update the contents and expand the scope in order to facilitate the complex process of making an investment in Russia.

This brochure contains a one-of-a-kind set of articles written by market leaders in each subject. The authors do not just describe well-known business processes focusing on areas specific for Russia, but also support their ideas with real life examples and provide valuable recommendations for existing and future investors.

The entire project of publishing this guide is part of the FIC AEB’s mission – “to assist in and contrib-

ute to the continued improvement of the investment climate in the Russian Federation for European business interests by addressing critical finance issues” and is a not-for-profit venture.

It was a challenge to bring together the best people of different nationalities from sometimes competing firms, but I am proud that this extraordinary team of professionals saw the benefit of helping the business community regardless of professional competition. We have left writing style and language almost untouched to ensure the authenticity of the ideas conveyed by the authors. However, a certain extent of editing was performed to make the flow seamless.

I would like to thank the team of writers for their time and contribution to this brochure. I would like to thank Clive Phillips of KPMG Transaction Services in the CIS for tremendous editorial work, and Maria Tertyshnaya of the AEB for making the entire process less problematic.

I would also like to thank those who contributed ideas, comments and suggestions to make this edition unique.

We all hope this publication will serve the purpose of helping to bring more investments and reduce the number of surprises while investing in Russia.

Dr. Vladimir Ismailov, Chairman,  
Finance & Investment Committee  
of the Association of European Businesses



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## RUSSIA AS A PLACE FOR INVESTING

### Why Russia?

(Dr. Vladimir Ismailov, CFO/ Deputy CEO, Specta AG)



#### Dr. Vladimir Ismailov

Dr. Vladimir Ismailov is CFO with Specta AG, supporting a range of corporate business functions of the group of companies specializing in steel based and other types of industrial packaging and marketing in Russia and the CIS.

Vladimir holds a PhD in Economics, as well as being a Certified Auditor of the RF and Member of the American Institute of Certified Public Accountants. He has a great deal of financial and auditing experience in a range of business sectors, having worked in the Media & Information sector, OEM, Telecom services and in public accounting and auditing.

Area of expertise – foreign investments and finance

It is hard to describe the investment attractiveness of a country during a global crisis. On one hand every country is trying to be integrated into the world economy as deeply as possible in order to diversify its risks and obtain access to foreign markets. On the other such integration, as the opposite to isolation, leads to greater vulnerability of local economies to

changes in the world markets. This is particularly the case for developing economies such as the Russian economy. However, despite what is currently happening in the world markets the macroeconomic indicators for the Russian market remain favorable. The key question is whether the Russian government will be willing and able to take all the right measures to mitigate the impact of the financial crisis. So far the actions taken by the government and lawmakers have been timely in most cases and well intended.

Many experts expect that BRIC countries (Brazil, Russia, India and China) will remain the locomotives of growth of the world economy during and after the crisis period.

### Russia, the world and the EU

The Russian market is one of the most dynamic and attractive in today's business world and the Russian economy is among the eleven largest. Moreover, the average gross domestic product (GDP) growth rate in Russia for the last eight years has substantially exceeded that of industrially developed countries (see Table 1).

Russia is well known for its vast natural resources. The country is a world leader in proven reserves of natural gas (25.2% of the world total), second in oil production (12.6%), and second in proven coal reserves (18.5%)<sup>1</sup>. Russia is also famous for advanced technology in certain sectors, especially the

<sup>1</sup> BP Statistical Review of World Energy June 2008

**Table 1: Top 12 economies GDP growth/(decline) year on year (%)**

		2000	2001	2002	2003	2004	2005	2006	2007	2000–2006 Average
1	China	8.4	8.3	9.1	10.0	10.1	10.4	11.6	11.9	10.0
2	India	5.7	3.9	4.6	6.9	7.9	9.1	9.8	9.3	7.1
3	Russia	10.0	5.1	4.7	7.3	7.2	6.4	7.4	8.1	7.0
4	Spain*	5.1	3.6	2.7	3.1	3.3	3.6	3.9	3.7	3.6
5	Brazil	4.3	1.3	2.7	1.1	5.7	3.2	3.8	5.4	3.4
6	Canada	5.2	1.8	2.9	1.9	3.1	2.9	3.1	2.7	3.0
7	UK*	3.9	2.5	2.1	2.8	2.8	2.1	2.8	3.0	2.7
8	US	3.7	0.8	1.6	2.5	3.6	2.9	2.8	2.0	2.5
9	France*	3.9	1.9	1.0	1.1	2.5	1.9	2.2	2.2	2.1
10	Japan	2.9	0.2	0.3	1.4	2.7	1.9	2.4	2.1	1.7
11	Germany*	3.2	1.2	0.0	(0.2)	1.2	0.8	3.0	2.5	1.4
12	Italy*	3.7	1.8	0.5	(0.0)	1.5	0.6	1.8	1.5	1.4

\* Member of EU.

Source: International Monetary Fund, World Economic Outlook Database, October 2008.

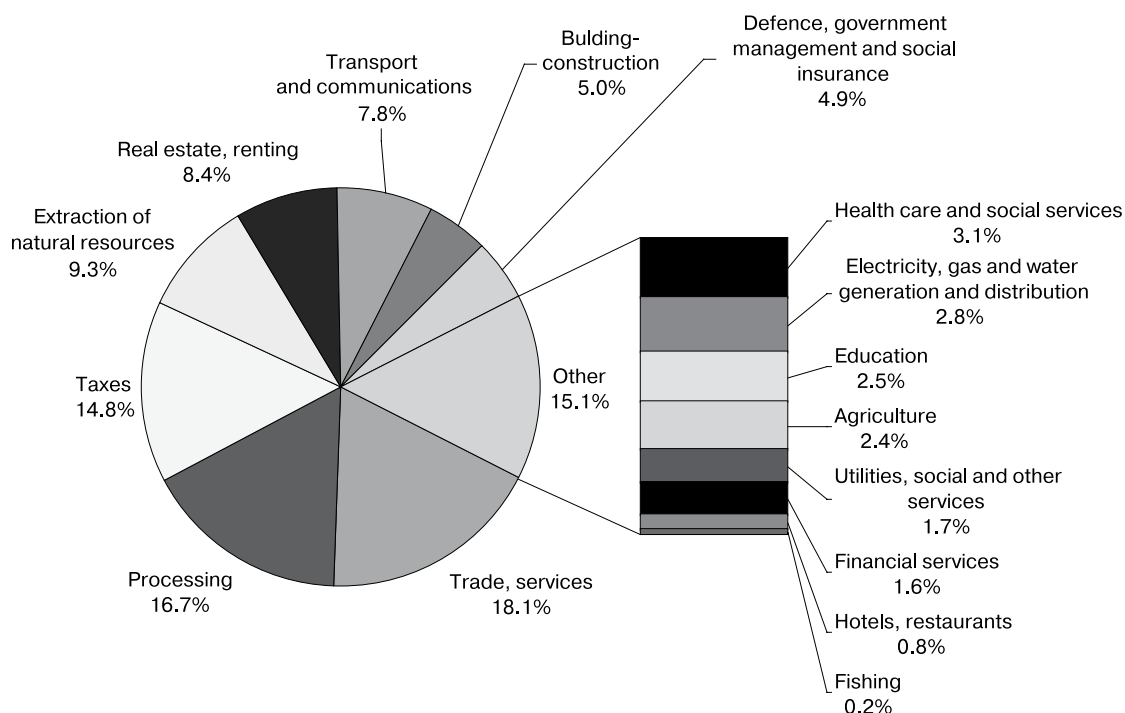
defense industry (air and space), and skillful programmers. It is no wonder the government is trying to consolidate these industries to take advantage of the assets and gain an edge while competing in the global market.

Russia's economy is still substantially dependent on natural resources obtained from mining and processing. Processing is growing faster than mining, and it is gaining an ever-larger share in GDP. Along with these two sectors of the Russian economy, retail and services, transport and communications, real estate and construction are gaining bigger roles, due to excess liquidity and steady growth in consumer demand (see Chart 1).

However, the global liquidity crisis that escalated in September has required the use by the government of a substantial part of the reserves to finance anti-crisis emergency measures. Although it is too early to tell whether the action plan put in place by the Russian government will be successful or not, it has been highly thought of by international experts so far. We will see more actions soon as part of the joint efforts within the Top 20 countries initiative on the Financial Markets and the World Economy.

The macroeconomic indicators for Russia still look strong. The current account to GDP ratio in Russia looks much healthier than in the EU (see Chart 2 for details).

**Chart 1: Russian GDP by sector (H1 2008)**



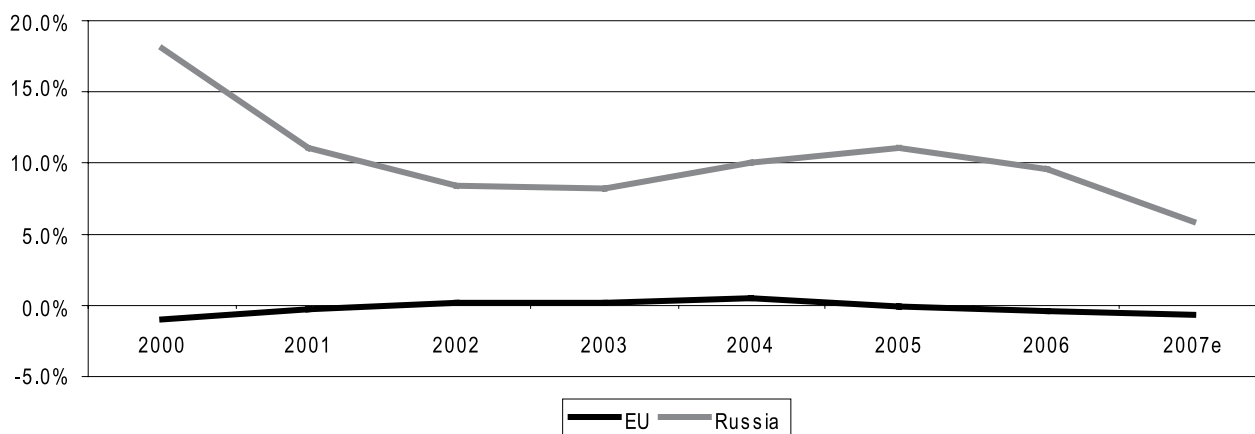
Source: Based on [www.gks.ru](http://www.gks.ru).

The high GDP growth rate is sustained by the significant level of internal investments, supported by positive current accounts, the low level of external borrowing, and significant foreign investments. Historically high prices for natural resources have led to a positive trade balance and excess cash in the economy. Currency and gold reserves reached a historical high of USD596.6 billion at August 1, 2008 compared to USD12 billion in 1998. In order to minimize the use of currency and gold reserves the Central Bank of Russia and the Ministry of Finance are allowing the ruble to weaken against other major currencies. It has been declared that this process will be gradual and managed.

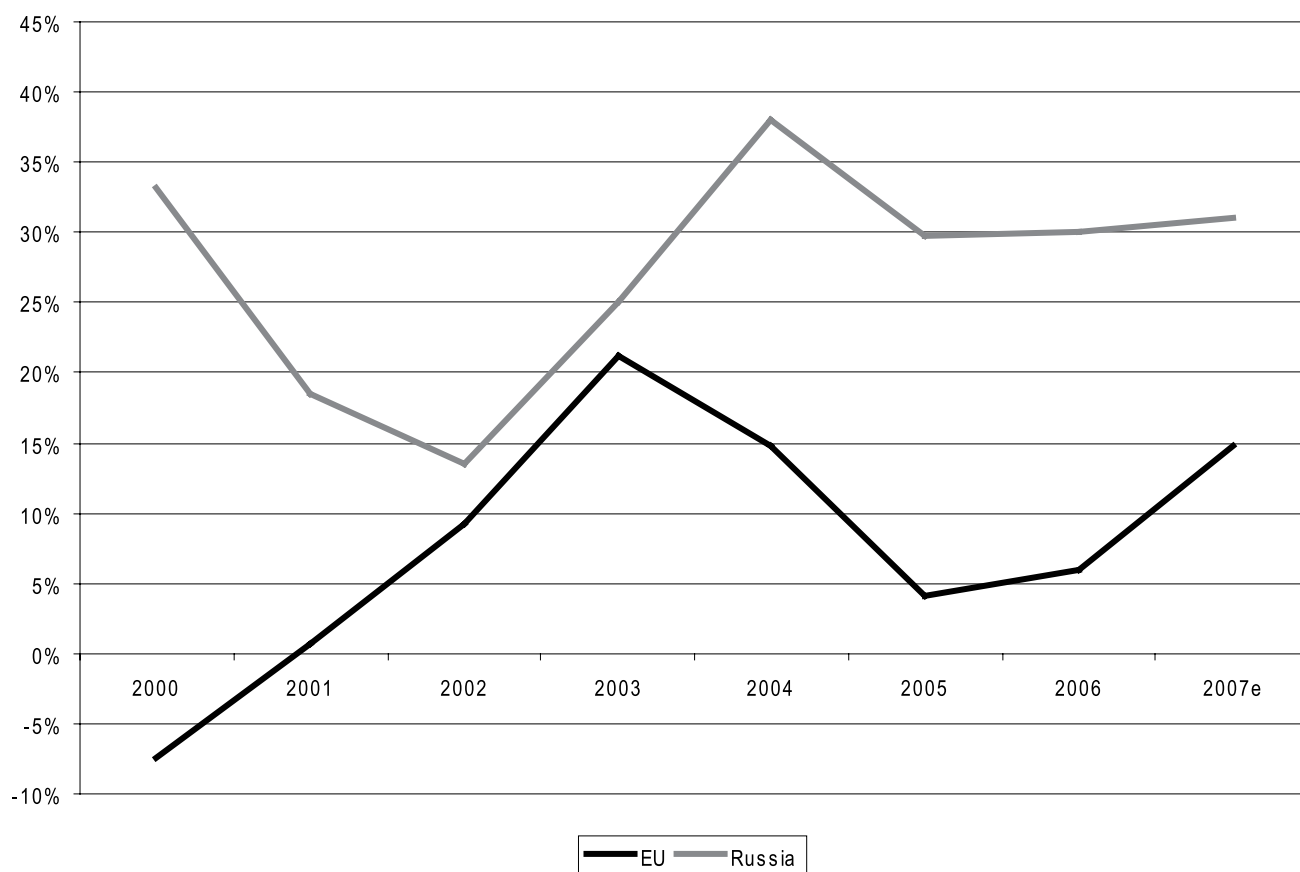
Russia is showing signs of an overheated economy. Markets and prices have grown fast and significantly. Such rapid growth is unlikely to be sustained in the future. It would be logical to expect a correction period after such growth; however, the chance that the cooling down period will be short is above average.

The growth of liquidity in the country has boosted personal income and spending. GDP per capita has been growing faster than in the EU for several years, driving a consumer market boom and rising living standards (see the trend comparison in Chart 3).



**Chart 2: Current account balance to GDP (current prices) ratio, Russia and EU**

Source: Based on IMF World Economic Outlook Database, October 2008 Edition.

**Chart 3: GDP per capita growth rate trend, Russia and EU**

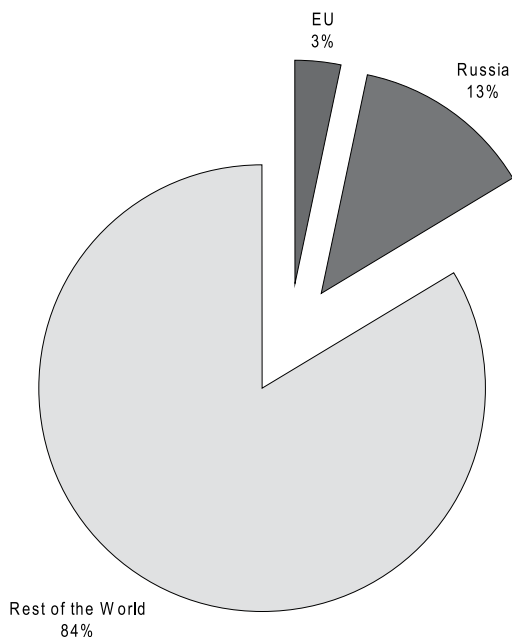
Source: Based on IMF World Economic Outlook Database, October 2008 Edition.

The EU is a major trade partner for Russia, and the economies of both regions are substantially interdependent. More than half (52.7% in January - August 2008) of Russia's foreign trade is with EU-member countries. During January - August 2008 the amount of trade between Rus-

sia and the EU increased by 54.4% and reached USD265.6 billion.

Historically Russia and EU countries have had close business connections. Both regions play a substantial role in the world's geo-political environment (See Charts 4 and 5).

**Chart 4: Land mass of Russia and EU as part of world land mass**



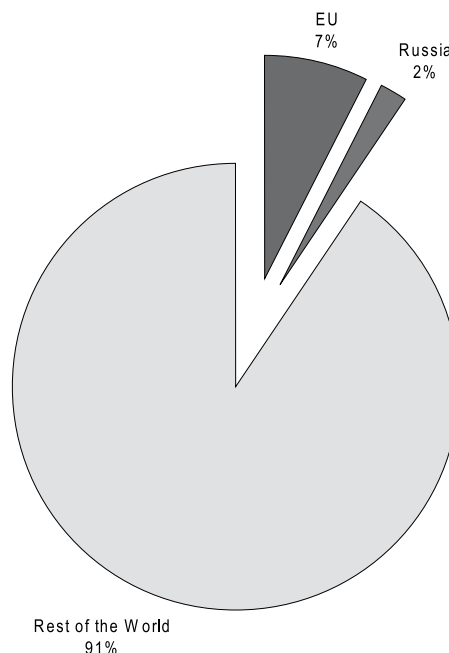
Source: [www.wikipedia.com](http://www.wikipedia.com).

Given the dynamics of Russia’s economy, significant numbers of European companies see the Russian market as an opportunity to build business value through expansion into new regions and developing localized products. The reasons for this include the size of Russia’s population (estimated at 142.1 million as of January 1, 2008<sup>2</sup>); the lower cost of supply chains, for example prices for oil, electricity, and steel in Russia are still lower than in Europe and North America; the highly qualified and less expensive labor force (the average monthly salary in September 2008 was USD709.45<sup>3</sup>, with a literacy level that remains over 99%<sup>4</sup>); and the advantageous geo-political location (for example, Russia borders with the EU, the US, China, and Japan).

**The investment climate in Russia**

Since 1987, when the former USSR first adopted legislation allowing foreign companies to participate in business (initially only as minority shareholders), foreign business initiatives in the Russian Federation have come a long way. According to the Federal State Statistics Service of the Russian Federation, some USD242.1 billion in foreign capital had accumulated in the Russian economy as of June 30, 2008. This is 35.6% more than as of June 30, 2007<sup>5</sup>. Foreign direct investments constituted 48.4% of that amount (up 3.2% compared to 12 months earlier), with portfolio investments making up 2.9% of

**Chart 5: Population of Russia and EU as part of world population**

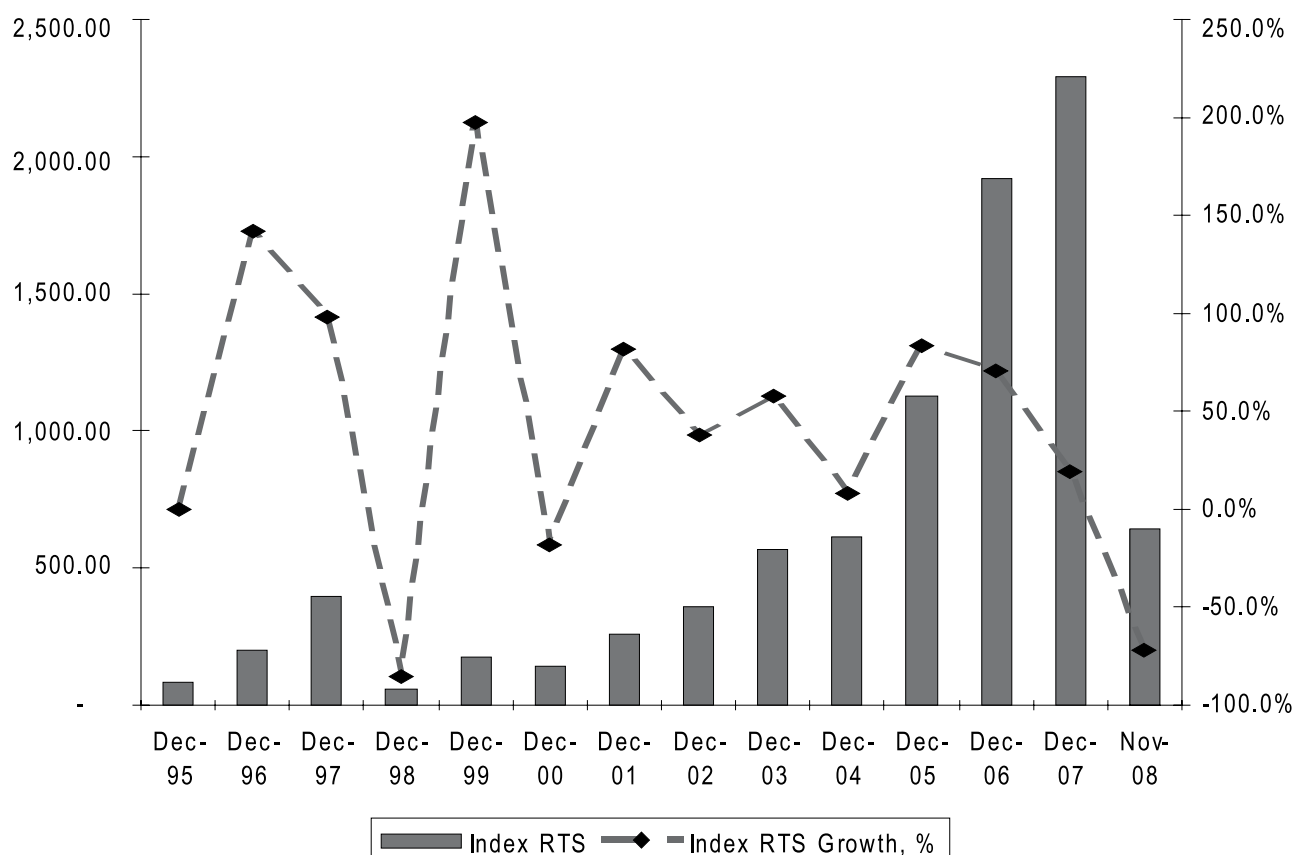


Source: [www.wikipedia.com](http://www.wikipedia.com).

the total (up 0.9%). During the first six months of 2008, the inflow of foreign investments into Russia totaled USD46.5 billion (USD22.9 billion less than in H1 2007)<sup>6</sup>. Of course, some of these assets represent repatriation of cash channeled out of Russian before. However, the volume keeps growing, and it is reasonable to assume that more and more foreign businesses and investment institutions will consider the Russian market as an alternative for their investments.

In the third quarter of 2008 outflow of foreign capital intensified due to several internal factors (the TNK-BP case, Mechel case), regional factors (war in South Ossetia) and the escalation of the global crisis. According to various sources the amount of outflow of capital is substantial; however, the government of the Russian Federation believes that the net effect for the year will be a sizable inflow of foreign capital.

<sup>2</sup> IMF World Economic Outlook Database, October 2008 Edition  
<sup>3</sup> Estimated equivalent of RUR value according to the Federal State Statistics Service of the Russian Federation website and CBR RUR/USD rates  
<sup>4</sup> World Bank Group “Russian Federation at a glance”, 2004  
<sup>5</sup> Federal State Statistics Service of the Russian Federation website  
<sup>6</sup> Federal State Statistics Service of the Russian Federation website

**Chart 6: Russian stock market index RTS trends (the index peaked in May, 2008, at 2,487.92)**

Source: Based on [www.rts.ru](http://www.rts.ru)

Attracting foreign direct investment is a top priority for any government. International businesses are always trying to find a way to:

- Broaden their product lines,
- Increase market share in a geographic region,
- Strengthen their company's financial position,
- Stabilize a cyclical or seasonal business,
- Obtain key executive or technical talent.

There is a clear willingness on the part of the government and the business community to develop a mutually beneficial relationship. However, they are still separate parties with their own interests and methods. On the one hand the government is trying to control key industries and is pushing for greater consolidation in areas like natural resources development (oil and gas, diamond mining), the automobile industry, aircraft and ship building. On the other hand, the government is also trying to attract more investment into the economy and improve the investment climate in general.

Russian companies are open for equity partnerships via direct buy in and/or equity market trading. The Russian equity market has demonstrated both its integration into world markets and its ability to

withstand the challenges of the world financial markets (see Chart 6).

The volume of IPOs by Russian companies in the first six months of 2008 fell to 13 deals raising USD1,922 million, from 25 transactions in the first half of 2007 raising USD20,235 million<sup>7</sup>. Such a drastic change is of course the result of unfavorable conditions globally. Nevertheless, the pipeline of companies that planned placements in 2008 still includes over 150 companies. In addition to those businesses that plan to go public in 2009, the group from 2008 will re-schedule their timetable as well. As long as the market conditions improve to the level warranting fair market value a large number of companies will be looking for equity financing to support their growth plans.

<sup>7</sup> According to [www.offerings.ru](http://www.offerings.ru)

## Why do due diligence when investing in Russia? (Simon Foster, KPMG, Partner, Transaction Services in Russia/CIS)



**Simon Foster**

Simon Foster is a partner in KPMG's Transaction Services team for Russia and the CIS. After seven years' experience of financial due diligence with KPMG in London he moved to KPMG's Moscow office in January 2005. Since then he has

worked with both Russian and non-Russian clients on acquisitions and disposals in Russia and the CIS, as well as for Russian clients raising equity or debt in western capital markets and making acquisitions outside Russia.

The Latin phrase 'Caveat Emptor' ('let the buyer beware') expresses the principle that the buyer alone takes responsibility for assessing the condition and quality of the purchase he makes. Although moderated by legally established concepts of protection, disclosure and implied warranties, these do not provide full protection and the principle remains applicable.

In Russia, while the legal framework is evolving and improving, in some areas doubts remain over the consistency and transparency of its application. The principle of Caveat Emptor is therefore very apposite, and in Russia effective due diligence requires an awareness and understanding of the evolving nature of Russia's legal and corporate environment.

The value of undertaking thorough due diligence on any significant transaction has been increasingly well understood in western merger and acquisition ('M&A') markets. Due diligence is considered as an essential part of pre-deal activity, and widely perceived by most as a key factor in increasing the chances of a successful, value enhancing deal. Due diligence can broadly be considered as satisfying various areas of need for the potential purchaser, including:

- providing a degree of assurance over the fundamentals of the business, including the existence, ownership and completeness of key assets and liabilities, and over trading performance;
- understanding the business model and its commercial and organisational structure; and
- assessing the value of the business.

Such needs are as relevant in Russia as they are elsewhere. In Russia, however, in comparison to more developed business environments and M&A markets, the focus of due diligence work still tends to be more on gaining some assurance over the fundamentals than on operational or integration planning, or on fine tuning the valuation. This is a reflection of the current state of Russia's evolving corporate governance, and the availability and quality of information. In particular, the relative lack of information both public and private, the ambiguities that often cloud ownership, and the rudimentary and sometimes opaque nature of the form and content of Russian companies' financial and tax reporting all make due diligence exercises in Russia particularly challenging.

### Evolving deal execution practice

The way in which transactions are executed in Russia today reflects the evolution of Russia's corporations since the privatisations of the 1990s and the impact of the recent growth in Russian M&A activity. In the early days of Russian M&A the approach to doing deals reflected a deficiency of corporate governance and the dominance of powerful individual shareholders in decision-making in many organisations. Corporate transactions were typically executed through closed negotiations between principal individuals, with little or no access to information or due diligence, and very little transparency over value or price.

The past few years, however, have seen the volume of Russian M&A grow rapidly, accompanied by a significant change in deal processes. Many deals are now conducted along western lines involving a structured timetable of information and management access, due diligence and international standard sale & purchase agreements, often governed by international or English law. Until a few years ago, Russian companies had little or no experience or knowledge of western style due diligence processes. But a growing number became subject to such processes as they were either bought or invested in by strategic western buyers, or they sought to raise finance in western capital markets. Moreover, since the late 1990s corporate governance has been gradually improving; many companies have recruited professionals with western qualifications and experience, and many of the larger companies now have dedicated M&A teams. These developments have contributed to a more sophisticated approach being adopted in the execution of Russian deals.

## Limitations in financial reporting

Despite steady development in corporate governance and reporting there remain some aspects of the Russian corporate environment which make due diligence somewhat different and more challenging than in the West.

The perception of the role of financial reporting and accountants, though much developed over recent years, still reflects the orientations and attitudes of the past. In the days of the USSR the emphasis of financial reporting, such as it existed, was on statistical reporting, rather than monitoring profitability and cash flows. Most Russian companies have now integrated accounting functions and are improving their financial reporting systems. According to the Finance Ministry over 90% of Russia's top 100 companies now issue audited financial statements under IFRS or US GAAP.

Gaining access to a target, however, can be difficult, as its management can be suspicious that the process may only serve to inform a competitor (or the authorities) about their business. There is still relatively little reliable publicly available information. Better intelligence on individuals and companies can be obtained with access to private networks of tried and trusted contacts with credible connections. The prevalence of 'related party' entities, often offshore, which may be used to implement transfer pricing or royalty schemes in order to move profits and minimise tax, also serve to obscure the beneficial ownership of businesses. Once access is gained, a general reluctance to provide information or explanations again stems partly from unfamiliarity with, or misconceptions of, a consultant's role in due diligence. A due diligence team's opening dialogue with the target's management often needs to emphasise that they are not auditors and are not there in any sort of compliance role. Information gathering can be a difficult and time-consuming process. It helps if the target's senior management fully brief and authorise those with whom the due diligence team have to work; otherwise fear and caution can cause middle management (who have previously not been through such a process) to stall the information provision and continually refer the investigators back to senior management.

Assessing a business's historic financial track record is usually complicated by the existence of more than one set of accounts, which are often not reconciled to one another. All Russian companies prepare accounts under Russian Accounting Principles ("RAP") as required by local law and mainly as a basis for tax accounts. These RAP accounts,

however, do often not provide a complete or representative picture of the company's trading as they differ from IFRS and US GAAP and can be impacted by various tax minimisation schemes. In order to produce IFRS or US GAAP financial statements the RAP accounts typically undergo a transformation process, which should, inter alia, incorporate any unofficial transactions related to such schemes. Some companies maintain a separate set of internal management accounts, which can include the unofficial transactions, but these will often not be reconciled to the audited financial statements. Management accounts are often rather rudimentary, with income statements sometimes comprising cash receipts and expenses (treating VAT as an income and expense item) instead of an accruals based profit and loss account. Other companies do not prepare any single set of accounts which regularly record the whole performance and position of the business in any detail. All this can mean that the financial due diligence involves more work and takes longer to complete than might be expected in more developed environments. Transfer pricing arrangements set up within groups to manage profits (either between different tax authorities or according to other legal, finance or ownership related factors) can also obscure the true or 'arm's length' profitability of some businesses.

## Evolving taxation system

Due diligence on Russian companies' tax position also brings its own particular challenges. The Russian taxation system was created in 1992, and is subject to fairly frequent changes in legislation, official pronouncements and court decisions that are not always clear, sometimes contradictory, and open to differing interpretation by the various tax authorities. Russian companies use a spectrum of techniques to reduce taxes, ranging from tax planning of varying degrees of aggressiveness to avoidance schemes, sometimes of questionable legality. The former include arguable interpretations of legislation that can be challenged by the tax authorities in court. The latter can include schemes that involve complex and opaque ownership and organisational structures.

Assessing the risks attached to such tax schemes is difficult, because the risk of discovery by the tax authorities is hard to gauge. The Yukos tax investigation seems to have marked the start of an era of renewed resolve on the part of the tax authorities, and it demonstrated the range of techniques and methods at their disposal. Events since

Yukos suggest that the tax authorities are taking a more assertive approach in their interpretation and enforcement of tax legislation. They are applying new analytical techniques to detect evasion, and a wider range of concepts to supplement the statute in enforcement. This is having an effect: a growing number of companies are reviewing their tax positions and exiting the more aggressive schemes – particularly those looking for new finance or ownership.

## Outlook

The investment climate in Russia has benefitted from ten consecutive years of economic growth (between 6% and 8% per annum), with some sectors such as consumer markets and services showing very high growth rates, due in part to rapidly rising disposable income. This extended period of strong economic growth has led to infrastructural and other economic bottlenecks, especially in Moscow. Such bottlenecks and shortages have also contributed to inflation, which in 2008 reached well over 10%. The second half of 2008 saw the onset of the global financial crisis in Russia. The banking sector and the more leveraged sectors such as real estate, construction and retail were most noticeably affected by the initial credit crunch. The spread of the impact to other corporate sectors has resulted in an increased level of general uncertainty and many Russian corporates facing complications in refinancing their debt. Russian GDP growth is expected to slow significantly to around 4% or less in 2009.

Other downsides continue to include corruption, bureaucracy, administrative barriers, ageing infrastructure, inadequate legislation and the inconsistent interpretation and application of laws. Nevertheless, while Russia remains a relatively difficult place to conduct business, for many investors the potentially huge rewards continue to outweigh the barriers and the risks. For some the global economic slowdown may actually accentuate the differences in opportunities between the emerging markets such as Russia (forecasting reduced but still positive economic growth) and the advanced economies (suffering negative growth). But effective due diligence in such an environment is critical to successfully tackling the barriers and risks, and to maximising the chances of realising those rewards.

Russia's M&A market has grown strongly in the past few years. In 2008 the upheavals in the financial markets, the global economic slowdown and some renewed political concerns have all contributed to a drop-off in inbound investment. The devel-

opment of Russia's M&A market over the past few years has, however, seen it become less reliant on foreign investors, and its growth is expected to continue at least in the medium term. As the full effects of the global financial crisis and economic downturn unfold, the nature and mix of Russian M&A activity is changing. In the short term, there is some distressed activity, and the switch from a sellers' to a buyers' market is evidenced by some accelerated deal processes and an increased number of asset deals (not normally favoured by Russian vendors). Going forward, some Russian groups may be moved to restructure and dispose of non-core assets, and as valuation expectations begin to reflect the new realities, renewed interest may be forthcoming from cash rich groups and private equity. Other Russian companies will continue to need to seek financing to fund their continued expansion.

A growing proportion of Russian companies expect to participate in sell side M&A at some point in the near or medium term future – either to raise finance or to exit investments of non-core businesses – and therefore will be subject to a form of due diligence. This trend is helping to drive the gradual improvement in governance, financial reporting and general business transparency across corporate Russia. As Russian companies become increasingly familiar with M&A processes and due diligence requirements, due diligence processes in Russia should over time become easier, if no less important.

## PERFORMING DUE DILIGENCE

### Integrity due diligence in Russia (Ian Colebourne, KPMG, Partner, Head of Forensic)



**Ian Colebourne**

Ian heads KPMG's Forensic operations in Russia and the CIS. He has over ten years experience with KPMG Forensic, with six years experience leading projects in Russia and the CIS. He has led a large number of investigations, corporate

intelligence and fraud risk management assignments, and was responsible for one of the largest forensic investigations undertaken to date in Russia.

The integrity due diligence process aims to identify significant risk areas for the prospective investor, which are not typically covered by the more traditional aspects of the due diligence exercise, such as financial, tax or legal due diligence. Typically these include reputational, undisclosed commercial and political risks. In the current worldwide economic turmoil, being aware of such risks has only increased in importance. Russia is no exception to this.

If these risks are not anticipated and managed prior to the start of business operations, the result can be financial loss, legal liabilities, or damage to reputation. Exposure to negative media coverage resulting from affiliation with a questionable partner, a partner's default on financial obligations or politically motivated prosecution of him are all good examples of such risk.

Investors that are unfamiliar with the local market can feel more exposed. While offering lucrative investment opportunities, Russia, due to generally lower levels of corporate governance and transparency, the legacies of the 1990s transition period and the general political and socio-economic environment, has a higher risk profile. Therefore, investors should adopt appropriate measures to limit this risk.

In its Corruption Perceptions Index surveys, Transparency International reports that the perception of corruption within Russian society remains high; in 2008, Transparency International ranked Russia 147<sup>th</sup> of 180 countries surveyed – a marginally worse result than in 2007, when Russia was

ranked 143<sup>rd</sup> of 179 countries surveyed. The World Bank has previously quoted sources that suggest Russia has been losing up to USD10 billion per year in potential foreign investments because of corruption, inadequate accounting procedures, weaknesses in its legal system and the lack of reliable financial information. The level of transparency also varies from industry to industry in Russia.

Increasingly becoming a well-accepted practice in M&A and other investment processes, an integrity due diligence is driven both by the potential investor's genuine wish to understand his partner better and by the increased attention of US and European regulators on fighting against bribery and money laundering<sup>1</sup>. Under anti-money laundering regulations, an investor's failure to gather enough information about his partner may result in prosecution by the regulatory authorities and, ultimately, extensive fines.

Such issues are, however, not insurmountable. As part of an integrity review, to gain comfort over a counterparty, an investor may typically seek information in relation to a range of questions, such as:

- Who is the ultimate beneficiary owner of the business? Is the listed shareholder the ultimate beneficiary or merely a nominee? Are there any hidden interests influencing the decision-making of the business, such as organised criminal groups?
- What is the modus operandi of the beneficial owner and/or the key management? Do they act legally, ethically and responsibly in their business dealings? Are there any indications that they may abuse their partners or default on financial obligations?
- What is their track record? Is the source of their wealth associated with questionable or illegal conduct? Have they been involved in litigation or disputes? Have they been or are they now the subject of an investigation by the authorities? Have they, or businesses with which they are associated, been subject to insolvency or bankruptcy proceedings, or disqualifications?
- Do they hold relevant licences and title to key assets? May their declared capabilities be verified?
- Do they have particular social or political associations? What is the impact of such associations? Do they generate any additional risk?

<sup>1</sup> E.g., trends towards stricter enforcement of the US Foreign Corrupt Practices Act; introduction of the 3<sup>rd</sup> EU Anti-Money Laundering Directive.

Integrity due diligence specialists gather information from a variety of sources, both publicly available and those restricted to the general public. A distinct feature of integrity due diligence is strict adherence to privacy and data protection legislation and high ethical standards of conduct. Gathered information is collated and analysed to identify potential areas of concern.

### Sources of information

The typical publicly available sources of information include:

<b>Corporate information</b>	Online and locally sourced company filings, including copies of original filings, directorship and shareholder records
<b>Insolvency and credit information</b>	Credit and bankruptcy records for companies and individuals
<b>Media and press</b>	International and local language press and media coverage
<b>Asset registers</b>	Vehicle, land, ships, planes and artwork registers
<b>Litigation and regulatory action</b>	Details of criminal and civil litigation and regulatory actions
<b>Specialist high risk individuals/entities databases</b>	Identification of high risk of individuals or entities from sources such as OFAC, UNI, EU, FSA, AFAC, UNO and Interpol
<b>Telephone directory and electoral roll records</b>	

Source: KPMG

It is generally accepted amongst practitioners that human source intelligence (essentially, human contacts in a variety of fields ranging from industry experts to investigative journalists) plays a higher role in integrity due diligence performed in emerging markets, as the desktop research infrastructure in such countries is underdeveloped, while the environment is generally opaque. Russia is no exception, although there is a clear, although somewhat slow, tendency for improvement.

Transparency is increasing, partly due to a number of Initial Public Offerings by Russian companies as well as growing investor demand for high quality information. In some sectors where there is a higher level of international participation, such as oil

and gas, notable improvements are perceived in the levels of corporate governance as a result of pressure from foreign investors.

Despite a number of inadequacies, public data is becoming more available in Russia. State and regional authorities are gradually disclosing more and more information to the public. Importantly, new commercial databases holding public records are emerging with differing levels of searchability, completeness and relevance. The large number of commercial providers of pay-for-access databases is stirring up competition, leading to better availability and access to data.

This does not necessarily mean that public domain sources are as comprehensive, complete or reliable as in more developed markets (e.g., in Europe) and it is important to appreciate the extent of information that is available, as well as some of the inherent limitations that apply.

That said, information gathered is typically evaluated across three dimensions:

- the source of information
- the channel through which the IDD specialist accessed it
- the information itself (relevance, completeness, etc.)

This assessment is essential to assess the reliability of information.

### Media sources

Media information encompasses the printed press, broadcast material and, increasingly, internet-based resources. Background investigations into companies or individuals would normally involve a thorough review of such sources, with particular focus on adverse issues that may serve as a warning of areas that require further investigation.

Press information in Russia does have inherent limitations. Although it is widely available, the breadth of reporting itself is limited and there has been systematic pressure on “independent” press sources from the state. In its most recent survey, Freedom House (an organisation that monitors the relative levels of press freedom across the world) concluded that the press in Russia was “not free”, ranking it 170<sup>th</sup> of 195 countries surveyed (on a par with Kazakhstan, Sudan and Yemen).<sup>2</sup> Some of the notable features of the low rating included political and economic pressure on the mass media, such as encroachment on the press by the state.

<sup>2</sup> <http://www.freedomhouse.org/uploads/fop08/FO-TP2008Tables.pdf>



In contrast, online resources that do not have an equivalent printed publication, such as Gazeta.ru, have grown rapidly in recent years. In addition, there has been a rise in independent media agencies dealing with business and economic issues, such as RosBiznessConsulting (RBC.ru), that have grown in popularity amongst users of the internet. The state appears to have interfered less with such information outlets which, in part, has given them a reputation for greater independence and impartiality.

As with many countries, some degree of challenge or healthy scepticism must be applied to media sourced information. It is not unknown for business disputes in Russia to spill over into articles 'placed' in newspapers or other media outlets. An awareness of local editorial affiliations and the background of the journalist can, therefore, be vital to checking and sifting the information obtained.

## Public records

In general terms, corporate information is more sporadic and difficult to obtain than in developed jurisdictions. Although laws exist requiring corporations to file information, in reality the penalties for failing to do so are trivial and consequently the level of actual filings remains relatively low. Anecdotal evidence suggests that approximately 40% of businesses trading in Russia regularly file information at a corporate registry. This can cause issues for prospective investors looking to obtain current, accurate filings since such filings may be incomplete or out of date. In order to obtain a more thorough understanding of a company's actual standing it is therefore often necessary to obtain information from a number of separate sources.

The Federal Commission for Securities Markets ("FCSM" – restructured as the Federal Service for Financial Markets "FSFM") Regulation on Disclosure of Information by Issuers of Emissive Securities (No. 05-5/p2-N of 16 March 2005, as amended on 12 April 2007) is the principal legislation relating to company information disclosure, but mainly affects larger companies that issue shares to the public. Even among these companies, timely and relevant compliance can be a problem, since it is generally perceived that fines for breaching the disclosure regulations are inadequately low.

A number of corporate databases do exist in Russia, such as SPARK (System of Professional Analysis of Markets and Companies), that provide comprehensive databases of collated official information, as is available. Underlying information is sourced directly from organisations including the

FSFM, the Federal Statistics Service, the Federal Tax Service and the Central Bank of the Russian Federation. Such sources provide information relating to the General State Register of Enterprises, financial statements, prospectuses, company reports, securities, registration numbers, addresses and ownership information.

A thorough review of these sources is an important starting point for any integrity investigation. Amongst other reasons, it may permit confirmation of reported ownership of a business; corporate structures; key executives or relevant addresses; and the incorporation status of the company. Concerns may be raised if there appears to be a complex group structure (including the use of offshore vehicles in jurisdictions with a low level of transparency) or if the listed shareholders appear to have little in common with those who exercise executive control over the business (the use of nominees remains prevalent).

## Legal filings

Legal filings, such as records of court actions or litigation, insolvency and bankruptcy records, and other regulatory filings can be challenging to obtain in Russia. This is due to a lack of any comprehensive database system, the fact such records tend to be held manually, and the decentralised nature of the court system. Press searches may reveal certain information; however, it would be necessary to access records at a local level.

## Real estate records

The primary source of information on real estate, transactions with it and any encumbrances is the Uniform State Registry of Titles to Real Estate and Transactions therewith. Excerpts from the registry are available upon application and typically take between 1 and 5 days to obtain. However, the content of publicly available information is very restricted.

## Human source intelligence

Reflecting the weaknesses in corporate filings, integrity investigations often call for the available formal information to be enhanced by intelligence gathered through informal channels. Commonly this requires an ability to turn to a network of contacts drawn from a variety of backgrounds including, for example, journalism, the civil service or those with relevant industry expertise. Naturally a distinction must be drawn between the two types of information

and steps should be taken to corroborate the intelligence gathered through informal channels. Nonetheless, such information can be a valuable addition to the formal corporate filings and can assist an investor to better understand or assess a prospective business partner.

In summary, the integrity due diligence process is a growing, and important element of the overall due diligence investigation. Undertaking such investigations at an early stage of a transaction allows adequate measures to be taken to limit any risks that arise. However, whilst public source information is of growing importance in Russia, a local network of knowledgeable contacts remains vital to conducting thorough investigations in the country.

## The US Foreign Corrupt Practices Act and due diligence (Henry N. Heinz, Deloitte (Moscow), Partner, Financial Advisory Services)



### Henry N. Heinz

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years advising banks and financial institutions in acquisitions, divestments and debt restructuring projects.

There is an increasing number of enforcement actions for violations of the US Foreign Corrupt Practices Act ("FCPA"). In part this may be due to common misconceptions, especially with regard to the applicability of the Act and the issue of successor liability.

Actual liabilities arising from violations and indirect costs (such as legal fees and intangible damages) can be significant. A number of enforcement actions were uncovered as part of pre-acquisition due diligence. Such violations translate into delays to closing and, potentially, were the reason that certain deals were "killed".

### Background:

There are four common misconceptions regarding the applicability of the FCPA to foreign buyers. These are as follows:

*Misconception 1: "The FCPA is a US Law. We are not a US company, so the FCPA does not apply."*

The FCPA applies to many foreign entities – foreign companies with registered US securities and others that file reports with the US Securities and Exchange Commission. Further, the FCPA applies not only to the business entity, but also to its directors, employees and agents. These individuals can face civil and criminal penalties, including fines and imprisonment. The Act prohibits a company from indemnifying them or paying fines on their behalf.

*Misconception 2: "We are not buying a majority stake. We can't be held responsible for how the target conducts day-to-day business".*

There are certain provisions in the FCPA that require a buyer, where they have less than 50% own-

ership or management control, to use their influence to cause a foreign entity to maintain adequate internal controls.

*Misconception 3: "The regulators cannot hold us responsible for the actions of management prior to acquisition."*

There have been enforcement actions where companies have been held responsible for the actions of investees prior to acquisition ("successor liability issues"). There is the additional risk that, if behavior led to violations prior to the acquisition, such behavior could continue after the acquisition, exposing the buyer to post-acquisition risk.

*Misconception 4: "Most violations aren't serious and there are not many enforcement actions."*

FCPA compliance has become an area of concern in the post-Enron world. Indeed, focus on corporate governance issues has become increasingly important as evidenced by other measures (e.g. Sarbanes-Oxley) and anti-corruption/governance related reforms by European governments including Switzerland, Italy, Germany and the UK. For example, laws in the UK cover the bribery and corruption of foreign public officials, as well as those in the private sector, whether or not the offences are committed in the UK. There is also an increase in information sharing. The risk to a foreign company is of being subjected to actions in multiple jurisdictions for similar violations.

"Seriousness of a violation" is a relative term. Fines and business costs for FCPA violations can be significant. A recent settlement in terms of fines, civil penalties, and disgorgement of profits exceeded USD44 million in an action involving a company with operations in the CIS. While this amount is significant, it does not include legal fees and other costs associated with defending regulatory enforcement actions. Aside from monetary outflows, there are other potential consequences, including being barred from certain business activities with the US government and damage to reputation.

## Planning is the first step

When planning an acquisition, consideration of FCPA matters should occur. The main points are:

- *Educate yourself:* Understand whether the FCPA (or similar laws) apply. There are many publications that provide FCPA guidance. A copy of the FCPA is available at <http://www.usdoj.gov/criminal/fraud/fcpa/>.

If the Act applies, the next step is to understand its provisions. The FCPA includes two broad types of provisions:

- *Anti-bribery provisions:* These make offers, payments, or authorization of payments to "foreign officials" to assist in securing a commercial advantage, a US federal offence.

These provisions are broadly interpreted. For example, the definition of a foreign official includes employees of majority state-owned enterprises, candidates for political office, international organizations, and a person that has a reason to know a payment would be passed to an official.

There are, however, some exclusions (e.g. payment of "facilitating payments" is allowed in certain circumstances).

- *Books and records provisions:* These provisions require that adequate internal controls and records are retained to evidence transactions. These provisions are also broadly interpreted.

- *Consider the overall risk of corrupt practices occurring:* Consider the likelihood of corruption within a) the country and b) the industry in which the target operates. One barometer is Transparency International's Corruption Perceptions Index. Russia is relatively low at 147 out of 180 in the country rankings in the 2008 Index (the lower the ranking, the greater the perception of corruption). A number of enforcement actions have occurred in certain industries such as Defense, Telecommunications, Oil and Gas. This analysis should serve as an indicator of the relative corruption risk.

- *Educate your due diligence team to be aware of potential violations.* The entire team should be aware of "red flags" of potential violations. Clear instructions to elevate red flags to a designated person in the team should be communicated. Some of the "red flags" include:

- The target is involved in business ventures with or provides gifts, entertainment, loans, etc. to foreign officials or their relatives
- The target does not file tax returns/pay government fees commonly paid in their industry
- There is evidence of "unusual" payments to tax or customs officials
- The existence of large/undocumented payments to consultants for "services" and/or poorly defined scopes for such services
- High commissions, agent fees etc. for services allegedly provided
- Large amounts of cash transactions
- Significant entertainment expenses not well documented as to purpose
- High discounts or refunds to customers; especially in relation to business relationships with governments/affiliated businesses

- Business junkets, site visits etc. where government officials participate.

## Pre-acquisition due diligence process

When due diligence commences a number of procedures should be considered, including the following:

- Evaluate the “tone at the top”. Undertake procedures to obtain an understanding of:
  - Target management’s awareness of FCPA (or similar) requirements,
  - Policies regulating ethical behavior (do they have written codes of ethics and conduct?), and
  - Control processes (ethics training and clear and effective communication to employees, plus other controls – internal audit or analyses that would detect potential unethical behavior).

These procedures should, at a minimum, include making inquiries of the target’s senior management. These procedures may need to be extended to other locations if there is a significant delegation of authority (such as in a highly decentralized organization).

- *Understand the target’s oversight of ethical business practices in relation to business partners:* When evaluating key contracts with business partners, contracts and agreements should be checked for clauses preventing unethical behavior.
- *Understand the effectiveness of controls over ethical compliance matters:* policies are effective only if enforced. Therefore, procedures should have an objective of gaining an understanding as to the adequacy and effectiveness of internal controls to monitor compliance with ethical business practices.

The depth of such procedures varies depending on the types of processes. However, indicators of effective control processes include:

- an active internal audit function,
- a process of robust financial analysis designed to uncover unusual transactions,
- analysis of commissions paid to agents/discount policies in relation to customers,
- active and effective training and communications policies on business ethics, and
- evidence of enforcement action taken against offenders.

These policies may be embedded in different management functions, It is therefore imperative that the entire due diligence team can recognize potential red flags.

## Potential “red flags” or violations are uncovered – what next?

Should pre-acquisition due diligence identify potential issues, a robust analysis should occur. The depth is dependent on the nature of the risks. However, the objective is to obtain an understanding of the potential magnitude of violations (e.g. whether one-off or recurring) and to develop a plan to mitigate risks to the buyer.

A buyer should also consider involving an attorney that is familiar with the FCPA. Involvement of an attorney may help the buyer’s protection by claiming attorney/client privilege at a later date. Secondly, the attorney can assist in defining (a) the scope of additional procedures and (b) mitigation strategies/remedies to protect the buyer’s interests, including assisting in dealings with the appropriate regulatory agencies in the US when violations or potential violations are identified.

## Deal closure considerations

Steps to be taken at closure vary depending on the results of due diligence. However, adequate representation and warranty provisions should be considered in sale and purchase documentation even if risks are considered low.

These clauses should cover disclosure of actual and contingent liabilities, responsibility for pre-existing conditions and, if applicable, specifically refer to FCPA matters. Even if these clauses may not be totally effective protection against successor liability, their inclusion serves to demonstrate to the target the importance of these issues.

## Post-acquisition considerations

The FCPA risk mitigation process does not stop at closing. In many transactions, a buyer may not have full access to documentation (due diligence is often conducted within short timeframes with limited information). Therefore, a more robust investigation should be considered either during exclusivity, or shortly after acquisition.

There are several matters to consider in the post-acquisition business integration process, including:

- Development of policies concerning ethical business conduct. Policies should be augmented with training programs.
- Contracts and other documents should contain clearly articulated terms regarding ethical business conduct. There should also be processes

requiring review of activities of contractors and agents, including conducting certification/background checks prior to engagement and periodic re-certification, as well as training of business partners.

- The appointment of a senior officer responsible for oversight and monitoring of FCPA matters (an “ethics officer”).
- Implementation of monitoring and reporting channels within the organization, such as anonymous hot-lines and similar “whistleblower” processes.

## Summary

In conclusion, the FCPA extends across borders. Laws of other jurisdictions may apply that pose similar concerns. The implications need to be carefully considered throughout the transaction process, as the costs associated with actual or alleged violations are significant in monetary and intangible terms. The processes that should be incorporated in addressing FCPA compliance issues are useful for a broader objective – understanding the target’s approach to ethical business practices.

## Commercial due diligence: secure growth – Russia’s place in your growth portfolio (Stefan Dierks, KPMG, Partner, Head of Strategy Group, Transaction Services)



### Stefan Dierks

Stefan Dierks heads the Strategy Group of KPMG Transaction Services in Russia and the CIS. He holds a degree as Diplom-Kaufmann and an MBA from the University of St. Gallen HSG and the Haas Business School/University of

California at Berkeley.

Since 1995 Stefan has focused on strategy and market-related issues in the field of Mergers & Acquisitions, with particular emphasis on internal and external growth strategies, as well as regional market expansions. He has also gained significant experience in industry consolidations.

His clients include Private Equity houses and refinancing banks, as well as large and medium size corporations. Stefan has helped a large number of international clients to develop and implement their market entry strategy for Russia.

One year ago in the previous edition of this publication, we mentioned the first dark clouds we saw arising in the bright sky of Russian growth: the credit crunch, the housing market and its impact on Russian liquidity and consumer spending, highly leveraged industries with productivity issues. Today these trends have materialized and are causing significant turbulence. In Russia it is raining, in a lot of other regions of the globe we already have a thunderstorm.

Of course these developments need to be reflected in the way investors look at the commercial perspectives of their opportunities in Russia. But overall, we think that the impact on Russia will be less fundamental than on most developed markets. Not to mention emerging markets, where volatility should be seen as a part of the cycle rather than a big surprise.

## Russian economy: despite the downturn, large, growing and stable, but with more uncertainty than before

In a nutshell the fundamentals of the Russian economy speak for themselves. In 2007, Russian GDP was USD1,290 billion at the market exchange rate. The average annual growth rate has been high at an

impressive 7.3% since 2003. This grants Russia the highest per capita GDP growth of the BRIC countries, and the highest among the G8.

But what do we see in the future? Definitely less certainty and lower GDP growth, driven by global and local developments. When writing this we still expect real GDP growth of 6% for 2008. However, we have already corrected our expectations more than once this year. For 2009 we started with an expectation of 6%, reduced it to 5.5% three weeks ago and are now tending towards 4%. Other factors are also causing uncertainty. Inflation remains high and the development of the rouble is difficult to assess. Oil prices have seen historic peaks and large declines.

Nevertheless, the Russian authorities deserve credit for the management of these factors so far. Backed by a large stabilisation fund and reserves, as well as by diligent macroeconomic measures, the negative impact on the population has been limited so far. We do not currently see indications of a drastic change for the worse.

However, for every commercial assessment of investments in Russia the overall economy requires detailed analysis. The situation is highly volatile and is likely to remain this way for the foreseeable future. Hence, the timing and pricing of investments needs to be aligned with the actual position in the cycle. It is not wise to try to catch a falling knife – neither in Russia nor the rest of the world.

### **Russian customers: appetite and income to spend**

The wealth generated by the Russian economy is increasingly spread among the population. Since 2003, real disposable income has shown yearly growth rates of around 10%. In 2007, average disposable income is estimated to be close to USD529 per month; again an increase of 10.7%.

Unlike in many other countries this disposable income primarily goes into consumption: 70% is spent on goods and services. Only 15% is transferred to savings. This makes Russians the customers of today rather than of tomorrow.

There is, however, still an enormous – and sad – difference in living conditions between rich and poor. While purchasing power is rising rapidly, income remains unevenly distributed and is characterised by regional disparities. The highest incomes are concentrated in Moscow and St. Petersburg, in large regional centres such as Yekaterinburg, Samara, Kazan, etc. and in smaller cities where mineral extracting industries are located. For a commercial assessment this means you need to look at least at

two areas: Moscow and the “other Russia”. In our opinion Samara can be seen as a good proxy for this “other Russia” when it comes to target groups.

Not surprisingly, consumers have been affected by the global financial developments. First of all, we can observe a decrease in consumer confidence. The percentage of people expecting worsening economical conditions has grown from 13% in October 2007 to 25% in October 2008. Secondly, the availability of credit for purchases of goods and real estate has drastically decreased. Early numbers indicate that applications for mortgages remain at the same high level but significantly fewer are granted.

All together, we can see a short-term negative impact on consumer behaviour. In September 2008 the monthly growth rate of the retail segment was at 0%. However, we do not think customer demand will be a bottleneck in the medium term.

### **Russian growth: a pure growth case becomes a strategic management case**

The growth fundamentals indicated above are still appealing. Accessing these opportunities, however, is a challenge for international players entering the region. Competition from local players is intense and Russian firms have mastered the art of protecting their market shares.

The clock speed of most industries is very high and does not leave much room for ‘greenfield’ projects. Acquisitions are therefore likely to be a key strategic tool of choice when entering Russia.

These ‘buy’ or ‘external’ market entries have to be planned in a very diligent manner, ensuring that a detailed understanding of the local rules of the game is obtained. This also includes determining what the application of the acquirer’s governance and ethical standards will mean for the competitive position in the future.

In particular, switching from ‘black’ value chains (non-compliant, highly profitable) to ‘white’ value chains (fully compliant) can have a significant cost impact. We have observed market share losses of up to 50% within only six months due to compliance driven cost increases.

This all comes together with a notable increased pressure on margins. One key challenge is productivity gains. Labour cost inflation is significant and it often comes with high staff turnover, in particular in the fast-developing regions. A labour cost increase of 15% is often accompanied by labour productivity growth below 5%. Brands are in demand but the related advertising costs often increase by more than 35% per year.

Acquirers therefore need to carefully analyse how the target compares with its market peers in terms of balancing cost increases and growth.

## **A different magnitude within the strategic framework**

What distinguishes successful from less successful market entry strategies in Russia? The dynamic of the Russian market and the differences between segments and acquirers make it difficult – if not impossible – to provide a scientific answer to this question. But based on our experience on the ground we can provide a number of insights that should help investors get the strategy for Russia right.

First of all, and we consider this crucial to note, we believe that economic rules are as true in Russia as elsewhere. Russia should not be seen as a ‘New Economy’ where these rules do not apply. Various factors, however, have a different significance that needs to be considered.

When compared to established markets the key differences in the magnitude of strategic significance appear to be the relative importance of stakeholders, of demand, of the value chain and the ability to implement.

## **Stakeholders: a key area of investigation**

In established markets it seems reasonable to assume (based on limited research) at least a moderate degree of transparency about the stakeholders in a market, their key interests and the way they influence the behaviour of other stakeholders or the market. Stakeholder assessment in Russia, however, requires a much wider approach.

This is not only because the interaction and relations between the authorities and companies are closer in Russia. But also because the secure supply of raw materials or goods (in particular in the ‘regions’) can be highly dependent on the support of a very limited number of individuals. Furthermore, relationships with key clients or suppliers are often not legally established but are based on a loyal network of friends and family.

The importance of friends and family highlights a significant issue. Business in Russia is much more relationship based than in most mature economies. Therefore, the group of stakeholders to be assessed is usually much wider than in established markets. And the circle that requires consideration during an assessment can widen significantly.

Finally, some stakeholders may have a more or less dubious background with which acquirers may

not want to be associated. Every entrant faced with this issue should prepare specific communication plans to be executed if things become public that were meant to remain private.

## **Demand: not even close to saturation**

Identifying the marginal differences in regional demand patterns and growth rates is a key success factor in mature markets and established regions. Finding these golden nuggets is less of a critical success factor in Russia. Markets can often be made by pushing products into the market, as most of the categories are underpenetrated.

Similar demand assumptions are true for most of the b2b and industrial markets. Significant capacity additions in downstream activities require not only the supply of raw materials (e.g. oil and gas) but also the availability of high-end engineering and construction capacity. Furthermore, the government is still focusing on increasing the added value in the country. This is often implemented by introducing new duty structures that support the production of more sophisticated products instead of exporting raw materials. An example is the wood industry where the export of logs is likely to be substituted by logs being used for in-country production of, for example, glued laminated timber.

Getting the demand assessment absolutely right is usually not the key focus of a market entry strategy for Russia. A practical 80/20 approach appears sufficient given the current environment. It goes without saying that the Russian customer (if the Russian customer exists at all) is not to be underestimated. Lifecycles in Russia seem to be even shorter than in other countries and success requires a good understanding of customer behaviour.

What we see becoming more important though is target group definition. Not only important from a regional perspective, as discussed above, but also in order to reflect the trends towards brands and the change in demographics. In the last four years the market has changed significantly, with consumers now demanding more from products in terms of quality/innovation or price. Consumers clearly identify high prices with high quality, leading to the emergence of a clear premium segment. On the other hand price-focused retail concepts have become available. This leaves less space for “medium priced” products. Furthermore, the Russian population itself is changing. Overall it is decreasing, but state programmes seem to be working and having a positive impact on the birth rate. The target group of young and wealthy families is becoming more important.

## Value chain and business model: the things you need to get right

The distribution of growth throughout the country is increasing the importance of a crucial element of any market entry in Russia: the value chain. Unlike in more mature markets, the value chain in Russia may be far from defined.

There is the obvious challenge that comes with the size and the weather conditions of Russia. Distances to be covered – even between the key growth cities – are very large and fast transportation capacity is limited. This is not only a challenge for retailers with a requirement for efficient distribution of fresh goods: the chilled supply chain is often characterised by significant interruptions, where the required temperature cannot be maintained at the appropriate level. The impact: either high investments in own supply chain capacity or uncertainty about a crucial quality issue.

This is also significant for service-based models like the commercial vehicle industry. The demand for modern commercial vehicles is evident and import numbers are rising. Key for the breakthrough, however, will be the establishment of an appropriate service and repair network. This is probably the largest challenge in a country used to simpler commercial vehicles which can be serviced and repaired by experienced drivers and do not require the highest fuel quality.

Another challenge, limited supply chain capacity, appears to be a by-product of the size, growth and the break-up of historic Soviet structures. In particular, bulk transportation suffers from the limited availability of railway and port capacity. Although private investors, as well as the government, are addressing these bottlenecks, it will take a while before sufficient capacity is available.

Control of the supply chain can prove particularly challenging for sensitive industries like chemicals and pharmaceuticals. A lack of control can lead to unauthorised trade (fraud), abuse of products, insufficient management of expiry dates, or repackaging and labelling.

Another issue to consider is the fast changes occurring in the structure and ownership of the value chain. Players with a historically upstream focus are now increasingly moving toward downstream activities. A good example is again the oil and gas industry, which is moving its focus from pure oil extraction to the petrochemical segment and last-mile distribution. These shifts have a significant impact on the level of access to individual value chain steps available, as well as on the competitive position.

The issues mentioned above are important but far from exhaustive in describing the importance

of the value chain in Russia. As a result of this a high number of different business models have emerged – even in the smallest industries. We have seen industries where the operating margin varies between 1% and 25% – purely driven by the business model.

Picking the right business model and building it as flexible is the key success factor for an entry into Russia. What are the value chain steps to be occupied? Where to cooperate, where to control? How to remain flexible? All of this needs to be considered.

And again we see the impact of global developments in Russia as well. Being so focused on growth a number of companies did not do their homework on optimizing value creation or operations. The corresponding low productivity plus cost increases that cannot be passed on to the customer, plus high leverage with short-term debt, leaves these companies in a very unpleasant position. If this builds up we may see a further postponement of the modernisation of Russian supply chain infrastructure.

## Be able to implement

It may appear to be stating the obvious, but there is no lack of ideas in Russia; there is a lack of execution and implementation capability. There are great benefits to be gained from combining excellent Russian know-how and resources with experience from mature markets.

However, this appears to be one of the most difficult things to do and it takes too long. Our analysis of mergers and cooperation between Russian and international firms has shown that there are plenty of differences. And these differences are vital to success. But there is one area you need to tackle right from the beginning: the operating style.

With respect to this issue we have seen that three areas require significant management attention in order to be resolved:

**Centralisation:** Russian companies tend to operate in a relatively centralised manner, which may often conflict with the management principles of investors

**Management decisions:** Decisions in Russian companies are often achieved via a top-down approach. Consensus-driven decision processes can be seen as a management weakness

**Result focus:** While investors often focus on results, Russian corporate behaviour is often focused on activities (form over substance)

If not addressed properly, these differences can lead to significant delays in decision making and a lack of implementation focus.



## Russia needs to be a star in your growth portfolio

As we have seen, the growth fundamentals of Russia are still valid: a history of significant growth, the fastest growing GDP per head of the BRIC countries, diversification of growth (industries and regions), customers willing and able to spend, and a reputation as one of the most stable economies in Europe. Even in these difficult times.

Economic laws are as true in Russia as everywhere else in the world. Russia is not anything like a new economy bubble. But the magnitude of individual components is very different from in established markets. You need to focus on stakeholders and the value chain, as well as having a flexible business model and managing a number of cultural challenges.

On the other hand, we have the significant impact of the global crisis: limited liquidity, decreasing consumer confidence, margin pressure and inflation, as well as currency challenges.

We stick by our conclusion from last year: Russia is not an easy or fast entry market, but performed with diligence, expansion in or into Russia will deliver a large part of your future growth. However, we must add that timing and strategic management capabilities require more attention than one year ago.

## Financial due diligence (Thomas Dix, KPMG, Partner in charge of Transaction Services in Russia/CIS)



**Thomas Dix**

Thomas Dix leads KPMG's Transaction Services practice in the CIS, and has extensive transaction advisory experience in Western Europe and the CIS. Thomas has solely focused on transaction support for the last 9 years. His

experience includes pre-deal evaluation, acquisition and vendor due diligence, vendor assistance for the sale of businesses, assistance in contract drafting and review for acquisitions, and stock exchange reporting for equity and debt listings. In the last 7 years Thomas has led numerous assignments in Russia, Ukraine and Kazakhstan working with both corporate clients and private equity investors in various industry sectors.

Financial due diligence in Russia often represents a significant challenge for investors. Statutory financial information can be significantly impacted by tax-motivated business practices, and reliable financial data is often difficult to obtain. A thorough understanding of the specific business model and accounting practices is essential to interpret financial information correctly and understand and evaluate properly the value drivers of a Russian business.

### Lack of reliable financial information

Russian companies are required to keep statutory financial accounts in accordance with local Russian accounting principles ('RAP'). Theoretically these accounting principles have moved towards International Financial Reporting Standards ('IFRS') over the last few years and now include concepts such as substance over form, prudence and the accruals principle. In practice, however, these concepts are not thoroughly applied, partly because RAP explicitly allow for certain departures from the concepts.

Moreover, statutory RAP financial accounts are primarily used by most companies to provide a basis for tax accounting, rather than as an instrument for measuring and controlling the financial sphere of the business. Therefore the accounting policies applied may be tax driven, rather than following the abovementioned accounting concepts.

Revenues and costs, but also assets and liabilities, are typically recorded in Russian statutory accounts only once their formal documentation (such as dispatch notes, invoices, acts of completion of services) is complete. The resulting prevalence of documented form over economic substance means that revenues, costs, receivables and payables as reflected in the statutory accounts may not be complete, especially at interim dates.

In addition to the inherent shortcomings of RAP, local Russian audit practices and standards must also be considered. Local law requires that Russian statutory financial statements of all open joint-stock companies, specific types of businesses (e.g. financial institutions, insurance businesses) and entities exceeding certain thresholds regarding revenues or total assets, be audited annually by an independent auditor. However, the audit practices and techniques applied by many local audit firms do not meet internationally recognised auditing standards. Statutory audits tend to focus on compliance with bookkeeping rules rather than on the provision of a true and fair reflection of the economic substance of a company's business. As a result, a statutory audit opinion generally provides very little comfort over the numbers and does not replace the need for thorough and detailed analysis.

To overcome the limitations of RAP financial statements and provide useful information to both external and internal stakeholders, a growing number of Russian companies prepare financial statements in accordance with IFRS or US GAAP on a voluntary basis. Moreover, financial institutions are required by Russian law to prepare quarterly IFRS accounts in addition to their statutory accounts. Although IFRS or US GAAP financial statements generally provide a better basis for financial due diligence, in practice their quality and reliability varies significantly.

## **Impact of tax avoidance and tax minimisation schemes**

A frequent issue which impacts the statutory financial accounts is the company's tax practice. Companies which are engaged in various types of tax minimisation or tax avoidance schemes may use frequently changing special purpose vehicles ('SPVs') through which sales or purchases are made. Such SPVs themselves may be involved in VAT and profits tax evasion. Their legal ownership often disguises their effective control by the company, its management or shareholders.

Transactions with these SPVs are typically made at artificially high or low prices, or even involve fictitious invoices for services which the SPVs do not actually render. The cash received under fictitious bill-

ings is returned to the company or its shareholders without recording the receipt in any official books. Such cash is used, for example, as a sort of dividend or to pay part remuneration unofficially, thereby avoiding payroll taxes.

A typical example of intentional abuse of tax legislation relates to the application of the simplified tax regime, an instrument which allows small businesses to pay virtually all taxes at one fixed rate based on turnover. Under such schemes, larger businesses are structured in such a way that their sub-divisions are individual legal entities, allowing them to apply the simplified regime, whereas the total size of the business would not qualify for the application of this regime.

The assessment of the risk associated with such tax evasion and of potential additional liabilities and penalties are key elements of tax due diligence. The statutory accounts of the companies involved are also often rendered quite meaningless as a result of them. In order to obtain a complete picture of a company's financial performance and position, it is necessary to consolidate the profits generated by SPVs.

A detailed understanding of the direct and indirect financial implications of tax driven schemes is also important for the assessment of the sustainable performance of the business going forward. Direct implications include the additional tax costs which will be incurred if the business is to operate on a fully legalised basis, abandoning trading through SPVs or the use of other questionable schemes. Indirect expenses may include, for example, the additional payroll cost required to compensate employees and management sufficiently for the impact of the additional personal income tax which they will incur on previously undeclared income.

In addition, one needs to understand the commercial implications of transforming the business to a legitimately operating and fully tax compliant entity. Such a transformation is likely to impact relationships with customers and suppliers if the latter have been previously involved in tax minimisation schemes. It may not be possible to pass the additional cost of being tax compliant onto customers, impacting future profitability.

But even if a company is not engaged in unlawful/legally questionable transactions, trading through complex structures of legal entities is a widespread phenomenon. RAP, however, do not require the publication of consolidated financial statements; consequently they are often not prepared. An understanding of the entities through which a business operates, and the economic relationships and cash flows between them, suppliers and customers, is essential for the assessment of a busi-

ness's financial performance and position, as well as the financial risks to which it is exposed.

### **Management accounts as a means of measuring financial performance**

In the absence of reliable statutory financial accounts, or IFRS or US GAAP financial statements, the only source of useful information for financial due diligence may be the company's management accounts. Whilst management accounts may provide a more complete and relevant picture of the company's trading, they are often prepared only on a cash rather than an accrual basis, or represent a mix of the two approaches. They are also typically limited to an income or cash flow statement, while no balance sheet is prepared, therefore providing limited or no information on the business's financial position.

VAT receipts and payments, for example, are often included within income and expense items; payroll, taxes and interest are accounted for on a cash basis, fixed asset purchases are written off as expenses, and no provisions or write-downs are made in respect of impaired assets or future expenses such as environmental commitments, product warranties or employee-related obligations. Management accounts require thorough analysis and adjustments for accruals, provisions, tax and others, using all available information, to obtain an approximation of the financial performance in accordance with IFRS or US GAAP.

### **Assessment of a company's financing and capital structure**

Due to the underdeveloped state of the Russian capital markets, many Russian companies, especially smaller and medium-sized companies, have difficulties raising debt finance. Most Russian corporate debt revolves on a relatively short-term basis which in times of decreasing availability of credit may put the business under extreme liquidity pressure. Also, in order to obtain debt, companies have often pledged a substantial part of their operating assets.

For larger companies, leasing has become increasingly interesting. Tax deductible depreciation expense can be claimed on leased assets three times faster than statutory depreciation. Leases are often arranged between group companies in order to take advantage of this tax treatment. The accounting for leased assets in the statutory accounts generally follows the prescriptive terms specified in the lease contract, regardless of economic substance.

Attention should be paid to companies with negative net assets. Under Russian law, a company which

has negative assets under RAP for two consecutive years can be subject to forced liquidation, which can be initiated by creditors and/or the state authorities.

### **Working capital issues**

In the unstable economic environment of the late 1990s, Russian companies often required their customers to pay in advance. In some industries this practice is still common, especially for purchases by medium-sized or small businesses. Until recently, however, due to extensive competition companies have increasingly been selling to their customers on credit. Such practices can result in higher than expected working capital requirements and companies often experience working capital constraints.

The approach to working capital management is somewhat different in Russia. Many Russian companies are not very proactive in their control of inventory levels or chasing of receivables. Conversely, most companies have settled their payables in the past on a very timely basis; this primarily stems from the practice of forced liquidation upon default which was a relatively common method of taking over businesses in the late 1990s. In light of the overall liquidity issues the settlement of trade debt is currently being increasingly deferred.

In the past companies may have issued extensive promissory notes to improve their liquidity, manage cash flows or reduce taxation. It is important to understand the rationale for transactions involving promissory notes, and to assess the value and liquidity of notes receivable, the liabilities arising from issued promissory notes and their total potential cash flow impact.

Assessment of the recoverability of receivables is often difficult due to the lack of ageing profiles. In practice, in Russian statutory accounts a provision for bad or doubtful debts is often not created and unrecoverable receivables are only written off after they have been overdue for three years.

Although subject to physical stocktakes, and despite the RAP requirement to create provisions, inventory is generally not assessed for slow moving or obsolete items, which are often included on the balance sheet at a cost which may not be recoverable.

### **Financial impact of VAT**

Unlike in other European countries, input VAT on services, raw materials and fixed assets acquired by a Russian company is generally not automatically repaid by the tax authorities, but can only be claimed as an offset against tax payables. Although VAT receivable balances can be offset against other federal taxes such as profits

tax, this practice can have a serious cash flow impact, especially for companies which undertake significant investments and which are in a start-up phase.

### **Assessment of the value of fixed assets**

The book value of fixed assets in the statutory accounts can be affected by a number of specific issues. The historic rouble cost of assets which were acquired before 1998 is largely distorted by hyperinflation and frequent revaluations. Although companies may claim that such revaluations reflected market value, there is little comfort over the quality and independence of the underlying valuations.

Depreciation rates which are lower than economically justified can lead to net book values which are not recoverable from future cash flows. Assets which have been taken out of operation and 'conserved' are often accounted for at their last net book value without further depreciation or write-off.

In practice, impairment reviews of fixed assets are rarely performed, and this can often lead to net book values which are higher than recoverable values. In many cases, only an assessment by a technical specialist can provide comfort over the value of fixed assets and identify potential write-downs.

In Russia, especially in Moscow, land is often not owned but leased by companies from the municipality for a 49 year term. Lease payments are sometimes not clearly defined in the lease agreements, and this leads to uncertainty about future lease expenses.

### **Financial instruments**

Under RAP, only investments classified as 'marketable' need to be accounted for at market value: other investments must be reviewed for impairment. Since impairment reviews are often neglected, due diligence should assess whether investments carried on the balance sheet can be liquidated and/or justify their book values.

The use of financial instruments for hedging purposes is currently limited in Russia, partly due to administrative difficulties and ambiguities in tax legislation. Companies which have foreign currency exposures may not have many tools at their disposal to hedge them.

### **Long-term liabilities and contingencies**

Russian statutory accounts generally do not reflect provisions for long-term liabilities. This is particularly important for those companies which provide guarantees for their products or which operate in

extractive industries. The future costs of legally required site restoration, for example, are not continuously accrued during the extraction work, but only expensed as the restoration work is performed. Consequently companies rarely assess the expected cost in advance. The financial impact of such a liability on future cash flows should be considered, as well as for the assessment of current profitability.

Similarly, the statutory financial statements often do not account for contingent liabilities which are considered more likely than not to be realised. Such liabilities are only recognised in the accounts when the related documentation, such as a court order, is received.

### **Prospective financial information and budgets**

Many Russian businesses do not prepare any detailed financial projections beyond an annual budget.

Budgets are often limited to monthly cash flows and rarely include balance sheet projections or an accrual based income statement. Although management usually monitors cash flows very tightly, budget variances are often not analysed in any detail.

Any mid- or long-term projections are often prepared based on high level parameters rather than on a detailed analysis of the underlying drivers for future performance and a robust financial model. Moreover, they are often heavily influenced by an overly optimistic view of future profitability, while insufficiently reflecting investment and financing needs. An investor is likely to have to prepare projections for business planning or valuation purposes from scratch by building a financial model, taking account of the findings of due diligence.

### **Summary**

The assessment of the value drivers, risks and opportunities to which a business in Russia is exposed requires careful financial due diligence, in particular in times of increased uncertainty about the economic prospects of the Russian market. Available financial information is often limited and can be misleading if not interpreted in the context of the specific environment and business practices under which a company operates. The examples provided above can only give a flavour of the challenges which a financial due diligence may face. For the evaluation of a potential transaction, detailed knowledge of the Russian economic environment is needed to understand and assess the issues which impact the value and prospects of a business.

## The credit rating as a tool for effective investing

(Dr. Vladimir Ismailov, CFO/Deputy CEO, Specta AG)



**Dr. Vladimir Ismailov**

Dr. Vladimir Ismailov is CFO with Specta AG, supporting a range of corporate business functions of the group of companies specializing in steel based and other types of industrial packaging and marking in Russia and the CIS.

Vladimir holds a PhD in Economics, as well as being a Certified Auditor of the RF and Member of the American Institute of Certified Public Accountants. He has a great deal of financial and auditing experience in a range of business sectors, having worked in the Media & Information sector, OEM, Telecom services and in public accounting and auditing.

Area of expertise – foreign investments and finance

This is probably not the best time to praise the usefulness of credit ratings. US capital market regulators are trying to determine the role of the credit rating firms in causing the liquidity crisis. The crisis that started last summer in the USA with the realization that structured financial instruments backed by pools of proceeds from sub-prime mortgages and rated relatively high by the rating analysts were more risky than the agencies thought they were. European capital markets regulators are trying to define to what extent the agencies are really independent from their opinion about their clients' ability and willingness to pay their debts. Regulators doubt the true independence of rating analysts' opinion from their clients who pay for analytical services. Even Russian capital market regulators are trying to get a better understanding of the role that rating agencies are playing and put some level of oversight over rating firms' activities. All capital participants and regulators are scrutinizing rating methodologies and making a number of recommendations to the firms. The general public is simply relying on those who take an active stand in this process. Some banks are considering switching their risk credit assessment policies away from credit ratings to credit default swaps (CDS) based systems given the current state of the world capital markets. But this does not look like a permanent solution simply because CDS have a different nature and there

are currently no market instruments available to build a system around this.

Despite the above, credit ratings have been and continue to be a source of detailed analytical information about a company. The information is not served as a sales pitch like in the case of equity research and recommendations by a banker who is simply trying to sell what he has to his/her equity investor. Also, rating firms have substantial analytical resources and methodology that have been used for decades. The rating agencies have data on the performance of companies over decades. This data represents a unique platform for trend analysis and various studies. It would be careless just to throw this away without putting an effort to fine tune the existing system and make the necessary adjustments. Most of the market participants are confident that credit ratings serve the needs of the complicated mechanism called a financial market.

Investors should take into account every aspect of business that assists them in making the most informed decision. One aspect that can play a useful role in the decision-making process is a company's credit rating.

### What is a credit rating and what it is not?

A credit rating is usually "the current opinion of the credit worthiness of an obligor with respect to a specific financial obligation, a specific class of financial obligations, or a specific financial program (including ratings on medium-term note programs and commercial paper programs)"<sup>1</sup>. When considering the benefits of using credit ratings in the due diligence process, it is important to understand what a credit rating is not: it is not an audit opinion; it is not a recommendation to buy/sell; and it is not a ranking.

Often, an investor may use a credit rating in order to:

- Evaluate an independent opinion about credit risks related to a particular company or a financial institution, or
- Compare one credit risk to another worldwide using global scale ratings, or within the same country using national scale ratings.

All of the above lead to risk premium evaluation. However, when a Russian company has a credit rating or has its financial instruments rated this could also be a preliminary indication of:

- The level of sophistication of the company's management,

<sup>1</sup> According to Standard & Poor's Ratings Definitions published on December 10, 2002

- The extent of the company's transparency,
- How much information the company is willing to disclose,
- The reliability of the information that the company provides to the investment community, or
- The company's key risk areas.

It also helps investors in certain analytical efforts. A credit rating can be:

- An instrument of debt market trend analysis,
- A database for a specific industry trend analysis, or
- An attempt by the management of an investing company to manage its investment portfolio.

All of the above may substantially affect an investment decision.

### How to take advantage of a credit rating

There are a number of attributes of a credit rating assigned by a respectable international rating agency that are very useful for decision making.

Companies, financial institutions, and the investment community know that, in most cases, a credit rating is public, meaning it can be obtained from a public source. This makes the process transparent and increases the level of the data's reliability.

There are companies that have confidential credit ratings; however, this is only until a company feels comfortable sharing its rating with the investment community. After that, a credit rating becomes public and the company will usually not choose to make it confidential again. A credit rating agency may withdraw a credit rating that was made public; however, the investment community usually reacts negatively to such an action. It takes a lot of explanation, reasoning, and demonstration of hard evidence to persuade the investment community that the withdrawal of the rating was not related to the issuer's credit worthiness.

A credit rating assigned by a respectable international credit agency is always up to date. Standard & Poor's (S&P), for example, regularly monitors every credit rating it has assigned. S&P promptly reacts to any significant change in the business and/or credit risk of an issuer and/or an issue in question. S&P performs surveillance of a credit rating, which includes daily monitoring of changes that may affect an issuer. Such changes may take place in a relevant industry or country, with a holding company (-ies), key vendor(s), and/or customer(s), etc. Any development that could affect the issuer is analyzed by a credit rating agency and, if the findings are significant, will be reflected immediately in the credit rating.

Credit ratings assigned by a respectable agency represent an independent view. A credit rating com-

mittee normally decides on the rating. As a rule, a credit committee has several people from different offices to assure objectivity and eliminate any possible influence from an issuer.

A credit rating agency's credit rating methodology is also public knowledge. Most international credit rating agencies have their methodologies and criteria available on their websites. This ensures a unified approach to the rating process, as well as its transparency.

The public availability of and unified approach to rating allow an investor to easily understand what areas are currently challenging an issuer. It can also assist the management of a target company in:

- Constructing an action plan for improving the company's credit worthiness,
- Benchmarking against peers,
- Developing an action plan to mitigate and manage business and credit risks, and
- Developing a financing plan to mesh with the details of the above.

Normally this information can be found in the credit rating research reports available to issuers' management.

A credit rating helps understand the credit history of an issuer.

### What is the use of a sovereign rating?

While considering a due diligence in Russia, an investor should consider the business environment surrounding the target company. Business-related issues to consider may include:

- The country's current sovereign debt rating,
- Current local and regional authorities' credit ratings,
- Industry credit ratings research papers, and
- The level of transparency and disclosure among the companies in the country.

A credit rating agency usually provides its opinion on these.

S&P has assigned a global scale<sup>2</sup> credit rating for Russian sovereign debt obligations at 'BBB+/Negative/A-2'. In other words, "...an obligor rated 'BBB' has adequate capacity to meet its financial commitments. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligated to meet their financial commitments.<sup>3</sup>" Given the level of influence that the government may exercise over

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<sup>2</sup> According to [www.ratingsdirect.com](http://www.ratingsdirect.com)

<sup>3</sup> Standard & Poor's Ratings Definitions published on December 10, 2002

an issuer operating in that country, it is hard to expect that a company can have higher credit strength than the government. However, there may be a few exceptions, such as a rating of a securitized obligation with a special finance vehicle registered in another jurisdiction with a credit rating higher than the sovereign. A credit rating report on sovereign debt obligations can provide some useful insight into risks and opportunities in the country. It may even discuss in more detail a specific industry if the industry has played a role in the credit rating assessment process.

## Default studies

Default studies present research about the average probability of default by an issuer who is assigned a credit rating over a certain horizon – up to fifteen years. Using this information helps a potential investor, who may not be familiar with various credit rating scales, qualify the risks associated with a target company.

It will be interesting to see this year's study and find out more about the performance of companies during the crisis and recession.

Based on S&P's "Annual 2007 Global Corporate Default Study and Rating Transitions," the incidence of corporate defaults in 2007 remained low, despite the liquidity crunch in the credit markets. Globally only 22 corporations defaulted on their obligations last year, eight fewer than in 2006 and the lowest number since 1996.

It is expected that the number will drastically change in 2008. However this statistical instrument will provide us with an objective picture of the depth of the crisis.

## Other aspects of using a credit rating

To find out more about a local jurisdiction, one can use the benefit of a credit rating report for one of 85<sup>4</sup> plus jurisdictions and about 100 local authorities in Russia that have the constitutional right to impose local regulations that may affect business. It is therefore beneficial to read about a local authority's affairs as an indirect indication of the region's investment climate.

Because international rating agencies have a large database of financial figures, they have the

ability to perform periodic Russian industry-specific sector research. An investor can familiarize himself with the contents of such reports, reading about key trends (from a business and credit risk perspective) in the industry of interest.

Some international credit rating agencies periodically conduct an assessment of the level of transparency and disclosure among companies in Russia. Such studies are useful in order to obtain a better understanding of what one can expect in day-to-day life while requesting a critical piece of information from a target company and/or customer, vendor, banking institution, or other organization.

Some rating agencies provide companies with *eco-ratings*.

As you can see, a credit rating assigned to an issuer (company, bank, insurance company, fund etc.) can be a very valuable tool for making investment decisions in Russia. Of course, credit ratings may be assigned by any credit agency and therefore an investor needs to understand what is behind the credit rating methodology and assess the credit rating agency's reputation (historical track record).

<sup>4</sup> The number of jurisdictions in the Russian Federation is currently decreasing due to a process of consolidation of some of them based on referendum results in those jurisdictions. It started with 89.

## Legal due diligence (Olga Koniuhova, Counsel, Chadbourne & Park LLP)



### Olga Koniuhova

Olga Koniuhova has over 16 years of experience in complex international transactions. Ms. Koniuhova's practice focuses on corporate, mergers and acquisitions, restructuring, private funds and labor law. She has significant experience in

implementing complicated corporate projects that require an unconventional approach and industry knowledge. She has an extensive background in project development requiring a full range of legal services, such as structuring related license and sales agreements, transnational mergers and acquisitions, and organizing private investment limited partnerships and registered investment companies. Olga's work in relation to labor includes creating stock option plans and structuring labor relationships with top management of client companies. Her clients include a variety of individual entrepreneurs, western, CIS-based, private and state-owned companies.

Prior to her work at Chadbourne & Parke, Olga worked for a number of major international legal and consulting firms.

Whether considering an equity investment, acquisition, seeking of trade credit, or other type of financing, it is essential to quantify and understand the risks involved.

Legal due diligence is a comprehensive legal review during which a prospective buyer or investor investigates and gathers all possible information about a seller company and its business/assets.

While a financial due diligence determines how much the business project can cost and predicts when the first revenue can be expected, a thorough legal due diligence provides an investor with insight into the potential acquisition target before binding commitments are made. It aims to help the investor to take a decision on whether to proceed with the transaction on the initially discussed terms, establish areas of risk that need particular attention or, if justified, withdraw from the proposed investment.

Often a Russian company may have "hidden" liabilities such as sureties, guarantees, or other contingent liabilities. Even if the proposed partner or acquisition target adheres to good corporate gov-

ernance principles and is upfront about any possible legal violations, there may still be issues of concern to an investor that may not be at all apparent or problematic to a Russian company. Such issues often arise in connection with environmental, labour, tax, and currency matters.

The flexibility of legal due diligence programmes allows the investor to make decisions that are both informed and timely by focusing on those issues deemed most important to the anticipated transaction.

### Typical stages of legal due diligence

**The first stage** of every transaction is to determine the legal status of the Russian company and to review whether the foundation documents correspond to current legislation. To ensure that the charter of the company complies with Russian Law and does not contain any restrictions on foreign ownership. There are frequently situations when the charter is in conflict with the law or with the company's day-to-day practice. For instance, the terms of the charter may stipulate the existence of a Board of Directors, but the latter may not have been elected, or its composition may not be sufficient for a quorum for making decisions. These violations can lead to disputes in relation to the company's transactions or removal of a director as illegally elected.

If, for example, the shares of the company were originally issued through privatisation of a state-owned enterprise, the privatisation documents must be reviewed to ensure that the initial transaction conveying title to the purchaser complied with the tender/auction requirements.

Proper issuance of shares of a Russian company generally requires shareholder approval and registration of the shares, typically with the local branch of the Federal Commission on the Securities Market. Additionally, any licences issued with respect to certain industries (particularly those involved in the exploitation of natural resources) must be reviewed carefully to ensure that the company has the proper authority to carry out its activities. Licences may also contain restrictions on foreign ownership.

This issue became especially topical in light of the new law "On the Procedure for Implementing Foreign Investment in Commercial Enterprises Having Strategic Importance for Securing the National Defense and Security of the State" No. 57-FZ (the Law) that became effective on 7 May 2008. Under this piece of legislation foreign investors acquiring direct or indirect control over Russian companies that are considered strategically important are required to obtain prior approval, or in certain cases



post-transaction approval, of the Antimonopoly Committee. To determine if the Law is applicable to a particular company and transaction it is necessary to find out:

- if the company performs activities included in the list of activities of strategic importance;
- the subject of the agreement and which rights are granted to the acquirer;
- if an agreement may be considered as a transaction meant for taking control of the company.

**The second stage** is to perform due diligence on the title of ownership of the company. Legal due diligence reviews the legality of the purchase to avoid disputes in the future. In certain situations the transfer of property may not have been duly formalised. In addition, the form and terms of the charter capital formation are reviewed. Violations in relation to charter payments are frequent.

Incomplete payment of the charter capital within the term set in the law of the Russian Federation results in the transfer of the non-paid shares to the joint stock company. It may be the case that the so-called owner, the party negotiating a sale, is not the legal holder of the title. If the charter capital was increased the following issues are also analysed: the method by which payment was made and whether any breach related to the payment procedure took place in the past.

**The third stage** of the due diligence is a comprehensive analysis of the company's business activity. The due diligence reviews the legality and correspondence of major transactions and transactions made with interested parties to antimonopoly and currency law.

It is also important to review the performance of concluded contracts. This analysis allows the prevention of litigation initiated by the counterparty or the state authorities.

In addition to the legal review of the acquisition of the business, legal due diligence evaluates the rights transferred by the legal entity. Quite often the title of the seller's ownership does not correspond to the one declared and may be disputed. This can be due to several reasons. For instance, non-payment of the charter capital or violation of the legislative limits set for prior transactions in connection with the sale of purchased assets.

The initial due diligence helps to collect very important information regarding a business. First of all it is necessary to decide if there are any advantages in a transaction with this exact business. In addition, it is important to determine the form of transaction. In most cases the form of transaction determines the final financial feasibility.

## Business acquisition scenarios

Based on current Russian legislation, there are three basic ways to acquire a business project:

1. Purchase of shares (participating interest) of a legal entity managing the activity of the whole holding directly or indirectly.
2. Purchase of the property utilised for the purposes of the current business project.
3. Purchase of the company as a property complex.

Each of these three ways has its advantages and disadvantages. To choose the proper way is quite difficult.

If a legal entity is being purchased by redemption of shares (participating interest), the new participant receives not only assets but also accounts payable and risks related to prior transactions. The



Legal company Schulze was founded in 1992 by the first German lawyer in Russia Robert Schulze and his partner Sergey Brutyan. In 2008 our company was renamed into Schulze, Brutyan and Partners. Over this time S&B has evolved into one of the leading legal companies in the sphere of national and international economic law, business, corporate, contract, land, leasing, currency, labour, fiscal, customs, competition, administrative law and other segments of the law.

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concern while conducting legal due diligence should be to focus on reviewing contractual work, tax and antimonopoly rules.

The purchase of property has the advantage that the purchaser obtains the assets free from any other liabilities. However, a business project is not only property. It can consist of different types of intellectual property, technical documentation, trademarks, and know-how. It is possible to purchase a part of this but there are some assets that are difficult to transfer, or the transmission itself will make the purchase of the property complicated. For instance, the transfer of trademarks requires re-registration and this procedure can last up to a year, or there could be a situation when the company can own a licence which is impossible to sell.

If the future owner intends to purchase property it is necessary to verify the legality of the seller's title to the property and the title history based on the sequence of transactions leading to the procession. The legality of a transaction, its form and terms are also reviewed. If an investor is considering an asset acquisition (as well as certain large share purchases from the issuer), it is necessary to confirm that additional corporate approvals have been obtained. For example, any transaction involving assets in excess of 50% of the balance sheet value of a Russian company's assets requires a qualified majority vote at a general meeting of shareholders. Transactions between the company and an "interested person" (including managers, directors, and shareholders with stakes of 20% or more) must be submitted for approval to the board of directors and the company's shareholders' meeting.

**Real estate and other property.** All real property, including land, and any transactions involving real property or land, must be registered with the appropriate registering body, which in most cases will be the local registry for immovable property, in order to be valid. Therefore, where real estate is involved, most due diligence will require reviewing title certificates, purchase contracts, leases, and mortgages to ensure that they have been registered and, for mortgages, notarised. It is also important to verify with the registering body whether any liens have been filed and to confirm that the use of the real property is permitted, especially with regard to land use.

From the finance and legal perspective, purchasing a company as a property complex is quite complicated. But at the same time it is made more complicated because of the formation of the necessary documents.

## Analysis of various business acquisition methods

Purchase of shares (participating interest) is a multi-stage procedure but the form and duration of the registration is not that complicated. In the case of an acquisition, to ensure that the shareholders have good title to the shares of the target company, due diligence should confirm that all necessary corporate actions – including special approvals that may be necessary if the state owns a stake in the enterprise – have been taken. Almost all Russian shares are "paperless," and ownership is recorded in book-entry form in the shareholder register. If newly-issued shares are acquired, investors should check whether the issuer's charter grants the existing shareholders pre-emptive rights to participate in the purchase of the shares. Closed joint stock companies and limited liability companies always grant pre-emptive rights, and they may also grant the right of first refusal.

It is easier to buy the legal entity's property than a property complex. When buying a legal entity's property, first the parties make a contract then the property should be transferred. If real property is the subject of such a transaction, the transfer of the title is subject to state registration. The registration process lasts for more than 30 days.

Purchase of a property complex is a rather complicated process. It is necessary to perform certain actions in addition to the standard due diligence: organisation of a complete inventory, preparation of an interim balance sheet and conducting of an independent audit (Article 561 of the Civil Code of the Russian Federation).

The systematic nature of a legal due diligence in connection with an asset transaction will allow the avoidance of negative surprises from purchasing new assets.

In practice foreign investors often choose a combination of the abovementioned scenarios. However, if such combinations are performed without consultation with local advisors they may potentially lead to the recognition of the transaction as void.

In conclusion, the due diligence process in Russia is never easy, but recognising and resolving fundamental issues early on can save a great deal of time, expense, and headaches in the future.

## Tax due diligence (Christian Ziegler, Rödl & Partner Moscow, Partner, Tax Services)



**Christian Ziegler**

Christiam Ziegler graduated from the University of Commerce in Vienna as a qualified tax advisor in 1978. He has been a Certified Public Accountant since 1982 and he earned a diploma as a Certified Mediator in 2002. Mr. Ziegler began

his career in 1978 with Exinger GmbH, an Austrian branch of BDO, as a tax, audit, and accounting advisor. In 1984, he founded TPA Treuhand Partner Austria, an audit and consulting firm, where he served until 1996 as a partner in charge of establishing and working with subsidiaries in Hungary and Czechoslovakia. In 1996-1997, he led the tax practice at Oesterreichischer Raiffeisenverband, the Austrian parent of Raiffeisenbank. In 1998, Mr. Ziegler joined the Austrian practice of PricewaterhouseCoopers, and was appointed as a Partner at PricewaterhouseCoopers Russia in 2004.

Russia is an emerging market, having come out of communism a little more than 10 years ago. This was followed by a “gold rush” period and then the crisis at the end of the 90s. Only at the beginning of the 21<sup>st</sup> century was a legal and tax system comparable to a western structure developed.

The current system was implemented from 2002 on and is still undergoing severe changes.

### Tax history of the target

Tax audits by the authorities usually cover 3 years. So you might find the report of the last tax audit in the data room or in the files of the target.

There is a high probability that you will find very good results in this report. There might even be a zero result. However, does this give you some comfort to driving due diligence? Unfortunately not. Tax legislation has changed significantly over recent years and the knowledge and attitude of the auditors has improved a great deal. Many tax avoidance schemes that were acceptable some years ago might nowadays lead to penalties or other consequences. Furthermore, this paperwork does not provide any insight into the relationship between the target and its auditors and how the positive result was achieved.

### Basis of a tax audit

Tax due diligence is based on the statements presented and the tax returns filed. If any doubt arises during the due diligence process or if the statements reflect the situation of the company that is not consistent with other sources of information, another kind of review would be necessary.

#### ■ Understanding tax planning mechanisms

The first stage of due diligence is based on interviews to understand the tax planning mechanisms of the particular target. In most cases you will not find written policies. These mechanisms might have changed over the years. If the chief accountant (the most important person for you during the due diligence) has changed, it might be useful to find the old one to involve him as well.

#### ■ Unrecorded tax liabilities

These might not be available at the beginning since companies usually do not calculate them. If any illegal schemes have been used, there will of course be an extremely high risk for the buyer, not only in relation to the payment of taxes but also penalties and other severe consequences.

#### ■ Results of the tax audit undertaken by the tax authorities

As mentioned before, these results might give you a general overview. The management of the target will use the argument that everything was done correctly. Unfortunately if this is not the case you will have to do a full tax due diligence yourself.

#### ■ Overall tax compliance assessment

If the awareness of tax issues is high and the formal requirements are fulfilled, the review might be limited to some extent.

#### ■ Transfer pricing

Transfer pricing (“TP”) in Russia is used by many companies to transfer their profits or losses to the companies in the group where they needed them. This practice is not in accordance with Russian TP rules. Russia has a strict system, with which methods for TP have to comply. These are not in accordance with OECD guidelines. And some methods, like cost sharing agreements, are not accepted. This part of due diligence needs special analysis. There are profit tax issues as well as customs issues. Since the two authorities have different interests, customs audits and profit tax audits might challenge the transfer prices in different directions.

#### ■ Overall assessment of currency regulations compliance

Russia still has currency regulations. In cross border transactions these are especially strict and should be checked during the due diligence.

- Assessment of risks and potential liabilities associated with importation of equipment

The importation of equipment is connected mainly with two tax issues: VAT and customs. There are legal opportunities to save customs and import VAT by contributing technical equipment, but all the formal requirements must be checked. Since customs and VAT are not located in the same ministry, the goals of the two authorities are different.

### Basic Issues:

- Determine the materiality level of tax analysis.

Some risks might be remote, but it is important to identify and evaluate the possible and especially the probable ones.

- Analyse increases/decreases in material taxes paid over preceding years.

From these deviations you can draw conclusions regarding deviations in the tax policy.

- Analyse methods of calculations of material taxes.
- Review existing and potential tax exposures.
- Analysis of the tax philosophy/“culture” of the tax policy
- Generally aggressive/conservative?

Innovative tax structuring with a number of cross border transactions is always attractive for the auditors. Since these activities require proper documentation, special checks are necessary. But even in companies with a conservative culture, risks cannot be completely excluded.

- Size and experience of accounting and tax department, use of outside tax advisors

Since the Russian tax accounting system is much more complicated than those in the west, the accounting and tax department must be staffed with more people of a high level. A check of fluctuation of staff should be made. The most important partner for your interviews will be the chief accountant. He has a specific, legally defined role in Russia. Outside tax advisors are another good source for information. Often they have a better picture of the history of the target than people inside the company.

During an acquisition process in Russia, the tax due diligence has an extremely important role. The consequences of a disagreement with the tax auditors in Russia are much more harmful than in western countries. Such a review requires the assignment of experienced Russian specialists. Open and frank discussions with the management of the target are necessary. Even with the best due diligence you will not be able to identify or eliminate all the risks, but you can minimise them to a manageable size.

## Technical due diligence (Tatiana Apatovskaya, Marketing Manager for Russia, SGS Vostok Limited, Moscow)



**Tatiana Apatovskaya**

Tatiana Apatovskaya is Marketing Manager for SGS Vostok Limited, Russian subsidiary of SGS, the world's leading inspection, verification, testing and certification company. Before joining SGS in early 2005,

she was engaged in the market research industry, in particular managing consultancy projects for international clientele focusing on Russian market entry and investment development.

During industrial project implementation the investor is usually dealing with a whole array of technical concerns. In Russia, many parties are traditionally involved in the investment process apart from the investor (financial institutions, property developers, designers, construction contractors, suppliers, and the authorities, to name just the key participants in the process), which can result in conflicts of interest. The investor's primary interest is to ensure that the project remains on schedule and within the projected budget, and naturally quality and cost-effectiveness also have to be ensured. Safety for both workers on site and for operators later on when the installation is in operation are a major concern. At the same time, with state authorities playing a decisive role in the approval process in the Russian context, conformity to their requirements is to be taken into serious consideration. Technical due diligence is one of the tools at an investor's disposal to minimize investment risks related to technical aspects of the project in question.

Technical due diligence may entail various types of scope and objectives depending primarily on the industry concerned and the stage of the investment process:

- Feasibility study and design phase;
- Procurement and construction phase.

A brief outline of the issues to be investigated is provided below for each of these phases. This outline is not intended to be exhaustive and aims to highlight the key topics for consideration when investing in Russia.

## Feasibility study and design phase

### **Status quo due diligence**

When concluding an M&A deal, a technical audit is required to obtain a clear understanding of the asset's status quo, its real value and pitfalls. The following questions are traditionally to be answered at this stage:

*a) Are all statutory technical requirements followed and approvals in place to legally and safely operate the site?*

Conformity to Russian regulations regarding health and safety of employees in the workplace, sanitary and hygiene conditions, as well as environmental impact are often the goals of a "status quo" technical due diligence. Operating without proper documentation is possible but risky in the sense that at any time the issue can be raised by the relevant state authorities, especially as a result of changes in ownership of the assets or staff rotation in the supervising bodies. In some cases production may be stopped and the gates of the plant may be locked.

Audit reports for ISO 14001 (Environment), OH-SAS 18001 (Occupational Health & Safety) or HACCP (Food Safety) certification purposes may ease the task of such a diagnosis, since these standards presuppose verification against local norms and regulations, i.e. Russian ones for a Russian organization. But the quality of such reports depends to a large extent on the auditor's qualification and the impartiality of the certification body; references should be collected about both. There are specific issues in Russian occupational safety and environmental legislation that differ from European laws, and only an auditor with a good understanding of Russian practices and extensive experience can identify all cases of non-compliance.

*b) Is the facility duly equipped and infrastructure available to ensure reliable performance and achieve the plant's business and operational goals?*

Plant integrity, safety and reliability are a major concern for all asset owners. By recognizing that risks and efficiency represent the "other side" of profit, it becomes imperative to fully identify and understand equipment's potential degradation mechanisms. Technical due diligence on this particular aspect may involve inspection of pressurized equipment and systems, high and low voltage installations, buildings and lifts, lifting and hoisting equipment, other tools and machinery, and coating systems. Risk Based Inspection (RBI) technologies allow the audit to be carried out without interrupting daily operations.

*c) Are there management systems in place to enable sustainable performance of the facility?*

The availability of certificates of conformity to ISO 9001 (Quality), ISO 14001 (Environment), OH-SAS 18001 (Occupational Health & Safety) etc. is a good indicator for assessing an organization's sustainability. However, it is important to note that there is the risk of being faced with a mere piece of paper without proper grounds. Technical due diligence should bring to light the real scope of the certification (for example, it could be the case that the ISO 9001 certificate covers just a storage facility and not the quality management system of the whole plant); the accreditation under which the certificate has been issued (the Russian accreditation system is called GOST R); and the name of the certification body. The reputation of the latter can provide an indication of the certificate's reliability.

### **Pre-project due diligence**

Greenfield investments or renovation of an existing industrial site in Russia imply the need to obtain a combination of permits, certificates, licenses and other approvals from different national and local authorities required to undertake engineering, construction and other technical activities. Technical due diligence is advisable at an early stage of the project to identify potential non-compliance and to take corrective measures well in advance, so as to avoid problems at later stages when undergoing official procedures and expert examination.

Firstly, an Investment Justification (formerly called a Technical-Economic Justification) has to be prepared. The goal of this document is to assess the technical, commercial, economic and social feasibility of the investment. The most complicated part of this phase consists of obtaining numerous approvals of the authorities and relevant surveying bodies: the local Administration; the Architecture and Municipal Building Committee; the Ministry of Economics (for industrial sites); the Forestry Committee (if located on state agricultural or municipal land); the State Environmental Expertise Committee; the State Sanitary-Epidemiological Control Center; the State Fire-Fighting Department; the Historical and Cultural Heritage Preservation Inspectorate; the Civil Defense and Emergency Prevention Department, among others. In some cases public hearings have to be arranged to clarify the local environmental and social impact of the considered project.

Secondly, project documentation has to be developed, taking into account the adaptation of the engineering process to local conditions, including its positioning on the construction site, planning of building structures, provision of required resources, etc. The key points to be audited here are the correct

application of technical requirements and norms; receipt of approval of the project documentation from the inspecting and official institutions such as an Industrial Safety Expert Examination Conclusion, an Environmental Impact Expert Examination (OVOS) Conclusion, a Labor Conditions Expert Examination and others. The final stage relates to the analysis of the compliance of the project documentation with the requirements of Gavgoexpertiza (General Expert Examination Body) of the Russian Federation, in order to obtain a consolidated State Expert Examination Conclusion.

A negative conclusion could potentially lead to the termination of the project. As soon as the positive State Expert Examination Conclusion has been obtained the investor may apply for bank loans, sign the relevant contracts with subcontractors and commence construction work on the site.

## Procurement & construction phase

### *Certification due diligence*

In accordance with Russian law, a wide range of products require mandatory certification in order to be used in Russia. This means that they should be approved by the relevant Russian authorities in terms of compliance with national standards, mostly focusing on safety characteristics. This concerns both locally produced and imported goods. Depending on the nature of the materials, machinery or equipment intended for constructing a new production facility, it may be necessary to comply with one or more certification requirements. There are a number of mandatory certification systems regulated by laws of the Russian Federation (“GOST R”, “Telecom”, “Fire Safety” etc), not to mention the 522 voluntary certification systems (registered by 1.01.2008), some of which are de facto compulsory. Moreover, a special procedure is established for devices to be operated at hazardous industrial facilities (e.g. at plants producing alloys of ferrous and non-ferrous metals) and for hazardous equipment (e.g. cableways, lifts, equipment for mining activities, pressure vessels), which requires receipt of a Rostekhnadzor Permit to Use. Rostekhnadzor is the abbreviation for the Federal Service for Ecological, Technological and Nuclear Supervision, which is responsible for industrial safety issues in Russia.

Many Russian effective standards are different from and not harmonised with European, other international or national standards. Verification methods also often differ considerably from those applied in Western Europe. Namely, different standards, rules and norms are set for: machine-building

and construction designs and specifications; denomination; grading and classification of steels and alloys; plastic materials and rubbers; methods of non-destructive testing (NDT); methods of material testing, strength, stability and oscillation analysis; etc. To cite some examples: in Russia, transformers have to be tested at -40 C temperature, i.e. in conditions twice as cold as in Europe; according to Russian safety norms, 100% of joints have to be inspected by NDT methods, whereas there is no such need according to ASME in Europe due to different welding control methods. Therefore, even if a product is well-known throughout the world and recognized as safe in the EU or any other country, it may still be necessary to prove that it complies with Russian requirements in accordance with Russian methodology. The availability of some conformity certificates might only facilitate the procedure of obtaining the appropriate Russian approvals but this certificate alone would not be sufficient to cross the Russian border and to commission the installation in the Russian territory.

In view of the above, technical due diligence for the procurement phase focuses on performing an analysis of certification requirements for all project supplies so as to clearly formulate the terms of reference for subcontractors. This is particularly important if orders are to be placed with non-Russian manufacturers, which may face GOST R or Rostekhnadzor procedures for the first time. This analysis can identify methods for process optimization.

Thus, it is notable that a complex industrial installation or a complete plant (e.g. a gas turbine power station to be installed at an oilfield) requires one single Permit to Use if there is evidence that all its components realize interconnected technological functions and that each of those components meets industrial safety requirements. Moreover, the plant cannot be commissioned unless the Permit to Use has been obtained for the entire installation. Still, quite often we face the situation when, due to the lack of coordination within the project team and also due to misunderstanding of Russian laws, each supplier of minor devices and components (e.g. rectification column, pressure vessels, valves etc) is obliged by the project contractor to obtain a Permit to Use for his device. Finally, when a permit for the entire plant needs to be obtained, the Industrial Safety Expertise process will be duplicated.

For measuring instruments that are components of the installation (e.g. pressure transmitters, temperature sensors, vibration detectors) so called Pattern Approval Certificates need to be obtained. These are issued by Rostekhnadzor based on results of

tests performed by accredited State Scientific Metrological Centres. To avoid excess testing expenditures during the approval procedure, a metrological assessment of the project should be performed and detailed process documentation should be generated. Such an assessment enables the investor to select the most rational and optimal range of measurement devices and methods. For example, instead of purchasing a measuring device that has never been used in Russia and therefore is not listed in the State Register, it may prove to be more cost-effective to choose a supplier which has already passed through this timely and costly procedure.

For electrical ex-proof equipment, the GOST R Ex-Proof Certificate of Conformity should be obtained. It is issued by certification bodies that are properly accredited by Rostekhnadzor. If the device has already been certified according to e.g. ATEX or CSA, the verification process to obtain a Russian Ex-Proof Certificate can be limited to the review of documentation without any additional laboratory testing. If a range of ex-proof devices is to be delivered for a specific project, all those devices could be grouped by application scope. Thereby only one single Ex-Proof Certificate could be issued for the entire group.

When is it the right moment to review certification and permit issues with regard to project equipment? Until recently, investors in Russia used to require Certificates and Permits to Use from their suppliers at the delivery stage. However, following the Governmental Decree №87 dated 16.02.2008 modifications have been introduced to the content of capital investment project documentation that should be submitted for State Expert Examination. In particular, a new requirement concerning the availability of Certificates and Permits to Use was added allowing ambiguous interpretation. It is unclear whether this requirement applies to all process equipment used at an industrial facility or just for underground mining works. As a result, some of the non-mining projects submitted for Expert Examination in 2008 faced a negative Examination Conclusion due to the absence of GOST R Certificates of Conformity and Rostekhnadzor Permits to Use as part of the project documentation. In such circumstances, unless there are revisions in the text of the directive, certification due diligence is recommended for implementation at an earlier project stage.

### **Construction budget due diligence**

When it comes to construction budgeting, a number of critical questions arise for an investor:

*a) Is the estimate correct in terms of work volume, allocated resources and prices? Which proposal should be chosen as a result of the tender?*

On the one hand, the estimate should not be over-valued so that the investor does not have to pay more than the project is worth. This is the case when some activities are budgeted although they are not supposed to be conducted since they are required neither by law, nor by technology.

On the other hand, the budget should not be under-valued so that real costs do not appear after start-up. Such situations occur when a contractor wishing to win a tender by cost criteria, budgets the cheapest materials or does not include some necessary work in the estimate. Sooner or later these hidden costs will show up, but it will be too late to change the contractor.

*b) Do actual expenses comply with the approved budget? Are unforeseen expenditures justified?*

Some deviations from the initially approved budget can arise in specific situations due to force-major or other reasons. However, the investor wants to be sure that the increase is really needed.

To answer the above questions, construction budget verification is to be conducted either at the stage of tender proposal evaluation or at the moment of considering a budget increase inquiry from the contractor and paying invoices. A documentary check and visual inspection of the site are required here. The judgment is usually based on comparison of the project data with best practices, taking into account similar jobs and market prices, as well as on the physical need for specific construction work and materials, versus design documentation and technical requirements. Timely and professional analysis of construction budget documentation may reduce costs allocated to construction work in Russia by up to 30%.

### **Construction performance due diligence**

Throughout the project implementation, the following questions have to be answered to minimize the investor's risks related to quality, safety and the progress of construction:

*a) Is the project progressing according to the schedule? What should be done to complete the project in time?*

Work can stop unexpectedly due to equipment breakages, material shortages, a lack of labor force or documentation. Anticipation enables the project to move on in line with the established timeline.

*b) Do work volumes comply with the approved designs and plans? Do actual resources (materials, equipment, manpower), methods, technologies and work quality correspond to standards and regulations?*

Investors want to be sure that the investment realization conforms to technical documentation and is in accordance with the construction permit. A typical example is when quality materials have been budgeted, but the cheapest are actually used. To avoid a shutdown of operations in relation to quality or safety problems emerging after the building is commissioned, certainty about the quality of the building is required.

Technical due diligence focusing on construction performance verification includes on-site supervision, comparison of actual construction to the design, verification of the proper use of procedures and materials, technical inspection of the structure and supervision of (sub-)contractors, verification and acceptance of “hidden works”. The installations (electrical, heating, air conditioning, etc.) of a building can also be subject to inspection and testing. Such audits are typically based on Russian construction industry standards (SNIps), design and other normative documents, product documentation (technical passports, certificates, test protocols) and benchmarking.

The critical issue when delivering construction performance due diligence is the supervisor’s qualification. To control the building site he needs to be a professional in the construction business, well aware of construction processes and technologies, experienced and competent enough to make the construction team respect and treat him accordingly. He should also be able to not just identify a case of non-conformity, but give practical recommendations on what should be done in order to comply: changes in design, use of some technical solutions, organizational changes, etc.

## HR due diligence (Tim Carty, Ernst & Young (Moscow) Partner, Human Capital)



**Tim Carty**

Tim Carty is a Partner with Ernst & Young, one of the leading international professional services firms. He is one of two partners focusing on services in connection with personnel related matters in Russia, including individual taxation

and other employee related taxes, immigration, compensation, performance management and Human Resource effectiveness. Since his arrival in Moscow in 1998, Tim has been involved in the HR Committee of the AEB, initially as a core group member, then as co-Chair from 2002, becoming Chair in 2003. The Committee has been one of the more active within the AEB, with regular meetings at a variety of levels from core group, through open meetings, sub-committees in compensation and benefits and recruitment, to an annual day long conference instituted under Tim’s leadership.

It is often stated that not all mergers and acquisitions achieve the objectives set out for the transaction, and failure is most commonly put down to people issues. However, more often than not, the analysis of HR issues features as little more than a footnote in a due diligence exercise, and items such as “culture change” and “reworking the values” within an organisation are viewed more as a post transaction exercise for HR to co-ordinate rather than something that requires genuine viability analysis during due diligence. Clearly due diligence programs will (by force of painful experience) have a good look at pension and equity plan related liabilities, but beyond this and some brief evaluations of headcount and savings this can be “HR” done and dusted.

This approach is of course dangerous anywhere, but in Russia there are a number of additional pitfalls which should serve to bring HR matters under a greater level of scrutiny in a due diligence process. Making sure that a due diligence team can source a suitable range of professional expertise and experience in the HR area (often sat outside a formal transaction advisory group in many consultancies) is one element to be considered. The second is what the approach should be in HR related matters and it is to this issue that the remainder of this article is devoted.



Organisations conducting an HR due diligence should focus on the following areas:

### Technical reviews

- Degree of technical compliance with obligations in terms of labour relations administration
- Degree of technical compliance with obligations in terms of payroll and compensation payments
- Degree of technical compliance with obligations in terms of payroll taxes

### Benchmark reviews

- Comparisons of compensation levels of staff in the target with market
- Benchmarking of staffing levels compared to international norms, adjusted for the Russian environment
- Analysis of effectiveness of HR policies and practices

### Cultural reviews

- Analysis of leadership and management structure
- Analysis of metric data with regard to employee satisfaction, level of employee absenteeism and turnover
- Analysis of effectiveness of trade union or similar activity

Now this is a very wide ranging selection of topics, and it is entirely possible that not all of the areas will get covered, either due to time or financial constraints. Upon first glance, a reader might also think that they would dearly like to get this information, but be sceptical as to how. However, whilst it may be unfeasible to do a survey of how employees in a target organisation feel about their jobs, there are a number of methodologies that can be used to elicit a considerable degree of feel with regard to each of the above issues.

### Technical reviews

This involves having someone go through, on a sample audit basis, the documentation in all these areas. Firstly, there should be an evaluation of how the target deals with contractual terms and conditions. Do these comply with labour law? Are policies which are referred to in contracts actually in place? Are labour books properly maintained? How are terminations documented? What policies are there on performance management? Is a health & safety policy in place? In particular, scrutiny should be focused on terms and conditions of management in the target,

as this tends to be where the most money is at stake, and where the most noise will result in the event of a dispute. The second step is to see whether the rules are actually being followed, even if they are documented correctly, by means of a process review. Is sickness properly reported? Is sickness pay accurately calculated? Are accidents properly reported, and the requisite funding obtained from the social fund? Are documents signed off on a timely basis by the persons authorised to make such sign offs? The third element is to examine payroll records to check whether taxes, social security and various other employer liabilities are being calculated and settled correctly.

The purpose of the technical review is primarily to establish risk in terms of liabilities that might be attached to a failure to comply in any of these areas. Russian labour law is not that restrictive in terms of the maximum payout for redundancy (five months for an ordinary employee, which is a lot less than in many western European jurisdictions). But the major problem is that a proven failure to comply means employees are reinstated and receive back pay. In organisations with significant turnover, or with significant internal movement, there may be many exposures with financial implications attached to them. Whilst disgruntled employees (or former employees) might not raise these with the existing owners, they may do so with new ones, and hence a good understanding of whether compliance is in order is required. Also, specific rules on termination exist for executives (with potentially very material notice periods), thus the terms and conditions of their employment agreements should be carefully analysed.

Aside from the terms and conditions, another issue which typically gets on the HR due diligence agenda is vacation. It is not uncommon for employees not to use all of their annual vacation, and thus to carry large vacation balances. This in itself may create a significant liability for the company (in particular, if any redundancy is planned as a result of the transaction). But also, unless vacations are properly documented, employees may potentially claim that they have never had any vacation and request respective compensation upon employment termination.

Whilst much of this review can be done in a data room environment, the preference is obviously to dig a little deeper than this. Experience tends to show that many Russian organisations actually handle this element of their HR work really very well indeed from a formal perspective. Rather it tends to be issues that do not go through the formal HR reporting that are the problem, and identifying these comes elsewhere in the process.

## Benchmark reviews

This is where a review moves out of the technical area and into a more commercial analysis of the situation of the workforce at the target. Reviewing compensation levels against market tends to have two main objectives. On the one hand there is a need to identify whether the compensation levels at the target are appropriate or not. However, material levels of shortfall against market, particularly in executive positions, may be a good indicator that remuneration is being delivered through alternate structures which do not feature in payroll. This can help qualify both the risk assessment arising from the technical review (above) but also give a better feel for the size of the change exercise that may be needed to bring the culture in line with the purchaser's ethical standards. The most detailed compensation benchmarking should be focused on key positions, or indeed individuals.

It is also important to evaluate staffing levels to see whether assumptions in the financial modelling are accurate. But, if significant redundancy may be required, to understand the size and cost of the exercise and the potential resources that would have

to be devoted to it. Each of these elements should be capable of delivering a feel of potential levels of financing that might be involved in the HR space going forward as a result of the transaction.

Another point for consideration is the effectiveness and efficiency of the HR function and the level of fit of the HR policies and practices of the target to international standards and the local market.

In Russia, of course, there is a problem with availability of data, both in terms of the level of compensation in any given market, but also with regard to appropriate staffing levels. This situation is improving, particularly in Moscow, with four or five professional level surveys available, each with their own good and bad points, but data in more remote locations remains sparse and closely guarded.

## Cultural reviews

This is perhaps the most difficult area in which to try to produce any degree of accurate financial output in terms of risk or potential necessary expenditure, but is also cited by many organisations as being the most important in terms of plans for post transaction activity. First, this involves identification of the main

The advertisement features the TMF logo in red at the top center, with the tagline 'GLOBAL INDEPENDENT MANAGEMENT AND ACCOUNTING OUTSOURCING' below it. A red horizontal bar separates the header from the main content. On the left, there is a photograph of a mountain peak with the handwritten text 'You can rely on our expertise and commitment' in red. The central text describes TMF as a global firm with 2,500 professionals in 79 offices across 61 countries, highlighting the expertise of the Russian office. A bulleted list of services includes bookkeeping, corporate secretarial services, payroll and HR administration, domiciliary and management services, and structured finance services. On the right, contact information is provided for the Moscow office, including the address, phone numbers, website, and contact person Pavel Zhegalov, Managing Director.

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resources of the target. Who are the key personnel, and what is the impact of the transaction on the ability to retain them? Identification of key relationship holders, key knowledge/skills, key roles, top performers, etc. whose retention is likely to be key to the transaction itself, or the future success of the business. Obviously, it is quite difficult to work out who the key players are through a data room review, except for a summary of the organizational structure, reporting lines, job descriptions, etc. The key findings in this area typically come out of the structured interviews, which allow a lot of people related issues that may have a significant impact on the transaction to be revealed.

Clearly it is also important to determine employee attitude to the target, but direct solicitation of this will be tricky. There are metrics that should be available however, including turnover statistics, sickness and other absentee levels, timing of returns from maternity leave, numbers of accidents; all of which give a feel of the attitude. The role of the unions should also be examined, together with the results of and reason for any formal employee disputes in recent years. Outside the target itself, there should be at least some attempt made to determine the state of the local market, including the likelihood that staff may rapidly find alternative work.

Beyond these items, which can be addressed in a due diligence situation, there is a host of other types of cultural analysis, particularly in terms of skills evaluations, competency reviews, and performance which are vital to any change exercise but are much more difficult to do prior to a transaction. However, even at the due diligence stage the purchaser may be able to sense what the main areas of focus in the post transaction stage will be.

Occasionally organisations can get scared of the complexity of dealing with HR related matters in a due diligence in Russia, and it is all too easy to simply state that the area is of limited materiality in making investment decisions. However, the degree of potential risk in the personnel area can be considerable, the degree and variance of financial effort also significant, and the ultimate success of the transaction will be substantially dependent upon getting the people aspects right. Whilst far from perfect, it is increasingly possible to more easily quantify some of these risks and costs, and HR is likely to feature more and more often as an important element of any properly structured due diligence in this country.

## Environmental due diligence (Galina Ermakova, Deputy Director, Advisory Group Environment, Royal Haskoning Moscow)



**Galina Ermakova**

Galina Ermakova holds the position of Deputy Director Advisory Group Environment in OOO Haskoning Consultants, Architects and Engineers a company of Royal Haskoning. Galina has experience in the field of environmental auditing

and environmental risk evaluation in different sectors of industry. She is well aware of the environmental legislation and regulatory standards of the Russian Federation and CIS countries, as well as International Financial Institutions (IFIs) standards. Her key areas of expertise are auditing, analysis of environmental management systems, legislation reviews, permitting and advisory support. Galina graduated from the Moscow State University, Geography Department.

Galina leads EHS due diligence projects of Royal Haskoning in Russia and CIS countries. Galina has experience in the field of environmental auditing and environmental risk evaluation in different sectors of industry. Galina has participated in EHS due diligence projects for both the private and public sector. She has worked also as environmental consultant for Russian/CIS countries oil and gas and metallurgical companies since 1998. Her key areas of expertise are auditing, analysis of EHS management systems, legislation reviews, permitting and advisory support.

Nowadays industrial property transactions are becoming more and more complex, so in addition to legal and financial due diligence companies also need to assess the performance of the target property in relation to environment, health and safety (EHS). However, such assessments are not yet widely used in transaction activities in Russia, not even in businesses with high risk. This is due to the fact that Russian companies often do not associate environmental issues with financial risks and liabilities. At the same time, an incorrect or insufficient understanding by companies of their EHS risks and associated liabilities in practice can lead to significant financial expenditure, as well as damage to the company's reputation. This is especially relevant where the legislative framework for liabilities associated with environmental issues is unclear.

Environmental, health and safety due diligence is a systematic assessment process to identify potential liabilities associated with the ownership of real estate, industrial operations or other activities which could harm the environment or have an effect on public health and safety. Typically the process is carried out in two phases, with information collected and compared against a set scope and criteria in Phase I. The most crucial environmental and public health and safety issues are then identified and focused on in the Phase II assessment. Field or laboratory tests (for example identifying soil contamination and groundwater pollution) may be required to fully identify the critical issues of concern. This is followed by an evaluation of the associated EHS risks. Opportunities can also be identified, for example in terms of potential pollution prevention and cost savings. An EHS due diligence assessment can therefore be seen as an essential risk reduction measure.

### When and why is EHS due diligence required?

EHS due diligence is usually performed to enable investors, purchasers or owners of industrial, commercial or agricultural property to identify and estimate the size of potential EHS risks and assess potential financial, reputation or criminal liabilities associated with owning or operating a certain site. EHS due diligence assessments are primarily initiated during company mergers/take-overs, as a condition of a loan agreement, following EHS accidents or near-accidents on the site or in the relevant industrial sector, following a change in legislation or as a requirement of an international EHS management system.

### Phase I EHS due diligence process

The available time for an EHS due diligence assessment is usually limited. Nevertheless adequate preparation is necessary to ensure that the due diligence assessment has an appropriate scope, uses resources efficiently and focuses on the most relevant issues. A competent assessment team is a key requirement to this process. It is crucial that the appointed team is experienced with Russian EHS related legislation and practice, and is aware of trends and the potential influence on the planned activity. The scope and criteria of the assessment are determined in cooperation between the assessment team and the client. The main actions to be taken are as follows:

■ **Site visit preparation.** A summary of the EHS issues that are likely to be of concern is developed. A more generic checklist is prepared for the site visit.

■ **Site visit and information collection.** This includes a site tour, interviews with EHS and technical/operations management, and document review. Information collection entails gathering relevant data through questionnaires, document reviews, inspections, interviews, sampling, analysis and data validation. Such information may be divided into two groups, such as general and EHS performance related information. General information includes data on the target property, its location and surroundings, the history of the target property and its surroundings, environmental conditions (e.g. climate, geology and hydrogeology) and social setting. The EHS performance information includes data in relation to permitted and actual air emissions, permitted and actual water use and wastewater discharge, use of hazardous materials, waste generation, handling, storage and disposal, restricted substances (asbestos, ionizing substances, PCBs etc.), occupational health and safety issues (key health issues, noise and vibration, emergency preparedness, fire prevention, etc.). One of the constraints during information collection is caused by the low awareness in Russia of the issues considered significant by foreign investors (for example asbestos containing materials, PCBs, underground tanks).

■ **Report preparation** including development of the EHS action plan and associated cost estimate.

The duration of a Phase I EHS due diligence is typically 3-4 weeks.

### Phase I EHS due diligence report

The scope of EHS due diligence assessments varies for different sites and objectives, and based on the key liability issues, specifications of the client and other aspects in relation to environmental, health and safety performance.

The EHS due diligence report may cover the following:

- Issues in relation to environmental permits required for the target property (permit for air emissions, wastewater discharge permit, contract for water use etc.);
- Air emissions;
- Water use and wastewater discharge;
- Waste management;
- Hazardous materials;
- Soil and groundwater issues;
- Restricted substances (asbestos, PCBs, ionizing substances, ozone depleting substances);
- Energy supply;
- Noise and vibration;

- Occupational health and safety (e.g. workplace conditions, emergency preparedness and response, fire and explosion prevention).

The results of a Phase I EHS due diligence are presented in a report which may provide input for the company's risk management register and should support the company's risk assessment and decision making process by providing the following data:

- Identification of the key issues of concern (absence of permit documentation, non-compliance with regulations and permits, poor hazardous materials management practices, potential soil and groundwater contamination etc.);
- Recommendation of actions which are strictly required (in case of non-compliance with local/national regulations) or recommended (in case of non-compliance with best EHS management practice);
- Estimation of the approximate costs associated with the actions to perform further investigation (Phase II EHS due diligence assessment).

Alternatively, if no EHS issues of concern were identified, the Phase I EHS due diligence report will state this and there is no need to proceed to Phase II.

## Phase II EHS due diligence

The findings of the Phase I EHS due diligence process often trigger a Phase II assessment. Usually the aim of the Phase II EHS due diligence is to identify whether soil or groundwater at a location are con-

taminated with hazardous substances, such as oil, solvents, PCBs, heavy metals and pesticides. This type of investigation often involves drilling into the subsurface to obtain soil and groundwater samples for laboratory analysis.

However, the Phase II EHS due diligence is not always limited to soil and groundwater investigations. Depending on the issues of concern identified during the Phase I EHS due diligence a range of surveys may be required. For example, such recommended studies may include an asbestos survey, subsurface air quality test or surface water survey.

The duration of a Phase II EHS due diligence assessment depends on a number of factors, e.g. the complexity of the site, size and nature settings at the site, etc. However, most Phase II EHS due diligence assessments are completed within 1.5-2 months. Based on the results of the Phase II EHS due diligence detailed recommendations are developed on the further required actions.

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## ISSUES DURING AN ACQUISITION

### Structuring a transaction (Peter Arnett, KPMG, Partner, Tax)



**Peter Arnett**

Peter has worked in the accountancy and tax professions for more than twenty years. His technical strengths lie in local country tax optimisation, cross-border tax planning, in-bound investment and transfer pricing. Before joining

KPMG in Russia in 2004, Peter worked for eighteen years with one of the other Big 4 accounting firms in London, Moscow and Singapore. During his previous posting in Moscow (1996 to 2001), Peter was elected chairman of the tax committees of the American Chamber of Commerce and of the European Business Club, in which capacity he represented the interests of businesses in Russia in discussions with the Russian Government on tax reform, particularly regarding profits tax, VAT, tax administration and transfer pricing. He has considerable experience of M&A tax due diligence and tax planning for transactions and headed up KPMG Russia's specialist tax team in this field from 2006 to 2007.

With all the difficulties of getting a deal done, it is perhaps not surprising that consideration of the legal structure for the future business is often put aside until after the transaction is executed. Whilst not surprising, it is also one of the places where value can be lost by not taking into account the time and cost of implementing desired changes.

Lost management time in lengthy processes, advisers' fees and additional tax costs are among the possible consequences that can result from changing (or failing to change) the established legal structure of a newly acquired business. Even if some such costs are unavoidable, they impact the economics of the acquired business and, therefore, the valuation.

Each transaction is unique, with the consequence that there is not a "best way" to structure or conduct a transaction. This article addresses some of the issues that typically arise and their effects.

### Governance

Consider the ownership structure where a transaction does not entail the purchase of 100% of the eq-

uity. This may be an acquisition of less than 100%, a merger of business interests, a step acquisition or similar transaction.

In such situations Russian corporate law may not offer sufficient protection. In a joint stock company it is not possible to restrict a shareholder from selling their shares, although pre-emptive purchase rights do exist. In a limited liability company the sale of participation units can be prohibited, but the investors' withdrawal from the company cannot. Upon withdrawal, the company must pay to the withdrawing investor its share of the company's net assets. Whilst shareholder agreements can cover these issues, such agreements amount to no more than a mutual promise not to do what the law otherwise allows and it is far from certain that a Russian court would enforce such agreements.

Company law provisions that protect the rights of minority shareholders can also be taken advantage of in situations where partners are no longer on good terms. Finally, the Russian court system is seen by some investors as not yet being fully impartial.

Together these issues suggest that where possible it is often preferable for a Russian company to be wholly owned, with any joint venture arrangement subject to an offshore jurisdiction where the legal system is more predictable and agreements more certain of enforcement.

In those situations where shareholdings cannot be moved to other jurisdictions and particularly where the transaction is not a majority acquisition, the corporate governance of the Russian group should be carefully considered. In a structure with a Russian holding company that has its principal commercial assets in subsidiaries, it can be difficult to prevent those assets from being transferred at less than fair value. Consideration should be given to acquiring a direct stake in the main companies rather than just a stake in the holding company.

### Russian holding companies

A Russian holding company is often considered as being the means by which a foreign investor can establish a corporate presence, as an acquisition vehicle – especially if a series of acquisitions are planned. Such a company can be a financing conduit, can provide corporate head office functions and can concentrate dividends from the subsidiaries before payment offshore. However, this structure is also likely to be very inefficient in any business model that envisages profit flows out of Russia as dividends.

With a 9% withholding tax on dividend payments between Russian companies, which tax is not credited against any withholding tax on dividend payments offshore, the tax cost of dividends paid through a Russian group structure is quite high (profits are paid out of post-tax profits, less 9% withholding tax, less at least a further 5% withholding tax under a double tax treaty upon payment offshore). This inefficiency is understood by the authorities but steps to address this effectively may take a while to bear fruit. Recently an exemption from the 9% withholding tax was introduced for very large investments, but this currently benefits only a very few investors and the criteria will need to be relaxed if it is to be more generally useful.

Under thin capitalisation rules, routing financing through the ownership chain may also limit interest deductibility (which currently can be avoided relatively easily through structuring the financing differently).

Finally, in the absence of group relief or tax consolidation in Russia, group head office cost recharges often result in deductibility issues and lost VAT recovery within subsidiaries. This can be manageable if planned properly, but remains a significant risk for companies.

As a consequence, a typical holding company structure in Russia is not necessarily the most tax efficient model and the future tax inefficiencies can be quite costly.

## Transfer pricing

Although transfer pricing regulations do apply to cross-border transactions, they are not applied in a manner comparable to how many foreign investors expect. Transfer pricing rules have largely been used to challenge transactions between Russian companies, since the absence of tax consolidation or group relief has led to the common practice that transfer pricing has been used to move profits to wherever required within Russia.

Acquiring a company that has used transfer pricing this way inevitably raises the risk of historic tax costs from transfer pricing challenges. Even though these challenges are not very effective at present, it cannot be assumed that they will remain that way.

Although these risks should be identified during due diligence, consideration needs to be given to whether there is a need for structural changes to mitigate these risks in the future. For example, if market-driven pricing between group companies (e.g. production and distribution) is not the preferred business model, then consideration will need

to be given to merging companies and establishing branches. This eliminates the transfer pricing risk, but only after the various steps are completed (which can entail considerable time and cost).

## Asset deals

Asset deals can often seem more attractive than share deals to the buyer, as historic tax liabilities can be left behind with the former owners. Partly for this reason, but mainly due to the tax issues this can cause for the seller, asset deals are often unacceptable to the latter.

However, in service or people businesses this is more viable. In such businesses there are typically very few assets involved that are on the balance sheet; the real value of the business is in the customer base or the people.

As a consequence, restructuring such a business as a new company prior to the proposed sale is feasible. To do this customers and people must be transferred to the new company, which entails administrative work (changing contracts, including supplier contracts), but which has been done successfully.

This can often be attractive to the seller due to the possibility of restructuring such a transaction as an offshore transaction (see below). If such a restructuring takes place, there is also an opportunity to consider the future business model and to make other changes at the same time.

Such a business transfer is not as simple as a share deal as more steps are involved. However, this may still be a preferred option if this allows the new owner to avoid inheriting the tax risks of the existing business.

## Offshore acquisitions

In many transactions the seller will not have restructured the business in preparation for a sale, but will simply expect a low value transaction within Russia with the balance of the purchase price (often the majority) to be paid offshore to a company not otherwise part of the deal.

This is often an opportunity to require the seller to restructure the business such that the transaction actually becomes an acquisition of an offshore vehicle. This can achieve the seller's objective of realising the gain outside of Russia but is also generally beneficial to the buyer (not least because it makes the transaction more transparent).

With the requirement for prior antimonopoly authority approval for larger transactions (including

simple group reorganisations), as well as the quite bureaucratic steps required to re-register Russian legal entity charters, it is often easier to sell an offshore holding company than the Russian company itself, although antimonopoly requirements must still be considered even for an offshore transaction. These are not the only benefits from an offshore group restructuring. Such a structure can also be used for eventual exit planning.

## Complex structures

It is not uncommon to find Russian groups, even in medium sized businesses, with a group structure that is complex and involving many companies with multiple cross shareholdings. It is also often the case that whatever historic logic there was for such a structure is no longer relevant.

It may be possible to carve out of such a structure those parts that the buyer is interested in (leaving behind the dormant and redundant companies). It is more likely that some degree of restructuring will be needed prior to the transaction. In either case it is worth considering how much of the redundant structure can simply be left behind (although care is required to ensure that such companies are not the actual asset owners, brand holders or similar). Such complexity is unlikely to be desirable in a newly acquired business and yet it can take a significant amount of time (and cost) to clear up.

*The author wishes to acknowledge the prior contribution of Jim McKinven, Partner, KPMG, Risk Management, on which this article is based.*

## Financing a transaction (Dr. Vladimir Ismailov, CFO/Deputy CEO, Specta AG)



### Dr. Vladimir Ismailov

Dr. Vladimir Ismailov is CFO with Specta AG, supporting a range of corporate business functions of the group of companies specializing in steel based and other types of industrial packaging and marking in Russia and the CIS.

Vladimir holds a PhD in Economics, as well as being a Certified Auditor of the RF and Member of the American Institute of Certified Public Accountants. He has a great deal of financial and auditing experience in a range of business sectors, having worked in the Media & Information sector, OEM, Telecom services and in public accounting and auditing.

Area of expertise – foreign investments and finance

While developing business plans for your new or expanding business, it is important to have a clear understanding about sources of financing that are available to companies in Russia and get an idea of the “local” specifics associated with some of them.

Limited cash resources may restrict a company’s ability to meet its business objectives and, therefore, may lower returns and negatively impact the company’s value. Excess cash may represent an opportunity to increase the effectiveness of the business through a balanced investment program and may become a good leverage tool in internal discussions amongst top managers, the board and shareholders.

Most companies in Russia are similar to companies in the rest of the world in trying to find a balance between various funding options, and the advantages and disadvantages related to them.

## Types of short-term financing tools

Examples of short-term funding instruments may include:

- Cash,
- Short-term investments (deposits etc.),
- Accounts receivable,
- Accounts payable,
- Bank overdraft facilities,
- Factoring arrangements, etc.



Most companies in Russia use only the first two instruments extensively, thus overlooking the great potential for additional cash flow through other types of short-term financing. For example, it is hard for managers of companies working in Russia (similarly to in other parts of the world) to appreciate the advantages of micromanagement of receivables and payables. Some financing options may not be very well known to the market and/or there may be no legal infrastructure to support them. For example, factoring is still a relatively new tool in Russia and the legal framework for this instrument is still in the development stage.

On the other hand, the banking industry in Russia is very heavily regulated. The prime regulator for banks is the Central Bank of Russia (“CBR”). The CBR dictates industry rules, monitors compliance, issues and revokes banking licenses, controls cross border and capital transactions, and micromanages the foreign exchange mechanism including exchange rates.

Bank overdraft facilities are very uncommon in Russia due primarily to the underdeveloped credit risk system in Russian banks. Some local banks are not keen on implementing financial instruments that are uncommon due to a lack of internal culture and unclear regulation from the CBR.

Therefore, before choosing a short-term instrument for financing a business it is important to assess the capabilities of internal resources (not just financial, but also HR, IT etc.), the capability of local management who will have to carry out daily micromanagement of the situation, and external factors such as the capabilities of counterparties (banks, clients, vendors etc.) and level of risk that the company is willing to tolerate.

## Types of long-term financing tools

Examples of long-term funding options may include:

- Bank loans,
- Fixed income financial instruments (bonds etc.)
- Derivatives (futures, swaps, hedging contracts etc.),
- Leasing arrangements,
- Retained earnings and reserves,
- Equity financing.

Again, only some are commonly used in Russia at present. Others are still a “premier league” attribute that are used by companies that have the resources to hire skilful finance and executive staff who can micromanage these instruments on a daily basis.

Bank loans are probably the most common long-term financing tool. However interest rates for bank loans are marginally higher than those in Europe and the US. Therefore, companies are exploring less expensive financing options.

The bond market in Russia has developed into a sizable tool for less expensive funding and less risky investments. Last year the internal and external (Eurobond) new bond market grew approximately USD45 billion<sup>1</sup>.

Before making a decision on the preferred type of funding one should carefully consider various aspect of the project:

- The existence of a developed market for the particular type of funding (for example, RMBS (residential mortgage backed securities) and CMBS (commercial mortgage backed securities) deals are just entering the Russian fixed income market).
- The existing legal framework (licensing, compliance with cross border funding regulations etc.).
- The time required to arrange funds (some types of funding, for example increasing share capital, may take several months to arrange).
- The availability of internal non-cash resources to support the project (a legal department to draft the necessary documents, a finance team which can work closely with banks, a business model and strategy that supports assumptions and scenarios, etc.).
- The presence of qualified consultants (investment bankers, lawyers, etc.) who may support the need for funding.
- The availability of a credit history, ideally supported by a credit rating and corporate governance score from a well recognised agency.

Despite the fact that equity and debt financing is a very complicated area of business management, Russian companies and even local subsidiaries of multi-national companies are moving into the corporate debt market very swiftly. Most companies used equity financing as their prime source of funding in previous years. However, quite a few companies and financial institutions have recently come to appreciate the benefits of sophisticated debt financing instruments. Local companies usually place debt and equity instruments at local exchanges (RTS and MICEX) and/or international debt and equity markets. In total, Russian companies raised over USD20 billion in 19 IPOs in the first ten and half months of 2007<sup>2</sup>. The European capital markets are currently attracting a significantly larger number of equity

<sup>1</sup> [www.Cbonds.ru](http://www.Cbonds.ru).

<sup>2</sup> [www.offerings.ru](http://www.offerings.ru)

placements than the US or any other markets. This is due primarily to the more rigorous regulations at NYSE and NASDAQ introduced by the SEC after the well-known series of corporate fraud scandals. Although European countries are actively discussing restrictive measures against extremely active foreign investors. This primarily concerns government investments from emerging markets and Russian companies with international business interests. This may eventually divert the interest of Russian companies to Asian markets, particularly Hong Kong and Singapore.

Financing your business in Russia is just as challenging as in other markets. Before making a decision in favour of a particular strategy one should fully assess the pros and cons of each scenario. Even though there are plenty of skilful advisors available in the market, the ultimate decision will be left for the owner(s) of the business.

## INDUSTRY SPECIFIC ASPECTS OF INVESTING IN RUSSIA

### Investing in the Russian insurance industry

(Tom Manson, Manson McCall International Ltd.)



**Tom Manson**

Tom Manson began his insurance career in Lloyd's of London where he became managing director of a number of Lloyd's syndicates, specialising in most types of insurance and reinsurance. He first visited Russia to discuss the

development of insurance in 1989 and since then has followed closely the growth of the insurance industry and is now acknowledged as one of the leading analysts of the insurance market, not only in Russia but in other countries of the former Soviet Union.

In recent years he has identified the need to raise capital as one of the key problems facing the insurance market and has helped a number of insurance and reinsurance companies find investment partners. He has worked closely with these companies through the whole process from the initial preparation of information to the conclusion of the final contracts.

The Russian insurance industry is now growing rapidly and it has the potential to continue growing for many years. The country has a large population which currently buys few insurance products, but as economic growth continues, more Russians will have the financial security that will encourage them to insure their property and to obtain financial protection from life insurance and pension products.

The numbers are large. In 2006, UFG, the investment bank that is now owned by Deutsche Bank, forecasted that non-life insurance alone would grow from about USD12.5 billion in 2006 to over USD100 billion in 2016. It seems that there is no reason to change this estimate based on 2008 experience, despite the fact that current world financial instability could have a short-term impact on growth rates.

On the face of it, this potential for substantial long-term growth should attract international investors. Yet the amount of international investment that the insurance industry in Russia has attracted so far is relatively small and the investments that have been

made have almost all been made by major international insurance companies – strategic investors.

Yet the obvious growth potential has aroused a growing interest from financial investors. Investment in insurance is difficult everywhere in the world: investing in Russian insurance is doubly difficult since there are a number of unique problems facing the insurance market. The aim of this article is to identify the real problems that face potential investors in Russian insurance, but at the same time to suggest investment strategies that might overcome the difficulties.

### The difficulties facing investors

The first set of explanations for the current low level of investment and its dominance by strategic investors relate to features in the post-Soviet economy that have hindered the development of an insurance industry. Under the Soviet Union, no commercial property was insured: this means that there is little experience of many important classes of non-life property/casualty business. This has clearly hampered growth in the past and still results in a shortage of specialists in the industry.

More importantly, the life insurance industry in Russia hardly exists even today. The hyperinflation of the early 1990s wiped out the value of millions of life insurance policies and the mistrust in financial institutions remains to this day. There are signs that long-term life insurance is beginning to grow, but premium volumes are, as yet, not significant.

These issues can and will be overcome in time but clearly the lack of experience and the slow growth in the past have led to potential investors delaying entry into the market.

Further long-lasting problems result from the way in which the industry has developed in Russia since the end of the Soviet Union. As the financial sector developed, insurance companies carried out a number of functions for clients which were not insurance as it is recognised outside Russia. Most of these functions related to tax minimisation and the figures were substantial: in the early 2000s, it was estimated that well over 60% of total industry premium was derived from such schemes. In addition, most major industrial groups had their own insurance company to carry out these schemes. Some of these 'captives' were amongst the largest insurance companies in the country and some still are today.

From an investor's point of view, this development history has led to substantial difficulties in as-

sessing potential investment partners. Many of the companies that appear to be the largest have only a relatively small proportion of their 'business' derived from standard insurance products. This problem is exacerbated by the Russian accounting system which makes it difficult to assess accurately all financial information provided by insurance companies.

### **Investment in non-life insurance**

As already noted, non-life (property/casualty) insurance predominates since life insurance hardly exists today in Russia.

Strategic investors are well aware that the class of business that invariably dominates a 'developing' insurance market is motor insurance. In all Eastern European countries, motor insurance is the largest non-life class and in many countries, motor insurance premiums account for over 60% of the total. Strategic investors are also well aware that developing markets have difficulties in pricing motor insurance and controlling claims: as a result motor insurance is often unprofitable in these markets in the early years of their development.

Russia is no exception to the rule that motor insurance dominates developing markets and the caution of strategic investors has meant that they have either tended to hesitate before entering the non-life market or have entered in a small way, minimising their exposure to types of motor insurance that could lead to underwriting losses.

### **Long-term life insurance**

Given the perceived unattractiveness of non-life business, the majority of strategic investor interest has been in the long-term life sector. Here, the absence of any real competitors has meant that a 'greenfield' approach has been the norm: there are in reality no life insurance companies to buy!

Strategic investors have the experience of developing markets and can import trained staff into a region where few locals have the necessary skills. Strategic investors also have deep pockets and are able to take a longer term view of an investment that is unlikely to show a profit in the short term, but where the long term growth prospects are so substantial.

### **Developing an investment strategy**

There are a number of possible ways in which financial investors can enter the Russian insurance market. At the moment it is not possible simply to buy

shares through a stock market since no Russian insurance company has yet gone through the hurdles of an IPO. As a result, all available strategies will involve a private purchase of shares in a Russian company and this will inevitably require a more 'hands on' approach by a cautious investor. It is simply not prudent to invest in companies at their current stage of development without exercising some degree of control over their operation.

### **People are vital**

It has already been noted that it will be difficult to determine exactly what business any potential partner has generated. The assumption must be that in both life insurance and non-life insurance, the quality of business is likely not to be high, given the current state of development of the market. For this reason, the reliability and ability of the people with whom the investor is proposing to do business becomes absolutely vital. The investor must either be comfortable with the current management team or must be confident that it can be strengthened enough to make the business successful.

All insurance skills are in short supply in Russia, and experienced high level insurance executives are almost non-existent, especially in the area of financial control, underwriting control and actuarial work. Assessment of current skills and recruitment in areas where experience is lacking must be an integral part of any investment strategy.

### **Questions to ask**

At the outset, there are two vital questions that must be answered before any rational investment decision can be made. The first question is 'how much scheme business is there?'. If the potential partner is not prepared to address the question as to how much of the recorded premium income is business that would be recognised as insurance outside Russia, then an investor must begin to be concerned about the possibility of reputation risk: tax reduction schemes will always lead to the possibility of falling foul of the tax authorities.

A second question relates to the real value of assets in the balance sheet of the potential partner. Many Russian companies have in their balance sheets assets that would not be considered assets under international accounting methods. Sometimes these assets form a large proportion of the total capital (net assets) of the company and therefore a revaluation, using international methodology, would make a considerable difference to the financial posi-

tion of the partner. Again, a failure to discuss the real financial position of the company could cause problems, since a lack of capital could lead to future solvency problems if the business is not profitable.

### **How profitable is the business?**

Russian accounting methods do not encourage companies to report on the profitability of their business using standard international methods. The standard Russian loss ratio calculation merely compares cash received against cash paid out, and in a market that is growing strongly, these figures underestimate the actual loss ratios, which include premium and claims reserves.

Financial investors should learn from strategic investors who are fully aware of the danger that the largest component of almost every non-life insurance company in Russia – the motor account – could well cause losses, now or in the future. For this reason, no investment should be made without a clear assessment of profit trends in all major classes of business using standard international methodology.

### **Insurance reserves**

In a developed insurance market, investors pay considerable attention to the adequacy of claims reserves. There have been a number of examples of investments being made in companies that subsequently turned out to be significantly under reserved, usually because of problems in the liability/casualty account.

In Russia, the adequacy of claims reserves is not normally a major problem, largely because liability/casualty business is underdeveloped. Motor business in particular is very 'short tail' and there is little evidence that outstanding claims reserves need to be a significant proportion of premium. The key areas where problems can arise are in the assets, as noted above.

### **Distribution**

One issue that will undoubtedly be raised is the distribution network that the company has established. In general, these networks have been established relatively recently and the result is that companies often have not developed methods of controlling the work of branches, which may be far away from the head office. The local staff are likely to be inexperienced and yet there is competition for these employees as many companies attempt to establish branch networks at the same time.

This lack of control is often made worse by the poor quality of the IT systems available to most companies. Most have been developed in house and are based on Russian accounting requirements rather than the need to impose management controls. Any investor should be cautious about assessing the value of the distribution system and should also bear in mind that it is highly likely that in the medium term, improving the IT system will be essential.

### **Valuation of the company**

Once the questions noted above have been satisfactorily answered, the investor will have some idea about the real business of the potential partner, the real value of its assets and how profitable it is using international methodology. Using these figures, the investor will be able to make a first assessment of the value of the company. It should be realised that this initial assessment is unlikely to be based on an IFRS audit: few companies undergo such an audit and whilst there are plans to make the industry move towards international audits (as in banking) nothing concrete has yet emerged from the insurance supervisor.

As has already been noted, the number of deals that have taken place in Russia is small and since all have been private deals, real concrete information about them is hard to obtain: no one is certain how the companies were valued or how the deals were structured.

This means that the valuation of companies can lead to very substantial differences between the parties. Clearly, the seller will try to base the current value on future cash flows and given the substantial growth possibilities, high multiples of future earnings will be used. Using a multiple of net assets is likely to lead to a substantially lower valuation.

Because of these types of differences, most investment deals are based on staged payments based on actual performance of the company over a period of time. In this way, not only is a vast overvaluation of the company avoided, but also a mechanism can be put in place to tie in key staff who will be vital to the future prospects of the company.

### **Financial due diligence**

If the above strategy has been followed, financial due diligence will be confirming answers to the key questions that have already been asked. Here experience shows that companies are not used to providing detailed information rapidly, especially where current systems need to be changed to provide data in a

format based on international methodology. For this reason, a potential investor should foresee the possibility of delays at this stage. It is also important to choose the advisor carefully since the advisor should be fully aware of the problems and ideally should have had experience in insurance due diligence.

### Legal due diligence

Legal due diligence in insurance is also likely to require the appointment of a legal advisor with experience of the specifics of Russian insurance so that some of the substantial potential pitfalls can be avoided. There are not many Russian or international companies with such concrete experience.

### Conclusion: developing a strategy

All investors should have a strategy. To invest in a company without having a clear idea how that company will flourish and grow in the context of its specific market is highly short-sighted.

Investing in insurance in a developing market requires a strategy that holds out long-term profitable growth. Strategic investors are well aware that in insurance it is simple to increase premium volumes: all that is required is for the company to reduce its prices and the business will flood in. Yet strategic investors know that such a strategy results in disaster. In the short term premiums increase, but over time claims also increase and because of inadequate pricing, losses result and the company either has to inject more capital or goes out of business. In other words, an investment strategy that aims for 'market share' or just 'growth' is a recipe for disaster in insurance.

At all times, the investor must bear in mind that the objective is to achieve profitable underwriting and that requires more than distribution: it requires choice and selection of business.

In Russia today, there is little evidence that this fundamental rule of insurance investment is widely appreciated, but that gives substantial advantage to a wise investor who does realise that to obtain long-term growth, profitable underwriting is more likely to be successful than aiming for market share and for 'growth at all costs'.

## Russian banking system: investment opportunities in a downturn

(Philippe Delpal, President of "BNP Paribas Vostok" Bank, Chairman of CETELEM (Russia))



**Philippe Delpal**

Philippe Delpal is Global Head of International Retail Services (IRS) of BNP Paribas Group in Russia since November 2007. Philippe brings over 14 years of banking industry experience to the role, having garnered extensive knowledge

in various business lines in leading banks. Prior to joining BNP Paribas Group, Philippe worked for Société Générale Group (1996–2006), Bank Indosuez in Hong-Kong and the European Organization for Nuclear Research in Geneva (1996). In 2007 Philippe acted as the Banking Committee Chairman of the Association of European Businesses in Russia. In 2008, he was named one of the "TOP 1000 most professional managers of Russia – 2008", the rating compiled by Association of Managers of Russia and Publishing House Kommersant. Philippe Delpal graduated from Ecole Nationale Supérieure des Télécommunications – Telecom Paris in 1994.

*The world economy has changed dramatically in just 14 months and these changes are continuing at a reactive pace today throughout the world, including in Russia.*

The last four decades have shaken the world economy with four events: the LDC debt crisis of the 1980's; the 1987 stock market crash; the 1997-98 Asia, Russia, Long Term Capital episode; and the current credit market crisis. With the midsummer credit crisis in 2007 which turned into a depressing year for the world's financial markets, the second half of 2008 has become the moment of truth for Russia as well.

At the beginning of 2007, the future of Russian industries, including banking, looked quite confident on the back of the global problems with liquidity. Since 2003, real disposable income has doubled, and a series of banking and financial sector reforms has improved investor confidence; with an average growth rate of 7% per year between 1999 and 2007, Russia's GDP regained its 1990 level in mid-2007.

The rapid growth of the Russian economy has been driven by high oil prices, increasing export revenue, fiscal surpluses, and domestic demand. Economic growth has been also driven by a consumption boom (12% on average since 2004) and, since 2007, by rapid growth in investment (20.8% in 2007).

Just six months ago the Russian indexes beat the historical records almost every day, and Russia has received the status of “a harbor of financial stability in the raging sea of the world crisis”. After a short episode of overheating, the economy has been slowing down since that moment, which has become a period of soft landing. The deceleration was marked in investment, construction and real estate sectors. Inflation has become the second hot issue on the back of the financial crisis, when the food price shock caused the acceleration of inflation up to 15% in August 2008. The outlook of the financial markets does not have a positive tone due to the decrease in oil prices, the sub-prime related financial crisis, claims against business leaders of Mechel and TNK-BP, and Ossetia related stress. The capitalization of the Russian market according to the RTS decreased below USD 500bn in August 2008, while in May it was more than USD 1.4 trn.

Obviously it is impossible to capture the difficulties of the current situation in a few sentences but I do think the key points of what happened and why it happened are clear.

On the back of the significant outflow of money in August-September 2008, the global liquidity problems arose in the Russian banking system. In September fears about the ability of small and medium-sized banks to respond on their payment obligations were transformed into the inter-bank confidence crisis, with the wide-spread closing of inter-bank credit limits. The Finance Ministry and the Central Bank of Russia reacted rapidly by providing additional liquidity to the system and increasing the volume of funds available for banks via all possible channels.

The next measure was the increase by the Central Bank of the maximum amount available for REPO operations to RUB 350bn (USD 14bn), which was increased further to the record level of RUB 430bn (USD 17bn).

State-owned banks, which account for almost half of the domestic loan market (Sberbank, VTB, Gazprombank), received an additional RUB 1,125bn in deposits from the Ministry of Finance with increased maturities of the deposits. However, the ability of the leading banks to rapidly pass on the liquidity to other financial sector players via REPO operations has been insufficient. For stabilization of

the situation on the inter-bank market, this facility was available to the top-28 banks only.

The next step was the announcement by the Russian Ministry of Finance its readiness to increase the maximum deposits available for private banks from 15% of their capital to 25% and from 40% to 50% for the leading banks.

At the end of October 2008, new liquidity facilities were opened: 116 banks were allowed to borrow from the CBR for up to 6 months without collateral. The first auction was organized at the CBR on October 20: 70 banks withdrew RUB 387.7bn for maturities of 35 days. In the short term, this measure could act as a powerful tool for maintaining bank liquidity, and in the medium-term, it should increase the role of the Central Bank as the regulator of the money supply, which is a necessary step towards inflation targeting.

An effective measure was undertaken for the private sector: as banks started to experience withdrawals of individual deposits, in order to avoid a run on households' deposits, the deposit insurance guarantee was increased from RUB 100,000 to RUB 700,000 (USD 27,000). In addition, in order to limit the impact of this measure on banking costs, the cost of deposit insurance was reduced.

For the moment, despite the forecasted deposit outflow in private banks partly compensated by the in-flow in state-owned banks, a massive run has been avoided. Banks have been trying to limit deposit withdrawals, notably via increases in commission for non-scheduled deposit withdrawals, various marketing campaigns with gifts and lotteries, and increases in deposit interest rates.

The general outlook demonstrates the fact that the state authorities reacted rapidly to provide the liquidity necessary to avoid the collapse of the system. However, currently, there is still scope for additional measures to be taken to restore trust and the financial system's “healthy” running.

In an uncertain situation on the financial market, banks keep excess liquidity, minimize their operations on the inter-bank market and have reviewed their credit programs. Some banks even stopped financing both short-term and long term loans. Still, even with the extensive support for the banking system from the central authorities, the banking system experienced a deposit outflow in September: Russian citizens withdrew 1.5% of deposits from the private banks. However, at the same time the state banks, VTB and Sberbank, benefited from their status through increased in-flow of deposits. In this case, the consolidation of the banking business around the biggest state-owned banks is becoming more and more visible.

The first bank that benefited from direct capital support from the government was VEB when it was granted a RUB 75bn (USD 3bn) capital increase. In addition, the government will provide support for the capital of other banking institutions via the mechanism of 10 year subordinated loans, which will consist of subordinated loans from the government directly to Sberbank (RUB 500bn) and to VEB (RUB 450bn). The latter will further provide USD 200bn to VTB, RUB 25bn to Rosselkhozbank and up to RUB 225bn to other banks with sufficient ratings.

The liquidity stress puts at risk small and medium-sized players on Russian financial markets as the government cannot rescue all of the banks. However, as the default of one financial institution could cause the fall of the whole system, the Russian authorities implemented the practice of 'guided bailouts' by state owned entities.

Since investment is one of the areas most exposed to the current crisis, investment plans are the first to be adjusted in response to increased credit rationing, higher borrowing costs and uncertainty about future earnings. Under these conditions, a huge part of investment projects in the private sector started to be postponed.

A credit crunch could bring the banking system back to the 2003-04: in the coming months banks will need to re-concentrate their activity on short-term liquidity. With the stabilization of the situation globally and locally, maturities will gradually be increased and smaller companies will have improved access to credit.

In fact, the development of the crisis in Russia in coming months will depend on two key factors: oil prices and the actions taken by the government. Oil prices directly impact budget revenues, and at the same time determine the attractiveness of Russia for foreign investors. The second factor is crucial for sustaining the stability of the financial system in this situation. And there is evidence, that the government is actively participating in the sanitation of the financial system and supporting the investment attractiveness of the country.

Why are these two factors crucial? Because, despite the financial turmoil, from the investment perspective Russia may still be considered as fruitful ground. It appears that the coming year 2009 will be quite active in terms of M&A and IPO activity thanks to the profitability of Russian companies compared to their global competitors. Driven by powerful basic trends, such as equity acquisition, as well as production capacity, Russia will likely increase its revenues.

Besides the indicated drivers, Russia has a strong position in human capital and innovation in-

dicators, including researchers in the research and development industry, patents granted, and high-tech exports (which constitute almost 10% of GDP). The low cost of starting a business, an entrepreneurship indicator, should allow these skills to be used as opportunities for economic growth.

Although in 2009 the gross national product growth will slow to approximately 6-7 %, this is still a good level for such a big country and in circumstances when the global economy is growing at a rate of 4.1% (according to the IMF's July estimates). Inflation of 15% per annum remains a serious issue for the country, yet, 10-20% growth in consumer prices is not an unusual occurrence for the economy. Therefore the slowing down of Inflation should become one of the positive consequences provided by the supervision of the Central Bank of Russia.

There is no doubt that Russia is a different country, being the world's largest and, in many ways, most diverse country. One of the most interesting peculiarities of the Russian economy is that two thirds of capitalization of the market depends on natural resources. Moreover, Russia is one of the few countries with a "diversified" commodities risk portfolio. Russia is in the top 5 world countries by natural resources thanks to its rich stock of oil and gas, ores, minerals and fertilizers.

Another special feature linked to the factor mentioned above is that the market capitalization is made mainly by globally unknown brands of metal and mining and energy segments, whereas in other countries market capitalization is made by well-known brands.

Hence for the further smooth development of the economy several crucial aspects must be taken into account: the country's low density (demographic and economic), vast distances, and regional barriers to market access including the special problem of isolated regions.

To get the economy back on track, some huge issues are to be solved: fiscal risks and intergovernmental fiscal relations, infrastructure needs, regional and internal trade integration, policies in relation to leading and lagging regions, social policy, the regional investment climate, and the environment. At the same time the crisis will help to clear away the financial bubble, adjust prices to an appropriate level, clear the economy of non-efficient players and open new opportunities for companies and banks.

As for the Russian banking sector, it still has a great market capacity. It remains underdeveloped and retains giant potential for further development. Despite its recent growth, the banking sector remains relatively small. At the beginning of 2000 the



banking sector's assets accounted for only 35% of GDP, which has already grown to 60%, but still remains notably below the level in many new European Union member states. That's why even in the current situation foreign players' activity won't be seriously reduced.

Since it is clear that the current crisis has not yet run its course, we must be cautious in making solid conclusions as to the lessons learned and their implications for future policy and private initiative.

Still, I do believe during the next five-seven years and beyond Russia will have a stable, growing economy. Despite the current correction, the country's investment opportunities have not changed: the current fundamental indices of the Russian economy are better than those of 10 years ago.

It is hard to give a detailed schedule for elimination of the crisis and the return to normal market conditions. However, I know that there are huge amounts of investment waiting for their turn to be realized. And when that stage occurs it may gather momentum much faster than many now anticipate.

## Commercial real estate: market nuances

**(Denis Sokolov, Cushman & Wakefield Stiles & Riabokobylko, Associate, Head of Research Department)**



### Denis Sokolov

Denis joined Cushman & Wakefield Stiles & Riabokobylko in September 2004 as a senior analyst.

Denis took an active part in the department's restructuring process and in creating a sustainable professional team

equipped with experience and modern data management tools.

Denis has managed research projects for such clients as EBRD, IFC, MLP, Deutsche Bank and Mirax, involving cross-sector market research in Moscow, the Russian regions, and CIS countries.

Prior to C&W/S&R, Denis worked in commodity markets analysis (grain, sugar, dairy products) for international and Russian companies. Several tools and methods developed by Denis are still used in the sugar industry and considered as an industry standard.

In Russian, the word for real estate, or immovable property, derives from the word "movement." It's something that cannot be moved no matter what happens. The liquidity crunch can bleed the banking system or empty supermarket shelves, but there's nothing it can do to real estate.

It is important that the infrastructure for business and retail is already there. It may leave much to be desired, but at least businesses have somewhere to put their offices, manufacturers their warehouses, and retailers can stake out a place in any mall, in any part of Russia. So unlike in 1998, when everything had to be restarted from scratch, businesses will have an easier time this time around.

It is no secret that asset management could use a lot of improvement in Russia. When the market is thriving, any project simply cannot fail. At this juncture, managers and advisors will have to be really creative to succeed against adversity and competition.

New construction has slowed down markedly of late after having grown 30% to 50% annually for years, depending on the segment. That kind of growth was bound to cause oversupply at some point. This time, financial "hunger" will perform

its own “natural selection” among construction projects, and only the best of them will be able to obtain financing in times of uncertainty. High-risk projects and those with bleak prospects will end up on the backburner for a long time.

Investors who have money to invest in construction feel confident today: competition will not be so tough next year between new projects.

### Things are going to slide in all directions

Quick staffing or instant business planning will not be the most sought-after skills next year; the ability to identify and cut redundant costs and squeeze profit out of thin air will. The Belle Epoque of business is over. It’s time to work hard. Western management experience will come in handy. But those who survived 1998 will have no problem making it through 2009.

Those companies who made conservative business plans and did not expect their market to double every year will be fine, too.

Growth drivers may change next year. Retail and real estate may be superseded by processing and shipping.

The construction industry will be sitting pretty as Russia gears up for the 2014 Winter Olympics in Sochi, not to mention the sprawling infrastructure projects in Moscow and other major cities, which all enjoy solid financial backing.

Finally, given Russia’s very substantial financial reserves, the government may want to move its ministries and agencies from worn-out and obsolete buildings to new, modern ones. If this happens, the old buildings will go into reconstruction, providing new construction jobs and substantial revenue streams for the government.

### Market downsizing

In the short term the following trends are dominating in real estate:

#### Office market

- Staff reductions in investment and banking sectors drive the sublease market.
- The vacancy rate in A class premises is increasing up to 15%.
- A correction of rental rates has started. The average decrease by the end of the year is expected at 20%.

### Retail market

- The consumer market is still strong. High inflation and exchange rate volatility force customers to spend.
- Retailers are offered discounts of up to 30% against original rents.
- Up to 150,000 square meters of retail space is expected for delivery by the end of the 2008 year.
- The government promised to provide support in the form of loans to major retailers.
- Few big box international retailers are considering entering the Russian market.

#### Industrial

- Rental rates and vacancy rates remain stable.
- Construction is slowing down

### Projected office market metrics

Quality stock, 000 m <sup>2</sup>			
	2007	2008	F2009
Class A	1116	1500	2000
Class B (B+ and B-)	5778	7400	7900

Take up, 000 m <sup>2</sup>			
	2007	2008	F2009
Class A	469	500	200
Class B (B+ and B-)	1166	1300	500

Rental rate USD/ m <sup>2</sup>			
	2007	2008	F2009
Class A	955	1200	1000
Class B (B+ and B-)	620	800	700

We expect that the real estate market in 2009 will shrink by 20% to 25% in comparison to 2008’s record levels. We will see downsizing of the market in terms of new construction, leasing activity, rents and prices. Vacancy rates will increase reflecting decreased demand.

We will also see changes in the commercial real estate sector:

- The market will move from landlord-driven to tenant-driven
- Bigger projects will become less attractive because of financing difficulties. Smaller projects will be more liquid
- Projects will compete not in terms of size but of efficiency.

However, the decrease in the construction rate will most likely bring the market into balance in 2010, when we may see a shortage of quality business and retail space returning.

## Currency issue

The ruble devaluation that is widely expected in the near future will have a major effect on the real estate market. In spite of the “de-dollarization” of the Russian economy that was caused by the strong ruble in 2004-2008, the majority of rents are denominated in US dollars. When the USD was weakening it was beneficial for Russian tenants with RUR based cash flows and foreign landlords with USD loans to repay. For tenants even the increasing rents were affordable, for landlords growth in the USD denominated rents meant additional profit. This situation drove the increase in rents at a rate of 20%-30% per year.

Now the RUR is starting to weaken and USD denominated rents are becoming less affordable, therefore tenants will try to renegotiate their agreements. Therefore, USD nominated rents are currently under heavy pressure caused by the exchange rate.

If the RUR devaluation continues we will see a correction in all segments.

Therefore, it is important that the business remains resilient to exchange rate fluctuations, and projects that generate hard-currency cash flows should be preferred.

## What should investors do?

Speculative capital has left Russia. Money will be hard to come by in the short term. In the real estate market, this may translate into more attractive deals. But each real estate property is unique in its own way. So if an investor gets a clear shot at a property that perfectly matches its investment strategy in every way, it hardly makes sense to wait for the price to drop. In all likelihood, the same property will not be available again, but those that will just won't be as “perfect.” In Europe, every real estate property goes on the market an average of once every 15 years. Russia is a young market. In 2009, investors will have great choices they may never see again. Next year, there will be more competition between minds and strategies, than between capitals.

At this juncture, it hardly makes sense to deliberate on which real estate segment is more attractive. All other things being equal, office properties are more exposed to the risk of a demand slump. But, as noted above, some properties are rock-solid. There are numerous successful office properties in Moscow that will always have great occupancy, crisis or no crisis. On the other hand, some shopping centers stand to be hit hard by the crisis.

The last (but not least) thing to bear in mind when weighing your investment options is that the era of a strong ruble is over. The Russian currency is losing ground, which has a lot to do with the government's effort to keep the financial services system going.

## Investing in the Russian strategic sectors: new limitations for foreign investors

(Tatiana Neveeva, Associate, Magisters; Elena Gorshkova, Associate, Magisters)



**Tatiana Neveeva**

Tatiana Neveeva is an Associate of M&A and Corporate practice with Magisters, a leading CIS-based legal firm. She specializes in providing legal support for M&A transactions with the participation of foreign investors. Tatiana con-

ducts legal due diligence and transaction structuring, participates in negotiations and corporate conflict regulation. During her work with Magisters Tatiana managed a project to support a USD 200 million sale of a mining company, acted as a legal adviser to foreign investors on the establishment of subsidiaries, advised international companies on the restructuring of their business, corporate and labor law, and on business permits and licenses. Prior to joining Magisters, Mrs. Neveeva worked with a Russian law firm, advising credit organizations and other financial institutions.

Tatiana Neveeva graduated from the Moscow State Law Academy, Moscow High School of Social and Economic Sciences (Master's degree program) and the University of Durham, UK (LL.M.).



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Prior to joining Magisters, Ms. Gorshkova worked as a Junior Associate at Corporate Legal Services (USA) international law firm, where she consulted, represented and supported foreign clients on their projects, and participated in legal due diligence. Elena is an author of the book "Witness evidence in international commercial arbitration: managing techniques and limitations", published in English by the German publishing house in 2008.

Elena graduated magna cum laude from the Russian State University for the Humanities and from the Central European University in Hungary where she was granted a Master in International Business Law degree (LL.M). She speaks English and Spanish.

The Federal Law "On foreign Investments in Strategic Sectors of the Russian Federation" (the Law) has recently come into force, and Russia has joined the states that provide for control and restrictions regarding foreign investments into so-called "sensitive industries". The Law faced much criticism from Russian commentators as well as from foreign investors, which have certain concerns in respect of the Law's assumingly protectionist nature. Some of the provisions of the Law were also found to be inconsistent with OECD "recommended best practice", which might make Russia's business climate less favourable for investors. However, as it will be discussed further in this outline, the Law in fact must have positive implications for investors' rights by means of providing for an exhaustive list of "strategic sectors" and setting out a transparent procedure on gaining clearance from the Russian government.

### Background of the Law

The idea of the Law appeared several years ago and was first expressly declared by the president in his annual address to the Federal Assembly of the Russian Federation, 2005. In this address the president highlighted that a de facto limitation on foreign investments, where the case concerned national security, already existed and was applied by the authorities. At the same time, no legal background for such a limitation was in place, which indeed could not satisfy foreign investors' interests. It was resolved to set out definitive rules on control over investments into a closed list of strategic activities, which would provide certainty for both foreign investors and the Russian government and thus would result in general improvement in Russia's investment climate.<sup>1</sup>

<sup>1</sup> See Annual Address to the Federal Assembly of the Russian Federation, April 25, 2005, available at: [http://www.kremlin.ru/appears/2005/04/25/1223\\_type63372type63374type82634\\_87049.shtml](http://www.kremlin.ru/appears/2005/04/25/1223_type63372type63374type82634_87049.shtml) (last accessed on November 7, 2008).

Russia was far from being the first nation to introduce foreign investment restrictions to protect its national security. It was acknowledged by the OECD that “sovereign governments have the right to take actions they consider necessary to safeguard national security and other essential public interests”<sup>2</sup> and it is a matter of fact that most OECD participants already had limitations on foreign investments in sensitive industries in place when Russia was only discussing the need for such limitations.<sup>3</sup> Thus in the United States the Exon-Florio provision of the Defense Production Act<sup>4</sup> was approved by Congress in 1988. This provision granted the president the right to prevent foreign acquisitions where such acquisitions could threaten national security. Similar limitations have also existed for a long time in Japan (Foreign Exchange and Foreign Trade Act as amended in 1991)<sup>5</sup>, the UK (the Industry Act as of 1975<sup>6</sup> and the Enterprise Act as of 2002)<sup>7</sup> and some other countries.<sup>8</sup>

Russian law, however, did not contain general limitations regarding foreign investors, which enjoyed national treatment under the Federal Law “On Foreign Investments” as of 1999. Although under the said Federal Law such restrictions could be established to protect “fundamental constitutional

principles, morality, health, or the rights and legal interests of others, or to provide for the defense of the country and security of the state”,<sup>9</sup> certain limitations only existed in respect of a small number of specific areas (such as owning agricultural land and land located next to Russia’s borders,<sup>10</sup> investment in banking<sup>11</sup> and insurance<sup>12</sup> sectors). The substantial growth in foreign capital inflow in recent years caused Russia to revise the existing rules for the sake of its own national security, as was previously done in other developed economies. The Russian government in these terms only followed a general worldwide trend, once the amount of foreign investments grew to a level that could realistically result in a threat to Russia’s public interest and the need for protection of sensitive industries arose.

The Federal Law “On foreign Investments in Strategic Sectors of the Russian Federation” was signed by the president on April 29, 2008 and entered into force on May 5, 2008. The Law established a regulatory<sup>13</sup> framework regarding control over foreign investments into sensitive sectors of the economy, provided for an exhaustive list of the industries it shall apply to, explicitly defined transactions which are subject to governmental review, and set out the specific terms and the procedure for such a review. The Law and corresponding regulations designated competent authorities which are in charge of control over foreign investments: the Federal Antimonopoly Service (“FAS”) responsible for preliminary review of documents and a special Government Commission for Control over Foreign Investments in the Russian Federation (the “Commission”) in charge of taking final decisions. The Law has now been applied for more than half a year and some of its inexactitudes and imperfections have already been detected. However, generally it must be regarded as an important factor which secures legal certainty and, subsequently, as a step forward in terms of foreign investors’ protection.

<sup>2</sup> OECD Roundtable “Freedom of Investment, National Security and ‘Strategic Industries’”, summary of discussions prepared by the Secretariat, June 21, 2006, at p.3, available at: <http://www.oecd.org/dataoecd/48/14/37156967.pdf> (last accessed on November 7, 2008).

<sup>3</sup> Progress Report by OECD Investment Committee “Freedom of investment, National Security and ‘Strategic Industries’”, March 26, 2008, at p. 4; available at <http://www.oecd.org/dataoecd/1/58/40473798.pdf> (last accessed on November 7, 2008).

<sup>4</sup> P.L. 100-418, title V, Subtitle A, Part II, or 50 U.S.C. app 2170.

<sup>5</sup> United States Government Accountability Office (“GAO”), Report to the Honorable Richard Shelby, Ranking Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate “Foreign Investments: Laws and Policies Regulating Foreign Investment in 10 Countries”, February 28, 2008, at p. 75; available at <http://www.gao.gov/new.items/d08320.pdf> (last accessed on November 7, 2008).

<sup>6</sup> Has never been applied. See *Id.*, at p. 100.

<sup>7</sup> *Id.*

<sup>8</sup> OECD, “Freedom of Investment, National Security and “Strategic” Industries: An Interim Report”, an article reproducing an interim report approved by the OECD Investment Committee at the fourth OECD Roundtable on Freedom of Investment, National Security and “Strategic” Industries on 30 March 2007, at p. 61; available at <http://www.oecd.org/dataoecd/36/37/41246110.pdf> (last accessed on November 7, 2008).

<sup>9</sup> Federal Law “On Foreign Investments”, No.160-Φ3 dated July 9, 1999, part 2 art. 4.

<sup>10</sup> See the Land Code of the Russian Federation, No. 136-Φ3 dated October 25, 2001, part 3 art. 15., Federal Law “On Circulation of Agricultural Land”, No. 101-Φ3 dated July 24, 2002, art. 3.

<sup>11</sup> Federal Law “On Banks and Banking”, No. 395-1 dated December 2, 1990, provides for the possibility to restrict foreign investments through establishment of a quota (art. 18).

<sup>12</sup> The quota for foreign capital in the Russian insurance market is 25%. See Federal Law “On Organisation of Insurance Business in the Russian Federation”, No. 4015-1 dated November 27, 1992, part 3 art. 6.

<sup>13</sup> Government Regulation N 510 “On establishment of the Government Commission for Control over Foreign Investments in the Russian Federation” dated July 6, 2008.

## Scope of regulation: foreign investors and control

### Foreign investor status

The Law applies where a foreign investor acquires shares (interests) in, or otherwise gains control over, a legal entity which carries out its activities in one of the strategic sectors of importance for Russian national defense and state security. A “foreign investor” pursuant to Russian law is a foreign legal entity (an organization not being a legal entity) the legal capacity of which is determined by the laws of the jurisdiction of its incorporation and which has the right to invest on the territory of the Russian Federation under the laws of the jurisdiction of its incorporation, as well as a foreign citizen or a foreign state.<sup>14</sup> Notably, the Law divides foreign investors into two groups:

a) individuals or legal entities, including those controlled by foreign investors and incorporated in the Russian Federation, i.e. *private foreign investors*;

b) foreign states or international organizations and the legal entities under their control, incorporated inside or outside the Russian Federation, i.e. *public foreign investors*.

The above two groups of investors have different rights regarding acquisition of shares (interests) in Russian strategic enterprises. In particular, public foreign investors are not allowed to acquire “control” over any sensitive business in Russia, and shareholding thresholds for mandatory preliminary approval of an acquisition are different for public and private foreign investors (for the definition of “control” see 2.3 of this brief).

This distinction between private and public foreign investors should not be regarded as discriminatory, since it is clear that where control over sensitive industries is gained by a foreign government, political reasons may prevail over economic ones in terms of further development of a strategic enterprise. Thus the threat to national security becomes more palpable. To compare, the US Foreign Investment and National Security Act of 2007 also sets out certain procedural distinctions for the review of foreign mergers and acquisitions where the investor is “a foreign government or entity controlled by or acting on behalf of a foreign government” (“foreign-governmental control”).<sup>15</sup> In addition, foreign-governmental control is listed as one of the factors

which must be considered by the president when deciding whether to block a transaction.<sup>16</sup>

### Strategic sectors

There are basically two main ways to determine foreign investment transactions falling under the governmental control: the “national security”<sup>17</sup> concept and the “closed list” of sensitive industries.<sup>18</sup> Russian law chose to specify all of the strategic sectors explicitly in the Law, and the list set out therein is regarded as exhaustive and cannot be interpreted loosely. The list contains 42 types of commercial activities which are regarded as essential for national defense and public security. This list is rather long compared to similar lists in other countries (in France – 11 strategic activities,<sup>19</sup> in Germany – 2 strategic activities<sup>20</sup>). However, de facto all of the activities listed in the Law may be grouped into five main types, namely, those related to:

a) *national defense* sector which includes working with nuclear materials, activities related to weapons and other military equipment, aviation and space, coding and encryption equipment;

b) *natural resources* sector, including exploitation of subsoil areas of federal importance, fishing;

c) activity of *natural monopolies* (including energy sector);

<sup>15</sup> According to the general rule, an investment transaction is subject to initial review by the Committee on Foreign Investment in the United States (“CFIUS”), which takes 30 days. Where the CFIUS reveals in the course of such a review that a transaction would result in a threat to US national security (and such a threat has not been mitigated), the transaction must be passed to the next step of review – a mandatory National Security Investigation. The same rule applies in the case a transaction results in foreign-governmental control, even though no threat to national security was established in the course of the initial review by the CFIUS. See the Defense Production Act of 1950 (50 U.S.C. App. 2170) as amended by the Foreign Investment and National Security Act of 2007, Sec. 721(a)(4) and Sec. 721(b)(2)(B)(i)(II).

<sup>16</sup> See CRS Report for Congress, “The Committee on Foreign Investment in the United States (CFIUS)”, updated April 8, 2008, at p. 13; available at: <http://www.fas.org/sgp/crs/natsec/RL33388.pdf> (last accessed on November 7, 2008).

<sup>17</sup> Also “public interest”, “public order”, “national defense”, “national economic security”. See GAO, supra note 5 at p. 18.

<sup>18</sup> OECD, supra note 3.

<sup>19</sup> See Monetary and Financial Code, art. R153-2; available at <http://www.legifrance.gov.fr> (last accessed on November 7, 2008).

<sup>20</sup> Para 7 item 5 of the German Foreign Trade Act dated 28.04.1961 as in force on 20.04.2008.

<sup>14</sup> Part 1 art. 2 of the Law.

d) mass media sector, including television, radio broadcast and printed media covering a significant share of Russia's audience;

e) *telecommunications*, including activities of the major telecom providers.

In other words, the 42 activities named in the Law generally itemize the above five strategic sectors. Still, according to the OECD the Law's "sectoral coverage is broader... than OECD recommended best practice".<sup>21</sup> In particular, certain questions arise regarding limitation on investment into the Russia's energy sector, including oil and gas natural monopolies.<sup>22</sup> However, it must be kept in mind that for Russia's budget the income derived from exploitation of its natural resources is material, and it is apparent that the loss of governmental control over these sectors could impair public security. In addition, the Law does not prohibit foreign investments into the above industries. It has only established a special procedure for the investors to get governmental permission to acquire control over legal entities involved in strategic activities, which should not be regarded as an absolute barrier to foreign capital. To support this statement, it is worth noting that the first two applications from foreign investors (*De Beers and Alenia Aeronautica*) regarding acquisition of shares in Russian strategic legal entities have already been approved by the Commission.<sup>23</sup>

Thus the closed detailed list of strategic activities set out in the Law serves for greater certainty regarding whether an investor shall or shall not apply for governmental approval of an acquisition. Given that most of the 42 activities listed are subject to licensing under Russian law, the fact that a company has a license for one of the strategic activities should serve as a signal for foreign investors to file for governmental approval of an acquisition. However, it is clear that though some companies have the respective licenses, they cannot reasonably be regarded as strategic entities due to the auxiliary

role of such licenses in their overall business. This is the case with credit organizations, most of which have a license for cryptographic activity while this activity is not their main business. It has recently been specifically resolved by the government that the credit organizations will not be subject to limitations provided by the Law,<sup>24</sup> and currently the FAS is considering amendments to the Law regarding additional exemptions in similar situations.<sup>25</sup>

While no official amendments or other regulations are in place, in case of any doubts an investor may address an individual inquiry to the FAS. The FAS will consider such an inquiry within 30 days and will issue its official response as to whether the investor has to file for approval of an acquisition.

## Control

One of the key concepts used by the Law is that of "control" over a strategic entity. Under the Law, management control over a company in strategic sectors means the ability of an investor to determine directly or indirectly (through third parties) the decisions taken by such a company. Control is deemed to exist where an investor:

- controls directly or indirectly more than 50% of the total voting shares in a strategic entity (on the basis of a sale and purchase agreement, simple partnership contract, a trust deed, exchange or gift contracts or otherwise);
- has the right to appoint a CEO and/or more than 50% of the members of the company's management board or any other management body;
- has the right to appoint more than 50% of the company's board of directors;
- is able to otherwise determine the company's management decisions.

Separately, for entities exploring the subsoil areas of federal importance the threshold of management control is 10% and not 50% as in other strategic sectors.

<sup>21</sup> See OECD "Investment Policy Review: Russian Federation. Executive Summary", 2008 at p. 9; available at: <http://www.oecd.org/dataoecd/16/28/41065076.pdf> (last accessed on November 7, 2008).

<sup>22</sup> See Heath, Jesse, "Strategic Protectionism? National Security and Foreign Investment in the Russian Federation", September 5, 2008, *George Washington International Law Review*, Forthcoming, at p. 39; available at SSRN: <http://ssrn.com/abstract=1264041> (last accessed on November 7, 2008).

<sup>23</sup> See news at <http://www.minproc.ru/news/index.html?mode=list&num=41369>, <http://www.interfax.ru/business/news.asp?id=38536> (no official publication is still in place).

<sup>24</sup> This was confirmed by I. Artemyev in the course of the event organized by The Finance and Investment Committee of the Association of European Businesses: a briefing by Igor Artemyev, Head of the RF Federal Antimonopoly Services, October 16, 2008

<sup>25</sup> See the news at <http://www.iip.ru/news/news1.php?n=8539>. It might also be the case that a company having a license for one of the strategic activities listed in the Law does not use it at all and is not planning to use it in the future. At this stage, while no relevant amendments to the Law have been made, it may be recommended that such a license be cancelled prior to the acquisition in order to avoid filing unnecessary paperwork.

Control is defined in the Law generally in accordance with the principles of corporate governance in the Russian Federation. In particular, most corporate decisions are normally taken by a simple majority of votes and therefore the ownership of 50%+1 vote is ordinarily called a “controlling share”. As mentioned previously, such a controlling share in a strategic entity cannot be acquired by public foreign investors. This type of investor, however, may have so-called “blocking rights” in respect of a strategic entity. Under Russian corporate law, the most important corporate resolutions are ordinarily taken by a qualified majority of votes, and thus a minority shareholder may block such resolutions. The Law sets out that blocking rights exist where:

- a public foreign investor directly or indirectly controls more than 25% of voting shares (interest) in a company; or
- is otherwise able to block decisions of the company’s management bodies, where such decisions by law or in accordance with the company’s charter are taken by qualified majority of votes; or
- a public foreign investor directly or indirectly acquires control over 5% of shares in a company exploring the subsoil areas of federal importance.

## **Prior approval and post-closing notification: requirements and procedures**

### **Preliminary approval of a transaction**

A foreign investor has to apply for approval of a transaction where the following conditions apply:

- the contemplated transaction concerns an entity which carries out one of the strategic activities set out in the Law; and
- as a result of the contemplated transaction a private foreign investor will obtain control over the strategic entity; or
- as a result of the contemplated transaction a public foreign investor will obtain blocking rights with respect to a strategic entity.

The preliminary approval procedure does not apply where, prior to the transaction, a foreign investor already controlled more than 50% of the voting shares in a strategic entity.

The official review of the investor’s application includes two stages:

### **FAS review**

The application together with the documents listed in the Law shall be submitted to the Investment Control Department of the FAS (“ICD”). Within 14 days the application will be registered, checked for the presence of all information required and reviewed by the ICD in terms of whether as a result of the transaction a foreign investor will acquire control/blocking rights in respect of a strategic entity. After having completed the review, the ICD will take one of the following decisions:

- to return the application where no signs of control/blocking rights will be established as a result of the transaction;
- to reject the application where pursuant to the transaction in question a public foreign investor will acquire control over a strategic entity;
- to perform a comprehensive review of the transaction.

Where the ICD identifies that the transaction will allow a private foreign investor to establish control over an entity, or for a public foreign investor – to obtain blocking rights, the ICD will carry out detailed research as to whether the transaction may impair national security. For this purpose the ICD will request from other official bodies, such as the Federal Security Service or the Commission on the Protection of State Secrets, their opinion on the matter and will prepare its own recommendations and suggestions regarding approval or rejection of the application. Such research must be completed within 30 days and the application must then be passed to the Commission.

### **Commission review**

The Commission studies the materials collected by the FAS and takes a final decision on approval or rejection of the investor’s application. The decision of the Commission must be taken within 30 days and it will depend on whether the transaction carries any potential threat to national security. Where the Commission decides that the negative effect of a transaction may be cured, it is entitled to approve a transaction subject to fulfillment of certain obligations by the investor. Additional obligations will also be imposed on the investor if fulfillment of these obligations is required by the law.

The practice of imposing of certain undertakings on foreign investors is also broadly used. For example, in France the government may approve a transaction provided that the investor agrees to guarantee the company’s continuing activity, per-



formance by the company of its current agreements, or to protect the company's research and development capabilities.<sup>26</sup> The Russian Law in turn provides for such supplementary undertakings as an obligation of a foreign investor to guarantee that a strategic entity will continue deliveries pursuant to a state defense order, will continue to comply with the tariffs set out natural monopolies, will comply with the business plan submitted by the investor to the FAS, etc. Additional obligations are set out in a special agreement with the investor, which is in force during the time a strategic entity is under the applicant's control.

According to the Law, the above two stages of review must not take more than three months and only in exceptional cases the term may be extended by an additional three months. The term for investigation thus is not excessively long and may be compared with that in some other developed countries.<sup>27</sup> At the same time, the Law definitely lacks criteria for assessing potential threats to national security. It may be assumed that in the near future certain supplementary regulations setting out such criteria will be elaborated.

### **Strategic investment approval and antimonopoly filing**

Until recently there was a gap in respect of relations between antimonopoly approval filing under Russian law and filing for an approval in terms of strategic investments. In accordance with the latest amendments to the Federal Law "On protection of competition", the superior importance and priority has expressly been given to preliminary approval of an acquisition pursuant to the strategic investment procedure. It has been clarified that when a transaction also requires additional filing of a petition on acquisition of shares under the Federal Law "On protection of competition",<sup>28</sup> the outcome shall depend on the results of the review carried out under the Law on strategic investments. Now the FAS is entitled either to extend the term of simple antimonopoly review until the

date when review under strategic investment procedure has been completed, or to reject a petition on an acquisition on the grounds that the strategic investment approval of the same transaction has been denied.

### **Post-closing notification**

A foreign investor must notify the ICD about an acquisition of 5% or more of the shares in a strategic entity. The notice must be sent within 45 days from the date of execution of the respective agreement.<sup>29</sup> The notice may be drafted in a free form, provided that it contains all the information required, such as a detailed description of the applicant and strategic entity, the details of the transaction, a copy of the agreement, the number of shares acquired and so forth.

Where at the date of the Law's enactment a foreign investor was the owner of 5% or more in a strategic entity, such an investor must also send a respective notice to the FAS within 180 days.

### **Violation of the Law**

If a foreign investor fails to comply with the Law, a transaction entered into by the investor will be null and void. As a result, the consequences of invalidity will be applied pursuant to Russian civil law. However, if the application of such consequences is impossible, the court may deprive the infringing investor of its voting and quorum rights, as well as declare resolutions of shareholders and of other management bodies of the strategic entity invalid, provided that such resolutions were taken after the investor had established its control over the entity.

The above consequences are certainly material for investors. Non-compliance with the Law practically nullifies all the effect of control an investor acquires and thus the Law must be strictly complied with.

### **Conclusion**

This short analysis of the Law allows to suggest that the rules set out in the Law are in line with the practice which already exists in many states. Its requirements cannot be regarded as unreasonably strict compared to other countries' legislation. In addition, it should be noted that the general worldwide trend

<sup>26</sup> GAO, *supra* note 5 at p. 22.

<sup>27</sup> In the US the review process includes 30 days of preliminary review by the CFIUS, 45 days of mandatory National Security Investigation plus 15 days of review by the president. ( See CRS Report, *supra* note 16). In the UK the review must be completed within 6 months (See GAO, *supra* note 5 at p. 21).

<sup>28</sup> Federal Law "On amendment of the Federal Law "On protection of competition" №195-FZ dated November 8, 2008

<sup>29</sup> Governmental Regulation № 795 dated October 27, 2008.

in terms of modernization of foreign investment law is that of tightening of the existing regulation.<sup>30</sup>

The Law does not intend to introduce a protectionist investment policy in Russia. It merely establishes definite rules and transparent procedures of control by the Russian government over its sensitive industries. It is apparent, however, that there are still improvements to be made to the established regulations. In this respect foreign investors must be active and address their concerns to the FAS so that all of the problems of the Law's implementation may be resolved in the near future.

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<sup>30</sup> OECD Roundtable on Freedom of Investment, National Security and "Strategic" Industries Paris, France, Summary Of Findings, March 30, 2007, at p. 2; available at: <http://www.oecd.org/dataoecd/56/33/38523191.pdf> (last accessed on November 7, 2008).

## POST ACQUISITION ISSUES AND HOW TO ADDRESS THEM

### The post-merger integration process: the “Russia” factor (Renee Stillings, Partner, Alinga Consulting Group (Moscow))



#### Renee Stillings

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Russian. In 1999 she co-founded and continues to be a Partner in Alinga Consulting Group, focusing on business development and overall company strategy.

Russia is increasingly feeling the effects of the global economic crisis. In addition to the lack of access to credit and investment, plummeting commodity prices and capital flight are bringing back the recurring nightmare of the devalued rouble. While this will lead to a decrease in foreign investment in the short-term, it is still important to look at the integration process in terms of existing and particularly recent mergers or acquisitions, with an eye towards potential opportunities for less expensive market entry in the current economic climate. In recent years, the heated investment climate put tremendous pressure on the limited labor and professional resources available to the international business community in Russia. It seems inevitable that this pressure will lessen and a greater pool of local and international talent can be tapped by new-to-market companies.

There are several issues that are of specific concern to companies expanding into the Russian market. These include HR management, selecting a CEO, legal compliance, and financial reporting. General functional integration issues are directly related to the size of the organization and the industry in which it works and less dependent on the specific business environment. In Russia, there are integration issues that apply to companies of all sizes and sectors. Indeed, these same issues also apply to those establishing a new business in Russia. The areas we will focus on are knowledge sharing, customer orientation, management, legal advising, and financial reporting.

### HR management: knowledge transfer and the kollektiv

The number of organizations who have decided to internationalize their operations has increased dramatically. For the competitive advantage of international expansion to be realized, however, effective knowledge sharing must offset the potential disadvantages of physical distance and cultural differences. Foreign managers with an understanding of the specific challenges related to transition or post-Communist business environments such as Russia will contribute more successfully to the integration process than those who lack in this knowledge.

Because international partners have typically brought technology and management know-how to the table, most of the focus has been on the one-way knowledge transfer from international business partners to local subsidiaries. However, it is important to note that knowledge transfer is a two-way process and it is perhaps the facilitation of knowledge transfer back from the subsidiary that is the greater challenge in Russia.

Key factors in Russian cultural and organizational behavior include the following:

- The concept of in-groups and out-groups plays a very important role. This concept is reinforced by the notion of the kollektiv, a term used to refer, fondly, to one’s colleagues. The size of the group referred to as the kollektiv may vary. In a very small company it may be everyone. In larger companies the reference may become departmental in nature as interaction across departments is less prevalent. It can be assumed that the kollektiv referenced by any one individual is their in-group. Note that managers and employees often view each other as separate out-groups, although a direct supervisor is likely part of a departmental in-group.
- Russians focus on the relationships created over time. These relationships, hierarchical in nature, repeat themselves in a social setting. In other words, the professional and social “in-groups” are far more intertwined than in western nations. Information is shared more readily with those with whom there is a long-term relationship established. There is an aversion to sharing knowledge with those outside one’s in-group.
- Russians are apt to share information such as salary levels readily with colleagues. While this tends to happen more frequently within perceived in-groups, it is not unusual for an employee to receive questions about his or her salary from colleagues

the first day on the job. It is likely the employee will not find this unusual at all and will readily share this information. Company policies should discourage this by making it clear that asking for and sharing such information is unacceptable.

- Throughout the Communist era, Russians were encouraged to conform, not deviate from the group, and not to admit mistakes. While the western approach has been to view mistakes as learning opportunities and to be shared, this is not the case in Russia.
- Russians have come to view personal connections as a substitute for reliable government and established rule of law. As such, in-groups and personal networking (referred to in Russia as *blat*) are an integral part of business.
- Russians have a tendency to amass knowledge but to then hoard it. Reasons range from saving it for possible future advantage to fearing that if the knowledge is shared, it might be misinterpreted to the sharer's disadvantage.
- Management has been strongly top-down in Russia. As such, Russians don't believe that knowledge can be acquired bottom-up in organizations.
- Russians appreciate regular and clear communication, especially about any new company rules and regulations. In the absence of clear communications (and even with it) Russians are prone to believing rumors and facilitating their dissemination. Russians are by nature skeptical (particularly of authority and rules).

Many will read the above points and wonder if or why these characteristics really still dominate. It is important to realize that these are deep-rooted – often going much deeper than simply the influence of the Communist era. It seems that, over time, there have developed more frequent exceptions to these rules, but a global change has yet to be effected.

What can management do to encourage information sharing given this cultural legacy? The first step is to gain a solid understanding of the dynamics at play. Then, don't try to "break" current relationships and in-groups, but rather try to determine how best to enter them. This may require intermediaries in the short term and one strategy is to focus on departmental managers with pre-existing networks. Don't create special work groups in an attempt to bridge out-groups. While many argue that this works in the West, it can lead to conflict in Russian business culture by creating new out-groups and tension in the pre-existing in-groups. Consider group-based incentives and rewards; in Russia this can stimulate knowledge sharing within the group. Well designed group training exercises and internal

seminars in which employees are the presenters can be very beneficial by creating mechanisms for knowledge sharing.

## **Customer service: does it exist in Russia?**

Service companies face additional challenges in Russia. This situation has changed considerably over the past few years with Russians traveling extensively abroad and bringing home some degree of greater service expectations. Furthermore, companies catering to the elite and affluent carefully select and train their staff, contributing to the number of service-conscious participants in the labor pool. Still, most are surprised when they receive good service in Russia and if you are managing a service company in Russia, it is important to consider a few additional aspects of Russian culture.

- In general, the customer-employee relationship is more oriented toward the employee, who is in the position of power. The customer is often expected to show politeness, humility, and perseverance. Even with this approach, there is a good chance of being ignored or shunned. Particularly in government and other low-wage sectors, this sense of empowerment is associated with self-respect.
- Russians associate good service with wanting to please someone important or famous or when there is something to be gained. An ordinary customer is usually perceived as more of a nuisance than as "beneficial to the company" and an average employee is likely to behave in a way that lets the customer know this.
- The service industry has been traditionally a low-status field in Russia, generally home to those who were not accepted into college. Obviously the situation has changed considerably, but not the underlying perception. Young people currently filling the ranks of the service sector view it as a temporary situation with flexible hours while attending school. Very few choose hospitality as a profession.
- Those working in the service sector have relatively low wages, meaning that they are less likely to travel abroad, eat out, or otherwise have opportunities to experience higher levels of service.
- Even in professional services where the overall "status" and wages are higher, the concept of customer orientation is not nearly as instinctive as it is in the West. The professional knowledge and work output may be excellent, but it often does not take the client into account. Often, clients can be presented with data without interpretation or recommendation, meaning that the client will feel

they are left to do much of the substantive work. Related to the knowledge-sharing issue described earlier, there is a tendency towards “why didn’t you know” or “you didn’t ask” as opposed to “why didn’t we tell you.” Another common complaint is a lack of time-sensitivity or urgency on the part of the professional.

Training and retention go hand-in-hand in attempting to instill customer orientation in staff at all levels. Some companies, notably the western brands, provide excellent training in customer service. If the Russian economy faces an extended downturn, Russian companies will also focus more on customer service so as to remain competitive.

### **Top management: local or imported expats – or repats?**

Facilitating knowledge transfer and building personal networks both inside and outside the organization are the greatest challenges of the CEO of a Russian subsidiary. As such, abilities and experience in this area could be the single greatest asset of a potential candidate for this position.

Regardless of other commercial titles that may have meaning in the West, the Russian Generalni Direktor (CEO) is clearly the top of the heap in the historically top-down management style. He/she will be responsible ultimately for implementing policies and strategies going forward. Therefore, any changes to the CEO position should be decided on during the merger/acquisition process. If possible, the previous CEO should remain in a deputy director position, helping to preserve current in-groups and facilitating the new CEO’s entry into these groups.

Who will have the best chances of success as the new CEO? Realistic candidates include a local expat, an “imported” expat, and a “repat.” For the purposes of this article and its emphasis on the international aspect, we will not consider a local Russian, although there are increasing numbers of Russians who have acquired an international education and/or international work experience and are viable candidates. Still, companies entering the market for the first time rightly feel they need to have “one of their own” on the ground.

A local expat is a known quantity. By “local expat” we refer specifically to those professionals with a solid track record in Russia, whom, in the current environment, you will likely need to headhunt. He/she usually knows the language and culture, and has often made a lifetime commitment to Russia by marrying and having children there. He/she is

likely familiar with some of the “ritual” surrounding breaking into an in-group and likely already has business and social in-groups beneficial to the position. The costs and risks surrounding such a candidate are lower than the other two candidate groups considered.

An “imported” expat often has no prior work experience in Russia. Indeed it is possible that he/she has not worked overseas ever, but has knowledge of the industry and management experience at home. Most with specific industry experience will not speak the language and may not have the slightest interest in Russian history or culture or adapting to them (which almost always affects the manager’s ability to enter in-groups). The risks, including the candidate simply not being prepared for daily life in Russia, are significant. Short-term or commuter expats may be able to succeed in specific departments and tasks within the company, but usually not at the CEO level.

The Russian “repat” is a relatively new phenomenon. He/she grew up and was educated outside of Russia, but spoke Russian and was exposed to Russian culture at home. Such candidates with business degrees and industry experience are finding a new home in companies in Russia. In considering such candidates it is important to note that while they may have the language skills and cultural sensitivity, their entire professional background, including networks (social and professional), may have nothing to do with Russia. A repat is not necessarily more qualified, then, than an expat, and in fact can in certain situations be viewed negatively – as an individual who left Russia when times were tough and only returned for the good.

For any of these candidates to succeed in the integration process, language ability and cultural sensitivity are important, and many companies even try to ensure that they are instilled vis- -vis an intensive pre-posting training program. While Russians are known for a degree of xenophobic and anti-western sentiment, young Russian professionals are most often eager to learn from an experienced expat boss. The CEO with experience, professionalism, leadership skills, and cultural sensitivity will quickly gain their respect.

While management and the challenge of knowledge transfer really only have in-house solutions, there are two areas in which outside professionals can assist with transitions, fill initial gaps, and even provide part or all of a long-term solution. In what is currently still a very tight labor market for top-notch professionals, it is often good to know there are options.

## Continued legal support and compliance

The work of your legal team does not end with closing the deal and filing all immediately relevant documents with the corresponding government offices. Evolving laws and regulations combined with inspectors that correlate more laws with increased opportunities for income, means that businesses of all sizes continuously face the economic choice of whether or not to pay for legal advice.

Depending on the nature of the business, an in-house lawyer or a relationship with an outside legal counsel may already be in place in Russia. In many cases, this may be sufficient. If the foreign partner is a public company, perhaps subject to Sarbanes-Oxley, increased sensitivity to compliance in all aspects of the company's business may necessitate an in-house lawyer with more experience (international), foreign language skills, and the ability to work with both the in-house lawyers at the home office and with outside counsel on complex matters. Legal support for any Russia-based offices should have specific experience not only in that regulatory environment in general, but also in industry-specific areas.

## Challenges in accounting and financial reporting

The Russian Accounting System (RAS) is in a state of slow transition. The process of aligning this system with International Financial Reporting Standards (IFRS) is currently underway, and reasonable progress is being made... at least on paper. The greater challenge is in transforming the approach of Russian trained accountants toward applying the financial accounting rules rather than only thinking in terms of "tax accounting." Accountants focus far more on reporting to the tax authorities than to management and the application of substance over form is still missing from the mindset of your average Chief Accountant. Particularly in situations of economic downturn, a lack of management accounting is perilous.

The task of preparing financial reports for a home office is two-fold —choosing a system and finding the personnel to implement it. Currently this issue is addressed in one of three ways, depending on the size of the company:

1. Maintain parallel accounting. This can be done by using two accounting systems independently or by using one of a select number of systems that generate statements in both formats with some degree of accuracy. This can often be cost prohibitive for smaller companies.

2. Maintain accounts in RAS and do periodic "transformation" of the financial statements for reporting to the home office.

3. More and more the the major ERP providers (Microsoft, SAP, Oracle) are successfully adapting their programs to be compliant with the Russian tax filing requirements and as such provide a single accounting system for both RAS and home office accounting. The acquisition and implementation costs of such a solution is still rather high.

The first two methods above, depending on the size of the company, could be performed in-house, or partially (transformation only) or wholly outsourced to a specialized professional services firm. The shortage of Russian accountants with IFRS and foreign language abilities means that smaller companies will often outsource at least the transformation of statements to an audit firm with IFRS experience and larger companies will bring on board a CFO to build a suitable accounting department.

While similar challenges likely exist to some degree in any international integration, those addressed here are Russia-specific, or at least specific to transition and/or post-Communist economies. They should be considered in planning the recruitment and allocation of resources.

## Accounting and control systems (Boris Lvov, KPMG, Partner, Risk Advisory Services)



**Boris Lvov**

Boris Lvov is a Partner with the Risk Advisory Services department of KPMG in Russia and the CIS. Boris has over 15 years of experience in the field of business process controls, risk advisory, internal audit and corporate governance. Boris is

a Certified Public Accountant of the USA, a Certified Information Systems Auditor, a Certified Internal Auditor, and the President of the Russian branch of the Information Systems Audit and Control Association.

For historical reasons, accounting and control systems in Russian organisations differ to internationally accepted practices. This is now changing and Russian organisations are taking major steps to transform the systems in place.

An increasing number of large and medium sized Russian companies are preparing audited IFRS and to a lesser extent US GAAP financial statements. These standards have largely been adopted to comply with listing requirements of international stock exchanges, to receive financing from banks or to attract investment.

A small number of Russian companies are listed on the US or UK stock exchanges and need to comply, respectively, with Section 404 of the Sarbanes-Oxley Act or the Combined Code on Corporate Governance. Certain Russian companies considering an IPO as a means of attracting investment are also seeking to comply with these regulations in advance of their listing.

However, the vast majority of small and medium sized businesses in Russia prepare only statutory financial statements based on Russian Accounting Principles and have not implemented a modern internal control system.

The purpose of this article is to provide the reader with a perspective on Russian accounting and control, to identify some key features and to examine areas of change in Russia where convergence with internationally accepted practice is taking place.

### Russian Accounting Principles

The term 'Russian Accounting Principles' (RAP), or sometimes 'Russian Accounting Standards' (RAS)

is used informally to describe the body of laws, decrees and ministerial orders governing, directly and indirectly, accounting and reporting in Russia.

Many current Russian accounting rules and regulations are remnants of the centrally planned economy of the former Soviet Union. In that economy all facets of the market, including production, pricing, and monetary regulation, were controlled by the government. Since the users of financial information in the former Soviet Union were government agencies, accounting policies were standardised for all entities. As a result, accounting in the former Soviet Union was rule based and involved little judgement.

Actual reform of the accounting and financial reporting system started with the adoption of the Federal Law on Accounting in 1996 and the revision of the Accounting and Financial Reporting Regulation in 1998. This continued with the introduction of the new Chart of Accounts in 2000 and a series of accounting regulations (so-called PBUs). Since 1995 many of the fundamental concepts of IFRS have been introduced into the Russian environment. However, significant differences remain between IFRS and RAP.

Financial accounting is now to a large extent separate from tax accounting, following the adoption of new chapters of the Tax Code in 2002. However, in practice, as the policing of tax reporting is far more apparent than the policing of financial reporting, the tax rules will usually prevail where there is perceived conflict.

Notwithstanding these reforms, many administrative provisions and reporting characteristics of the former Soviet system remain. Accordingly, current Russian accounting practice is characterised by the following:

- Regulations are rule rather than principle based.
- Although accounting principles often appear very similar to IFRS, in many cases they are applied differently in practice.
- While the main function of accounting under the law is to provide the users of financial statements with complete and reliable information on an entity's performance and financial position, accounting is still seen as a tool to ensure that entities comply with legislation and use material, labour and financial resources within set limits.
- The law emphasises supporting every transaction with formal source documents, that represent the basis of the accounting records (e.g. an invoice for a sales transaction, and an internal administrative note with supporting calculations for a provision).
- Prudence plays an important role in accounting. However, although prudence is defined formally

as a “higher preparedness to recognise expenses and liabilities rather than possible income and assets”, in practice it is interpreted to mean a need for appropriate source documents. For example, often entities do not record accruals at the end of the year on the grounds that no supporting documents were available at that time.

- While substance over form is stated as a principle, in practice form often takes priority over substance.
- Consolidation requirements are limited and sometimes unclear due to the absence of ‘true’ acquisitions in the past in Russia.

Although differences remain, it is the Russian government’s stated policy to align RAS with IFRS as far as is practical. Progress has been made, although the pace has slowed somewhat over recent years.

A draft law on the requirement for public listed entities to prepare consolidated financial statements in accordance with IFRS is currently being considered by the Russian State Duma. In many respects, the draft law as proposed is similar to the recent introduction of IFRS in the European Union for public listed entities. The timeframe for the adoption of the law is currently unclear.

## Control systems

The concept of a control system is closely linked to accounting in Russian business. It may be argued that control in the Russian context has a narrower definition than control as defined and understood from an international perspective.

At the international level, there have been a number of legal regulatory developments in relation to corporate governance which firmly place responsibility on the Board of Directors to ensure that an installed risk and control environment exists within the business to identify, quantify and manage business risk.

The legacy control systems of Russian companies have evolved in a different manner and along a narrower definition of control as relating to accounting and financial reporting, and with limited involvement and oversight by the directors.

The chief accountant plays an important role in Russian companies. The function of the chief accountant in Soviet companies was in many respects to control the general director and to ensure the safe and accurate accounting for what were after all state assets.

Chief accountants are responsible for maintaining books of accounts in compliance with Russian

laws and can minimise issues arising from tax and accounting inspections. They have a large amount of personal responsibility for the correct application of the rules.

There is a function usually called the Control and Revision Group (KRU) in many Russian companies. Historically the role of the KRU was to observe and check transactions and ensure compliance with procedures, instructions, laws and regulations. Testing was undertaken at transaction level on historical financial data in the form of manual and detective type controls.

The KRU is usually focused on past events and is used as part of the management control function. Reporting lines are typically to a financial executive and, as such, KRUs are not truly independent in terms of determining the scope of work of the function, performing work and communicating the results of work.

In many modern Russian companies the KRU exists alongside Internal Audit (IA), which functions as the instrument used by the Board of Directors to independently assess how management is performing functions delegated to them by the Board. Specifically, the IA independently assesses whether management effectively performs the function of ‘risk management’ and ‘business process controls’.

The Russian securities market regulator, the Federal Service for Financial Markets (FSFR) encourages companies to invest in internal control and audit systems, and promotes the Code of Corporate Governance. Order of the FSFR № 06-68 of 22 June 2006 specifically requires (for A and B level listed companies) that “...the Board of Directors of the issuer should approve a document that determines internal control procedures over financial reporting and business operations. Control over compliance with the internal control procedures should be performed by a separate department that reports to the Audit Committee or equivalent of the issuer”.

Russian companies, especially those that strive to be leaders in their sectors, are learning well from the lessons of North America and Europe. Whilst investment in internal control systems is difficult, especially now that the pressures of a fast growing Russian economy are combined with demand for greater efficiency and empowerment, management and owners are becoming aware that this is a priority.

There is often a gap between the control systems currently in place and frameworks such as COSO, or those required by individual jurisdictions for listing purposes. Russian organisations are therefore investing significant resources in upgrading both their accounting and internal control systems.



## Outlook

Russia has made significant progress in recent years in terms of both accounting and corporate governance reform. The reform process is continuing and moving ahead in response to evolving legislation and the developing maturity of corporations. Changes are being driven by the desire to raise capital and debt from international banks and financial institutions, including through listings on foreign exchanges. The forecast is for further change and convergence with IFRS and corporate governance frameworks in accordance with best international practice.

## Financing a business (Alexander Arutyunyan, First Vice-President of IC RUSS-INVEST)



**Alexander Arutyunyan**

Alexander Arutyunyan is First Vice-President (chief investment officer) of IC RUSS-INVEST. He joined the company in 1997. Since that time he has held various positions in the company in the area of asset management, strategy and re-

search. Alexander graduated from Moscow State University, USSR, where he received a Candidate of Science in Economics degree (PhD) in 1988. He holds an MBA degree from Eastern University, USA (1992).

Intensification of the world financial crisis, which happened in August-September 2008, seriously affected the Russian credit system and caused a considerable liquidity squeeze. This credit crunch was triggered by the inability of some Russian banks to fulfil their obligations on the REPO market and reflected the high debt burden of Russian banks and companies, which have to repay USD47.5 billion of accrued interest and debt to foreign creditors in the fourth quarter of 2008 alone<sup>1</sup>. These payments combined with the exodus of foreign portfolio investors caused considerable outflow of capital. As a result, the abundance of capital disappeared at once, and companies and banks are striving to find new sources of financing.

Recent Russian economic growth caused considerable M&A activity. In 2001-2007 the number of M&A deals increased 2.9 times, while the total value rose from USD12.4 to USD120.7 billion.<sup>2</sup> As a result the GDP share of M&A more than doubled from 4.0% to 9.3%. In the first half of 2008, despite the periodical lack of liquidity, the total value of M&A deals was equal to USD71.8 billion.<sup>3</sup> Those figures are still modest in comparison with the USA and the EU, but it is necessary to underline that the majority of Russian companies are run by their owners who prefer to control up to 75% of listed stock. Low free float sometimes creates a serious obstacle for corporate mergers and effective restructuring of a Russian business. However, the current financial crisis and

<sup>1</sup> Source: [www.cbr.ru](http://www.cbr.ru)

<sup>2</sup> Source: [www.mergers.ru](http://www.mergers.ru)

<sup>3</sup> Source: [www.mergers.ru](http://www.mergers.ru)

the drastic decrease in stock prices will create new opportunities to acquire assets of bankrupt companies despite the inevitable slowdown of M&A activity in Russia and will make the Russian economy more efficient and competitive.

Like in developed economies the rationales for Russian M&A transactions (mainly operating mergers) are connected with synergy creation, tax optimization, diversification, and concentration of market share. However there are some specific features of this process in Russia. In expanding their business, Russian companies first of all relied on accumulated net income, because there were substantial barriers in relation to raising capital in the past. Only in 2005–2007 the situation changed due to the massive inflow of capital, and Russian companies and banks borrowed heavily. Despite the initial lack of funds most M&A transactions were financed by cash, and stock issuance was as rare as leveraged buyouts (LBO). In 2007 the share of LBO deals in the total M&A value was equal to only 2.2%.<sup>4</sup> In addition, almost all deals were public, whereas private financing remained insignificant. Russian companies, choosing a basic financial approach, adopted an aggressive one concentrating on short-term financing as an easy and less costly way to finance a business. Today, due to the financial crisis, this situation has been changing rapidly, and Russian companies are eager to balance the advantages and disadvantages of both short and long-term financing. But, as for the source of business financing, they will continue to rely mainly on accumulated net income, at least in the short run, because of the liquidity squeeze.

### Short-term financing

In Russia short-term financing instruments (like cash, accounts receivables, trade credit, bank loans, bills of exchange) usually have a maturity less than a year and are used to finance additional working capital and current assets, or as a risky means of interim long-term project or bridge financing.

One of the most widespread sources of short-term financing remains commercial lending. In 2001–2007 domestic short-term bank loans lent to Russian companies soared from USD23.6 to USD289.3 billion.<sup>5</sup> They are still the dominating form of financing. In 2007 one-year-or-less bank loans were equal to 52.1% of the total amount. This year, despite the current liquidity crisis, the volume of these loans has increased by almost 25.8%. The structure of bank

lending is also changing and becoming more favourable for Russian companies. The share of short-term loans decreased from 83.7% in 2001 to 52.1% in 2007, while the share of 3-year (and longer) loans increased from 6.5% to 20.0%. In contrast to the international financial market this kind of financing is more expensive in Russia because of higher interest rates and commission. Nevertheless, borrowing became cheaper as in 2001–2007<sup>6</sup> rouble interest rates declined from 18.5% to 9.2% p.a. As a result real yields became negative. In a situation of negative real yields, rising inflation and growing liquidity pressure it was unreasonable to expect a further decline in interest rates. Today nominal yields of almost all financial instruments are on the rise and interest rates are not an exception – they climbed up to 15–20% p.a.<sup>7</sup> The era of relatively cheap credit is over at least for a couple of years, as long as inflation remains high.

When making a financial decision it is also important to take into account the extensive regulation of the Russian banking industry, including mandatory reservation requirements and risk management, which could prevent your bank from opening a credit line.

Another short-term instrument of financing in Russia is bills of exchange or promissory notes. The issuance of these instruments is regulated by a simple covenant. The relative shortage of money in the nineties, the lack of regulation and certain differences in reservation requirements made this instrument quite popular in Russia. The nature of the Russian bill market to some extent resembles the commercial paper market in the USA. In 2006 the approximate value of the market ranged from USD19 billion to USD25 billion. The market has been growing since 1999, but it is quickly losing its position to the bond market, resulting in a declining share of bills in gross Russian debt. As a rule, bills of exchange are used to finance current assets and almost never to finance M&A transactions. The bill of exchange legislation is straight-forwarded, permitting direct enforcement of failed transactions. An obvious disadvantage of this instrument is the lack of transparency and regulation.

Corporate bonds belong to long-term financing instruments. However, Russian legislation created an entirely new tool – short-term exchange bonds. These bonds are exempt from provisions on state registration (including registration of a prospectus) with the Federal Financial Markets Service (FFMS),

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<sup>4</sup> Source: [www.mergers.ru](http://www.mergers.ru)

<sup>5</sup> Source: [www.cbr.ru](http://www.cbr.ru)

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<sup>6</sup> June 2007

<sup>7</sup> Source: [www.cbr.ru](http://www.cbr.ru)

but the issue must be registered at a stock exchange together with a prospectus. Moreover, the company is able to issue exchange bonds only if its shares are listed at the same floor. Total placement of exchange bonds exceeded RUB43 billion (USD1.6 billion) in 2007–2008.

### Long-term financing.

The fast expansion of business and, especially, the current financial crisis, makes consideration of the capital structure one of the most important issues for Russian companies, because, as a rule, major stakeholders are not willing to lose control over the company. Recent events, when some prominent Russian businessmen received margin calls on their collateralized loans, will make them more sensitive to this issue in the future. In choosing between debt and equity they preferred to use equity financing, as a cheap method, only if they retain power or, on the contrary, as a way out of the business. As in the rest of the world, long-term financing provides an opportunity to finance expansion of the business or a project rather than to complete just one transaction. There are two major sources of long-term financing – bond placement and a stock initial public offering (IPO) – and both are used by Russian companies.

Born in 2000 the corporate bond market became a leading source of long-term financing for Russian companies and helped them to create a public credit history. In 2007 the value of the corporate bond market increased by 41.0% compared to 2006. Today the Russian corporate bond market is equal to USD61.8 billion.<sup>8</sup> The spreads and effective yields have been declining for the last five years, as well as the commission, making bond issuance a less expensive and more competitive debt instrument. For example, in 2005–2007 the aggregate effective yield of corporate bonds decreased from 9.56% to 8.21% p.a.<sup>9</sup> However, recently corporate bond yields have come back to a level between 15% and 30% p.a. Obviously these yield levels will be not sustainable for a long period of time and will decrease when liquidity returns. But, today Russian companies and banks are postponing bond placements for the reason that market sentiments are negative.

In accordance with Russian legislation any stock or bond issue (except short-term exchange bonds) must be accompanied by a registration statement

(with attached copies of the Board of Directors decision, articles and some other corporate documents) and a prospectus registered by the Federal Financial Markets Service. Such a prospectus should contain data about the issuer, its business (including financial statements), full details of the offered securities and other important information relevant for investors. Thus the pre-filing, waiting and post-effective (including state registration of the placement) periods involve a considerable amount of time and labour.

Due to the large demand for additional capital the Russian IPO/SPO (second public offering) market began to quickly develop from 2004. The total value of IPO deals in 2004–2007 increased from USD4.6 billion to USD31.0 billion<sup>10</sup> and in 2007 the Russian IPO market was among the top 10 leading world markets. Russian legislation in this area is comparable with international standards. Moreover, IPOs at Russian exchanges may be performed in a shorter period of time than in London or New York. The costs of an IPO inside Russia are also lower. Although a major part of Russian IPO deals is still done through foreign exchanges, the trend was encouraging for the domestic market. The share of IPO sales bought by international investors inside Russia was rising in 2007. However, we expect that Russian companies will continue to use foreign exchanges for IPO/SPO purposes, because of the recent crisis and administrative intervention of the Federal Financial Markets Service. Halting of trading on Russian stock exchanges has already moved turnover to London again. Like bond issuance IPO procedures are established by law and require registration of issued securities. The current financial crisis will slash initial and secondary public offerings due to the extremely low current valuations of Russian companies.

While debt and equity financing are the most popular tools in Russia, there is increasing use of other long-term financing instruments like bank loans and leasing contracts. Another example is creation of unit investment or mutual funds. Such financial solutions, combining the advantages of tax savings and raising additional liquidity, are especially popular in the real estate industry. The establishment of unit investment funds in this case paves the way for the securitization of the assets. It helps to raise additional funds using the real estate and some other assets as collateral put into the unit investment fund. At the end of December 2007 the

<sup>8</sup> Cbonds.ru (do not include eurobonds).

<sup>9</sup> Cbonds.ru

<sup>10</sup> National Association of Stock Market Participants (NAUFOR), MICEX.

net asset value of real estate and direct investment mutual funds was equal to USD9.1 billion.<sup>11</sup> But this is not an appropriate means for financing a sole transaction due to the lengthy process of registration, costly infrastructure and intense regulation of the unit investment industry. The legislation in this area is changing quite frequently. Therefore, professional and legal support becomes a key factor for the success of such financing projects. It is also necessary to take into account the consequences of the financial crisis, such as outflow of investors from unit investment funds.

Before making a decision any company in Russia will have to consider the benefits of different sources of financing, taking into account estimated funding needs, current and target capital structure, maturity matching between debt and assets, costs of financing, the effect on financial ratios and credit ratings, future interest rates and debt burden, tax consequences and certain other material aspects. Management must provide solid financial, consultant and legal support for such deals to make financing cheaper and less risky, resulting in a growing and effective business.

It is worth noting that the Russian government understands that the recent economic expansion based on inflow of foreign capital and relatively cheap foreign loans is vanishing, and it is necessary to change the economic model to maintain more than average GDP growth rates. The reaction of the monetary authorities was pro-active and helped, to some extent, to stabilize the financial situation. The Central Bank of Russia has cut reserve requirements twice and provides additional liquidity through REPO operations and Lombard auctions. The Ministry of Finance deposited RUB60 billion (USD2.2 billion) in Sberbank, Vneshtorgbank and Gazprombank. Russian Vnesheconombank received USD50 billion to refinance foreign debt of Russian banks and companies and opened the first credit lines. These measures will substitute foreign sources of financing and will make internal sources of financing more important and widely used in the future.

## Reorganising through staff outsourcing (Lyudmila Kazimirova, Head of Recruitment and Staff Leasing Services, SGS Vostok Limited, Moscow)



### Lyudmila Kazimirova

Lyudmila Kazimirova is the Head of SGS Recruitment and Staff Outsourcing Services for Russia and Kazakhstan, a role she has filled since 2006. Previously she worked in staff outsourcing and recruitment consultancy for a Moscow-based recruiting agency. At SGS, Lyudmila is responsible for the development and operations of the staffing services business-line in Russia and Kazakhstan, including executive search, mid-level and mass recruitment, staff leasing and project staffing focusing on industrial sectors of the economy. Her field of competence covers oil, gas, chemical, engineering, IT and other industries.

One of the first issues faced by an investor after an acquisition in Russia is personnel management. It is common practice for the investor to start reorganization, coupled with either a reduction or increase in staff. To reduce the risks arising as a result of such activities foreign investors would think of staff outsourcing in Russia as they do in the rest of the world. Below we shall focus on the pitfalls and recommendations with regard to staff outsourcing in Russia.

### Lack of legal framework

The key characteristic of the current market situation is the absence of any law regulating the relations between the staff provider keeping the payroll, the company physically employing the person and the employee.

There have been a lot of talks and disputes about the draft of such a law that will hopefully be considered in the Russian State Duma in 2009. The draft is entitled as follows "Regarding protection of rights of the employees hired by private employment agencies with the objective to provide their labour to third parties". Authors of the law propose to implement a licensing system for the agencies engaged in staff outsourcing so as to eliminate "grey" and not reliable providers from the market. There are also clauses determining the division of responsibilities between

<sup>11</sup> [www.investfunds.ru](http://www.investfunds.ru)

an employer and a staff provider, for example on HSE, financial responsibility and so on. Still, as long as this law is not enforced all the stakeholders are subject to the existing labour and civil law systems of the Russian Federation that do not take into account staff leasing particularities.

Therefore, when taking a decision on whether to use outsourcing in Russia, so far the investor should rely on his own and his partner's ability and experience to judge the best scheme for his specific situation and make relevant provision in the agreement between the two parties for every potential handicap.

### **Escaping paperwork?**

Staff outsourcing provides an opportunity to concentrate on an organisation's core business without being distracted by diverse and time-consuming paperwork and administrative issues in relation to personnel management. Indeed, you get rid of prikazy (orders), zayavleniya (applications), tables, pay-roll and other documentation necessary for the Russian kadrovoye deloproizvodstvo (paperwork related to HRM). Advantages are obvious when expatriates are concerned since staff outsourcing releases the organization from the need to go through the registration and work permitting procedure for foreign staff in Russia.

At the same time you should be prepared for assuming documentary logistics and communication concerning any changes in the employee's activities. In the contract between a provider and the employer it is advisable to clearly define responsibilities and specify timeframes. For example, if an employee goes on a business trip (komandirovka), the employer should send notice to his provider a few days prior to the trip so that the latter is able to issue a komandirovochnoe udostovereniye (trip authorising document) to the employee and transfer an avans (advance payment) to the person sent on the trip. It is also necessary for an employer and his staff provider to come to an agreement with regard to how soon a provider should issue required documents to employees following their personal requests. Quite often employees need to obtain spravki (references) or copies of trudovye knizhki (labour books) to provide to banks or other organizations and they might need to get these papers urgently. Ideally, the service provider should be able to cope with this.

### **Information needs protection**

One should also pay attention to the security of the information passed to the agency concerning all

HR matters of the outsourced personnel, especially concerning remuneration figures etc. Unless you stipulate a confidentiality clause in your contract with the staff provider information security could be at risk.

### **Social risks**

When opting for staff outsourcing, the social climate in the organisation should not be neglected. In Russia, many people still have no scruples in sharing labour contract terms with colleagues, which creates serious barriers for practising unequal conditions of work. If office personnel is partly outsourced and partly kept on your pay-roll, large discrepancies between their salary levels and fringe benefits could be critical for staff productivity and loyalty.

### **What kind of personnel to outsource?**

One of the key issues when considering an outsourcing scheme is to decide upon the right category of personnel to outsource. There are basically no problems for white-collar workers, but there can be difficulties when outsourcing blue-collar workers. The Russian social insurance system includes mandatory social insurance against accidents at work and occupational diseases with rates varying from 0.2% up to 8.5% from the total of labour remuneration depending on the organisation's occupational risks. A traditional recruitment agency would normally have a 0.2% tariff, whereas a manufacturing facility would be obliged to pay more. The legal solution for such a case could be partnering with a staff provider classified as an industrial facility itself and consequently paying the appropriate rate of the so called "traumatic tax", otherwise the outsourcing scheme could be considered as illegal. The same ambiguity relates to pensions, which an industrial worker is entitled to receive earlier than other employees. If he is not on the pay-roll of the plant, what is he supposed to be classified as by the pension fund— an office employee?..

### **The need for cooperation**

When outsourcing staff, an investor considerably reduces his legal risks due to the fact that according to the relevant documentation his workforce is employed by another company (the staff provider). Indeed, it is the provider who deals with hiring, dismissal, etc. However, if something happens in relation to discipline or HSE there should be cooperation between the two organisations to solve the problem, including in cases involving court examination.

Apart from having everything stipulated in the contract and hopefully in the law in the near future, Russian business environment still depends a lot on relations. The key to success in outsourcing, like in other activities engaging more than one party, is to have a clear understanding what each side expects from the partnership, implementation of an effective interaction scheme and a trustworthy relationship.

## **Taking security over receivables in Russia: the key legal issues** **(Elena Perepelkina, Legal Counsel, Vice-President in the Deutsche Bank Ltd. Legal Department)**



**Elena Perepelkina**

Elena Perepelkina has over 8 years of experience in structured international financing. Elena focuses on secured financing (including commercial real estate and development financing, securitization etc.), infrastructure projects, private

equity deals, and restructuring. Elena actively participates in the work of various round tables and public committees organised by Russian governmental agencies and major financial institutions, which work on development and improvement of existing legislation governing various types of financing (including securitization).

Prior to joining Deutsche Bank in 2007 Elena worked as a senior associate at Linklaters in both Moscow and London for 6 years.

Every investor is keen to secure its claims against a debtor and, hence, is interested in knowing how to take security effectively over various types of assets (including receivables) in Russia. Contractual rights to receive payments from local customers are often the only valuable asset of a Russian obligor. This is especially the case in the retail sector. As such receivables are governed by Russian law, investors need to comply with Russian law when taking security over such contractual rights. This is why both local and international financial institutions need to understand in detail how the rules on the creation, perfection and enforcement of security over Russian law receivables work. It is critically important for us now to analyse the applicable legal background carefully in the context of the market's needs. This will help us to identify the weaknesses in Russian law's current security mechanisms and determine the ways in which we can improve the existing regulatory regime. Any legislative improvements will inevitably facilitate the use in finance transactions of Russian law security structures which, at the moment, are viewed as being of little worth. Developments in legislation and market practice will help to ensure that the claims of investors are indeed effectively secured when they take security over Russian law governed contractual rights.

## A pledge over Russian law governed receivables

A pledge is the only form of security interest recognised by Russian law.

The principal features of a Russian law pledge are as follows:

- 1) A pledge does not entail the transfer of legal title to the pledged asset. Instead, the pledgee should be recognised by a Russian court as a secured creditor with priority rights over the pledged asset, i.e., with a right to satisfy its claims out of the sale proceeds of the pledged asset in priority to the claims of other creditors;
- 2) A pledgee's priority rights can be subject to certain exceptions. In particular:
  - Pledged receivables may be attached by unsecured creditors without the consent of the pledgee. Although current law requires that the legal rights of the pledgee are recognised, the procedure for the realisation and protection of a pledgee's priority rights in a third party creditor enforcement action is uncertain;
  - Furthermore, in bankruptcy proceedings, pledged assets (including contractual rights) are not excluded from the pledgor's bankruptcy estate and are subject to the general stay of execution applicable to the pledgor's assets; and
  - The pledgee's priority rights may be subject to certain super-priority claims of third party creditors under Russian law (such as persons with personal injury, employee wage or royalty claims), both in bankruptcy and in ordinary enforcement proceedings;
- 3) A pledge is not a very useful tool for 'offensive' purposes as the enforcement of Russian pledges is generally subject to significant substantive and procedural legal uncertainties and the enforcement process is potentially lengthy. Probably all financial institutions lending in Russia are aware of the fundamental rule of Russian pledge enforcement: a pledge may be enforced only through the sale of the pledged assets at a public auction to a third party and secured creditors in Russia are not able to benefit from most remedies (including self-help remedies) available in common law jurisdictions (e.g., taking possession of collateral immediately on default outside the normal legal process, selling collateral by way of a private sale, etc.); and
- 4) A pledge over receivables also has very limited value as a 'defensive' tool (i.e., from the point of view of establishing a pledgee's interest in the collateral assets and defending that interest

vis-à-vis third parties). As there is no registration system for pledges over receivables, third parties may not be aware that the contractual claims of an obligor are encumbered in favour of a lender.

Even on the basis of such a brief overview, it is obvious that there are a variety of material limitations on the effectiveness of Russian law pledges generally. This is why creditors wanting to take security over Russian law receivables often consider whether the disadvantages of a Russian pledge can be mitigated by using other arrangements (such as factoring) that, while not creating a formal security interest, have the economic effect of a secured borrowing. This is why there is a growing interest in using factoring agreements for security purposes among local and foreign lenders.

## Factoring of receivables

Pursuant to a factoring agreement, receivables owed to an obligor by third parties are assigned to the creditor 'by way of security' (i.e., not by means of an outright transfer). On the one hand, such a 'security assignment' does not create any proprietary interest in the assigned receivables and is simply a contractual arrangement. On the other hand, however, the enforcement of such a security assignment will not result in a public auction. As soon as there is a default under an agreement secured by factoring, the relevant claims of the obligor are automatically assigned to the creditor, who can then either satisfy the debts of the obligor out of the relevant receivables or privately sell those receivables. These general rules are quite straightforward which has meant that creditors have felt positive about factoring. There are, however, certain legal restrictions which need to be taken into account and should be carefully analysed. We summarise those restrictions briefly below:

### **Licensing requirement**

Unfortunately, under Russian law it is not absolutely clear whether a creditor wishing to secure its claims by entering into a factoring agreement needs a special licence. The relevant provisions of the Russian Civil Code make it clear that banks and other credit institutions have the right to engage in factoring business<sup>1</sup> (i.e., they may enter into factoring agreements as the assignees of the relevant claims) by virtue of their banking licence, whereas any other commercial organisations will need a special licence to do that. However, given that there is no established procedure for obtaining such a special licence and no regulator has yet been appointed to supervise this business or to licence it, it is impos-

sible in practice for a non-banking organisation to obtain a factoring licence. The question then arises as to whether the inability of a non-banking institution to obtain a factoring licence means that only banks and other credit institutions may currently enter into factoring agreements as assignees of the relevant receivables.

There are a number of arguments based on the interpretation of current Russian legislation to support the view that no licence is needed and, thus, that any commercial entity is entitled to be a creditor under a factoring agreement. Some lawyers (including commentators, academics and lawyers from both local and international law firms) consider these arguments to be quite robust and are of the opinion that any legal entity (whether incorporated in Russia or offshore) has the legal capacity to enter into a factoring agreement. There have also been some initiatives on the part of the Russian legislators to introduce amendments to the existing law expressly stipulating that no special licence is needed for a creditor to enter into a factoring agreement. However, although the relevant discussions started more than 3 years ago, no law to this effect has so far been adopted.

Unfortunately, due to the ambiguous drafting of the relevant provisions of the Russian Civil Code on factoring, which are then inconsistently interpreted and applied, there is still a risk that factoring agreements might be challenged due to the absence of a special licence granted to a creditor (assignee of claims). There are a few, but unfortunately unhelpful, decisions of the highest Russian courts supporting the view that non-banking institutions are not allowed to enter into factoring agreements as they do not hold a special license. However, those decisions date back to 1998-2004. Perhaps because the relevant rules are quite old, and because no publicly available court practice supports the same view today, market participants typically take a more relaxed approach to factoring. It is well known that a

number of non-banking institutions are actively and successfully involved in factoring business in Russia and for several years have purchased receivables under factoring agreements. This may be encouraging some non-Russian institutions when they decide to enter into factoring agreements to secure their claims this way.

#### ***Disposal of receivables assigned to a creditor under a factoring agreement***

It is important to remember that any further assignment of receivables being assigned to a creditor under a factoring agreement needs to be expressly permitted by that factoring agreement. The Russian law provisions relating to factoring will also apply to any such further assignment. This gives rise to a number of considerations:

- This may be interpreted as constituting a conflict of laws provision that purports to apply Russian law to any assignment of factoring receivables, even when such receivables are further assigned to a non-Russian entity and, in general, Russian law would allow such a further assignment to be governed by a law other than Russian law.
- The requirement to comply with the provisions of the Civil Code in relation to factoring may also give rise to a discussion as to whether it is possible to assign factoring receivables to a non-licensed offshore entity (broadly for the same reasons as described above).
- The other concern is whether the fact that an assignment of factoring receivables is subject to a special regime limits the ability to pledge such receivables as collateral for any borrowings made by the creditor. The concern arises because the pledge and assignment of receivables are closely related and, as a general principle, a claim may be pledged only to the extent it is capable of being assigned. Since the application of Russian law provisions relating to factoring to an assignment of factoring receivables may be interpreted as constituting a restriction on the assignability of such receivables, the concern arises as to whether such restrictions might amount to a limitation on the ability to pledge the factoring receivables. In the absence of any precedents or academic discussion, it is difficult to assess whether this is a material concern and, if so, what the implications would be. Arguably, the question of the assignability and/or pledgeability of factoring receivables is dependent on whether factoring requires a special licence or not. As mentioned, there are strong arguments to support the view that no licensing requirement should apply. If a court were to share this view, it might also be of the opinion that there should be

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<sup>1</sup> Russian law provides for two types of factoring agreements. The first type contemplates a true sale assignment (i.e., by outright transfer) in favour of the relevant creditor that provides financing to a debtor claims owed by third parties to such debtor. Entry into such factoring agreements has become a regular business for some entities and this is why it is sometimes referred to as 'factoring business'. The second type contemplates an assignment of a claim 'by way of security', which is the type of factoring addressed in this article. Both types of factoring are governed by the same Russian civil law rules (i.e., for instance, the same licensing requirements are applicable in each of the cases).



no reason why the validity of a pledge of factoring receivables to a non-licensed entity should not be acknowledged.

Finally, it should be noted that a factoring agreement may only be entered into by a creditor with a borrower of funds (and not a third party), i.e., unlike a pledge (which can be granted by a person who is neither a borrower of the relevant funds nor a guarantor of the secured obligations) factoring cannot exist as a form of third party security.

### **A pledge vs. factoring – how to improve the Russian legal framework**

Despite all the risks associated with factoring, market practice suggests interest in this instrument as a way of securing claims is increasing amongst both local and international financial institutions. Clearly, unlike pledgees, creditors entering into factoring agreements will benefit from the absence of highly regulated enforcement procedures which, in practice, may require a long period of time and result in the unreasonable protection of an obligor in default. Although there is no requirement for a potential pledgee to obtain a licence in order to enter into a pledge agreement in respect of contractual rights and a pledge is the only security interest currently recognised by Russian bankruptcy legislation, the public auction and court approval requirements substantially limit the pledgee's ability to realise value quickly from a pledge of assets. Furthermore, in the absence of perfection requirements enabling an investor to establish its security interest clearly over contractual rights, a pledge is of no real value as a defensive tool and, thus, it does not offer any meaningful advantage to a creditor when compared with factoring.

The above concerns indicate that the provisions of Russian law described in this article need to be improved. For instance, it is clear that the existing pledge enforcement rules need to be amended to make a pledge of contractual right more flexible and creditor friendly. A private sale of pledged receivables and an assignment of relevant contractual rights to a pledgee should be permitted. With regards to factoring, Russian law should make it clear that no licence is required to enable a creditor to use factoring as a form of security for its claims. Finally, it may also be useful to recognise that factoring is also a security interest for the purposes of Russian bankruptcy law.

This article is just a starting point in a detailed and thorough discussion which needs to be initiated amongst legislators, market participants, court

judges and legal counsel. Hopefully, this article will generate interest in the issues described and inspire a further critical analysis of the existing rules in relation to taking security over Russian law governed contractual rights. That will lead to further steps being taken towards the creation of effective security mechanisms in Russia.

## WHAT TO EXPECT IN THE FUTURE IN RUSSIA

### Outline of the declared future tax policy of the Russian Federation – 2009 to 2011

(Richard Wellmann, BDO Unicon, Moscow)



**Richard Wellmann**

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tional Tax, currently at BDO Unicon, Moscow, Russia. Richard worked in the German BDO member firm's tax department for almost 7 years before coming to Moscow. Here he has been working with international clients, mostly from Germany, providing them with tax advice on their investments in Russia.

A critical factor of a pre-investment evaluation in any circumstances is an assessment of the likely tax environment faced. In the case of Russia, this process should carry a higher priority as the fiscal reform process and subsequent refinements are ongoing. A realistic estimate of tomorrow's tax burden on the business's core activities, the general direction of legislation and any possible industry specific items are vital to the success of any undertaking. Tax laws in Russia, as elsewhere, are subject to the interests of various different parties, so constant changes are par for the course and any outlook is likely to be sufficiently accurate only for a short to medium period of time. In Russia, interest in courting additional investment is high and in order to address this, a medium term tax strategy has been published.

On May 26, 2008 the Presidium of the Government of the Russian Federation adopted the Russian Ministry of Finance's ideas on the evolution of Russian tax policy for the period 2009 to 2011 ("Основные направления налоговой политики в Российской Федерации на 2009 год и на плановой период 2010 и 2011 годов", hereinafter "the Guidelines")<sup>1</sup>. The Guidelines continue last year's declared tax policy for the period 2008 to 2010<sup>2</sup> and take it further. Accordingly, within the medium term the existing tax system is to be nur-

tured and developed. Among the goals are in particular exclusion of a rise in the nominal tax burden – provided the tax system stays balanced – unification of tax rates, improvement in the effectiveness of tax administration, and integration of the Russian tax system into the international tax system.

The fact that in some areas the proposed changes have already been put into effect, e.g. regarding taxation of dividends<sup>3</sup>, depreciation<sup>4</sup>, VAT tax exemptions<sup>5</sup> and social allowances<sup>6</sup>, may be cited as evidence as to the level of reliance that can be placed on their future implementation in general. What follows is a short overview of the intended changes that are most likely to affect foreign investments into the Russian Federation the most.

### Corporate income tax

**Transfer pricing** – So far the existing regulations on transfer pricing (art. 20 and 40 of the Tax Code of the Russian Federation, hereinafter also "NK-RF") are problematic in terms of practical application due to their ambiguity. The Guidelines criticize in particular the catalog of controlled transactions<sup>7</sup>, the current definition of "related party" ("взаимозависимое лицо"), the existence of a rigid 20% price range that – if observed – avoids tax drawbacks, the lack of detailed regulations for determining the arm's length price and the absence of sources of information. These deficiencies are to be remedied by 2009–2010. Furthermore, while currently the bur-

<sup>1</sup> The document can be downloaded from [http://www1.minfin.ru/ru/tax\\_relations/policy/](http://www1.minfin.ru/ru/tax_relations/policy/)

<sup>2</sup> "Основные направления налоговой политики в Российской Федерации на 2008–2010 гг.", see last year's edition of the AEB's «How to invest in Russia» publication, pg. 38-41

<sup>3</sup> Federal law № 76-ФЗ of May 17, 2007 - taking effect from January 1, 2008 – lowered tax rates on dividends

<sup>4</sup> Federal law № 121-ФЗ of July 22, 2008 – taking effect from January 1, 2009 – raises tax deductible allowances and thresholds

<sup>5</sup> Federal Law № 195-ФЗ of July 19, 2007 took effect in 2007 re innovative companies, Federal Law № 240-ФЗ of October 30, 2007 re special economic harbor zones took effect in 2007 (but zones themselves have not been implemented yet)

<sup>6</sup> Federal law № 76-ФЗ of May 17, 2007 taking effect from January 1, 2009 introduces (some) new rules re straight-line and declining depreciation

<sup>7</sup> E.g., loans are not within the scope of transfer pricing rules (letter of the RF Ministry of Finance of March 14, 2007 N 03-02-07/2-44)

den of identifying irregularities is placed on the Russian tax authorities, the Ministry of Finance aims to require that taxpayers maintain documentation on transfer pricing in the future. In this context the introduction of mutual agreement procedures between the tax authorities and taxpayers is also intended. Determination of arm's length prices is to be referenced to standard OECD terms and recommendations. The latest draft of a bill on transfer pricing was published on the web-pages of the Russian Ministry of Finance is dated November 11, 2007 and was intended to be discussed at the assembly of the RF Government on November 22, 2007.<sup>8</sup> So far no draft bill can be found in the Duma's database and it remains unclear when the amendments will be considered by the Duma to become a law.

**Tax groups** – Together with new transfer pricing regulations the Ministry of Finance plans to introduce group taxation rules regarding corporate income tax (“консолидированная налоговая отчетность”). A draft bill was published in April 2008.<sup>9</sup> Under certain preconditions, not only the distribution of dividends but also the implications of transactions within the group are planned to be disregarded for corporate income tax purposes. It is intended that losses of group companies may be set off against profits of other group companies.

**Depreciation of fixed assets** – The Guidelines on the one hand comment on stimuli to boost investment in fixed assets, e.g. increased one-off deductions (currently 10% of depreciable fixed assets can be deducted as ‘investment premiums’) or requalification of assets within asset groups. On the other hand they elaborate on measures to prevent misuse of such tax benefits, e.g. a ‘return of tax benefits’ if holding periods are not met or certain contractual designs are effected. Citing simplification of depreciation computation as the reason the RF Ministry of Finance is considering abandoning, for the greater

part, the unit account method of valuation in favor of a pool account method from 2010-2011 onwards.

**Loss carry-forward** – From 2010 onwards the Guidelines suggest considering the introduction of loss offset restrictions regarding group reorganizations or acquisition of legal entities carrying forward losses.

**Permanent establishments** – From 2009 onwards the RF Ministry of Finance suggests considering that foreign companies may create a permanent establishment in Russia without having a definite location there, e.g. by employing traveling sales representatives or service personnel, and by being a partner in a ‘simple partnership’ (“простое товарищество”, chapter 55 of the RF Civil Code).

**Tax year** – From 2010 onwards the RF Ministry of Finance intends to consider whether the tax year should always coincide with the calendar year and if monthly or quarterly calculations of profit tax prepayments can be abandoned in favor of paying a corresponding part of last year's profit tax.

**Taxation of non-residents and tax residency** – To this day there are no statutory regulations on controlled foreign companies in the Russian Federation. In last year's tax policy guidelines the Ministry of Finance suggested that rules for base companies established in low tax jurisdictions be introduced and that extended reporting duties of parent companies that are taxpayers in the Russian Federation be imposed. This year's Guidelines did not elaborate on such regulations.

At present the Russian Tax Code uses the terms “Russian organization” and “Foreign organization” (art. 246 NK-RF), that both exclusively refer to legal entities (or, for that matter, their respective branches or representative offices under Russian legislation). Last year's tax policy guidelines suggested that the term “tax residency” (“налоговое резидентство”) be introduced in 2009 replacing both older terms. Accordingly, legal entities whose head office was located in the Russian Federation or whose majority shareholders were resident in the Russian Federation would then be deemed tax residents. Profits of such tax residents earned outside the Russian Federation were to become subject to corporate income taxation “in the amount of the difference between foreign and Russian tax”. This year's Guidelines no longer mention this concept.

## Taxation of the extraction of mineral resources

Natural resources that are extracted under the jurisdiction of the Russian Federation are subject to

<sup>8</sup> Проект федерального закона “О внесении изменений в часть первую и часть вторую Налогового кодекса Российской Федерации, а также признании утратившими силу отдельных положений Федерального закона от 9 июля 1999 года №154-ФЗ “О внесении изменений и дополнений в часть первую Налогового кодекса Российской Федерации”; the draft bill and additional statements can be downloaded from [http://www1.minfin.ru/ru/tax\\_relations/policy/use\\_regulation/government\\_docs/](http://www1.minfin.ru/ru/tax_relations/policy/use_regulation/government_docs/)

<sup>9</sup> The document entitled «Законопроект о внесении изменений в Налоговый кодекс Российской Федерации. Пояснительная записка (21.04.2008)» can be downloaded from [http://www1.minfin.ru/ru/tax\\_relations/policy/use\\_regulation/](http://www1.minfin.ru/ru/tax_relations/policy/use_regulation/)

taxation in accordance with legislation (“Налог на добычу полезных ископаемых”). Due to the enormous quantity of oil, gas and other commodities that are extracted on the territory of the Russian Federation, the tax on the extraction of mineral resources contributes a major part to Russian federal tax revenue (according to the information of the Federal Tax Service of the Russian Federation, the natural resources and commodities sector contributed about 16% to the budget in 2007).

In order to develop new deposits and to boost the efficiency of production at already mostly depleted deposits, new tax incentives have already been introduced to legislation<sup>10</sup>, e.g. the introduction of a zero tax rate in parts of eastern Siberia, north of the Arctic Circle, in the Azov and Caspian Seas and Yamal-territory.

### Value added tax

Value added tax (VAT) is ascribed great importance in Russia as it contributes a substantial percentage to the Federal Budget (in 2007 almost 20% according to the statistics published by the Federal Tax Services of the Russian Federation). In addition to the standard VAT rate of 18% and a reduced rate of 10% there is a zero rate that applies in particular to the export of goods from the Russian Federation. As it is still often necessary to turn to the courts for help at least in easing delays in reimbursement of input VAT, the Russian Association of Producers and Entrepreneurs’ (“Российский Союз Промышленников и Предпринимателей”) publicly demanded at the beginning of 2007 that the regular VAT rate be lowered to 10% in order to limit entrepreneurs’ effective spending on and in relation to VAT. Claims to merge regular and reduced VAT rates into one common VAT rate that is lower than the current 18% rate have surfaced regularly since then and the Guidelines suggest that a decision on this issue should have been made by August 2008. However, so far no concrete details of changes have been announced and it seems that discussion will not commence anew before 2009<sup>11</sup>.

The Guidelines suggest considering whether in the future in order to qualify for the zero rate on exports payment documents should be submitted to the tax authorities as part of the necessary supporting documentation and considering whether the purchaser necessarily has to be a foreigner. Furthermore, from 2009 onwards issues in relation

to credit-invoices (“кредит-счетов”), insignificant inaccuracies in invoices that can be tolerated for input-VAT deduction, and input-VAT deduction in relation to the set-off of mutual claims should be tackled.

The introduction of an obligation to register for VAT purposes is no longer mentioned in this year’s Guidelines.

### Administrative proceedings

Taking effect already in 2007, a number of new provisions have been introduced<sup>12</sup> to improve taxpayers’ rights in relation to field audits conducted by Russian tax authorities. From 2009 onwards, the currently voluntary preliminary (administrative) proceedings against decisions by the Russian tax authorities are going to become mandatory before an issue goes to court. In a recent statement<sup>13</sup> the Federal Tax Service reports on improvements and arrangements that have been made in order to cope with such appeals and suggests that several details should be revised and amended to ensure a satisfactory handling of appeals.

In conjunction with the intended tightening of recording and documentation obligations in relation to transactions in an international context, in particular with foreign subsidiaries, the information exchange with foreign tax authorities is to be intensified to enable the Russian tax authorities to carry out their work more effectively. In light of cases that have become known to the public in Germany regarding requests of disclosure of information without probable cause<sup>14</sup> this road seems to have already been taken, at least as far as disclosure by the Russian tax service upon the request of foreign (in this case German) tax authorities is concerned.

### Unified social tax

Last, but not least, although barely mentioned in the Guidelines it should be noted that social contribu-

<sup>10</sup> Federal Laws № 151-ФЗ of July 27, 2006 and № 121-ФЗ of July 22, 2008

<sup>11</sup> See journal “Vlast”, № 39(792) of October 6, 2008

<sup>12</sup> Federal Law № 137 of 27 July 2006 (see footnote 6 above) brought, amongst others, in particular changes to art. 88 of the NK RF – desk tax audit, art. 89 of the NK RF – field tax audit, art. 93 of the NK RF – claim for documents during a field audit and № 100 of the NK RF – issuing of findings of a tax audit, specifying procedure and authority

<sup>13</sup> Letter of the RF Federal Tax Service of June 2, 2008 N MM-9-3/63

<sup>14</sup> Federal Fiscal Court of Germany, ruling of February 15, 2006, I B 87/05; Fiscal Court of M nster, ruling of January 10, 2005, 4 V 5580/04 S

tions are under scrutiny and expected to be raised significantly as pensions need higher funding.

Currently social contributions are combined in the Unified Social Tax that is exclusively paid by the employer and has a regressive rate from (generally) 26% to 2% (including 2 breaks) of an employee's remuneration. On October 1, 2008 the RF Government was presented "Plan 2020" that also included the proposal to raise Unified Social Tax from 2010 to 34% and to raise the first break in the rate from kRUR 280 to kRUR 415.<sup>15</sup> Public opinion disapproved of such measures and the decision on the reform measures to be taken was postponed until 2009.

## Financial reforms and investments, an international and Russian perspective

(Art Franczek, President, American Institute of Business and Economics)



**Art Franczek**

Art is currently the president of The American Institute of Business and Economics in Moscow (an English language MBA program that was founded in 1989). He holds degrees in History and Political Science in addition to an MBA, CPA

and a Masters of Taxation. In addition to managing AIBEc he teaches courses in IFRS, Taxation and Cost Management. He has served as a consultant for the Russian Central Bank (IAS 39), the World Bank (on implementing IFRS in Russia), The Bank of Albania (implementing IFRS and IAS 39) and has written many articles on IFRS, Customs and Taxation issues in addition to a book on IFRS.

Prior to coming to AIBEc Art served as a business consultant in Togliatti after working for many years as a Corporate Tax Manager for a Fortune 1000 company.

History tells us that great economic crises give rise to significant reforms. In 1929 the US Stock Market Crash resulted in the SEC Acts of 1933 and 1934 that among other things required listed companies to produce audited financial statements. In 1972 Watergate and the rampant corporate corruption bribes resulted in the Foreign Corrupt Practices Act of 1977 that required significant internal control procedures along with prohibiting US companies from making bribes... More recently, the scandals related to Enron, WorldCom, Parmalat and others gave rise to Sarbanes-Oxley in the US and comparable reforms in Europe. New financial reforms are currently being written to deal with the global sub prime crisis. The purpose of this article is to review some of the recent reforms such as Sarbanes-Oxley and to discuss some of the current trends in reforms that will have significant impact on international and Russian investments.

Several months ago I participated in a Corporate Governance conference in Moscow. One of the sessions had a panel that included David Tweedie, Chairman of the IASB, Robert Hertz, Chairman of the FASB, William McDonough, former chairman of the PCAOB, and Kathleen Casey, a Commissioner

<sup>15</sup> See newspaper "Kommersant" № 178(3995) of October 2, 2008

of the SEC. The audience of 15 people included Senator Sarbanes and Congressman Oxley. Needless to say the discussion portrayed SOX in a favourable light pointing out how the EU has adopted similar legislation and how the improved transparency can reduce the cost of capital by about 15 percent. At the next session I attended on Shareholder Activism SOX was discussed. It was pointed out that many directors now need to take their lawyers to board meetings because of SOX. Other panellists mentioned that the indirect costs to the American economy were about 1.1 trillion dollars and the cost of compliance was 6 billion dollars annually. In addition it was mentioned how a significant percentage of IPOs are going to London rather than New York. I mention this story because in my mind it crystallizes many of the controversial issues relative to Sarbanes-Oxley.

Many of the provisions of SOX were a direct result of the Enron scandal. For example Section 302 requires the CEO and the CFO to certify that the company's financial statements do not contain any intentional material misstatements and it subjects the CEO or CFO to criminal penalties of 20 years in jail and a 5 million dollar fine if any are found. This provision is referred to as "the buck stops here" provision. Section 201 restricts the services that an outside audit firm can provide to the company it audits, this provision was put in because Arthur Andersen, Enron's audit firm, provided Enron with many consulting services and a conflict of interest was perceived. Section 802, which provides criminal penalties for altering documents, was a response to Arthur Andersen's shredding of documents that were requested by the SEC and it was part of their document retention policy. Section 806 protects "whistleblowers" and was put in because the Enron case was investigated due to an Enron employee who was a "whistleblower". Section 401 requires much stricter disclosures for Special Purpose Entities. Enron's extensive use of 3,000 SPEs in order to exclude many undesirable business transactions from its financial statements was a principal reason for Enron's demise.

The most onerous provision of SOX is Section 404. This section requires that the CFO and CEO attest to the effectiveness of the internal controls of their company and also requires that the company's audit firm review and attest to their effectiveness. This provision was put in SOX because many of the scandal ridden companies such as Enron and WorldCom outsourced their internal control function, sometimes to the audit firm. The implementation of section 404 can be very costly for a company.

The PCAOB has mandated that companies adopt COSO, a standardised internal control system, in order to fulfill the section 404 requirements.

No law, no matter how well intended, can be effective unless there are strong enforcement procedures. Title I. of Sarbanes-Oxley establishes the Public Company Accounting Oversight Board that has a wide range of authority. The PCAOB is responsible for registering accounting firms that perform audits of corporations. The required registration is a comprehensive process that requires detailed information on the CPAs who will be performing the audit and the audit firms must also disclose the fees collected from the corporation it has audited. Another important responsibility of the PCAOB is to establish Auditing Standards; these standards include auditing, quality control, ethics independence and other key audit areas. In 2003 shortly after the PCAOB was inaugurated the auditing standard AS2 was issued that provided rules-based detailed procedures on how to establish internal controls for a company. The PCAOB received many complaints from companies because AS2 was far too complicated and expensive to implement. The PCAOB subsequently issued auditing standard AS5 in July of 2007. AS5 is a principles-based standard and has been much easier for companies to implement.

The PCAOB is also responsible for conducting inspections of registered public accounting firms, conducting investigations and providing disciplinary procedures and enforcing SOX compliance. During the last several years the PCAOB has issued major fines and penalties against all of the Big Four firms for failure to provide adequate audit procedures in areas such as valuation, IT controls and the departure from GAAP. The PCAOB has made itself clear to all that there will be serious consequences for those firms who violate audit procedures.

The significance of the PCAOB may be greatly enhanced in several years when GAAP and IFRS complete their convergence project. SEC chairman Christopher Cox has said he wants to propose a "public policy oversight board that will oversee the IASB. Mr Cox said that the oversight body should be made up of national securities regulators and makes the IASB's governance consistent with the requirements of Sarbanes-Oxley. It must be noted that the EU has adopted most of the provisions of SOX that are mainly reflected in the 8th Directive; the EU has some difficulty enforcing these because of the inconsistent application of some EU countries. Cox's proposals should help to make SOX a worldwide standard that will have effective enforcement procedures.

On the 27th of August 2008, the SEC approved for public comment a long awaited proposed "roadmap" related to the eventual use of International Financial Reporting Standards (IFRS) by US companies. The roadmap anticipates mandatory reporting under IFRS beginning in 2014, 2015 or 2016 depending on the size of the issuer and provides for early adoption in 2009 by a small number of very large companies that meet certain criteria. The objective of this convergence project is to establish a high quality global reporting system that can allow companies to attract capital at a reduced cost through a transparent accounting system. The convergence of GAAP, a rules-based accounting system and IFRS, a principles-based accounting system involves many different issues. The FASB and the IASB are currently working on convergence projects in Intangible Assets, Leases, Post Employment Benefits, Revenue Recognition, Consolidations and SPEs and Business Combinations.

The current sub prime crisis that is engulfing the world's financial markets has many causes such as predatory lending practices, poor government regulation, and the encouragement of sub-prime loans by Fannie and Freddie, loose monetary policy and other reasons. The driver of sub-prime loans for a number of years was the widespread practice of securitization among many financial institutions. The alchemy of securitization turned illiquid mortgages into liquid securities, available for sale. These were now financed by short-term debt, vulnerable to every fluctuation in the market. Whereas before securitization, the underlying mortgages generally ended up with investors who held them to maturity and not for sale. Hundreds of billions of dollars in CDOs generated from the securitization process were now required to be reported at fair value on their balance sheets under GAAP and IFRS. Fair value for these securities can be easily determined if they are listed on an exchange. However most of these CDOs were not listed and their value had to be determined by some sort of financial model or by an ABX index for sub prime mortgages. Many blame fair value for causing the credit crisis, arguing that it can cause a downward spiral in prices by encouraging institutions to sell assets quickly and forcing them to take write-downs that do not reflect the "true value of the underlying assets." The fair value issue is a high priority issue as IFRS and GAAP move toward convergence. Provisions concerning the use of Fair Value were also included in the recent 700 billion dollar Wall Street bailout package.

The last few months have demonstrated that Russia is not immune from fluctuations in the inter-

national financial markets. The RTS has declined by over 50% largely because foreign investors have fled the market due to the sub-prime crisis; in fact the Russian stock exchanges seem to stop trading on a regular basis because of declines in value. The price of oil has declined in recent weeks because of the world economic downturn. The lack of liquidity in Russia has caused a significant decrease in auto sales and mortgage lending. Many IPOs and other major deals have been put on hold because of the worldwide liquidity crisis.

All of the reforms I have discussed are designed to improve transparency, corporate governance and to facilitate the international movement of capital. We can expect many more reforms in the near future as governments respond to the sub-prime crisis.

For the past few years Russia has had little incentive to adopt many financial reforms such as the adoption of IFRS (Russia has adopted about 20 out of 42 IFRS standards) because it was generating huge cash reserves from oil related revenues. Just as the sub-prime crisis will motivate governments around the world to adopt significant reforms perhaps Russia will adopt these reforms as it further integrates into the world economy. If it does so it will create a more positive business environment for investment.

## **ABOUT THE ASSOCIATION OF EUROPEAN BUSINESSES (AEB)**

The AEB was established in 1995 on the initiative of several European companies registered in the Russian Federation, Ambassadors of EU member states and the Head of the Delegation of the European Commission to the Russian Federation. The AEB is an independent non-commercial association with a membership of over 600 companies

AEB membership is made up of enterprises and entrepreneurs from the member states of the European Union (EU) and the European Free Trade Association (EFTA), which have business activities with and in the Russian Federation. These members form the AEB General Assembly (GA), which determines the overall strategy and policies of the association.

The mission of the AEB is to represent and promote the interests of its Members by supporting them in doing business with and in Russia through quality lobbying, information support, and through activities aimed at improving the Russian trade and business environment in conformity with internationally accepted business principles and promoting integration and partnership between the European Union (EU) and Russia.

The AEB conducts lobbying activities through its committees and working groups, which cover a wide spectrum of industries and sectors, including Finance and Investment, Visa Task Force, Energy, Customs & Transport, Machine Building and Engineering, Safety, Health, Environment and Security and, Finance and Investments – to name but a few.

The committees work closely with the Russian and European authorities, for instance by holding public and closed meetings with government representatives and submitting comments and amendments to draft laws.

The AEB also offers informational support to the European business community via its website and publications, press campaigns, surveys and legislative and business alerts.

The Association works hard to support its members wherever they are located in Russia by hosting regional presentations, business missions and maintaining regional representations, such as Krasnodar Steering Committee and local presence in Yekaterinburg.

## **ABOUT THE FINANCE & INVESTMENT COMMITTEE OF THE ASSOCIATION OF EUROPEAN BUSINESSES**

Since 1995, the AEB, (formerly the European Business Club), has evolved from an informal business organisation into an influential group that improves the business and trade environment of European business in the Russian Federation. The AEB has over 400 member companies that participate in sixteen committees, two working groups and numerous sub-committees. In addition to events held in Moscow, the AEB is increasing its activity in the Russian regions as well, with a Steering Committee in Krasnodar and a Delegation in Yekaterinburg.

The AEB's mission is to represent and promote the interests of European companies conducting business in and with the Russian Federation. The AEB promotes economic integration and partnership between the Russian Federation, European nations and the European Union.

The three main functions of the AEB are effective lobbying, quality information, and valuable networking. The AEB is a forum for dialogue between international businesses and the Russian Govern-

ment. The AEB participates in lobbying in the Duma and in the Federation Council.

Over the last ten years, the AEB's lobbying initiatives have included a wide range of issues of importance to its members including: small- and medium-size business issues; transport and customs; alcoholic beverages import; visa issues; taxation; corporate governance issues; and anti-monopoly issues, making it a significant voice in policymaking in the Russian Federation.

Furthermore, the AEB participates in dialogue with administrative bodies to promote AEB member interests. These organisations include: the European Union; Industrialists' Round Table (IRT); Foreign Investment Council (FIAC); EBRD; OSCE; IFC; IMF; and the Federal Anti-monopoly Service.

The mission of the AEB Finance Committee is to improve the investment climate in Russia by integrating the information and discussion related to the critical finance issues that are of prime importance for foreign companies working in Russia. These in-



clude accounting, auditing, and financial reporting; capital markets; ratings standards; and investment, corporate finance, and venture capital. To achieve these objectives, the Finance Committee serves as

a forum for discussion, lobbying and information network for the exchange of ideas concerning finance issues among finance officers, accountants, auditors and policy makers in Russia Federation.



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