

## 9. INVESTMENT POLICY

### Financial risks associated with investments in Ukrainian companies



A foreign investor that intends to invest in Ukrainian companies or to buy a stake in a Ukrainian company (further: to invest) will meet the following financial risks associated with Ukrainian business:

1. Maintaining of accounting records and preparation of financial statements are based on Ukrainian GAAP. However Ukrainian GAAP were implemented based on IFRS conceptual framework, some differences exist. The differences relate to bookkeeping of certain transactions as well as to applicable bookkeeping practices. Ukrainian companies keep their records not after the transactions were completed but after receiving documents that support the transaction (so called “source document” principle). Such bookkeeping practice is a heritage of tax accounting and does not match with faithful representation principle of IFRS. As a result, accounting records made based on local GAAP do not reflect the substance of business activity. Consequently, during the analysis of financial performance and financial position of a Target company, vague trends that even management cannot explain arise. So there is a risk of making wrong investment decision based on inadequate financial information.

Where the company’s financial statements are prepared following local practices on the basis of “primary/supporting document” principle, special adjustments are required to use financial statements for investment decision making. Consequently, during financial Due Diligence procedures, adjustments related to local bookkeeping practices should be made to align financial information with IFRS conceptual framework.

2. The next peculiarity of financial accounting based on Ukrainian GAAP concerns accruals. Ukrainian companies seldom perform accruals regarding transactions carried out with no supporting documents. Thus, the information about the actual liabilities of the company is not always represented in the statement of financial position. That is why there is a risk of incomplete representation of current liabilities in financial statements.

It is worth mentioning that there is a program of transition to IFRS in Ukraine (insurance companies, banks and public companies will be obliged to prepare financial statements according to IFRS since 2011).

3. Separate tax accounting. Unlike the common world practices, tax reporting in Ukraine is not in any way connected to financial accounting. Tax base is calculated based on the “first event” principle (so the basic principle of accounting – accrual basis is not applied in tax accounting). Thus, to ensure that tax base (corporate income tax and VAT) is estimated correctly, a special tax audit must be performed. During the assessment of tax risks even audited financial statements are not useful.

It is also worth mentioning that from the January 1<sup>st</sup>, 2011, the new Tax Code is expected to be effective, which will fundamentally change the tax system of Ukraine and bring together the tax and financial accounting (the data of financial accounting will be accepted as a basis for determination of tax base).

4. Tax evasion and use of optimization schemes. Tax evasion is widespread among Ukrainian companies. However, unlike the

world practice of tax planning through the use of jurisdictions with a low tax rate, Ukrainian business uses other methods, based on dummy transactions. Dummy transactions influence not only data of tax accounting but also distort the data of financial accounting. That is why during the financial Due Diligence procedures, the financial data need to be adjusted to eliminate any “optimization” transactions, which have nothing in common with the company’s business activities.

The other side of using the Ukrainian methods of tax optimization is incomplete representation of income and expenses. The major portion of income and expenses related to business activities are not represented in accounting records, and therefore in financial statements, therefore distorting the financial performance. That is why additional expenses may be incurred subsequent to the investment made, which were not taken into account during the investment decision making, which will significantly impair the effectiveness of the investment. Unrecorded Income might not be subsequently stated in financial accounting records, since business partners refuse to change the worked out format of business relationships. Such income cannot be neither represented in financial statements, nor confirmed by the auditors’ report, which significantly reduces the investment attractiveness of a company and its ability to raise financial resources on favorable terms.

5. The peculiarities of management accounting. Because of the practice of intensified tax optimization, financial statements do not reflect the actual financial performance and are not suitable for pre-investment analysis (it is not always possible to adjust all “optimization” transactions). In such case management accounting may be helpful, which is used in local practice not only to make management decisions, but also as an alternative for financial reporting. However, management accounting also has certain features that must be taken into consid-

eration during pre-investment analysis, which significantly influence the investment decision making. First of all, Ukrainian companies mostly keep management accounts using the cash method of accounting. It means that the basic principle of financial accounting – the accrual basis is not applied. Moreover, income and expenses comprise also indirect taxes, VAT in particular. That is why management accounts cannot even partly replace financial statements in terms of obtaining reliable financial information, since management accounting data do not even correspond to the basic principles of financial accounting. It is also worth mentioning that management accounting generally does not contain the full financial reporting package: usually only a statement of cash flows is prepared; and since the accrual basis is not used, both income statement and analogue of statement of financial position are not available. That is why management accounting is not suitable for making a reasonable investment decision, because it contains no data on the company’s financial performance and cost effectiveness.

However, if an investor still made a decision to use the management accounts during the pre-investment analysis, then information about the income and expenses must be adjusted for VAT amounts. The company should also present the analogues of income statement and statement of financial position. In respect of the adjustments to income and expenses regarding VAT, it should be mentioned that it is a rather laborious task. In Ukraine there are special tax treatments for the non-VAT payers. That is why the adjustment procedures may require analysis of almost every transaction separately.

Therefore, using the management accounting data for the purposes of investment decision making without additional adjustments is subject to the risk of distortion of financial information and hence making “overoptimistic” decision, which may substantively reduce the investment effectiveness.

6. Unrecorded liabilities regarding founders' pledges. Since all the above factors do not allow to use the financial statements as a basis for making an investment and credit decision, it is a common practice in Ukraine to pledge the property from other companies as collateral to guaranty founders/shareholders liability for credit relations with banks. Thus, it is probable that the company's property is pledged as collateral for credit liabilities of other company of the founder (these obligations have no relation to the business activities of the company). Such liabilities are very tricky, since they are not disclosed in financial statements (but only in off-balance-sheet accounts). It is quite difficult to identify such liabilities, if they are not stated in the off-balance-sheet accounts in violation of the financial accounting requirements. It creates the risk of both additional financial losses and the loss of company's property after making the investment.

7. The procedures of administrative or court appeal of accrued additional tax liabilities and penalty provisions. According to Ukrainian tax legislation, in case a company does not agree with accrued additional tax liabilities and penalty provisions, it has the right to initiate administrative or court appeal. During the appeal procedures, accrued tax liability is considered as non-agreed and is not to be represented either in tax reporting or financial statements. Accordingly, there are some serious risks of financial losses. Such risks can be minimized if the acts of tax

audits and the company's correspondence with tax authorities are substantively examined during Due Diligence procedures.

It should be mentioned, that according to the certain interpretations of new Tax Code, the tax authorities can exercise the right of tax pledge even during the period of administrative or court appeal.

8. Internal controls. Usually the internal control system in Ukrainian companies is under development. Internal audit services are seldom in place, and the company's business activities are strictly controlled by the founder. That is why a potential investor will have to strive for establishment of internal control system and to prevention from possible loss of assets and outflow of financial recourses.

All these and other factors, related to generally accepted business and accounting practices in Ukraine, bear considerable financial risks for a potential investor who is not aware of the peculiarities of Ukrainian business environment. At the same time, most financial risks can be prevented or minimized if they were identified during Due Diligence procedures.

Moreover, such risks should be considered during the negotiations regarding the investment, drafted in the investment agreement company's sales and purchase agreement, and also during the valuation of a Target Company.