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# INTERNATIONAL FINANCE CORPORATION

# UKRAINE
# BUSINESS DEVELOPMENT PROJECT

Final Operational Report

May 2001

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## I. PROJECT INFORMATION

| | |
|---|---|
| **Project:** | IFC Ukraine Business Development Project |
| **Grantee:** | International Finance Corporation |
| **Award No.** | 121-G-00-98-00618-00 |
| **Agreement Date:** | 9/17/1998 |
| **End Date:** | 4/30/2001 |
| **Amount Obligated:** | $2,496,250 (incl. Leasing Advisory Project - $170,000) |
| **Strategic Objective (SO):** | Accelerated Growth and Development of Private Enterprises |

## II. EXECUTIVE SUMMARY

***Overview***

With funding from the United States Agency for International Development (USAID), the International Finance Corporation (IFC) managed and implemented the Business Development Project in Ukraine, the goal of which was to improve conditions for the growth and development of small and medium-sized businesses. The project was a successor to IFC's USAID-funded Post Privatization Project in Ukraine and IFC Small-Scale Privatization Project in Ukraine as well as its two years of Post-Privatization work funded by the British Know How Fund (BKHF) in Ukraine and Belarus.

***Rationale***

The formal small business sector in Ukraine is small, even compared to neighboring countries that are going through similar transitions. IFC's research over the past three years in Ukraine confirms that some of the key obstacles to the development of small and medium-sized businesses are lack of managerial know-how, inadequate access to market information, and excessive government regulation. Particular weaknesses in the Ukrainian economy would be greatly improved by an increase in number of healthy small and medium-sized enterprises, and there is broad consensus among experts, donors, and policy-makers that small business development is a priority. The Ukrainian government had requested that IFC continue the Business Development Project (formerly Post Privatization Project) by supporting Consulting Centers in regional capitals and by advising the Ukrainian government on policy toward small businesses.

***Project Description***

The Project had four components: (i) establishment of Consulting Centers that provide training, consulting, and information services to small and medium-sized businesses in a sustainable manner; (ii) advisory work with local and central governments on business regulation; (iii) an information campaign directed at key government officials and the public at large on the importance of small and medium-sized businesses to the economy; and (iv) assessing and making recommendations for the improvement of the legal and market environment for leasing in Ukraine.

***Project Accomplishments***

Since August 1996, IFC opened 7 consulting centers (3 of which were opened directly under the current grant), all of which are self-sustainable. Collectively, these centers have assisted over 17,100 Ukrainian SMEs. This includes a wide variety of clients and activities covering three main areas of consulting, training, informational services. In total, UCN centers have:

- had almost 10,000 direct SME engagements;
- trained nearly 6,500 business people in a variety of areas;
- consulted 1,675 firms in areas like business planning and market research;

- provided other technical assistance to 1,800 entrepreneurs, and;
- engaged in almost 7,300 other client contacts and information services.
- Helped secure $5.4 million in direct investment and financing for Ukrainian SMEs

The Project has helped gain significant improvements in the SME enabling environment through its policy and public education activities. Specifically, IFC has advised the government and parliament on 26 different laws and regulations, which have made it easier for SMEs to survive and compete. Additionally, the Project conducted the only annual SME Survey in Ukraine (for 5 years running), which highlighted enabling environment issues such as registration, licensing, inspections and other key SME barometers of and traces their trends from year to year. The project has also educated millions of Ukrainians on the importance of SMEs to the economy through several hundred articles, television reports, and other publications.

Within the framework of UBDP, the Ukraine Leasing Advisory Project prepared a detailed assessment of the legal and market conditions for leasing in Ukraine and recommendations for their improvement. On the basis of these recommendations, the project provided training to entrepreneurs, financial institutions and government officials in 10 different regions of Ukraine. ULAP worked closely in advising key government officials in Kiev on necessary reforms for the development of a competitive leasing industry in Ukraine. As a result, a new Law on Leasing, drafted by the Project has already gone through three Parliamentary readings. The Project also published a leasing manual – "Leasing in Ukraine" (Annex 5)– that provides the reader with a clear understanding of how leasing works internationally and in Ukraine, and what is necessary to further improve the legal and tax environment for leasing.

## III. FINAL RESULTS

### IR – 1: Improved access to market business skills and information[1]

The scale and scope of a consulting center's activity are important indicators of its overall level of outreach to the business community. These, in turn, represent some measure of the centers' overall impact in terms of both the quantity and character of its work. Over the last 4.5 years, the centers created by IFC with USAID funding have delivered a wide range and high volume of services to Ukrainian SME's. These services fall into three broad categories – consulting, training, and provision of information services. It is important to note that IFC has never mandated centers to deliver specific services, training programs, etc. The goal has always been operational sustainability. Consulting centers were provided with all of the required tools to assist local business and then allowing the market to dictate what services were required.

Here we present a summary and analysis of both the volume and array of service delivered. The table below summarized broadly the activities for all seven centers created by USAID via IFC since August 1996:

**Table 1: SME Client Engagements**

| Center | Total Clients | Consult | % | Train | % | Tech. Info | % | General Info | % |
|---|---|---|---|---|---|---|---|---|---|
| Zhitomir | 3,612 | 598 | 16.6% | 768 | 21.3% | 1,357 | 37.6% | 889 | 24.6% |
| Sumy | 3,192 | 540 | 16.9% | 1,675 | 52.5% | 25 | 0.8% | 952 | 29.8% |
| Vinnytsia | 3,560 | 76 | 2.1% | 1,624 | 45.6% | 59 | 1.7% | 1,801 | 50.6% |
| Dnipropetrovsk | 3,029 | 180 | 5.9% | 1,334 | 44.0% | 80 | 2.6% | 1,435 | 47.4% |
| Simferopol | 1,467 | 72 | 4.9% | 350 | 23.9% | 105 | 7.2% | 940 | 64.1% |
| Chernigiv | 824 | 50 | 6.1% | 250 | 30.3% | 46 | 5.6% | 478 | 58.0% |
| Chernivtsi | 1,486 | 158 | 10.6% | 465 | 31.3% | 87 | 5.9% | 776 | 52.2% |
| **Client total** | **17,170** | **1,674** | 9.7% | **6,466** | 37.7% | **1,759** | 10.2% | **7,271** | 42.3% |

[1] All quantitative data in this report is correct as of December 2000.

***Business Education : Training and Seminars***

While the largest share of such assistance was in providing general business information (42%), more than half of all client contact has resulted in tangible, direct assistance to SMEs. The largest source of direct assistance was in the area of enterprise training (38%). Since their inception, consulting centers have developed more than 60 different training courses and seminars on topics as varied as Market Research for SMEs, Enterprise Restructuring, Risk Management, and Using the Internet in Your Business (*please refer to Annex 4 for more information*). Many of these topics have been adjusted or replaced by other themes to reflect changing market conditions and client demands. Collectively, in 4.5 years they have conducted:

- 460 business education programs, including
- 250 intensive training sessions, and;
- 210 thematic business seminars;

and, in the process, educated:

- more than 6,500 entrepreneurs and business managers
- from 4,200 Ukrainian firms.

Training sessions typically constitute 3-5 day, intensive sessions on topics such as international accounting standards, business planning, market strategy and marketing research, and cost and managerial accounting. Seminars are shorter sessions of anywhere from one-half day to two days in length and tend to fall into two categories – more narrow, highly specialized topics such as taxation and foreign trade and sub-components of broader training topics like the use of focus group research in developing marketing strategy for the firm.

In the context of business training and education, measuring business development service outreach can be done by looking at the number of events held, people engaged, or firms participating, depending on the goals of the outreach program. Table 2 below displays in detail the full scale and scope of consulting center business education activities and includes all three measures of outreach – people, firms, and activity volume or events.

**Table 2: IFC Consulting Center Training Courses and Seminar Activities**

| *Topic* | *Events* | *%* | *People* | *%* | *Firms* | *%* |
|---|---|---|---|---|---|---|
| Business plan/strategy | 69 | 15.0% | 1,027 | 15.9% | 602 | 14.3% |
| Marketing/Sales | 125 | 27.2% | 1,832 | 28.3% | 928 | 22.1% |
| Advertising/PR | 29 | 6.3% | 545 | 8.4% | 248 | 5.9% |
| Finance/Budgeting | 45 | 9.8% | 458 | 7.1% | 325 | 7.7% |
| Accounting | 56 | 12.2% | 774 | 12.0% | 608 | 14.5% |
| Personnel management | 32 | 7.0% | 527 | 8.1% | 599 | 14.3% |
| Other | 100 | 21.7% | 1,235 | 19.1% | 583 | 13.9% |
| Unknown | 4 | 0.9% | 67 | 1.0% | 304 | 7.2% |
| *Totals* | 460 | 100.0% | 6,466 | 100.0% | 4,198 | 100.0% |

As can be seen from the table above, overall marketing and sales were the topics that have been most demanded, representing more than one-quarter of all those educated by the consulting centers. These 1,800 managers and entrepreneurs have brought these skills back to more than 925 different firms throughout Ukraine. Following closely in popularity was business planning which accounted for 19% of all business persons educated by the consulting centers, 1,000 people in all. Accounting was also an important educational topic with 775 people and over 600 firms served. The typical delivery mechanism – seminars vs. training – differs between the topics, however, with business planning and accounting done

typically in long-course sessions while marketing topics are handled more often in shorter seminars.

These results reflect a strong and growing demand for marketing knowledge among Ukrainian SMEs. The fact that seminars are the major delivery vehicle for marketing education reveals the rather introductory nature of the topic for enterprises in general. Initially, firms were not keenly interested in marketing issues so when marketing topics were first rolled out by the consulting centers, they were done in short seminar format as an introduction to stimulate further interest. Today, however, the centers have full fledged, dedicated courses on marketing and marketing research, which are well attended, though they continue topical seminars in the realm of marketing as well.

Breaking out the overall information in Table 2 further, business planning was the most popular in depth training course, accounting for 27 percent of all entrepreneurs and managers trained. Marketing and sales related training courses brought in just under one-quarter (23 percent) of training participants while accounting training attracted another 20 percent.

Seminar activity was much more diverse than training, and covered literally dozens of themes. The flexibility, lower cost and convenience of the seminar format allowed for more experimentation and greater topical variety. Over the previous 4.5 years, consulting centers have combined to teach 2,100 people from 1,350 different firms a variety of short-theme topics using training seminars. Marketing/Sales was far and away the most popular seminar type, accounting for almost on half (47.6 percent) of all seminar participants, though this is a broad category that includes topics as diverse as The Art of Effective Sales, Effective Tools for SME Market Research, and The Creative Process in Modern Advertising.

As consulting centers gained more experience, they increasingly offered customized training solutions for their clients after conducting a thorough training needs assessment. These training solutions incorporated elements from different stand alone training courses and seminars, and were provided with a wider range of delivery options depending on the client's needs - for example, evening classes, residential training, role playing, on site or at the consulting center, etc.

***Consulting and Advisory Assignments***

IFC consulting centers have provided direct advisory services to 1,674 clients. These projects tended to be much longer-term (typically a few weeks to many months) and required a much greater amount of dedicated resources to deliver than training or information services. Table 3 offers a brief account of both the volume and type of consulting engagements taken on by the consulting centers.

**Table 3: UBDP Consulting Engagements**

| *Topic* | *Events* | *%* |
|---|---|---|
| Business plan/strategy | 342 | 20% |
| Marketing/Sales | 432 | 26% |
| Advertising/PR | 126 | 8% |
| Finance/Budgeting | 147 | 9% |
| Accounting | 121 | 7% |
| Personnel management | 79 | 5% |
| Other | 426 | 25% |
| *Totals* | 1,674 | 100% |

Marketing and sales related engagements were the most common, followed closely by business planning. This result is reflective of the changing market mentality of Ukrainian enterprises which, previously were interested almost solely in "consulting" simply as a vehicle for receiving a business or investment plan. The marketing engagements weree mostly related to market research but included projects such as creating a new marketing division in

a manufacturing enterprise, conducting market survey research to ascertain basic consumer characteristics, organizing focus group research for a new product launch, and many others.

Finance related engagements including accounting made up 16 percent of all consulting deals. These typically involved assisting with accounting transformation to new national standards. They also included conducting cost accounting for an enterprise or creating a detailed internal .budgeting system for enterprises to help make better strategic and managerial decisions.

***Other Technical Assistance and General Information***

The consulting centers offered a wide variety of information and other technical assistance to enterprises. This ranged from standing weekly or monthly orders for legal and regulatory information (as a result of frequent changes in Ukrainian law) to searches for business partners or hunts for trade leads and specialized information searches over the internet. It also included registering a business or assisting with obtaining a license, permit, or other official business approval.

In total, the centers have had more than 9,000 such exchanges with Ukrainian SMEs, almost 1,800 of which have been for very specific technical assistance (rather than general information). While no extremely detailed records of the exact volumes and types of such services were kept, the results of a client impact survey (conducted in December 2000) are certainly suggestive of the relative use of and interest in each service.

Table 4 below displays the use patterns and characteristics of each type of service. From the table we see that legal/regulatory information was the most demanded of such services. It also had the highest percentage of repeat customers (45%) which is twice as much as the next two closest rivals – taxation, and basic business information. Among other services, tax and financing information was also fairly high on firms' interest lists, though firms are much more likely to pay for tax information.

**Table 4: Information and Other Services - Survey Results**

| *Topic* | *Services* | *% Total* | *Paid* | *% Paid* | *Firms* | *Avg/Firm* | *% Repeat* |
|---|---|---|---|---|---|---|---|
| Legal / Regulatory | 122 | 18.9% | 60 | 49.2% | 64 | 1.9 | 45.3% |
| Other | 116 | 18.0% | 45 | 38.8% | 88 | 1.3 | 10.2% |
| Taxation | 81 | 12.6% | 46 | 56.8% | 53 | 1.5 | 24.5% |
| Sources of Financing | 73 | 11.3% | 23 | 31.5% | 62 | 1.2 | 12.9% |
| Roundtable participation | 60 | 9.3% | - | 0.0% | 49 | 1.2 | 8.2% |
| Informational presentation | 48 | 7.5% | 37 | 77.1% | 35 | 1.4 | 22.9% |
| Business partner search | 40 | 6.2% | 30 | 75.0% | 34 | 1.2 | 14.7% |
| Find investment/financing | 40 | 6.2% | 18 | 45.0% | 35 | 1.1 | 8.6% |
| Business in Ukraine | 26 | 4.0% | 18 | 69.2% | 18 | 1.4 | 22.2% |
| Trade Leads | 22 | 3.4% | 8 | 36.4% | 18 | 1.2 | 16.7% |
| Business registration | 13 | 2.0% | 12 | 92.3% | 12 | 1.1 | 8.3% |
| Licence acquisition | 3 | 0.5% | 3 | 100.0% | 3 | 1.0 | 0.0% |
| *Totals* | 644 | 100.0% | 300 | 46.6% | 241 | 2.7 | 61.0% |

## IR – 2: Improved financial viability of business service centers

***Sustainability Snapshot***

*All seven consulting centers created by IFC are sustainable* - most on a fully commercial basis.[2] While the three newest centers in Simferopol, Chernigiv, and Chernivtsi have only just begun working without donor support, they have been consistently generating high enough

[2] Sustainability is defined as operational sustainability whereby consulting centers continue to offer training and consulting services to local firms and charge fees to cover their costs. This includes other donor revenues which the center may have received after the IFC-USAID subsidy ended. Commercial sustainability, on the other hand, refers specifically to centers to consulting centers covering their costs with income derived solely from commercially generated client fees and contracts, excluding donor funding.

levels of independent commercial income that there is sufficient confidence in their long-term viability. The first four centers created (Dnipropetrovsk, Sumy, Zhitomir, and Vinnytsia) have been operating independently (post-IFC/USAID donor support) for more than three years. As for the most recent centers created, all three are today in much stronger positions for success both financially and in terms of their level of service potential, than any of the other four centers were at their project ends.

***Three Main Paths to Sustainability***

In general, centers have forged one of two different paths (or some combination of them) to sustainability:

1) focus on more specialized commercial services;
2) competitive donor substitution

Providing more specialized commercial services was the primary strategy centers used to survive, a pattern consistent with the BDS experience in Central Europe, particularly in Poland and the Czech Republic. This means that the centers began with the foundation of consulting skills and knowledge provided to them through the IFC training model and continued to deepen and extend their skills in key areas of increasing demand (marketing, for example).

The second path to sustainability used only in part by a few centers, was direct or implicit donor substitution. Only two centers (Vinnystia and Dnipropetrovsk) have turned to other donor funding as a significant source of income. And donor funds are no more than 40% of one firm's total revenues, while for the other this is just 10%. The remaining five centers are fully engaged in commercial service provision without any donor substitution whatsoever.

However, the donor substitution strategy represents a rational, business driven response to market conditions and one that a number of commercial consulting and training service provides in Ukraine have also pursued. This includes not just local Ukrainian firms, but large, western consulting and accounting firms, for example PriceWatershouseCoopers, Deloitte&Touche, and others who see donor measures which aim to build private sector markets in Ukraine as a direct opportunity to build their own consulting practices as well.

***Sustainable, But Not Money Machines***

While each consulting center is sustainable in its own right, they are neither massive revenue generators nor extremely profitable. The important point is that they continue to provide needed services to Ukrainian SMEs - firms that would otherwise have no resources to assist them with their business. And they do so in a way that is both affordable for local firms and still reasonably well paying for the centers to continue to providing the services on an ongoing basis.

The centers operate with monthly revenues ranging from a few hundred to a couple of thousand dollars. By international standards, this may seem to be very small sums, but in Ukraine it represents a well-above average income in a country where the average monthly wage is between $30 and $40.

***A Look at the Numbers***

Table 5 below provides a basic snapshot of sustainability for all seven centers created by IFC with USAID funding. On the whole, the first round of centers created rely more on training and donor substitution for survival whereas the most recently created centers are more squarely aligned with consulting as the primary if not only source of income. This is largely a reflection of changes in the market and the overall market readiness for consulting services. However, it also reflects a much stronger programmatic emphasis by IFC with the most recently created centers to drive them toward financial self-sustainability as quickly as possible. The entire design of the project reflected this thinking – from the screening process used in selecting consultants and the structure and content of the training program to the work order system design and all other incentive systems put in place.

Consultants in the new centers (*i.e.* Chernigiv, Chernivtsi and Simferopol) were inundated from Day 1 with the sustainability concept so that it drove their daily thinking and approach to client work. They benefited from the lessons learned from their predecessors and, therefore, had a running start toward self-sufficiency. They also benefited from an improved market in Ukraine that is more willing to contract and pay for such services. IFC UBDP also learned lessons from the previous centers and structured its operating subsidy to the centers in such a way as to maximize their motivation in earning independent commercial revenue from client services.

Notwithstanding this fact, however, the centers were opened in cities that had no prior local consulting capacity. Therefore, local SME exposure to such services was, for all intents and purposes, negligible. Despite the "head start" the newest centers may have had in many regards, they still experienced many of the same growing pains and market barriers faced by their predecessors.

**Table 5: Sustainability Snapshot**

| *Center* | *Org. Form** | *Donor %* | *Avg. Rev/Mo.* | *Primary Services (Share of Revenue)* |
|---|---|---|---|---|
| Vinnitsa | NGO | 40% | $747 | Training (50%), Consulting (35%) |
| Dnipropetrovsk | LTD / NGO | 10% | $860 | Consulting (75%), Training (20%) |
| Sumy | SME / NGO | 0% | $754 | Consulting (60%), Training (35%) |
| Zhitomir | NGO | 0% | $696 | Training (55%), Consulting (35%) |
| Chernigiv | SME / NGO | 0% | $797 | Consulting (75%), Training (20%) |
| Chernivtsi | NGO / SME | 0% | $878 | Consulting (60%), Training (25%) |
| Simferopol | SME / NGO | 0% | $1,004 | Consulting (80%), Training (15%) |

* NGO = non-profit organization, LTD = limited liability company; SME = private enterprise

From the table and our analyses, the following conclusions can be drawn:

- *Commercial* sustainability ranges from a low of 60% in Vinnytsia (the rest made up by other donor funding) to 100% in most all other centers;
- Not one center has turned to donor substitution as its primary survival strategy (i.e. greater than 50% of revenues);
- When measured against a benchmark cost structure for future expected expenses of between $700 and $1,000 monthly, *all three centers are already commercially sustainable*;
- On the whole, the centers have turned to more specialized business consulting services with some business training as their primary source of income;
- Average monthly income levels for all centers were between $700 and $1,000 with a low of $0 and a high of nearly $4,000;
- Over the last six of months of the Project, each of the three newest centers consistently earned near or in excess of $1,000 in monthly revenue, exceeding even the most successful of the older centers;
- The centers are today in a much stronger position for success both financially and in terms of their level of service potential, than any of the other eight other centers were at their respective project ends;
- Consulting services are by far the major source of revenue for the three newest centers, representing a fundamental shift in service delivery vehicle away from

training. This behavior is consistent with prior SME development experience in Central and Eastern Europe which shows that the path to more serious revenues and consulting center sustainability is via the provision of higher-value added consulting and not training.

## IR – 3: Improved environment for leasing in Ukraine

The Ukraine Leasing Advisory Project, within the overall goal of the UBDP and SME development in general, was given the mission to, "improve conditions for leasing in Ukraine," through three specific objectives:

- Assess the legal, tax and market conditions for financial leasing in Ukraine
- Develop recommendations on improving the legislative and tax framework for financial leasing
- Conduct an information campaign directed at key government officials and the general public on leasing as an important part of the financial sector and an alternative source of financing for SMEs and develop a manual on leasing in Ukraine.

The Project was heavily involved in the development and promotion of recommendations to improve legislative, tax and market framework for leasing in Ukraine. Primary activity and results include:

- Trained over 400 government officials, entrepreneurs, and mass media personnel on the economic fundamentals of financial leasing and the requirements for its development;
- Led various working groups in developing a new draft Law on Leasing and coordinated work with the Parliament's political factions in an effort to push the draft Leasing Law for voting through its third reading;
- Prepared recommendations to improve existing tax legislation and the draft Tax Code relative to leasing;
- Prepared recommendations to the sections of the draft Ukraine Civil Code that affect leasing activity;
- Continued advising leasing companies on the importance of improving leasing legislation and in how they may attract foreign capital;
- Trained a base of local consultants on financial leasing transactions who will represent their SME clients in seeking financing;
- Initiated, organized and funded an international investment conference along with Ukrleasing Association focusing on the development of Ukraine's leasing industry;
- Developed and published a manual on Leasing in Ukraine.

## IR – 4: Improved Public Awareness of SME Development Issues

IFC's SME development model partnered the task of creating local consulting capacity with an important public awareness effort to raise the understanding of and support for SME development issues. The aim of this strategy was to help build the market for SME services and reduce legal and administrative barriers to SME growth and development.

The public awareness actions were primarily targeted toward market building efforts such as improving SME and public understanding of the benefits of consulting, building a broad base of local and national support for SMEs, and educating the general public about business-related topics. Of particular long-term concern via these efforts was the need to foster greater public understanding of economic reform issues, business legislation, and stimulating demand for consulting services and training by reducing psychological barriers to using outside professional assistance.

These efforts included organizing one-off public forums such as SME roundtables, exhibitions and conferences, as well as continuous, on-going efforts such as publication of newspaper or journal articles, and creation and development of business clubs or associations. Most of these events or activities the project delivered directly through the central office, though some were coordinated through the consulting centers or in partnership with other organizations that shared a similar purpose or mission.

Among the range of activities engaged in by the project, there are some important distinctions to be made between one-off events vs. those of an on-going nature and entrepreneur-directed efforts vs. those geared toward the general public. The mix of event and publication types with program goal and target audiences is important for achieving the greatest impact and outreach. Below is a brief discussion of the role that each of these event types had within the project and a more detailed description of a few select events. This description attempts to capture the essence of their purpose, target audience, and outcomes.

***One-Off Events vs. On-Going Activities***

The project employed a mix of one-time, sometimes large, but infrequent events with much smaller, on-going educational or public awareness activities to build support for or understanding of business development services. The choice of event or vehicle was directly tied to the intended outcome or goal. For example, the project typically created a large public relations event to promote or advertise a consulting center or to draw significant and sudden attention to a specific business issue like the need for investment for example. This usually took the form of a conference, business roundtable, or exhibition.

When the need was primarily intended to build a broader, more general, long-term understanding and acceptance of the project's goals and activities, we employed vehicles of an on-going nature such as publishing a sequence of newspaper articles, creating a serial radio program or distributing informational booklets or brochures.

***Entrepreneur Directed Efforts vs. General Public***

The choice of event type or information format was similarly driven by the intended audience, the primary consideration being whether the information was entrepreneur-directed or more targeted to the general public. Items such as business booklets, brochures and serials were created specifically for distribution to the business community. These sometimes took the form of very detailed and usable business reference resources, though they also came in shorter, more marketing-oriented forms like a project pamphlet or newsletter. Those items published or produced for the general public tended to fall into the categories of mass media actions or advertisements.

What follows is a brief description of the public education and awareness tools utilized by the project along with some examples of each. Wherever possible, we have attempted provide the reader with a basic account of output volume and level of outreach.

***Conferences, Roundtables and Educational Seminars***

The project and the centers organized, coordinated, presented at, or otherwise participated in over 300 business and policy conferences, roundtable discussions, and exhibitions and another 75 educational seminars. Most of these focused on building public support for SME development and educating both entrepreneurs and government officials on various business development topics.

An example that most strongly demonstrates the basic function and goal of such events were three investment conferences that the project organized between November 2000 and April

2001. The goals of the project were threefold: 1) Create a massive public relations event for each of the three consulting centers currently receiving direct support under the donor agreement, 2) Facilitate financing and investment of Ukrainian enterprises by introducing good firms with active lenders and investors, and 3) Acclimate enterprise managers to the requirements of serious, modern sources of finance.

Project staff, in conjunction with the consulting centers, created conferences for each of the three new centers. Each conference had between 120 and 200 participants with a mix of enterprises, bank representatives, investors, and journalists. Enterprises invited to the conferences included hundreds of the strongest, mostly medium sized firms that had either investment-ready projects or serious potential for new project development.

The conferences were structured in two basic parts. The first half of the day included presentations by banks and investment companies with a special emphasis on teaching the managers what is required for good firms to receive financing or investment. Presenters typically explained the importance of good market research and a strong marketing strategy, clarity of ownership and transparent corporate governance, transparent and reasonable financial assumptions and analysis, and strong management, among other topics. The presentations were intended not simply for informational purposes but as a serious learning tool for enterprises.

Part two of the conference provided an opportunity for one-on-one meetings between banks and investment funds and SMEs. Here the participants were able to acquaint themselves with each other's activities, discuss the merits of a proposed project on the spot, and to explore the possibility of working together in the future.

These conferences provided a number of key results. First, they gave a serious promotional boost to the centers as the day's events were widely publicized and broadcast in the local and national media. Second, the centers made direct contact and were able to start nurturing potential relations with the strongest potential clients in their regions. Third, they brought some direct business to the centers. In fact, the conferences resulted in each center beginning new (and serious) commercial relations with a few key enterprises. This has taken the form of contracts for market research, development of a business plan, and other services. Fourth, they educated nearly 400 enterprise managers about the key requirements demanded by good quality banks and investors. Armed with this knowledge, these firms can now actively and more accurately reorganize themselves and their activities to meet key investment criteria.

Below you will find a few additional examples that will suggest something of the scope of work and the types of engagements utilized by the project.

- In 1999, for example, the project arranged and moderated two round table meetings for experts from international business support organizations and government bodies, dedicated to improving licensing and certification procedures.

- In December 1998, the project offered a seminar for local officials entitled "Regulatory Reform on the Local Level." The seminar covered problems hindering business development including the start-up and running of businesses in the construction and service sectors.

- The project also organized and conducted a round table meeting of representatives working for key government institutions and non-government organizations to discuss the current government's Deregulation Policy concept.

- As a result of the annual business survey conducted by UBDP, the Project would sponsor a meeting of officials working for the State Regulatory Policy and Entrepreneurship Committee or officials of the Ministry of Economy to discuss the findings, implications and present recommendations for further policy change.

***Mass Media Activities***
One of the most common and important tools used in creating public awareness in support of the enabling environment is the mass media. It is the most effective vehicle in terms of outreach to the general public and was used extensively in IFC's BDS model. These mass media activities include newspaper and journal articles as well as radio broadcasts, interviews and television programming. Often the impetus for this work was a special event like one of the conferences or roundtables discussed above. These events provide the "hook" needed by mass media outlets to consider the event news worthy.

Sometimes, however, the work was more subtle and involved placing articles in strategic newspapers or business journals. Typically these were theme pieces that attempted to help change the mindset of Ukrainian entrepreneurs by introducing them to new or challenging business concepts. The ultimate goal in all this, of course, was to help generate more businesses for the consulting centers in order to assist them in becoming self-sufficient. As was described previously in this section, however, many entrepreneurs had to overcome certain psychological barriers before they would take that leap of faith. Building a broad base of public support and belief in the principles espoused by the project and the consulting centers was one strategy used to help win over the hearts and minds of Ukrainian entrepreneurs.

In a very conservatively estimated total, the project facilitated over 1,300 mass media event related to SME development, including over 700 different newspaper and journal publications and another 600 plus radio and television broadcasts. Among these events, topics covered ranged from the project's presentation of a recently completed legislative and policy analysis to the announcement of a new market research seminar offering, to a detailed, 20-minute television profile/expose on a consulting center. Articles written and published by the project covered many dozens of topics ranging from the role of corruption in a private economy to the importance of SMEs to the private sector.

***Brochures, Booklets, Newsletters***
In addition to the mass media activities and large events organized in support of SME development, the project also put out thousands of publications for entrepreneurs. This can be roughly divided into educational resources and marketing materials, though the emphasis was primarily on producing learning guides and reference sources for entrepreneurs. In total, the project developed and distributed:

- 60,000 educational publications (including training materials, how-to guides for SMEs, etc.) and:
- 42,000 other items raising awareness of SME issues

The first set of published learning resources was created by the project during the second round of consulting center openings in 1998. During that year, more than 9,000 booklets and brochures were created and distributed to entrepreneurs and business leaders throughout Ukraine. These items were very basic introductions on the following topics (with a circulation of about 1,000 per item):

- Business Planning
- Marketing in the Activity of an Enterprise
- Market Research
- Financial Management of a Company
- Basic Legal Information for Businesses
- Regulation and Deregulation of Small Business
- Entrepreneurship
- Small Business

During the most recent phase of the project, a more comprehensive and detailed set of business booklets was created. The Entrepreneur's Bookshelf Series was a complex of eight mini-books (40-80 pages each) that explained and demonstrated to enterprises the heart of a business concept. The booklets are not intended to be exhaustive reference sources, but rather to provide a broad overview of a particular business topic and offer some salient insights into the matter.

The booklets do not overload readers with sophisticated scientific terms and concepts. They are written in a simple and easily comprehensible manner, but stress a practical, hands-on approach. The booklets are written by UCN business consultants in conjunction with IFC experts, which allows them to include international best business practices. In addition to theoretical material, the publications also contain relevant Ukrainian case studies and success stories. This approach has been proven to be a lot more successful than mere translation of western text books and management guides which are often inappropriate for local entrepreneurs. The full set of booklets currently have over 25,000 in circulation, include:

- International Accounting Standards
- Foundations of Business Planning
- Legal Aspects of Entrepreneurship
- Personnel Management
- Marketing Research
- Business Communications (Public Relations)
- Financial Management
- Quality Management

During the final phase of consulting center creation, the project began publishing 'Business Consultant', a quarterly journal that was distributed to SMEs through the consulting centers. The goal of the journal was to help build a more common understanding of business consulting among entrepreneurs and to help explain the kinds of issues the project was fighting for on behalf of SMEs. A total of five issues were published in Ukrainian with a special sixth issue in English. Total circulation of Business Consultant was 17,500.

The project produced many other items both for independent publication as well as for contribution to other published sources. Included in these (to name just a few) were brochures describing step-by-step how to register a business, prepare a business plan or search for loan opportunities, a guide for young entrepreneurs who are interested in starting a business, and many others.

***Other Events and Actions***

One of the more unique aspects of the project was its calendar competition in which Ukrainians were invited to submit editorial cartoons related to the selected theme for the year. This competition was begun in 1997 and grew in size and public visibility each year. Each year, the twelve best submissions were selected for inclusion in the following year's calendar. Winners were awarded a prize and the competition results were covered widely in the press. Calendar circulation totaled more than 30,000.

## IR – 5: Legal and regulatory environment more conducive to business development

An equally important goal of the project, designed as a complement to the consulting centers was to reduce barriers to SME growth and development. These have traditionally taken two basic forms - structural (*i.e.* legal or administrative) and competitive or commercial. Over the last four years, IFC UBDP, researched and documented the breadth and depth of these barriers through its annual SME survey in Ukraine. This research, described in detail below, consistently documented that Ukrainian SMEs have historically suffered from massive government interference and other barriers to competitive success.

Structural barriers identified include excessive regulation, abusive inspection regimes, abnormally high tax burden, a volatile legislative environment, a weak basis of commercial law, unreliable legal system, regional disparities in administrative oversight of SMEs, and corruption. Primary among the competitive restrictions are poor access to capital and operational financing and operations and lack of market information.

IFC UBDP's model for improving the enabling environment for SMEs included a number of tactics to assist in the reform of the legal and regulatory environment. Over the years, IFC became increasingly active in its policy reform efforts by building on its experience and successes. The Project worked both on the central level and locally with regional and municipal governments. The Project's policy-related activities can be broken down broadly into three categories:

- SME policy research
- Policy review, monitoring and recommendations
- Training and information for government officials

***SME Policy Research***

At the most basic level of the Project's policy reform effort was SME policy research work. This included a range of research efforts from geographically localized and highly focused survey work to national, wide-ranging efforts that characterized the entire sphere of SME operations and experience in Ukraine.

The project completed a number of other such policy research efforts. Among these was a survey of SME managers in the fall of 1998 to assess their reaction to a series of tax law amendments that had passed parliament the previous month. These changes gave the tax inspectors (police) new expanded powers to seize tax related business documents among other things. Another study was conducted in May 1998 when the project surveyed small-scale traders at regional markets to determine which flat tax rates had been introduced in various Ukrainian regions and to hear opinions of small businesses on how the introduction of the flat tax impacted their activities.

The most important policy research for the project in terms of impact and scope was the national SME survey. Each year, IFC has conducted a comprehensive survey of SMEs in Ukraine. Over time this survey has grown and today it represents the most comprehensive assessment of the state of Ukrainian SMEs. The most recent survey (May 2001) included over 2,000 firms located in all oblast capitals in Ukraine. A copy of this report can be found in Annex 6. The substance of the questionnaire has also expanded greatly to include topics such as registration, licensing, inspections, shadow economy activity, the use of barter, restructuring activities at an enterprise, export activity, financing and investment flows, and much more.

Based on the national survey results, each year IFC UBDP developed targeted recommendations for reform and both the results and recommendations were widely distributed - and not only to national and local government officials. Foreign embassies, foreign donors, the foreign and local press, international organizations, NGOs, enterprises interested in monitoring the business environment, and others have utilized the research to inform their own work. To date more than 5,000 copies of the survey have been distributed throughout Ukraine and abroad. And the results have also been widely reported in local print and television news.

Most importantly, however, is that the survey results have served as *the* major source of information about the SME sector in Ukraine. Moreover, it has provided a common starting point and shared knowledge upon which IFC and others have been able to engage Ukrainian policy leaders on the need for substantive change in the SME sector.

***Policy Review, Monitoring and Recommendations***
As a second policy reform tactic, IFC's BDS model also included active, on-going review, monitoring, and analysis of existing and proposed laws and regulations affecting SMEs. This included a wide variety of topics ranging from taxation, inspections, registration, and licensing to commercial legal protection, financial sector reform, and many others. This work was typically heavily informed by the results of the broad SME policy research work described above.

Based on research findings and analysis, project staff developed corresponding recommendations for amendments or other changes, as well as direct policy advice that was provided to government officials and other influential organizations. Most work in the policy realm was conducted on a national level, particularly with regard to registration, licensing, taxation, and inspections, though local-based policy work was also conducted on occasion. The policy work spread to other areas too including financial sector reform among others.

The scope and volume of legislative analysis and policy development engaged in by the project was quite large. While it is impossible to state for certain the number of laws, regulations, amendments, and other policy related documents and drafts reviewed by the project, or the number of recommendations provided and the quantity of advice rendered to government officials, it is fair to say that on both counts (review and recommendation) this number exceeds many dozen. However, IFC UBDP directly assisted in drafting certain important pieces of legislation, in total amending and/or introducing 26 pieces of legislation that directly impact SMEs. A complete list of this legislation can be found in Annex 3 of this report.

The following is a brief description of representative policy actions taken by the project:

- Completed a comprehensive review of draft Ukrainian legislation pertaining to franchising and conducted an overview of worldwide franchising experience. Based on this work, the project team then developed a set of recommendations that were provided to members of the Verhovna Rada.

- Conducted a legal analyses of the draft law, "On Liability of Producers" and prepared a report on the impact the Law might have if it were passed and delivered the report to Ukraine's Deputy Prime Minister.

- Surveyed SME managers in two cities, Sumy and Zhitomir, to assess their reaction to new tax law amendments that gave tax inspectors (i.e. tax police) new and expanded powers to seize tax related business documents among other things.

- Analyzed, at the request of the State Regulatory Policy and Entrepreneurship Committee, the committee's concept plan for state deregulation reform.

- Participated in regular, active discussions and meetings of the working group for the System for Tracking and Monitoring Regulatory Reform in Ukraine.

- At the request of the Kiev City Administration, commented on the their draft "Concept of Attraction of Foreign Investment", a plan to improve the investment climate in the Kiev region.

- In response to a request from the Parliament, prepared recommendations on how to improve Ukraine's overall macro-economic environment for private sector growth and development.

***Training and informing government officials***
The question of policy advice and its effectiveness lies not only in the research and analysis, but also in the methods or vehicles used to transfer that knowledge effectively to policy makers. While a major goal of the project was to inform and educate the general public about the importance of a dynamic, vibrant SME sector (this Public Awareness and Education

function is explored in more detail below), a much more focused strategy had to be used with policy leaders.

The key issue when working with government leaders includes both access and development of key contacts. IFC UBDP utilized a combination of direct, one-on-one relationship building techniques and organization of educational seminars and training sessions to affect policy reform.

At the national level, relationship-building was done with a range of key officials including influential members of Parliament, well positioned staff in government agencies and departments, and high ranking officials among the President's cabinet and staff. UBDP staff and management also cultivated key relationships among other interested parties including consulting firms, private sector proponents, policy activists and others. While much of this work was performed on a person-by-person basis, the project also utilized educational seminars and training sessions to both orient policy leaders to a topic and to help convince them of the kind of change necessary to improve the SME enabling environment.

The Project's leasing initiative provides a good example of this type of work. After project staff first established its excellent reputation for quality of analysis and recommendations on leasing, they began to cultivate key industry and legislative contacts. Much of this work was done trough a leasing "road show" so to speak in which project staff traveled throughout Ukraine to conduct information and training sessions with government officials.

In total, the project conducted 24 seminars and training sessions covering nearly every important regional city in Ukraine and trained more than 500 government officials on leasing as a tool for business development. During the seminar, local leaders were taught the basics of leasing from both a legal and economic standpoint and educated about the benefits of leasing to business. The project partnered these training and information sessions with public relations events including television coverage, newspaper articles, etc., to win broad support.

## IV. LIST OF ANNEXES

1. **Financial Report.**
2. **Contact Information for Consulting Centers of the Ukraine Consulting Network.**
3. **Legislation Impacted by IFC's Ukraine Business Development Project**
4. **Training Courses and Seminars Offered by IFC's UBDP.**
5. **Leasing in Ukraine: A Manual by IFC Ukraine Leasing Advisory Project, April 2001.**
6. **Ukrainian Enterprises in 2000: An IFC Survey and Report of Ukrainian Business by IFC Ukraine Business Development Project, May 2001**

## ANNEX 2
## Contact Information for Consulting Centers of the Ukraine Consulting Network (UCN) Established by IFC's Ukraine Business Development Project

### USAID Funded Consulting Centers

Chernigiv Consulting Center (also UCN central office)
Konstantin Ivanov
51 Vulitsa Lenina
Tel: (0462) 101 866, 101 867
Email: kostya@ifc.cn.ua

Chernivtsi Consulting Center
Maria Porchuk
20 Vulitsa Olga Kobylyanska
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Simferopol Consulting Center
Vladimir Kudashev
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Tel: (0652) 516 484
Email: admn@bconsult.crimea-ua.com

Dniproptrovsk Business Center
Alexander Kondrashov
3rd Floor
National Mining Academy of Ukraine
19 Prospekt Karla Marksa
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Email: postmaster@ifc.dp.ua

Sumy Consulting Center
Oleg Denisenko
Giprohim Institute
13 Vulitsya Krasnogvardeiska
Tel: (0542) 271 185
Email: bcenter@ifc.sumy.ua

Vinnytsia Consulting Center
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TsNTI
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Email: ifcvinn@sovamua.com

Zhitomir Business Center
Valerii Ivanov
54 Vulitsya Pobedy
Tel: (0412) 208 566, 258 336
Email: valeo@zt.ukrtel.net

**British Know-How Fund (DFID) Funded Centers**

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Tel: (0642) 538 501, 526 081
Email: info@viva.lugansk.ua

Cherkassy Business Center
Anatoliy Rekun
78 Vultsya Smeliansky
Tel: (0472) 470 075
Email: asim@majar.com

Khmelnitsky Business Center
Volodymyr Chenash
3 Vulitsya Gagarina
Tel: (0382) 795 981
Email: vchenash@infocom.km.ua

Mariupol Business Center
Vladimir Lebedev
11 Vulitsya Kronshtadtska
Tel: (0629) 376 038, 372 059
Email: lebedev@anet.donetsk.ua

## ANNEX 3
## Legislation Impacted by IFC's Ukraine Business Development Project

Based on UBDP analysis and research, the Project determined that the main policy areas to focus on were issues related to business registration, licensing, and state inspections of businesses. The following list of legislation were directly amended or introduced following the Project's recommendations. In most cases the Project contributed actual text to the legislation in question.

1. **Resolution of the Cabinet of Ministers of Ukraine "On Small Business Development Program for 1997-1998" of 29.01.97 # 86**

2. **Presidential Decree, "On the Licensing Chamber of Ukraine" of 7.2.97, #104/97**

3. **Presidential Decree, "On the Operating Procedures for the Licensing Chamber of Ukraine" of 27.11.97, #1311/97**

4. **Amendments to the Law of Ukraine "On Amending the Law of Ukraine "On Entrepreneurship" #762/97- BP of 23.12.97**

5. **Resolution of the Cabinet of Ministers of Ukraine "On Licensing of Entrepreneurial Activity," of 03.07.98 # 1020**

6. **Resolution of the Cabinet of Ministers of Ukraine "Sizes of Fees Charged for the Issue of and Introducing Changes into Licenses for Certain Types of Business Activity," of 04.01.99 #6.**

7. **Law of Ukraine "On Enterprises"**

8. **Presidential Decree "On the State Support of Small Business Sector" of 12.05.98, 456/98**

9. **Law of Ukraine "On Amending the Cabinet of Ministers of Ukraine Decree "On Income Tax Payable by Individuals" #129/98 – BP of 13.02.1998**

10. **Presidential Decree "On Eliminating Obstacles Hindering Business Development" of 03.02.98 #79/98**

11. **Presidential Decree "On Simplified Taxation, Accounting and Reporting Systems for Small Businesses" of 03.07.98 #727/98**

12. **Presidential Decree "On Certain Measures on De-Regulating Entrepreneurial Activity" of 23.07.98 #817/98**

13. **Resolution of the Cabinet of Ministers of Ukraine "On the Procedures for State Registrations of Subjects of Entrepreneurial Activity" of 25.05.98 #740**

- UBDP introduced all of the following changes to Ukrainian legislation (listed below) in the Small Business Development Program for 1998.

14. **Presidential Decree, "On the Licensing Chamber of Ukraine" of 7.2.97, #104/97**

And

15. **Presidential Decree, "On the Operating Procedures for the Licensing Chamber of Ukraine" of 27.11.97, #1311/97**

- UBDP proposed that the Licensing Chamber have the status of a central executive organ. Previously the Licensing Chamber was a department of the Mininstry of the Economy (had less power). UBDP proposed that there should be one central body that monitored state issue of licenses and procedural violations as well as being responsible for all business registration. In the event the GOU accepted all of UBDP's proposals to make the Licensing Chamber a central body monitoring all licenses.

16. **Amendments to the Law of Ukraine "On Amending the Law of Ukraine "On Entrepreneurship" #762/97- BP of 23.12.97**

And

17. **Resolution of the Cabinet of Ministers of Ukraine "On Licensing of Entrepreneurial Activity," of 03.07.98 # 1020**

- UBDP proposed that the definition of the aim of licensing be legislatively defined to ensure public health, national security and protection of the environment. Previously there were no such limits on licenses and correspondingly there were many licenses that regulated practically all economic activity.
- UBDP proposed limiting the number of business activities subject to licensing by 22. In the event the parliament limited the number by only 15, from 56 to 41. UBDP is still working on lowering amount of licenses, and license-like permits.

18. **Resolution of the Cabinet of Ministers of Ukraine "Sizes of Fees Charged for the Issue of and Introducing Changes into Licenses for Certain Types of Business Activity," of 04.01.99 #6.**

- UBDP proposed that licensing fees be legislatively fixed. Previously state bodies could charge and change fees arbitrarily.

19. **Law of Ukraine "On Enterprises"**

And

20. **Presidential Decree "On the State Support of Small Business Sector" of 12.05.98, 456/98**

- UBDP proposed that the definition of small business be tied to the number of employees and turnover. Previously this was determined by sector and number of employees. This was unworkable and lead to too many different definitions, which further lead to inconsistent legislation and regulation.

21. **Law of Ukraine "On Amending the Cabinet of Ministers of Ukraine Decree "On Income Tax Payable by Individuals" #129/98 – BP of 13.02.1998**

- UBDP proposed a flat tax for market traders.

22. **Presidential Decree "On Eliminating Obstacles Hindering Business Development" of 03.02.98 #79/98**

- UBDP proposed that the President charge the GOU to simplify taxation for small businesses and limit state inspections of businesses.

23. **Presidential Decree "On Simplified Taxation, Accounting and Reporting Systems for Small Businesses" of 03.07.98 #727/98**

- UBDP proposed that taxation and accounting for small business be simplified by introducing a unified tax (instead of 13 different taxes) for all small businesses of 6% of turnover (if enterprise pays VAT) or 10% of turnover (if enterprise does not pay VAT).

24. **Presidential Decree "On Certain Measures on De-Regulating Entrepreneurial Activity" of 23.07.98 #817/98**

- UBDP proposed to limit state inspections of businesses by dividing all business inspections into planned and unplanned inspections. Planned inspections can only be undertaken if a written notice of a minimum of 10 days is given.
- UBDP proposed that all inspecting organs have to coordinate their inspections with one state organ. The GOU decided that there should be two such organs, the tax authority and the state monitoring and revision directorate.
- UBDP proposed limiting the number of planned inspections to once annually.

25. **Resolution of the Cabinet of Ministers of Ukraine "On the Procedures for State Registration of Subjects of Entrepreneurial Activity" of 25.05.98 #740**

- UBDP disagreed with a CMU decision to have a registration fee payable annually, as this turns the fees into a virtual tax. The CMU agreed and removed this point.
- UBDP disagreed with a CMU decision to remove state registration of changes to founding documents (articles of agreement and charter), as entrepreneurs could too easily abuse this system. The CMU agreed and removed this point.
- UBDP proposed that there should only be one state body that an entrepreneur has to deal with in setting up a company. In the event, the GOU reduced the number of state bodies involved in registration by 3, from 10 to 7. UBDP is working to reduce this number further.
- UBDP proposed that government officials should be personally responsible for violations of registration procedures.

26. **Law of Ukraine "On Leasing", passed 2nd parliamentary reading on 05.04.01**

- IFC draft finally allows financial leasing in Ukraine. Removes minimum lease term requirements, defines the rights of the parties, allows more flexibility.
- Allows for sub leasing.
- Clarifies repossession issues.

## ANNEX 4
## Training Courses Developed by IFC's Ukraine Business Development Project

UBDP in, conjunction with local and international experts, has a developed one of the most extensive business training programs in Ukraine. Typically, responding to client needs passed up to the Project, UBDP would source the best specialists in particular areas and, in conjunction with project and consulting center training experts develop a training program specifically suited for Ukrainian businesses. Apart from the very early days of the project, no 'off the shelf' training programs have been used. Rather, the emphasis has always been to develop local training solutions suited to local firms. UBDP's experience with transplanting western training courses has on the whole been negative, with inappropriate examples and case studies, geared towards companies operating in completely different business environments.

Typically, UBDP sources specialist in a particular area (marketing, taxation, financial management, *etc.*), then teams up the specialist with specialist trainers and consultants within the consulting center network, who then jointly develop a training product. This is then delivered to fee-paying clients and through a continual process of feedback from the training courses and consulting process, is constantly updated and refreshed.

The list below shows some of the more popular business training courses and seminars (though is not an exhaustive list) developed by UBDP and in demand at project end. For a more complete breakdown please refer to the Training Catalogue which follows.

### *MARKETING, SALES & ADVERTISING*

1. Market Research and Promotion
2. Advertising: Theory and Practice
3. Business, Marketing and Market Research
4. Art of Successful Sales
5. Advertising Project Management
6. Market Research: An Industry Sector Approach
7. Market Research for SMEs
8. Sales Methods

### *ACCOUNTING, FINANCE & BUDGETING*

9. Financial Management
10. Working Capital and Cash Flow Management
11. Conversion of Ukrainian Financial Statements to International Accounting Standards (IAS)
12. Budgeting
13. Assessment of the Investment Environment
14. Accounting and Financial Reporting According to IAS
15. Management Accounting
16. Practical Aspects of Taxation in Ukraine
17. Reporting with National Accounting Standards (NAS)
18. Developing a Management Accounting System

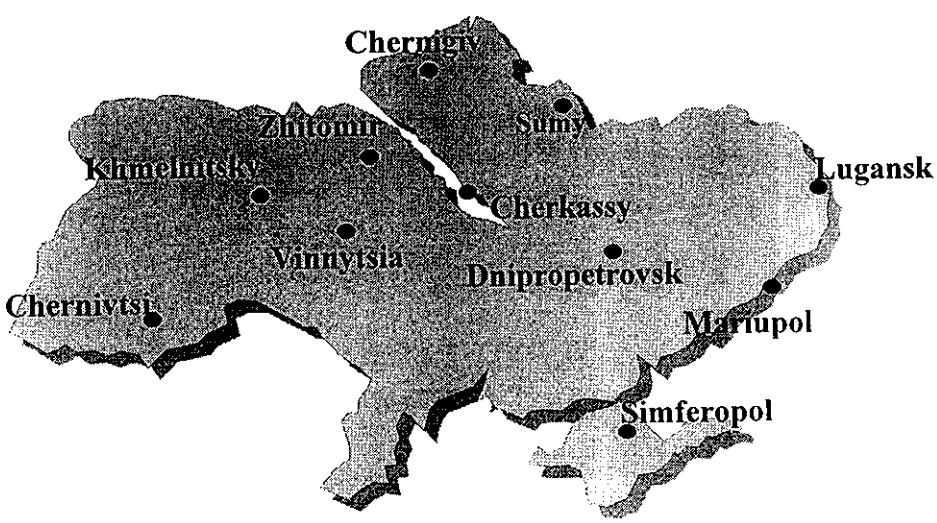
19. Principles of Accounting and Financial Report Preparation According to International Accounting Standards (IAS)
20. Cost Management

***GENERAL MANAGEMENT***

21. Business Planning
22. Organizational and Psychological Aspects of Management
23. Breakeven Analysis
24. Personnel Management
25. Conflict Resolution
26. Leadership in Business
27. Foreign Economic Activity in Ukraine: Rules, Requirements, and Regulations
28. Risk and Risk Management for SMEs
29. Organizational Culture
30. The Fundamentals of Leasing
31. Business Communications and Negotiations
32. Enterprise Restructuring for Competitiveness
33. Personnel Management for SMEs
34. Using Excel for Business Management

**Ukraine Consulting Network**
**Украинская Консалтинговая Сеть**

# TRAINING PROGRAMS OFFERED BY CONSULTING CENTERS OF THE UKRAINE CONSULTING NETWORK



# Ukraine Consulting Network
# Украинская Консалтинговая Сеть

The Ukraine Consulting Network (UCN) consists of 11 consulting centers that offer consulting advice, training courses, and information services to Ukrainian and international businesses. Over the last several years UCN, in conjunction with the International Finance Corporation's Ukraine Business Development Project, has developed over 30 training programs designed specifically for Ukrainian SMEs. These include in-depth, multi-day courses AND SEMINARS detailed in this training catalogue.* These programs, developed in Ukraine, combine international best practice with knowledge of the local business environment to provide state-of-the-art training to Ukrainian firms. Our courses are constantly being updated and are tailored to a client's specific needs.

UCN combines case studies from real Ukrainian enterprises with advanced business management theory to provide a comprehensive training experience. Our unique, interactive training methodology requires active participation of clients to contribute to theoretical discussions, practice sessions, case studies, role-playing exercises, and video films. The training programs emphasize practical skills development in the areas of finance, marketing and management, and the application of these skills to daily business operations.

UCN offers seminars and courses, as detailed in this catalogue. Seminars are typically short training sessions lasting less than a day which are designed to be an introduction to a business topic or alternatively are for topics that do not warrant in-depth training. Courses are longer, more in-depth and typically last for several days. A standard training day includes 8 hours of interactive learning, not inclusive of participants' own preparatory work and assignments. The length of a course can be adjusted (reduced or extended) according to client requirements. Moreover, UCN can tailor training programs by combining different modules of its course offerings. Training materials include overhead slides for trainers and detailed hard copy hand outs for participants.

**Information listed in this catalogue is current as of August 1, 2000. Please contact any member of the Ukraine Consulting Network or the IFC office in Kiev for more up to date information.*

# TRAINING PROGRAMS

## *MARKETING, SALES & ADVERTISING*

1. Market Research and Promotion
2. Advertising: Theory and Practice
3. Business, Marketing and Market Research
4. Art of Successful Sales
5. Advertising Project Management
6. Market Research: An Industry Sector Approach
7. Market Research for SMEs
8. Sales Methods

## *ACCOUNTING, FINANCE & BUDGETING*

9. Financial Management
10. Working Capital and Cash Flow Management
11. Conversion of Ukrainian Financial Statements to International Accounting Standards (IAS)
12. Budgeting
13. Assessment of the Investment Environment
14. Accounting and Financial Reporting According to IAS
15. Management Accounting
16. Practical Aspects of Taxation in Ukraine
17. Reporting with National Accounting Standards (NAS)
18. Developing a Management Accounting System
19. Principles of Accounting and Financial Report Preparation According to International Accounting Standards (IAS)
20. Cost Management

***GENERAL MANAGEMENT***

21. Business Planning
22. Organizational and Psychological Aspects of Management
23. Breakeven Analysis
24. Personnel Management
25. Conflict Resolution
26. Leadership in Business
27. Foreign Economic Activity in Ukraine: Rules, Requirements, and Regulations
28. Risk and Risk Management for SMEs
29. Organizational Culture
30. The Fundamentals of Leasing
31. Business Communications and Negotiations
32. Enterprise Restructuring for Competitiveness
33. Personnel Management for SMEs
34. Using Excel for Business Management

# 1. MARKET RESEARCH AND PROMOTION

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | Marketing managers, marketing department staff |
| **Duration:** | 3 days |
| **Goals and objectives:** | Learn techniques of market research, sales and conducting negotiations<br>Obtain skills in marketing strategy development<br>Learn theory and practice of advertising |

1. **Market Research: problems and techniques**
   - Organization and implementation of market research studies
   - Market segmentation
   - Targeting and positioning
   - Writing marketing plans: objectives, strategies, case studies

2. **Developing marketing strategies**
   - Implementing marketing strategies with the proper choice of pricing, packaging, advertising, selling, and distribution

3. **Successful sales**
   - Marketability of a product
   - Real sales: internal and external situations

4. **Conducting negotiations**

5. **Advertising as a marketing tool: theory and practice**
   - The function of advertising in the marketing plan
   - Advertising in small business
   - Advertising research
   - Assessing advertising effectiveness

## 2. ADVERTISING: THEORY AND PRACTICE

| | |
|---|---|
| **Form:** | Training Course |
| **Target audience:** | Advertising managers, advertising agents, marketing department managers and experts |
| **Duration:** | 4 days |
| **Goals and objectives:** | Systematic study of organizational, economic and legal principles of advertising.<br>Advertisement planning.<br>Practical skills in advertising.<br>How to improve effectiveness of advertising staff. |

**1. Advertising in the system of marketing**

- Definition of client and market.
- Marketing mix? How to use 4 Ps to meet your client's needs.
- Main definitions and concepts in advertising.
- The advertising process.
- Basic types, forms, and means of advertising.
- Target group – positioning advertisements
- Difference in advertisement for end-user and corporate customer.

**2. Organizational basis of advertising**

- Principles of organizing an advertising company's activities.
- Legal and public regulations in advertising.
- Agency – client paper work.
- Types of advertising products.
- Current techniques in advertising production.
- The publishing process.
- Pricing in advertising.

**3. Advertising for small business**

- Low-cost advertising strategies.
- Direct mail advertisement.
- Tradeshow advertisements.
- Non-standard types of advertising.

**4. Development and implementation of advertising strategy**

- What is advertising strategy?
- How to develop an advertising strategy.
- Obtaining information to use in an advertising campaign.

- Market research studies.
- Media planning.
- Planning and control of advertising campaigns
- Adjusting for peculiarities of customer perceptions.
- Assessing advertising effectiveness.

**5. Working with clients.**

- Testing of advertising.
- How to sell your advertising to client?
- How to write a business proposal?
- How to create a successful long-term relationship with a client?

**6. Linking the word and image in advertising**

- Creativity in advertising
- The structure of an advertising message
- Structure of advertising texts.
- Peculiarities of verbal advertising message.
- Psychological principles of customer perception in advertising.

***Notes:***

At the request of a client this course can be delivered with a two-day training seminar entitled "The Art of Selling Advertising". At the end of the training, professional testing of a client's staff is offered.

## 3. BUSINESS, MARKETING, MARKET RESEARCH

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | Entrepreneurs, SME managers |
| **Duration:** | 3 days |
| **Goals and objectives:** | To introduce entrepreneurs to the concepts of marketing and market research.<br>To show entrepreneurs how to gather and utilize market information to make management decisions. |

1. **Marketing and it's role in business**
2. **Market research as a marketing function**
3. **Marketing mix**
4. **Consumer behavior**
   - Consumer needs vs. consumer purchasing
   - Customer values
   - Consumer segmentation
   - Consumer behavior models
   - Customer perception of new goods
5. **Purchase decisions**
   - The purchasing department
   - Purchase decision-making
   - Analyzing the purchasing process
6. **Economic mission of a firm**
7. **Correlation of strategic and tactical goals**
8. **Marketing audit**
9. **Estimating market size**
10. **Market segmentation**
    - General criteria of consumer markets
    - Conditions for effective segmentation
    - Criteria of segmentation
    - Role of segmentation in marketing planning
11. **Searching for target markets**

**12. Product life cycle**

**13. Distribution and its impact on profit**

**14. Role of information in market research**

**15. Developing a marketing information system**
- Sources of marketing information
- Data base structure
- Requirements for information used in market research

**16. How to conduct interviews**

**17. How to conduct consumer opinion polls**

**18. Selecting appropriate survey respondents**

**19. Questionnaire development**

## 4. ART OF SUCCESSFUL SALES

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | Managers of trade businesses and departments, commercial agents and salesmen. |
| **Duration:** | 3 days |
| **Goals and objectives:** | To develop special sales and communications skills for sales agents/managers.<br>To master psychological techniques of sales. |

**1. The sales function of marketing**
- Product promotion and basic marketing principles
- Market regulations and peculiarities
- Product's special features
- Consumer behavior

**2. The sales reality**
- A dynamic model of consumer behavior
- The skills of a salesperson
- Lessons in failure and threats of success
- The practical philosophy of the service
- Consumer purchasing patterns
- Gaining a competitive edge
- Consumer preferences
- The unsatisfied customers

**3. Sales tactics and techniques.**
- Five phases of business communications
- Four types of listening
- Methods of questioning
- Overcoming arguments and barriers

**4. Conducting negotiations.**
- Determine the key issues
- First sell the meeting, and then the goods
- Purchasing strategies and types of buyers
- Sales scenarios
- Completing the transaction

## 5. ADVERTISING PROJECT MANAGEMENT

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | Sales managers, advertising managers |
| **Duration:** | 3 days |
| **Goals and objectives:** | To obtain skills in advertising project management |

1. **Promotion strategies and market segmentation**
2. **Identifying and working with target groups**
3. **Consumer markets**
4. **Consumer behavior analysis**
   - Human needs
   - Consumer's motives and behavior
   - Communication problems
   - Consumer's profile
5. **What we see in an advertisement?**
   - "Ten golden rules" for the advertiser
   - Advertising products
6. **Advertising Implementation**
   - Setting goals and objectives of an advertising campaigns
   - Setting advertising budgets
   - Monthly planning
   - Creative plan: design, TV, radio, press
7. **Two platinum rules for the media-planner**
   - Media-planning activities
8. **Advertising: where to place your ads?**
   - Characteristics of mass-media outlets
   - Evaluating advertising campaign effectiveness
9. **Creative advertising**
   - Advertising as a tool of marketing communication
   - Five stages of advertising communication
   - The creative dilemma
   - Stages of the creative process
   - Brain storming for idea generation
10. **Methods of assessing advertising effectiveness**

## 6. MARKET RESEARCH: AN INDUSTRY SECTOR APPROACH

| | |
|---|---|
| **Form:** | Training-consultation |
| **Target audience:** | Marketing managers, marketing department staff |
| **Duration:** | 1 day |
| **Goals and objectives:** | Develop skills of conducting marketing research by sectors |

1. **Identifying goals and objectives of market research**
2. **Marketing mix**
3. **Developing models to assess market demand**
4. **Firm positioning within the micro and macro market**
5. **Consumer profile**
6. **Product assortment matrix**
7. **Methodology for marketing research**
8. **Information sources**
9. **Research planning**
10. **Conducting surveys and interpretation of their results**
11. **Stages of research**
12. **Low cost marketing research**
13. **Advice for researching specific industry sectors**

## 7. SALES METHODS

**Form:** Seminar

**Target audience:** Sales mangers

**Duration:** 1 day

**Goals and objectives:** To develop effective sales skills and techniques

1. **Consumer behavior.**
2. **Seller-buyer-product correlation.**
3. **Customer needs.**
4. **The consumer market.**
5. **Categories of buyers.**
6. **Key factors in purchase decisions.**
7. **Three levels of customer satisfaction.**
8. **Types of goods.**
9. **Consumer perception of new goods.**
10. **How to win the customer's trust.**
11. **Customer persuasion.**

## 8. MARKET RESEARCH FOR SMEs

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | Entrepreneurs, marketing department staff, SME managers. |
| **Duration:** | 2 days |
| **Goals and objectives:** | Learn low-cost methods of conducting market surveys.<br>Developing skills in survey design. |

1. **Organizing a market study**
2. **Estimating market size.**
3. **Sources of market information.**
4. **Practical aspects of information gathering and data processing.**
5. **Using questionnaires as an important tool for gathering information.**
   - How to structure a questionnaire.
   - Survey design and methodology.
   - Sampling overview.
   - Sampling techniques.
   - Types of questions – evaluating their strengths and weaknesses.
   - Conducting field surveys.
6. **Processing and interpretation of the survey results.**

# 9. FINANCIAL MANAGEMENT

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | SME managers and staff, middle management and experts willing to develop business skills |
| **Duration:** | 3.5 days |
| **Goals and objectives:** | Intensive studies of basics of financial management.<br>Develop practical skills of financial analyses and management for enterprises engaged in production, trade and service industries. |

## 1. Overview of Financial Management

- Definition and goal of financial management
- Structure, goals management of business finance
- Information technology in financial management.
- The notion of cash flow.
- Functions of financial management.
- Elements of financial management.
- Management accounting as a part of financial management
- Financial accounting vs. management accounting

## 2. Cost Management and Profit Planning

- Main concepts of profit management.
- Cost management.
- Cost classification and analysis.
- Break-even analysis.
- Target planning of profit
- Cost classification in the decision-making process.
- Cost accounting for management and control.
- Practical assignments using "mini case studies".
- Main concepts of budget planning.

## 3. Financial Management and Financial Reporting

- Requirements for financial information.
- Common accounting principles.
- Difference between Ukrainian accounting system and international accounting standards (IAS).
- Types of financial statements.

- The balance sheet statement.
- The income statement (Profit and loss).
- The cash flow statement.
- Practical assignments (based on financial data from a real Ukrainian enterprise or client's own business).
- Testing.

**4. Analysis of Financial Performance.**

- Why is financial analysis important.
- Introduction to ratio analysis.
- Profit.
- Asset turnover.
- Liquidity.
- Capital structure.
- Interconnection of company's financial performance ratios.
- Interpretation of the financial analysis ratios.
- Practical assignments.

**5. Investment Management.**

- The notion of company's investment activities.
- Types of investments.
- Investment strategy.
- Basic concepts used in investment assessment.
- Algorithm of investment decision-making process.
- Quantitative methods of investment assessment.

**6. Financial Activity and Capital Structure.**

- Definition of financial activity.
- Managing funding sources.
- Structure and cost of capital.
- Enterprise development and dividend policy.

## 10. WORKING CAPITAL AND CASH FLOW MANAGEMENT

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | *Financial managers, accountants, financial officers* |
| **Duration:** | 2 days |
| **Goals and objectives:** | To acquire skills in working capital management through control over inventory stock<br>Compiling a budget. |

1. **Working capital**
   - Definition and structure of working capital
   - Current assets profitability and turnover

2. **Financial cycle**
   - Duration of financial cycle.
   - Analysis of working capital structure and required capital.

3. **Management of accounts receivable**
   - Tools for managing accounts receivable
   - Control and analysis of accounts receivable
   - Entering into agreements with customers
   - Accounts payable and accounts receivable balance
   - Calculating cash ratios on the basis of ageing register

4. **Inventory control and management**
   - Inventory control
   - Inventory management
   - ABC Method of inventory control
   - Estimation of the most efficient size of purchase order
   - Product cost management

5. **Barter operations**
6. **Compiling cash flow budget**
7. ***Extraordinary measures to receive money***
8. **Short-term funding**

# 11. CONVERTING UKRAINE FINANCIAL STATEMENTS USING INTERNATIONAL ACCOUNTING STANDARDS (IAS)

| | |
|---|---|
| **Form:** | Seminar |
| **Target audience:** | Accountants of joint-stock companies, SME managers, economists |
| **Duration:** | 1 day |
| **Goals and objectives:** | Investigation of the structure and contents of financial statements in accordance with IAS.<br>Development of skills in preparation of Ukrainian financial statements according to IAS standards. |

1. **Basic requirements of financial information.**
2. **Generally accepted accounting principles (GAAP).**
3. **The basic categories of IAS.**
4. **The difference between the Ukrainian accounting system and IAS.**
5. **Basic forms of financial statements.**
6. **Balance sheet**
   - The essence and contents of a balance sheet.
   - Classification of assets; classification of liabilities.
   - The notion of equity capital and net working capital.
   - The international standard balance sheet structure.
   - Conversion of a Ukrainian balance sheet into the international standard.
7. **Profit and Loss Statement**
   - The essence, contents and objectives of profit and loss statements.
   - International standards in the preparation of profit and loss statements.
   - The structure of profit and loss statement: Ukrainian standard.
   - The structure of profit and loss statement: International standard.
   - Conversion of the Ukrainian profit and loss statement into IAS.
8. **Cash Flow Statement**
   - Notion of cash flow statements.
   - Structure of cash flow statement.
   - Principles of cash flow statements preparation.
   - Role of depreciation payments in cash flow calculation.
9. **Correlation between different forms of financial statements.**
10. **Practical assignment.**

## 12. BUDGETING

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | Enterprise managers, financial managers, production planning department staff of middle and large enterprises. |
| **Duration:** | 3 days |
| **Goals and objectives:** | Review the basic principles of budgeting.<br>To develop skills in situational economic modeling through budget models. |

1. **Budgeting and its role in financial planning.**
2. **Budgeting as a modern managerial tool.**
   - The main problems in planning company's activities.
   - The core goals and objectives of budget planning.
3. **Cash flow management and its link to budgeting.**
4. **The notion of "centres of responsibilities".**
5. **The structure of a budget.**
   - The role of structural subdivisions in budgeting.
   - Operating vs. financial budgets.
6. **Budget making scheme.**
7. **Process of budget development.**
   - Stages of compiling a budget.
   - Budgeting committee.
   - Budgeting management.
8. **Situational analyses with the help of budgets.**
9. **Budget development techniques.**
10. **Case study on developing a budget.**
11. **Measuring budget variation.**
12. **Business situational analyses: practicum.**
    - Situational modeling using various data inputs.
    - Search for an optimal solution.
    - Analysis, discussion and presentation of budgets
    - Practical recommendations on additional budget tasks.

# 13. ASSESSMENT OF INVESTMENT ENVIRONMENT

| | |
|---|---|
| **Form:** | Training-consultation |
| **Target audience:** | SME managers |
| **Duration:** | 1 day |
| **Goals and objectives:** | Develop skills in assessing investment environment |

1. **Investment environment – an overview**
2. **Stages of studying the investment market**
   - Developing investment strategies
   - Developing an investment portfolio
3. **Western criteria for assessing the investment environment**
4. **The investment environment in Ukraine**
5. **Investment market structure**
6. **The role of financial analyses**
7. **Financial reporting**
   - Balance sheet
   - Income statement
   - Cash flow statement
8. **Financial ratio analysis**
   - Financial analyses for shareholders
   - Financial analyses for short-term creditors
   - Financial analyses for long-term creditors
9. **Market value of shares**
10. **Return on assets**
11. **Return on capital**
12. **Working capital**
13. **Business solvency analyses**
14. **Characteristics of major investment sources**
15. **Methodology of investment project financing**
16. **Structuring the investment**

17. Calculating financial leverage
18. Structure of business plan for an investment project
19. Assessing investment efficiency
20. Calculating cash flows
21. Duration of investment cycle

## Legal framework regulating investment environment in Ukraine

# 14. ACCOUNTING AND FINANCIAL REPORTING ACCORDING TO IAS.

| | |
|---|---|
| **Form:** | *Training course* |
| **Target audience:** | Accountants, financial and economic planning department managers |
| **Duration:** | 3 (overview) to 7 (comprehensive course) days |
| **Goals and objectives:** | To study the general principles of IAS to prepare financial reports.<br>Applying accounting information in managerial decision making. |

1. **Introduction**
2. **Accounting process**
3. **Financial accounting**
   - Assets
   - Capital and liabilities
   - Cost and income accounting. Income statement (profit and loss)
   - Cash flow statement.
   - Financial reporting analyses.

4 . **Management accounting.**
   - Organization of financial reporting. Classification of costs.
   - Principles and methods of calculations.
   - Break-even analyses.
   - Budget planning and control.
   - Analyses of alternative decisions.

5. **Capital investment projects assessment methodology.**

# 15. MANAGEMENT ACCOUNTING

| | |
|---|---|
| **Form:** | *Training Course* |
| **Target audience:** | SME managers |
| **Duration:** | 3 days |
| **Goals and objectives:** | Explain the basic concepts of costs management<br>Learn about low-costs areas of business<br>Develop skills in implementation of cost reduction programs |

1. **Introduction into cost management**
   - What is cost management?
   - Benefits of cost management
   - Bankruptcy as a result of improper cost management
   - Primary cost calculation
   - Distributing cost by category

2. **Variable costs calculation model**
   - Grouping of costs by categories
   - Direct and indirect costs
   - Fixed and variable costs
   - Target profit planing
   - Marginal contribution analyses
   - Analyses of multi-product enterprise

3. **Objectives and methods of cost distribution – Cost Drivers**

4. **Cost drivers**
   - How to use cost drivers
   - Identification of cost drivers
   - Classification of cost drivers

5. **Analysis of cost reduction**
   - Graphical analysis
   - Comparative analyses
   - Using cost sheets

6. **Case studies**

## 16. PRACTICAL ASPECTS OF TAXATION IN UKRAINE

| | |
|---|---|
| **Form:** | Seminar |
| **Target audience:** | SME managers |
| **Duration:** | 1 day |
| **Goals and objectives:** | Develop skills in assessing investment environment |

1. **Overview of taxation in Ukraine**
2. **Elements of taxation system**
3. **Classification of taxes**
4. **Value added tax**
5. **Excise duties**
6. **Land taxes**
7. **Profit tax**
8. **Income before taxes**
9. **Taxable profits**
10. **Allowable expenses**
11. **Direct and indirect costs**
12. **Depreciation of major assets and intangibles**
13. **Payroll**
14. **Costs for social needs**
15. **Other costs**

## 17. REPORTING WITH NATIONAL ACCOUNTING STANDARDS (NAS)

| | |
|---|---|
| **Form:** | Training course and workshop |
| **Target audience:** | Accountants, financial managers, SME managers, economic planning department management |
| **Duration:** | From 1 to 3 days |
| **Goals and objectives:** | Develop accounting skills to create and maintain accounting records in accordance with Ukrainian National Accounting Standards. |

1. ***Introduction.***
2. **General requirements of financial reporting.**
   - Roles and objectives of financial reports
   - Users of financial reports
   - The financial year
   - Requirements of financial information
   - Financial report writing
3. **Ten common accounting principles.**
4. **Preparation of balance sheets.**
5. **Statement of financial results.**
6. **Compiling the cash flow statement.**
7. **Equity capital statements.**

## 18. DEVELOPING A MANAGEMENT ACCOUNTING SYSTEM.

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | Managers, financial managers, economic planning department managers (mid-sized and large production enterprises) |
| **Duration:** | 3 days |
| **Goals and objectives:** | To obtain practical skills in management accounting development and implementation and applying summary reports' data for budget development and implementation (case study of the meat-processing factory "Polesye")*<br><br>*Note:* Joint stock company "Polesye" is engaged in procurement, raw material reprocessing, sales of intermediate, processing of raw material into finished products, wholesale and retail trade, exporting and importing. |

1. **Theoretical introduction to developing a management accounting system.**
2. **Theory in practice: Management accounting at joint stock company "Polesye".**
3. **System implementation – a step-by-step approach.**
4. **Implementation of the management accounting systems in "Polesye".**
5. **Developing a management accounting system for one's own business.**

# 19. PRINCIPLES OF ACCOUNTING AND FINANCIAL REPORT PREPARATION ACCORDING TO INTERNATIONAL ACCOUNTING STANDARDS (IAS)

| | |
|---|---|
| **Form:** | Auxiliary training course on preparation to pass an exam on IAS. |
| **Target audience:** | Accountants, financial mangers, economic and planning department managers. |
| **Duration:** | 3 or 5 days |
| **Goals and objectives:** | To master IAS theory and practice |

1. **Introduction**
2. **Accounting process**
3. **Preparation of:**
   - Asset accounting
   - Investment accounting
   - Cash flow accounting
   - Bond accounting
   - Vexel accounting
   - Inventory accounting
   - Intangible accounting
   - Fixed assets
   - Fixed assets – depreciation and write-off
   - Short-term and long-term liabilities
   - Equity capital accounting
   - Profit and income statement
   - Cash flow statement
   - Financial report analyses

## 20. COST MANAGEMENT

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | Financial department managers, economic planning department managers, chief accountants, financial managers. |
| **Duration:** | 3 days |
| **Goals and objectives:** | To study correlation of cost management, important economic decisions, and general business's activities.<br>To identify key areas for cost reduction<br>To master the cost reduction programs. |

1. **Introduction into cost management**
2. **Classification of costs**
3. **Variable costs model of calculation**
   - "Costs-volume-profit" analyses
   - Notion of marginal contribution.
   - Break-even level assessment.
   - Marginal contribution analyses under less than full capacity.
   - Marginal contribution analyses under conditions of low demand.
4. **Cost drivers.**
5. **Approaches to cost reduction.**

# 21. BUSINESS PLANNING

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | Managers and experts of small and middle-sized enterprises, sole proprietors. |
| **Duration:** | 3 or 5 days. |
| **Goals and objectives:** | Master basic business concepts.<br>Study business planning methods and techniques.<br>Generation and analysis of business ideas. |

## 1. Introduction

- Goal, tasks and expected outcomes of the training course.
- Training methodology of the course.
- Definition of business planning.
- Principal components of a business plan.
- The notion of investment.

## 2. Definition of business

- Goals of business
- Definition of business
- Functions of business.
- Innovation in business
- Business productivity
- Role of profit
- Business needs hierarchy.
- Linking business goals and objective

## 3. Marketing

- Basic concepts of marketing
- Stages of marketing development
- Definition of marketing
- Marketing mix and its components: The 4 «Ps».
- Product
- Price
- Place – marketing channels.
- Promotion and its functions
- Key factors impacting marketing strategy
- SWOT- analysis
- Market Assessment: Segmentation, Targeting, Demand Estimation
- Competition and Competitive Advantage

- Sales forecast and its connection to company's market strategy

4. **Finance and Accounting**
   - Characteristics of main sources of investment
   - Types of funding of investment projects
   - Five Cs of Credit
   - Typical questions asked by creditors
   - Financial reporting
   - Financial and accounting documents: balance sheet
   - Cost classification
   - Income statement
   - Cash flow Statement
   - Financial analysis
   - Criteria of investment attractiveness

5. **Project description**
   - Project description and justification
   - Cost estimate
   - Sources of project funding
   - Calculating the break-even point
   - Sales forecast and operational profit
   - Terms of project financing
   - Loan repayment and service schedule
   - Pro forma financial statements
   - Criteria of project investment assessment.
   - Project financial ratios
   - Project risks
   - Project Schedule and timeframes

6. **Summary**
   - Requirements for business plan summary.
   - Project implementation plan.
   - Manager's role and functions

# 22. ORGANISATIONAL AND PSYCHOLOGICAL ASPECTS OF MANAGEMENT

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | Top and middle managers |
| **Duration:** | 3 or 5 days |
| **Goals and objectives:** | To study main concepts of management<br>To master practical techniques of organizational management.<br>Improvement of personnel management skills. |

1. **Overview of management principles and functions**
   - The objectives and functions of management.
   - Management methods and techniques.
   - Organizational and economic structures of management.
   - Stages of data processing in management.
   - Practical assignment for developing management structures.

2. **Psychological analysis in management.**
   - Psychological structure of professional activities
   - Study of professions.
   - Psychogram. The stages of surveys in applied professiography.
   - Professional efficiency factor.
   - The core and structure of individual professional activity.

3. **Group activities in management systems.**
   - The notion of a group and group classification.
   - Peculiarities of management in formal and informal groups.

4. **Communication and interpersonal relations in management systems.**
   - Psychology of communication.
   - Informational functions of communication.
   - Types of interaction.
   - Interpersonal relations in groups.

5. **Interpersonal interaction in group management systems.**
   - Personality overviews.
   - Cognitive processes.

- Psychological cohesion in management systems.
- Psychological compatibility.

**6. Management and leadership.**

- The concept of management and leadership.
- Manager's functions.
- Styles of management.
- Manager's personality.
- Manager's communicative culture

**7. Methods of psychological influence**

- The power of reasoning
- Methods of argumentation
- Regulation of activities and relationships.

**8. Conflicts in a team**

- The source of conflicts.
- The dynamics and development of conflicts - methods of control.
- Psychological practicum on conflict study.

**Case Study**

"Analyses and development of organisational and management structure in an enterprise. Diagnostics of management."

## 23. BREAKEVEN ANALYSIS

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | SME managers, middle managers and economists. |
| **Duration:** | 1 day |
| **Goals and objectives** | Development of practical skills in break-even analysis. |

1. **Break-even analysis and cost management of an enterprise**
2. ***Costs classification and analysis as a part of break-even analysis.***
   - Fixed costs.
   - Variable costs.
   - Mixed costs and methods of their conditional distinction.
   - Marginal contribution.
3. **Marginal contribution put into practice.**
4. **Assumptions and limitations of break-even analysis.**
   - The break-even point concept and its graphic description.
   - Methods of break-even analysis in single-product enterprises.
   - Methods of break-even analysis in multi-product enterprises.
   - The correlation of break-even analysis and product assortment.
   - The notion of the financial safety line.
   - Application of break-even analysis methodology in target profit planning.

## 24. PERSONNEL MANAGEMENT

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | Directors of enterprises, managers, personnel and training departments' staff. |
| **Duration:** | 2 days |
| **Goals and objectives:** | Learn how to create an organizational management structure relative to a firm's objectives and functions.<br>Study of personnel management techniques. |

1. **Methodology of personnel management in an organization.**
   - *Principles of organizational planning.*
   - Elaboration of the organization's personnel management system.

2. **Organizing a personnel management system.**
   - Employee recruitment, review and selection.
   - Staff evaluation.
   - Management of personnel's business carriers and qualifications.

3. **Preparing to work with company staff.**

4. **Personnel management techniques and company's staff development.**
   - Theory of individual and social groups' conduct.
   - Methods of motivation of working activities.

## 25. CONFLICT MANAGEMENT / RESOLUTION

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | High and middle managers, personnel department staff. |
| **Duration:** | 1 day |
| **Goals and objectives:** | Develop skills in creating favourable psychological climate in teams.<br>Improve the overall professionalism and quality of management with the application of conflict resolution skills. |

1. **Conflict as a stage in company's development.**
2. **The structure, dynamics and types of conflict.**
3. **Delegation of responsibilities – a source of conflict.**
4. **The basis of business and interpersonal conflicts.**
5. **Identifying the source of conflict - the cartographic method.**
6. **Conflict biases.**
7. **Psychological aspects of conflicts.**
8. **Behavioral patterns in conflicts.**
9. **Conflict management methodology.**
10. **Constructive conflict resolutions.**
11. **Coordinating conflict resolution.**
12. **Practicum: tasks, tests, case approach.**

## 26. LEADERSHIP IN BUSINESS

| | |
|---|---|
| **Form:** | Seminar |
| **Target audience:** | Managers |
| **Duration:** | 1 day |
| **Goals and objectives:** | Develop leadership knowledge, skills, and potential |

1. **The functions and qualities of a leader**
2. **Directions of leadership in the system of management**
3. **Types of power and authority**
4. **Leadership communications with partners and clients**
5. **Team building**
6. **Feedback**
7. **Testing your leadership skills**

## 27. FOREIGN ECONOMIC ACTIVITIES (FEA) IN UKRAINE: RULES, REQUIREMENTS, AND REGULATIONS

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | Managers of SMEs engaged in FEA |
| **Duration:** | 3 days |
| **Goals and objectives:** | Develop skills in assessing the investment environment and opportunities |

1. **Who can conduct foreign economic activity in Ukraine?**
2. **Regulations for FEA**
   - FEA according to government regulation
   - State powers for FEA regulation
   - The legal status of foreign subjects in Ukraine
3. **Foreign trade operations**
4. **General classification of goods**
5. **FEA commodity classification**
6. **Foreign trade policy of the state**
7. **Classification of services**
8. **Types of exchange deals**
   - Non-cash basis
   - Cash and financed transactions
   - Production cooperation agreements
9. **Export and Re-exporting**
10. **Importing**
10. **Types of quotas**
11. **Types of licenses**
12. **Indicative pricing**
13. **Swaps**
14. **Types of foreign economic operations**
15. **Customs duties**
16. **Accounts in hard currency**
17. **Taxation for import-export operations**
18. **Foreign economic contracts**

## 28. RISK AND RISK MANAGEMENT FOR SMEs

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | SME managers |
| **Duration:** | 3 days |
| **Goals and objectives:** | Develop skills in measuring and controlling risk and assessing investment environment |

1. **An overview of risk analysis**
2. **What is risk management?**
3. **Decision-making under risks**
4. **Risk and uncertainty**
5. **Types of risks**
   - Financial risks
   - Industry risks
   - Economic risks
   - Political risks
6. **Risk assessment**
7. **Methodology for risk analysis**
8. **Sensitivity analysis**
9. **Probability analysis**
10. **Expected value**
11. **Analyses of scenarios**
12. **Choice under uncertainty**
13. **Principles of attitude to risk**
14. **Case studies: assessment of two investment projects**
15. **The process of risk management**
16. **Methods of risk control**
17. **Financial assessment of risk**

## 29. ORGANIZATIONAL CULTURE

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | SME managers |
| **Duration:** | 3 days |
| **Goals and objectives:** | Improve knowledge of organizational cultural issues<br>Develop skills for creating and managing desired organizational cultural characteristics |

1. **The essence of organizational culture.**
2. **Cultural layers within an organization.**
3. **National aspects of culture.**
4. **Multinational environment in an organization.**
5. **Analyses of cultural mentality.**
6. **Alternative cultural forms of an organization.**
7. **Organizational culture objectives.**
8. **Assessing characteristics of organizational culture.**
9. **Functional roles within the context of organizational culture**
10. **Types of organizational culture (by Harrison and Hendy)**
11. **Matrix of organizational cultures**
12. **Organizational behavioral styles**
13. **Mechanisms of culture development**
14. **Professional ethics issues**

## 30. THE FUNDAMENTALS OF LEASING

| | |
|---|---|
| **Form:** | Training-consultation |
| **Target audience:** | SME managers |
| **Duration:** | 1 day |
| **Goals and objectives:** | Develop overall understanding of the fundamentals of leasing<br>Describe the roles and responsibilities of participants in the leasing process |

1. **What is leasing?**
2. **What can be leased?**
3. **Who is involved in the leasing process?**
4. **Scheme of leasing operations**
5. **Types of leasing**
   - Direct leasing
   - Indirect leasing
   - Domestic leasing
   - International leasing
   - Financial leasing
   - Operational leasing
6. **Functions of leasing**
7. **Leasing-related regulations**
   - Cross-border leasing
   - Leasing in Ukraine
8. **Leasing management**
9. **Leasing payments**

## 31. BUSINESS COMMUNICATIONS AND NEGOTIATIONS

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | SME managers |
| **Duration:** | 3 days |
| **Goals and objectives:** | Improve business communication and negotiation skills |

1. **Non-verbal communication**
2. **Theoretical principles of transactional analyses**
3. **Rules of adjustment for successful communication**
4. **Behavior patterns and strategies**
5. **Preparation for negotiations: practical and creative techniques**
6. **Creating win-win negotiations**
7. **The power of reasoning**
8. **Social and psychological aspects of persuasion**
9. **Reasons for unsuccessful negotiations**
10. **Practical guide for conducting negotiations**
11. **Types of conflict resolution**
12. **Negotiations in practice**

## 32. ENTERPRISE RESTRUCTURING FOR COMPETITIVENESS

**Form:** Training course

**Target audience:** SME managers

**Duration:** 3 days

**Goals and objectives:**
Introduce the concept of enterprise restructuring
Learn the step-by-step process of restructuring
Linking external analysis to restructuring

1. **Enterprise restructuring.**
   - Management development
   - Marketing development
   - Financial restructuring
2. **Succession of restructuring: problems, objectives, strategies, tactics, logistics.**
3. **Business competitiveness.**
4. **Competitive strategies.**
5. **The "wheel of competitive strategy".**
6. **Principles of decision-making process on competitive strategies.**
7. **Why environment analyses is compulsory?**
8. **Analyzing the macro and micro economic environment.**
   - Economic environment
   - Political environment
   - Legal environment
   - Technological environment
9. **Analyses of competitive environment.**
   - Consumer market analyses
   - Supplier market analyses
   - Competitor analyses
   - Infrastructure analyses
10. **Key factors for success.**

## 33. PERSONNEL MANAGEMENT FOR SMEs

| | |
|---|---|
| **Form:** | Seminar |
| **Target audience:** | SME directors and managers, personnel and training departments' staff. |
| **Duration:** | 1 day |
| **Goals and objectives:** | Learn how to create an organizational management structure relative to a firm's objectives and functions. Study of personnel management techniques. |

1. **The role of personnel management in SMEs.**
2. **Linking personnel management to firm style and culture.**
3. **The role and importance of team spirit.**
4. **Principles of team building.**
5. **The boss's shadow and a leader's transparence.**
6. **Recruitment and hiring process.**
7. **Dismissal process.**
8. **Staff motivation: principles and techniques.**
9. **Managing staff for efficiency and effectiveness.**

## 34. MANAGEMENT TOOLS USING MICROSOFT EXCEL®

| | |
|---|---|
| **Form:** | Training course |
| **Target audience:** | Entrepreneurs, businessmen interested in developing their computer skills. |
| **Duration:** | 2 days |
| **Goals and objectives:** | To learn opportunities of the software package and range of its application.<br>To develop sufficient skills in applying techniques for budgeting and accounting standards conversion, and to generally broaden PC user's qualifications. |

1. **General information.**
2. **Basics of using a PC.**
3. **Work with books and sheets.**
4. **Data input and manipulation with cells.**
5. **Management of lists.**
6. **Absolute and relative addressing.**
7. **Formatting tools.**
8. **Creation of formulas.**
9. **Work with diagrams.**
10. **Creation of databases.**
11. **Summary tables.**

Richard Caproni
Serghiy Kysil
Nadezhda Ryazanova
Denis Vasilenko

# LEASING
## IN UKRAINE

Manual by IFC Ukraine
Leasing Advisory Project

IFC

USAID

*Funded by:*
United States Agency for International Development

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# PREFACE

This manual was prepared by IFC's Ukraine Leasing Advisory Project (the Project) and funded by the United States Agency for International Development (USAID).

The Project began in 1998 as part of IFC's Ukraine Business Development Project with the goal of "improving conditions for financial leasing in Ukraine." The Project has focused on assisting the Ukrainian government and industry stakeholders in reforming leasing-related legislation. The legal and tax framework for financial leasing represents the most significant barrier to the development of a financial leasing industry in Ukraine.

Since its first leasing investment in Korea in 1977, IFC has been promoting leasing in countries all over the world. For over 30 years, IFC has been advising member governments on leasing legislation and regulation, undertaking feasibility studies, identifying sponsors and technical partners, and investing in new leasing companies. Over half of the developing countries that have a leasing industry today have had IFC invest into their local leasing companies — over 130 projects in about 45 countries.

The degree to which leasing can be effective in a difficult economic environment has been witnessed among many of Ukraine's neighbors where leasing has grown quite rapidly. IFC has invested in leasing companies in Russia, Estonia, Bulgaria, Romania, Czech Republic and Slovenia, and is actively preparing leasing investments in other countries in the region.

This manual provides Ukraine's leasing industry participants and enterprise managers with a thorough understanding of leasing (particularly financial leasing), both internationally and according to Ukrainian legislation. After reading this manual, the reader will understand why financial leasing is such a widely used form of asset financing around the world and why it has not developed in Ukraine.

This document is called a 'manual' because it provides the reader with a practical guide to the legal, tax, and accounting treatment of leasing under Ukrainian law. The analyses and recommendations in this manual are based on discussions with current lessors and parties to other forms of asset financing in Ukraine to present current practice rather than theory. It covers, in detail, the key issues that enterprises and lessors must consider when assessing a potential lease agreement.

In each section of the manual, we explain the weaknesses of Ukraine's leasing-related legislation relative to other countries and how it may be improved. Therefore, this document also serves as a guide for industry participants and government officials on the reforms necessary to encourage the development of a leasing industry in Ukraine.

The authors and members of IFC's Leasing Advisory Project — Denis Vasilenko, Nadezhda Ryazanova, Serghiy Kysil and Richard Caproni would like to thank those who contributed to the preparation of this manual. First and foremost, the Project would like to thank the managers and staff of Ukraine's lessors and industry participants whose assistance to the Project and this manual was paramount. Significant contributions to this manual were made by Elena Beryozkina and Karim Ahmad of IFC, as well as members of IFC's Russia Leasing Development Group. Editing and corrections of the English version were made by Daniel Kohn and the Ukrainian version by Galina Slivinskaya.

The views and opinions in this report are those of the authors and do not reflect the opinions of International Finance Corporation or the United States Agency for International Development. This manual has been produced in both English and Ukrainian languages, however, in the case of any ambiguity, the English will prevail.

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# I. INTRODUCTION

Leasing has generated a great deal of interest in the press and among government officials as an effective financial instrument to facilitate economic development in Ukraine. Many advantages which leasing provides over conventional bank financing particularly address the capital and liquidity problems faced by Ukrainian enterprises. Many of Ukraine's neighbors have seen their leasing industry take off, leaving many wondering why has this yet to happen in Ukraine.

This manual provides the necessary information to understand the nature of lease transactions and the issues relevant to the development of leasing in Ukraine.

**This manual will do this by:**

- Providing a conceptual understanding of leasing and why it has developed as such a widely-used and effective financial instrument throughout the world; and
- Analyzing Ukraine's taxation and legislation for leasing transactions. This will show why the typical benefits and advantages that financial leasing provides in many other countries are currently not realized in Ukraine.

Leasing, and particularly financial leasing, is defined quite differently from country to country. Therefore, this manual will explain the core principals and fundamentals of leasing followed by an explanation of leasing under Ukrainian law.

A commonly accepted definition of leasing is:

*"A contract between two parties, whereas one party (the lessor) provides an asset for usage to another party (the lessee) for a specified period of time in return for specified payments."*

This definition is simple and provides the foundation of a lease transaction, but it says little about the way leasing works. To understand better how leasing works, one must look separately at the two kinds of leasing, operating leasing and financial leasing.

Under both operating and finance leases, assets are provided for use. The difference between the two is that under financial leasing the goal of the lessee is either to acquire the asset or at least use the asset for most of its economic life. Operating leasing on the other hand is analogous to rent and a lessee is interested in using the asset for just a specific project or a shorter period.

Financial leasing is often defined as, *"a form of credit arrangement including certain payments for a definite period of time in exchange for the use of an asset for most of its useful life with an agreement or option for the eventual acquisition for ownership."* This definition refers to financial leasing as a credit arrangement because in most cases, enterprises use financial leasing to finance the purchase of fixed assets.

Although regulation and taxation of leasing transactions varies in different countries, there are a few core concepts from which leasing derives its advantages relative to other forms of financing.



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1. *Lessors provide an asset for usage and therefore retain legal ownership of the leased asset until the end of the lease term. This provides lessors with a stronger security position than a collateral agreement.*
2. *Lessors do not take deposits from the public and thus do not require the burdensome regulations concerning reserves and collateral that depository institutions endure.*
3. *Because financing is for a specific client and for a specific asset, the payment structure can be matched to the lessee's scheduled cash flow.*

These factors allow lessors to focus on the potential cash flow of the lessee and not on their balance sheet and credit history. Where leasing has developed successfully, lessees often do not need collateral other than the leased asset. Lessees are usually required to come up with a lower percentage of the asset cost at the beginning of a lease relative to bank credit and other forms of financing. As a result, new and small enterprises around the world that would have had difficulty obtaining financing for much needed equipment and/or vehicles have been successful in leasing these assets.

Leasing finances over $40 billion per year in new equipment and vehicle purchases in developing countries alone. The leasing industry globally is enormous and in many countries accounts for more than a quarter of all equipment financing.

The effectiveness of leasing in any country depends heavily on the taxation and regulation that surround or influence such a contract. Most important are taxation laws, particularly with regard to methods of depreciation allowed for tax purposes.

Many countries realize the importance of promoting leasing as an important element in their overall economic development. Leasing provides an opportunity for enterprises to modernize equipment and thus improve their efficiency and competitiveness. Leasing is also an effective way for manufacturers of leasable assets to sell more of their products.

### Leasing in Ukraine

Looking at the current economic situation in Ukraine, particularly the condition of the financial sector, one comes to the realization that the need for leasing is especially acute. The banking sector's lack of liquidity and experience in lending to SMEs has left enterprises with virtually no access to capital. The shortage of long term asset financing negatively affects the competitiveness of even Ukraine's most creditworthy enterprises and thus Ukraine's overall economic development.

Financial leasing has enormous potential in Ukraine in that it addresses the problems of many Ukrainian enterprises that do not qualify for bank financing. However, the development of a leasing industry in Ukraine has been hampered mostly by problems related to the legal and tax treatment of lease transactions.

The legal and tax treatment of financial lease transactions in Ukraine includes serious disincentives to conducting financial leasing in Ukraine. Contradictions

and ambiguities in legislation make the tax treatment and rights of parties to a lease incomprehensible. The result is that the term 'leasing' in Ukraine is often misused to describe all sorts of mechanisms used to finance the purchase of equipment and other fixed assets.

There are also market driven factors that negatively influence the potential development of leasing in Ukraine that also create problems for banks and other sources of financing. Most of these factors are related to the lack of macroeconomic stability and consequently, higher country risk. This results in high interest rates and a lack of funding sources for lessors. Potential lessees need to earn very high returns in order to generate sufficient cash flow to qualify for financing on a cash flow basis.

Despite these market issues, research has shown that there remains significant unfulfilled demand for leasing if offered on appropriate terms. Additionally, lessors are ready to enter the Ukrainian market once the legislative environment improves. The potential demand for leasing in Ukraine is further evidenced by the use of pseudo–leasing transactions such as 'sale with deferred payments,' which potential lessors and lessees have developed in response to the impassible tax and legal requirements for lease transactions.

There are currently only a handful of financial intermediaries in Ukraine which classify themselves as leasing companies. However, due to shortcomings of the Ukrainian taxation and legislation governing leasing transactions, these companies do not carry out leasing transactions as defined by Ukrainian law. Most 'leasing companies' use deferred sales as defined by Ukrainian law which is the closest financing mechanism to the international concept of financial leasing (for an explanation of the installment sales under Ukrainian law, please refer to Appendix 3). Some asset financing institutions also use operating leasing with a separate purchase contract.

In December 1997, the Ukrainian Parliament adopted the first, Law on Leasing, which currently provides the legal foundation for lease transactions. Tax treatment for lease transactions are covered in the Law on Corporate Tax and Law on VAT. These laws need to be modified to provide a consistent approach to the treatment of lease transactions such that parties to a lease transaction will be able to assess confidently the risks and costs involved.

This manual will help the reader to understand how Ukrainian laws treat a lease transaction. This analysis also describes those problems, which have scared off lessors from working in Ukraine. We provide general recommendations as to the key issues that need to be addressed so that a competitive leasing industry may develop in Ukraine.

The last section will cover the treatment of leases under Ukraine's recently adopted National Accounting Standards (UNAS). This section will help the reader to understand more of the economic nature of lease transactions and how UNAS for leasing transactions differ from International Accounting standards (IAS).

# II. FUNDAMENTALS OF LEASING

## DEFINITION AND TYPES OF LEASING

***Leasing — a contract between two parties whereas one party (the lessor) provides an asset for usage to another party (the lessee) for a specified period of time, in return for specified payments.***

As explained in the introduction, leasing has no universal definition. A number of legal and taxation models are currently in use worldwide that affect the usefulness of leasing as a financial instrument relative to alternative financing sources. In order to provide an understanding of what a leasing transaction encompasses we must compare the two types of leasing, *operating* and *financial*.

Characteristics of financial leasing include:

- *The goal of the lessee is either to acquire the asset or at least use the asset for most of its economic life.*
- *Rights and responsibilities for 'economic ownership' of the leased asset are borne by the lessee. Economic ownership refers to bearing the rewards and risks associated with possessing and using an asset. This includes the risks of accidental ruin or damage of the asset. Thus, damage, that renders an asset unusable, does not exempt the lessee from financial liabilities before the lessor.*
- *The lessee intends to cover all or most of the full cost of the asset during the lease term and therefore is likely to assume title for the asset at the end of the lease term. The lessee may gain title for the asset earlier, but no earlier than when he has paid the full cost of the asset.*
- *The lessee chooses the supplier of the asset and applies to the lessor for funding. This is significant because, as was noted earlier, the leasing company that funds the transaction, should not be liable for the asset quality, technical characteristics and completeness, even though it retains the legal ownership of the asset.*
- *The lessee may or may not buy-out the leased asset at the end of the lease.*

Characteristics of operating leases include:

- *The goal of the lessee is usage of the leased asset for a specific short-term need.*
- *Economic ownership with all corresponding rights and responsibilities are borne by the lessor.*
- *The duration of an operating lease is much shorter than the useful life of the asset.*
- *It is not the lessees' intention to acquire the asset and lease payments are determined accordingly.*
- *The present value of all lease payments is significantly less than the full asset price.*



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This conceptual understanding describes the nature of the two transactions but should not be used as legal framework. Both sides should have maximum flexibility to close the contract which best suits their needs. In fact, many countries do not have any specific 'Law on Leasing.' The reason such distinctions are made are mainly for taxation and financial reporting purposes.

For example let's take a look at how the distinction is made by International Accounting Standards (also used in Ukrainian National Accounting Standards). These standards, which determine procedures for financial reporting state that a lease is a financial lease if there is at least one of the following features:

- *the lease transfers ownership of the asset to the lessee by the end of the lease term;*
- *the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable and at the inception of the lease, it is reasonably certain that the option will be exercised;*
- *the lease term is for a majority of the useful life of the asset. The Title may or may not eventually be transferred;*
- *the present value of the minimum lease payments at the inception of the lease, is greater than or equal to the fair value of the leased asset.*

*Any leases that do not have any of the above characteristics are considered to be operating leases.*

As is evident, this is far from an exact definition, which is why many countries see no need to define the types of leases in legislation. From a policy standpoint, countries realize the value in providing maximum freedom to the parties to a lease transaction to structure the transaction that suits them best. The transaction is subsequently classified for tax purposes based on the nature of the transaction, as seen above.

There are many different tax models due to the unique nature of financial leasing as a form of asset financing where the lessor maintains legal ownership but the lessee assumes the risks and reward of economic ownership. So how are policy makers to determine how to tax such transaction?

If we take another look at a common definition for financial leasing:

> ***Financial leasing is often explained as a form of credit arrangement, including certain payments for a definite period of time in exchange for the use of an asset for most of its useful life with an agreement or option for its eventual acquisition for ownership.***

Given this definition, a financial lease may be treated as if it were just a loan. Although many countries tax financial leases simply as a purchase and sale of the asset by the lessor (European model). While others treat financial leases as though the lessor is just providing the asset for usage (US model). There is obviously no 'right' model and each country simply chooses the model that is best



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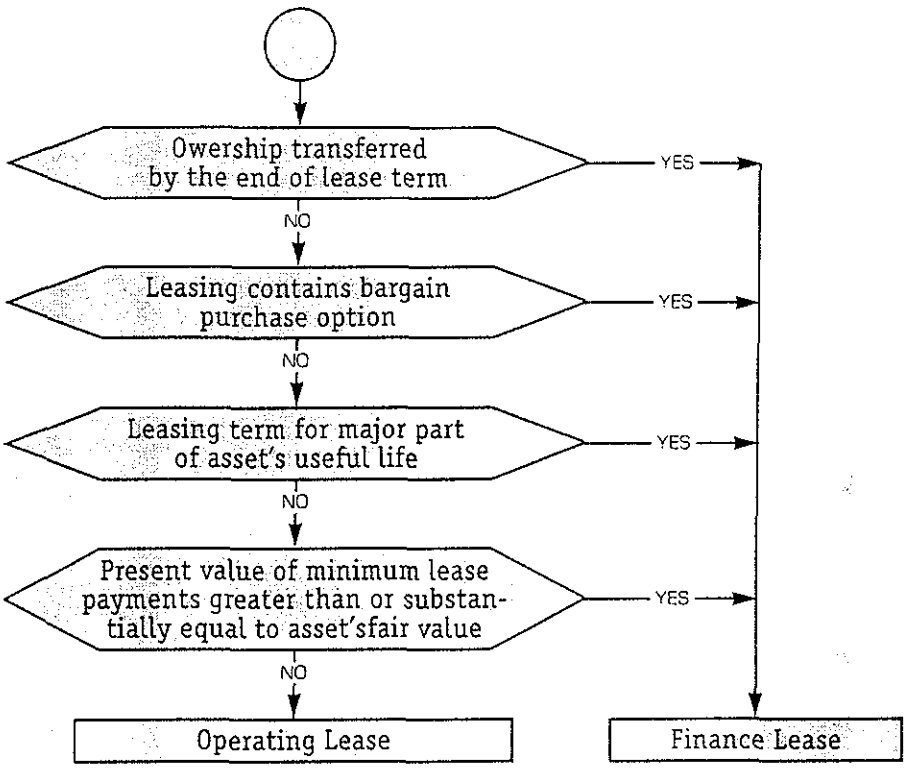
suited to their economic policies and goals.




THE IMPORTANCE OF LEASING – A Practical Look

**Consider the following three scenarios, each describing a business seeking financing:**

1. The owner of a small, two-year old car shop decided to expand his service list and set up a painting facility. Market research clearly showed that local demand exceeded the capacity of existing paint shops. The owner prepared a quality business plan and applied to a local bank with an active lending program but was refused on the basis that the car shop lacked sufficient collateral. The bank was unwilling to recognize that the company's strong cash flow projections and reputation represented a large part of the company's market value. Eventually, lack of collateral was the decisive factor why the loan application was refused.
2. Having analyzed losses borne at harvesting, a large farming business concluded that it incurs significant losses at harvest because it still uses outdated harvesters. The farm sought to import modern harvesting machinery with much better productivity, which would significantly increase the farm's profits. The farm applied to a bank for a loan and offered a processing line as collateral to secure the loan. The banking institution was happy with the col-



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lateral value and liquidity, but the bank's own financial resources allowed them only to offer a one-year foreign currency loan with monthly payments at 25% interest. The farm could not meet such a repayment scheme.

3. A small furniture manufacturer had begun exporting to a group of large discount furniture retailers in Western Europe. However, the furniture manufacturer's prices were being driven up by extremely high delivery costs it was paying to a third-party trucking company. Based on its current level of exports, the company realized that their projected shipping costs would allow them to pay off the cost of two trucks plus interest in less than three years. The company applied to a local bank to finance the purchase of the trucks. The bank agreed to provide 70% of the costs of cost of trucks if the company provided the other 30%. The company was not able to come up with such a large sum of cash and finance the increase in their production at the same time.

The scenarios described above are quite typical today in transition economies such as Ukraine. The examples under review assumed stable operating businesses, planning to purchase or replace fixed assets and requiring external funding. In all three cases funding could not be accessed for objective reasons.

Lack of collateral in the first example, availability of only short-term bank financing in the second scenario and large up-front cash flow requirements in the third case made it impossible to purchase the required equipment.

Without financial leasing, these plans would be unfeasible. What follows is a description of how leasing companies acted in these situations and how they differ from conventional financing institutions.

1. Rather than look at the value and liquidity of the car enterprises assets, the leasing company saw the market perspectives of the company and its ability to effectively sell its services based on its skills and expertise. Revenues and net profit generated by the company were sufficient to service lease payments, without disrupting the company's current activities. The leasing company supplied the required equipment to the car shop notwithstanding its lack of sufficient collateral. The lessor held the title for the equipment during the entire duration of the lease contract. After having met all terms of the lease, the car shop assumed title for the equipment.
2. In this example, the farm was not happy with the terms of bank funding — neither with the repayment schedule nor with the cost of funding. A Ukrainian leasing company was able to receive a trade credit from a foreign supplier of the required equipment at 15% annual rate, as it had a long-term relationship with the supplier and enjoyed its trust as a reliable partner. Moreover, as a permanent client of the foreign supplier, the company enjoyed discounts for equipment price and was able to set up a seasonal repayment schedule that was consistent with the cash flow of the farm. Therefore, a foreign bank funded the supplier who provided the equipment as a trade-credit to the Ukrainian lessor. The lessor provided the farm access to the banking system of the supplier country, which could provide resources for a longer term and at a lower interest.

3. Although the furniture manufacturer could not come up with a huge up-front payment for the purchase of new trucks, its contracts with the large Western European retailers, was sufficient to convince a captive leasing company for a major truck manufacturer to lease them the vehicles. The leasing company agreed to a 10% up-front payment and a 3-year lease with quarterly payments.

## ADVANTAGES OF LEASING

Some conventional advantages of financial leasing vis-a-vis bank financing include:

- ***Simpler security arrangements*** *as the asset provided for leasing represents the primary collateral. Because the lessor retains legal ownership of the leased asset, they will not have to compete with other creditors to repossess the leased asset if the lessee's business fails. Therefore, financial leases generally have lower collateral requirements. For this same reason, lessors typically have more lenient credit-history requirements. This allows young and small enterprises to access leasing finance much more easily than bank loans.*
- ***Availability.*** *In developing countries, leasing may be the only form of medium to long-term financing available for purchasing equipment. Lessors tend to specialize in certain types of equipment which allows them to attract trade financing from equipment producers or access foreign financial markets by sharing in the credit risk when providing leased equipment. Enterprises would have much more difficulty accessing these sources themselves.*
- ***Convenience and lower transaction costs.*** *Leasing can be arranged more quickly and simply than conventional loan financing because 1) lessors do not take deposits and therefore are not subject to regulation 2) additional security is usually not necessary. These factors remove much of the red tape often associated with bank loans and allow lessors to make quicker decisions and require less documentation. This helps the lessee to avoid costs associated with assigning collateral, documentation and slower processing times connected to bank borrowing which may be significant, particularly for smaller borrowers.*
- ***Less cash required up-front.*** *Leasing can finance a higher percentage of the capital cost of equipment than bank borrowing, often with little down payment. This is again due to the stronger security position of a lessor than just a collateral agreement.*
- ***Flexibility.*** *Leasing contracts can be structured to meet the cash flow needs of the lessee. Lessors have less liquidity concerns than banks and can more easily balance the timing of assets (leases) and liabilities (bank credit lines and trade credit).*
- ***Tax incentives.*** *In many countries lessees can offset their full lease payments against income before tax, compared to just the interest on bank loans. Many governments grant tax incentives to leasing because they recognize that it enables new and small firms to access financing for investment.*

## FINANCIAL LEASING — A History

Leasing may be defined as a set of property relations where one party (lessor) provides assets for use by another party (lessee), for a definite period and in exchange for payment. More specifically, financial leasing may be defined as a form of credit arrangement including certain payments for a definite period of time in exchange for the use of an asset with an agreement for its eventual acquisition for ownership.

Transactions of this nature can be traced back thousands of years, although leasing has evolved considerably and received a legal basis only during the last 40 years. In the days of the industrial revolution, mass producers began leasing type schemes as a marketing tool that helped them sell more of their manufactured goods.

Utility companies such as Bell Telephone Company used short-term leases to allow the population to afford telephones who they could then charge for service. Gas and electricity companies used the same scheme in installing electricity and gas meters.

As the 20th century rolled around, manufacturers of large production equipment began realizing the usefulness of leasing as did the railroad sector. In late 1930s, Henry Ford was selling his cars using deferred payments, where each payment reimbursed the cost of capital and a portion of the car price.

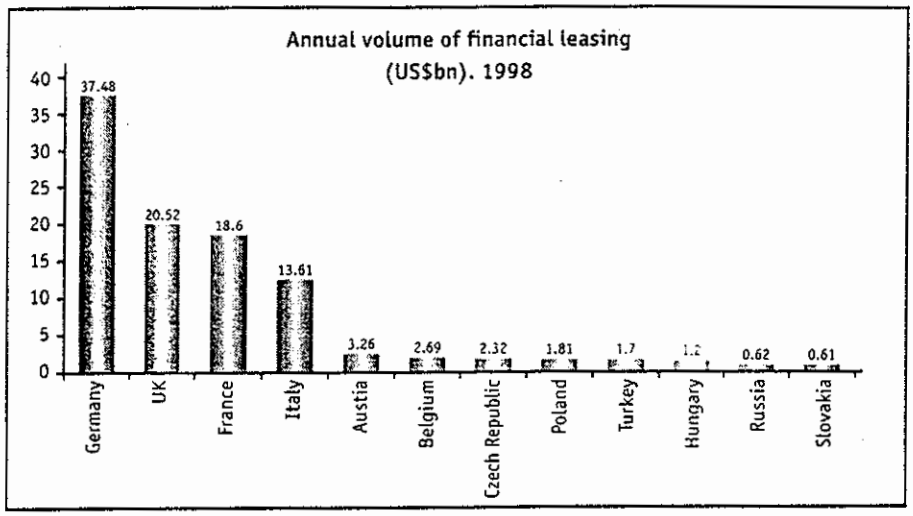
It is these manufacturers who began refining the art of financial leasing on a grand scale. The producers had resources to finance production of the asset but their customers obviously did not have enough cash for immediate payment. Given that many potential clients did not qualify for bank financing, the only thing left for the producer to do was to pass the product on in exchange for deferred payment with a markup to cover his cost of capital. Thus, the idea of payment for fixed assets in portions enabled producers to increase the number of clients, volume of output, and to gain a significant competitive advantage in the market.

However, as the number of deals with deferred payments grew, the selling technique broke away as a separate type of business and leasing developed into a specialized financial service. Along with the development of the leasing industry, specific norms and rules for players pertaining to financial leasing evolved. The concept of the distribution of risks and rewards under a financial lease was adopted, where risks and rewards are distributed with respect to the objectives of the lessor and the lessee *(explained in detail in the next section)*.

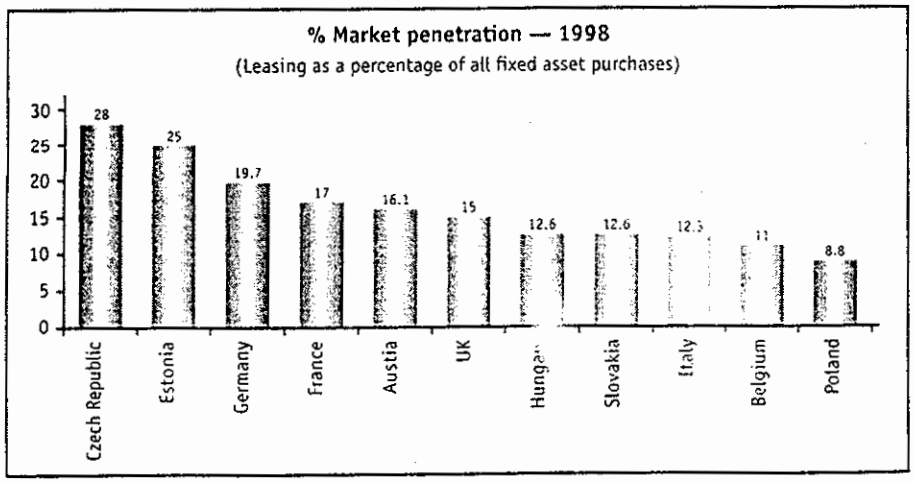
Eventually, leasing ceased to be just a manufacturer's selling technique. In 1952, Henry Shonfeld founded "United States Leasing Corp," the first independent leasing company in the United States. Originally, the company was established for administering one specific lease. However, the founder soon realized that leasing has plenty of undiscovered capabilities. The industry extended to Europe and Japan in the 1960s and has been spreading through developing countries since the mid-1970s. By 1994 leasing had been established in over 80 countries, including over 50 developing economies.

## WORLD LEASE VOLUMES

Below you can see the volume of financial leasing transactions throughout Europe.




As evidenced by the following chart, leasing is used to finance a significant portion of capital expenditures in many developed and transition economies.




See potential demand for leasing in Ukraine based on such indicators in the *Leasing Market in Ukraine* Section.



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# III. LEASING MARKET IN UKRAINE

## CURRENT 'LEASING' ACTIVITY IN UKRAINE

There are currently only a handful of financial intermediaries in Ukraine that refer to themselves as leasing companies. However, due to shortcomings of the Ukrainian taxation and legislation governing leasing transactions, these companies do not carry out leasing transactions as defined by Ukrainian law.

To discuss the leasing industry in Ukraine, we must understand 'leasing' as asset financing provided by non-bank financial intermediaries whose primary goal is to finance the usage and/or purchase of fixed assets. Leasing does not require licensing in Ukraine and there are no particular regulations or requirements in place for leasing companies. A business of any form of ownership may become a lessor and there is no legal restrictions prohibiting leasing companies from being involved in other types of activity. These factors make it next to impossible to measure the amount of 'leasing' activity in Ukraine.

Although a Ukrainian company may have the word 'leasing' in its title, it may not offer such services or provide a negligible portion of leasing services compared to the rest of its activities. Further complicating attempts to measure leasing activity in Ukraine is that due to problems presented by Ukrainian legislation, those companies which are in the true sense leasing companies, use other financial instruments as defined by Ukrainian legislation.

Most financial 'lessors' actually use 'deferred sales' as defined by Ukrainian law which is the closest financing mechanism to the international concept of financial leasing (for an explanation of installment sales under Ukrainian law, please refer to Appendix 3). Some asset financing institutions also use operating leasing with a separate purchase contract.

Those lessors who provide actual financial leases fall into two categories: 1) foreign captive lessors who use the legal jurisdiction of the country from where the leased asset is imported; or 2) State owned lessors or leasing funds. The latter are able to resolve the legal and tax issues that hinder private lessors.

The majority of this asset financing in Ukraine is provided by captive finance companies of vehicle manufacturers. These lessors are mostly representatives of large vehicle manufacturers, including VOLVO, Scania, MAN, and Daimler-Chrysler and include trade and finance companies of major producers of agricultural equipment such as AGCO. Most foreign lessors have a representative office in Ukraine, the staff of which familiarizes clients with conditions and requirements offered for new leases, and monitors existing projects. The most common types of leased assets are trucks, cars, office and bank equipment, farming equipment and equipment for processing food products.

### Additional Barriers to the Development of the Leasing Industry

In addition to weaknesses in Ukraine's civil and tax legislation other problems hinder the development of a leasing industry in Ukraine.

Ukraine's ten years of independence have been dominated by a lack of macro-

economic stability in terms of inflation and currency devaluation. This has resulted in high costs of capital and difficulties in long term financial planning. Such conditions have created significant problems for Ukraine's banks and the financial sector as a whole. Therefore, leasing companies are faced with an absence of long-term, moderately priced funds with which to purchase leased assets. In additional, lessors experience problems in finding creditworthy lessees that can generate high enough returns to qualify for financing on a cash flow basis. However, Ukraine has witnessed significant improvements in its macroeconomic stability in 2000 and there are many reasons to be optimistic that conditions will continue to stabilize in 2001.

Ukraine's inefficient civil court system increases the risks to lessors in settling potential disputes with lessees as it hinders investment in general. Legal proceedings in Ukraine tend to be slow, expensive and lack transparency. This makes it much more difficult for domestic lessors to raise long term, lower-cost funds from foreign capital markets as well as frightens off foreign lessors from entering the Ukrainian market.

Another factor that removes an economic incentive from leasing is Ukraine's outdated depreciation policies (See Annex 6 on depreciation methods). One of the essential factors behind the huge popularity of leasing worldwide is the tax benefits connected with the depreciation of leased assets. Most countries realize that providing flexible accelerated depreciation options to enterprises will lead to increased investment, as enterprises will be looking to replace fixed assets more often. The net effect is that tax revenues from increased economic activity, particularly by manufacturers of equipment and other fixed assets, outweighs any tax revenues lost from allowing enterprises to claim more depreciation early in the useful life of an asset.

### Need For Leasing In Ukraine

The advantages which leasing provides over conventional bank financing address the capital and liquidity problems of the Ukrainian market. Small and mid-sized firms in particular can access lease finance more quickly and simply than conventional loan financing because leasing does not always require additional security or a strong credit history and balance sheet.

The degree to which leasing is effective in a difficult economic environment has been witnessed among many of Ukraine's neighbors, where leasing has grown quite rapidly due to greater availability, convenience, flexibility and lower transaction costs relative to bank loans. For example, IFC has invested in leasing companies in Russia, Estonia, Bulgaria, Romania, Czech Republic and Slovenia, and is planning leasing investments in other countries in the region.

Because a leasing company retains legal ownership of the asset, it enables enterprises to qualify for use of leased equipment based on its generated cash flow rather than on its credit history or capital base. Moreover, the amount of initial capital a lessee needs is less than other forms of conventional financing, freeing up much needed cash flow for the lessee.

The need for leasing in Ukraine is magnified by the fact that bank financing is limited to high-interest, short-term loans. Most bank loans are made to mid/large-sized borrowers already known to the banks and are heavily collateralized. Moreover, the banking system as a whole is undercapitalized, can be discriminatory, and has not provided new market instruments to replace the collapsed state subsidy system. The acute shortage of medium and long term funding for the industrial sector plagues the Ukrainian economy.

The result is significant pent up demand for alternative sources of financing to replace outdated and run-down equipment. The largest potential demand for leasing in Ukraine may be concentrated in the following areas:

**The transport industry** has been the most active sphere in generating lease transactions and has shown significant enthusiasm and demand for leasing including recent attention by the aviation industry.

**Ukraine's agro-industrial complex,** has been the greatest force in pushing for improvement in the legislative and tax base for the leasing industry. Leasing, as it has been in so many other emerging markets, is a critical financing tool in helping to cope with the overwhelming demand for new machinery in Ukraine's agricultural sphere.

**Ukrainian manufacturers** *suffer a material disadvantage due to outdated* production facilities. The need for implementation of new technologies inevitably leads to the need for replacement or upgrade of production lines and other equipment.

**Small business and start-ups** would likely benefit most from the development of leasing in Ukraine as they do not qualify for bank financing and lack the financial resources to purchase fixed assets to grow their business.

### Potential Market For Leasing In Ukraine

Based on the issues discussed in the previous section, it is apparent that there is huge demand for leasing in Ukraine. The strong potential demand for financial leasing in Ukraine is further evidenced by the pseudo-leasing transactions such as 'sale with deferred payments,' and operating leases with purchase options that lessors developed in response to the impassible tax and legal requirements for financial leasing transactions.

However, quantifying the potential demand for leasing in Ukraine is much more difficult. Below is an attempt to show the potential demand based on traditional indicators. This estimate is very conservative in terms of the percent of fixed investments and Machinery imports. These figures may be compared with the market penetration figures in the *World Leasing Volumes* Section.

TABLE 1 / TABLE OF ECONOMIC INDICATORS RELEVANT TO LEASING

| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001* |
|---|---|---|---|---|---|---|
| GDP (Bn USD) | 44.5 | 50.2 | 41.9 | 30.8 | 32.2 | 33.2 |
| Imports (Bn USD) | 19.8 | 19.6 | 16.3 | 13.0 | 15.3* | 16.8 |
| NFI** (Mn USD) | 6,862 | 6,667 | 5,697 | 4,250 | 3,593 | 3,109 |
| Machinery Imports (Mn USD) | | — | 4,369 | 2,895 | 2,690* | 3,922 |

* Estimates
** Net Fixed Investment

Potential share of Leasing in NFI has been assumed to be 5%
Potential share of Leasing in Machinery Imports has been assumed to be 10%

TABLE 2 / POTENTIAL VALUE OF LEASING MARKET IN UKRAINE FOR 2001

| | (Mn USD) |
|---|---|
| Share of Leasing in Net Fixed Investment (5%) | $ 155.5 |
| Share of Leasing in Machinery Imports (10%) | $ 392.2 |
| [1] Estimated Vehicles Leasing in Ukraine | $ 50.0 |
| Estimate of movable assets for Leasing in Ukraine | $ 597.7 |

- *GDP figures taken from the Ukrainian State Statistics Committee.*
- *Import and Machinery import figures taken from Economic Intelligence Unit's Country Report for the 1Q2001.*
- *Net Fixed investment Data taken from official statistics of the Ukrainian Ministry of Economy*

[1] Estimate of Vehicles Leased in Ukraine based on 2000 results (over $50m) obtained from discussions with Ukraine's major lessors and vehicle manufacturers. Thus $50m projected for 2001 is conservative.



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# IV. EXISTING LEGAL FRAMEWORK FOR LEASING IN UKRAINE

This portion of the manual provides the reader with a detailed analysis of key legal issues to be considered before entering into a lease agreement in Ukraine.

As you will see over the next several pages, Ukraine's *Law on Leasing* attempts to provide a strict legal definition and framework for leasing in Ukraine. However, as explained in previous sections, leasing is a unique set of property relations that draws its strength from being flexible and adaptable. Ukraine's rigid and contradictory definitions in the *Law on Leasing* limit the options available to both lessors and lessees and thus detract from leasing's effectiveness as a financial tool.

**Each section of this report is divided into three parts:**

1) relevant excerpts from leasing laws and regulations that deal with particular aspects of leasing;
2) an analysis of the terminology used in these laws and its practical implications for parties to a leasing transaction as well as the leasing industry as a whole. Key considerations for a potential lessee when entering into a leasing agreement; and
3) suggestions for improving Ukrainian legislation, based on the complexities discussed in Part 2.

Lawmakers are already working to remedy the problems that current legislation has created for the leasing industry. Amendments to the Law on Leasing passed its second reading on April 5, 2001. This report will provide the reader with a quick reference guide to some key issues that may be changed if the bill is passed (in the colored text boxes at the end of some sections).

## THE DEFINITION OF LEASING

Ukraine's Law on Leasing provides the following definition of leasing:

**Article 1. Definition of Leasing**

*LEASING is a type of commercial activity in which one party (the lessor) uses either his own or invested capital to acquire an asset for exclusive use by another party (the lessee) for a definite period of time and in exchange for specified periodic payments. The leased asset may either be the lessor's own property or may be acquired by the lessor, upon the lessee's request, from an appropriate vendor.*

At first glance, this definition appears to encompass the nature of leasing as described in Section II. However, this simple definition demonstrates the inadvertent restrictions that can be brought about by terminology.

By defining leasing as a **commercial activity** in this and other clauses, the law restricts leasing to commercial entities and individuals; it therefore excludes government agencies and non-profit organizations, such as hospitals and educational institutions.

The phrase **"[one's] own or invested capital"** may be interpreted to mean that a lessor cannot take out loans from a bank or other credit organization in order to fund the purchase of a leased asset.

The Ukrainian Law on Investment Activity clearly stipulates three types of financial sources of investment: an entity's own *working capital, borrowed funds,* or *investment capital.* The Law on Leasing does not include borrowed funds (defined as loans from banks or other credit organizations) as a possible source of finance for leases.

One might assume, on the following grounds, that this was simply an oversight on the authors' part and that the provision was not meant to be enforced:

1) The omission of "borrowed funds" contradicts other clauses within the Law, which refer to "capital borrowed from creditors."
2) Ukrainian lessors have chosen to ignore the matter altogether and frequently borrow money from banks in order to purchase leased assets.
3) Most importantly, if this point were to be enforced, it would undermine the very nature of leasing as a financial mechanism.

[For more details, please see the appendix on "Weaknesses of Ukrainian Leasing Legislation.]

**"...to acquire an asset for exclusive use..."** This terminology effectively prohibits subleasing, as it stipulates that the leased asset may only be used by the lessee, never by a third party — even with the lessor's consent.

***POSSIBLE IMPROVEMENTS TO LEGISLATION***

***Current legislation contains inappropriate restrictions on the signatories to a lease, the instances where bank loans may be used to finance a lease, and the very legality of subleasing. Proposed amendments to legislation currently with the Verkhovna Rada will remove these restrictions.***

## TYPES OF LEASING

Ukraine's Law on Leasing tries to pinpoint exact definitions and distinctions between financial and operating leasing. In reality, however, this distinction is conceptual (see Section II, pps. 8–9), and not based on strict economic criteria. The Ukrainian government's attempt to formalize this distinction has only created problems for the country's leasing industry.

Here we shall discuss the three main areas of the Law on Leasing that deal with the distinction between financial and operating leases.

**Article 4. Types and Forms of Leasing**

**1. Types of Leasing**

*1)* **A financial lease** *is a contractual arrangement whereby the lessee may use a requested asset (leased asset) in exchange for specified payments over such period of time as the asset's original value depreciates by at least 60%. (The original value being the asset's book value on the date when the lease was signed)*



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*The lessee must pay at least 60% of the asset's original value through lease payments over the course of a financial lease.*

*Upon expiration of a financial lease, the lessee must redeem the asset's residual value, unless he has already redeemed its full value through the lease payments.*

*2)* **An operating lease** *is a contractual arrangement whereby the lessee may use the requested asset in exchange for specified payments over such period as the asset's original value depreciates by no more than 90%.*

*When an operating lease expires, it may either be renewed, or the lessor may repossess the leased asset and lease it to another lessee.*

**Article 9. Transfer and Repossession of the Leased Asset**

*An asset leased under a financial lease must be recorded on the lessee's balance sheet, with a note indicating that it was acquired under financial lease. An asset leased under an operating lease must be recorded on the lessor's balance sheet, with a note that it has been leased to another party; meanwhile the lessee must include the asset in his off-balance account, with a note that the asset was acquired under lease.*

**Article 14. The Risk of Unintentional Damage to or Destruction of a Leased Asset and the Matter of Insurance for Leased Assets**

*1. The risk of unintentional damage to or destruction of the object of a financial lease shall be borne by the lessee, unless otherwise stipulated under the lease agreement.*

*2. The risk of unintentional damage to or destruction of the object of an operating lease shall be borne by the lessor, unless otherwise stipulated under the lease agreement.*

**Article 15. Expenditures towards the Maintenance of Leased Assets**

*1. Under a financial lease, all expenses relating to the maintenance of a leased asset (insurance, operating expenses, technical service and repair) shall be borne by the lessee, unless otherwise stipulated under the lease agreement.*

*2. Under an operating lease, the lessor shall bear all expenses relating to the maintenance of a leased asset (except those relating to its operation and the renewal of consumable materials), unless otherwise stipulated under the lease agreement.*

Lessors and lessees may draw the following conclusions from these four articles of the Law on Leasing:

**Under a financial lease:**

- *The lessee must redeem the full original cost of theleased asset.*
- *The term of a financial lease must be at least as long as it takes the leased asset to depreciate by 60%, based on its original value at the time when the lease was signed.*

- *The leased asset must be recorded on the lessee's balance sheet with a that it has been acquired under financial lease.*
- *The lessee must bear the risk of accidental damage to or destruction o leased asset, unless otherwise stipulated under the lease agreement.*
- *The lessee must bear all costs relating to the insurance of the leased unless otherwise stipulated under the lease agreement.*

**Under an operating lease:**

- *The lessee may not redeem the leased asset upon expiration of the (rather he must return the asset to the lessor).*
- *The term of an operating lease must not be longer than it takes the le asset to depreciate by 90%, based on its original value at the time whe lease was signed.*
- *The leased asset must be recorded in the lessee's off-balance account, w note it has been acquired under lease.*
- *The lessor must bear the risk of accidental damage to or destruction o e leased asset, unless otherwise stipulated under the lease agreement.*
- *The lessor must bear all costs relating to the insurance of the leased as unless otherwise stipulated under the lease agreement.*

These provisions have several implications that one should keep in mind before entering into a lease agreement.

1. The effects of fixing the lease term to the leased asset's depreciation schedule:

   - *The first obvious problem is that this limits the options of both lessors and lessees, restricting them to long-term leases. Given Ukraine's current economic conditions of high interest rates and inflation, the costs of long-term financing, when it can be found at all, are extremely high. Even if one uses accelerated depreciation, the minimum term of leases exceed what the market will currrently bear (see Annex 6 covering asset depreciation).*
   - *Another problem with fixing the lease term to the asset's depreciation period is that if the depreciation laws or regulations suddenly change, a lease agreement may cease to be in compliance with the law and may therefore require modifications. Modifying an agreement is likely to create various points of disagreement between the signatories. The duration of the lease affects both the size and the schedule of lease payments, the cost of technical maintenance, the amount of interest charged, and so on. Therefore, changing the duration of a lease may make it unprofitable for one of the parties, who might naturally resist any such modifications.*

2. The Law on Leasing stipulates whether the leased asset should be recorded on the lessor's balance sheet or the lessee's. This is something that should be (and currently is) determined by Ukraine's tax and accounting regulations (UNAS). The Law on Leasing happens to be consistent with



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these laws. If any contradictions should arise, the tax and accounting regulations should take precedence, and one should consult with the local tax authorities.

***POSSIBLE IMPROVEMENTS TO LEGISLATION***

***It is clearly necessary to make the lease term independent of the depreciation period for both financial and operating leases. Furthermore, the Law on Leasing should not attempt to regulate tax or accounting policies, but should leave these to the appropriate legislation or regulations.***

***If the Verkhovna Rada passes the amendments to the Law on Leasing that are currently under discussion, Article 9 will be eliminated altogether and these problems will be resolved. The reform bill suggests the following definitions for financial and operating leases:***

**Article 2. Types And Forms Of Leasing**

*1. Depending on enforcement peculiarities, leasing may be of two types: financial and operating.*

1. *Financial lease is an agreement of direct or indirect leasing, under which an asset is provided to a lessee for use for a particular period specified by the agreement, and which a lessee may eventually purchase after termination of the lease term upon payment of the full asset price as fixed in the agreement;*
2. *Operating lease is an agreement of direct leasing, under which an asset is provided for use to a lessee, and where the asset will be returned to the lessor at the end of the usage term that should be less than the period of the asset useful life;*

## FORMS OF LEASING

Not only does Ukrainian law define two distinct "types" of leases (financial and operating), it also distinguishes between various "forms" of leasing. The "form" of a lease simply refers to the specific relationship between the parties to a lease agreement. Each form may be either a financial or an operating lease.

**Ukraine's Law on Leasing**

**Article 4. Types and Forms of Leasing.**

*2. Forms of Leasing*

*1) A purchase and lease-back agreement is one in which the lessor purchases an asset and leases it back to the vendor.*

*2) A shared lease (multiple lessor) is one in which multiple lenders contribute their own funds to the lease. The total investment contributed by these lenders may not exceed 80% of the leased asset's value.*



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*3) An international or cross-border lease is one in which the lessor and the lessee are located in different countries, and the leased asset or lease payments are transferred across national borders. International leases are regulated by Ukraine's Law on Leasing, other relevant Ukrainian laws, international treaties to which Ukraine is a signatory, and the lease agreements themselves.*

The Law on Leasing does not place any restrictions on the forms that a financial or operating lease may take. Let's take a closer look at the forms of leasing defined under the law.

**A purchase and lease-back agreement** is one in which the lessor purchases an asset and subsequently leases it back to the vendor. Enterprises enter into such agreements for a variety of reasons. Two of the most common are:

1) Taxes. If an enterprise has a fully depreciated fixed asset which it still uses, it may want to sell it to a lessor and then lease it back, as it can then write the lease payments off as a production cost.
2) If an enterprise owns valuable assets, it may be able to leverage these assets and use the cash to earn profit in excess of the finance costs.

Both strategies are contingent on having an asset that has significant market value and a useful service life. It is important to remember that a purchase and lease-back agreement is still classified as either a financial or operating lease and is therefore subject to the relevant leasing laws and tax regulations.

**Shared or syndicated leasing** refers to an arrangement whereby two or more sources of credit are signatories to the lease. However, the wording of the clause in the Law on Leasing gives rise to certain questions:

1. What is meant by a creditor's "own funds" in the context of a syndicated lease agreement?
2. Why are lenders not allowed to contribute more than 80% of the asset's value?
3. How can "one or more lenders" "contribute" to a lease where the signatories are the vendor, the lessor and the lessee?

On the one hand, these questions may be considered irrelevant, since the Law on Leasing has a separate clause that allows "one or more lenders" to contribute to a lease as signatory parties. Therefore, one might ignore these restrictions altogether, as well as the definition itself, when signing a lease agreement, provided that one did not wish the agreement to have the status of a shared lease.

However, for those who do wish to formalize a shared lease agreement, these legal ambiguities make it very difficult to determine the allowable structure of the lease. The term 'own funds' is open to interpretation, as is the manner in which a lender may 'contribute' to a lease if he is not a signatory.

As for limiting the lenders' contribution to 80% of the leased asset's value, it may be in the lender's best interests to ensure that the leasing company also contributes some of the financing. However, such matters should be left to banking regulations as it is the lender who should be choosing the level of risk

they choose to take.

**A cross-border lease** is one in which the lessor and the lessee are located in different countries and the leased asset or lease payments are transferred across national borders. The key elements for assessing a cross-border lease can be found in Annex 7.

***POSSIBLE IMPROVEMENTS TO LEGISLATION***

***The terminology used to describe a shared lease could be improved in two key areas:***

***1) The law should clarify what is meant by a lender's "own capital"***

***2) If Ukrainian legislators wish to regulate the structure of shared leases and ensure prudent behavior on the part of lessors by requiring them to contribute their own equity, they should make it clear that a lease is "shared" whenever one or more lenders become signatory parties, and that in such cases the lessor must also contribute a portion of his own funds towards the purchase of the leased asset.***

## LEASABLE ASSETS

In principle, almost any kind of fixed asset may be leased. Most assets that are leased throughout the world tend to be business-related equipment, such as manufacturing and construction equipment, all forms of transport vehicles, office equipment, and so on. But there are also cases of leasing livestock, medical equipment, etc. In practice, however, lessors are always restricted by the legal framework in which they operate.

Ukraine's Law on Leasing attempts to define which assets may be leased and which may not.

**Ukraine's Law on Leasing**

**Article 2. Leased assets**

*1. The leased asset can be any movable or immovable property, including properties of state-owned enterprises (machinery, equipment, vehicles, computers and other technical devices, telecommunication systems, etc.), that are classified as fixed assets, that are not prohibited from free-market circulation, and that are not subject to any other restrictions on leasing.*

*2. The state-owned property mentioned in Clause 1 above may only be leased with the approval of the property's management board and in accordance with the procedures established by the Ukrainian Cabinet of Ministers.*

*3. This law prohibits the leasing of:*

- *State-owned assets listed under Article 4 of Ukraine's Law on Renting State-owned Property, except for those assets that are listed as non-essential by state-owned enterprises;*
- *Land and other natural resources.*

What all of this boils down to is that one may lease any kind of fixed asset except for:

- *land and other natural resources;*
- *assets explicitly prohibited from general circulation such as narcotics, illegal weapons, etc;*
- *other assets prohibited to be provided for leasing (rent) in Ukraine's Civil Code or Law on Rent.*

All three clauses of this article seek to ensure that the lessor actually has the legal right to lease a given asset to another party. Due to Ukraine's difficulties with its privatization process over the last ten years and a frequent lack of adherence to general corporate governance practices, it can often be difficult to determine who has legal control over certain assets.

Considering this and other legal complexities, one should always seek expert legal advice, particularly when leasing a used or previously owned property. Throughout Ukraine's privatization process, the concept of leasing has frequently been abused. One must be particularly cautious when leasing from a state enterprise or when the supplier of the asset is a state enterprise. For more information on leasing state-owned, communal, or jointly owned assets, see Annex VII.

The use of the term 'fixed assets' in Ukraine's Law on Leasing effectively excludes the following objects:

a) Objects that lack consumer quality (i.e., those which cannot be put to use), such as unfinished construction sites, incomplete equipment or machinery;

b) Objects that are quickly consumed, such as glue, gas, lubricants, bores, etc.

***POSSIBLE IMPROVEMENTS TO LEGISLATION***

***Ukraine's Law on Leasing makes reference to other laws, some of which have changed over the years. As this now results in certain contradictions, such references should be removed from the Law on Leasing, as indeed they would be if the current bill of amendments were adopted.***

***Also note that the current bill of amendments to Ukraine's Civil Code includes a section on leasing, which states that a lessor may only supply an asset under financial lease if it was specifically acquired for that purpose. This effectively eliminates the possibility of direct or bilateral leasing. The current draft of the Law on Leasing, on the other hand, would allow for both direct and indirect leasing. One should hope that the new Civil Code will be amended to allow for both kinds of leases before it is adopted.***

**Leasing as a means of purchasing land?**

***In Ukraine, it has been suggested that a financial lease might be an appropriate mechanism for purchasing land (in spite of the fact that land leasing is currently prohibited by Ukrainian law).***

***The short answer is 'no', it would not be, as the essential advantage of leasing is that it allows one of the parties to depreciate the leased asset. Since land does not depreciate, leasing would not a very attractive way to purchase it. Therefore, Ukraine's ban on leasing land is quite superfluous and, one might assume, purely political.***

## THE SIGNATORIES TO A LEASE

Potential parties to lease transaction according to Ukrainian law are explained below.

**Ukraine's Law on Leasing**

**Article 3. The Signatories to a Lease**

*The parties to a lease include:*

**The lessor,** *an individual or legal entity (including banking or non-banking financial institutions) that provides the asset under lease in accordance with a lease agreement;*

**The lessee,** *an individual or legal entity that receives the leased asset on the basis of a lease agreement;*

**The seller or vendor,** *an individual or legal entity that manufactures the leased asset (machinery, equipment, etc.) and sells it to the lessor.*

*Article 3* states that any individual or legal entity may enter into a lease transaction. However, definitions of leasing and the types of leasing in Ukraine's Law on Leasing contradict this by stating that the signatories to a lease must be "commercial entities", i.e. legal entities and individuals holding commercial licenses and certificates of state registration. This automatically excludes all institutions and organizations that are financed by the state (e.g., clinics, research institutes, state universities, etc.), as well as all government bodies and municipalities, non-profit research and educational establishments, and private individuals.

Other articles of Ukraine's Law on Leasing allow for additional creditors to act as signatories to a lease, as explained in the *"Forms of Leasing'* section on page 20.

***Possible Improvements to Legislation***

***All restrictions on the signatories to a lease should be lifted as many of the excluded institutions suffer acute shortages of equipment and other technology.***

***The bill of amendments currently being debated in the Verkhovna Rada would eliminate these restrictions and allow any legal entity or individual to enter into a lease agreement.***



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## LEASE PAYMENTS

Typically, one of the key advantages of leasing over other forms of financing is flexibility in terms of the payment schedule. However, there are a number of gray areas in Ukrainian legislation that one must consider when structuring a lease.

In this section, we shall analyze a number of legal issues that have a direct bearing on lease payments. Tax issues also play an important role in deciding how to structure a lease payment schedule, but these will be explained in a later section.

**Ukraine's Law on Leasing**

**Article 4. Types and Forms of Leasing**

*1. Types of Leasing:*

*1) The lessee must pay at least 60% of the asset's original value through lease payments over the course of a financial lease.*

*Upon expiration of a financial lease, the leased asset may either be transferred to the lessee based on the terms of the lease agreement, or redeemed by the lessee at residual value.*

**Article 10. Ownership Rights to the Leased Asset**

*1. The lessor retains legal ownership of the leased asset for the duration of the lease.*

*2. A financial lease agreement may stipulate the lessee's right to redeem the leased asset either before or after the lease expires, but not until the leased asset has depreciated by at least 60%.*

*The lessee will obtain the ownership rights to the leased asset as soon as the asset's total value has been fully redeemed as stipulated under the lease agreement and relevant Ukrainian laws.*

**Article 16. Lease Payments**

*1. The lessee must make periodic payments to the lessor in return for the right to use the leased asset. The lease payment schedule must be stipulated under the lease agreement and may be irregular.*

*2. The lease payments consist of:*

- *compensation for the amount by which the leased asset has depreciated over the payment period;*
- *interest paid on loans used to acquire the leased asset, as stipulated under the lease agreement;*
- *the lessor's commission;*
- *compensation for the cost of insurance (as stipulated under the insurance agreement) if the asset is insured by the lessor;*
- *the lessor's additional expenses as stipulated under the lease agreement.*

*3. The size, manner, form and terms of the lease payments, as well as their terms of revision, must be stipulated under the lease agreement in accordance with this law and other current regulations.*

*The lessee must make all mandatory payments in a timely manner as stipulated under the lease agreement.*

*4. The lessee should include lease payments in his production costs, as stipulated under current legislation.*

While the Law on Leasing provides lessors and lessees with some flexibility, it also imposes considerable restrictions on the size and timing of payments:

- *Article 10 requires a financial lease to last at least as long as it takes the leased asset to depreciate by 60%.*
- *According to Article 16, lease payments must include* ***"compensation for the amount by which the leased asset has depreciated over the payment period."*** *This is by far the most problematic part of this Article. It would appear the lessor is supposed to break lease payments down into their constituent parts and make sure that compensation for the asset's value equals its depreciation for each payment period. This results in the parties needing to develop silly for advances, accelerated lease payment schedules, etc.*
- *The lessee must pay at least 60% of the asset's original value through the lease payments over the course of the lease.*

**Requiring each lease payment to include full compensation for the leased asset's depreciated value unduly restricts the parties' freedom to choose the most advantageous payment schedule for redeeming the asset.**

Some aspects of Article 16 might serve as a useful guide for structuring a lease agreement. However, because they are codified into law, they take on a proscriptive (and therefore restrictive) character. In many cases, lessors and lessees may wish to structure their leases differently, and in Ukrainian practice they often do so at the risk of weakening the agreement's legal foundation by contradicting the Law on Leasing.

A strict interpretation of Article 16 is that each lease payment must include compensation for the amount by which the leased asset has depreciated over the payment period and only the amount depreciated. This causes various problems. The first issue will be that the parties will need to devise some system where the lessee provides his advance other than in the form of a lease payment. This clause removes the flexibility of the sides to negotiate different lease terms such as decreased pricing for an accelerated payment schedule.

In addition, redemption payments should not be included in the lease payments, since they do not meet the legal definition of "compensation for depreciated value" **Redemption payments should be made after the lease expires.** The asset's residual value is calculated as the portion of its value that has not depreciated over the course of the lease (taking into account any revaluation).

According to the Law on Leasing, the residual value of a leased asset is calculated as its book value on the date of purchase. The Law on Leasing places no

restrictions on the form or manner in which the lessee may compensate the lessor for the leased asset's residual value.

Although the Law on Leasing does not contain an exhaustive list of the elements that constitute a lease payment, one condition must always be met: any constituent parts of the lease payments not listed under Article 16 of the Law on Leasing must be of a compensatory nature, enabling the lessor to recover costs incurred under the lease agreement. As with all other payments made under the lease agreement, these additional payments may be made in any manner or form, as agreed by the parties.

For example, Article 16 requires the lessee to reimburse the lessor for insurance costs through the lease payments. Other sections of the Law require the lessee to insure the leased asset himself, since he is financially liable to the lessor for any damage to (or destruction of) the leased asset. What if the lessee wishes to insure the leased asset directly as part of a larger insurance relationship (see subsequent sections on insuring a leased asset). The risk is that, should any conflict arise, one of the parties may renege on his obligations on the grounds that the agreement was legally invalid to begin with, since it failed to comply with Article 16.

Under a shared lease, where one or more lenders act as signatories, the lessee must also compensate the lessor for interest paid on loans that were used to acquire the leased asset. The parties to a lease are free to determine the manner and form in which these payments are to be made, as well as the payment schedule. If the payment size must be fixed in a specific loan agreement, the lessor and the lessee must agree to it beforehand. Legally, these payments are of a compensatory nature, as they compensate the lessor for his actual expenses. The signatories are free to determine whether these payments will be due before or after the lessor has paid interest on the loans.

## V. LEGAL CONSIDERATIONS IN CLOSING A LEASE AGREEMENT

One of the reasons why leasing has developed so successfully is its unique legal structure. It is important that all aspects of a country's legislation support this structure, and equally important that the parties to a lease understand the benefits that this legal base provides.

The nature of a lease agreement, particularly a financial lease agreement, contains nuances that are typically not covered by regular contract law and therefore require specialized legislation. This section will take a close look at the rights and responsibilities that Ukrainian legislation stipulates for each of the parties to a lease.

The following text is structured to provide the reader with a practical reference guide to the key legal elements of a Ukrainian lease agreement. For each legal aspect you will find:

1. Excerpts from relevant legislation.
2. An analysis of the legislation's practical implications.
3. Key issues that one should consider before entering into a lease agreement in order to minimize risks and guarantee the protection of one's rights.
4. Some of the weaknesses of Ukrainian legislation, the resulting problems, and suggested amendments (see the colored boxes at the end of some sections).

## PURCHASING AN ASSET FOR FINANCIAL LEASING

Under a trilateral lease agreement, the lessor purchases the leased asset on behalf of the lessee. As a result, there are some important factors that one must consider in order to ensure that the lessee has full legal protection in relation to the vendor (i.e., in terms of the asset's quality, integrity, maintenance and warranty repairs), without requiring any intervention on the part of the lessor.

The legal relationship between the vendor of the leased asset and the lessee are defined under the following Ukrainian laws:

> ***The Ukrainian Civil Code, Article 164. "Entrusting third parties with the fulfillment of obligations."***
>
> ***Ukraine's Law on Leasing, Article 1. "The Definition Of Leasing" and Article 11. "The Lessor's Rights And Responsibilities"***

Ukraine's *Law on Leasing* attempts to define the trilateral nature of a lease agreement and ensure that the vendor's obligations to the lessor are automatically transferred to the lessee. However, these attempts are thwarted by the wording of Ukraine's Civil Code.

There are two provisions in the *Law on Leasing* that attempt to capture the nature of this relationship:

1. *The Law stipulates that the lessee may "make direct claims against the vendor of the leased asset in terms of the asset's quality, integrity, delivery time or warranty repair, as well as non-fulfillment of other obligations stipulated under the purchase agreement."*
2. *The Law stipulates that "the lessor is prohibited from interfering with the lessee's choice of vendor or the asset's specifications."*

However, Article 164 of Ukraine's Civil Code stipulates that no rights or obligations may be transferred to a third party unless such transfer is "explicitly stipulated under an agreement or relevant legislation."

Ukraine's *Law on Leasing* does not explicitly state that the vendor's obligations under a purchase agreement carry over to the lessee. Therefore, vendors may justifiably argue that they are accountable only under the terms of the purchase agreement itself, and only to the lessor.[3]

**If the lessor and the lessee want to ensure that the vendor of the asset is legally required to fulfill his responsibilities under the purchase agreement directly to the lessee, there are two ways to accomplish this:**

1. *The lessee must be party to a trilateral purchase agreement in which the vendor agrees that the lessor's rights as the purchaser of the leased asset may be transferred to the lessee.*
2. *The vendor of the asset must be party to a trilateral lease agreement in which he agrees that the lessor's rights as the purchaser of the leased asset may be transferred to the lessee.*

3 For more details, please see Annex I on "Weaknesses of Ukrainian Leasing Legislation."

***SUGGESTED IMPROVEMENTS TO LEGISLATION***

***The legal shortcomings described above create unnecessary work and expenses for all of the parties concerned. Correcting these flaws would make leasing simpler and cheaper.***

***This problem could easily be solved by adding a provision to the Law on Leasing stipulating that the lessor's rights as purchaser of the leased asset are automatically transferred to the lessee***

## THE FORMAT OF A LEASE AGREEMENT

This section provides a brief summary of the most appropriate format for a lease agreement to best ensure its enforceability.

**Ukraine's Law on Leasing**

**Article 6. The Lease Agreement**

*2. The lease agreement must be concluded in writing and must fully comply with current legislation.*

Ukrainian legislation makes no specific provisions regarding the format of a lease agreement. It does, however, contain certain requirements that one should keep in mind when signing cross-border leases, leases on state-owned property, syndicated lease agreements that involve borrowing from the state, lease agreements backed by state guarantees, and simple lease agreements that allow for early repossession of the leased asset on the basis of a notary's writ. Here are some answers to basic question regarding lease agreements.

***Should a lease agreement be notarized?***

It is best to have a contract notarized if any aspects of the contract may be enforced on the basis of a notary's writ. According to Ukraine's Law on Leasing, a lessor may repossess the leased asset on the basis of a notary's writ if the lessee fails to make his lease payments for two consecutive periods. To ensure that such actions will be enforceable, one should refer to the Law on Notarial Services.

***Special considerations in a cross-border lease agreement.***

When signing a lease agreement, the lessor and the lessee may choose the laws of either party's country as the legal framework for their agreement.

Article 6 of the Law on Foreign Trade makes the following provisions in regard to international leases:

*a. all foreign trade agreements must be executed in writing, unless otherwise stipulated by the laws of the country which has jurisdiction over the agreement or by international agreements to which Ukraine is a signatory party;*

*b. the format of a foreign trade agreement is determined by the legislation of the country in which it was executed (an agreement concluded abroad may not be declared invalid just because it fails to comply with Ukrainian norms in terms of format, as long as it otherwise complies with Ukrainian law).*

Compliance with these requirements is crucial, because the same article also stipulates that *"a foreign trade agreement may be declared invalid through litigation if it fails to comply with Ukrainian legislation or international agreements to which Ukraine is a signatory party."*

Therefore, even when one is concluding an agreement outside of Ukraine's jurisdiction, one should have the agreement analyzed by a Ukrainian lawyer to ensure that it does not contradict any such documents (For further discussion of cross-border leasing, see Annex VI).

According to Ukraine's Law on Leasing, all *leases of state-owned assets, all shared leases involving state-owned capital, and all leases backed by the state* must be concluded in writing and registered with the appropriate state agencies.

According to the *Procedures for Registering Lease Agreements, confirmed by the CMU's Resolution 913 of 16/06/1998,* for those assets required to be registered, lease agreements must bear evidence of official registration in the form of a note stating the name of the registering agency, the registration number and the date of registration, confirmed by the registering official's signature and the registering agency's official seal. Agreements that have not been properly registered may be declared invalid.

## TRANSFERRING THE ASSET TO THE LESSEE FOR USE

One nuance of a leased transaction is the potential ambiguities of who is responsible for a leased asset until the lessee officially receives it into his possession. The legislation and analyses below explain this point and other related issues connected with the tranfer of a leased asset to the lessee for usage.

**Ukraine's Law on Leasing**

**Article 11. The Lessor's Rights and Responsibilities:**

*1) To provide the lessee with an asset which he (the lessor) owns, and allow the lessee temporary possession and use of this asset; or, upon the lessee's request, to conclude a purchase agreement with an appropriate vendor and allow the lessee temporary possession and use of the purchased asset.*

**Article 12. The Lessee's Rights and Responsibilities:**

*1. The lessee may claim all rights and responsibilities stipulated under the purchase agreement for the leased asset, particularly regarding the asset's quality, integrity, terms of delivery, warranty repairs, etc.*

According to Ukraine's Law on Leasing, the leased asset may be transferred and delivered to the lessee by either the lessor or the vendor.

Let's consider the latter option, where the lessee receives the asset directly from the vendor. The terms for transferring and delivering the leased asset are important not only in their own right, but also in relation to the transfer of financial obligations (e.g., liability for damages). For example, the Law on Leasing stip-

ulates that if the leased asset is damaged or ruined during a delay in its transfer or delivery, the party that caused the delay will be held liable.

In order to receive the leased asset directly from the vendor, the lessee must be authorized by the lessor to sign the transfer and delivery papers, since the lessor is the legal owner. Otherwise, the lessor will have to send a representative to sign the papers.

If the lessee is to receive the leased asset directly from the vendor on the lessor's behalf, the lease agreement must clearly authorize him to do so. If it does not, the lessor must sign the transfer papers beforehand.

## INSURING THE LEASED ASSET

Insuring a leased asset is mandatory under Ukrainian legislation. Provided below are those relevant pieces of legislation which affect this process.

### Ukraine's Law on Leasing

**Article 7. Key Provisions of the Lease agreement**

*1. The key provisions of the lease agreement include:*

- *terms for insuring the leased asset*

**Article 14. Insurance and the Risk of Unintentional Damage to or Destruction of the Leased Asset**

*4. In order to protect their interests over the course of the lease, the leasing parties must insure the leased asset, in accordance with this law and other current regulations, against all risks incurred by executing the terms of the lease agreement, including the risks of accidental damage to (or destruction of) the leased asset.*

Thus, the Law on Leasing stipulates that the leased asset must be insured by one of the parties (as agreed between them) in accordance with current legislation. Furthermore, the precise terms for insuring the leased asset must be stipulated within the lease agreement, as they are considered mandatory conditions for a lease agreement.

A simple comparative analysis of the Law's provisions leads us to the following conclusions:

1. *The lease agreement must contain a clause stipulating the terms for insuring the leased asset.*
2. *The parties may agree to take out additional insurance policies in accordance with current legislation.*

Unfortunately, Ukrainian legislation is rather vague in terms of the particular risks that the parties must agree to insure. According to the Law on Insurance (Article 5):

*a. Insurance may be either optional or mandatory;*

*b. Optional insurance is based on an agreement between the insurer and the insured. The insurance policy's general terms and procedures are to be determined by the insurer in accordance with the Law on Insurance. The policy's specific terms are to be agreed between the insurer and the insured prior to signing.*

*c. Mandatory insurance is based on Article 6 of the Law on Insurance, which specifies the cases requiring mandatory insurance and presents a model agreement. The specific terms and procedures for mandatory insurance are outlined by the Ukrainian Cabinet of Ministers.*

The Law on Insurance does not list leases as a "case requiring mandatory insurance (see Article 6). Nevertheless, the lease agreement must include provisions for insuring the leased asset; otherwise, according to Articles 48 and 153 of the Civil Code, the courts may declare the lease agreement invalid. Since the Cabinet of Ministers has not yet specified the terms or procedures for mandatory insurance, one should follow the guidelines currently in place for optional insurance policies. Mandatory insurance must be based on an agreement between the insurer and the insured. It should follow the general conditions and procedures established by the insurer in accordance with the Law on Insurance.

One must also keep the following two points in mind:

*a. Unless otherwise stipulated under the lease agreement, the lessee must bear all costs relating to the insurance of an asset under financial lease, while the lessor must bear these costs under an operating lease.*

*b. According to Article 6 of the Law on Insurance, insurance is always mandatory for leased aircraft. Furthermore, the insurance policy should follow the model agreement and other guidelines provided by the Cabinet of Ministers.*

Although insurance may be mandatory in some cases, this does not necessarily mean that the lessor must be compensated for bearing the cost of insurance. The Law on Leasing explicitly states that the lessor must bear all insurance costs under an operating lease, while the lessee must bear these costs under a financial lease, unless otherwise stipulated under the lease agreement. The lessee does not have to reimburse the lessor for the cost of insurance unless he is specifically required to under the terms of the lease agreement.

As with all other payments made under a lease agreement, any compensation for insurance costs should be paid in accordance with the manner, form and payment schedule agreed by the parties. The size of these payments should be determined by the insurance agreement, but both the lessor and the lessee must agree to it beforehand. Legally, these payments are compensatory in

nature, since they compensate the lessor for his actual expenses. The leasing parties are free to choose whether the payment should be transferred to the lessor before or after the latter makes the insurance payment.

Thus, when drafting the lease agreement, the signatories should keep in mind that they must make provisions for insuring the leased asset. They may also make provisions for other kinds of insurance at their own discretion.

## REGISTERING THE LEASED ASSET

There are certain situations where a leased asset must be registered.

**Ukraine's Law on Leasing**

**Article 7. Key Provisions of the Lease Agreement**

*1. The key provisions of the lease agreement include:*

- *provisions for registering the leased asset*

**Article 13. Registering the Leased asset**

*1. Leased assets that must be registered with supervisory government agencies (e.g., motor vehicles, hazardous equipment, etc.) may be registered in the name of either the lessor or the lessee, as agreed by the parties, in accordance with established procedures.*

*2. The leased asset must be registered in cases specified by current Ukrainian legislation, in accordance with established procedures.*

Ukraine's Law on Leasing contains contradictory requirements for registering a leased asset. On the one hand it states that the leased asset must be registered only in such cases and in accordance with such procedures as are established by current legislation, allowing the parties to register the asset in the name of either the lessor or the lessee. On the other hand, it effectively mandates the registration of all leased assets, regardless of whether a given case is provided for under current legislation, or whether registering a particular asset is technically feasible.

**In order to avoid having problems in the future, the leasing parties should do the following:**

- *If the law specifies that a given asset must be registered, as well as the procedures for doing so, then the parties should decide who will register the asset, in whose name, and under what conditions (unless these factors are already determined by law).*
- *If the law does not specify whether an asset should be registered, the parties should decide in the event that registration should become legally compulsory who will register the leased asset, in whose name and under what conditions.*

## CONDITIONS FOR USING THE LEASED ASSET

In a leasing transaction, both parties have certain expectations as to how the asset will be used and who is responsible for maintenance. As explained below, to avoid conflict, these points should be spelled out as best as possible in the lease agreement.

**Ukraine's Law on Leasing**

**Article 7. Key Provisions of the Lease Agreement**

*1. Key provisions of the lease agreement include:*

– *conditions for the use, maintenance and upgrading of the leased asset and the disclosure of information regarding the asset's technical state*

**Article 12. The Lessee's Rights and Responsibilities**

*1. The lessee's responsibilities include:*

*1) receiving and using the leased asset properly and maintaining it according to the terms of the agreement under which it was transferred, taking into account the asset's natural wear and tear;*

*2) informing the lessor of the asset's physical condition, as well as his own financial standing, and allowing the lessor access to the asset in order to verify its condition and the manner in which it is used.*

Ukraine's Law on Leasing obliges the leasing parties to stipulate within the agreement the conditions for using, maintaining and upgrading the leased asset and disclosing information about its technical state. This clause contains a list of provisions concerning the use of the leased asset. Let's take a closer look at each of them.

**Conditions for Use and Technical Maintenance of the Leased Asset.** According to the Law on Leasing, the lessee may only use the leased asset *"in accordance with the provisions stipulated under the lease agreement."*

Therefore, when drafting the provisions of the lease agreement that deal with the leased asset's proper use, it is important to indicate any restrictions on the asset's use or the absence of such restrictions. Furthermore, if the manufacturer has provided operating instructions for the asset, the lease agreement should stipulate compliance with these instructions on the part of the lessee.

It would also make sense to require the lessee to maintain the asset in operable condition. Moreover, the lease agreement should specify the kind of technical maintenance that will be performed, which party will take responsibility for major and routine repairs, and which party will bear the costs of maintenance. If the lease agreement fails to distribute these costs between the parties, the Law on Leasing stipulates that the lessee must bear all costs relating to the technical maintenance and repair of any assets under financial lease, while the lessor must bear these costs under an operating lease (except for those costs arising in connection with the renewal of consumable resources).

**Conditions for Upgrading the Leased Asset.** Regarding the legal aspects of the upgrading the leased asset, the following points should be included in the

lease agreement, as they are not explicitly covered by any law:[4]

- The ways in which the lessee may improve the leased asset;
- The legal consequences of such improvements, depending on whether they were made with or without the lessor's consent;
- And the legal consequences of improvements that result in the creation of new assets. (For further details, please see Clause 1.8 of the Model Agreement in Annex II).

**Reporting on the Technical State of the Leased Asset.** The lessor, as owner of the leased asset, must be able to supervise the way in which his asset is being used. Whether or not the lessor will have access to accurate and timely information regarding the asset's condition will depend on the lessee's obligations as stipulated under the lease agreement. The Law on Leasing requires the lessee: a) to keep the lessor informed of the leased asset's technical condition; and b) to allow the lessor to inspect the leased asset "*at any time and in any manner stipulated under the lease agreement*".

In other words, the law gives leasing parties complete freedom to stipulate the terms for reporting the asset's condition, including the amount of detail and the types of documentation that the lessee must provide, the nature and extent of the lessor's access to the leased asset, etc. (For further details, please see Clause 1.9 of the Model Agreement in Annex II).

*Considering the lack of detailed regulations, the parties to a lease should:*

*a. be as specific as possible in defining the terms for using the leased asset; in addition to the standard clause requiring the lessee to use the asset in accordance with its intended purpose and the terms of the lease agreement, indicate any specific restrictions, or the lack thereof;*

*b. stipulate within the lease agreement the ways in which the lessee may improve the leased asset, as well as the legal consequences of such improvements, depending on whether they were made with or without the lessor's consent, and the legal consequences of improvements that result in the creation of new assets;*

*c. specify within the lease agreement the exact ways in which the lessee will keep the lessor informed about the leased asset's technical condition, as well as the conditions under which the lessee must allow the lessor access to the leased asset.*

## ADDITIONAL KEY PROVISIONS TO A LEASE AGREEMENT

Under current Ukrainian legislation, lease agreements are required to include specific provisions guaranteeing the fulfillment of their terms and the main rights and responsibilities of all parties. However, they are far from inclusive for all aspects that need to be considered in closing a lease agreement.

4 The Civil Code addresses these issues in the context of rental agreements, but it is not clear, under current legislation, whether leases fall into this category.

**The Ukrainian Civil Code**

**Article 153. Concluding an Agreement**

*A contract will only be considered valid if the parties have reached agreement on all of the essential terms, properly expressed within the contract.*

*Essential terms are those recognized as such under Ukrainian law and crucial for agreements of a particular type, as well as any other terms that either party deems essential.*

**Article 178. Ensuring the Fulfillment of Obligations**

*Fulfillment of the contract terms may be ensured through penalties, fines, collateral or guarantees, as stipulated under the agreement itself or relevant legislation. Obligations between individuals may be secured with a deposit, and obligations between social organizations with a guarantee.*

Here are some provisions that seem not to be commonly used in Ukraine but would help to avoid problems in a lease transaction.

***Fee for using the leased asset after the marginal term of usage has expired***

The lease agreement should clearly stipulate a fee for using the leased asset beyond the term of the agreement, in the case that the lessee fails to return an asset in a timely fashion upon expiration of an operating lease, or when he neglects to redeem an asset's full value upon expiration of a financial lease. One must be careful that this provision of the agreement does not violate current legislation. Moreover, it would spare the lessor from having to seek compensation for losses through the courts.

***Summary repossession of the leased asset in the event of two consecutive non-payments by the lessee***

Here it is important to consider the legal requirements for summary recovery of debts. In order to obtain a notary's writ of execution authorizing summary repossession of an asset, the creditor (in this case the lessor) must submit an original copy of his agreement with the debtor (in this case the lease agreement), which must clearly state the lessor's right to repossess the asset in a summary fashion. In spite of this general norm, the Law on Leasing does not require the lease agreement to contain provisions for summary repossession of the leased asset. Furthermore, Article 9 of the Law does not require the lessor to obtain a notary's writ of execution in order to repossess a leased asset, provided that his right to do so is stipulated under the agreement. At any rate, lessors can save a considerable amount of time, expense and worry by writing the necessary provisions into the lease agreement.

***Requiring the lessee to pay an advance equal to the sum of two lease payments plus the cost of a notary's writ of execution***

Ukrainian law entitles the lessor to repossess a leased asset from the lessee, on the basis of a notary's writ of execution, in the event that the lessee defaults on two consecutive lease payments. As default usually means that the lessee is unable to make payments and may be going bankrupt, there is little hope to recover these lost payments through future litigation. Therefore, the lessor

often protects himself against such losses by requiring the lessee to pay an advance equal to the sum of two lease payments plus the cost of a notary's writ of execution.

***Annual interest rates on overdue debts***

According to the Civil Code, "a debtor must, upon the demand of a creditor, repay the full amount of a delinquent debt, indexed by the rate of inflation for the entire period of delinquency, plus a surcharge of 3% APR, unless a different percentage rate was stipulated under the agreement in compliance with Ukrainian law." Therefore, if the parties wish to establish a different rate of interest for outstanding debts, they must stipulate it within the lease agreement.

***Penalties imposed on the lessee for failing to provide accurate information about the leased asset's physical condition or his own financial standing, or for failing to allow the lessor to inspect the leased asset and the manner in which it is being used***

As the lessor's access to reliable information about the physical condition of the leased asset and the financial state of the lessee, as well as his right to inspect the leased asset unimpeded, are of crucial importance, he should secure these rights under the lease agreement by stipulating financial penalties for noncompliance.

***Requiring a deposit from individual signatories***

This is particularly important for the lessor. The Ukrainian Civil Code states that individuals may require deposits as additional guarantees for liabilities stipulated under their agreements. Thus, under a lease agreement:

- *One party to the lease may give a certain sum (deposit) to another party as confirmation of the agreement and a guarantee that its terms will be fulfilled.*
- *If the party that gave the deposit fails to meet its obligations, the other party may retain the deposit.*
- *If the party that received the deposit fails to meet its obligations, it must return twice the sum of the deposit.*
- *Any party that fails to meet its obligations under the lease agreement must compensate the other party for any losses incurred, unless otherwise stipulated under the agreement.*

This is again a good example as to why parties to a lease transaction should be sure to make the lease agreement as comprehensive as possible. This will reduce the risk of unforeseen conflicts arising and as well as reduce the risk of being unknowingly subject to obligations due to such legislation explained above.

## POTENTIAL HIDDEN OBLIGATIONS IN A LEASING TRANSACTION

There are various aspects of a lease transaction that are stipulated in either legislation or a lease agreement that require certain actions by the parties to a transaction and/or incur certain costs. This section will help you to forsee some of these aspects and take appropriate measures.

**Ukraine's Law on Leasing**

**Article 4. Types and Forms of Leasing**

*1. Types of Leasing:*

1. *When a financial lease expires, the lessee must redeem the leased asset's residual value, if he has already redeemed its full value through the lease payments.*
2. *When an operating lease expires, it may either be renewed, or the lessor may repossess the leased asset lease it to another party.*

**Article 10. Ownership Rights to the Leased Asset**

*2. The lessee may assume ownership of an asset under financial lease once he has redeemed the asset's full value in compliance with the lease agreement and Ukrainian legislation..*

Ukraine's Law on Leasing states that when a financial lease expires, the leased asset must be redeemed by the lessee; but when an operating lease expires, the asset must be returned to the lessor.

Both the redemption and the return of the leased asset include certain financial obligations. For the most part, these pertain to the lessee, since he is the indebted party. If the lessee has any outstanding debts to the lessor, certain disagreements about bookkeeping may arise when the lease expires. *The lease agreement should therefore specify:*

- *whether the lessee may choose the methods and procedures for repaying his outstanding debts;*
- *whether the lessee must fulfill all of his financial obligations under the lease agreement prior to assuming ownership of the leased asset, or whether he may assume ownership of the asset as soon as he has redeemed its full value, regardless of whether he has met other financial obligations under the agreement;*
- *whether the lessee must continue to make lease payments (particularly the lessor's fees) if he redeems the asset before the end of the lease term.*

Another factor that hinders enforcement of a lease agreement is the lease term's rigid dependence on the depreciation period of the leased asset. If parties have followed the law on Leasing and planned their lease on the basis of the depreciation schedule, any changes to the latter could force them to restructure the lease. In such cases the lease agreement might even fall out of compliance with the law.[5] The parties should therefore stipulate within the lease agreement that the term of the lease, as well as the size, composition and

5 For further details, please see Annex 1 on "Weaknesses of Ukrainian Leasing Legislation."

6 See Clauses 1.2 and 1.4 the Model Agreement in Annex II.

schedule of lease payments, may be revised should the leased asset's depreciation rate be modified. [6]

Yet another factor that makes it difficult to enforce the financial terms of a lease agreement is revaluation. By stipulating that the leased asset must be redeemed at its book value, legislators effectively prohibited the parties from setting their own price on the asset.[5] Meanwhile the law requires lease agreements to include a clause allowing for revaluation of the leased asset, whether up or down (i.e., increasing or decreasing its book value). Therefore, the lessor may end up receiving a smaller sum than previously agreed, or the lessee may end up paying more than he expected.

The parties can significantly reduce these risks by discussing beforehand the particular instances where revaluation may occur (i.e., cases clearly mandated by the state, such as major deterioration of the asset due to circumstances beyond the parties' control), as well as the various methods for revaluing an asset (e.g., expert assessment, published price lists, etc.).

**In order to prevent misunderstandings, the parties should:**

1. *clearly stipulate within the agreement how funds received from the lessee will be counted towards the reduction of his debts;*
2. *include a provision allowing for changes to the lease period, as well as to the size, composition and schedule of lease payments, in the event that the asset's depreciation rate is altered;*
3. *include provisions for the asset's revaluation.*

## EARLY TERMINATION OF THE LEASE AGREEMENT

This section highlights the relevant legislative aspects which come into play in the case of a lease agreement being terminated prior to its original maturity date.

**The Ukrainian Civil Code**

**Article 162. The Unacceptability of Unilateral Refusals to Fulfill Obligations**

*No party may unilaterally refuse to fulfill its obligations under an agreement, except in special cases defined by law.*

**Article 233. Cessation of Liabilities Due to the Liquidation of an Entity or the Death of an Individual.**

*An entity's obligations will be terminated in the even that it is liquidated.*

**Ukraine's Law on Leasing**

**Article 7. Essential Provisions of the Lease Agreement**

*The following provisions are deemed essential for lease agreements:*

- *terms governing the repossession of the leased asset in the event that the lessee becomes insolvent*
- *terms governing early termination of the lease agreement*



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**Article 9. Transfer and Repossession of the Leased Asset**

*5. Should the lessee fail to make his lease payments for two consecutive periods, the lessor may summarily repossess the leased asset on the basis of a notary's writ of execution.*

**Article 17. The Regulation of Disputes**

*2. Should a breach of the lease agreement occur, the signatories may terminate the agreement in accordance with the procedures established by Ukrainian law.*

*Thus, Ukraine's Law on Leasing indicates the following possible grounds for terminating a lease agreement:*

- *the lessee becomes insolvent;*
- *one of the parties unilaterally refuses to fulfill his obligations;*
- *the courts rule that the agreement should be dissolved (unless the parties have already reached a peaceful settlement).*

The lessee's bankruptcy is a clear and unambiguous justification for terminating the lease agreement. Whenever a debtor is liquidated, all of his liabilities are automatically canceled, as clearly stipulated in the Civil Code.

Legally sanctioned cases of unilateral, out-of-court dissolution are not so clear. Ukrainian law does not allow parties to unilaterally renege on their obligations except in special cases defined by law. The lessor's right to summarily repossess a leased asset on the basis of a notary's writ of execution, as stipulated under the Law on Leasing, is one such example.[7] Since the lessor cannot exercise this right unless the lessee fails to make two consecutive lease payments, he may want to ensure that the payment periods, as stipulated under the lease agreement, are not too long.

According to the Law on Leasing, the lessee may reject the asset if it fails to comply with the terms of the lease agreement. Although the Law does not specify that the agreement should be terminated in such cases, the Civil Code does explicitly state that "the creditor may refuse to meet his obligations, and may recover all damages, if the debtor's tardiness in fulfilling obligations has caused the lessor to lose his interests under the agreement."

This means that unless the lease agreement provides for specific remedies to be performed within a given period (e.g., the lessor must replace the non-compliant asset or rectify its defects). The lessor's refusal to meet his obligations will result in early dissolution of the agreement. In order to avoid such situations, the parties should ensure that the lease contract contains provisions governing the lessee's rejection of the leased asset, as well as the terms under which the lessor may bring the asset into full compliance with the agreement.[8]

According to the Law on Leasing, the parties may demand early dissolution of the lease agreement, in accordance with Ukrainian law, in the event that anoth-

7 For more details see Annex 9 on "Repossession of the Leased Asset on the Basis of a Notary's Writ of Execution."

8 See also Clause 1.13 of the Model Agreement in Annex II.

er party violates its terms. In other words, any violation of the terms of the agreement may serve as grounds for its dissolution. However, these grounds must be stated explicitly in the lease agreement.

**Most frequently, early dissolution becomes necessary when the lessee has gone bankrupt and the lessor wishes to repossess the leased asset.** In such cases, it is especially important not only to stipulate the conditions and procedures for repossessing the leased asset (i.e., who repossesses it, at whose expense, etc.), but also to determine the stages of bankruptcy at which the asset may be repossessed.

One should bear in mind that the Law on Bankruptcy divides bankruptcy into two stages:

1) prior to the commencement of liquidation hearings, at which time the lessee may still transfer the leased asset under the supervision of a Receiver appointed by the court;
2) after the commencement of liquidation hearings, at which point the liquidator assumes full control over all assets held by the lessee. The Law on Bankruptcy does not explicitly require the liquidator to return leased assets to the lessor. Therefore, the lease agreement should specify the exact times and conditions for repossessing the leased asset in the event that the lessee does go bankrupt.[9]

Another factor that may compel one of the parties to seek dissolution of the lease agreement is any change in the leased asset's depreciation rate. Such a change could dictate certain alterations to the lease agreement, which may be unacceptable to one or more of the parties. Since current legislation does not allow for unilateral modifications of an agreement, and consensus may be hard to reach in such cases, the lease agreement should include provisions for early dissolution of the lease in the event of unfavorable changes in depreciation rates.

The parties should consider providing for early dissolution of the lease agreement in the event that the lessee's commercial license is revoked, and in other similar cases.

Finally, it is important to note that these legal grounds for terminating a lease do not exclude the possibility of reaching an out-of-court settlement on mutually agreeable terms.

9 See also Clause 1.5 of the Model Agreement in Annex II.



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## VI. TAXATION OF LEASING IN UKRAINE

Taxation is a powerful instrument for developing or discouraging particular aspects of a country's economy. A country's tax policies should seek to promote economic development as a whole, as well as to promote or discourage specific types of economic activity. Unfortunately, many countries' tax policies actually hinder their economic development.

How a country chooses to tax leasing transactions will, determine how its leasing industry develops. Many countries have created special taxation for leasing in recognition of its positive effects on overall economic development. Leasing is particularly important in emerging and transition economies, where it is often the only financial tool available to local small and new enterprises.

One of the biggest barriers to the development of leasing (especially financial leasing) in Ukraine is the country's current tax system. The following section will give the reader an understanding of how leasing transactions are taxed in Ukraine. It will also try to explain the shortcomings of this system and suggest possible improvements.

**This section includes five main sections:**

- *Profit Tax for Financial Leasing*
- *Profit Tax for Operating Leasing*
- *VAT for Financial Leasing*
- *VAT for Operating Leasing*
- *Withholding Tax and Customs Duties for Cross-Border Leases*

This part of the manual deals with certain key aspects of taxation from the perspective of each party to a lease. Each section includes:

- *Excerpts from the tax laws that govern how leases are to be recorded for tax purposes;*
- *A practical explanation and example of how to interpret these tax laws;*
- *An analysis of the problems inherent in the current system;*
- *Suggested solutions to these problems.*

## PROFIT TAX FOR FINANCIAL LEASING

The following section describes the tax treatment for financial leasing in Ukraine. Also included is an analysis of alternative taxation models for financial leasing used in other countries.

### LESSOR'S PROFIT TAX FOR FINANCIAL LEASES

The following provisions from *Ukraine's Law on Corporate Tax* stipulate how the lessor must record his revenue and expenditures in the context of a financial lease:

**Lessor Revenue**
**Article 4.1.1.**
*The lessor's revenue consists of proceeds from the sale of goods (labor, services), including revenue generated by auxiliary and service production facilities that do not have the status of legal entities, as well as proceeds from the sale of securities (except primary issue (placement) and maturity (liquidation)).*

**Article 1.31. Paragraph 3**

*The sale of products of labor (or services) is defined as any legal transaction involving the provision of products of labor (or services), or the transfer of usage or management rights to a an asset (including intangible assets and valuables other than goods), in exchange for compensation; as well as any transaction involving the free provision of products of labor (or services).* The sale of products of labor (or services) includes the provision of usage rights to an asset within the framework of a lease (rent) agreement...

**Lessor Expenditures:**
**Chapter 1.18.2 Paragraphs 2 and 3**

*The lessor may not include expenditures for the purchase of leased assets in his gross costs or fixed assets.*

*All fixed assets under financial lease shall be included in the lessee's fixed assets.*

**Analysis:**
*One can draw the following conclusions from these clauses of the Law on Corporate Tax:*

- *The lessor's income is defined as gross revenue from the sale of services*
- *The lessor provides (sells) a service to the lessee that involves transferring a leased asset to the lessee and allowing him to utilize it*
- *An asset under financial leasing is placed on the lessee's balance sheet. The lessee records the leased asset as a fixed asset and charges depreciation on it.*
- *The lessor may not record the purchase of the leased asset as an expense, nor may he claim depreciation allowances, as it is the lessee who charges depreciation.* ***Thus, Ukrainian lessors must record the entire lease payment as revenue with no offsetting expense.***

Under this system, the lessor has to record as income, the lessee's redemption of the cost of the leased asset. The lessor is therefore forced to increase his margin if he wishes to cover the tax burden and earn a positive return on their investment.

***To get a clearer picture of the economic effects of these provisions, let's consider the following hypothetical example of a financial lease.***

Let's assume that the lessor has provided an asset under a three-year financial lease. The lessee has agreed to repay 100 'units' of the asset's value per year.

| ASSUMPTIONS: | |
|---|---|
| Components of the Lease Payments | Amount |
| Value of the leased asset | 300 |
| Annual interest on lessor's bank loans | 14 |
| Lessor's margin | 6 |
| Annual insurance payment | 2 |

Below is an example of how the lessor would need to record this transaction during the first year according to *Ukraine's Law on Corporate Tax*. For analysis purposes, annual lease payments are assumed.

| INCOME STATEMENT | | |
|---|---|---|
| Revenue | | |
| Lease Payments | 122 | Financial lease payments are exempt from VAT |
| Less Expenses | | |
| Depreciation of leased asset | 0 | Lessee depreciates asset under financial leasing |
| Interest on bank loans | 14 | Included into gross expenses |
| Insurance payment | 2 | Included into gross expenses |
| Profit before tax | 106 | |
| Less Profit Tax(30%) | 32 | |
| Retained earnings | 75 | |

In this example that the lessor would have to increase his margin considerably in order to compensate for his Profit Tax and earn a profit. Under this system, financial leasing is not an attractive financing option for an enterprise looking to acquire fixed assets. In this example, the lessor still must pay back 100 units to its creditor out of retained earnings, which in this case results in negative cash flow.

## ALTERNATIVE UKRAINIAN MODEL FOR FINANCIAL LEASING

For financial leasing, Ukrainian tax law does not allow the lessor to deduct the reimbursement of the leased asset's value from his taxable revenues. However, the State Tax Administration's Letter #6630/6/15-1116 of 30/11/2000 provides a partial solution to this problem of excess tax. The letter effectively eliminates tax on that portion of the leased asset's value that is equal to the depreciation charges for the lease payment period:

*"Because the lessor was not permitted to include the purchase cost of the leased asset in his gross costs or fixed assets, he should deduct from his gross revenue that portion of the lease payments which compensates him for the depreciated value of the leased asset."*

This model is based on the version of financial leasing provided for in Ukraine's Law on Leasing. This model requires that the term of the lease is long (greater than the period in which 60% of the asset is depreciated), and that a lessor breaks down each lease payment into its respective parts. The portion representing reimbursement for the cost of the asset is to be equal to the asset depreciation for the period.

This is problematic due to Ukraine's rigid and long depreciation policies. The combination of the lack of flexibility and the resulting economic disincentives eliminate the key advantages of financial leasing. (See next section).

If the amendments to Ukraine's Law on Leasing that are being debated in the Verkhovna Rada are passed into law, it will:

1. *Eliminate the minimum term requirement for financial leasing; and*
2. *Remove the requirement that the portion of lease payments that reimburse asset cost is equal to the depreciation of the asset for that period.*

However, as one can see in the example below, changes to Ukraine's Law on Leasing must be accompanied by improvements to tax legislation in order to make financial leasing an attractive financing option in Ukraine.

Based on market conditions and typical structures for financial leases, parties to a transaction will choose a more practical (shorter) payment schedules resulting in the following situation.

| ASSUMPTIONS ARE THE SAME AS THE PREVIOUS EXAMPLE ALONG WITH ANNUAL ASSET DEPRECIATION OF 25% OF REMAINING BOOK VALUE (SEE NEXT SECTION FOR EXPLANATION OF DEPRECIATION RATES). | | |
|---|---|---|
| Net Gross Revenue | 97 | Financial lease payments are not subject to VAT.<br>Total payment = 122<br>Depreciation charges for the period = 25.<br>Net gross revenue = 97 (i.e. 122-25) |
| *Expenses* | | |
| Depreciation of the Leased Asset | 0 | Under a financial lease it is the lessee who charges depreciation. |
| Interest on Bank Loans | 14 | Included in expenses |
| Insurance Payment | 2 | Included in expenses |
| *Profit before Tax* | 81 | |
| Profit Tax (30%) | 24.3 | |
| **Retained Earnings** | **56.7** | |

***The lessor's overall cash flow for this transaction:***

| | |
|---|---|
| Depreciation | 25 |
| Retained Earnings | 56.7 |
| **Total** | **81.7** *(this total should be equal to reimbursement of asset cost plus the lessor's margin)* |

Using a typical repayment schedule for a financial lease, one can see that the reimbursement of the asset cost exceeds the depreciation of the asset for each period. As a result, the lessor pays Profit Tax on that difference which is in reality, the return of his own or borrowed capital that was invested to purchase the leased asset. In order to make such a transaction profitable, lessors must charge extremely high margins or offer very long leases where the repayment schedule corresponds with the asset's depreciation schedule.

**Depreciation of Fixed Assets in Ukraine**

| TO ILLUSTRATE THIS IN PRACTICE, BELOW IS A QUICK SUMMARY OF UKRAINIAN TAX DEPRECIATION RATES AS DETERMINED BY ARTICLE 8 OF THE LAW ON CORPORATE TAX. | | |
|---|---|---|
| Group 1 | Buildings, residential housing | 5% APR |
| Group 2 | Motor vehicles, household and office equipment | 25% |
| Group 3 | All other fixed assets | 15% |

The tax depreciation rate applies to the book value of a fixed asset at the beginning of the tax period, (i.e., its residual book value). Given the rate for Group 2 assets, 99% of the value will be repaid only in the 15th year, while 60% will be depreciated in the first part of the lease's fifth year.

| HERE IS AN EXAMPLE OF A **4-YEAR FINANCIAL LEASE FOR A GROUP 2** ASSET THAT ILLUSTRATES THE PORTION OF LEASE PAYMENTS THAT REPRESENT REIMBURSEMENT FOR THE LEASED ASSET AND FOR WHICH THE LESSOR WILL BE HAVE TO PAY PROFIT TAX. | | | | |
|---|---|---|---|---|
| | Year 1 | Year 2 | Year 3 | Year 4 |
| Residual book value | 100.0 | 75.00 | 56.25 | 25% |
| Depreciation (25% of the residual book value) | 25.0 | 18.75 | 14.06 | 10.55 |
| Repayment schedule | 25.0 | 25.00 | 25.0 | 25.0 |
| Portion of lease payment representing reimbursement of asset cost which is taxed | 0 | 6.25 | 10.9 | 14.45 |

*Accelerated depreciation* may be applied to the assets in **Group 3,** as shown in the table below:

| Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 |
|---|---|---|---|---|---|---|
| 15% | 30% | 20% | 15% | 10% | 5% | 5% |

Accelerated depreciation is charged on the purchase price of these assets. A taxpayer may choose to use accelerated depreciation at his own discretion. Using accelerated depreciation it is possible to structure a three-year lease, however, this will result in tax disincentives that again will force the lessor to charge very high margins.

HERE IS AN EXAMPLE OF THE TREATMENT OF A **3-YEAR FINANCIAL LEASE FOR A GROUP 3 ASSET** THAT ILLUSTRATES THE PORTION OF LEASE PAYMENTS THAT REPRESENT REIMBURSEMENT FOR THE LEASED ASSET COST AND FOR WHICH THE LESSOR WILL BE HAVE TO PAY PROFIT TAX.

| | Year 1 | Year 2 | Year 3 |
|---|---|---|---|
| Residual book value | 100.0 | 75.00 | 56.3 |
| Depreciation | 15 | 30 | 20 |
| Repayment schedule | 33.3 | 33.3 | 33.3 |
| Portion of lease payment representing reimbursement of asset cost which is taxed | 18.3 | 3.3 | 13.3 |

## LESSEE'S PROFIT TAX FOR FINANCIAL LEASES

A lessee is able to record lease payments as operating costs, *minus* the portion of a lease payment that represents payment for the cost of the asset as the lessee charges depreciation on the asset.

Based on the components lease payment as provided for in Ukraine's *Law on Leasing*, this table shows the provisions of Ukrainian tax law related to how a lessee is to record lease payments for tax purposes.

| | |
|---|---|
| **Compensation for the asset's value** | Not treated as an expense but the lessee depreciates the asset according to rates established under Articles 8.6.1. and 8.6.2. of the Law on Corporate Tax using coefficients specified under Article 22.4 of the same law. The *difference* between actual compensation for asset value and depreciation charges is not expensable as it is the reduction of a liability incurred as part of investment in fixed assets. |
| **Interest on the lessor's loans** | Expensed according to Article 5.1.1. |
| **Lessor's premium** | Treated similarly to *interest* and included in expenses in accordance with Articles 1.10 and 5.5.1 of the Law on Corporate Tax. |
| **Insurance costs** | Included in expenses, according to Article 5.4.6 of the Law on Corporate Tax.[10] |
| **Lessor's additional expenses** | Must be considered on a case by case basis. |

***From the lessee point of view, taxation of financial leases are generally straightforward and the same as if the lessee had received a bank loan and purchased the asset themselves.***

### *Summary of Profit Tax Treatment for Financial Leasing in Ukraine*

Financial leasing implies that the lessee will repay the lessor for all or most of the asset's value over the term of the lease, and therefore the lessor is likely to assume ownership of the leased asset with little or no additional payment at the end of the lease term.

10 In cases where the lessor assumes responsibility for insuring the leased asset, he should take note of Tax Administration Letter of #4592.11.15-2116 (May 4, 1998), which clarifies certain tax regulations.

From the perspective of profit tax, financial leasing is a viable financing option for acquiring fixed assets *only if* parties to a financial lease are comfortable with a lease term and payment structure in which the portion of lease payments representing reimbursement of the asset cost throughout the lease term, do *not exceed depreciation of the leased asset for the period. Unfortunately, given* Ukraine's market conditions, the high cost of capital, and depreciation schedules allowable in Ukraine (illustrated in the previous section) this is very unlikely.

It can be assumed that parties to a lease transaction will seek to structure a shorter–term lease with a sizable advance payment. However, in doing so, the current taxation system for financial leasing will make the transaction much more expensive. This is due to the lessor needing to recover the taxes paid on the difference between the portion of lease payments that represent reimbursement of the asset cost and depreciation of the leased asset for the period.

This problem could be fixed rather easily by stating in tax law that the portion of lease payments representing reimbursement of the leased assets cost received by the lessor, is to be excluded from the lessor's taxable revenue as it represents the return of lent capital.

Provided in the next section is an explanation of the most common models for tax treatment of financial leasing used in other countries.

**There are two commonly accepted models for taxation of a financial lease.**

1. To treat financial leasing as a sale of an asset. The asset is recorded on the balance sheet of the lessee who depreciates the asset. The part of lease payments reimbursing the original cost of the leased asset are excluded from the lessor's revenue and from the lessee's expenses.
2. To treat financial leasing as the sale of a service. The asset remains on the balance sheet of the lessor who depreciates the asset. The entire lease payment is included in the lessor's gross revenue and the lessee's expenses.

Each of these models results in tax being levied **only** on the lessor's margin.

Some countries use a combination of these models to provide additional benefits to parties of a leasing transaction in order to promote economic growth in their country. However, to a country where leasing is a new concept, policymakers should consider the two options and decide whether to treat financial leasing according to its form, *which is a service (payment for usage of an asset), or* according to its economic substance, which is the sale of an asset.

Most countries treat financial leasing for tax purposes as an asset sale because they perceive a loss of revenue to the budget when treated as a service. However other countries disagree with this viewpoint and believe that offering tax benefits will increase overall investment in the economy and thus revenues to the budget.

Countries like the United States treat financial leasing like a service and offer accelerated depreciation schedules to provide incentives for enterprises to upgrade their equipment more often. This results in companies staying com–

petitive globally and increases the amount of manufacturing equipment purchased in the economy.

*When financial leasing is treated as a sale*, the sale is realized upon transfer of the leased asset to the lessee at which time it is placed on the balance sheet of the lessee.

*Periodic payments made by the lessee to the lessor under the lease agreement* typically are treated as deferred payments of the purchase price for the asset. Therefore, the lessee treats a portion of each payment as payment of the purchase price of the asset. The lessee records as an expense the lease payment, less the portion representing payment for the purchase price of the asset. The lessee also charges depreciation of the asset according to the country's depreciation policy.

In this model, the lessor reports the amount of all payments to be received in the entire course of the lease as revenue in the period when the property is handed over to the lessee. In the same period, the lessor will record as an operating expense, the cost of purchasing or producing the leased asset.

| FINANCIAL LEASING AS THE SALE OF AN ASSET | |
|---|---|
| **Benefits** | **Disadvantages** |
| Simple definition under relevant laws. | The lessor records all revenues under a lease agreement upon delivery of leased asset to lessee. This results in an increased tax burden for the lessor at the beginning of a lease. |
| Conforms to the real economic nature of financial leasing (lessee of leased asset is such in reality). | Contradicts Ukraine's Civil Code, which treats financial leasing as the transfer of leased asset for usage. |
| Conforms to European tax standards. | Legal awkwardness as the lessor has technically sold the asset and yet retains the ownership rights. |

If financial leasing is treated as a service, the leased asset remains on the balance sheet of the lessor who then depreciates it. The lessor records the full lease payment as gross income for the period in which payments are received or, if earlier, as they are due. The lessee records the entire lease payment as an expense.

A key element of this model is the value at which to consider the purchase of the asset if the lessee chooses to assume ownership of the asset at the end of the lease term. Because a portion of the lease payments represents repayment of the cost of the asset, the sale should be recorded at a predetermined residual value of the asset at the end of the term that takes into account how much of the asset the lessee has already provided for in lease payments.

| *FINANCIAL LEASING AS THE SALE OF A SERVICE* | |
|---|---|
| **Benefits** | **Disadvantages** |
| Simple and clear treatment under relevant Ukrainian legislation and consistent with Ukraine's Civil Code. | Will result in large tax obligation by lessor if repayment schedule is shorter than asset depreciation (such as in Ukraine). This will be eventually offset if the lessor may write-off the asset when it transfers it to lessee at the end of the lease term. |

| Benefits | Disadvantages |
|---|---|
| Even distribution of the lessor's tax liabilities over the entire lease term which will result in lower pricing for the lessee. | Lack of clarity as to how the final payment of a financial lease is to be treated when the lessee assumes ownership of the asset. |
| Clear implications of early dissolution: no more services means no more payments — and therefore no more tax liabilities. | |

There exist additional tax models that combine these two basic models or that treat a financial lease exactly like a loan. These models usually are developed to encourage increased volume of financial leasing. Unfortunately, in Ukraine the way in which these two models are combined results in economic disincentives for financial leasing.

Leasing transactions involve multiple stages with many possible payment schedules and methods. Hence, a tax system needs to be clear and leave no room for ambiguous interpretation and needs to be consistent across different pieces of legislation.

In Ukraine the key problems related to profit tax for financial leasing transactions are a result of some pieces of legislation treating financial leasing as a service while the asset is placed on the balance sheet of the lessee at the beginning of the lease period as if it was a purchase.

## LESSOR'S PROFIT TAX FOR OPERATING LEASES

Although financial and operating leases differ considerably, Ukrainian tax law makes only one distinction between them: under an operating lease, the leased asset is recorded on the lessor's balance sheet, and the lessor makes depreciation charges.

**Article 1.18.1. Paragraph 2**

*Under an operating lease, the leased asset should be recorded among the lessor's fixed assets.*

Ukraine's tax treatment for operating leases is much more logical and in line with common international practices. However, Ukraine's depreciation policies put local lessors and enterprises at a certain disadvantage over their foreign counterparts.

**In analyzing profit tax for a lessor under operating leasing, let's assume that:**

- *The operating lease has a term of one year*
- *The asset has a useful economic life of 3 years*
- *The lessor receives 100 units per year as compensation for the cost of the asset*
- *Depreciation for the first year is 25% of the asset's value.*

| LET'S USE THE SAME ASSUMPTIONS AS THE PREVIOUS EXAMPLE FOR FINANCIAL LEASING: | |
|---|---|
| **Components of the Lease Payment** | **Amount** |
| Cost of leased asset | 300 |
| Annual interest on lessor's bank loan | 14 |
| Lessor's margin | 6 |
| Annual insurance payment | 2 |

| HERE IS A SIMPLIFIED PICTURE OF HOW THE LESSOR SHOULD RECORD THE LEASE: | | |
|---|---|---|
| *Income Statement* | | |
| ***Revenue*** | | Cost of leased asset |
| Lease payments | 122 | Operating lease payments are subject to VAT (not extended in the example) |
| ***Less Expenses*** | | |
| Depreciation of leased asset | 25 | Interest on bank credit is the asset |
| Interest on bank credit | 14 | Included in expenses |
| Insurance payment | 2 | Included in expenses |
| **Profit before tax** | 35 | |
| Less Profit Tax (30%) | 10.5 | |
| **Retained earnings** | 24.5 | |

Since the established procedure for calculating depreciation implies a reduction of absolute calculated values (fixed percentage of remaining book value), the amount of depreciation will decrease and the profit before tax will increase with future periods (See page 71).

The end result of Ukraine's rigid and drawn out depreciation schedules is that Profit Tax is paid on the the part of the lease payment which represents reimbursement for the cost of the asset that exceeds allowable depreciation for the period. Again, this results in shorter-term leases being extremely expensive so that the lessor can cover these tax obligations.

*Passing of the proposed amendments that are currently being debated in the Verkhovna Rada will help solve some of these issues. However, as illustrated in the last few sections, improvements must also be made to the laws that determine taxation of leasing transactions as well as those of depreciation of fixed assets.*

Ukraine's Law on Corporate Tax (Article 8) gives businesses an extremely limited choice of depreciation methods for fixed assets. The list of choices should be expanded along the lines of the recently adopted Ukrainian National Accounting Standard #7 "Fixed Assets." (See Annex V)

## LESSEE'S PROFIT TAX FOR OPERATING LEASES

The following legislation comes into play when attempting to determine a lessee's tax obligation under an operating lease.

**Ukraine's Law on Corporate Tax**

**Article 7.9.1**

*In light of the procedures established by this Law, the following assets and funds shall not be treated as gross revenue, nor taxed as such:*

*Assets received by the taxpayer on the basis of an agreement for lease (rent), concession, commission, consignment, entrusted management, custody, or any other civil contract that does not imply the transfer of the ownership rights.*

**Article 5.5.1**

*Expenses shall include all payments or accruals of borrowing costs (including credits, deposits) effected during the accounting period, provided such payments or accruals were made in connection to the taxpayer's business.*

**Article 2.10**

*Interest is revenue payable (or accruable) to a creditor by a debtor as a fee for the right to use borrowed capital or assets for a specific period. Interest shall include:*

- *Fees for the use of capital or goods (labor, services) received for credit*
- *Fees for the use of capital received for deposit*
- *Fees for purchase of goods by installment.*

**Ukraine's Law on Leasing:**

**Article 16. Lease Payments**

*2. Lease payments include:*

- *Compensation for the depreciated value of the leased asset per payment period;*
- *Interest on loans taken out by the lessor in order to purchase the leased asset, as stipulated under the lease agreement;*
- *The lessor's premium or commission;*
- *nsurance payments, if the leased asset is insured by the lessor;*
- *The lessor's other expenses as specified in the lease agreement.*

The lessee is allowed to expense the entire sum of the lease payment, since this payment is understood as a mere fee for the right to use the leased asset. In addition, the Law on Leasing stipulates that the leased asset must be returned to the lessor when the lease expires, which means that the lessee never assumes legal ownership.

## VAT FOR FINANCIAL LEASING

Under Ukraine's *Law on Value Added Tax* (VAT), the following provisions relate to leasing:

**Law on Value Added Tax**

**Article 3.2.2**

*Assets transferred under a lease by non-resident lessors to resident lessees, as well as the return of such assets to lessors upon the expiration of a lease;*

*Payment of rental fees under a financial lease agreement or a rental agreement for a domicile which is the lessee's place of residence.*

**Article 7.4.2**

*In cases where the taxpayer sells goods, labor or service that are exempted from tax under Articles 3 and 5 of this Law, the* **amount of tax** *payable or accruable in connection with the purchase of goods, labor or services whose costs are included in production costs, as well as depreciable fixed or intangible assets,* **will be treated as production costs and counted towards the value of fixed and intangible assets, and may not be included in any tax credit.**

Parties to a lease agreement need to pay particular attention to VAT treatment of each stage of a lease: purchase of the asset, transfer of the asset to lessee, receipt of lease payments, transfer of ownership rights to the lessee or return of the asset to the lessor.

**Under a financial lease,** it is the inconsistency of treatment among these different stages that present the biggest problem. For example, at first glance the exemption from VAT provided for in Article 3.2.2 of the *Law on VAT* may appear to be a tax benefit, but it is actually canceled out by Clause 7.4.2. In order to take a closer look at this, let's look at the stages of a financial leasing transaction one by one under current Ukrainian law.

1. On the lessee's request, the lessor purchases a specified asset.
2. The lessor transfers the asset to the lessee.
3. The lessee gradually repays the lessor for the cost of the asset.
4. The lessee redeems and assumes ownership of the asset (mandatory in Ukraine)

Amazingly enough, this entire problem would be rectified simply by eliminating the clause in Article 3.2.2 of Ukraine's *Law on VAT* that exempts financial leasing from VAT. This would alleviate the lessee's excessive tax burden and enable him to distribute his tax liabilities evenly over the entire term of the financial lease.

1. *The lessor pays VAT when purchasing the asset to be leased from the supplier.*
2. *Upon providing the asset to the lessee (which includes transfer of the leased asset's value to the lessee's balance sheet), the VAT paid when purchasing the asset from the supplier is capitalized as part of the cost of the asset and the lessor's VAT credit is cancelled.*
3. *The lessor effectively finances the lessee by the amount of VAT for the entire term of the lease. This results in a higher asset cost as well as higher financing costs to the lessee which is slightly offset in that the lessee may then depreciate the cost of the asset, including the capitalized VAT*
4. *At the end of the lease term when ownership of the leased asset is transferred to the lessee (mandatory), the lessee is subject to VAT on a taxable base of the asset's original purchase price.*

Some market participants claim that they have been able to convince the tax administration that they have already paid VAT through the lease payments and were not hit with this 'double taxation.' However, some participants have not and therefore use other types of transactions to avoid paying VAT again at the end of the transaction.

Under a financial lease, the lessee **must** assume ownership of the asset at the end of the lease term; consequently, conditions for returning the asset are generally not an issue. However, there is one exception: if the contract is dissolved prematurely due to lessee default or some other breach of contract. There is no clear explanation of how the returning of the leased asset should be recorded for VAT purposes. It would appear that because the financial lease itself was not subject to VAT in the first place, there are no transactions to reverse.

## VAT FOR OPERATING LEASING

Value added tax for operating leasing is quite straightforward. The same two articles of the *Law on VAT* that apply for financial leasing also apply for operating leasing.

**Law on Value Added Tax**

**Article 3.1. Tax-payer is liable to pay VAT on the following transactions:**

*3.1.1. sales of goods (works, services) on the customs territory of Ukraine, including payment of rental fees under an operating lease agreement and transfer of title for assets pledged as collateral, to the lender, to offset outstanding debt of the pledger.*

For purposes of analysis, let's look at the stages of an operating lease:

1. The lessor purchases or produces an asset to provide for leasing.
2. The lessor transfers the asset to the lessee.
3. The lessee gradually pays the lessor for usage of the asset.
4. The lessee returns the asset to the lessor at the end of the lease term (mandatory in Ukraine)

*Under an operating lease, only the purchase of the asset and lease payments are subject to VAT resulting in the lessor paying VAT to the budget only on his margin.*

1. *The lessor pays VAT in relation to the purchase of the asset or for the inputs to produce the asset.*
2. *Transferring the leased asset to the lessee for usage is not subject to VAT as there is no exchange of ownership or paid service associated with this.*
3. *The lease payments are subject to VAT.*
4. *Returning the asset to the lessor at the end of the lease term is not subject to VAT as there is no exchange of ownership or paid service associated with this.*

## WITHHOLDING TAX

The following provisions from the Law on Withholding Tax are relevant to leasing transactions.

**Law on Withholding Tax**

**Article 13.1.**

*All commercial revenue received by nonresidents from sources in Ukraine (including revenue accrued by nonresidents in hrivnya accounts) will be taxed according to the rates and procedures stipulated in this article.*

*For the purposes of this article, revenue received by non-residents from sources in Ukraine shall be understood as:*

... ...

*d) Lease payments that are effected by residents or representative offices for the benefit of nonresident lessors;*

**Article 13.2.**

*All commerce-related payments effected by resident entities or representative offices from sources in Ukraine and received as commercial revenue by nonresidents (including revenue accrued by nonresidents in hrivnya accounts), except for the types of revenue specified in Articles 13.3–13.7, will be taxed at a rate of 15% unless otherwise stipulated under international agreements to which Ukraine is a signatory.*

Here, the key issue is determining the taxable base for withholding tax from the legislation quoted above. Under article 13.1.d of the Law on Withholding

Tax, it is discernable that all lease payments under a cross-border lease agreement are considered "commercial revenue received by non-residents."

However, it is only the lessor's margin that should be considered taxable revenue. The portion of lease payments that represent reimbursement for the cost of the leased asset or reimbursement of other transactions related to the transaction should not be subject to withholding tax.

As a result, the Ukrainian State Tax Administration issued Letter #427/7/22-2217 on Jan. 1, 1999. This letter clarifies that *"the taxable base is calculated as the total sum of the lease payment less compensation for the value of the leased asset."*

Please note that it is the lessee who must pay the withholding tax. *Therefore, the lessee should draw the tax authorities' attention to the structure of a lease payment, emphasizing that most of the payment does not constitute non-resident revenue, but rather compensation for the value of the leased asset.*

Lessees should also review the international treaties on double taxation that have been ratified by the Verkhovna Rada. A number of these treaties may provide lower rates of withholding tax, or even full exemptions.

## CUSTOMS DUTIES

The following articles of Ukraine's Law on VAT stipulate the customs duties for assets brought into Ukraine under a lease agreement.

**Ukraine's Law on VAT:**

**Article 7.3.6**

*Tax liabilities on imported goods become effective on the date when a customs declaration is signed, indicating the amount of tax to be paid. Tax liabilities on imported labor or services become effective on the date when payment for such labor or services is deducted from the taxpayer's bank account, or when the taxpayer signs a document confirming that labor or services have been performed, whichever occurs first.*

**Article 7.3.8**

*Tax liabilities shall not commence with an advance payment for goods that will be exported or imported across the customs border of Ukraine.*

Leased assets imported by Ukrainian residents do not enjoy any additional benefits in comparison with other imports.

Article 7.3.6 clearly implies that lessees must pay taxes and duties on leased assets, including VAT, during customs clearance. Specific customs duties vary depending on the type of asset.

One should keep in mind that *no tax obligations arise when resident lessees make advance payments to nonresident lessors as compensation for the value of an asset under financial lease.*

When entering into cross-border lease agreements, Ukrainian lessees should review Articles 7.4.2 and 3.2.2 of the Law on VAT to see whether the value of the leased asset should be increased by the sum of VAT.

***POSSIBLE IMPROVEMENTS TO LEGISLATION:***

***It would make sense to exempt leased assets from VAT during customs clearance, since they are not importing their own property. An asset imported under financial leasing will not become the resident lessee's property unless the contract is fulfilled. If the agreement is terminated prematurely, the asset will be returned to the lessor.***

***It would therefore be advisable to defer the payment of VAT for assets imported under financial lease agreements. VAT could be charged on the original contract value when the lessee assumes ownership of the leased asset after paying it off in full.***

## ACCOUNTING FOR LEASING TRANSACTIONS

As with a country's tax system, the policies governing financial reporting (accounting) influence the economic decisions made by investors and managers. Leasing is particularly sensitive to these policies, which is why most countries have developed separate accounting procedures for leasing transactions.

Financial reporting for leasing transactions depends on such factors as the methods of depreciation, the valuation of the leased asset, the choice between recording the leased asset on the lessor's balance sheet or the lessee's, and the treatment of indirect expenses related to the leasing transaction.

The following section aims to provide a clear understanding of:

- *The differences between financial and tax accounting, the conceptual reasons for these differences, and the effects these differences can have on a country's economic development;*
- *How Ukrainian accounting standards treat leasing transactions*
- *The effects of Ukrainian tax and accounting policies on the development of leasing in Ukraine.*

### THE FORMS OF ACCOUNTING

Economic theory and practice differentiate between the notions of (1) financial accounting and financial statements and (2) tax accounting and tax statements.

Ukraine's Law on Accounting and Financial Reporting defines *accounting* as an information system that covers the entire process of disclosing, measuring, recording, collecting, generalizing, preserving and transferring information about a business's performance.[11] In the West, this is known as *financial accounting*.

Throughout the world, the goal of financial accounting is to provide objective, meaningful, and accurate information needed in order to make investment, management and other business-related decisions. Establishing of standard principles ensures consistency across borders and financial markets and is critical to the ability of companies and investors to operate internationally.

*Tax accounting* refers to the process of preparing information (tax reporting) for tax authorities; this includes calculations of one's taxable base, tax deductions and taxes due (Please refer to Section VI for a detailed discussion of tax accounting in the context of a lease agreement). Tax accounting serves the fiscal goals of the state and is a key element in implementing a country's economic policy.

As one can see, the goals of financial and tax accounting are quite different and each is governed by a separate set of laws with its own specific requirements. Each interprets an enterprise's financial indicators differently. That is why the actual revenues and costs found in financial accounts differ from the gross revenues and total costs reported in the tax accounts.

11 See Article 1 of Ukraine's Law 87 on Accounting and Financial Reporting (31/03/1999).

In countries that actively support and encourage the development of leasing, the differences between financial and tax accounting are minimal: tax accounting is made as similar as possible to financial accounting. In countries where the development of leasing is not a priority, the tax system typically fails to reflect the actual economic nature of leasing transactions as described in Section II.

In Ukraine, there are some substantial differences between tax accounting and financial accounting for leasing transactions, particularly in the context of financial leases. Financial reporting procedures under Ukraine's recently adopted National Accounting Standards are quite similar to IAS. Given that financial reporting generally tries to reflect the true economic nature of leasing transactions, it can be inferred that Ukraine's tax accounting system does not.

***INTERNATIONAL ACCOUNTING STANDARDS (IAS)***

***The International Accounting Standards Committee (IASC) was formed in London in 1973. Its goal has been to develop and publish accounting and financial reporting standards, and to encourage companies throughout the world to adopt and abide by these standards.***

***IAS are commonly accepted worldwide as the way to present the financial condition of an enterprise to investors, partners, shareholders, etc. It is these common standards that allow for global financial markets to work so effectively. Without such standards, investments and other business decisions would take much more time while investors and partners would have to take the time to understand and verify the financial condition of an enterprise.***

***IAS are not overly rigid and try to provide flexible regulations. They are revised regularly in order to adjust to changes in the global economy and the needs of the people who use them. This is important because each company is unique and the range of possible transactions is endless.***

***International standards play an important role in improving and fine-tuning the methods of financial reporting. Bringing national accounting systems into agreement with IAS can helps reduces the cost of borrowing funds and facilitate access to international capital markets.***

***Some countries see no point in creating their own national standards, as this can be quite a costly undertaking. Realizing how important it is to standardize their accounting and financial reporting procedures, these countries either adopt the international standards completely, or use them as a framework for developing their own standards (as has been the case with Ukraine).***

## LEASING AND UKRAINIAN NATIONAL ACCOUNTING STANDARDS (UNAS)

In the late 1990s, Ukraine implemented a new financial reporting system that complies with IAS but includes some deviations from IAS recording procedures. Ukrainian banks switched over to the new accounting and reporting system in 1998, and the rest of Ukraine's industries followed suit two years later.

Since October 1, 2000, leases in Ukraine have been subject to the provisions of Ukraine's Accounting Standard #14 "Rent" (NAS #14).[12]

As in Ukraine's Law on Leasing, NAS #14 stipulates that, *"under a financial lease, the lessee assumes all of the risks and rewards associated with the use and possession of the leased asset,"* (which also coincides with IAS and the tax laws of many countries).

*NAS #14 also includes the definition of a financial lease from IAS which states that, "a lease qualifies as a financial lease if it has at least one of the following features:*

*The lessor transfers ownership of the leased asset to the lessee upon expiration of the lease;* [13]

*The lessee intends to, and may, redeem the leased asset at a price which is significantly lower than the asset's fair value at the beginning of the lease, and it is reasonably certain that this option will be exercised;*

*The lease term covers most of the asset's useful service life. The title may or may not be transferred;*

*The current value of the minimum lease payments at the beginning of the lease is greater than or equal to the real market value of the leased asset."*

Risks associated with *use* and *possession* include possible losses resulting from the asset's technical malfunction or obsolescence, as well as all fluctuation in cash revenues due to macroeconomic changes. The rewards under a financial lease refer to the economic benefits from the use of the leased asset over its useful life, gains from the asset's market value appreciation and proceeds from the sale of the asset (assuming that the lessee has redeemed the full cost of the leased asset and assumed ownership).

In return for these benefits, the lessee also assumes responsibility for paying the lessor a sum approximately equal to the fair value of the leased asset plus the cost of financing the lease.

12 See National Accounting Standard #14 "Rent", confirmed by Ukrainian Ministry of Finance's Order 181 on 28/07/2000.

13 The lease term is the period of time for which an irrevocable lease agreement is valid, plus the extension period stipulated at the beginning of the lease term. A lease agreement is considered irrevocable if it may only be broken under the following circumstances:
- With the consent of the lessor;
- in case of certain unexpected events (force majeure);
- if the lessee has signed a new lease agreement for the same asset, or another asset with a similar function provided by the same lessor.

Fair value is the amount for which an asset could be exchanged or a liability repaid, as of the time when the agreement is knowingly and willingly signed by the parties. Under IAS, this is automatically assumed to be the sum of all lease payments. UNAS is likely to treat fair value in the same way but this is not specifically stated.

NAS #14 is the first Ukrainian regulation that attempts to define, however vaguely, the concept of sub-rent (subleasing). It defines sub-rent as a contractual arrangement whereby a renter (lessee) lets (leases) an asset which he *himself holds under rent (lease) to a third party.*

## ACCOUNTING FOR OPERATING LEASES UNDER UNAS

Recording operating lease transactions under UNAS is quite straightforward and coincides with the recording of operating leases under Ukrainian tax law.

1. Accounting for Lessees

The lessee should record the leased asset in his off-balance account at the price specified in the lease agreement.

If the lessee wishes to modernize, upgrade or complete the leased asset, the cost of such improvement should be reflected as capital investment under "Other long-term assets."

The lessee's lease payments are classified and reported as *"other operating costs"* for the corresponding reporting period.

2. Accounting for Lessors

Since it is the lessor who keeps the asset on his balance sheet under an operating lease, he is the one who should record it under the relevant sub-accounts for fixed assets and charge depreciation under the sub-accounts for long-term depreciation of assets.

The lessor's revenue from an operating lease should be reflected under "Other operating revenue" for the corresponding reporting period.

The lessor may choose to record the costs of contract negotiation (legal fees, commission, etc.) under "other operating costs" for the reporting period during which they were incurred. These costs are then recovered from the lessee in the cost of the lease. Some lessors, however, simply have the lessee pay these costs directly and exclude them from the lease amount.

## ACCOUNTING FOR FINANCIAL LEASES USING UNAS

The following section serves as a guide for reporting *financial leasing* transactions according to UNAS.

1. Accounting for Lessees

The lessee reflects a financial leasing transaction on their balance sheet under both assets and liabilities. The appropriate group of fixed assets are increased by the book value of the leased asset. The increase should be the total amount of lease payments, which may include transportation and installation costs, as well as other expenses incurred by the lessee in connection with obtaining the leased asset.

The lessee should record the leased asset on his balance sheet at its **lowest value (LVA)** as of the date when the lease began (cost of asset under financial lease).

This value may be equal to (1) the fair value of the asset or (2) the present value of the sum of minimum lease payments.

Minimum lease payments are payments made by the lessee over the entire lease period (less cost of services and taxes to be paid by and reimbursed to the lessor, and other contingent payments), increased by the following:[14]

a. *(for lessees) the* ***amount of residual value guaranteed*** *by the lessee or a related party;*

b. *(for lessors) the* ***amount of residual value guaranteed*** *by the lessee or a third party (**e.g.** supplier) unrelated to the lessor who is financially capable of discharging the obligations under the guarantee agreement.* [15]

A lease agreement may provide for revision of the minimum lease payments by the amount of unforeseen lease payments.

*Contingent payments* represent a portion of the lease payment which is not fixed in amount and is based on some factor other than the passage of time, such as sales percentages, amount of use, price indices, or market rates of interest. If, for example, the lease payment is adjusted for inflation, this adjustment is considered a contingent payment. It should not be included in the sum of minimum lease payments and should be recorded separately.

The total sum of minimum lease payments ($\sum$MLP) consists of two major components (see charts on pages 93–94):

- *Value of the leased asset (LVA), as originally recorded on the lessee's balance sheet; and*
- *the lessee's finance costs over the entire lease term. ($\sum$FC).*

In other words:

$$\sum MLP = LVA + \sum FC \qquad (1)$$

*Finance costs* are payments for the use of the leased asset. They are calculated as the difference between the sum of minimum lease payments and the leased asset's book value:

$$\sum FC = \sum MLP - LVA \qquad (2)$$

The *present value of minimum lease payments* for the entire lease period is meant to represent the sales price of the leased asset at the inception of the lease. It should take into account the interest rate implicit in the lease.

14 Cost of services payable by the lessee may include, for example, insurance or other costs associated with maintenance of the asset. Taxes may include VAT required as part of the lease payment.

15 In addition to guaranteed residual value, NAS #14 also defines unguaranteed residual value. This refers to the portion of the leased asset's residual value which may or may not be paid at the end of the lease. According to current tax laws, the ownership title to an asset under a financial lease must eventually be transferred to the lessee; therefore, this issue is not relevant. However, if current proposed amendments to the Law on Leasing are passed into law, the purchase and transfer of ownership at the end of a financial lease will be optional and parties will need to define the unguaranteed residual value.

The *interest rate* implicit in the lease is the proportion of the present value of the sum of minimum lease payments to the cost of the leased asset (including costs associated with providing it to the lessee) at the beginning of lease. This rate should be specified under a financial lease agreement.

If this rate is not specified under the agreement, then the *lessee's incremental borrowing rate of interest* will apply by default.

The *lessee's incremental borrowing rate of interest* refers to the interest rate that the lessee would have to pay on a similar lease. If this rate cannot be determined, then it shall be calculated as that rate at which the lessee could borrow funds over a similar period, and with similar guarantees, to finance the purchase of the leased asset.

The procedures for calculating the present value of total lease payments (PV∑MLP) depend on terms of the agreement. If payments are made at the beginning of each period, this value should be calculated as follows:

$$(PV\sum MLP) = MLP \cdot \left[1 + \left(1 - \frac{1}{(1+i)^{n-1}}\right) \div i\right] \qquad (3);$$

*If payments are made at the end of each period,* the following formula should be used:

$$(PV\sum MLP) = MLP \cdot \left[\left(1 - \frac{1}{(1+i)^{n}}\right) \div i\right] \qquad (4),$$

**Where:** **MLP** = minimum lease payments, paid regularly (annuity);
n = number of periods
*i = the interest rate for the indicated period.*

For recording purposes, finance costs are reflected in the amount attributable to the each reporting period *(see charts on the following two pages).*

Finance costs for each reporting period (FCr) are distributed according to the lease's rate of interest on outstanding liabilities at the beginning of the reporting period (OLBr).

$$FCr = OLBr \times i \qquad (5)$$

In financial accounting, the financial lease payment must be broken up and recorded separately under finance costs and reduction of outstanding obligations of the lessee. This is necessary to calculate at the beginning of the lease because the cost of the purchase of the asset is recorded upon tranfer of the leased asset for usage to the lessee. Therefore, the reduction of the lessee's liability is not expensed as it was capitalized and will be reflected in the lessee's depreciation charges.

## How Lessees Should Calculate Finance Costs and Distribute Them Between Relevant Reporting Periods

### Example 1

The parties have signed a three-year lease for a piece of equipment, effective from January 2, 2001, at an interest rate of 26%. The lessee makes his lease payments in advance once every six months, at the beginning of each period (January 2 and July 1), in the amount of Hr 40,000.

Using Formula 3 from the previous page, i = 0.13 (semiannual rate) and n = 6, we can calculate the present value of minimum lease payments as 40,000 x 4.5176 = 180,704 Hr.

The lessor will receive 240,000 Hr (40,000 x 6) in lease payments, but the real (present) value of this amount will be 180,704 Hr.

Total sum of finance costs will be 240,000 – 180,704= 59,296 Hr.

| Date | Minimum Lease Payments Paid Regularly (MLP) (annuity) | Finance Costs (FC)[16] | Present Value of Lease Payment (PVL)[17] (decrease of liability for each period) | Outstanding Liabilities at the Beginning of the Period (OLB) |
|---|---|---|---|---|
| January 2, 2001 | 40,000 | - | 40,000[18] | 140,704[19] |
| July 1, 2001 | 40,000 | 18,291 | 21,709 | 118,995 |
| January 2, 2002 | 40,000 | 15,469 | 24,531 | 94,464 |
| July 1, 2002 | 40,000 | 12,280 | 27,720 | 66,744 |
| January 2, 2003 | 40,000 | 8,676 | 31,324 | 35,420 |
| July 1, 2003 | 40,000 | 4,580[21] | 35,420 | 0 |
| ***Total*** | ***240,000*** | ***59,296*** | ***180,704**** | |

*Present value of lease payments should reflect the approximate cost of tansferring the asset to the lessee including the lessor's purchase or manufacturing costs.

16 Calculated as outstanding liabilities on the previous date of payment multiplied by the interest rate for that period:
18,291 = 140,704 x 0.13 15,469 =118,995 x 0.13
12,280 = 94,464 x0.13 8,676 = 66744 x 0.13

17 Calculated as the difference between the minimum lease payment and the finance costs:
21,709 = 40,000 - 18,291 24,531 = 40,000 - 15,469
27,720 = 40,000 - 12,280 31,324 = 40,000 - 8,676.

18 In this example, the lease payments are paid in advance; therefore, the first payment is for Hr 40,000.

19 140,704 = 180,704 - 40,000, where 40,000 is the first advance lease payment.

20 118,995 = 140,704 - 21,709 94,464 = 118,995 - 24,531
66,744 = 94,464 - 27,720 35,420 = 66,744 - 31,324

21 Takes into account outstanding liabilities under the lease: 4,580 = 40,000 – 35,420

**Example 2**

Let's assume the same conditions as in Example 1, but with the lease payments made at the end of each period (June 30 and December 31).

Now based on Formula 4, provided earlier, the present value of the sum of minimum lease payments is calculated as 40,000 x 3.9976 = 159,904 Hr. The finance costs are 240,000 – 159,904 = 80,096 Hr.

| Date | Minimum Lease Payments Paid Regularly (MLP) (annuity) | Finance Costs (FC)[22] | Present Value of Lease Payment (PVL)[23] (decrease of liability for each period) | Outstanding Liabilities at the End of Each Period (OLEr)[24] |
|---|---|---|---|---|
| January 2, 2001 | - | - | - | 159,904 |
| June 30, 2001 | 40,000 | 20,787 | 19,213 | 140,691 |
| December 31, 2001 | 40,000 | 18,289 | 21,711 | 118,980 |
| June 30, 2002 | 40,000 | 15,447 | 24,553 | 94,447 |
| December 31, 2002 | 40,000 | 12,278 | 27,722 | 66,725 |
| June 30, 2003 | 40,000 | 8,674 | 31,326 | 35,399 |
| December 31, 2003 | 40,000 | 4,601 | 35,399 | 0 |
| ***Total*** | ***240,000*** | ***80,096*** | ***159,904*** | |

One should make similar calculations for each financial lease agreement before entering the sums into the relevant accounts.

These calculations should be made for the entire term of the lease. If the parties alter the terms of their agreement, the tables should be adjusted accordingly.

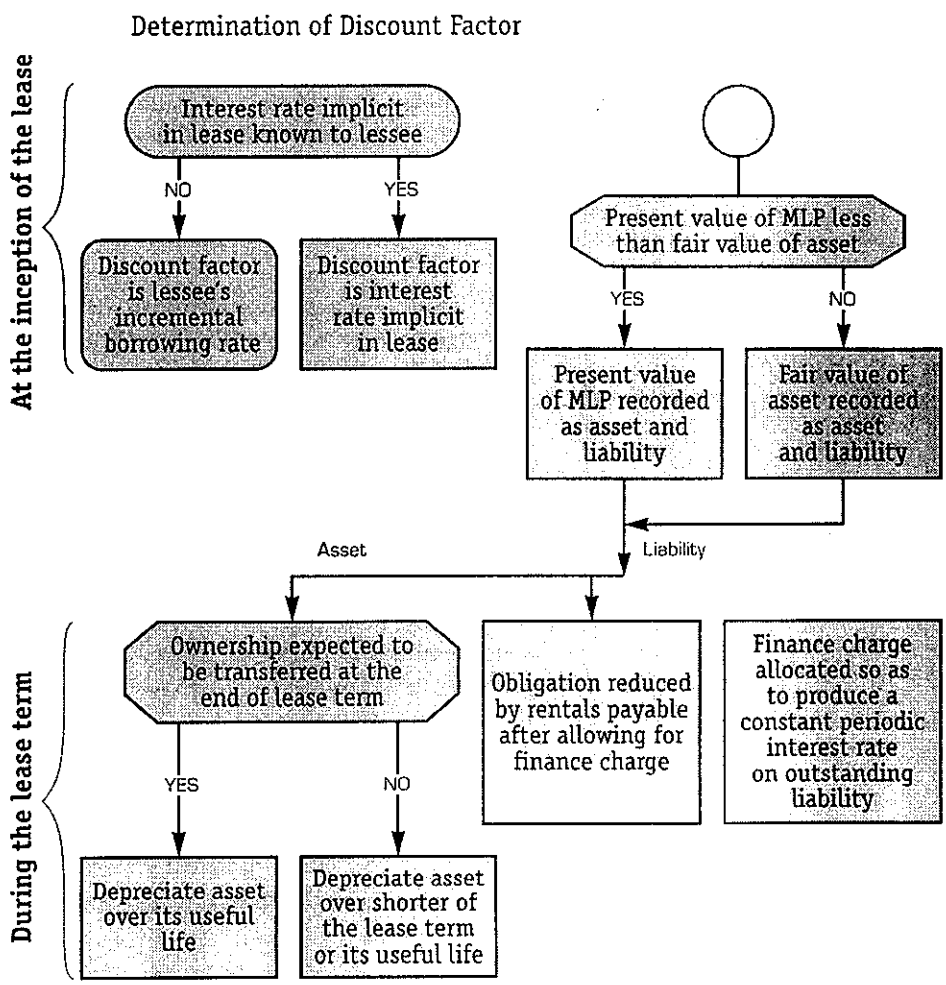
A lessee may improve an asset under a financial lease through modification, modernization, completion, upgrading, renovation, etc. This may add to the future economic benefits of possessing and using the asset. *The costs of improving an asset should be recorded as capital investment and added to the value of the leased asset.*

22 Finance Costs are equal to the lessee's outstanding liabilities on the date of previous payment multiplied by the leasing interest rate for the relevant period.

23 The difference between minimum lease payments and finance costs.

24 Takes into account outstanding liabilities under the lease: 4,601 = 40,000 - 35,399.

**Figure 2. Accounting of Financial Leasing for Lessees**




*MLP — Minimum lease payments

*This diagram is taken from the the book, "International Accounting Standards" published by the International Standards Committee.This diagram also pertains to the treatment of financial leasing under UNAS*



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**Accounting for Financial Leases by Lessors**

The lessor's accounting procedures depend on whether or not he is also the manufacturer of the leased asset.

If the lessor is **not** the manufacturer, then he records the leased asset under the sale of fixed assets. In other words, the leased asset's residual value should be deducted from the lessor's balance sheet and recorded as receivables. This is done by recording the asset's residual value as a cost of sold fixed assets and recording the residual value as income.

The lessor should record any costs incurred related to contract negotiation (legal fees, commission, etc.) under other costs for the period in which they were incurred.

The value at which the asset is recorded under accounts receivable (AR) should be equal to the sum of minimum lease payments ($\sum$MLP) minus finance income ($\sum$FI):

$$AR = (\sum MLP) - (\sum FI): \qquad (7)$$

The lessor's finance income is the difference between the overall sum of minimum lease payments and their present value:

$$(\sum FI) = (\sum MLP) - PVA \qquad (8)$$

The lessor should distribute his finance income over the reporting periods for the term of the lease, taking into account the lease agreement's rate of interest on outstanding receivables. This calculation can be expressed in the following formula:

$$FIr = ORr \times i \qquad (9)$$

**Where:** FIr = lessor's finance income for the reporting period;

ORr = lessor's outstanding receivables at the beginning of the reporting period.

The present value of the total sum of minimum lease payments received by the lessor should be calculated on the basis of the interest rate implicit in the lease agreement, using the following formula:

$$PVL = MLP \times \left[ \left( 1 - \frac{1}{(1+i)^n} \right) \div i \right] - 1 \qquad (10).$$

**How the Lessor Should Calculate His Finance Income and Distribute It over the Relevant Reporting Periods**

**Example 3**

Let's use the same conditions as in Examples 1 and 2, but assume that the asset's fair value was 119,952 Hr.

Using Formula 10, we can calculate the present value of the total sum of minimum lease payments on the basis of the leased asset's fair value: thus, 119,952 x (1/3.9976) = 30,000 Hr.

The total sum of minimum lease payments equals 180,000 Hr (i.e. 30,000 x 6), while the lessor's finance income equals 180,000–119,952 = 60,048 Hr.

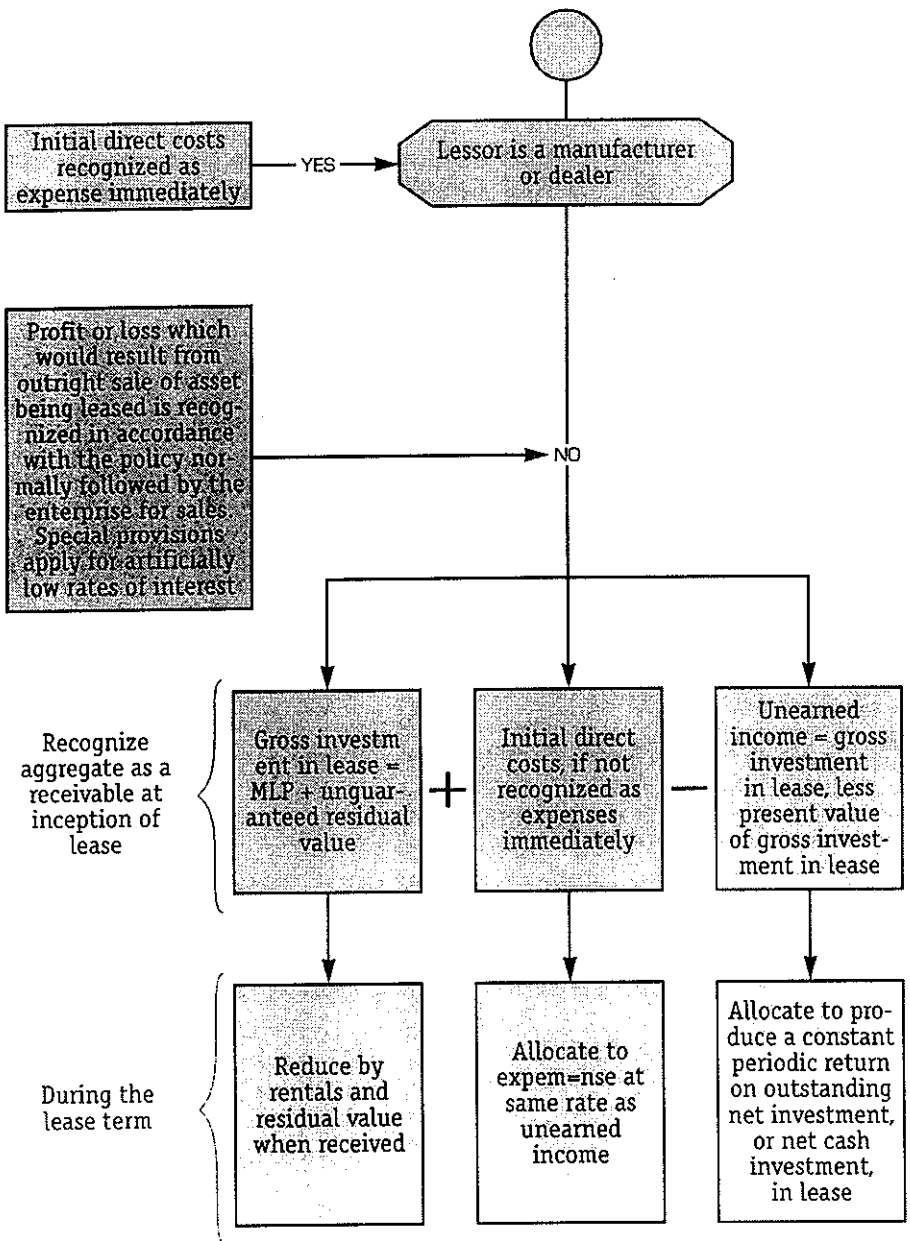
| Date | Minimum Lease Payments received regularly (MLP), (annuity) | Finance Income (FI)[25] | Present Value of Lease Payment (PVL)[26] | Lessee's Outstanding Liabilities at the end of period (OLL) |
|---|---|---|---|---|
| January 2, 2001 | - | - | - | 119,952 |
| June 30, 2001 | 30,000 | 15,593 | 14,407 | [illegible] |
| December 31, 2001 | 30,000 | 13,720 | 16,280 | 89,265 |
| June 30, 2002 | 30,000 | 11,604 | 18,396 | 70,869 |
| December 31, 2002 | 30,000 | 9,212 | 20,788 | 50,081 |
| June 30, 2003 | 30,000 | 6,510 | 23,490 | 26,591 |
| December 31, 2003 | 30,000 | 3,409[27] | 26,591 | 0 |
| *Total* | *180,000* | *60,648* | *119,952* | |

25 The lessee's outstanding liabilities on the date of previous payment multiplied by the leasing interest rate for the relevant period.

26 The difference between minimum lease payments and finance income.

27 Taking into account the lessee's current indebtedness: 30,000–26,591.

**Figure 3. Accounting of Financial Leasing for Lessors**




* **MLP** — Minimum lease payments

*This diagram is taken from the the book, "International Accounting Standards" published by the International Standards Committee.This diagram also pertains to the treatment of financial leasing under UNAS*



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### Accounting for Lessors Who Are Also Manufacturers of the Leased Asset

The manufacturer of an asset may also become its lessor under a financial lease. In such cases, the lessor should record the leased asset under revenues from the sale of finished products, which should be equal to the accounts receivable.

*The lessor/manufacturer's income* from the sale of the leased asset should be declared as the smaller of: 1) the fair value of the asset or 2) the present value of the sum of minimum lease payments. The latter should be calculated taking market interest rates into account (see Formula 10).

The "cost of goods sold" recorded should be equal to the book value of the leased asset which is removed from the lessor's balance sheet.

*The lessor/manufacturer's finance income* should be calculated as the difference between the total sum of minimum lease payments and present value of such payments, **and be distributed over reporting periods in which they are realized** as in Example 3.

### Accounting for the Seller/Lessee of a Leased Asset in a Sales–Leaseback Transaction

In some cases, the owner of a fixed asset may decide to sell his asset to a particular buyer, only to lease it back again under a financial lease. Thus, the original owner becomes a lessee, while the new owner becomes a lessor. Under most leaseback agreements, the asset never changes hands.

The essence of such an agreement is that the new owner (i.e., lessor) is giving the original owner (i.e., lessee) a loan with the leased asset acting as collateral.

Under such transactions, the lessee should declare revenue from the sale of asset as:

- **the sales price of the asset,** *if the sales price is lower than or equal to the asset's book value after all indirect taxes and other charges have been deducted;*
- **the asset's book (residual) value,** *if its sales price (after deducting all indirect taxes and other charges) is higher than its book value. Any amount in excess of the book value should be recorded as "accrued revenues" and carried over into future periods.*

The book value of the sold asset should be equal to the cost of the leased asset.

A special feature of leaseback transaction is that **the seller/lessee includes income from the sale of the asset in his gross revenues for future periods and any** profits from the sale (difference between sale price and book value) are distributed over the entire term of the lease as part of revenues for each of the corresponding reporting periods.

# ANNEX I

## WEAKNESSES OF UKRAINIAN LEASING LEGISLATION

This Annex deals with some of the major problems in Ukrainian leasing legislation. We draw your attention to what, in our opinion, are the most important ones.

1. **Article 4 of the Law on Leasing currently sets the minimum term of a financial lease at "60% of the leased asset's depreciation period." The situation will become even worse if the Verkhovna Rada (VR) adopts Article 860 of the proposed new Civil Code which has already passed its first and second readings in the VR and will undergo only one more revision before its final vote and acceptance into law. The proposed Civil Code would increase the minimum term of a financial lease to coincide with the leased asset's full depreciation period.**

   **This presents two serious problems:**

   i. **It establishes inappropriate minimum periods for financial leases, making financial leasing economically unattractive.** The law indirectly stipulates a minimum financial lease of 3 years and 3 months for fixed assets in depreciation group 2, or 5 years and 6 months for assets in group 3. Even with accelerated depreciation, the minimum lease period for assets in group 3 is 2 years and 9 months. Given high interest rates, lack of long-term capital and volatile business conditions, lessors in Ukraine are unwilling to provide such long-term leases.

   ii. If depreciation rates in Ukraine are changed, (as was recommended by a recent Presidential decree), lease agreements may fall out of compliance with the law. This will result in parties to a lease transaction having to quickly amend the lease agreement.

   Amending an agreement is likely to be quite problematic as the parties will have to reevaluate the overall economic feasibility of the lease, as well as its specific conditions (size of payments, payment schedule, maintenance costs, compensation for depreciated value, etc.) on the basis of current depreciation rates. If either party refuses to extend the term of the lease, then it may fall out of compliance with the Law on Leasing's minimum requirements once the new depreciation rates go into effect. According to the Ukrainian Civil Code (Articles 48 and 59), such violations may invalidate a lease agreement.

   The general assumption that new regulations should not be enforced retroactively does not apply here, since the Law on Leasing (Articles 16 and 18) stipulates that **depreciation charges should be calculated and made in accordance with the rates effective on their due dates.** At the same time, the lease period can only be changed by mutual consent (Article 162 of the Civil Code prohibits unilateral modifications to any agreement).

A revised Law on Leasing passed its second reading in the VR in April 2001. This draft appropriately eliminates any connection between depreciation and the term of a lease agreement. However, if the Civil Code is passed in its current form, it will most likely have precedence over the corrected Law on Leasing and these problems will again deter lessors from working in Ukraine. This Article would fix the lease term to the leased asset's full depreciation period. The problems described above would arise inevitably and automatically every time depreciation rates were revised.

2. According to Article 16 of the Law on Leasing, lessors and lessees are limited to a redemption schedule for the leased asset that coincides with the asset's depreciation schedule. Furthermore, the last payment which redeems the cost of the asset at the end of the lease must be equal to the asset's book value rather than a previously agreed upon residual value and repayment schedule.

   Under a financial lease, the lessee must eventually assume ownership of the leased asset. According to Article 4, Clause 1, ownership may be transferred in two ways:

   a) 100% of the asset's value is repaid through regular lease payments, *with repayment corresponding to the asset's depreciated value for each payment period (Article 16, Clause 2 of the Law on Leasing), i.e.* 100% of the asset's book value is repaid to the lessor.

   b) 60% of the asset's value is repaid through regular lease payments, *with repayment corresponding to the asset's depreciated value for each payment period, followed by repayment of the asset's residual (book) value, i.e.* repayment of 60% of the leased asset's book value, followed by repayment of the residual (book) value.

   According to Article 16 of the Law on Leasing, lease payments must be broken down into its respective parts such as lessor's margin, reimbursement of interest, insurance, and redemption of the asset. Then, as seen above, the redemption portion of each lease payment should be equal to the portion of the leased asset that is depreciated in that period. The total amount paid as redemption of cost of the asset over the term of the lease must not be less than 60% of the leased asset's value, as established on the date when the agreement was signed (Article 4, Clause 1 of the Law on Leasing).

   The revised Law on Leasing that is with the VR, eliminates the problems with Article 16 and Article 4 described above. However, the proposed new Civil Code as described on the previous page as well as Article 860 of the proposed new Civil Code stipulates that the leased asset may be redeemed "at a

**price agreed upon by the parties and equal to the leased asset's book value." Therefore, the last payment will need to be equal to the book value of the asset which again diverts to long term payment schedules and higher risk transactions for lessors.**

3. **The Law on Leasing fails to provide an exact legal definition of "compensation for the depreciated value of the leased asset," which must be included in each lease payment under a financial lease.**

   The wording of the clause seems to imply that this portion of the lease payments is of a compensatory nature. However, the Law on Leasing explicitly states that:

   a) *The lessor retains full ownership of the leased asset for the duration of the lease;*

   b) *The lessee may not assume ownership of the leased asset until he has redeemed its value in full.*

   Hence, the lessee does not acquire any share of the leased asset by making regular lease payments (i.e., he does not gradually become a partial owner). Since the lessee does not obtain any ownership rights to the leased asset until he has redeemed it in full, the seemingly "compensatory" portion of the lease payment is actually a form of prepayment. Therefore, the lessee has the legal right to demand a full refund of these payments if the lease agreement is terminated prematurely, which in our opinion would not be fair to the lessor.

4. **Current legislation (the Law on Leasing) gives the lessor the right to repossess a leased asset if the lessee has failed to make two consecutive lease payments, but not in the case of any other breach of contract.**

   The party that bears the greatest risk in a leasing transaction is the lessor who acts as a financial intermediary between the lessee and the vendor. In order to alleviate this risk, some countries allow the lessor to use a simplified procedure for repossessing leased assets from the lessee in cases of lessee default, misuse of the leased asset, or any other circumstance that puts the leased asset in jeopardy.

   This simplified procedure is an essential element in making financial leasing an effective instrument allowing access to asset financing for enterprises that would otherwise be unable acquire said assets. If the lessor is able to reposess a leased asset quickly and efficiently, he can recover the capital he invested in the asset by leasing or selling it to another party.

   Unfortunately, Ukrainian lessors have to go through lengthy pre-arbitration procedures (30 days, not including mail delivery time, according to Articles 5 and 7 of the Arbitration Code), followed by a hearing in arbitration court (up to 2 months, according to Article 69 of the Arbitration Code).

5. **Neither the Law on Leasing, nor any other law, ensures the lessee's right to protect his interest in the leased asset before third parties.**

   Ukraine's Law on Ownership (Article 48, Clause 2) establishes that *"the* **owner** *of an asset may demand cessation of any violation of his ownership rights, even if this violation does not entail actual dispossession, as well as indemnification for losses incurred because of this violation."* Article 48, Clause 5 of the same law extends these provisions to "**any person** *other than the owner who* **possesses** *the property..., in accordance with the law or a legal contract.'*

   According to the Law on Leasing, lessees only receive usage rights to the leased asset. Therefore, it would seem that the above provisions of Article 48 do not apply to them. However, one might also attempt to draw a parallel with Article 28 of the Law on Rental of State or Communal Property, which protects a renter's interest in a rented asset to the same extent as the owner's.

   In reality, both scenarios are possible: the courts may either refuse to protect the lessee's interests, in accordance with the Law on Ownership, or they may recognize the lessee's rights by way of analogy with other laws. This ambiguity is a serious problem for both lessors and lessees.

6. **The Law on Leasing limits signatories of lease agreements to commercial entities.** This provision automatically disqualifies a number of potential lessees, including all institutions and organizations financed by the government (clinics, scientific institutes, etc.); agencies of the local, regional or national governments and non-profit research and educational establishments. This hardly seems justified, since many of these institutions are in urgent need of new equipment and machinery.

   **This issue will be corrected by the passing of the current draft of the revised Law on Leasing with the VR. However, this improvement would be erased if the current Civil Code draft of Article 858, which retains the clause "commercial entities," is adopted.**

7. **Ukrainian legislation does not make the vendor of a leased asset liable to the lessee for the quality or integrity of the asset, its timely delivery, warranty repair etc.**

   A traditional feature of financial leases is that the vendor should be liable to the lessee for the quality and integrity of the leased asset, its timely delivery, warranty repair, etc. The lessor, as a financing creditor, is thus relieved of this obligation.

   Unfortunately, the situation in Ukraine is somewhat different. Unless vendors are directly liable to lessees under trilateral agreements, they are in no way obligated to satisfy lessees' claims regarding a leased asset. At first glance, it may seem that **Article 12 of the Law on Leasing** does oblige

the vendor to satisfy such claims by granting the lessee all of the rights and responsibilities stipulated under the sales agreement. However, according to the **Ukrainian Civil Code (Article 164, Part 2)**, *"liability for non-fulfillment or improper fulfillment is borne by a party to the agreement, from which it has arisen."* Under a lease agreement, that party would be the lessor. Article 164 also states that, *"third party (e.g., vendor) will not bear any liability unless otherwise stipulated by law."* Since the **Law on Leasing** does not oblige the seller of the leased asset to satisfy any claims brought by the lessee, *"the lessor must bear full responsibility for non-fulfillment of these claims."*

It is important to note that the law only allows lessees to make claims regarding non-fulfillment of the terms of a sales agreement. It is not clear whether the same rights apply in cases where the vendor supplies the asset under some other type of agreement. This may be avoided by making sure that this point is emphasized in the purchase agreement between the lessor and vendor and then again in the lease agreement.

8. **In Article 1 of the Law on Leasing, leasing is defined as, "... a business activity, directed at investing one's own or attracted capital." The phrase "[one's] own or attracted capital" may be interpreted to mean that <u>a lessor may not take out loans from a bank or other credit organization in order to fund the purchase of a leased asset.</u>**

   **Ukraine's Law on Investment Activity, (Article 10 Clause 1, para.1 and 3),** clearly defines three types of financial sources of investment: an entity's own <u>working capital</u>, <u>borrowed funds</u>, or <u>attracted capital</u>. The Law on Leasing does not include borrowed funds (defined as loans from banks or other credit organizations) as a possible source of finance for leases.

   Bank loans and bonds are not referred to as attracted capital (Article 5, Clause 2 and Article 10 of the said law). It's true that, Article 7, Clause 4 of the Law entitles an investor to attract capital in the form of loans. However, the issue whether it will be an investor's attracted capital or an investor's borrowed capital remains unresolved (Article 5, Clause 2 and Article 10 of the **Law On Investment Activity**). Hence, there arises the ambiguity as to whether borrowed funds may be used for the purchase of leased assets.

   One might assume, on the following grounds, that this was simply an oversight on the part of lawmakers and that the provision was not meant to be enforced:

   1) The omission of "borrowed funds" contradicts other clauses within the Law, which refer to "capital borrowed from creditors."
   2) Ukrainian lessors have chosen to ignore the matter altogether and frequently borrow money from banks in order to purchase leased assets.
   3) Most importantly, if this point were to be enforced, it would undermine the very nature of leasing as a financial mechanism.

9. **The current arbitration system is extremely inefficient.**

The pre-arbitration procedure aims to give the parties an opportunity to settle out of court by requiring the claimant to give the defendant at least 30 days notice, not including mail delivery time (Articles 5 and 7 of the Arbitration Code). Article 5 of the Arbitration Code enumerates all of the cases where pre-arbitration proceedings are not required; leasing is not one of them. In fact, pre-arbitration proceedings are clearly required in each of the following cases:

a) *disputes concerning repossession of a leased asset from the lessee by the lessor;*

b) *disputes concerning repossession of the leased asset from a third party;*

c) *disputes concerning restitution of an illegally seized asset to the lessee;*

d) *disputes concerning recovery of overdue lease payments from the lessee.*

Furthermore, Article 69 of the Arbitration Code stipulates that the arbitration courts should resolve disputes within two months after claims were filed. In cases where the leased asset is at risk of damage or destruction, the lessor simply cannot wait that long: he needs to be able to repossess his asset even before the arbitration hearings begin. This might be achieved with the help of security measures, but Article 67 of the Arbitration Code contains an *exhaustive list of such measures, and these only prohibit the lessee from performing certain actions;* they do not authorize the courts to *compel the lessee to perform any actions.* For instance, the courts cannot require the lessee to transfer the asset into the lessor's custody for the duration of the arbitration hearings but they may prevent the lessee from moving it or using it in a certain way.

10. **Legislation related to leasing contains various contradictions and ambiguities. The following section will point out some of the most significant and comment on the risks they present to parties to a transaction and how they may hinder the enforcement of lease agreements.**

a) **The lessor may be found to have no method of repossessing a leased asset in the case of lessee default, neither through the courts, nor on the basis of a notary's writ of execution.**

This problem would not have arisen, had not the Supreme Arbitration Court decreed in its Letter #01-8/104 of 03/23/98 (henceforth "Letter") that *"claims regarding repossession of a leased asset due to payment default by the lessee shall not be heard in any arbitration court."* Unfortunately, Article 12, Clause 3 of the Law on Arbitration Courts stipulates that *"explanations issued by the Supreme Arbitration Court are compulsory for all judges and relevant commercial entities."* The Letter is not officially defined as an "Explanation," and its preamble merely indicates a need "to draw the atten-

tion of the arbitration courts to the meaning of certain clauses in the Law on Leasing..." At no point does the Letter use the term "explanation." However, the clauses laid out within the letter are clearly explanations by their very nature. Therefore, arbitrators may deem the provisions of the Letter to be compulsory, which could cause significant problems for the lessor.

It is not always feasible to repossess a leased asset on the basis of a notary's writ of execution. Article 47 of the Law on Notary Services stipulates that notaries may not sign any document that has corrections, additions, crossed-out words or other unexplained corrections, defects that render any portion of the text illegible, or any text written in pencil. While these requirements are not always observed in practice, they may serve notaries as sufficient grounds for refusing writs of execution. Therefore, lessors must also have the right to defend their interests in court.

b) **The law only allows lessees to make claims regarding non-fulfillment of the terms of a sales agreement.** It is not clear whether the same rights apply in cases where the vendor supplies the asset under some other type of agreement (the law does not require the lessor to obtain the leased asset under a sales agreement). This ambiguity is of major concern to all parties.

c) **Article 4 of the Law on Leasing requires the lessee to assume ownership on an asset under financial lease, but other provision of the same law cast this requirement into doubt.** Article 10, Clause 2 stipulates that the lease agreement must allow for, rather than require, redemption of the leased asset by the lessee upon expiration of a financial lease. This appears to be a mere slip of the pen. The clause should only have provided for the lessee's option of redeeming the asset *either before or after the lease expires.*

Articles 11 and 12 of the Law on Leasing contain similar provisions. Article 12, Clause 2 (Subclause 5) refers to the lessee's right, not his obligation, to redeem the leased asset. *Article 11, Clause 2 stipulates that the lessor must take the leased asset back upon expiration of the lease unless the lessee has redeemed it.* Evidently the author did not quite grasp the specific rights and obligations associated with financial and operating leases in other parts of the Law on Leasing.

d) **While one clause of the Law on Leasing (Article 6, Clause 1) limits the possible signatories to a multilateral lease to the vendor, lessor and lessee, another clause (Article 6, Clause 1) allows for the "involvement" of one or more lenders under a shared lease agreement.**

At the first glance, it would seem that lenders may not be signatories to shared lease agreements. A shared lease implies "the execution of a multiparty agreement (where only the seller, the lessor and the lessee are signatories) and the involvement of one or more lenders." The ambiguity can only be resolved through clarification of the phrase "*involvement of one or more*

*lenders."* Article 21 of the Law on Leasing, which requires the registration of shared lease agreements involving state-owned capital, gives one reason to assume that lenders may also act as parties to a shared lease.

e) **While one clause of the Law on Leasing (Article 7, Clause 1) makes insurance provisions compulsory for lease agreements, another clause indicates that the leased asset should be insured "...subject to agreement between the parties, and in accordance with current legislation."**

Article 14, Clause 4 of the Law on Leasing establishes that *"...the parties may elect to insure any of the following in accordance with current legislation:"* a) the leased asset; b) any risks arising from the execution of the lease agreement; c) the risk of accidental ruin or damage. Nevertheless, there is no doubt that the text of a lease agreement must include provisions for insuring a leased asset, (otherwise, according to Articles 48 and 153 of the Ukrainian Civil Code, the agreement may be declared null and void).

A simple comparative analysis of Articles 7 and 14 of the Law on Leasing enables us to draw the following conclusions:

1) The only type of insurance that must be provided for under the lease agreement is insurance of the leased asset itself;
2) The parties are free to decide whether or not to provide for other kinds of insurance.

f) **One clause of the Law on Leasing (Article 7, Clause 1) requires lease agreements to include provisions for registering the leased asset, while another clause (Article 13, Clause 2) states that the leased asset need only be registered in cases stipulated under Ukrainian law.**

The incongruity is obvious. On the one hand, Article 13 states that "the leased asset need only be registered in cases specified by current Ukrainian legislation." Article 13 also allows the parties to register the leased asset in either the lessor's name or the lessee's. Article 7, on the other hand, indicates that all leased assets must be registered (otherwise, according to Articles 48 and 153 of the Civil Code, the lease agreement may be declared null and void).

Therefore, if the law specifies that a given asset must be registered, as well as the procedures for doing so, then the parties should decide who will register the asset, in whose name, and under what conditions (unless these factors are already determined by law). If the law does not specify whether an asset should be registered, the parties should decide who will register the leased asset, in whose name and under what conditions in the event that registration should become legally compulsory.

# ANNEX II

## MODEL LEASING AGREEMENT

The purpose of this Appendix is to assist enterprises who are entering their first lease agreement to analyze the full impact of the lease agreement. For a better understanding of the essential provisions and specific terminology used in this model, we suggest that you refer back to the appropriate sections of this manual.

For the sake of clarity, certain provisions of this model agreement will be accompanied by commentary, particularly those provisions that were not discussed within the main sections of the manual. Please bear in mind that the Model Agreement is only an amalgam of the most common essential provisions. It is not a ready-made formula, fit for any situation. Its goal is merely to help you draft more effective agreements.

**MODEL LEASE AGREEMENT № _____**

**City of Kiev** **«___»_____2001**

**PREAMBLE**

VERSION 1: Preamble of an agreement between Ukrainian residents

**_____(COMPANY NAME)_____, state registration # ____ issued _____ 200_, identification code #_____, further referred to as the Lessor, in the person of the director _____, acting on the basis of the Statute, as one party, and _____ (COMPANY NAME) _____, state registration # ____ issued _____ 200_, identification code #_____, further referred to as the Lessee, in the person of the director _____, acting on the basis of the Statute, as the other party (the Lessor and the Lessee may be referred to herein collectively as the Parties and individually as a Party) conclude the following Agreement:**

VERSION 2: Preamble of an agreement between a Ukrainian resident and a foreign entity

**_____(COMPANY NAME)_____, state registration # ____ issued _____ 200_, identification code #_____, further referred to as the Lessee, in the person of the director _____, acting on the basis of the Statute, as one party, and _____(COMPANY NAME)_____, which is a legal entity under the jurisdiction of _____, excerpt from the trade, banking, or judicial register (indicate document proving state registration in another country), further the Lessor, in the person of the director _____, acting on the basis of the _____, as the other party, (the Lessor and the Lessee may be referred to herein collectively as the Parties and individually as a Party,) conclude the following Agreement:**

**COMMENTS:** *The preamble is an important part of an agreement, but non-lawyers usually neglect to fill it out carefully. If the parties fail to indicate within the preamble their proper legal authority (i.e., list of commercial activities provided for by the Statute) or the authority of the persons signing the agreement, or if they fail to observe the proper signing procedures established for their particular type of agreement, the essential terms of the agreement may lose their legal force. The Ukrainian Civil Code stipulates that agreements may be declared null and void if they fail to comply with all legal requirements (Article 48); if they are concluded contrary to the interests of one of the parties (Article 50); if one of the signatories was not legally authorized to represent the legal entity on whose behalf he signed the agreement, unless this entity gives further consent (Article 63); or if a foreign trade agreement failed to comply with current signing procedures at the time when it was concluded (Article 45).*

*The preamble must also clearly identify each of the signatories; i.e., it must provide the full names of all parties, whether legal entities or private entrepreneurs, as well as the full names of any officers authorized to sign on behalf of legal entities. It must also provide details of documents that prove the parties' commercial status, the state registration of foreign participants, and the authority of individuals signing on behalf of legal entities.*

## 1. SUBJECT OF THE AGREEMENT

*This section will present versions of both types of essential provisions: a) those required by law (Article 7, Clause 1 of the Law on Leasing); b) those which may be written into the agreement only by mutual consent of the parties. Our suggested provisions will suit most lease agreements regardless of their type or form. Some problematic provisions will be accompanied by brief Commentary.*

**Clause 1.1:** *Composition and value of the leased asset, and its usage period*

1. In accordance with the terms of this Agreement, the Lessor will provide and the Lessee will accept into exclusive paid use until _____ 200_ the following assets (further referred to as leased asset/s):

| # | List of Leased Assets | Quantity | Asset's Value on Date of Signing |
|---|---|---|---|
| 1. | | | |
| 2. | | | |
| Total Value of Assets on Date of Signing | | | |

2. Usage of the Leased Asset implies that the asset will be used for the following purposes: _____
_____.
3. The date specified in this clause is the last date when the Leased Asset may be used.



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4. **Whenever the leased asset's depreciation rate is legally revised, its usage period shall be extended automatically either: a) proportionate to the revised depreciation rates; or b) through an adjustment of the leased asset's depreciated value over the usage period.**

**COMMENTS:** *The Law on Leasing makes the leased asset's usage term strictly dependent on its depreciation period. Therefore, a lease agreement that fully complies with the law at the time of signing may suddenly become invalid if the depreciation rates are legally revised. (For more details, see Annex I "Weaknesses of Ukrainian Leasing Legislation"). The provision suggested under subclause 4 is not a foolproof solution to this problem. However, it may help to mitigate the effects.*

**Clause 1.2:** *Terms and conditions for the leased asset's transfer and receipt*

Version 1 (the lessor delivers the leased asset)

**Between the dates of _____ and _____ 200_, the Lessor shall prepare and deliver the leased asset to the Lessee at the following address: _____, on the basis of a Transfer and Receipt Act, signed by duly authorized representatives of both Parties.**

Version 2 (the lessee arranges for delivery of the leased asset)

**Between the dates of _____ and _____ 200_, after duly authorized representatives of both Parties have signed a Transfer and Receipt Act, the Lessee shall remove the leased asset from the Lessor's premises at (full address) and arrange for its delivery to his own premises.**

Version 3 (the vendor delivers the leased asset)

**The vendor of the leased asset shall deliver the asset to the lessee, _____, on the basis of a Transfer and Receipt Act (signed by duly authorized representatives of both Parties) and in full compliance with the terms of Sales (Supplier's) Agreement #____ signed _____ 200 _; specifically:**

**delivery date – _____;**
**place of delivery, transfer and receipt _____;**
**other terms _____.**

**COMMENTS:** *The terms for transferring and delivering the leased asset are important not only in their own right, but also in relation to the transfer of financial obligations (e.g., liability for damages). For example, Article 14, Clause 3 of the Law on Leasing stipulates that if the leased asset is damaged or ruined during a delay in its transfer or delivery, the party that caused the delay will be held liable. Furthermore, proper fulfillment of the transfer and delivery terms must be proven in writing. Therefore, the parties must be able to provide legal documentation confirming the transfer and receipt of the leased asset. If the representative who signs for the leased asset is not legally authorized to do so, the relevant party may have to bear full responsibility for any damages incurred during delayed transfer of delivery.*

*One should also remember that when the lessee signs for a leased asset delivered directly by the vendor, he certifies not only the delivery, but also the transfer of ownership to the lessor. Therefore, if the lessee is reluctant to assume this additional responsibility, he should insist that the lessor send a representative to sign the Transfer and Receipt Act.*

**Clause 1.3:** *Composition, size and schedule of lease payments*

**1. For the duration of this Agreement, the Lessee will make lease payments to the Lessee, by means of transfers to the lessor's bank account, #_____ in (name, address and MFO of lessor's bank) (or any other bank account specified by the Lessor), on the following dates, for the following amounts, and of the following composition:**

| | |
|---|---|
| 25 September 200_. | Total 2000 (two thousand) Hr, including: |
| | 500 (five hundred) Hr — fee for use of the leased asset;<br>500 (five hundred)Hr — compensation for the asset's depreciated value;<br>500 (five hundred)Hr — compensation for interest paid under loan agreement # __ of _____ 200_;<br>500 (five hundred)Hr — compensation for insurance payments made under Insurance Agreement #___ of _____ 200_ |
| 13 November 200_. | Total 1200 (twelve hundred) Hr, including: |
| | 300 (three hundred) Hr — fee for use of the leased asset;<br>300 (three hundred)Hr — compensation for the asset's depreciated value;<br>300 (three hundred)Hr — compensation for interest paid under loan agreement # __ of _____ 200_;<br>300 (three hundred) Hr — compensation for insurance payments made under Insurance Agreement #___ of _____ 200_. |

And so on.

2. The Lessor shall be responsible for complying with any additional requirements introduced by law during the term of the lease, including: registration of the agreement or the leased asset, insurance for events related to the execution of this agreement, and any other legal requirements that directly affect the execution of this agreement. The Lessee shall reimburse the lessor for any

expenses he incurs in complying with these new requirements. Such reimbursement shall be made no later than two working days after the lessor has provided the lessee with written notification of these expenses, along with supporting documentation.

COMMENTS: *The Law on Leasing (Articles 1, 7 and 16) requires that the lease agreement clearly specify the size, composition and payment schedule for all leasing charges that can be known beforehand. There is always a possibility that new regulations will come into effect over the course of the lease, and that compliance with these regulations will entail additional expenses. Subclause 2 stipulates the obligations of each party in such cases.*

*The composition of lease payments used in this model is only an example. For the sake of presentation, it includes all of the types of leasing charges specified under Article 16 of the Law on Leasing, even though some of these are rather atypical for real lease agreements.*

**Clause 1.4:** *Conditions for revising the size, composition or schedule of lease payments*

**1. The Parties may decide to revise the size, composition or schedule of lease payments.**

**2. If the legal depreciation rate for the leased asset should change over the term of this agreement, the amount of compensation for the leased asset's depreciated value, as specified under Clause 1.3 of this Agreement, shall be adjusted in proportion to the new depreciation rate.**

**The Parties shall accept this adjusted amount of compensation for the leased asset's depreciated value beginning with the date when the depreciation rate was revised.**

**3. If the interest rates specified under Loan Agreement # ___ of ___ _____ 200_ (henceforth** *Loan Agreement***) should be reduced, the amount of compensation payable to the lessor, as specified under Clause 1.3, shall be adjusted accordingly. The rate of interest shall not exceed that which is specified under the Loan Agreement.**

**4. If the Lessor's rate of interest under the Loan Agreement should increase, the Lessee shall increase the amount of compensation accordingly, as stipulated under Clause 1.3 of this Agreement, but only if the Lessor gave his written consent to this increase beforehand and the Loan Agreement provided for such automatic revisions with the Lessee's consent.**

**5. Disputes concerning any revision of the size, composition or schedule of lease payments shall be resolved according to the procedures established by current legislation.**

COMMENTS: *Each party is entitled to introduce changes or amendments to the lease agreement. However, the size of specific lease payments (compensation for the leased asset's depreciated value plus the lessor's loan interest) does not depend solely on the parties' will. Clauses 2, 3 and 4 attempt to regulate these questions.*

*Subclause 4, like Subclause 4 in Clause 1.1, does not offer total protection against the possibility that the lease agreement will fall out of compliance with the law over the term of the lease* (see the Appendix on "Weaknesses of Ukrainian Leasing Legislation"). *However, Subclause 4 may at least mitigate the effects of any changes in legislation.*

Clause 1.5: *Conditions for revaluing the leased asset*

**1. In cases specified by this Agreement and current legislation, the leased asset's book value may either be appreciated (increased by the amount of revaluation) or devaluated (reduced by the amount of revaluation).**

**2. The leased asset will undergo revaluation whenever its book value differs from the value of its remaining service life by ___% (_____ percent) or more. The value of the leased asset's useful service life will be determined on the basis of an evaluation requested by the Lessor and performed by one of the following independent experts: _____.**

**3. The leased asset will also undergo revaluation whenever required by law in accordance with the procedures established by this Clause, unless other procedures are stipulated under current legislation.**

COMMENTS: *The suggested draft of Clause 1.5 is not universally applicable. The parties may stipulate other cases and procedures for revaluation of the leased asset (see also Section IV "Financial Aspects of Enforcing a Lease Agreement"). Furthermore, the parties to a financial lease agreement have to realize that the title to the leased asset may not change hands until the leased asset has been redeemed in full.*

Clause 1.6: *Conditions for repossessing the leased asset in the event of lessee insolvency*

1. If an arbitration court should initiate bankruptcy proceedings against the Lessee, the Lessee must notify the Lessor in writing and return the leased asset within seven calendar days after the court issues its decision, unless the parties conclude a written agreement to extend this period.

2. Should the lessee fail to fulfill his obligations under this Clause, or should fulfillment of these obligations seem unfeasible, the lessor may summarily repossess the leased asset; the lessor shall assist him and compensate him for all expenses incurred.

COMMENTS: *Clause 1.6 is not obligatory. The parties are free to determine any other procedure for repossessing the leased asset in the event of the lessee's bankruptcy (see also Section IV "Financial Aspects of Enforcing a Lease Agreement").*

Clause 1.7: *Conditions for insuring the leased asset*

1. The Lessor/Lessee shall bear the risk of accidental damage to or destruction of the leased asset.

2. The Lessor/Lessee shall insure the leased asset against accidental damage or destruction with any one of the following insurance companies: _____.

3. The Lessee shall reimburse the Lessor for the cost of insurance payments, as stipulated under Clause 1.3 of this agreement.

COMMENTS: *The terms for insuring the leased asset will vary according to the type of agreement, the legal requirements and the wishes of the signatories (see also Section IV "Financial Aspects of Enforcing a Lease Agreement"). Our model only satisfies the minimum requirement of the Law on Leasing (Article 7): to insure the leased asset itself.*

Clause 1.8: *Conditions for utilizing the leased asset and performing technical maintenance and upgrades*

1. The Lessee must: operate the leased asset in accordance with its intended purpose, the manufacturer's technical manuals and the conditions of this agreement; maintain the leased asset in operating condition; maintain the leased asset at his own cost; perform all technical service and both minor and major repairs; and replenish all consumable supplies required by the asset.

2. The Lessee may not enhance or upgrade the leased asset without the Lessor's written consent. The Lessee is entitled to recover costs incurred by such enhancements or upgrades if the Lessor has signed a written agreement to that effect beforehand. If such reimbursements have not been agreed upon in advance, and the enhancements may be separated from the leased asset without damaging it, then the Lessee may retain these enhancements upon expiration or termination of the lease.

3. If enhancements performed with the Lessor's consent should transform the leased asset into a new asset, then the Lessee shall be granted partial ownership of the new asset (i.e., of the added components).

4. The Lessee may not claim reimbursement from the lessor for any enhancements performed without the lessor's consent.

COMMENTS: *This is just one possible version of the conditions for operating, maintaining and upgrading the leased asset. The Parties have considerable freedom to establish their own terms, depending on the type of lease agreement and its particular provisions (see also Section IV "Financial Aspects of Enforcing a Lease Agreement").*

Clause 1.9: *Reporting on the Technical State of the Leased Asset*

1. The Lessee shall provide the Lessor with a monthly report on the technical state of the leased asset no later than the 4th day of the following month.

2. The Lessee shall allow duly authorized representatives of the Lessor unrestricted access to the leased asset twice per calendar

month, at times confirmed in advance by the Lessee, for the purpose of inspections.

3. The Lessee shall give the Lessor written notice within 24 hours after discovering any defect, breakage or malfunction in the leased asset, after failing to perform obligatory, periodic maintenance, or after any other event that could have a negative effect on the leased asset's technical condition.

4. The Lessee shall give the Lessor written notice of any major repairs or upgrades of the leased asset at least 7 calendar days in advance.

5. Should the need for emergency repairs arise, the Lessee shall notify the Lessor at least 24 hours before undertaking such repairs.

COMMENTS: *This is only one possible version. The Parties are free to structure this clause to suit their particular needs. However, lessors should realize that the clearer these provisions are, the easier it will be for them to obtain accurate and timely information about the condition of a leased asset. The Law on Leasing (Article 12, Clause 2.4) requires the lessee: a) to report to the lessor on the technical state of the leased asset; b) to allow the lessor unrestricted access to the asset to verify its condition and the manner in which it being used, within the time periods specified under the agreement (see also Section IV "Financial Aspects of Enforcing a Lease Agreement").*

**Clause 1.10:** *Conditions for registering the leased asset*

Version 1: The Lessor registers the asset

1. The leased asset shall be registered by the Lessor in his own name with the [full name of government agency] at the lessor's principal place of business no later than ____ calendar days after the Agreement was signed.

2. If, over the term of this Agreement, new regulations should go into effect requiring the leased asset to be registered with additional government agencies, the Lessor shall register the leased asset with these agencies at his principal place of business and in his own name, unless otherwise agreed between the Parties.

3. The Lessee shall reimburse to Lessor for all costs incurred in registering the leased asset, as stipulated under Clause 1.3 (2) of this Agreement.

Version 2: The Lessee registers the asset.

1. The leased asset shall be registered by the Lessee in his own name with the [full name of government agency] at the Lessee's principal place of business no later than ____ calendar days after the Agreement was signed.

2. If, over the term of this Agreement, new regulations should go into effect requiring the leased asset to be registered with additional government agencies, the Lessee shall register the leased

**asset with these agencies at his principal place of business and in his own name, unless otherwise agreed between the Parties.**

**COMMENTS:** *These are just two variants. The parties are free to structure this clause to suit their particular needs and conditions (see also Section IV "Financial Aspects of Enforcing a Lease Agreement").*

**Clause 1.11:** *Conditions for returning or redeeming the leased asset*

I. Conditions for returning the leased asset:

**1.The Lessee shall return the leased asset to the Lessor in the state in which it was received (except for reasonable wear and tear), no matter whether the lease has expired or been terminated prematurely.**

Return of Asset to Lessor

Version A: The lessee returns the asset to the lessor.

**The Lessee shall return the leased asset to the Lessor at [full address] on the basis of a Transfer and Receipt Act duly signed by both Parties' authorized representatives. If the lease has expired, the Lessee shall return the leased asset within the maximum usage term specified under Clause 1.1; if the lease has been terminated prematurely, the lessee shall return the asset within 72 hours.**

Version B: The lessor repossesses the asset.

**The Lessor, with maximum support from the Lessee, shall arrange and undertake to remove the leased asset from the lessee's possession at [full address] on the basis of a Transfer and Receipt Act duly signed by both Parties' authorized representatives. If the lease has expired, the Lessor shall remove the asset within the maximum usage term specified under Clause 1.1; if the lease has been terminated prematurely, the Lessor shall remove the asset within 72 hours.**

II. Redemption of the Asset under a Financial Lease

Version 1: The lessee fully redeems the leased asset through his regular lease payments.

**1. The Lessee shall redeem the leased asset by compensating the Lessor for the its full depreciated value, as stipulated under Clause 1.3 of this Agreement.**

**2. The Lessee shall assume ownership of the leased asset as soon as he has compensated the Lessor for its full depreciated value.**

Version 2: The lessee redeems the leased asset by compensating the lessor for both its depreciated and residual values.

**1. The Lessee shall redeem the leased asset by transferring the sum of ____ Hr, equal to the asset's residual value, to the Lessor's bank account #_____ in [full name, address and MFO of lessor's bank], or any other bank account specified by the Lessor, within the maximum usage term specified under Clause 1.1 of this Agreement.**

2. The Lessee shall assume ownership of the leased asset as soon as he has compensated the Lessor for both its depreciated and residual values.

*Version 3: The lessee redeems the leased ahead of term by compensating the lessor for its residual value.*

1. The Lessee shall redeem the leased asset by transferring the sum of ____ Hr, equal to the asset's residual value, to the Lessor's bank account #_____ in [full name, address and MFO of lessor's bank], or any other bank account specified by the Lessor, within the maximum usage term specified under Clause 1.1 of this Agreement.

2. The Lessee may redeem the asset earlier by transferring the sum of ____ Hr, equal to the asset's residual value, to the Lessor's bank account #_____ in [full name, address and MFO of lessor's bank], or any other bank account specified by the Lessor, between the dates of _____ 200_ and _____ 200_.

3. The Lessee shall assume ownership of the leased asset as soon as he has compensated the Lessor for both its depreciated and residual values.

COMMENTS: *These versions are only suggestions. The parties are free to structure this clause to suit their particular needs and conditions (see also Section IV "Financial Aspects of Enforcing a Lease Agreement").*

Clause 1.12: *Conditions for early termination of this Agreement*

1. The Lessor may demand early termination of the agreement in the following cases:

1) The Lessee has misused or neglected the leased asset.

2) The Lessee has impaired the condition of the leased asset through misconduct or gross negligence.

3) The Lessee has transferred the leased asset to a third party without the Lessor's consent.

4) The Lessee has missed two consecutive lease payments.

5) The Lessee has failed to perform major or minor repairs on the leased asset within the time frame established under this Agreement.

6) The Lessee is more than 10 (ten) calendar days late in providing the Lessor with information about his (the Lessee's) financial standing or the leased asset technical condition;

7) The Lessee has failed on one or more occasions to give the Lessor (or his duly authorized representative) unrestricted access to the leased asset for the purpose of inspection.

8) The Lessee's negligence or actions jeopardize the leased asset, or exposes it to the risk of damage or destruction.

**COMMENTS:** *The Law on Leasing (Article 17, Clause 2) entitles the parties to terminate their agreement, in accordance with established procedures, "...should any terms of the lease agreement be violated." This means that if either party breaches the terms of the lease agreement, the injured party may file suit with the arbitration courts for early dissolution of the contract under the provisions of Articles 1 and 11 of the Arbitration Code (though he must first go through a thirty-day pre-arbitration waiting period). In order to avoid unnecessary disputes, the parties should always specify beforehand the possible grounds for early termination (see also Section IV "Financial Aspects of Enforcing a Lease Agreement").*

**2. The Lessor may unilaterally terminate the lease and summarily repossess the leased asset on the basis of a notary's writ of execution should the Lessee miss two consecutive lease payments.**

**COMMENTS:** *The List of Documents on the Basis of which Debts May Be Recovered in a Summary Fashion on the Basis of a Notary's Writ of Execution (Clause 8), contained within CMU Resolution 1172 of 06/26/99, stipulates that a creditor (in our case the lessor) may not summarily repossess an asset with a notary's writ of execution unless he is able to provide an original agreement that explicitly allows for summary repossession. Hence, the lessor may be denied a notary's writ of execution, even if the lessee has missed two consecutive lease payments, if the lease agreement fails to include the necessary provision*

*Furthermore, Article 162 of the Civil Code permits unilateral termination of an agreement only in certain cases specified by law. Repossession of a leased asset is one such case, but one would be well advised to emphasize this point in the lease agreement (see also Section IV "Financial Aspects of Enforcing a Lease Agreement").*

**3. The Lessee may request from the court to terminate the Agreement in the following cases:**

**1) The asset becomes unusable due to circumstances for which the Lessee is not responsible.**

**2) The Lessor fails to perform major or minor repairs on the leased asset as required under the Agreement.**

**3) The Lessee discovers defects in the leased asset which prevent him from using it for its intended purpose or in accordance with the Agreement.**

**COMMENTS:** *The Law on Leasing (Article 17, Clause 2) entitles the parties to terminate their agreement, in accordance with established procedures, "...should any terms of the lease agreement be violated." This means that if either party breaches the terms of the lease agreement, the injured party may file suit with the arbitration courts for early dissolution of the contract under the provisions of Articles 1 and 11 of the Arbitration Code (though he must first go through a thirty-day pre-arbitration waiting period). In order to avoid unnecessary disputes, the parties should always specify beforehand the possible grounds for early termination (see also Section IV "Financial Aspects of Enforcing a Lease Agreement").*

4. The Lessee may unilaterally terminate the Agreement if the leased asset fails to comply with his stated requirements. However, the Lessor and/or Vendor of the leased asset shall have 30 days to bring the asset into full compliance with the Lessee's demands or provide a suitable replacement.

COMMENTS: *The Civil Code (Article 213, Part 2) establishes that "the creditor may refuse to meet his obligations, and may recover all losses, if the debtor's tardiness in fulfilling obligations has caused damage to the lessor's interests under the agreement." Therefore, the lessee effectively terminates the lease agreement whenever he rejects a leased asset. If the lessor and the vendor would like to avoid such unexpected dissolution of the lease agreement, they should stipulate within the agreement a deadline by which all of the leased asset's defects may be corrected (see also Section IV "Financial Aspects of Enforcing a Lease Agreement").*

Clause 1.13: *Conditions for reporting on the lessee's financial standing*

1. For the duration of the lease, the Lessee must provide the Lessor with the following certified documents:

- Form #1 «Balance Sheet», provided monthly no later than the 12th day of the following month;
- Form #2 «Income Statement», provided monthly no later than the 12th day of the following month;
- Form #3 "Statement of Enterprise's Finances and Assets" (essentially an abridged Cash Flow Statement), provided annually no later than the 24th day of the following fiscal year.

COMMENTS: *This is only one possible version. The Parties are free to structure this clause to suit their particular needs. However, lessors should realize that the clearer these provisions are, the easier it will be for them to obtain accurate and timely information about the lessees financial standing. The Law on Leasing (Article 12, Clause 2.4) requires the lessee to report to the lessor on his (the lessor's) financial standing on the dates specified under the agreement (see also Section IV "Financial Aspects of Enforcing a Lease Agreement").*

Clause 1.14: *The Parties' Liabilities*

1. Any Party that fails to fulfill his obligations under this Agreement shall compensate the other party for any losses incurred.

2. The Lessee shall compensate the Lessor for losses suffered due to any deterioration in the leased asset's condition, unless the Lessee can demonstrate that he was not to blame for this deterioration.

3. Any Party that defaults on payments stipulated under this Agreement shall pay the other Party a penalty of 0.5% of the overdue amount for each day the payment is delayed, but in total this penalty shall not be more than two times the NBU's discount rate for the overdue amount. Payment of this penalty shall not

exempt the defaulting Party from making the overdue payment.

4. Every time the Lessee misuses the lease asset, he shall pay the Lessor a fine in the amount of ____% of the leased asset's total value.

5. Any Party that fails to provide in a timely fashion any information, data, statements or other documents required under this Agreement shall be fined _____ Hr for each violation.

6. Version A. Should the Lessee fail to return an asset under operating lease within the maximum usage period, or should he fail to return the leased asset by the deadline for early return specified under the law or this Agreement, then he shall pay the Lessor a fine in the amount of 0.__% (_____) of the leased asset's total value. Payment of this fine shall not relieve the Lessee of his obligation to return the leased asset and pay an additional fee (as stipulated under this Agreement) for using the asset beyond the established deadline.

   Version B. Should the Lessee fail to redeem an asset under financial lease within the maximum usage period, or should he fail to return the leased asset by the deadline for early return specified under the law or this Agreement, then he shall pay the Lessor a fine in the amount of 0.__% (_____) of the leased asset's total value. Payment of this fine shall not relieve the Lessee of his obligation to redeem the leased asset and pay an additional fee (as stipulated under this Agreement) for using the asset beyond the established deadline.

COMMENTS: *The following is only one possible version of Clause 1.14. The Parties are free to structure this clause to suit their particular needs. (see also Section IV "Financial Aspects of Enforcing a Lease Agreement"). When the lessee fails to return or redeem a leased asset in a timely fashion, he clearly continues to use it in the meantime. The lessor should obviously be compensated for this unauthorized use of his property. Since the law does not stipulate any fee for unauthorized use, the Lessor would be better off writing this provision into the Agreement.*

7. If the Lessee should hinder the Lessor from inspecting the leased asset, monitoring its repair and/or technical maintenance, or repossessing it in cases specified by the law and/or this Agreement, or should the Lessee fail to support the Lessor in these undertakings in such a way as to prevent him from exercising his legal rights, then the Lessee shall be fined in the amount of _____ for each time he fails to fulfill these obligations.

8. Any party that fails to fulfill payment obligations in a timely manner at the request of the other Party shall repay the overdue amount, adjusted by the established rate of inflation for the entire overdue period, as well as ____ % (annual interest rate).

COMMENTS: *This subclause almost replicates the provisions of Article 214 of the Ukrainian Civil Code, except for the size of the interest payments: Article 214 suggests an annual interest rate of 3% on overdue payments. However, the Article permits the parties to choose an interest rate at their own discretion, except for certain cases specified by law.*

Clause 1.15: *Registering payments in the accounting records*

**1. Should the lessee have overdue lease payments, any payment that he makes towards fulfillment of his obligations under the Agreement shall first be counted towards settlement of his overdue debt, unless otherwise stated under current legislation.**

COMMENTS: *This provision is not obligatory, but it is advisable for many lease agreements, as it clarifies the procedures by which the lessee shall fulfill his financial obligations.*

**2. Unless otherwise stated under current legislation:**

**a) the lessee may not redeem an asset under financial lease until he has fulfilled all of his lease payment obligations under the Agreement;**

**b) any funds that the Lessee pays as compensation for the value of the leased asset shall first be counted towards settlement of his outstanding lease payments, calculated on the day such funds are transferred.**

COMMENTS: *This provision is not obligatory, but it is advisable for many lease agreements, as it prevents the lessee from assuming ownership of the leased asset until he has fulfilled all of his financial obligations towards the lessor.*

## 2. RIGHTS AND RESPONSIBILITIES OF THE PARTIES

*This section is typical for any type of agreement. It reiterates and, to a certain extent, clarifies the rights established under the essential terms of agreement. The following version is only a rough example. The Parties are free to structure this clause to suit their particular needs.*

Clause 2.1 *The Lessor's rights and obligations*

1. The Lessor has the following rights:

1) To monitor the Lessee's use and maintenance of the leased asset, in accordance with the terms and procedures specified under this Agreement;

2) To repossess the leased asset unilaterally should the Lessee miss two consecutive lease payments;

3) To demand early dissolution of this Agreement and repossess the leased asset in the cases specified under current legislation and in this Agreement;

4) To demand compensation for losses incurred due to the Lessee's misconduct or gross negligence.

2. The Lessor has the following obligations:

   1) To provide the Lessee with a fully operating leased asset in total compliance with the contract terms;

   2) To inform the Lessee about any special features of the leased asset that may pose a health risk to the Lessee or any other persons, or that may cause the asset to break or malfunction during use.

   3) To perform both major and minor repairs on the leased asset in full compliance with the terms of this Agreement;

   4) To reimburse the lessee for all costs incurred in repairing, upgrading or enhancing the leased asset in any of the circumstances specified under this Agreement;

   5) To take the leased asset back in the event that this Agreement is terminated prematurely [or when the usage term expires under an operating lease].

Clause 2.2 *The Lessee's rights and obligations*

1. The Lessee has the following rights:

   1) To reject a leased asset that does not fully satisfy his stated requirements or fully comply with the contract terms;

   2) To withhold lease payments for the duration of any period during which he is unable to use the leased asset for its intended purpose due to circumstances beyond his control;

   3) To demand a reduction in the fee for using the leased asset if the proper functioning of the asset is significantly impaired due to circumstances beyond his control;

   4) To terminate this Agreement unilaterally by rejecting a leased asset that fails to comply with the contract terms, unless the Lessor or Vendor of the leased asset is able to bring it into full compliance or find a suitable replacement within 30 days after receiving notice from the Lessee;

   5) To demand early dissolution of this Agreement in cases specified under current legislation or this Agreement;

   6) To recover damages from the Lessor should the latter fail to meet his obligations under this Agreement;

   7) To demand one of the following in the event that he discovers a hidden defect in the leased asset which impairs its proper use:

      - the replacement of the leased asset, if possible;
      - a suitable reduction in the fee for using the asset;
      - any repairs or alterations needed to bring the asset into full working order (at the lessor's expense).

8) To redeem an asset under financial lease as stipulated under the Agreement.

2. The Lessee has the following obligations:

1) To accept and use the leased asset in accordance with its intended purpose and the terms of the agreement;

2) To maintain the leased asset in good working order; as stipulated under the agreement;

3) To make lease payments in a timely manner;

4) To report to the Lessor on his (the Lessee's) financial standing and the technical condition of the leased asset, as stipulated under this Agreement;

5) To give the Lessor unrestricted access to the leased asset for the purpose of monitoring its condition and the manner in which it is being used;

6) To inform the Lessor within 24 hours if the leased asset should in any way break or malfunction, should he (the Lessee) fail to perform scheduled maintenance on a specified date, or should any other event occur that could have a negative impact on the asset's condition;

7) To notify the Lessor within 24 hours should he (the Lessee) become subject to bankruptcy proceedings, foreclosure of his assets, any license suspension that may prevent him from using the leased asset, or any other event that could have a negative impact on he execution of this Agreement;

8) To reimburse the Lessor for the cost of repairing the leased asset in cases specified under current legislation or this Agreement;

9) To return the leased asset in the condition in which it was received, except for normal wear and tear, or in a condition specified under the agreement, in the event that this Agreement should be terminated prematurely [or should the usage term expire under an operating lease]

3. FORCE MAJEURE.

*This section is also typical for all types of agreements, but the particular wording is subject to the parties' discretion.*

3.1. The Parties shall not be held responsible for failing to fulfill obligations under this Agreement as long as they are prevented from doing so by circumstances beyond their control.

3.2. The Party that has suffered force majeure shall provide the other Party with documentary evidence and a full description of the event, its character and expected duration, within 3 calendar days

of the occurrence. If he fails to do so, the affected Party will not be entitled to claim force majeure, unless the circumstances themselves are such that he is unable to give proper notification.

3.3. Under no circumstances shall the Parties be exempted from their financial obligations under this Agreement.

## 4. RESOLUTION OF DISPUTES.

*This section, like the previous two, is typical of any type of agreement. The particular wording is subject to the parties' discretion.*

Version 1: Domestic lease agreements

4.1. Any dispute arising during the execution of this Agreement, and in connection with this Agreement, shall be subject to resolution according to current Ukrainian legislation.

Version 2: Cross-border lease agreements

Option A: 4.1. The Parties agree that any dispute arising during the execution of this Agreement, and in connection with this Agreement, shall be submitted for review and final resolution by the International Commercial Arbitration Court under the Ukrainian Chamber of Commerce and Industry.

This Agreement shall be governed by Ukrainian law.

One arbiter shall represent the Arbitration Court.

The court shall convene in the city of Kiev.

Arbitration proceedings shall be conducted in the Ukrainian language.

Option B: 4.1. The Parties agree that any dispute arising during the execution of this Agreement, and in connection with this Agreement, shall be resolved according to the UNCITRAL Arbitration Rules.

There shall be three arbiters. Each of the Parties shall appoint one arbiter, and these two arbiters shall choose a third arbiter. If the arbitration court has not yet convened six months after the claim was filed, the President of the International Court shall appoint the arbiters at the request of either party. The court shall convene in Paris, France, and proceedings shall be conducted in English.

## 5. OTHER PROVISIONS.

*Traditionally, this section of the Agreement, which is usually the last section, includes provisions which, due to their nature, have not been included in previous sections. The parties are free to choose both the contents and wording of this section.*

5.1. Any relationship between the Parties that has not been regulated by this Agreement shall be subject to current Ukrainian legislation.

5.2. Each Party shall notify the other Party within 3 calendar days if he should change his name, location, or bank account, as specified under this Agreement, or if any other event should occur that may prevent the other Party from fulfilling his contractual obligations properly.

5.3. The Agreement shall be deemed effective from the date when it is signed by each of the Parties.

5.4. This Agreement shall be produced in two copies (one for each Party). Each of these copies shall have equal legal force.

## LEGAL ADDRESSES AND BANK ACCOUNTS OF THE PARTIES

| Lessor | Lessee |
|---|---|
| _____ | _____ |
| _____ | _____ |
| b/acc. # _____ in____ | b/acc. # _____ in ____ |
| _____ | _____ |
| _____MFO _____ | _____ MFO _____ |

## SIGNATURES OF THE PARTIES

| Lessor | Lessee |
|---|---|
| Director /_._._____/ | Director /_._._____/ |

# ANNEX III

## INSTALLMENT SALES

Due to disincentives of Ukraine's leasing-related legislation, 'lessors' and enterprises use 'installment sales' (sometimes referred to as, 'sales with deferred payments'), to finance the acquisition of fixed assets. In an 'installment sale,' parties are guided by provisions from Ukraine's Civil Code[1] on purchases and sales.

An installment sale is similar to financial leasing in substance, with two significant disadvantages that increase the lessor's risks.

1. An important element of financial leasing is that the manufacturer or seller of the asset to be leased bears liability for delivery, quality and warranty. The lessee applies to a leasing company after selecting the equipment and supplier themselves. The leasing company only fulfils the request for financing. However, in an installment sale, it is the lessor is also liable for delivery and asset quality.
2. In an installment sale, just as a financial lease, ownership of the asset does not transfer to the lessee (buyer) until the asset has been completely paid for. However, in an installment sale, if there is a breach of agreement and the seller (lessor) is forced to repossess the equipment, the seller (lessor) is entitled to keep only the amount paid by the buyer (lessee) equal to the portion of the asset that was depreciated. The seller (lessor) may contest this in court, (for which there is precedence in Ukraine). Ukrainian courts have ruled that the seller (lessor) is entitled to keep the difference between the original contract price of the asset and the market value of the asset at time of repossession.

Despite these problems, installment sales remain the most acceptable tool for purchasing equipment in Ukraine. Parties to an installment sale may determine their own payment schedule and do not have the problems of excessive taxation that results from Ukraine's laws governing financial leasing.

Due to the fact that domestic leasing companies have trouble finding acceptable credit resources the most common scheme for asset financing varies significantly from the way lessors work in other countries. The usual system – take a loan, purchase equipment and lease it out is replaced by the following:

1) They purchase equipment from the manufacturer on terms of a trade credit (commercial credit);
2) The equipment is provided to the lessee under an installment sale contract.

Domestic leasing companies use this scheme mostly with Ukrainian manufacturers.

1 See Civil Code of Ukraine, Ch.20. Please note that Instructions by CM: Installment Sales Rules of 01.06.1998 are for installment sales to individuals only and not legal entities.

ANNEX IV

## LIST OF DOMESTIC LESSORS

| # | Title | Contact Phone# | E-mail | Address | Contact Persons |
|---|---|---|---|---|---|
| 1 | Aval-Leasing | (0512) 368580, 500085, 367342, 397342, fax: 351357 | | 19 Artilleriyskaya str., Nikolayev | Sergey Ryzhkov, Director |
| 2 | First Lease | (044) 4905556/57 | | 4 Muzeyny lane, Kyiv | Dmitry Valerievich Krisanov, Director |
| 3 | Ukrainian Finance-Leasing House -Bank "Ukraina" | (044) 5735137, 5591076 | leasfld@i.kiev.ua, leasfld@ip.telecom.net.ua | 3 Kaunasskaya str., Kyiv | Nikolay Ivanovich Soroka, Head of Department |
| 4 | SergoGammaLeasing | (044) 4577734 | | 7 Lebedeva-Kumacha str., Kyiv | Igor Yurievich Vishnyakov, Head of Leasing Department, Viktoria Vladimirovna Lavrenyuk, Head of Marketing Department |
| 5 | Severokrymskaya Pilot Economic Zone "Sivash," Leasing Company "Eurosivash" | (044) 4641095, 4641096, факс 4641097 (06565) 25045 | evro@sivash.kiev.ua | 26 b., Yaroslavov Val str., #8, Kyiv 1a Geroyev Perekopa sq., Krasnoperekopsk, Crimea | Svetlana Zagrebelnaya, General Director Sergey Sergeevich Dubrovin, Commercial Director, Natalia Kovalenko |
| 6 | "Energoleasing" | (044) 2465958 | | 15 Kominterna str., Kyiv | Valery Leonidovich Osetsky, Director |
| 7 | Bank "Nadra" | (044) 2465260, fax: 2464840 | | 42/4 Pushkinskaya str., Kyiv | |
| 8 | Ukrainian Finance Leasing Company (Ukrleasing Association) | (044) 2443843, fax: 2443842 | | 23/1, Tolstogo str., Kyiv | Yury Sosyurko, Director Ludmilla Semenovna Zolotoryova |
| 9 | Ukrinkomlease | (044) 296 96 55 (044) 296 98 50 | | Kyiv | Aleksandr Sergeevich Zubanev - Director |
| 10 | Kharkiv Regional Leasing Company (Kharkovsky Leasingovy Fond) | (0572) 528197 | | 60a Lenin Avenue, Kharkiv | Anatoly Nikolayevich Pogorelov, "Realbank" President and Deputy Chairman of BOD |
| 11 | "Ukrgosleasing" Company | (044) 2469531 | | 73, Artema str., Kyiv | Vladimir Aleksandrovich Borisov |
| 12 | "Agrotechleasing" | (0482) 23 21 72, 34 09 44, 20 26 49 | | 72 Chernomorskogo Kazachestva, Odessa | Igor Anatolievich Krikliviy |
| 13 | "AVIS" | (044) 294 77 06 | | 4 Kamyshinskaya str., Kyiv | Born Marksted, General Director |
| 14 | Universal-Servis | 8 (0482) 63 02 17 8 (0482) 60 41 54 | us@odessa.net www.us.odessa.net | | Vladimir Alekseevich Odintsov |

Note: Leasing activity in Ukraine is not licensed or subject to additional regulations. Therefore, it is difficult to determine exact number of companies involved in leasing activity. For this reason the many captive lessors operating in Ukraine have been excluded.

# ANNEX V

## INFLUENCE OF DEPRECIATION POLICIES ON LEASING

Depreciation policy is an important tool that may be used either to promote or to discourage the growth of leasing. This section will address the following topics:

- *the essence of depreciation for* ***accounting*** *purposes;*
- *five depreciation methods;*
- *examples and comparison of different depreciation methods;*
- *depreciation rates;*

## THE ESSENCE OF DEPRECIATION

Depreciation policies in Ukraine are currently regulated under both accounting[1] and tax[2] legislation. Unfortunately, the two do not always agree.

National Accounting Standard (NAS) #7 "Fixed Assets" defines the depreciation of a leased asset as the systematic reduction of its value over the course of its useful service life. The following section will focus on the treatment of depreciation by UNAS.

Depreciation is charged separately for each leased asset. To charge depreciation means to calculate the portion of an asset's value that will be treated as a cost and will therefore be deductible from taxable income.

**Depreciated value** (DV) is equal to the original or reassessed value (RV) of the leased asset minus its residual value (LV):

$$DV = RV - LV \qquad (1)$$

**The original value (RV)** of a leased asset is the value first recorded on the balance sheet of the party entitled to make depreciation charges. It should be equal to the costs he incurred in acquiring the asset.

**The residual value (LV)** is the net sum that a lessee expects to receive for a leased asset at the end of its useful life after deducting the expected costs of its disposal.

**The useful service life** is understood as either the period over which the lessee will use the leased asset, or the number of production units that he expects to obtain from the asset. The service life may be revised if the economic benefits of using the asset are expected to change.

Depreciation may be charged throughout an asset's useful service life, but should be suspended during renovation, upgrading, modernization or storage.

A leased asset's **depreciation period** depends on whether the lessee will assume ownership of the asset upon expiration of the lease. If so, then the depreciation period should coincide with the useful service life. Otherwise, the

1 NAS #7 "Fixed Assets" confirmed by Ministry of Finance Order 92 of April 27, 2000; NAS #8 "Intangible Assets" confirmed by Ministry of Finance Order 242 of October 18, 1999.

2 Ukraine's Law on Corporate Tax of May 22, 1997

depreciation period should coincide with either the useful service life, or the lease term, whichever is shorter.

Under financial accounting procedures, unlike tax accounting, depreciation is charged on a monthly basis. If a business has a seasonal operating mode, then depreciation charges will accrue annually.

Depreciation charges should commence with the first fiscal month after the leased asset was first put to use towards the production or sale of goods. The charges should stop from the first fiscal month after the asset is removed from operation.

In financial accounting, depreciation charges are recorded as a business expense under depreciation of fixed assets or depreciation of intangible assets.

Ukraine's Law on Corporate Tax defines the depreciation of fixed assets as a decrease in taxpayer's net revenue[3] equal to the sum of his expenditures towards the purchase, production or improvement of these assets.

For financial accounting purposes, the amount of compensation that the lessee must pay to the lessor for the value of the leased asset may be equal to, larger than or smaller than the sum of depreciation charges. However, *Ukraine's Law on Leasing* states that the portion of each lease payment that represents compensation to the lessor for the value of the asset should be equal to depreciation for that period.

Ideally, the lessor will recover 100% of the asset's value over the term of the lease. However, in order for this to be possible, the lessee must establish a reserve equal to the difference between the original value and the total depreciation charges. Accruals to this reserve should be made on a monthly (or quarterly) basis over the entire term of the lease. Thus, if the total sum of depreciation charges over the term of the lease comprises 60% of the asset's value, the reserve should contain the remaining 40%.

## DEPRECIATION METHODS

Ukraine's **accounting** laws offer a much broader range of depreciation methods than its tax laws.

NAS #7 allows for the following depreciation methods:

- *straight line/linear;*
- *declining balance;*
- *accelerated declining balance;*
- *cumulative;*
- *production;*
- *any other depreciation method stipulated under Ukrainian tax law*

For purposes of financial reporting under UNAS, an enterprise is free to choose any one of these depreciation methods. If necessary, it can also switch

3 Net Revenue is gross revenue less excise and VAT, as well as the sum received by a business as compensation for alienation for its assets, income received as a result of claims satisfied in court, return of taxes paid in excess, and so on. Gross revenue includes proceeds from all of a business's activities, received (accrued) during the reporting period (see Article 4 of Ukraine's Law on Corporate Tax of May 22, 1997).

from one method to another. However, an enterprise may only begin to use a new method during the next fiscal month after the decision was made.

When choosing a depreciation method for a leased asset, businesses should keep in mind that the same method must be used consistently for all similar assets (i.e., all assets serving a similar purpose). The freedom to choose any one of the depreciation methods listed under NAS #7 is one of the most progressive achievements of financial reform in Ukraine. However, not everyone is entitled to exercise this right.

Despite the wide range of depreciation methods offered by Ukrainian accounting laws, most lessees still prefer to use the methods suggested under Ukraine's tax laws, both for financial accounting and for tax accounting. There are a number of reasons for this. One is that businesses are already more familiar with the tax laws' depreciation methods, and the NAS methods differ from these rather substantially. In addition, not all businesses are comfortable with the idea of choosing their own accounting policies (as suggested by NAS), since they are already accustomed to complying with strictly regulated conventional accounting (as required under tax laws).

**Linear depreciation** *(often referred to as 'straight-line depreciation')* implies an equal portion of an asset's value is depreciated each period over the leased asset's useful service life. As a general rule, it is used for assets that perform approximately the same amount of work from one accounting period to the next and are subject to physical deterioration (e.g., buildings, structures, gas pipes, tanks, tools, etc.). The linear method is common throughout the world. It is simple and easy to revise, which makes it very attractive in comparison to other methods.

It makes sense to use the linear method under the following circumstances:

1) the enterprise does not anticipate any major increase in maintenance or repair costs to extend the asset's useful service life;
2) the asset is not susceptible to rapid obsolescence; or
3) it is difficult to predict the asset's overall production capacity.

With linear depreciation, yearly depreciation charges (DC) are calculated by dividing the asset's depreciable value (DV) by its expected service life (T) expressed in years.

$$DC = \frac{DV}{T} \qquad (2).$$

**Example: The Linear Method of Calculating Depreciation**

A financial lease agreement has been signed for a piece of equipment with a useful service life of 4 years (8 six-month periods). The lessee receives the equipment on January 2, 2001, and makes lease payments on the last day of each semester (June 30 and December 31). The lessee has recorded the leased asset on his balance sheet at the present value of minimum lease payments totalling 159,904 Hr.

Using Formula 3 from Section VII, where i = 0.13 (semiannual rate) and n = 6, we can calculate the present value of minimum lease payments as 40,000 x 4.5176 = 180,704 Hr.

The following table shows depreciation charges based on the linear depreciation method and the asset's book value at the end each semester:

| Useful Service Life | Semiannual Depreciation Charges: Original Value (book value) of the Asset (DV) | Number of Six-month Periods (T) | Total Depreciation Per Semester (TD)[5] | Cumulative Depreciation[4] | Residual Book Value |
|---|---|---|---|---|---|
| A | B | C | D | E | G = B - E |
| 2.01.2001 | 159,904 | - | - | - | 159, 904 |
| 1.07.2001 | 159,904 | 8 | 19,988 | 19,988 | 139,916 |
| 2.01.2002 | 159,904 | 8 | 19,988 | 39,976 | 119,928 |
| 1.07.2002 | 159,904 | 8 | 19,988 | 59,964 | 99,940 |
| 2.01.2003 | 159,904 | 8 | 19,988 | 79,952 | 79,952 |
| 1.07.2003 | 159,904 | 8 | 19,988 | 99,940 | 59,964 |
| 2.01.2004 | 159,904 | 8 | 19,988 | 119,928 | 39,976 |
| 1.07.2004 | 159,904 | 8 | 19,988 | 139,916 | 19,988 |
| 2.01.2005 | 159,904 | 8 | 19,988 | 159,904 | 0 |

Accelerated depreciation methods include: (1) declining balance, (2) accelerated declining balance and (3) cumulative. What sets these methods apart is that they enable one to write off larger amounts of an asset's value during earlier accounting periods. The main difference between these methods is their rate of depreciation.

Accelerated depreciation methods are generally used for assets that quickly become obsolete (e.g., computer equipment), or whenever there is a need to maintain relative parity between maintenance costs and annual depreciation charges over the asset's service life (as in the case of motor vehicles, whose maintenance and repair costs grow considerably over time).

**The declining balance method** allows one to depreciate the asset most quickly during the earliest periods.

With this method, the annual depreciation rate (ADR) is calculated as

$$ADR = 1 - \sqrt[T]{\frac{LV}{OP}} \qquad (3).$$

4 Cumulative depreciation calculations: 39,976 Hr = 19,988 + 19,988; 59,964 Hr = 39,976 + 19,988; 79,952 Hr = 59,964 + 19,988; 99,940 Hr = 79,952 + 19,988; 119,928 Hr = 99,940 + 19,988; 139,916 Hr = 119,928 + 19,988; 159,904 Hr = 139,916 + 19,988.

5 Semiannual depreciation: 19,988 Hr = 159,904/8

**Where:** T = Service life expressed in years
LV = Liquidation value
OP = Original price

The annual amount of depreciation (AAD) is calculated as the balance value (BV) at the beginning of the fiscal year (or the starting value on the date when depreciation charges commenced) multiplied by the annual depreciation rate (ADR).

$$AAD = BV \cdot ADR \qquad (4).$$

**Example: Declining Balance Method**

Let's assume the same conditions as in the last example and see what happens when we use the declining balance method to calculate the depreciation charges and remaining book value. Let's assume, that the asset's residual value (LV) is 12,792 Hr (or 8% of its original value).

| | | Semiannual Depreciation Charges | | | | |
|---|---|---|---|---|---|---|
| **Useful Service Life** | **Original Value (OV)** | **Book Value of the Asset BOP (BV)** | **Semiannual Depreciation Rate (ADR)[6]** | **Semiannual Depreciation Amount (AAD)** | **Cumulative Depreciation** | **Remaining Book Value at the End of Period** |
| A | B | C | D | E =C x D | F | G |
| 2.01.2001 | 159,904 | - | - | - | - | 159,904 |
| 1.07.2001 | 159,904 | 159,904 | 0.271 | 43,334 | 43,334 | 116,570 |
| 2.01.2002 | 159,904 | 116,570 | 0.271 | 31,590 | 74,924 | 84,980 |
| 1.07.2002 | 159,904 | 84,980 | 0.271 | 23,030 | 97,954 | 61,950 |
| 2.01.2003 | 159,904 | 61,950 | 0.271 | 16,788 | 114,742 | 45,162 |
| 1.07.2003 | 159,904 | 45,162 | 0.271 | 12,239 | 126,981 | 32,923 |
| 2.01.2004 | 159,904 | 32,923 | 0.271 | 8,922 | 135,903 | 24,001 |
| 1.07.2004 | 159,904 | 24,001 | 0.271 | 6,504 | 142,407 | 17,497 |
| 2.01.2005 | 159,904 | 17,497 | 0.271 | 4,705 | 147,112 | 12,792 |

**The accelerated declining balance method** presents the simplest procedure for calculating depreciation rates (ADR):

$$ARD = \frac{100\%}{T} \cdot A \qquad (5).$$

The annual amount of depreciation (AAD) is calculated as follows:

$$AAD = BV \cdot ADR \qquad (6).$$

**Where:** BV = Balance value

6 $ADR = 0.271 = 1 - \sqrt[4]{\frac{12792}{159904}}$

7 4,705 (Hr.) = 17,497 - 12,792.

8 147,112 Hr = 4,705 + 142,407

**Example: Accelerated Declining Balance Method**

Using the same data as the previous example, let's use the accelerated declining balance method to calculate the depreciation charges and remaining book balance for each semester:

| | | Semiannual Depreciation Charges | | | | |
|---|---|---|---|---|---|---|
| Useful Service Life | Original Value (OV) | Book Value of the Asset BOP (BV) | Semiannual Depreciation Rate (ADR)[9] | Semiannual Depreciation Amount (AAD) | Cumulative Depreciation | Book Value at the End of Period |
| A | B | C | D | E = C x D | F | G |
| 2.01.2001 | 159,904 | 159,904 | - | - | - | 159,904 |
| 1.07.2001 | 159,904 | 159,904 | 25 % | 39,976 | 39,976 | 119,928 |
| 2.01.2002 | 159,904 | 119,928 | 25 % | 29,982 | 69,958 | 89,946 |
| 1.07.2002 | 159,904 | 89,946 | 25 % | 22,487 | 92,445 | 67,459 |
| 2.01.2003 | 159,904 | 67,459 | 25 % | 16,865 | 109,310 | 50,594 |
| 1.07.2003 | 159,904 | 50,594 | 25 % | 12,649 | 121,959 | 37,945 |
| 2.01.2004 | 159,904 | 37,945 | 25 % | 9,486 | 131,445 | 28,459 |
| 1.07.2004 | 159,904 | 28,459 | 25 % | 7,115 | 138,560 | 21,344 |
| 2.07.2005 | 159,904 | 21,344 | 25 % | 21,344[10] | 159,904 | 0 |

**The cumulative depreciation method** is considered a linear method because the annual depreciation charges are reduced in two even portions.

When using this method, one must calculate a cumulative coefficient (Cc) according to the following formula:

$$Cc = \frac{ST}{T-t} \qquad (7).$$

Where: ST = Useful service life (expressed in years)

T-t = Number of years remaining until the end of expected usage term

The useful service life may be calculated as:

$$ST = \frac{T(T+1)}{2} \qquad (8).$$

If the useful service life is relatively short, one can easily find it without using the formula. For example, if the service life is only 4 years, then:

$$ST = 4 + 3 + 2 + 1 = 10.$$

The annual amount of depreciation under the cumulative method (AC) is calculated as the product of depreciable value and the cumulative coefficient:

$$AC = DV \cdot Cc \qquad (9).$$

9 Calculated as: 15:25% = 100%: 8 x2

10 All value remaining at the end of the previous semester is written off.

**Example: Cumulative Depreciation Method**

Given the same data as in previous examples, let's use the cumulative depreciation method to calculate the depreciation charges and remaining book value for each semester. The asset's residual value is 12,792 Hr.

| | | Semiannual Depreciation Charges | | | | |
|---|---|---|---|---|---|---|
| Useful Service Life | Original Value (OV) | Depreciable Value (DV)[11] | Cumulativel Coefficient (Cc)[12] | Amount of Semi-annual Depreciation (AD)[13] | Cumulative Depreciation | Book Value at the End of Period |
| A | B | C | D | E | F | G |
| 2.01.2001 | 159,904 | - | - | - | - | 159,904 |
| 1.07.2001 | 159,904 | 147,112 | - | 29.,422 | 29,422 | 130,482 |
| 2.01.2002 | 159,904 | 147,112 | 4/10 | 29,422 | 58,844 | 101,060 |
| 1.07.2002 | 159,904 | 147,112 | - | 22,067 | 80,911 | 78,993 |
| 2.01.2003 | 159,904 | 147,112 | 3/10 | 22,067 | 102,978 | 56,926 |
| 1.07.2003 | 159,904 | 147,112 | - | 14,711 | 117,689 | 42,215 |
| 2.01.2004 | 159,904 | 147,112 | 2/10 | 14,711 | 132,400 | 27,504 |
| 1.07.2004 | 159,904 | 147,112 | - | 7,356 | 139,756 | 20,148 |
| 2.01.2005 | 159,904 | 147,112 | 1/10 | 7,356 | 147,112 | 12,792 |

Monthly depreciation charges under each of the above methods (linear, declining balance, accelerated declining balance and cumulative) equals annual depreciation divided by 12.

**The production method** is based on calculating the depreciation charges attributable to one produced item. Under this method, depreciation charges are proportionate to the volume of products manufactured with the asset.

Most frequently, this method is used for assets whose degree of wear and tear depends on how rigorously they are used (e.g., trucks).

The production depreciation rate (PDR), or the size of depreciation charges per single item of produced goods (labor, services), is calculated as:

$$PDR = \frac{DV}{N} \qquad (10).$$

Where: DV = Depreciable value of the leased asset

N = Number of goods expected to be produced with the leased asset

11 Calculated under formula 11: 147,112 Hr = 159,904 - 12,792.

12 Cumulative coefficients for calculation of depreciation are computed under formula 17. At the end of each year, cumulative coefficients will be the following:

as of 2.01.2002: 4: (1+2+3+4) = 4/10; as of 2.01.2003: 3: (1+2+3+4) = 3/10.

as of 2.01.2004: 2: (1+2+3+4) = 2/10; as of 2.01.2005: 1: (1+2+3+4) = 1/10.

13 Half-year amount of depreciation will be determined by dividing annual depreciation charges by 2. It should be equal to:

as of 1.07.2001: 29,422 Hr = 147,112 x 4/10: 2; as of 2.01.2002: 29,422 Hr = 147,112 x 4/10: 2;

as of 1.07.2002: 22,067 Hr = 147,112 x 3/10: 2; as of 2.01.2003: 22,067 Hr = 147,112 x 3/10: 2;

as of 1.07.2003: 14,711 Hr = 147,112 x 2/10: 2; as of 2.01.2004: 14,711 Hr = 147,112 x 2/10: 2;

as of 1.07.2004: 7,356 Hr = 147,112 x 1/10: 2; as of 2.01.2005: 7,356 Hr = 147,112 x 1/10: 2;



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The annual amount of depreciation (AAD) under the production method is calculated as:

$$AAD = DCu \cdot N \qquad (11).$$

**Where:** DCu = Depreciate charges per product unit

N = Number of units produced over the accounting period

Monthly depreciation charges under this method equal the actual monthly volume of production multiplied by the production depreciation rate.

**Example: The Production Method**

The lessee acquires an asset under financial lease with an original value of 159,904 Hr and a residual value of 12,792 Hr. The asset is expected to produce 397,600 units of a particular good over 4 years of useful service life.

| | | Semiannual Depreciation Charges | | | | | |
|---|---|---|---|---|---|---|---|
| Useful Service Life | Original Value (OV) | Depreciable Value (OV)[14] | Production Depreciation Rate(PDR)[15] | Production Volume (Units)(N)[15] | Amount Of Semiannual Depreciation (AD) | Cumulative depreciation | Book Value the End at of Period |
| A | B | C | D | E | F = D x E | G | H |
| 2.01.2001 | 159,904 | - | - | - | - | - | 159,904 |
| 1.07.2001 | 159,904 | 147,112 | 0.37 | 50,000 | 18,500 | 18,500 | 141,404 |
| 2.01.2002 | 159,904 | 147,112 | 0.37 | 49,800 | 18,426 | 36,926 | 122,978 |
| 1.07.2002 | 159,904 | 147,112 | 0.37 | 49,000 | 18,130 | 55,056 | 104,848 |
| 2.01.2003 | 159,904 | 147,112 | 0.37 | 49,700 | 18,389 | 73,445 | 86,459 |
| 1.07.2003 | 159,904 | 147,112 | 0.37 | 49,100 | 18,167 | 91,612 | 68,292 |
| 2.01.2004 | 159,904 | 147,112 | 0.37 | 51,000 | 18,870 | 110,482 | 49,422 |
| 1.07.2004 | 159,904 | 147,112 | 0.37 | 49,200 | 18,204 | 128,686 | 31,218 |
| 2.01.2005 | 159,904 | 147,112 | 0.37 | 49,800 | 18,426 | 147,112 | 12,792 |
| Total | x | X | x | 397,600 | X | X | x |

## DEPRECIATION RATES

The choice of depreciation method is one of the most important elements in a company's depreciation policy, as it can have a major influence on the total depreciation charges. No less important, however, is the depreciation rate, which the company may also choose at its own discretion.

**The depreciation rate depends on the following factors:**

- *The cost of the depreciated asset (generally the asset's purchase price or reassessed value, minus liquidation value*
- *The residual value*[16]
- *The useful service life*
- *The depreciation method.*

14 See 31.

15 Calculated under Formula 20: 0.37 Hr/unit = 147,112 Hr / 397,600 units.

16 Under the accelerated declining balance method, liquidation value is not factored into the depreciation rate.

The only one of these inputs that is specific is the purchase price; the rest are estimates.

Under a financial lease, the asset's original value may be either its fair value or the present value of the total minimum lease payments.

Residual value can be estimated fairly accurately for assets with a comparatively short service life. In most cases, however, the residual value will only be an approximation. It is usually based on the value of sellable scrap (i.e., whatever remains after the asset has been used up); sometimes it also includes the value of components that may be sold as spare parts.

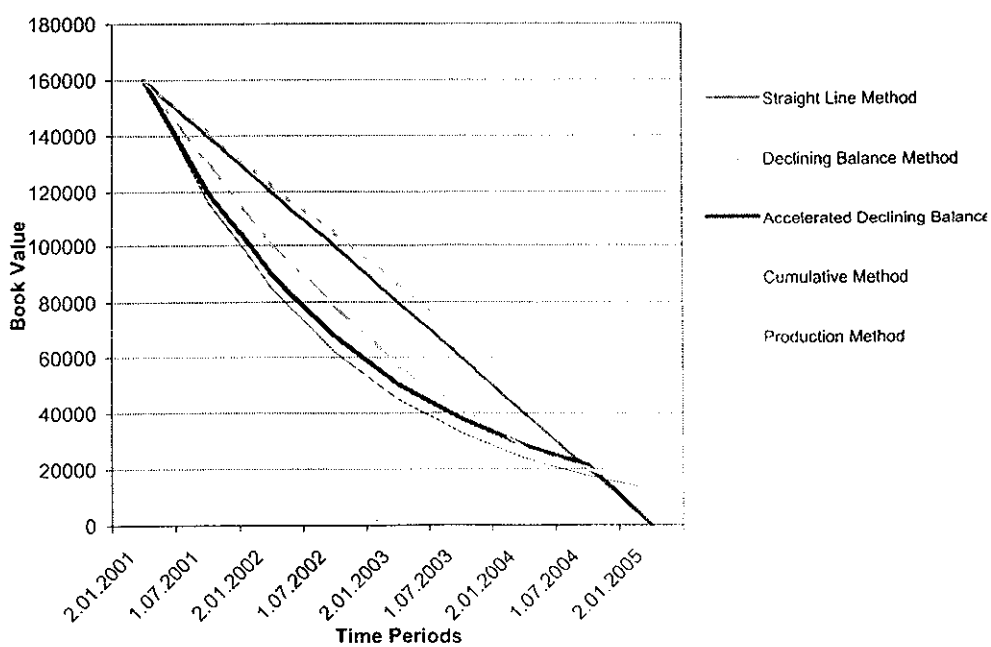
In short, the leased asset's residual value will depend on its condition and salability.

The asset's useful service life is based on:

- *Expected physical and moral depreciation*
- *Expected duration of use, taking into account the asset's capacity and productivity*
- *Legal and other restrictions on service life.*

The estimated useful service life does not always have to coincide with the legally established period of use. This will depend on the business's cost reduction policy. For example, a business may replace an asset after a service life of 5 years, even though it could be used for 10. This approach is fully consistent with the requirements of the National Accounting Standards.

**Dynamics of Book Value under Various Depreciation Methods**



A Comparison of Depreciation Charges and Book Values under Different Depreciation Methods

| | Linear Method | | Declining Balance Method | | Accelerated Declining Balance Method | | Cumulative Method | | Production Method | |
|---|---|---|---|---|---|---|---|---|---|---|
| Useful Service Life | Amount of Semiannual Depreciation | Book Valu at the End of Period (EOP) | Amount of Semiannual Depreciation | Book Valu at the End of Period (EOP) | Amount of Semiannual Depreciation | Book Valu at the End of Period (EOP) | Amount of Semiannual Depreciation | Book Valu at the End of Period (EOP) | Amount of Semiannual Depreciation | Book Valu at the End of Period (EOP) |
| 2.01.2001 | - | 159,904 | - | 159,904 | - | 159,904 | - | 159,904 | - | 159,904 |
| 1.07.2001 | 19,988 | 139,916 | 43,334 | 116,570 | 39,976 | 119,928 | 29,422 | 130,482 | 18,500 | 141,404 |
| 2.01.2002 | 19,988 | 119,928 | 31,590 | 84,980 | 29,982 | 89,946 | 29,422 | 101,060 | 18,426 | 122,278 |
| 1.07.2002 | 19,988 | 99,940 | 23,030 | 61,950 | 22,487 | 67,459 | 22,067 | 78,993 | 18,130 | 104,848 |
| 2.01.2003 | 19,988 | 79,952 | 16,788 | 45,162 | 16,865 | 50,594 | 22,067 | 56,926 | 18,389 | 86,459 |
| 1.07.2003 | 19,988 | 59,964 | 12,239 | 32,923 | 12,649 | 37,945 | 14,711 | 42,215 | 18,167 | 68,292 |
| 2.01.2004 | 19,988 | 39,976 | 8,922 | 24,001 | 9,486 | 28,459 | 14,711 | 27,504 | 18,870 | 49,422 |
| 1.07.2004 | 19,988 | 19,988 | 6,504 | 17,497 | 7,115 | 21,344 | 7,356 | 20,148 | 18,204 | 31,218 |
| 2.01.2005 | 19,988 | 0 | 4,705 | 12,792 | 21,344 | 0 | 7,356 | 12,792 | 18,426 | 12,792 |

# ANNEX VI

## PAYMENTS UNDER CROSS-BORDER LEASES

Ukrainian laws and regulation are quite restrictive in defining the procedures for making foreign currency payments under export and import agreements, including cross-border (or international) lease agreements. The web of legislation and regulation governing export of assets and receipt of payment from abroad make it virtually impossible for a Ukrainian lessor or manufacturer to lease an asset on an export basis. However, cross-border leases by foreign lessors for assets imported into Ukraine are feasible and implemented regularly in practice. In assessing whether to enter such a transaction, one should thoroughly understand all relevant tax and customs implications as described in the respective sections of Section IV.

The main problem for Ukrainian lessors looking to export assets under a lease agreement result from Ukraine's *Law on Procedures for Foreign Currency Payments* (08/23/1994, last updated 05/07/96). This law stipulates a maximum term for foreign currency receivables of Ukrainian residents under export contracts, as well as maximum periods for the delivery of goods after payment is made under import contracts. In both cases, marginal terms may not exceed 90 calendar days from the date of export or import. When an enterprise exceeds this term, it must obtain a license from the National Bank of Ukraine in order to make currency transactions.

Specific provisions for operating and financial leases are contained in *Article 6 of the Law on Leasing and Clauses 1.5 and 4.1 of NBU Instruction 136 on Procedures for Controlling and Obtaining Licenses under Export, Import and Leasing Transactions* (henceforth "Instruction") of 03/24/1999. Without going into detail about the procedures for obtaining a license, it would be fair to say that they are difficult. The National Bank will consider a license application only with a statement from the State Tax Administration authorizing an extension of the payment period, and a confirmation from the Ministry of the Economy that neither the resident nor the non-resident are under any foreign trade restrictions, and that their agreement complies with all current legislation.

The Tax Administration's statement must substantiate the grounds for extending the original term and may be subject to approval by the Ministry of the Economy. Moreover, an applicant must submit his application and supporting documents before the leased asset is delivered. This is clearly stipulated in the *Procedures for Resident Transactions under Foreign Trade Agreements* (e.g., production-sharing, consignment, complex construction, operating and financial leases, delivery of sophisticated technical products and special purpose goods), last updated 10/02/98 and confirmed by CMU Resolution 882 of 12/28/94.

According to this regulation, CMU will authorize an extension of the payment period only if the resident enterprise provides confirmation from the Ministry of Foreign Trade and Relations to the effect that:

a) neither the resident enterprise nor its foreign partner is subject to any of the foreign trade restrictions listed under *Article 37 of the Law on Foreign Trade;*

b) The foreign trade agreement fully complies with Ukrainian legislation.

In short, receiving a license for international export leases is hardly feasible.

For cross-border leases between a foreign lessor and a Ukrainian lessee importing a leased asset, there may be issues relative to the currency in which the lease payments may be made.

*Clause 1 of the CMU's Resolution 1998 on Improvements to Pricing Procedures* of 12/18/98 stipulates that *"...commercial entities may not form, establish or implement prices on Ukrainian territory in any currency except the national currency of Ukraine."* However, the same clause also states that *"... at the time of price formation...prices calculated in dollar equivalent will only be recognized as valid in the* **import portion of the price structure** *(i.e. the portion for which payment is made in foreign currency.)"*

This mean that the lessee's advance payment may be made in foreign currency, but once the asset is received by the lessee for usage, payments should be made in Ukrainian currency in accordance with the above mentioned legislation. Therefore, foreign lessors will seek a method to hedge the risks of inflation and/or currency devaluation.

Although a lease agreement may stipulate that payments will be paid in advance, one must be sure to follow Ukrainian leasing legislation with regard to limitations on the lease term and payment schedule. According to *Article 382 of Ukraine's Civil Code, "an organization may only make advance payments to another organization in cases provided for by law."* Moreover, *Clause 24 of NBU Instruction 7 on Payments by Order in the National Economy of Ukraine,* confirmed by NBU Board Resolution 204 of 09/02/96, clearly states that *"enterprises are entitled to make advance payments only if this is provided for under their agreements..."*

# ANNEX VII

## LEGAL ISSUES IN LEASING STATE-OWNED, COMMUNAL, OR JOINTLY-OWNED ASSETS

*Leasing of State-owned Assets*

According to Ukraine's *Law on Leasing*, state-owned property not removed from civil circulation may be leased only upon approval of the body that manages this property. Bodies managing the appropriate state-owned assets must register all leasing agreements. Unregistered lease agreements for state-owned assets will be deemed invalid. The *Procedure on Registration of Leasing Agreements, approved by the CMU's Resolution of 16.06.1998 #913* (further – the Procedure) describes legal practices for registration of leasing agreements.

If intending to lease state-owned assets, it is important to verify the rights that the corresponding state-owned or kazenny enterprise [strategic state-owned enterprises not subject to privatization] may exercise in relation to the asset. According to **Article 10 of the Law On Enterprises of 27.03.1991, #887-XII:**

1) State-owned assets entrusted to a state-run enterprise (except for a kazenny enterprise), are owned by this enterprise on terms of 'full economic possession', where the enterprise possesses, uses and disposes of these assets at its own discretion, and is entitled to undertake any action, as long as it does not contradict the law and the enterprise's charter documents;
2) Assets of a kazenny enterprise are owned by the enterprise on basis of 'operating management,' where the enterprise possesses and uses these assets. The kazenny enterprise may dispose of its fixed assets only subject to permission granted by the body, specifically authorized to manage this state property. The charter of the kazenny enterprise will outline management peculiarities of other assets.
3) Stated-owned production assets entrusted to a state-owned enterprise, will be alienated from the state on a competitive basis (through exchange market or competitive auction) following the procedure established by the State Property Fund of Ukraine whereas cash receipts from such alienation will be further invested.

The *Law on Leasing* prohibits leasing the following items:

a) *"... individually defined assets owned by state companies, and specified in Article 4 of the Law of Ukraine on Renting State Property," which include the following:*

- *integral property complexes of enterprises (economic objects with the closed cycle of production, together with land plots on which they are located, and autonomous utility and energy supply systems);*
- *integral property complexes of their subsidiaries (workshops, shopfloors, divisions);*
- *immovable property (buildings, premises)*



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In attempting to define assets that may or may not be leased, the *Law on Leasing* refers to clauses of the *Law of Ukraine on Rent of State Property.* This law has since been renamed to the *Law of Ukraine on Rent of State Property and Communal Property.* This raises the question of whether an object of communal property may be leased. One should seek an expert opinion on this issue if considering leasing communal property.

If leasing an asset with 'joint-shared ownership,'(i.e. with specification of shares) or 'joint-common ownership (without indication of shares) one must be quite careful that the necessary parties have agreed to the full terms of the lease agreement. One should make an extra effort to make sure all the asset's owners understand and agree to terms such as the following:

- *terms of performance of financial liabilities by the lessee,*
- *the procedure for leased asset repossession in an indisputable manner:*
  - *a) whether non-performance of liability by a lessee must take place against one co-owner or all co-owners,*
  - *b) steps taken by co-owners in case of executing resolution in a state notary office.*
- *redemption of the leased asset [according to Article 114 of the Civil Code — when a co-owner sells his interest in an asset, all other co-owners have the right to preferred purchase of the interest, at such a price as it may be otherwise sold, and on other equal terms, except when it is sold at public auction],*
- *or its repossession [who will sign a transfer-receipt act: all co-owners, or only those properly authorized by others], etc.*

# ANNEX VIII

## REPOSSESSING A LEASED ASSET ON THE BASIS OF A NOTARY'S WRIT OF EXECUTION

By their very nature, financial leases are a type of lending agreement. One of the key advantages of a financial lease relative to a bank loan is the lessor's additional security from the fact that he maintains ownership of the asset until the end of the lease term. This stronger security position relative to a simple collateral agreement allows lessors to lend to enterprises that would otherwise not qualify for other forms of financing.

In many cases, lessees are new enterprises with so-called 'zero balance sheets.' Their only source of funds for paying off the lease is the revenue they generate by using the leased asset. Therefore, many lease agreements are quite risky for lessors. In order to alleviate this risk, most countries allow the lessor to use a simplified procedure for repossessing leased assets from the lessee, particularly in cases of lessee default, misuse of the leased asset, or other circumstances that put the leased asset in jeopardy. This simplified procedure is an essential tool for protecting the lessor's interests. If the lessor is able to repossess a leased asset quickly and efficiently, he can recover the capital he invested in the asset by leasing or selling it to another party.

Ukraine's Law on Leasing (Article 9, Clause 5), appropriately allows the lessor to unilaterally repossess his leased asset, on the basis of a notary's writ of execution, if the lessee misses two consecutive lease payments. Otherwise, Ukrainian lessors have to go through lengthy pre-arbitration procedures (30 days, not including mail delivery time, according to Articles 5 and 7 of the Arbitration Code), followed by a hearing in arbitration court (up to 2 months, according to Article 69 of the Arbitration Code).

The legal procedure for obtaining a writ of execution is described under Section 14 of *Law #3425-XII on Notary Service*, adopted 9/2/93 and last revised 5/24/98; and the *Instruction on Procedures for Obtaining a Ukrainian Notary's Writ of Execution*, last revised 6/29/99 and confirmed by Ministry of Justice Order 18/5 of 6/1494 (henceforth 'Instruction'). These regulations establish the following procedures for obtaining a notary's writ of execution:

1. According to Article 47 of the Law on Notary Services, supporting documents must meet the following requirements:

   - *Documents consisting of two or more separate sheets must be stapled and the pages must be numbered and stamped.*
   - *All documents must indicate the full names and addresses of any individuals mentioned therein.*
   - *The text of an agreement, translation or application [illegible] as copies or extracts of any document, must be written clearly [illegible]; dates and numbers must be written out in words at least [illegible] document; and*



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*the names of legal entities must be written in full (without any abbreviations) and include legal address.*

- *The notary cannot accept documents that "have any trace of erased words, additions, crossed-out words or other unexplained corrections, illegible words or words written in pencil."*

2. Article 87 of the *Law on Notary Services* refers to a list of documents established by the Cabinet of Ministers that a claimant must submit in order to obtain a writ of execution. This list is called the *List of Documents on the Basis of which a State Notary May Issue a Writ of Execution Authorizing Summary Collection of Overdue Payments* (henceforth 'List'), *confirmed by Government Resolution 1172 of 6/2999.* According to Clause 8 of this regulation, lessors must submit the following documents in order to obtain a writ of execution:
   a) *an original copy of the lease agreement, which must provides for summary repossession of the leased asset;*
   b) *a copy of the lease payment invoice with proof that the lessee has been notified in writing of his default.*
3. According to *Article 88 of the Law on Notary Services*, the supporting documents *must prove the indisputable nature of the debt.*
4. According to *Article 88 of the Law on Notary Services*, one may make claims under a writ of execution for up to 3 years in the case of agreements between individuals, and up to 1 year in the case of agreements between enterprises, institutions and organizations.

Moreover, according to article 91 ofthe Law On Notary Service, an executive approval may be submitted for enforcement only within one year of its execution for legal entities and up to three years for individuals.

According to *Article 87 of the Law on Notary Services and Clause 168 of the Instruction*, notaries may only execute resolutions on documents that bear evidence of the unpaid debt. Furthermore, according to the Instruction (Clause 168), notaries may only execute such resolutions on **original copies** of documents that bear evidence of the unpaid debt.

According to *Article 90 of the Law on Notary Services*, the bearer of a notary's writ of execution should repossess his assets in accordance with the procedures established by *Law #606 XIV on Executive Enforcement, adopted 4/21/99*, and the *Instruction on Performance of Executive Actions*, confirmed by Ministry of Justice Order 75/5 of 12/15/99.

# Ukrainian Enterprises in 2000

## An IFC Survey of Ukrainian Business

Report by IFC Ukraine Business Development Project
May 2001

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INTERNATIONAL FINANCE CORPORATION

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# INTRODUCTION

The International Finance Corporation (member of the World Bank Group) has been one of the most active players in private sector development in Ukraine. IFC has been particularly active in the development of the small business sector through such programs as Small Scale Privatization (privatization of the vast majority of small businesses); Divestiture of Unfinished Construction Sites; Land Privatization and Agricultural Reform; Agri-Business; Mass Privatization (assisting enterprises undergoing voucher privatization); Corporate Governance; Leasing Reform. Since 1994 IFC has been heavily involved in providing direct services to Ukraine's emerging private sector through the Business Development Project, which established the Ukraine Consulting Network of 11 business consulting companies.

The Business Development Project has conducted annual surveys of the small and medium enterprise sector in Ukraine since 1996 to gauge the overall-enabling environment for SMEs. These surveys have been targeted towards analyzing the role that the state has in influencing the operating environment for domestic business in Ukraine, particularly small business. These surveys have been influential in stimulating real debate among policy makers and government on private sector development issues as well as used to monitor the progress of various reforms and changes in the business environment.

This report is published in both English and Ukrainian, however the English version will prevail in the event of any ambiguity. While every effort has been made to directly translate the English version into Ukrainian, in certain instances, form has been sacrificed to preserve substance.

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# SAMPLE SELECTION AND METHODOLOGY

IFC's annual surveys have traditionally covered the small and medium sized business sector. The 2000 survey has been expanded to include medium and large firms, as well as different forms of firm origin (state-owned, privatized, and start-ups) to allow for better comparisons between different types of firms.

The survey has attempted to capture a representative picture of business in Ukraine's oblast capitals and has therefore surveyed firms in every single oblast capital in Ukraine as well as Kyiv and Simferopol, that are engaged in commercial activity. In order to construct the survey sample, manufacturing firms were used as the baseline. 1,005 manufacturing firms were selected, distributed proportionally amongst all cities based on their proportion of manufacturing firms in Ukraine (in any case not less than 20 manufacturing firms per city.) Please refer to Annex 1 for a full sample breakdown.

For non-manufacturing sectors, fixed quotas were used for each city, but also ensuring that the total number of firms in each sector was representative of the sector as a whole. This allows for comparisons across cities, but is not necessarily representative (with the exception of manufacturing) of sectors and overall business in each city. Further, it cannot be said that the findings of the survey reflect all business in Ukraine, nor that the proportions of each type of firm in the survey correspond to the overall breakdown of such firms in Ukraine.

The fixed quotas for each city were as follows:

- Construction: 6 firms
- Trade: 15 firms, including 4 wholesale and 12 retail
- Public Catering: 6 firms, including 4 cafes and 2 restaurants
- Transport: 1 freight and 4 passenger transport firms
- Telecommunications: 2 firms, including one internet service provider and one paging company. For Kyiv two vehicular communication firms were added.
- Other Services: 12 firms including a hotel, travel agency, commercial bank, insurance company, domestic service firms and public utilities.

**Sectors**

The sectors (given above) were selected so as to encompass as much business in Ukraine as possible and also to follow the breakdown used by the State Statistics Committee of Ukraine in compiling national statistics. Agriculture, which accounts for a significant proportion of economic activity in Ukraine, was not surveyed at all as, due its specific nature, comparisons with other sectors would have been difficult. Further state-owned and primarily state financed entities (so called budget organizations) were not surveyed. This class of entities include hospitals, educational establishments, *etc.*

Firms were selected based on their responses of what they considered to be their main area of business activity. Ukrainian firms in general are more diversified than their counterparts in more economically developed countries and it is not uncommon for large state-owned enterprises to have smaller, private (semi-independent from the parent enterprise) commercial entities in unrelated fields.

**Firm Origin**

Rather than attempt to provide information on different forms of firm ownership (14 legal forms of ownership were surveyed – *see Annex 1*), this survey looked at firm origin instead. All companies were divided into three different types according to their origin: state-owned, privatized, and start-ups.

State-Owned Firms

These are firms where majority ownership (not less than 50%), and hence control, is held by the government. Further state-owned enterprises have been divided into two categories, *municipally* owned and *nationally* owned. Municipally owned enterprises (*i.e.* communal ownership) include firms in all of the sectors surveyed (except telecoms.)

Privatized Firms

These are formerly state-owned firms where a controlling stake (not less than 50%) has been divested through the privatization process. There were a large number of firms privatized in the period 1992 – 1995 and consequently privatized firms have been further sub-divided into early and late privatized firms, January 1, 1996 being the cut-off date. 54.7% of all privatized firms in the sample were early privatizations.

Start-Up Firms

For comparison purposes the survey also included completely new private firms that were established (since the establishment of such firms was allowed in the late 1980's.) Again, similar to privatized firms, start-ups have been divided into early and late start-ups, with January 1, 1996 being the cut-off date. 38.7% of all start-ups in the sample were early start-ups.

**Table 1**
***Sample by Sector, Firm Size and Firm Origin***

| | Firm Size | | | Firm Origin | | | | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | | Privatized | | Start-Ups | | |
| | | | | National | Municipal | Early | Late | Early | Late | |
| ***Sector*** | | | | | | | | | | |
| Manufacturing | 375 | 328 | 302 | 128 | 23 | 290 | 248 | 142 | 174 | **1005** |
| Construction | 96 | 55 | 18 | 14 | 3 | 45 | 28 | 40 | 39 | **169** |
| Transport | 40 | 35 | 40 | 12 | 22 | 22 | 27 | 7 | 25 | **115** |
| Telecoms | 44 | 2 | 4 | 7 | | 1 | 2 | 14 | 26 | **50** |
| Trade | 362 | 45 | 11 | 10 | 7 | 72 | 57 | 76 | 196 | **418** |
| Public Catering | 134 | 11 | 0 | 18 | 3 | 26 | 30 | 26 | 42 | **145** |
| Other Services | 157 | 58 | 41 | 26 | 36 | 53 | 31 | 51 | 59 | **256** |
| Total | **1208** | **534** | **416** | | | | | | | |
| ***Firm Size*** | | | | | | | | | | |
| Up to 50 | | | | 69 | 28 | 167 | 170 | 285 | 489 | **1208** |
| 51-250 | | | | 63 | 20 | 187 | 146 | 59 | 59 | **534** |
| More than 250 | | | | 83 | 46 | 155 | 107 | 12 | 13 | **416** |
| Total | | | | **215** | **94** | **509** | **423** | **356** | **561** | **2158** |

**Pertinent Information**

Medium and Large Trading Firms:

The sample contained medium and large trading firms. Typically these were supermarkets and larger wholesalers. There were also large state-owned enterprises in this sector.

State-Owned Public Catering:

There are still some state-owned public catering firms. Typically, large canteens and restaurants that belong to state-owned firms or are still majority owned by municipal governments.

Municipal Firms:

Across all sectors in this survey there are firms that have a majority stake held by municipal governments. These include hotels, service firms, food processing, manufacturing, metal works, taxi firms, *etc.* Some public utilities have also been included as they are also a component of local business and charge for their services.



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Telecoms:
The telecoms sector was selected to compare firms in this dynamic, growth oriented, sector with other sectors in Ukraine. However, there are only a limited amount of firms that state that telecommunications is their primary field of activity. For example, there are only 7 national state-owned telecoms firms in our sample, no municipal telecoms firms, only 1 early privatized firm and 2 late privatized firms. The rest of the 50 telecoms firms surveyed were all start-ups. *This is pertinent in comparing averages.*

Sole Proprietors and Micro-Firms:
As this survey covered medium and large firms and attempts to draw comparisons between them, very small firms (less than 5 employees) and sole proprietors have not been surveyed. As with agricultural entities, very small firms, market traders and sole proprietors tend to have a different set off issues than larger more established firms.

# EXECUTIVE SUMMARY

This report is based on a survey of Ukrainian enterprises and is designed to reflect as closely as possible the structure of business in Ukraine. The survey also covered the whole of Ukraine and therefore covers regional differences as well. This report is in four main sections: enterprise performance, barriers to market entry and expansion, use of information technologies and external business assistance.

2000 was the first year of GDP growth in Ukraine since independence and this was reflected in enterprise performance over the year. A larger proportion of Ukrainian firms were profitable in 2000 than in 1999 and there has been almost universal growth in value added activities. On the whole smaller firms were more dynamic, and more of them were profitable than larger firms. Further, start-up firms[1] generally performed much better than either state-owned[2] or privatized[3] firms.

*Sales and Value Added Growth*

According to survey data real sales increased by 28% over 2000. Reflecting improved purchasing power, the sectors that had the best sales growth were trade (sales growth of 46%), telecoms with 41%, and public catering (*i.e.* cafes and restaurants) with 38%. Sales growth favored smaller enterprises rather than larger ones, small firms (up to 50 employees) experienced sales growth of 38%, medium firms (51 – 250 employees) of 27%, and large firms (more than 250 employees) the same as medium firms at 27%. Start up firms who experienced 48% sales growth outperformed both state-owned and privatized firms who had 18% and 30% respectively.

The picture with value added is similar to sales growth. Overall value added increased by 11%. Trading firms outperformed all others with value added growth at 33%. In second place was the service sector at 23%. Both public catering and the transport sectors experienced a very slight contraction in value added over 2000 of almost 1%. Again start up firms were the best performers, collectively achieving 26% value added growth. Privatized enterprises as a whole performed worse than state owned firms with only 6% value added growth compared with more than twice as much at state-owned firms (13%.) However, there is a large difference between early and late privatized firms. Early privatized firms, who have had more time to restructure and adapt under new private ownership, saw value added growth rates of 14% compared with late privatized firms who saw value added shrink by 3%.

A more accurate comparison would be between privatized firms and national state-owned firms as they experience more competitive pressure than municipal firms. More municipal firms are monopolists or have a higher degree of market power than national state-owned firms. National state-owned firms experienced value

[1] Start-up firms in this report are defined as all newly created enterprises with majority of private ownership, *and* not as a result of privatization. In this report they are further divided into early and late start-ups, with January 1, 1996 being the cut-off date.

[2] State-owned firms are enterprises with not less than 50% stake hold by the state. In this report state-owned firms are split into two groups; nationally owned enterprises and municipally owned enterprises.

[3] Privatized firms are previously state-owned enterprises that run through privatization process and have a majority non-state ownership. In this report they are split into early and late privatizations, with January 1, 1996 being the cut-off date.



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added growth rates of 12% compared with 14% for early privatized firms and –3% for late privatized firms.

*Profitability*

4% more enterprises were profitable in 2000, 64% compared with 60% in 1999. Again, a greater proportion of smaller enterprises were profitable (70%) compared with medium sized firms (56%) or large firms (53%). More start-up firms were profitable (76%) than either privatized firms (55%) or state owned firms (52%). The worst performing sector was transport with only 38% of firms profitable (up from 37% a year earlier.) The trade and services sector were the best with both sectors having 71% of firms profitable.

*Exports*

Only 20% of all companies exported in 2000, with exports accounting for 14% of the overall sales of all surveyed firms. A larger proportion of large firms exported their products (46%) compared with 23% of medium sized firms or 10% of small firms. Large firms also exported a greater proportion of their sales (16%) than either medium sized firms (6%) or small firms (5%). The best performers were privatized enterprises with around 20% of their sales exported. By far and away the most popular export market was the CIS with 14% of all Ukrainian firms (or 73% of all exporters) stating that that was their main export market, compared with only 5% of all firms who quoted Europe and the rest of the world as their main export markets.

*Employment and Labor Productivity*

Improved financial performance of surveyed firms was accompanied by a contraction in work forces of 3%. Only the telecoms sector experienced any significant job creation (6%). The construction sector contracted the most, losing over 8% of its work force. Start-ups again demonstrated their dynamism by employing an extra 4%, which was almost exclusively accounted for by late start-ups who employed an extra 8%. Amongst firm origin state-owned firms overall contracted the most, shedding on average 4.5% of their work forces.

Labor productivity at surveyed firms increased by 15% compared with 1999, with start-ups performing the best, increasing their labor productivity by 21%. Early start-ups (one fifth of all start-ups) increased their productivity by 30%. Start up service firms performed best of all experiencing 39% productivity growth. There was a very large difference in productivity growth between early and late privatized firms. Firms privatized prior to 1996 improved labor productivity by 19% whereas those privatized in 1996 and later experienced a drop in productivity of 1%. State-owned enterprises improved labor productivity overall by 18%, though this is probably due a proportionally greater reduction in work forces compared with firms in the private sector.

*Budget Constraints*

The softness of budget constraints (in this survey the degree to which enterprises can evade tax and payments for energy) has been acknowledged as one of the biggest problems in restraining further private sector development and restructuring in Ukraine. More state-owned firms had significant tax and energy arrears compared to firms in the private sector. 16% of state-owned firms compared with 9% privatized firms and an insignificant 1% of start-ups. Further the larger a company is the more likely it is to have budget arrears, with 12% of large firms in arrears, compared with only 2.7% of small firms. Further, a third of the sales of state-owned firms were in the form of non-monetary instruments (which can also

be considered to be a form of soft budget constraint, especially if the transaction is with a state-owned entity) compared with 17% of sales for privatized firms and 9% for start-ups.

*Enterprise Restructuring*

It is generally difficult to define enterprise restructuring as by definition it is a change from the old to the new and is unique to each enterprise. This survey defined restructuring as 13 activities related to changing products, technology, employment, markets and organizational structure over the last three years.

The survey shows that the most important factor influencing both enterprise performance and enterprise restructuring is the level of competition. The more competition a firm faces the greater the likelihood of sales growth and the greater the chance of restructuring. Hard budget constraints imposed on enterprises correlate with more intensive strategic restructuring, whilst soft budget constraints are more conducive to more passive forms of restructuring, for example labor contraction and asset disposal.

Firm origin also influences the likelihood enterprise restructuring. Unsurprisingly, the companies most actively restructuring or changing their operations in 2000 were privatized and start up companies. Early start-ups and late privatized companies were the most active at developing new products (58% and 47% respectively.) Start-ups were the best at attracting new clients, with over 40% doing so. Early privatized firms were the most likely to shed employees (50% of all early privatized firms), closely followed by late privatized firms (46%) and national state owned firms (45%.) Late privatized companies were the most active in changing their organizational structure with 22% doing so. On the whole nationally owned and municipally owned firms (together state owned firms) were the least dynamic and responsive in our survey.

*Capital Expenditures and Working Capital*

A relatively small proportion of firms experienced investment expenditure in 2000 ( 41%.) The likelihood of investment into fixed assets does not seem to be strongly dependent on firm origin. More start-up firms experienced investment expenditure (44%) followed by state-owned firms (40%) and then privatized firms (38%). A larger range was observed with firm size, ranging from 35% of small firms to 44% of medium sized firms to 52% of large firms experiencing investment into fixed asstes. The sector with the highest frequency of capital expenditure was telecoms with almost half of all telecoms firms (48%) investing into fixed assets.

New equipment and production facilities was the most popular form of investment expenditure into fixed assets. In 2000 28% of all firms bought new equipment followed by repairs of premises (23%). The most common source of investment financing was retained earnings and depreciation. 35% of all companies (or 86% of all companies experiencing fixed asset investment) financed their investment expenditures from retained earnings, followed by only 6% of all firms receiving bank credit for investment into fixed assets (with only 4% of small firms receiving bank credit.) Other sources of financing were not significant.

The picture with working capital is a little more optimistic with double the amount of firms receiving bank credit for working capital (13%) as did for fixed assets (6%.) though this is still very small indeed. 9% of small firms were able to secure bank credit for working capital compared with 25% of large firms. Amongst firm



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origin, more privatized firms were able to secure bank credit for working capital than other classes of firms.

Firms were more optimistic about investment spending in 2001. 58% of firms plan to have investment into fixed assets in 2001 with 20% of them planning to obtain bank credit to finance investment.

*Taxation*

Surveyed firms quoted taxation issues as the main constraint for market entry and expansion. Instability of tax legislation ranked as the biggest tax problem followed by tax burden in second place.

The average number of taxes paid by all Ukrainian companies is 11, ranging from 9 for small firms to 14 for large firms (out of a total of 17 national and 6 local taxes and duties that were applicable to surveyed firms.) This represents an overall tax burden of 24% of sales, with most firms somewhere around this level. Trade firms had the least with 19% of sales turnover paid in tax and construction firms the highest with 28%. However, in terms of value added, the figures are very different. Over half (53%) of value added or wealth creation of all firms was paid in tax with the service sector having the highest value added tax burden (60%.) In terms of firm size this ranged from 44% for small firms to 52% for medium sized firms to 56% for large firms. The level of tax burden that firms stated was tolerable was half of the actual value at 27% of value added. This is perhaps one of the reasons that 16% of all turnover was concealed from taxation and the state.

*Unfair Competitive Practices*

As effectively functioning markets and oversight in Ukraine is still nascent, the issue of anti-competitive business practices is still prevalent in Ukraine. Out of general business barriers this issue ranks fourth, behind taxation, low demand and inflation, with all firms reporting some form of anti-competitive behavior. In addition to firms experiencing unfair competition from shadow activities and competitors receiving more favorable tax treatment, the biggest impediment quoted by all sectors (except manufacturing) was privileged permits/ permissions given to competitors by local authorities. This was the most acute form of anti-competitive behavior across all sectors. However, looking at firm size, this issue was only in second place behind privileged access to credit which ranked first for both medium and large sized firms. The anti-competitive barriers ranked third and fourth for all firms were privileged access to clients and subsidies to competitors from the national government.

*Main Regulatory and Administrative Barriers to Business Development*

The regulatory and administrative environment does not appear to have significantly changed over the last year. Ukrainian companies still complain of taxation problems and the very large role that the state plays in regulation and otherwise interfering in the operations of business.

Out of all regulatory and administrative issues, the most acute in 2000 was frequently changing business legislation, quoted by 94% of all respondents. In second place by severity customs procedures which, however, only applied to 44% of all firms. In third place by severity, obtaining permits and permissions (which was applicable to 86% of all firms.) Out of the choices presented firms ranked business registration procedures last.

*Unofficial Payments*

All firms surveyed had to make some sort of unofficial payments in dealing with regulatory and administrative issues. 23% of all surveyed firms had to make unofficial payments in obtaining permits and permissions, 15% in obtaining licenses, 15% in product certification. 28% of all firms had to make unofficial payments in relation to inspections and 39% of all firms had to make some form of 'voluntary' contribution to municipal or charitable funds.

*Time Tax*

The survey shows that the average amount of work time that senior company management spent on various dealings with the state amounted to 16% over 2000. Small and medium firms spent about the same amount of time (15% and 16% respectively) on dealing with the state, whereas larger firms spent about 20% of their time. Among cities the largest time tax was in Lugansk with 21%, followed by Ivano-Frankivsk with 20%. The smallest time tax out of all oblast capitals was in Uzhgorod with only 9%, and there small firms had a time tax of 7%, and medium firms had the lowest level of time tax in Ukraine at only an average of 5% of senior management time.

*Licensing*

Due to the fact that a large sample of both private and state-owned, small, medium and large enterprises were surveyed, it is difficult to analyze this issue as different firms face different licensing requirements. The survey instead asked firms whether they felt that business licensing presented an obstacle to business development. 72% of all firms had to undergo licensing in 2000, of which 42% felt that it presented a significant or major constraint to business development. 15% of these firms had to make unofficial payments in obtaining licenses.

The most difficult licensing environments (according to the respondents) were to be found in Simferopol (54% stated that licensing was a significant or major barrier), followed by Dnipropetrovsk (53%.) The best environments were to be found in Chernigiv (26%) , and Lutsk (28%.)

*Permits and Permissions*

86% of all firms faced the need to obtain permits/ permissions over 2000, of which 44% stated that permits and permissions presented either a serious or major barrier to market entry. The most problematic permits and permissions were in connection with land and construction. 58% of all companies felt that it was difficult or very difficult to obtain a permit for the allocation of a land plot, followed by 43% of all firms who complained about the procedures for receiving permits and permission for construction.

*Inspections*

The overall level of state inspections of business in Ukraine has not declined over 2000. Across all firms the average number of inspections in 2000 was 14.4, with small firms experiencing 11.5 inspections, medium sized firms 16.8 inspections and large firms 20.4 inspections over the course of 2000. The average total duration of all inspections was 26.6 days. Notwithstanding the fact that small firms had fewer inspections than large firms, smaller firms had a much greater inspections burden. Micro firms (less than 10 employees) had more than 20 times more inspections per employee than very large firms (more than 500 employees.)

*Inspection Consequences*

44% of all surveyed firms faced some sort of sanction from inspecting bodies. Of these, the most widespread was the use of 'kartoteka' (direct debit of fines and arrears from a company's bank account) faced by 18% of all companies. This was followed by repeated inspections in second place quoted by 17% of all firms and frozen bank accounts in third place quoted by 13% of all firms. The average duration of kartoteka was 171 days, firm assets seized as tax collateral – 174 days and frozen bank accounts - 95 days.

*Barriers to Receiving Financing and Credit*

The biggest barrier to receiving commercial financing was high interest rates, followed by lack of long term credit. Medium sized firms put lack of long term credit in first place as their biggest problem with obtaining financing. In third place for all firms was the issue of collateral requirements.

*Computer and Internet Use*

Three quarters of all surveyed firms had at least one computer (on average 1 computer for 20 employees) and around a third of all firms had some sort of internet access, with more larger firms (52%) having access than medium sized firms (31%) or small firms (27%.)

The biggest barriers to internet access were the low quality of phone lines and the high price of internet services. Internet use in Ukraine is still primarily passive with 80% of companies using internet access for email and 77% for obtaining news and information.

# MAIN ISSUES IN BUSINESS DEVELOPMENT IN UKRAINE

This report is based on a survey of 2,158 companies located in every oblast center in Ukraine and is therefore geographically representative. Further, it attempts to capture a representative picture of business[4] in Ukraine and therefore surveyed small (5 to 50 employees), medium (51 to 250) and large (more than 250) companies; state owned, privatized and start up companies. State owned companies were divided into municipal enterprises[5] and nationally owned companies. Privatized enterprises were divided into early and late privatized companies with January 1, 1996 being the cutoff. Privatized enterprises were defined as those that had a majority non-state ownership (*i.e.* not less than 50% privately owned.) Similarly startups were divided into early and late startups, with January, 1 1996 as the cut off date. Please refer to Annex 1 for a full explanation of the survey methodology used.

This survey looked at enterprise performance over 2000 and attempts to capture the main issues and problems faced by Ukrainian businesses. Broadly speaking, the main barriers facing Ukrainian firms can be divided as follows:

- Demand side restrictions: Low purchasing power, low demand.
- Macroeconomic instability: High and changing interest rates, inflation, exchange rate volatility.
- Micro-level non-financial constraints: legal-institutional issues (taxation and regulatory climate), market failure due to anti-competitive practices, access to infrastructure, difficulty in sourcing inputs, criminal pressure.
- Micro-level financial constraints: access to external financing, high cost of capital, underdeveloped financial markets.
- Corruption

Survey respondents were asked to rate what they considered to be the most important issues hindering their development and further growth. Fig.1 below shows the distribution of responses for 10 major business barriers in Ukraine.

There is almost total unanimity across all firms on the major barriers facing business development, irrespective of firm size or firm origin. The issue of taxation emerged as the biggest barrier for all sectors and also for small, medium, large, state and private companies as well. This confirms previous research carried out by IFC and other organizations, that consistently ranks taxation as the biggest business headache in Ukraine. As this report will later show, the biggest problem with taxation is not just high tax rates, but large number of different taxes and duties and frequently changing tax regulations, leading to inspections, unofficial payments and shadow economic activities. Again there is unanimity across the whole sample on the instability of the taxation regime in Ukraine as the main problem with taxation in Ukraine.

[4] Certain classes of firms were not surveyed, in particular agricultural producers and state financed enterprises (health care, educational establishments, *etc.*)

[5] More correctly 'communally owned' enterprises that are engaged in commercial activity, including transport, cafes and restaurants, construction firms, manufacturing firms, shops, hotels, *etc.*

**Figure 1**
**Rating of Barriers Hindering Business Development in Ukraine**[6]
*(distribution of responses for all firms)*

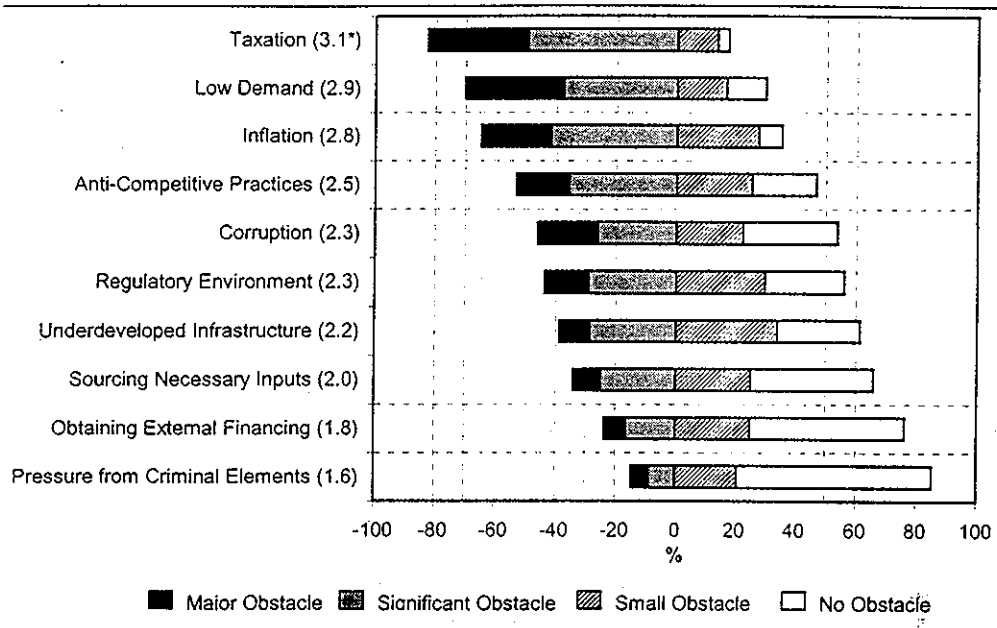


*Figure in brackets give the average score of answers on a 4-point scale from 1 – no obstacle to 4 – major obstacle, for each obstacle listed

Across all firms, general macroeconomic conditions, as characterized by low demand and inflation,[7] were cited as being the next most important issues for Ukrainian business. It is probable to assume that higher input prices in Ukraine have lead to cost-push inflation over 2000 leading to producers attempting to pass on higher costs to consumers. Low demand is ranked in second place for firms in the survey.

This is followed by Ukrainian firms complaining of anti-competitive behavior, discriminatory practices and a non-level playing field for all. The issue of corruption ranked as next most important in fifth place. This is followed by the general regulatory environment and access to infrastructure. Interestingly, in general firms ranked access to external financing almost in last place. Given the low level of investment, retained earnings and credits, in Ukraine, this is very surprising indeed and implies that the administrative, regulatory and business environment is much more important to the immediate operations of Ukrainian businesses than obtaining financing.

No real differences are observed between private or state companies amongst the rating of the main business problems in Ukraine, and in most cases the responses of state owned enterprises are identical with the responses of the entire sample. There was only one exception, and that is the issue of corruption. State owned enterprises ranked corruption as eighth most important compared to the whole sample ranking of fourth.

[6] Please refer to Table 21 for breakdown of main barriers by firm size and origin and Table 80 for sectoral breakdown.
[7] Inflation for 1999 - 19%, for 2000 - 26%.



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# ENTERPRISE PERFORMANCE

## *Financial Performance*

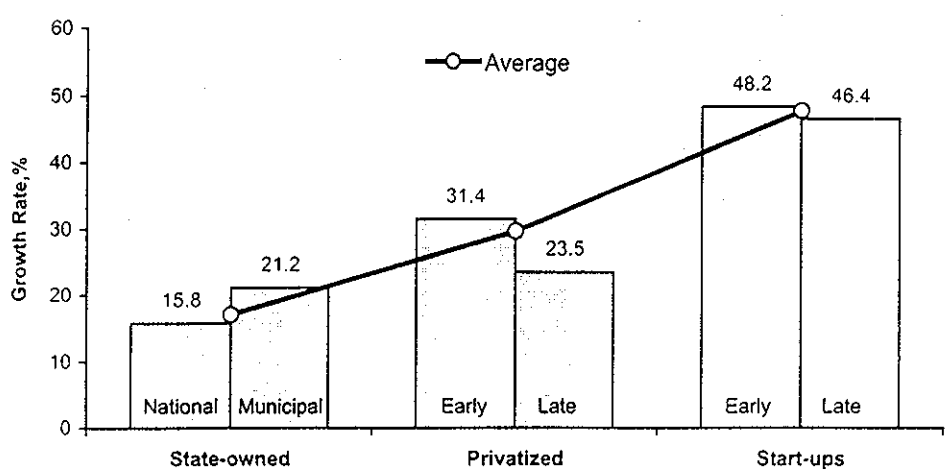
2000 was the first year of economic growth in Ukraine. Overall the results correspond well with national statistics on economic growth. The real volume of sales and value added of surveyed enterprises grew on average by 28% and 11% respectively.

The three best performing sectors by sales in descending order were trade, telecommunications and public catering (see Table 2.) The general service sector experienced the lowest growth rate at 15%. More encouraging was that overall sales growth was skewed towards smaller firms (38%), compared with medium and large firms which experienced an average sales growth rate of 27%.

**Table 2**
**Real Sale Growth Rates in 2000**
*(% weighted year on year average change)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 31.6 | 29.3 | 28.3 | 19.2 | 31.1 | 42.7 | **28.5** |
| Construction | 35.4 | 14.4 | 11.4 | -17.8 | 20.0 | 39.6 | **18.6** |
| Transport | 39.4 | 4.4 | 14.5 | 21.8 | 2.2 | 41.2 | **17.1** |
| Telecoms | 50.8 | 39.6 | 20.0 | 19.5 | -6.5 | 41.9 | **40.9** |
| Trade | 42.9 | 64.6 | 32.0 | 17.5 | 30.1 | 59.2 | **45.8** |
| Public Catering | 48.6 | 7.7 | | -10.2 | 45.4 | 47.6 | **38.2** |
| Other Services | 40.3 | 10.7 | 16.1 | 12.9 | 3.7 | 53.2 | **15.0** |
| **Average** | **37.5** | **26.6** | **26.8** | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | 9.3 | 15.9 | 49.8 | **37.5** |
| 51-250 | | | | 9.8 | 24.1 | 49.1 | **26.5** |
| More than 250 | | | | 18.8 | 31.0 | 25.8 | **26.8** |
| **Average** | | | | **17.1** | **29.6** | **47.6** | ***27.7*** |

**Figure 2**
**Real Sale Growth Rates in 2000 by Firm Origin**
*(% weighted year on year average change)*



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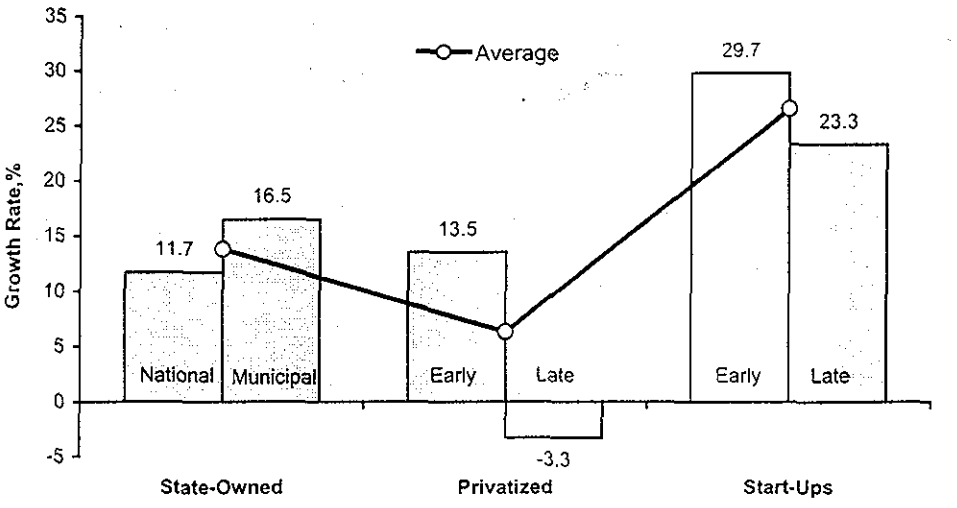
However, results of value added growth differ from the sales picture. Value added provides an assessment of wealth creation in an economy and at the firm level. In terms of value added growth the best three performers were trade, services and telecommunications (see Table 3). The worst in terms of value added growth rates was transport with almost zero. The average rates of growth in value added for each size group of enterprises were approximately at the same level – about 11%.

**Table 3**
**Value Added Growth Rates in 2000**
*(% weighted year on year average change)*[8]

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 1.9 | -0.9 | 10.7 | 13.8 | 5.0 | 20.0 | **8.5** |
| Construction | 24.2 | 13.2 | -20.2 | -30.1 | 8.9 | 36.0 | **3.5** |
| Transport | 4.2 | 4.5 | -2.5 | 9.0 | -8.6 | 0.5 | **-0.2** |
| Telecoms | 37.8 | 8.9 | 20.0 | 15.4 | -24.0 | 12.6 | **12.4** |
| Trade | 15.3 | 64.1 | 27.1 | -7.2 | 21.5 | 47.4 | **33.4** |
| Public Catering | 12.8 | -20.7 | | -43.3 | 16.7 | 8.1 | **-0.9** |
| Other Services | 16.6 | 24.5 | 22.4 | 17.9 | 20.5 | 48.2 | **22.5** |
| **Average** | **10.5** | **10.8** | **11.2** | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | -44.2 | 8.2 | 24.6 | **10.5** |
| 51-250 | | | | 6.4 | 0.7 | 29.5 | **10.8** |
| More than 250 | | | | 17.4 | 7.5 | 19.5 | **11.2** |
| **Average** | | | | **12.8** | **6.3** | **26.5** | ***11.0*** |

**Figure 3**
**Value Added Growth Rates by Firm Origin**
*(% weighted year on year average change)*




On the whole the private sector outperformed the state sector in sales growth in 2000. Sales growth for the private sector was 32% (privatized firms and start-ups) versus 17% for state-owned firms. However, the state sector did better as a whole in value added terms compared with sales growth. Municipal enterprises did well with value added growth of

[8] Value added growth rate was calculated by using the real sales growth data provided by respondents in 2000 compared with 1999 and the shares of material costs in sales in 1999 and 2000.



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17%.[9] Late privatized companies that are probably still undergoing more intensive restructuring, fared worse in value added growth than early privatized companies and lowered the average figures for privatized firms as a whole.

Probably the most appropriate comparison to make is between early privatized firms, who have already had time to undergo some restructuring and national state-owned firms (more direct competition.) Here we find that early privatized firms as a whole have performed a little bit better than the state-owned firms. This is encouraging as it shows that on an aggregate level within a particular sector privatization does lead to improved efficiencies, especially if it is borne in mind that in a lot of cases those firms still left in state ownership are more attractive or have a higher degree of market power than firms that were privatized earlier.

**Table 4**
**Profitable Enterprises in 1999**
*(% of all firms)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 67.8 | 49.1 | 51.4 | 51.4 | 48.3 | 74.0 | **56.5** |
| Construction | 58.3 | 58.2 | 66.7 | 25.0 | 53.5 | 72.9 | **59.2** |
| Transport | 68.8 | 30.3 | 17.5 | 15.2 | 31.9 | 76.0 | **37.1** |
| Telecoms | 76.3 | 100.0 | 75.0 | 80.0 | 50.0 | 80.6 | **79.1** |
| Trade | 65.9 | 65.9 | 63.6 | 53.3 | 58.7 | 70.3 | **65.8** |
| Public Catering | 55.6 | 63.6 | - | 57.1 | 46.3 | 65.0 | **56.3** |
| Other Services | 72.5 | 69.6 | 43.9 | 58.1 | 59.5 | 78.6 | **66.9** |
| **Average** | **66.1** | **52.9** | **48.5** | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | 58.2 | 53.9 | 72.8 | **66.1** |
| 51-250 | | | | 56.1 | 45.1 | 73.6 | **52.9** |
| More than 250 | | | | 36.2 | 51.9 | 78.3 | **48.5** |
| **Average** | | | | **48.3** | **50.2** | **73.1** | ***59.2*** |

**Table 5**
**Profitable enterprises in 2000**
*(% of all firms)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 71.2 | 51.4 | 56.3 | 53.1 | 52.7 | 76.6 | **60.2** |
| Construction | 65.2 | 65.5 | 61.1 | 29.4 | 58.3 | 78.9 | **64.8** |
| Transport | 70.0 | 25.0 | 17.5 | 14.7 | 31.9 | 74.2 | **38.4** |
| Telecoms | 83.3 | 100.0 | 100.0 | 100.0 | 66.7 | 84.6 | **85.1** |
| Trade | 72.2 | 69.0 | 54.5 | 58.8 | 67.4 | 74.1 | **71.4** |
| Public Catering | 59.1 | 90.9 | - | 66.7 | 52.7 | 67.2 | **61.5** |
| Other Services | 74.8 | 71.4 | 53.7 | 62.9 | 66.7 | 78.1 | **70.6** |
| **Average** | **70.5** | **55.9** | **52.8** | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | 61.5 | 61.7 | 75.6 | **70.6** |
| 51-250 | | | | 56.1 | 48.9 | 75.9 | **55.9** |
| More than 250 | | | | 41.7 | 55.6 | 82.6 | **52.8** |
| **Average** | | | | **51.5** | **55.4** | **75.8** | ***63.5*** |

Given the sales and value added growth, the proportion of profitable firms has grown by 4% to 64% of all enterprises in 2000. Moreover, more firms were profitable across all sectors, sizes and irrespective of firm origin. The largest proportion of profitable firms were

[9] 2 municipal enterprises were excluded from the averages. One a monopolist electricity utility with value added growth of 208% and the other a monopolist fuel utility with value added growth of 164%.



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in telecoms, small firms and start-ups. Conversely, the largest proportions of loss making enterprises were to be found in transport (62% of all transport firms) and state-owned companies (48%).

## *Exports*

The vast majority of surveyed enterprises (80%) did not export their products. The proportion of exporters among large enterprises is five times greater than among small firms. Less than 10% of small firms exported any products.

The international competitiveness of Ukrainian firms (as measured by the prevalence of non-CIS exports) is still very low (see figure 4). For example, 4 times as many large firms perceive CIS countries to be their major markets than Europe and the rest of the world, implying that firms still tend to follow more traditional export markets.

An average of almost 14% of the combined sales of all surveyed enterprises is exported (see table below.) As expected, larger firms export a greater proportion of their output than smaller firms, by a factor of three. By firm origin, privatized firms exported more than three times more of their output (20%) than either state-owned or start-ups.

**Figure 4**
**Distribution of Exports**
*(% of all firms)*

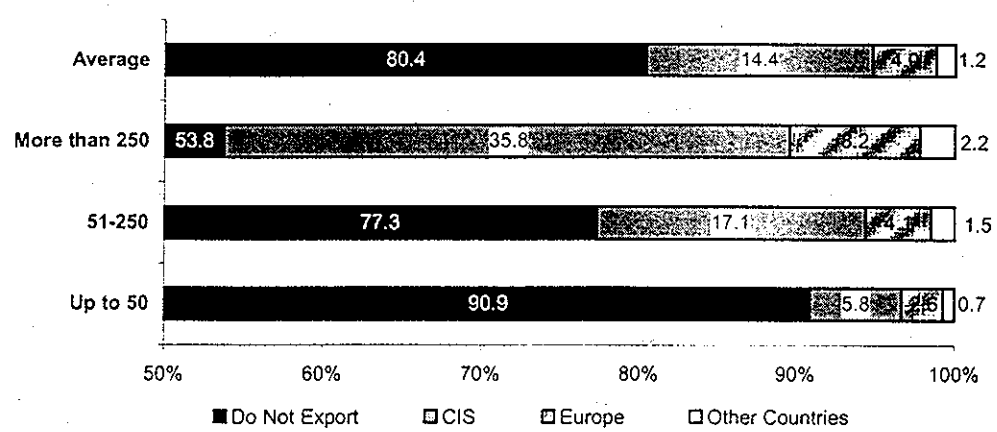




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**Table 6**
**Volume of Exports in 2000**
*(% of total sales of all firms in each group)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| **Sector** | | | | | | | |
| Manufacturing | 8.2 | 8.5 | 18.4 | 8.1 | 21.9 | 8.1 | 16.9 |
| Construction | 3.1 | 1.0 | 1.0 | 0.1 | 2.3 | 1.3 | 1.6 |
| Transport | 12.2 | 2.0 | 7.2 | 0.9 | 10.4 | 23.0 | 7.2 |
| Telecoms* | 2.2 | 14.8 | 5.0 | 15.8 | 0.3 | 13.0 | 12.8 |
| Trade | 0.7 | 0.0 | 9.2 | 0.0 | 5.4 | 0.6 | 2.5 |
| Public Catering | 12.8 | 0.0 | - | 0.0 | 19.0 | 0.0 | 9.3 |
| Other Services | 1.8 | 0.3 | 0.0 | 0.0 | 0.0 | 2.0 | 0.2 |
| Average | 5.2 | 5.7 | 16.4 | | | | |
| **Firm Size** | | | | | | | |
| Up to 50 | | | | 2.9 | 10.4 | 3.7 | 5.2 |
| 51-250 | | | | 2.0 | 6.9 | 7.8 | 5.7 |
| More than 250 | | | | 6.5 | 22.7 | 14.2 | 16.4 |
| Average | | | | 5.7 | 20.0 | 6.2 | *13.6* |

*High export figures for the telecoms sector may be explained by international data traffic counting as exports, and the diversified nature of telecoms companies (also have other lines of business.)

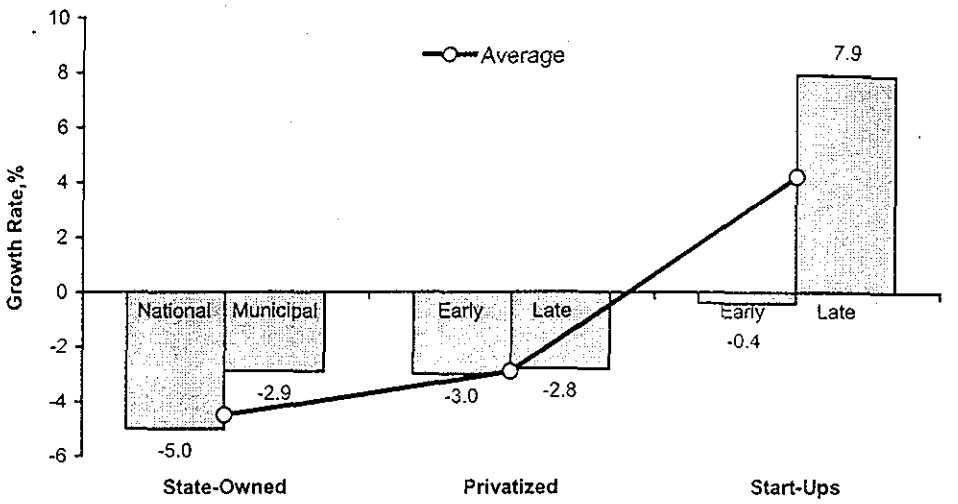
## *Employment and Labor Productivity*

Economic growth in 2000 was not accompanied by job growth at existing enterprises. Despite a rosier financial performance outlook most surveyed companies shed employees, though the data is insufficient to determine the direction of the causal link between job creation and enterprise performance. The average downsizing across the whole sample amounted to 3%. The only exceptions were in telecoms, trade and services and private sector start-ups in general (see Table 7). However, only late start-ups experienced positive job growth (see Figure 5). Internet service providers and mobile communication companies in the telecommunications sector were the only ones experiencing positive job growth irrespective of company size.

**Table 7**
**Employment Growth Rates in 2000**
*(% weighted year on year average change)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| **Sector** | | | | | | | |
| Manufacturing | -5.4 | -7.1 | -2.7 | -5.3 | -1.9 | -4.2 | -3.2 |
| Construction | -11.4 | -7.6 | -8.2 | -14.8 | -15.2 | 20.1 | -8.3 |
| Transport | -28.9 | -16.6 | -4.4 | -4.5 | -10.7 | 0.8 | -6.0 |
| Telecoms | 7.7 | 44.7 | 4.0 | -1.6 | 0.0 | 33.4 | 5.9 |
| Trade | -0.5 | 5.4 | -2.9 | -5.8 | -5.1 | 9.7 | 0.4 |
| Public Catering | 0.0 | -7.6 | | -13.4 | -4.4 | 6.5 | -2.4 |
| Other Services | 1.4 | -1.0 | 0.9 | 1.1 | -1.1 | 6.7 | 0.7 |
| Average | -4.2 | -6.3 | -2.7 | | | | |
| **Firm Size** | | | | | | | |
| Up to 50 | | | | -14.8 | -12.3 | 3.9 | -4.2 |
| 51-250 | | | | -5.1 | -9.0 | 3.6 | -6.3 |
| More than 250 | | | | -4.4 | -1.7 | 4.8 | -2.7 |
| Average | | | | -4.5 | -2.9 | 4.2 | *-3.1* |

**Figure 5**
**Employment Growth Rates in 2000**
*(% weighted year on year average change)*




The survey shows that, as a result of negative net job creation, greater restructuring and increases in sales and value added, labor productivity at Ukrainian enterprises has increased in 2000. Table 8 below shows changes in labor productivity. All surveyed sectors experienced labor productivity growth which averaged 15%. The best performers were trade (33%), services (22%) and construction (13%). Public catering performed the worst with productivity increasing by only 1.5%. Medium sized firms fared the best with average productivity of 18%, consistent with them proportionally shedding the most employees (by 6%).

**Table 8**
**Labor Productivity Growth Rates in 2000***
*(% weighted year on year average change)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 7.7 | 6.7 | 13.8 | 20.5 | 7.1 | 25.3 | **12.1** |
| Construction | 40.2 | 22.6 | -13.1 | -18.0 | 28.4 | 13.2 | **12.9** |
| Transport | 46.6 | 25.4 | 2.0 | 14.1 | 2.4 | -0.2 | **6.1** |
| Telecoms | 28.0 | -24.8 | 15.4 | 17.3 | -24.0 | -15.6 | **6.2** |
| Trade | 16.0 | 55.6 | 30.8 | -1.4 | 27.9 | 34.4 | **32.9** |
| Public Catering | 12.7 | -14.2 | - | -34.6 | 22.1 | 1.5 | **1.5** |
| Other Services | 15.1 | 25.7 | 21.3 | 16.6 | 21.8 | 38.9 | **21.7** |
| ***Average*** | **15.4** | **18.2** | **14.2** | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | -34.5 | 23.3 | 20.0 | **15.4** |
| 51-250 | | | | 12.0 | 10.7 | 25.0 | **18.2** |
| More than 250 | | | | 22.9 | 9.4 | 14.0 | **14.2** |
| **Average** | | | | 18.1 | 9.5 | 21.4 | ***14.6*** |

*Calculated as value added growth ratio (1999-2000) divided by employment growth ratio (1999-2000).

At an aggregate level, over 2000 state-owned enterprises improved labor productivity more rapidly than private firms – by 18% compared to the 13% average for all private firms. This is probably due to state-owned enterprises reducing their work forces more so than other companies. However the picture is more interesting if the data is disaggregated (*see Figure 6 below*). Companies with the highest productivity growth were early start-ups (30%). Followed by municipal enterprises (20%). Early privatized companies performed similarly



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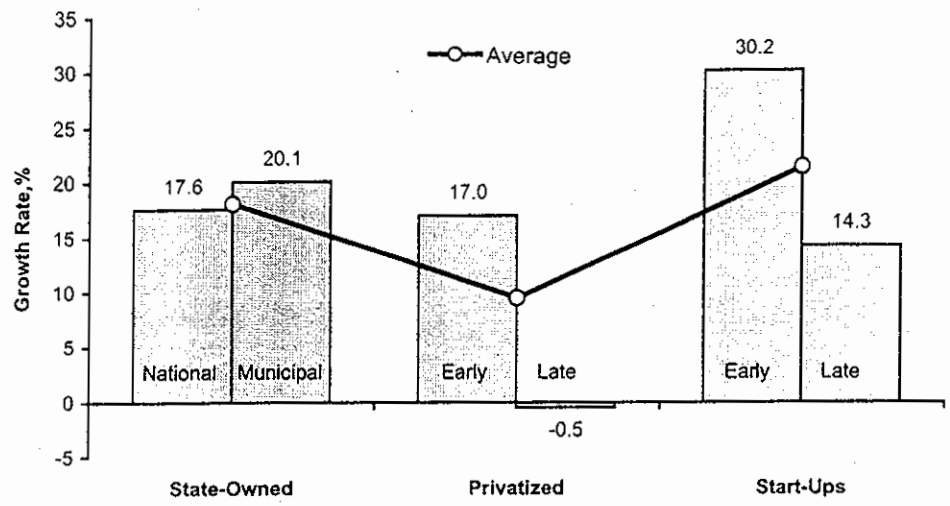
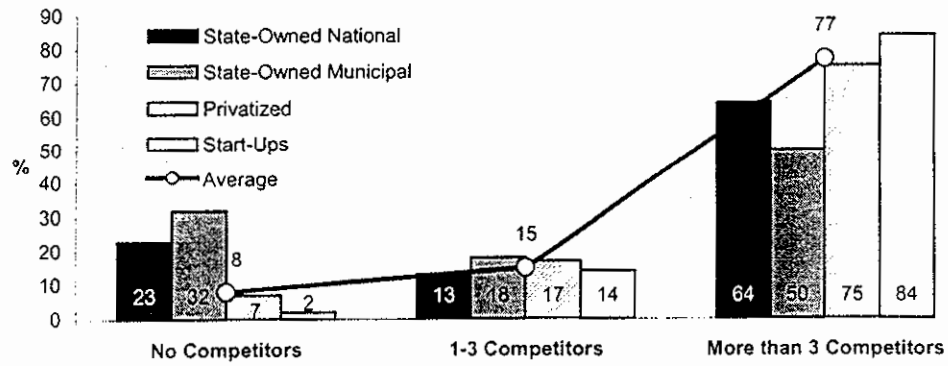
to nationally owned state enterprises increasing their productivity figures by 17% and 18% respectively.

**Figure 6**
**Labor Productivity Growth Rates in 2000**
*(% weighted year on year average change)*




## *Competition*

**Figure 7**
**Number of Competitors**
*(% of all firms)*




Start up enterprises operate in the most competitive environment - only 2% of new entrants have no competitors (see Figure 7). Further, start-ups experienced the most domestic competitive pressure, compared with privatized and state-owned firms (see Figure 8.) Privatized enterprises on the other hand faced the most foreign competitive pressure. As expected, municipal enterprises experienced the smallest competitive pressure (32% of the group are monopolists).



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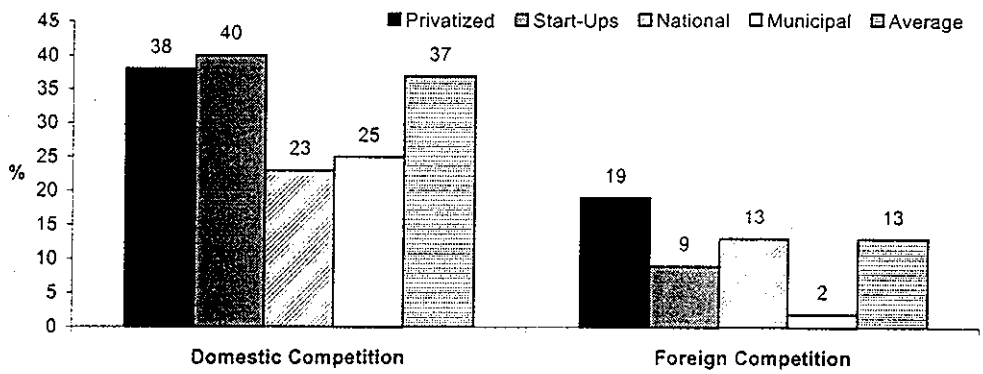
**Figure 8**
**Pressure from Domestic and Foreign Competitors**
*(% of the total of each type of enterprise who stated significant and very significant competition)*




## *Softness of Budget Constraints*

In a fully functioning market environment enterprises are led by market prices, supply and demand, and the relation between revenues and expenditures. Imposition of hard budget constraints on firms implies that enterprises bear full responsibility for their actions, in particular, they make all of their payments to the state in full and on time, receive no state subsidies or credits on preferential terms to finance operational and capital expenditures, and cannot influence the legislative and regulatory environment exclusively in their favor. In addition enterprises should expect that these conditions will not change in the future. Hard budget constraints are therefore one of the more important mechanisms that a government has in determining a level playing field for all and stimulating enterprise efficiency. The violation of any of the above mentioned principles means that an enterprise operates under conditions of soft budget constraints.

For the purposes of our survey soft budget constraints at the enterprise level were defined by the presence of significant tax and/or energy arrears. Table 9 below shows the proportion of enterprises that reported that they were in significant arrears to the state and/or energy suppliers.

**Table 9**
**Firms with Significant Tax and/or Energy Arrears***
*(% of all firms)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| **Sector** | | | | | | | |
| Manufacturing | 3.5 | 12.2 | 10.9 | 15.2 | 10.4 | 2.2 | 8.6 |
| Construction | 3.1 | 12.7 | 22.2 | 11.8 | 16.4 | 0.0 | 8.3 |
| Transport | 7.5 | 14.3 | 12.5 | 20.6 | 10.2 | 3.1 | 11.3 |
| Telecoms | 0.0 | 0.0 | 25.0 | 14.3 | 0.0 | 0.0 | 2.0 |
| Trade | 1.4 | 0.0 | 0.0 | 17.6 | 0.0 | 0.7 | 1.2 |
| Public Catering | 3.0 | 0.0 | - | 9.5 | 1.8 | 1.5 | 2.8 |
| Other Services | 3.2 | 5.2 | 19.5 | 15.9 | 6.0 | 0.9 | 6.3 |
| Average | 2.7 | 10.3 | 12.3 | | | | |
| **Firm Size** | | | | | | | |
| Up to 50 | | | | 12.4 | 3.9 | 1.0 | 2.7 |
| 51-250 | | | | 13.3 | 12.6 | 1.7 | 10.3 |
| More than 250 | | | | 19.2 | 9.2 | 8.3 | 12.3 |
| Average | | | | 15.5 | 8.5 | 1.3 | 6.4 |

*In answering the question on presence of tax and/or energy arrears firms were given 4 options: 'none', 'insignificant', 'manageable' and 'hopeless'. For the purposes of the table 'manageable' and 'hopeless' were aggregated.

Whilst there is significant variation between sectors, the data shows significantly less small firms have significant arrears to the state than either medium or large firms. As can be observed more larger state owned enterprises experience soft budget constraints than other types of firms. In fact almost 12 times as many state owned firms than start-ups are likely to have significant tax and energy arrears. This has very obvious implications for state revenues.

The use of non-monetary instruments in transactions can also be considered to be a type of soft budget constraint especially as it relates to fiscal discipline of enterprises.

**Table 10**
**Volume of Sales Using Barter, Off-sets, Bills of Exchange and Other Non-monetary Instruments**
*(% of sales, weighted)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| **Sector** | | | | | | | |
| Manufacturing | 14.7 | 17.4 | 22.9 | 33.8 | 16.9 | 11.6 | 21.9 |
| Construction | 21.3 | 29.1 | 21.8 | 12.7 | 30.6 | 18.7 | 24.4 |
| Transport | 23.3 | 14.7 | 7.9 | 9.1 | 11.0 | 20.7 | 11.2 |
| Telecoms | 6.0 | 5.0 | 58.6 | 48.2 | 15.0 | 5.0 | 7.4 |
| Trade | 6.3 | 3.0 | 15.9 | 12.1 | 7.7 | 7.4 | 7.7 |
| Public Catering | 8.7 | 2.0 | - | 4.4 | 11.3 | 1.9 | 6.9 |
| Other Services | 2.6 | 37.4 | 38.2 | 40.2 | 34.8 | 1.9 | 36.0 |
| Average | 11.6 | 20.7 | 23.8 | | | | |
| **Firm Size** | | | | | | | |
| Up to 50 | | | | 23.1 | 10.3 | 10.3 | 11.6 |
| 51-250 | | | | 35.4 | 19.8 | 6.0 | 20.7 |
| More than 250 | | | | 34.2 | 17.2 | 16.0 | 23.8 |
| Average | | | | 34.1 | 17.4 | 9.0 | 22.3 |

Non-monetary instruments, which are by definition more opaque, often allow for transactions at non-market prices and minimizing or even evading taxes. For example, a large enterprise producing a non-competitive product and thereby with little cash flow, may use barter or mutual off-sets to cover energy debts at below-market prices which in turn distorts the true financial state of the firm.

On average state-owned firms had more non-monetary transactions than privatized firms, who in turn had more that start up firms. However, there were significant variations with for example, state owned transport and construction firms being more cash based than their counterparts in the private sector. Similarly there is tendency for larger firms to use more non-monetary instruments than smaller ones.

## *Enterprise Restructuring*

According to the definition of Pohl *et al.*,[10] enterprise restructuring during the transition from a planned to a market economy is a complex process of changes at the firm level to support profitability under conditions of a continuously changing economic environment, technological progress and competition from other market participants. Existing economic literature on enterprise restructuring in transition defines at least two major types of restructuring activities: passive and strategic restructuring:[11]

Passive restructuring is imposed by new market environment on almost all enterprises regardless of firm origin. It includes the following measures influencing the short-term prospects of an enterprise: postponing production not demanded by the market, reducing costs by the sale or lease of idle assets, decreasing real wages and/or reducing the workforce.

Strategic restructuring include measures aimed at making an enterprise viable in the long run. The market value of an enterprise in this case is maximized by the development of new business strategies, organizational changes, investment into new production lines and technologies, new product development, expansion into new markets, etc. Strategic restructuring usually leads to an increase in output and new job creation.[12]

This survey attempts to reveal the intensity of restructuring, or alternatively firm dynamism (as some of these activities are not purely restructuring activities) at the enterprise level. Respondents were asked questions regarding both strategic and passive kinds of restructuring activity performed by their enterprise over the last three years. Table 11 presents a breakdown of restructuring activities by firm origin.

[10] Pohl, Gerhard, Robert E. Anderson, Stijn Claessens and Simeon Djankov (1997): Privatization and Restructuring in Central and Eastern Europe: Evidence and Policy Options. World Bank Technical Paper No. 368, The World Bank.

[11] See, for example, Irina Akimova, "Export Orientation and its Influence on Enterprise Restructuring in Ukraine", pp 209, ed. Hoffmann and Moellers, 2001.

[12] EBRD Transition Report 1999, pp.143-144.



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**Table 11**
**Restructuring by Firm Origin**
*(% of the total of each type of enterprise)*

| | | Firm Origin | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | State-Owned | | Privatized | | Start-Ups | | Average |
| | | National | Municipal | Early | Late | Early | Late | |
| Strategic Restructuring | Developed New Products | 36 | 22 | 45 | 47 | 54 | 39 | 43 |
| | Improved Existing Products | 41 | 24 | 50 | 44 | 55 | 43 | 46 |
| | Changed Sales Channels | 27 | 8 | 31 | 32 | 28 | 24 | 27 |
| | Attracted New Major Clients | 32 | 16 | 34 | 30 | 41 | 39 | 34 |
| | Introduced New Technologies | 26 | 30 | 31 | 28 | 34 | 24 | 28 |
| | Purchased/ Leased New Assets | 7 | 8 | 8 | 10 | 20 | 15 | 12 |
| | Changed Major Suppliers | 14 | 5 | 20 | 19 | 22 | 19 | 18 |
| | Attracted New Employees | 29 | 24 | 34 | 36 | 47 | 45 | 38 |
| | Trained Employees in New Technologies | 18 | 15 | 27 | 26 | 29 | 24 | 25 |
| | Changed Legal Organizational Structure | 11 | 10 | 8 | 22 | 5 | 8 | 10 |
| Passive Restructuring | Discontinued Production of Old Products | 17 | 5 | 23 | 18 | 15 | 9 | 16 |
| | Sold/ Leased Out Excess Assets | 26 | 19 | 32 | 25 | 9 | 6 | 19 |
| | Shed Excess Labor | 45 | 32 | 50 | 46 | 30 | 25 | 38 |

Development of new products is perceived by many economists as the most important sign of strategic restructuring since it reflects an enterprise's ability to meet changing demand and other market conditions. Early start-ups are clearly the most innovative, with over half developing new products and services. Privatized firms (irrespective of when they were privatized) also performed well in developing new products. State owned enterprises performed worst of all in adapting to changing market conditions though this could also be

more of a reflection of the fact that state owned enterprises tend to face less competition in general.[13]

On the whole the data shows start ups and privatized enterprises to be most dynamic in response to changing conditions, they were better at finding customers, developing new products, and creating new jobs. Passive types of restructuring, represented by discontinuation of old products and production and a reduction in excess labor, were also performed most frequently by privatized enterprises. Across all restructuring parameters surveyed, more privatized firms were active than state-owned firms, particularly in strategic restructuring.

The worst performers across almost all restructuring indicators were municipally owned enterprises, an important confirmation of the need to further reduce the role of city governments in local business.

## *Management Turnover*

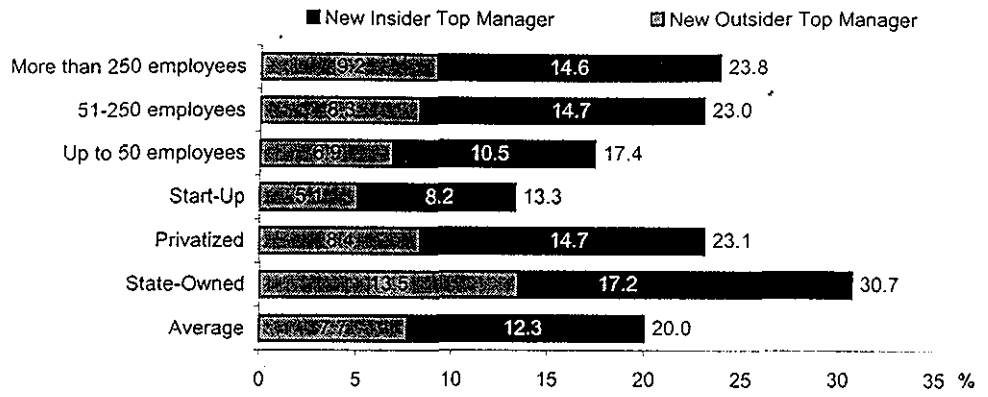
Another important component of enterprise restructuring (or enterprise dynamism) is the frequency with which key enterprise decision makers are changed, if at all. Company managers take all key operational decisions and are in a position to initiate restructuring. The role of outside professional company management (in the sense of taking key operational decisions) is still novel in Ukraine.

Directors could be disciplined in different ways, in particular, by enterprise owners and external factors. Company directors are appointed by enterprise owners who could have different objectives. For instance, the objectives of insider owners (workers or existing managers) are quite different from the objectives of the outsiders - direct and portfolio investors or government representatives. Among the major external factors influencing management turnover according to the survey are market structure (*i.e.* competition) and degree of softness of budget constraints.

On average, each fifth enterprise changed its top management over last three years. At the same time 7.7% of surveyed companies attracted new top managers from outside. Evidence of the latent state of the managerial talent market is the relatively low influx of new outside managers into privatized enterprises -- only 8.4%. The high proportion of management turnover at state-owned enterprises is probably explained by administrative and/or political decisions rather than market pressures. The table below shows by firm size and origin those firms that changed their management, as well as showing whether they were insiders or outsiders.

[13] For comparisons between the state and private sectors in enterprise restructuring it is better to use only nationally owned enterprises as representative of state enterprises due to the specific market conditions under which municipal enterprises operate (product homogeneity and high degree of market power.)

**Figure 9**
**Management Turnover**
*(% of all firms)*




The telecoms sector experienced the highest rate of attracted managerial talent, however the general manufacturing sector also experienced substantial management turnover (23%), especially so with state owned enterprises (65.5% of all state owned manufacturing companies.)

A possible reason for the relatively low level of influx of new outside managers into privatized firms could be that enterprise ownership is more dispersed, and therefore the chances of a majority owner are reduced. Another possible reason is the dominance of inside owners in an enterprise rather than outside owners, thereby increasing the chances for insider management.

**Table 12**
**Ownership Dispersion at Privatized Enterprises and Start-ups**
*(% of all private firms)*

| | Holders of Major Stakes, %* | | | | Total |
|---|---|---|---|---|---|
| | One (State) | One (Private) | Two-Three | More than Three | |
| **Privatized** | **1.7** | **13.8** | **22.0** | **62.5** | **100.0** |
| Early | 1.6 | 12.2 | 18.0 | 68.2 | 100.0 |
| Late | 1.9 | 15.5 | 26.8 | 55.8 | 100.0 |
| **Start-ups** | **0.5** | **43.5** | **36.3** | **19.6** | **100.0** |
| Early | 0.9 | 35.7 | 38.9 | 24.5 | 100.0 |
| Late | 0.4 | 48.3 | 34.5 | 16.9 | 100.0 |

*Refers to holders of the largest relative stakes. The state could very well have the largest single, though minority, share.



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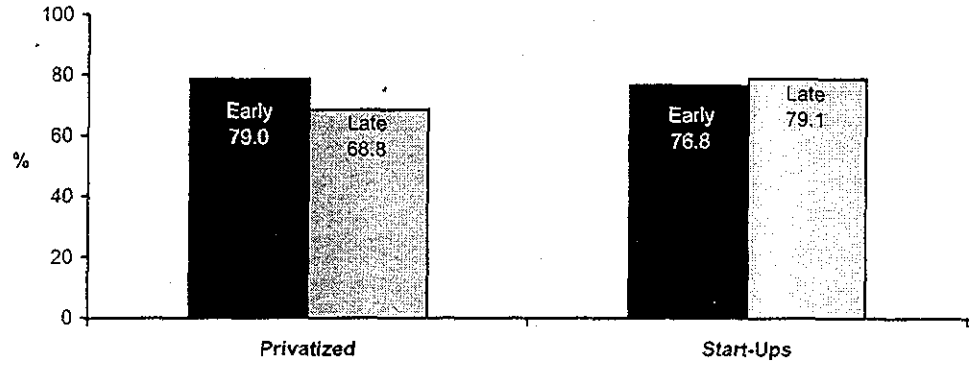
**Figure 10**
**Privatized Enterprises and Start-ups with Dominant Inside Owners***
*(% of total in each firm origin group)*




*Controlling stake with management and/ or employees.

A statistical analysis (*see Annex 2 for more information*) revealed that there are several main factors that increase the probability of the appointment of new outside management. In order of significance these are: the presence of outside owners, an increase in the number of competitors and the probability that management will change increases with the presence of significant tax and/or energy arrears.

Start-ups change their managers the least frequently. More than twice as many state-owned firms compared have changed their management as start-ups. Ownership concentration appears to have no significant influence on the probability of management turnover.

## *Factors That Influence Enterprise Performance*

An important objective of the survey was to determine what relationship, if any, exists in Ukraine between enterprise performance and various internal and external factors influencing enterprises. This follows on from similar research carried out by EBRD in 1999[14] where they examined enterprise performance in the medium term (over three years) in 22 transition countries.

*EBRD Business Environment and Enterprise Performance Survey*
*Main Results:*

- *Sales growth is higher for those firms experiencing significant pressure from foreign competitors, but is not higher for firms reporting significant pressure from domestic competitors. Firms with 1-3 competitors have much higher sales and productivity growth than firms with no competition or very strong competition. Pressure from foreign competitors and customers is a significant source of sales and productivity growth. Competition contributes to the growth of firms through its impact on the development of new products and technologies.*
- *Strategic restructuring at the firm level is conducive to sales and productivity growth. The launch of new products and the upgrading of existing ones are closely linked with sales growth. At the same time the influence of switching suppliers and firm reorganization on sales growth is very weak;*
- *Soft budget constraints measured by the presence of tax arrears leads to a slower expansion in sales.*

[14] Business Environment and Enterprise Performance Survey. EBRD Transition Report 1999.



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The analysis in this report (*see Annex 2 for regression analysis*) used the same approach as in EBRD's survey and showed that, in the short term (over one year), the following factors are related to enterprise performance:

- Significant domestic competition is associated with increasing sales. However, significant foreign competition leads to a slight decrease in real sales volumes;
- When control is made for other factors, firm origin status does matter for financial performance. Start-ups and privatized enterprises performed better than state-owned companies in terms of sale growth whilst municipal enterprises outperformed nationally owned state enterprises in terms of value added growth;
- Strategic restructuring measures have different effects. New product development correlates with a reduction in sales and value added, whilst improving existing products is associated with increasing sales. Changing sales channels increases the volume of sales and value added. Attracting new clients leads to higher value added volumes. Changing major suppliers correlates with a reduction in value added. Training employees to meet new technologies and attracting new employees is associated with an increase in value added. Changing a firms organizational structure correlates with a decrease in value added (however, it is not clear why);
- The consequences of passive types of restructuring are varied as well. Ceasing old production increases a firm's value added. Sale/lease of excessive assets is associated with a reduction in real sales. Reducing the workforce correlates with a reduction in value added. This is a positive sign if accompanied by productivity growth;
- The short term influence of soft budget constraints on firm financial performance is unclear.

## *Factors That Influence Enterprise Restructuring*

Some restructuring measures in the short term are associated with increasing sales and value added, others with a decrease. However, other research carried out in this field that uses a more long term approach and simple common sense indicate that restructuring, especially strategic restructuring, is a precondition for improving competitiveness and sustainable growth of an enterprise. Therefore, this report seeks to analyze which factors are the most conducive for restructuring at the firm level.

According to the EBRD Business Environment and Enterprise Performance Survey[15], the degree of enterprise restructuring in transition economies in general is positively influenced by the level of competition experienced by firms, hard budget constraints, presence of concentrated outside private owners and quality of the investment climate in the particular country.

Studies of the Ukrainian corporate sector have drawn similar conclusions. Research carried out by the London Business School[16] found that outsider rather than insider firm ownership leads to greater restructuring activity, notably with respect to products (*i.e.* adjustment to quality, product mix, structure of sales by region and sales outlets) and inputs (reducing waste in material inputs, energy, changing suppliers.) The German Advisory Group on Economic Policy[17] concludes that enterprise restructuring is triggered by an increase in competitive pressure, especially by exposure to foreign competition, changes in top

[15] EBRD Transition Report 1999.

[16] Estrin Saul, and Rosevear, Adam, Enterprise Performance and Corporate Governance in Ukraine. Journal of Comparative Economics, 27, 1999, pp. 442-458.

[17] See, Irina Akimova, "Export Orientation and its Influence on Enterprise Restructuring in Ukraine", pp 206-232, Ukraine on the Road to Europe, ed. Hoffmann and Moellers, 2001.



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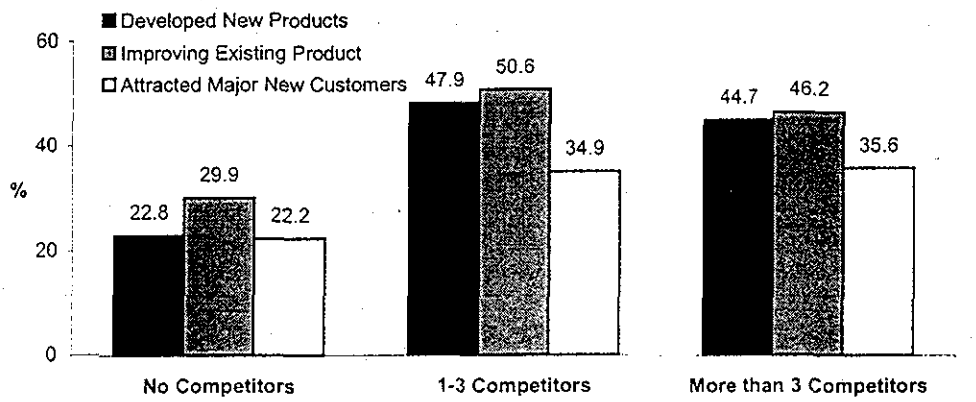
management and training for enterprise staff. At the same time soft budget constraints significantly slow down restructuring activity.

Our survey generated sufficient data to explore the factors that influence enterprise restructuring. A regression analysis was employed to assess the influence of such variables as competition, firm origin and budget constraints on enterprise restructuring. The detailed results are presented in Annex 2.

The analysis confirms that the most important factor associated with enterprise restructuring is competitive pressure. Further, pressure from foreign competitors seems to be much more important than pressure from domestic rivals. This accords well with previous research. Oligopolistic competition (1-3 competitors) promotes the development of new products and the improvement of existing products more so than other types of enterprise restructuring. Stronger competition (more than 3 competitors) has a larger influence, not on the development of new products, but on more frequently changing sales channels - *i.e.* more dynamic marketing. Facing competitive pressure, enterprises are more likely to look for new customers. Significant foreign competition pushes Ukrainian enterprises to innovate and introduce new technologies. Competition also acts as a strong influence on persuading enterprises to sell off or lease unwanted assets. Competition also seems to be the biggest motivator in reducing excess labor at an enterprise. The stronger the competition the more likely that an enterprise will shed excess labor.

**Figure 11**
**Level of Competition and Strategic Restructuring**
*(% of all firms that performed strategic restructuring)*




*Statistical analysis shows that firm origin status* does indeed correlate with enterprise restructuring. Less state-owned firms performed any restructuring measures than either privatized firms or start-ups. Privatized firms and start-ups are much more likely to provide training for their employees than state-owned enterprises. In addition, start ups are also the most frequent buyers of new assets and the major source of new jobs. Across all of the variables tested municipal enterprises introduce restructuring measures least of all. This may be explained by lack of the profit motive, by the higher degree of market power enjoyed by most of them at the city level and the presence of relatively stable local budget financing (*e.g.* for public transport.)



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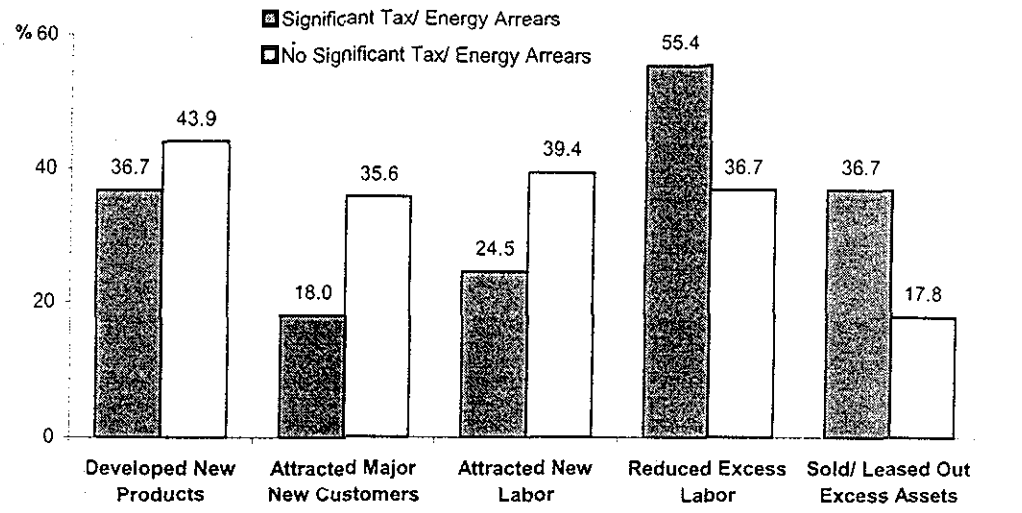
**Figure 12**
**Softness of Budget Constraints and Restructuring**
*(% of all firms that restructured)*




The analysis shows that soft budget constraints do indeed influence restructuring. The presence of soft budget constraints, approximated by tax and energy arrears, is associated with sluggish change at the enterprise level, except for contraction measures (*i.e.* passive forms of restructuring.) Soft budget constraints seem to significantly reduce the probability of introducing and improving products. Further the presence of soft budget constraints negatively correlates with improved marketing (*i.e.* less likely to find new customers.) Companies with arrears are also the least likely to employ new workers. However, they are associated with the shedding of excess labor and excessive assets.

## *Paternalism*

One of the more interesting aspects of this research was attempting to get an idea of the degree of 'paternalism', or expectation of state support, still prevalent in company management in Ukraine.

Decentralization of economic decision making lies at the essence of the transition from a planned to a market economy. Market reforms need to transfer the consequences of business decisions, including their benefits and costs, to the enterprise level and away from the state. Only under such conditions will private initiative promote proper restructuring and productivity growth instead of rent seeking activities (search for subsidies, privileges and preferential treatment) and other methods of market distortion.

The figure below shows the views of firm managers regarding the role of the state in the economy. The figure on the left shows the proportion of enterprises who would like to have the state support them should they incur losses (*i.e.* desire for support.) The second figure reflects the proportion of enterprises that do not actually expect to receive any real support from the government and rely on themselves only.



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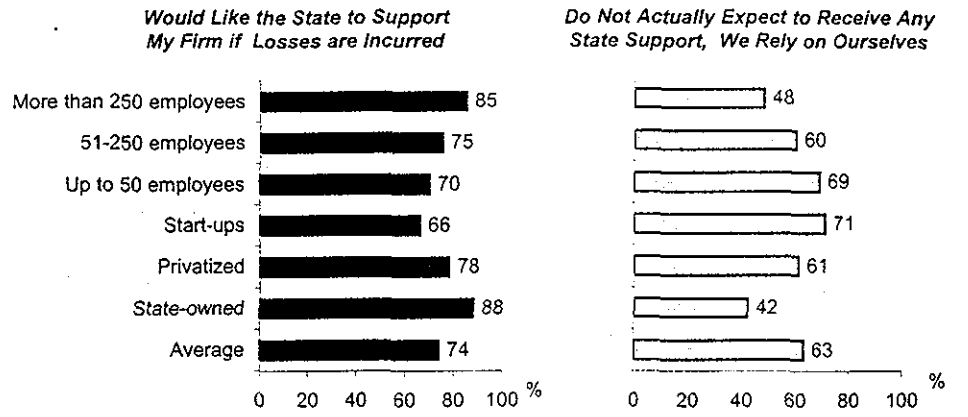
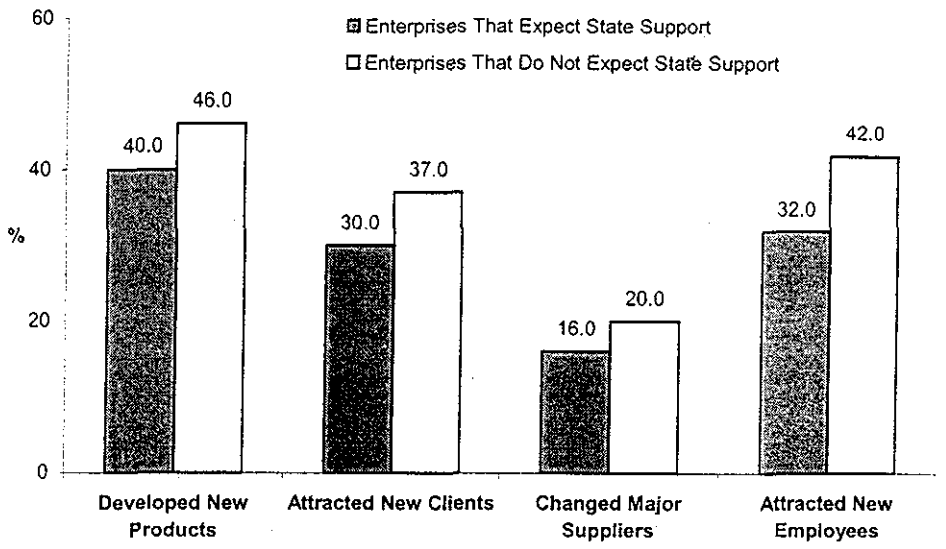
**Figure 13**
**Expectation of State Support**
*(% of positive answers for all firms)*




About three quarters of respondents (74%) would like the government to cover losses incurred by their firms or provide funds for investment. Another startling result is that two thirds of start up businesses would like to receive government support if they incur losses or if their businesses start to fail. These entrepreneurs should be amongst the most progressive supporters of enterprises and the primacy of the private sector. That these figures are so high is a very disappointing finding and demonstrates how much more work needs to be done on promoting market principles in Ukraine. At the same time 63% of managers do not expect in actual fact to receive any state support at all and rely on their own resources if losses are incurred. This figure may be considered as another indicator of restructuring at enterprise level. Not surprisingly, this independence from the state is the highest for start-ups and the lowest for state-owned companies. Moreover, expectations of government support positively correlate with enterprise size.

Based on the above results, it is interesting to see the relationship between the degree of paternalism and intensity of strategic restructuring. Without exception, those enterprises with lower levels of moral hazard experienced more strategic restructuring. The figure below compares those firms given in the second chart of Figure 13 and their corollary, *i.e.* firms who do and do not in actual fact expect to receive any government support if they incur losses. Strategic restructuring measures for the two different types of firms were compared and the results presented in Figure 14.

**Figure 14**
**Intensity of Strategic Restructuring and Expectation of State Support**
*(% of the total of each type of enterprise)*




Those firms with lower levels of moral hazard undertook more strategic restructuring than those who expect state support, or in other words the more independent an enterprise the better it is at adapting to change. This is consistent with the picture with profitability. Analyzing the responses between those who answered yes or no to the question of "We should rely only on ourselves" shows that 64% of those who answered yes were profitable in 1999. In 2000 this figure had increased to 69%. Of those who disagreed with the statement (*i.e.* do expect state support) 51% were profitable in 1999 and 53% in 2000. The data does show a link between profitability growth and expectations of paternalism, however this information is insufficient to show a causal link.

## *Capital Expenditures and Working Capital*

A very important factor of the health of an economy is investment. Investments increase production potential, allow for job creation, and establish conditions for sustainable growth. The survey sought to identify the incidence of capital investment into individual firms and usage of investment funds.

Over 2000, 41% of surveyed firms experienced capital investment. Table 13 below shows the breakdown of companies who had investment expenditures over 2000 by sector, firm size and firm origin.

**Table 13**
**Proportion of Enterprises That Experienced Fixed Capital Investment in 2000**
*(% of all firms)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 41.1 | 41.5 | 54.6 | 47.0 | 40.6 | 52.4 | **45.3** |
| *Construction* | 32.3 | 45.5 | 44.4 | 29.4 | 35.6 | 41.8 | **37.9** |
| Transport | 40.0 | 42.9 | 42.5 | 29.4 | 46.9 | 46.9 | **41.7** |
| Telecoms | 45.5 | 50.0 | 75.0 | 42.9 | 33.3 | 50.0 | **48.0** |
| Trade | 28.8 | 46.7 | 45.5 | 35.3 | 26.4 | 33.2 | **31.2** |
| Public Catering | 33.6 | 45.5 | - | 14.3 | 32.1 | 42.6 | **34.5** |
| Other Services | 33.1 | 51.7 | 48.8 | 39.7 | 34.5 | 44.0 | **39.8** |
| **Average** | **35.0** | **43.6** | **52.4** | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | 23.7 | 26.4 | 40.1 | **35.0** |
| 51-250 | | | | 37.3 | 38.0 | 64.1 | **43.6** |
| More than 250 | | | | 53.1 | 51.1 | 62.5 | **52.4** |
| **Average** | | | | **39.7** | **37.5** | **43.8** | ***40.5*** |

There is small variation between firms of different origin in terms of frequency of investment expenditure. Naturally, start-ups are more frequent investors (44%) than state-owned firms (40%), and privatized companies (38%). This is also the case with capital-intensive sectors, such as telecoms (48%) and manufacturing (45%) compared with labor-intensive trade (31%) and public catering (34%). Larger enterprises are also more likely to experience capital expenditure than smaller firms (52% vs.35%.)

Table 14 shows what firms used capital investment for. Purchasing new equipment was the most popular form of investment with 28% of all firms doing so, whereas new construction projects the least with 9% of all firms investing into construction.

**Table 14**
**Investment into Fixed Assets in 2000**
*(% of all firms in each firm origin group)*

| | National | Municipal | Privatized | Start-Up | Average |
|---|---|---|---|---|---|
| Investment Took Place | 42.0 | 36.6 | 37.5 | 43.8 | **40.5** |
| New Equipment | 27.8 | 20.4 | 24.2 | 32.9 | **27.9** |
| Repair of Premises | 24.5 | 19.4 | 22.2 | 22.7 | **22.5** |
| Repair of Equipment | 21.2 | 20.4 | 19.2 | 11.2 | **16.2** |
| Transport Assets | 13.2 | 11.8 | 12.7 | 15.4 | **13.8** |
| New Construction | 9.0 | 7.5 | 9.3 | 9.6 | **9.3** |

Over 2000, retained earnings and depreciation was the major source of investment into fixed assets (see Table 15). 86% of firms who had investment expenditures did so from internally generated sources. In a very distant second place for sourcing investment capital were bank credits at 15% of those who experienced investment. Other forms of longer term financing were insignificant.

**Table 15**
**Sources of Investment into Fixed Assets in 2000**
*(% of firms who had investment expenditures)*

| | National | Municipal | Privatized | Start-Up | Average |
|---|---|---|---|---|---|
| Retained Earnings and Depreciation | 81.9 | 76.5 | 89.4 | 79.3 | 86.4 |
| Bank Credit | 19.0 | 6.0 | 15.7 | 13.5 | 15.1 |
| Non-Bank Credit | 0.0 | 0.0 | 4.5 | 6.3 | 4.9 |
| Domestic Investor | 2.1 | 20.5 | 6.1 | 4.9 | 5.9 |
| State Funds | 12.4 | 23.5 | 1.3 | 0.2 | 3.0 |
| Leasing | 2.1 | 0.0 | 3.2 | 1.9 | 2.5 |
| Direct Foreign Investor | 2.1 | 3.0 | 1.9 | 1.3 | 1.7 |
| Portfolio Investor | 1.2 | 3.0 | 1.3 | 1.5 | 1.5 |

Table 16 presents more detailed data on attracting bank credits for capital investment. More than twice as many large firms (11%) received bank credit than small firms (4%.) There is almost no variance within firm origin with around 6% of firms able to secure bank credit.

Over 2000, banks found most attractive telecoms firms, large trading firms, transport start-ups and large state-owned manufacturing enterprises.

**Table 16**
**Proportion of Firms that Used Bank Credits for Investment into Fixed Assets in 2000**
*(% of all firms in each group)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 5.3 | 7.0 | 11.3 | 9.3 | 7.1 | 7.9 | 7.7 |
| Construction | 2.1 | 3.6 | 0.0 | 0.0 | 1.4 | 3.8 | 2.4 |
| Transport | 12.5 | 8.6 | 10.0 | 8.8 | 10.2 | 12.5 | 10.4 |
| Telecoms | 2.3 | 50.0 | 25.0 | 0.0 | 0.0 | 7.5 | 6.0 |
| Trade | 3.9 | 13.3 | 18.2 | 0.0 | 4.7 | 5.9 | 5.3 |
| Public Catering | 1.5 | 0.0 | - | 0.0 | 1.8 | 1.5 | 1.4 |
| Other Services | 4.5 | 3.4 | 7.3 | 4.8 | 3.6 | 5.5 | 4.7 |
| Average | 4.2 | 6.9 | 10.6 | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | 4.1 | 3.0 | 4.8 | 4.2 |
| 51-250 | | | | 4.8 | 4.2 | 16.2 | 6.9 |
| More than 250 | | | | 9.2 | 11.5 | 8.3 | 10.6 |
| Average | | | | 6.5 | 5.8 | 6.3 | 6.1 |

In terms of working capital financing the picture is a little more optimistic, with 13% of all firms managing to obtain short-term bank credit to finance working capital in 2000 (see Table 17). Again, obtaining short-term bank credits was easier for larger firms than for smaller ones: a quarter of all large firms managed to secure bank credit for working capital compared with only 9% of small firms. Among larger firms trading companies did especially well with 55% managing to obtain short-term bank credits.



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**Table 17**
**Proportion of Firms that Used Bank Credit for Working Capital in 2000**
*(% of all firms in each group)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-owned | Privatized | Start-ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 11.7 | 11.6 | 27.5 | 17.2 | 17.1 | 14.9 | **16.4** |
| Construction | 5.2 | 12.7 | 5.6 | 5.9 | 11.0 | 5.1 | **7.7** |
| Transport | 10.0 | 11.4 | 10.0 | 11.8 | 8.2 | 12.5 | **10.4** |
| Telecoms | 2.3 | 0.0 | 50.0 | 14.3 | 0.0 | 5.0 | **6.0** |
| Trade | 12.2 | 35.6 | 54.5 | 11.8 | 20.9 | 13.6 | **15.8** |
| Public Catering | 2.2 | 0.0 | 0.0 | 0.0 | 3.6 | 1.5 | **2.1** |
| Other Services | 4.5 | 5.2 | 22.0 | 7.9 | 10.7 | 4.6 | **7.4** |
| **Average** | **8.9** | **12.7** | **25.2** | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | 6.2 | 8.6 | 9.4 | **8.9** |
| *51-250* | | | | 10.8 | 11.1 | 18.8 | **12.7** |
| More than 250 | | | | 18.5 | 29.0 | 20.8 | **25.2** |
| **Average** | | | | **12.6** | **15.2** | **10.9** | ***13.0*** |

Surveyed enterprises have more ambitious investment plans for 2001 compared with actual capital expenditures over 2000 (see Table 18). 58% of all respondents plan investment into fixed assets compared with the 42% in 2000. It remains to be seen whether this will actually take place. Privatized enterprises are the most ambitious in terms of investment projections with 60% planning to invest into fixed assets.

**Table 18**
**Planned Investment into Fixed Assets in 2001 by Firm Origin**
*(% of total number of respondents in each group)*

| | National | Municipal | Privatized | Start-Up | Average |
|---|---|---|---|---|---|
| Investment Will Take Place | 52.4 | 50.5 | 60.2 | 58.7 | **58.4** |
| New Equipment | 34.4 | 29.0 | 36.1 | 36.3 | **35.7** |
| Repair of Premises | 19.3 | 17.2 | 29.4 | 17.1 | **22.8** |
| Repair of Equipment | 24.1 | 24.7 | 22.8 | 10.8 | **18.1** |
| Transport Assets | 12.7 | 14.0 | 14.5 | 17.4 | **15.5** |
| New Construction | 9.0 | 8.6 | 11.7 | 14.0 | **12.2** |

Table 19 shows expected sources of investment over 2001. Firms are starting to look more at external sources – obtaining bank credits (19% of firms expecting investment compared with 15% in 2000) and attracting strategic investors - 8% of all firms expect a local investor in 2001 compared with the 6% in 2000, and 5% of all firms expect a foreign investor compared with 2% in 2000.

**Table 19**
**Expected Sources of Investment into Fixed Assets in 2001 by Firm Origin**
*(% of firms who expect investment expenditures)*

| | National | Municipal | Privatized | Start-Up | Average |
|---|---|---|---|---|---|
| Retained Earnings and Depreciation | 84.5 | 78.8 | 77.9 | 84.7 | **81.3** |
| Bank Credit | 19.8 | 12.9 | 20.6 | 18.1 | **19.2** |
| Non-Bank Credit | 0.0 | 0.0 | 3.3 | 4.6 | **3.4** |
| Leasing | 3.6 | 2.2 | 7.0 | 5.5 | **5.8** |
| Domestic Investor | 6.3 | 17.0 | 9.3 | 4.8 | **7.5** |
| Foreign Investor | 6.3 | 12.9 | 5.6 | 3.4 | **5.1** |
| Portfolio Investor | 1.7 | 4.4 | 1.8 | 0.9 | **1.5** |
| State Funds | 11.6 | 25.5 | 2.7 | 0.7 | **3.6** |



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## *Enterprise Performance – Conclusions*

Official statistics[18] show that Ukraine's GDP has grown by 6% over 2000 and this is reflected by the surveyed firms whose value added increased on average by 11%. On the demand side, external demand for Ukrainian goods grew much faster than internal demand. Export growth of goods reached 26% compared with domestic capital investment growth of 11% and growth in household expenditure of 10%.[19] Export growth was a result of increased overseas demand for Ukrainian products (particularly CIS markets) and the positive impact of currency devaluation, which took place in late 1998. Internal demand grew due to an expansionary monetary policy in 2000 as well as from the multiplier effect from export growth. Further, the government reduced wage and pension arrears in 2000 which has had a positive effect on household income.

This survey offers evidence that on the supply side, the Ukrainian economy has been improving as well. Firms are adapting to market conditions and there is evidence that restructuring efforts are paying off with growth in labor productivity. The survey sought to establish which groups of firms contributed most to economic growth and to determine what factors influence the pace of restructuring at the firm level.

Small firms experienced the highest sales growth in 2000 (see Table 20**Error! Reference source not found.**.) However, this was not accompanied by a respective increase in value added. Small firms experienced 11% value added growth, similar to medium sized and large firms. At the same time more small firms (70%) were profitable than medium sized (56%) and large firms (53%.) Medium sized firms demonstrated the highest growth in labor productivity (18%), mainly due to larger lay-offs of 6% on average.

**Table 20**
**Summary Table of Changes in Financial Performance in 2000**
*(% year on year change)*

| | Real Sales Growth | Value Added Growth | Employment Growth | Productivity Growth |
|---|---|---|---|---|
| **Sector** | | | | |
| *Manufacturing* | 28.5 | 8.5 | -3.2 | 12.1 |
| Construction | 18.6 | 3.5 | -8.3 | 12.9 |
| Transport | 17.1 | -0.2 | -6.0 | 5.1 |
| Telecoms | 40.9 | 12.4 | 5.9 | 6.2 |
| Trade | 45.8 | 33.4 | 0.4 | 32.9 |
| Public Catering | 38.2 | -0.9 | -2.4 | 1.5 |
| Other Services | 15.0 | 22.5 | 0.7 | 21.7 |
| **Firm size** | | | | |
| *Up to 50* | 37.5 | 10.5 | -4.2 | 15.4 |
| 51-250 | 26.6 | 10.8 | -6.3 | 18.2 |
| More than 250 | 26.8 | 11.2 | -2.7 | 14.2 |
| **Firm Origin** | | | | |
| All State-owned | 17.1 | 12.8 | -4.5 | 18.1 |
| *National* | 15.8 | 11.7 | -5.0 | 17.6 |
| *Municipal* | 21.2 | 16.5 | -2.9 | 20.1 |
| All Privatized | 29.6 | 6.3 | -2.9 | 9.5 |
| *Early Privatized (up to 1996)* | 31.4 | 13.5 | -3.0 | 17.0 |
| *Late Privatized (1996 and later)* | 23.5 | -3.3 | -2.8 | -0.5 |
| All Start-Ups | 47.6 | 26.5 | 4.2 | 21.4 |
| *Early Start-ups (up to 1995)* | 48.2 | 29.7 | -0.4 | 30.2 |
| *Late Start-ups (after 1995)* | 46.4 | 23.3 | 7.9 | 14.3 |
| Average | **27.7** | **11.0** | **-3.1** | **14.6** |

[18] State Statistics Committee of Ukraine.
[19] Authors' estimates.



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Start-ups showed the highest growth in sales, value added, employment and labor productivity compared to either privatized or state-owned firms. Further, significantly more start-ups were profitable (76%) than either privatized (53%) or state-owned firms (51%.)

On average value added and labor productivity grew faster at state-owned enterprises than at privatized enterprises, however it is instructive to disaggregate the data and look value added growth in more detail.

The overall results of the state-owned sector were considerably boosted by municipally owned firms in the survey sample. There is a much higher incidence of monopolists amongst municipal firms than with either national state-owned firms or with privatized firms. Further, municipally owned firms in general have a much higher degree of market power than either types of firms.

There is also a large difference amongst firms privatized before and after 1996. This is especially evident in value added growth and labor productivity growth, where early privatized firms performed very well whereas late privatized firms actually contracted. A possible reason is that early privatized firms have had more time to adjust, find an effective owner and implement strategic changes, whilst late privatized firms are still in the early stages of restructuring.

Comparison of national state-owned firms and early privatized firms is more appropriate as both groups operate in a similar market environment with similar competitive pressures and early privatized firms have already gone through the difficult transition to private ownership. Early privatized firms outperformed national state-owned firms in terms of real sales growth and value added growth. Labor productivity growth is similar for both privatized and national state-owned firms, though there was higher labor contraction at national state-owned firms of 5% compared with only 3% at privatized firms.

Hard budget constraints are imposed on Ukrainian business very unevenly. In particular, more state-owned enterprises have significant tax and energy arrears more often than their counterparts in private sector. The proportion of barter, mutual off-sets, bills of exchange and other non-monetary instruments in the transactions of state-owned enterprises is larger than in private companies as well.

The survey shows that competition is the most important factor in producing a positive effect on restructuring and enterprise performance. The number of competitors and the origin of competitive pressure are of great importance. The higher the level of competition, the sooner a business will restructure and increase sales. Innovation (*i.e.* new product development and introduction of new technology), which demands additional costs, is associated with a more moderate level of competition. Another important result is that pressure from foreign competitors is a much more powerful incentive to restructure than pressure from domestic rivals.

Statistical analysis shows that firm origin correlates with enterprise restructuring. Less state-owned firms performed any restructuring measures than their counterparts in the private sector. Soft budget constraints also influence enterprise restructuring. Soft budget constraints, approximated by tax and energy arrears, is associated less enterprise dynamism (*i.e.* less restructuring), except for contraction measures – shedding employees and assets. Soft budget constraints also reduce the chances of introducing and improving products.

Over the course of 2000, two fifths of surveyed companies experienced capital expenditures, or in other words invested in their own businesses. Reflecting the poor state of the Ukrainian investment environment, retained earnings and depreciation were the primary sources of investment, used by 86% of firms who experienced investment.

Investment capital was mostly used for purchase of new assets as reported by 28% of all respondents. Only 6% of all businesses were able to finance capital investment with bank loans, though the figure is higher for working capital. This shows the underdeveloped nature of the banking sector in Ukraine and banks' general reluctance to offer long term credit, preferring instead to offer short term credit, especially working capital for trade operations and manufacturing

Overall the survey provides good arguments in favor of further privatization. Privatized companies were more dynamic, restructured more frequently and more of them were profitable than state-owned firms. If it is also borne in mind that the state still owns some of the more attractive larger firms then this provides even more reason to privatize as they could perform even better in the private sector. The survey also shows that municipalities still retain a wide array of business interests, that should also be transferred to the private sector.

# BARRIERS TO MARKET ENTRY AND EXPANSION

This section of the report analyses most of the barriers to business development given at the beginning of this report. For ease of reference, the information is again provided below along with firm size and firm origin breakdowns (*a full sectoral breakdown is provided in Annex 4.*) This section follows the main priorities given the main barriers listed below, in particular taxation, business regulations, unfair competition and issues of administrative corruption.

**Table 21**
**Rating of Barriers Hindering Business Development in Ukraine**
*(for all firms)*

| | Average | | Firm Origin | | | | | | Firm Size | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | State-Owned | | Privatized | | Start-Ups | | Up to 50 | | 51 - 250 | | More than 250 | |
| | Score* | Rank | score | rank | Score | rank | score | rank | score | rank | score | rank | score | Rank |
| Taxation | 3.1 | 1 | 3.1 | 1 | 3.2 | 1 | 3.0 | 1 | 3.1 | 1 | 3.2 | 1 | 3.2 | 1 |
| Low Demand | 2.9 | 2 | 2.8 | 2 | 3.0 | 2 | 2.8 | 2 | 2.9 | 2 | 2.9 | 2 | 3.0 | 2 |
| Inflation | 2.8 | 3 | 2.8 | 3 | 2.9 | 3 | 2.7 | 3 | 2.8 | 3 | 2.8 | 3 | 2.8 | 3 |
| Non-Level Playing Field/ Anti-Competitive Practices | 2.5 | 4 | 2.3 | 4 | 2.6 | 4 | 2.5 | 5 | 2.5 | 4 | 2.5 | 4 | 2.4 | 4 |
| Corruption | 2.3 | 5 | 2.0 | 8 | 2.3 | 5 | 2.5 | 4 | 2.5 | 5 | 2.2 | 6 | 2.2 | 6 |
| Regulatory Environment | 2.3 | 6 | 2.3 | 5 | 2.3 | 6 | 2.4 | 6 | 2.4 | 6 | 2.2 | 5 | 2.4 | 5 |
| Underdeveloped Infrastructure | 2.2 | 7 | 2.2 | 6 | 2.2 | 7 | 2.3 | 7 | 2.3 | 7 | 2.1 | 7 | 2.2 | 8 |
| Sourcing Necessary Inputs | 2.0 | 8 | 2.1 | 7 | 2.1 | 8 | 1.9 | 8 | 1.9 | 8 | 2.1 | 8 | 2.2 | 7 |
| Obtaining External Financing | 1.8 | 9 | 1.8 | 9 | 1.8 | 9 | 1.7 | 9 | 1.8 | 9 | 1.8 | 9 | 1.8 | 9 |
| Pressure from Criminal Elements | 1.6 | 10 | 1.4 | 10 | 1.6 | 10 | 1.6 | 10 | 1.6 | 10 | 1.5 | 10 | 1.4 | 10 |

*Calculated as simple average using the following scale: 1 – no obstacle, 2 – small obstacle, 3 – significant obstacle, 4 – major obstacle.

## *Taxation*

As taxation is consistently cited as one of the biggest obstacles faced by business in Ukraine (rated as the biggest problem in this survey), respondents were asked more detailed questions on this issue.

Figure 15 below shows the distribution and ranking of obstacles related to taxation. The overall scores are given on a four point scale with 1 – no obstacle to 4 – major obstacle.



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**Figure 15**
**Main Issues with Taxation**
*(distribution of responses for all firms)*

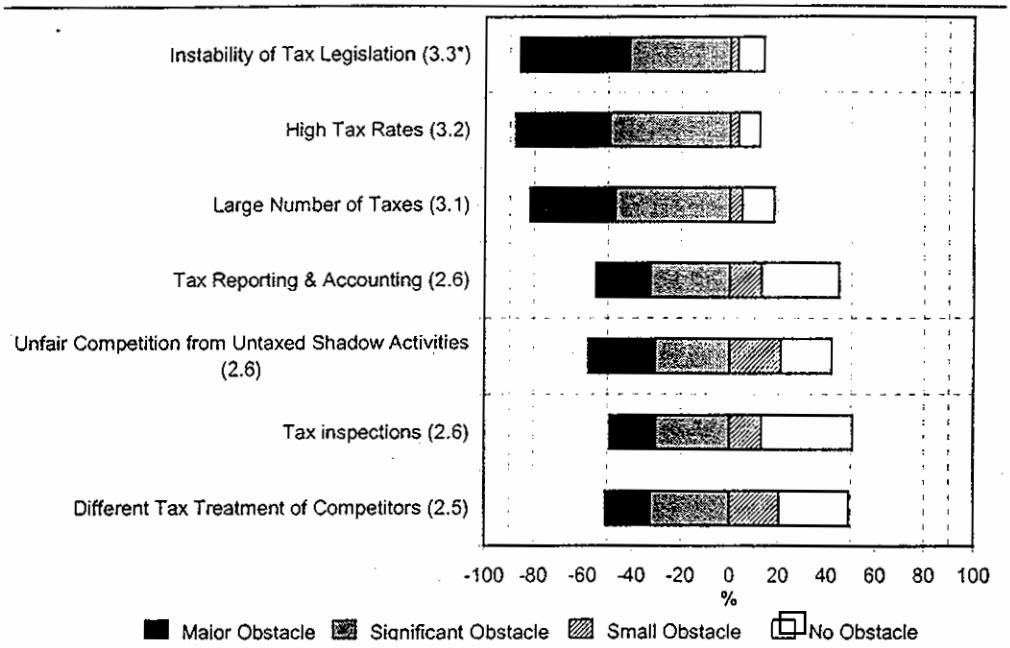


*Figure in brackets gives the average score of the answers on a scale on 1 – no obstacle to 4 – major obstacle for each obstacle listed.

**Table 22**
**Main Issues with Taxation**
*(for all firms)*

| | Average | | Firm Origin | | | | | | Firm Size | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | State-Owned | | Privatized | | Start-Ups | | Up to 50 | | 51 - 250 | | More than 250 | |
| | Score | rank | score | rank | Score | rank | score | rank | score | rank | score | rank | score | rank |
| Instability of Tax Legislation | 3.3 | 1 | 3.3 | 1 | 3.3 | 2 | 3.3 | 1 | 3.3 | 1 | 3.3 | 2 | 3.3 | 1 |
| High Tax Rates | 3.2 | 2 | 3.2 | 2 | 3.3 | 1 | 3.2 | 2 | 3.2 | 2 | 3.3 | 1 | 3.3 | 2 |
| Large Number of Taxes | 3.1 | 3 | 3.1 | 3 | 3.2 | 3 | 3.0 | 3 | 3.1 | 3 | 3.2 | 3 | 3.2 | 3 |
| Tax Reporting & Accounting | 2.6 | 4 | 2.8 | 4 | 2.7 | 5 | 2.6 | 4 | 2.6 | 5 | 2.7 | 4 | 2.7 | 4 |
| Unfair Competition from Untaxed Shadow Activities | 2.6 | 5 | 2.5 | 6 | 2.7 | 4 | 2.6 | 5 | 2.6 | 4 | 2.7 | 5 | 2.5 | 6 |
| Tax Inspections | 2.6 | 6 | 2.7 | 5 | 2.5 | 7 | 2.5 | 6 | 2.5 | 6 | 2.5 | 7 | 2.7 | 5 |
| Different Tax Treatment of Competitors | 2.5 | 7 | 2.5 | 7 | 2.6 | 6 | 2.4 | 7 | 2.5 | 7 | 2.5 | 6 | 2.5 | 7 |

The problems with the tax environment in Ukraine can be broadly split into three main areas: instability of tax legislation; size of tax burden (which refers to tax rates, number of taxes, duties, payments and other tax-like payments and tax reporting procedures); and uneven tax distribution caused by different tax regimes and unrecorded 'shadow' activity.



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## Instability of Tax Laws and Regulations

Frequently changing tax legislation, regulations and reporting requirements have often been raised by businesses in Ukraine as one of their biggest taxation concerns. Whilst a detailed analysis of this legislative and regulatory instability is beyond the scope of this report, the authors have counted the number of changes in tax regulations over 2000. Over the last year there have been 110 changes to the tax regulations and laws in Ukraine, including the introduction and amendment of 31 laws, 28 Cabinet of Ministers resolutions, 28 State Tax Administration orders, 15 State Customs Committee orders, and other changes introduced by other state bodies. This number represents those changes that were published centrally in Kyiv and does not include internal instructions of state bodies or any local tax regulations.

## Tax Burden

There are a large number of taxes and duties levied on Ukrainian businesses. Currently there are a total of 24 national taxes (of which 17 are applicable to surveyed firms) and 16 local taxes and duties (of which 6 are relevant.) In this report the word 'taxes' is taken to mean all forms of taxes, duties, and obligatory tax-like payments. The table below shows the average number of taxes paid by businesses by firm size and origin over 2000.

**Table 23**
***Number of Taxes in 2000[20]***

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-owned | Privatized | Start-ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 10.0 | 12.6 | 14.3 | 12.8 | 13.0 | 10.4 | 12.1 |
| Construction | 10.0 | 11.5 | 16.8 | 10.1 | 12.7 | 10.1 | 11.2 |
| Transport | 10.3 | 12.5 | 12.7 | 12.9 | 12.4 | 9.4 | 11.8 |
| Telecoms | 8.4 | 17.0 | 13.0 | 11.2 | 9.0 | 8.8 | 9.1 |
| Trade | 9.7 | 12.2 | 14.7 | 10.2 | 11.2 | 9.5 | 10.0 |
| Public Catering | 8.7 | 12.0 | . | 8.4 | 9.4 | 8.8 | 9.0 |
| Other Services | 7.5 | 11.8 | 13.5 | 10.7 | 9.8 | 8.6 | 9.5 |
| Average | 9.4 | 12.4 | 14.2 | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | 10.1 | 9.9 | 9.1 | 9.4 |
| 51-250 | | | | 11.6 | 12.6 | 12.4 | 12.4 |
| More than 250 | | | | 13.1 | 14.5 | 16.6 | 14.2 |
| Average | | | | 11.8 | 12.2 | 9.7 | *11.1* |

As can been seen for Ukrainian businesses with this number of taxes, issues of accounting and reporting are a major administrative burden. On average Ukrainian businesses paid 11 different taxes. The largest number of taxes on average are levied on manufacturing enterprises with more than 12, the lowest levied on companies in the public catering and telecoms sectors (9). However, the sample contained manufacturing companies that paid up to 23 different taxes. According to the EBRD's survey of transition economies, Ukraine has the second highest number of principal national taxes in Eastern Europe and the CIS[21].

The data also shows that there is a tendency for larger firms to face more taxes and duties, however this is more as a result of smaller firms electing to move towards simplified systems of taxation, whereby various different taxes are unified. However, small firms in Ukraine still face too many taxes on average around nine.

[20] The table contains responses to the question, "How many taxes, duties and other obligatory payments into state/ local budgets and non-budgetary funds were made by your firm in 2000?"
[21] "Transition Report 1999", EBRD p.157



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Quarterly business surveys conducted by a leading Ukrainian business newspaper[22] show that businesses reckon that the most problematic taxes, in descending order are, VAT, profit tax, payroll taxes. It is probable that VAT is ranked in first place due to the fact that it is more difficult to avoid than other taxes and also because of numerous problems that exist with VAT refunds (especially for exporters.) Payroll taxes are problematic due to high rates; however they are more easily evaded by paying employees in cash.

In order to assess the effects of a large number of taxes and high tax rates, the tax burden on firms was calculated. Table 24 below shows the proportion of taxes in relation to enterprise sales, weighted by sales volume. It is important to note that the survey did not attempt to assess tax incidence (distribution of tax burden between producers and consumers.)

**Table 24**
**Enterprise Tax Burden**
*(taxes paid as % of gross sales, weighted)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 23.5 | 29.7 | 22.5 | 26.9 | 22.0 | 28.7 | **23.6** |
| Construction | 26.1 | 28.0 | 28.6 | 28.8 | 26.5 | 29.8 | **27.6** |
| Transport | 34.5 | 26.9 | 19.3 | 27.7 | 22.2 | 18.1 | **23.6** |
| Telecoms | 33.2 | 15.1 | 15.0 | 23.9 | 26.3 | 16.4 | **16.6** |
| Trade | 23.1 | 13.7 | 17.4 | 18.7 | 15.0 | 21.8 | **18.8** |
| Public Catering | 30.1 | 13.0 | - | 15.2 | 22.5 | 32.8 | **24.6** |
| Other Services | 26.7 | 36.0 | 24.4 | 25.5 | 34.5 | 21.2 | **26.7** |
| **Average** | **24.9** | **26.9** | **22.7** | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | 33.5 | 24.8 | 23.7 | **24.9** |
| 51-250 | | | | 37.8 | 26.2 | 22.5 | **26.9** |
| More than 250 | | | | 24.8 | 21.4 | 35.0 | **22.7** |
| **Average** | | | | **26.5** | **22.2** | **24.0** | ***23.6*** |

The data shows that enterprises paid taxes of around a quarter of their sales. However, if the tax burden is expressed as a proportion of value added, then the burden is very high indeed at more than half of all value added (see table below.)

[22] "Bizness" newspaper, issue 7, 2001, pp. 37-38.



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**Table 25**
**Enterprise Tax Burden[23]**
*(taxes paid as % valued added, weighted)* [24]

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-owned | Privatized | Start-Ups | Average |
| **Sector** | | | | | | | |
| Manufacturing | 43.0 | 61.7 | 55.9 | 47.1 | 60.2 | 59.3 | 56.0 |
| Construction | 42.3 | 49.4 | 60.0 | 52.6 | 49.6 | 49.2 | 50.1 |
| Transport | 92.9 | 54.8 | 44.2 | 58.1 | 51.5 | 56.3 | 54.7 |
| Telecoms | 43.4 | 21.7 | 15.8 | 29.6 | 32.3 | 23.4 | 23.6 |
| Trade | 40.6 | 17.3 | 30.5 | 51.4 | 21.2 | 37.1 | 29.5 |
| Public Catering | 55.1 | 17.6 | - | 21.7 | 39.5 | 57.4 | 41.3 |
| Other Services | 40.4 | 52.5 | 66.4 | 65.8 | 70.6 | 26.1 | 60.3 |
| Average | 44.0 | 47.4 | 56.1 | | | | |
| **Firm Size** | | | | | | | |
| Up to 50 | | | | 63.3 | 40.2 | 42.8 | 44.0 |
| 51-250 | | | | 65.6 | 48.2 | 37.4 | 47.4 |
| More than 250 | | | | 49.1 | 60.6 | 61.5 | 56.1 |
| Average | | | | 51.6 | 57.0 | 41.6 | *52.8* |

Further, larger enterprises tend to pay out more in taxes relative to their value added, than smaller companies. These high tax burdens are unsustainable and are detrimental to investment and sustained economic growth and help to explain why Ukraine has such high levels of shadow economic activity.

Enterprises were then asked to estimate the level of taxation that they felt would not hinder their further development. Obviously, rational entrepreneurs will always seek to minimize their tax burdens and will therefore underestimate the level of taxation that they are able to bear. Nonetheless, it does provide an insight into what would make companies more comfortable with paying taxes. Respondents felt that it in general the tax burden should be cut in half to around 27% of value added.

**Table 26**
**Bearable Taxes and Other Obligatory Payments**
*(bearable taxes as % of value added, weighted)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| **Sector** | | | | | | | |
| Manufacturing | 20.6 | 27.6 | 31.3 | 30.9 | 30.4 | 24.9 | 30.2 |
| Construction | 16.5 | 20.5 | 23.6 | 15.5 | 20.0 | 24.0 | 20.0 |
| Transport | 17.4 | 20.8 | 17.9 | 17.4 | 18.2 | 19.9 | 18.1 |
| Telecoms | 13.7 | 11.5 | 8.4 | 14.1 | 47.4 | 11.4 | 11.8 |
| Trade | 17.7 | 8.8 | 12.0 | 16.5 | 10.1 | 15.9 | 13.1 |
| Public Catering | 20.0 | 5.7 | - | 6.9 | 19.8 | 13.0 | 15.1 |
| Other Services | 13.0 | 11.1 | 35.4 | 30.0 | 23.9 | 15.5 | 26.5 |
| Average | 18.3 | 19.8 | 30.9 | | | | |
| **Firm Size** | | | | | | | |
| Up to 50 | | | | 17.0 | 16.8 | 18.9 | 18.3 |
| 51-250 | | | | 13.0 | 24.2 | 16.7 | 19.8 |
| More than 250 | | | | 32.3 | 29.9 | 25.4 | 30.9 |
| Average | | | | 30.0 | 28.2 | 18.4 | 27.4 |

[23] The tax burden was calculated as a weighted average of the responses to the question , "What per cent of gross sales was accounted for by all taxes paid by your firm?"

[24] Value added was calculated as sales less material costs. Respondents did not give actual sales figures, rather they selected out of various sales bands. The midpoint of each band was used in the above valued added calculations. It is important to note, that the data is that reported by respondents, and not independently verified.



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## Shadow Economic Activity

Three quarters of the entire sample responded to questions on concealed turnover. The primary question being "how much do similar enterprises to yours conceal from taxation?" Respondents were given the option of selecting from different levels of sales, given below. In order to make the data easier to understand the responses have also been combined to give a weighted (by sales) average across all oblast capitals in Ukraine. It is important to note that this information was given in an anonymous questionnaire and represents respondent's opinions of other firms similar to theirs. Table 27 below gives the breakdown of concealed sales by cities in order to allow the reader to draw comparisons with data given in this report. A weighted (by sales) average was developed for each city showing the overall average proportion of sales in that city concealed.

### Table 27
### Sales Concealed from Taxation
*(% of all firms reporting concealed sales of firms similar to theirs )*

| | Concealed Sales | | | | | | | Weighted Average |
|---|---|---|---|---|---|---|---|---|
| | 1-10% | 11-20% | 21-30% | 31-40% | 41-50% | 51-60% | >60% | |
| **City** | | | | | | | | |
| Vinnytsia | 49.2 | 19.0 | 9.5 | 9.5 | 4.8 | - | 7.9 | **11.2** |
| Dnipropetrovsk | 39.0 | 14.3 | 15.6 | 6.5 | 15.6 | 3.9 | 5.2 | **20.5** |
| Donetsk | 41.8 | 12.7 | 10.9 | 12.7 | 12.7 | 3.6 | 5.5 | **11.5** |
| Zhytomyr | 49.2 | 16.9 | 8.5 | 13.6 | 8.5 | 3.4 | - | **20.7** |
| Zaporizhya | 39.6 | 22.9 | 16.7 | 8.3 | 2.1 | 4.2 | 6.3 | **9.2** |
| Ivano-Frankivsk | 46.2 | 13.5 | 11.5 | 17.3 | 5.8 | 3.8 | 1.9 | **23.1** |
| Kyiv | 39.0 | 15.8 | 13.7 | 8.9 | 8.9 | 3.4 | 10.3 | **12.3** |
| Kirovograd | 18.9 | 8.1 | 13.5 | 13.5 | 18.9 | 8.1 | 18.9 | **29.6** |
| Lugansk | 44.9 | 6.1 | 12.2 | 6.1 | 20.4 | 6.1 | 4.1 | **9.9** |
| Lutsk | 40.0 | 21.8 | 20.0 | 9.1 | 5.5 | 1.8 | 1.8 | **17.9** |
| Lviv | 33.3 | 16.7 | 15.4 | 9.0 | 9.0 | 6.4 | 10.3 | **18.7** |
| Mykolayiv | 23.8 | 20.6 | 23.8 | 14.3 | 6.3 | 4.8 | 6.3 | **23.0** |
| Odesa | 27.6 | 17.2 | 11.5 | 8.0 | 17.2 | 5.7 | 12.6 | **18.4** |
| Poltava | 33.9 | 12.5 | 12.5 | 8.9 | 12.5 | 16.1 | 3.6 | **16.9** |
| Rivne | 34.9 | 9.5 | 9.5 | 19.0 | 14.3 | 6.3 | 6.3 | **16.7** |
| Simferopol | 25.0 | 22.6 | 19.0 | 9.5 | 11.9 | 8.3 | 3.6 | **10.9** |
| Sumy | 24.3 | 27.0 | 13.5 | 8.1 | 16.2 | 5.4 | 5.4 | **24.3** |
| Ternopil | 43.9 | 30.3 | 7.6 | 7.6 | 1.5 | 4.5 | 4.5 | **13.2** |
| Uzhgorod | 36.2 | 5.2 | 17.2 | 5.2 | 19.0 | 8.6 | 8.6 | **9.8** |
| Kharkiv | 34.0 | 14.0 | 19.0 | 12.0 | 10.0 | 6.0 | 5.0 | **22.6** |
| Kherson | 34.1 | 20.5 | 18.2 | 13.6 | 6.8 | 2.3 | 4.5 | **8.8** |
| Khmelnitsky | 29.4 | 10.3 | 25.0 | 5.9 | 8.8 | 10.3 | 10.3 | **18.6** |
| Cherkasy | 44.4 | 13.3 | 17.8 | 6.7 | 8.9 | - | 8.9 | **7.9** |
| Chernigiv | 61.7 | 20.0 | 10.0 | 1.7 | 1.7 | 1.7 | 3.3 | **8.8** |
| Chernivtsi | 41.7 | 21.7 | 3.3 | 5.0 | 13.3 | 6.7 | 8.3 | **20.9** |
| **Average** | **37.3** | **16.5** | **14.3** | **9.5** | **10.3** | **5.3** | **6.7** | ***15.8*** |

No firm that answered this question stated that no sales were concealed. On average around 16% of all sales were concealed. What is more important here is not the actual percentage sales concealed but rather the regional and sectoral differences. The following table provides the same data as above broken down by sector, firm size and origin and shows the average level of concealed sales for each firm group.



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**Table 28**
**Firms With Sales Concealed from Taxation**
*(% of concealed sales, weighted by sales)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 18.3 | 20.9 | 14.0 | 10.7 | 15.7 | 22.1 | 15.1 |
| Construction | 19.3 | 28.5 | 14.3 | 11.0 | 22.5 | 24.8 | 20.2 |
| Transport | 17.7 | 15.5 | 17.1 | 11.6 | 19.4 | 23.7 | 16.9 |
| Telecoms | 14.7 | 5.0 | 5.0 | 6.6 | 25.0 | 13.4 | 11.4 |
| Trade | 18.8 | 28.6 | 18.0 | 12.6 | 14.9 | 25.4 | 21.4 |
| Public Catering | 22.9 | 18.8 | - | 20.8 | 20.7 | 23.4 | 21.7 |
| Other Services | 22.7 | 9.4 | 17.6 | 8.7 | 26.7 | 20.3 | 15.2 |
| **Average** | **18.9** | **19.8** | **14.4** | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | 12.4 | 15.9 | 21.1 | 18.9 |
| 51-250 | | | | 8.8 | 21.6 | 25.7 | 19.8 |
| More than 250 | | | | 10.5 | 15.5 | 26.8 | 14.4 |
| **Average** | | | | **10.3** | **16.3** | **23.1** | ***15.8*** |

State owned firms were able to conceal or otherwise misreport the least amount of sales, than private sector firms. This is probably due to a higher level of scrutiny from state bodies (witness the number of inspections, see Table 41). The highest level of shadow activity is observed in trade, public catering and construction and smaller firms are able to conceal more sales than larger firms.

## Simplified Taxation

There are two systems of taxation in Ukraine: ordinary and simplified taxation. The ordinary tax system is composed of separate reporting and payment of all the taxes mentioned at the beginning of this section, including principal national taxes (corporate profit tax, value added tax, payroll taxes), numerous local taxes and other duties and tax-like payments. However, firms with up to 50 employees and turnover not exceeding UAH1 million can go over to one unified tax that replaces most of the principal taxes, including profit tax and contributions to the pension fund. Further, there are two unified tax rates; 6% of turnover with VAT payable separately as under the regular system of taxation or 10% of turnover, which exempts businesses from VAT.

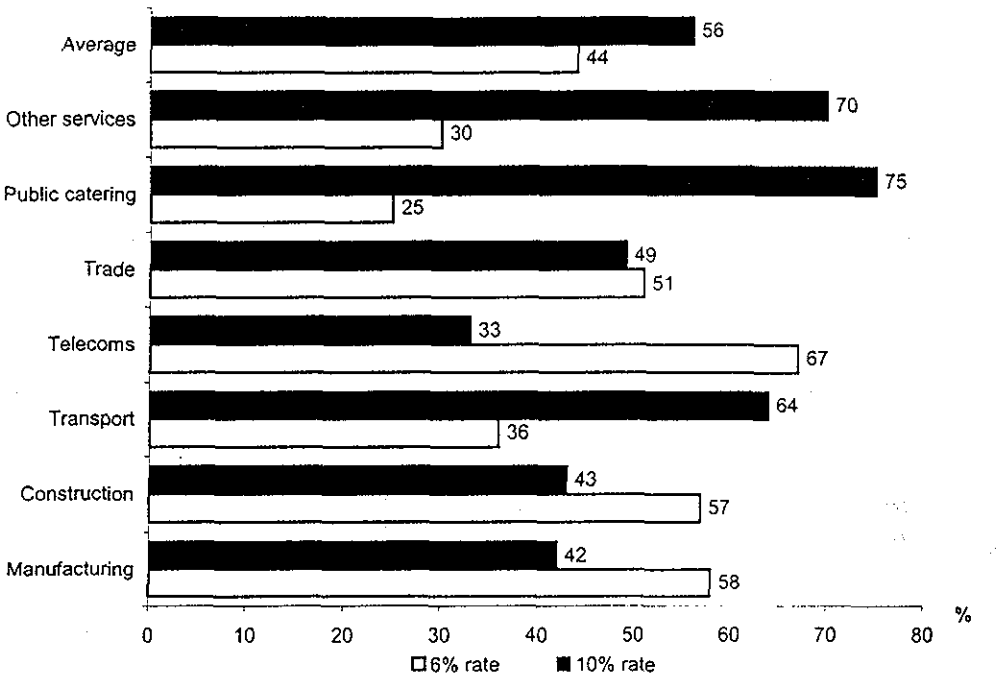
29% of all respondents reckoned that they were eligible for simplified taxation, however of these only half actually switched. Almost 19% of eligible firms intend to switch in the future. The table and figure below show the eligibility for simplified taxation and the choices made by firms in particular sectors.

**Table 29**
**Eligibility and Transfer to Simplified Taxation**

| | Firms Who Stated That They Are Eligible (% of all small firms) | Switched to Simplified Taxation (% of eligible small firms) | Intend to Switch to Simplified Taxation (% of eligible small firms) | Do Not Intend to Switch to Simplified Taxation (% of eligible small firms) |
|---|---|---|---|---|
| ***Sector*** | | | | |
| Manufacturing | 48.3 | 43.1 | 22.1 | 34.8 |
| Construction | 47.9 | 50.0 | 23.9 | 26.1 |
| Transport | 52.5 | 66.7 | 28.6 | 4.8 |
| Telecoms | 50.0 | 40.9 | 18.2 | 40.9 |
| Trade | 51.7 | 39.0 | 19.3 | 41.7 |
| Public Catering | 61.2 | 64.6 | 9.8 | 25.6 |
| Other Services | 59.2 | 64.5 | 14.0 | 21.5 |
| **Average** | **52.3** | **49.1** | **18.7** | **32.3** |

Further, enterprises were asked if they had switched to simplified taxation whether they had selected the 6% (excluding VAT) or 10% (including VAT) tax rate.

**Figure 16**
**Choice of Simplified Tax Rate**
*(% of firms that switched to simplified taxation)*




## Conclusions and Recommendations

Taxation issues are by far and away the biggest administrative and operational burden on enterprises in Ukraine. The penalties for full tax compliance in Ukraine are large indeed. Further, the high level of evasion is taken into account, firms that wish to be fully compliant are invariably at a competitive disadvantage with those who evade taxes (who are in effect subsidized.) On average more than half of enterprise value added needs to be paid out in numerous taxes and other obligatory payments. However, the biggest taxation issue in Ukraine is frequently changing tax reporting and accounting requirements that creates very real obstacles for firms.

Simply put, Ukraine taxation system contributes to a large unofficial economy, with the corresponding problems of corruption, lack of investment, unfair competition and much lower levels of response to market signals.

Based on the results of survey, it is clear that urgent tax reform is required, however this raises several issues. How to introduce taxation stability in an unstable transition economy? How to introduce an equitable and bearable taxation system, with an equal tax burden for all, regardless of sector, business activity, size or ownership? How to minimize the size of the shadow economy, which creates unfair competition and deprives the state of revenues?

Some steps that would be helpful are:

- Eliminate tax breaks and privileges, including special economic zones, and move to hard budget constraints for all firms regardless of ownership status.
- Eliminate or consolidate a large number of various taxes, duties and tax like payments, which contribute only small amounts to state revenues but which create a large burden on businesses. Drastically reduce the frequency of changes in tax regulations and tax rates, thresholds and reporting requirements. Adopt the new tax code currently under debate and them implement a freeze on further changes.
- Reduce marginal rates for principal taxes (VAT, profit tax, personal income tax), thereby freeing more capital for internal investment.
- Unify simplified and ordinary tax systems. Simplified taxation for smaller enterprise has generally been effective (rather smaller businesses have faced fewer accounting and reporting problems), but in the medium term, this uneven distribution of tax burden could lead to inefficient use of resources (*e.g.* large firms with higher productivity could suffer from a higher tax burden than smaller less efficient firms) and abuse (larger firms attempting to become simplified tax payers.) Simplified taxation also creates an income gap whereby small firms that are growing do not want lose their simplified tax status and move to higher levels of ordinary taxation. Either growth could be curtailed or more probably any extra income above simplified taxation thresholds will be concealed.
- As there will be a decrease in state revenues initially if number of taxes and tax rates are reduced, the government should carefully prioritize state expenditure and attempt to broaden the tax base.
- Introduce pension reform to change perceptions of contributions to the Pension Fund. At the moment pension contributions are perceived as additional income taxes. Personalized pension accounts will allow people to treat their pension contributions as personal savings and will make available more investment capital.

## *Unfair Competition*

Companies in Ukraine, both foreign and domestic, consistently complain, of competitors using unfair practices. In our general rating (see Table 21), this problem was ranked fourth, over and above such issues as lack of financing and regulatory environment. Figure 17 below shows the importance assigned by all surveyed firms to different forms of anti-competitive practice, including privileged access to markets and key inputs, state subsidies and collusion of rivals.

**Figure 17**
**Rating of Unfair Competitive Practices**
*(distribution of responses for all firms)*

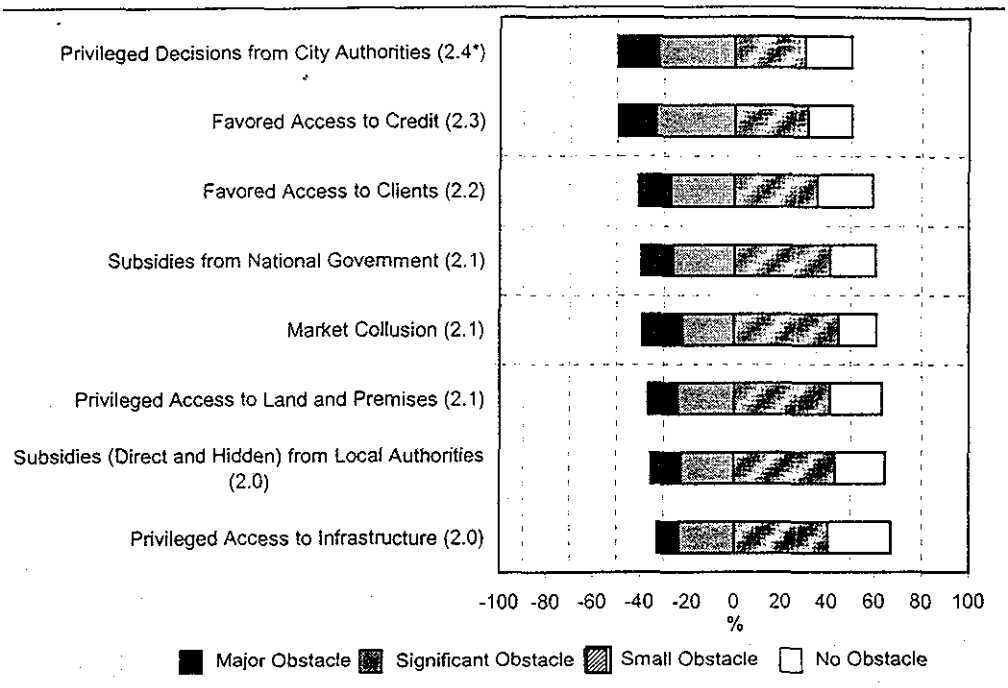



*Figure in brackets gives the average score of the answers on a scale on 1 – no obstacle to 4 – major obstacle for each obstacle listed.

The survey revealed that the main anti-competitive practices is local authorities issuing permits/permissions to rivals on favorable terms. The table below shows, that small businesses are hit hardest when their competitors receive privileged decisions from city authorities. For larger firms the biggest perceived problem is related to favored access to credit resources by competitors (see Table 82, Annex 4 for more detail.)



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**Table 30**
**Rating of Unfair Competitive Practices in Ukraine by Firm Size and Origin**
*(for all firms)*

| | Average | | Firm Origin | | | | | | Firm Size | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | State-Owned | | Privatized | | Start-Ups | | Up to 50 | | 51 - 250 | | More than 250 | |
| | Score | rank | score | rank | Score | rank | Score | rank | score | rank | score | rank | score | rank |
| Privileged Decisions from City Authorities | 2.4 | 1 | 2.0 | 1 | 2.4 | 2 | 2.5 | 1 | 2.5 | 1 | 2.3 | 2 | 2.1 | 3 |
| Favored Access to Credit | 2.3 | 2 | 2.0 | 2 | 2.4 | 1 | 2.4 | 2 | 2.4 | 2 | 2.4 | 1 | 2.2 | 1 |
| Favored Access to Clients | 2.2 | 3 | 2.0 | 4 | 2.2 | 3 | 2.3 | 3 | 2.2 | 3 | 2.2 | 3 | 2.0 | 5 |
| Subsidies from National Government | 2.1 | 4 | 2.0 | 3 | 2.2 | 4 | 2.1 | 6 | 2.1 | 7 | 2.2 | 4 | 2.1 | 2 |
| Market Collusion | 2.1 | 5 | 1.8 | 6 | 2.1 | 6 | 2.2 | 4 | 2.2 | 5 | 2.0 | 7 | 2.0 | 4 |
| Privileged Access to Land and Premises | 2.1 | 6 | 1.8 | 8 | 2.1 | 7 | 2.2 | 5 | 2.2 | 4 | 2.1 | 6 | 1.8 | 8 |
| Subsidies (Direct and Hidden) from Local Authorities | 2.0 | 7 | 1.9 | 5 | 2.1 | 5 | 2.0 | 8 | 2.1 | 8 | 2.1 | 5 | 2.0 | 6 |
| Privileged Access to Infrastructure | 2.0 | 8 | 1.8 | 7 | 2.0 | 8 | 2.1 | 7 | 2.1 | 6 | 2.0 | 8 | 1.9 | 7 |

## *Regulatory and Administrative Environment*

As the regulatory climate and the role of the state in 'regulating' private business in Ukraine is often acknowledged as one the main areas of concern to Ukraine businesses, this survey sought to examine this issue in more detail for issues related to instability of business legislation, customs procedures, licensing, certification, procedures for receiving permits and permissions and business registration procedures. We asked business to rate on a 4 point scale the extent to which various regulatory issues presented obstacles to their operations.

**Figure 18**
**Main Regulatory and Administrative Barriers to Business Development**
*(for firms that particular barrier was relevant)*

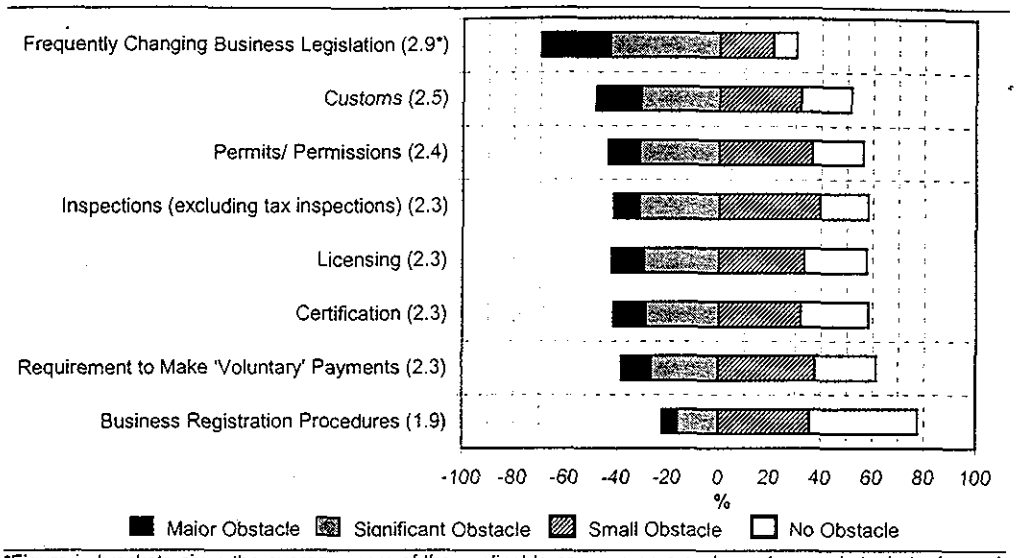


*Figure in brackets gives the average score of the applicable answers on a scale on 1 – no obstacle to 4 – major obstacle for each obstacle listed

**Table 31**
**Main Regulatory and Administrative Barriers to Business Development in Ukraine by Firm Size and Origin**

| | Average | | Firm Origin | | | | | | Firm Size | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | State-Owned | | Privatized | | Start-Ups | | Up to 50 | | 51 - 250 | | More than 250 | |
| | Score* | %** | score | % | Score | % | score | % | score | % | Score | % | score | % |
| Frequently Changing Business Legislation | 2.9 | 94 | 2.9 | 92 | 2.9 | 94 | 2.8 | 96 | 2.8 | 95 | 2.9 | 94 | 3.0 | 94 |
| Customs | 2.5 | 44 | 2.5 | 40 | 2.5 | 46 | 2.4 | 43 | 2.4 | 42 | 2.6 | 45 | 2.4 | 50 |
| Permits/ Permissions | 2.4 | 86 | 2.3 | 87 | 2.4 | 85 | 2.4 | 87 | 2.4 | 86 | 2.4 | 86 | 2.3 | 86 |
| Inspections (excluding tax inspections) | 2.3 | 94 | 2.3 | 95 | 2.4 | 95 | 2.3 | 93 | 2.3 | 94 | 2.4 | 94 | 2.4 | 95 |
| Licensing | 2.3 | 72 | 2.3 | 70 | 2.3 | 71 | 2.3 | 73 | 2.3 | 73 | 2.4 | 70 | 2.3 | 72 |
| Certification | 2.3 | 70 | 2.3 | 67 | 2.3 | 73 | 2.2 | 68 | 2.2 | 69 | 2.4 | 73 | 2.3 | 71 |
| Requirement to Make 'Voluntary' Payments | 2.3 | 77 | 2.3 | 76 | 2.3 | 76 | 2.3 | 79 | 2.3 | 78 | 2.3 | 76 | 2.2 | 78 |
| Business Registration Procedures | 1.9 | 70 | 1.9 | 70 | 1.9 | 68 | 1.9 | 71 | 1.9 | 71 | 1.9 | 67 | 1.8 | 71 |

*average score for the respondents to whom certain regulation is applicable
**% of respondents to whom certain type of regulation is applicable

## Unofficial Payments

Respondents were asked whether or not they had to make unofficial payments in dealing with some of the major regulatory issues (*i.e.* bribes and other payments not stipulated by



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law) over the course of 2000. The table below gives information given not only on those firms who stated that they had made unofficial payments, but also for those who abstained from answering, claiming that this information was confidential.

**Table 32**
**Proportion of Companies Who Made Unofficial Payments by Company Size**
*(% of firms to whom certain type of regulation is applicable)*

| | Firm Size | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Up to 50 | | 51-250 | | More than 250 | | Average | |
| | Made Unofficial Payments | Information Confidential | Made Unofficial Payments | Information Confidential | Made Unofficial Payments | Information Confidential | Made Unofficial Payments | Information Confidential |
| Permits/ Permissions | 28.4 | 22.1 | 18.5 | 19.4 | 14.9 | 15.7 | 23.3 | 20.2 |
| Licensing | 17.8 | 20.2 | 10.5 | 14.2 | 11.1 | 12.1 | 14.8 | 17.2 |
| Business Registration | 17.6 | 18.6 | 11.7 | 16.8 | 4.9 | 12.7 | 13.7 | 17.0 |
| Certification | 18.0 | 19.3 | 12.2 | 15.8 | 10.7 | 11.0 | 15.0 | 16.7 |
| Customs | 14.5 | 17.9 | 11.0 | 18.1 | 13.4 | 12.4 | 13.4 | 16.7 |

The biggest proportion of firms (23%) stated that they needed to make unofficial payments in receiving permits and permissions. For all firms for whom a certain regulation was applicable a larger proportion of small firms had make unofficial payments than either medium sized or large firms.

## Instability of Business Legislation

As can be seen the biggest regulatory and administrative challenge that the majority of businesses face are rapidly changing rules of the game. Regulatory, and to a lesser extent legislative changes, in Ukraine tend to be arbitrary and non-consultative in nature. The concept of consultation and public awareness in amending regulations is not widely practiced in Ukraine, simply because there are no requirements to do so and there are no well defined feedback mechanisms in any case. Though there have been some attempts by the government in pushing administrative reform and more attempts to make public key policy decisions, a general lack of predictability of the business environment still prevails. This problem is further compounded by three factors; firstly that central state bodies do not face the requirements to make public a lot their decisions below Cabinet of Ministers level (*see Box*); secondly that new regulations are often taken in isolation and with no consultation with other state bodies – often leading contradicting business legislation. Finally, little control exists over implementation of such decisions at the local level, further increasing the perceived arbitrariness of decisions.

*Hierarchy of Laws and Regulations*
*The hierarchy of laws and regulations that affect business are ranked as follows:*
*Constitution*
*Codes of Ukraine*
*Laws of Ukraine*
*Presidential Decrees*
*Verkhovna Rada Resolutions*
*Cabinet of Ministers Resolutions*
*National Bank of Ukraine Normative Legal Acts*
*Ministries and Central Executive Bodies' Normative Acts and Regulations*
*Local Authorities' Normative Acts*

*In accordance with the constitution all normative acts and laws that impinge on the rights and interests of citizens have to be made public by law. However, no such law currently exists.*

*Currently, according to a Presidential Decree, only Laws, Decrees, Verkhovna Rada Laws and Resolutions and Cabinet of Ministers Resolutions, are obliged to be published. For the remainder (representing the bulk of regulations) there are no well-defined procedures of making regulatory changes public.*

As the problems with legislative instability are so acute the survey asked managers whether it was easy to obtain information on laws and regulations that impact on their enterprises and whether they thought legislative and regulatory environment was more or less predictable in 2000 compared with 1999. On the whole, two thirds of Ukrainian firms feel that it is relatively easy to obtain necessary information on the legislative and regulatory environment for their firms. The bigger problem appears to be not so much with obtaining information (although one third of Ukrainian firms find it difficult to find this information), rather it is the fact that business legislation changes often, creating operational problems for companies and making the planning process more difficult.

**Table 33**
**"It is Easy to Obtain Information on Laws and Regulations that Influence my Firm"**
*(% respondents who agreed with the statement)*

| | Firm Size | | | |
|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | Average |
| **Sector** | | | | |
| Manufacturing | 62.0 | 70.6 | 73.9 | **68.4** |
| Construction | 60.0 | 74.5 | 72.2 | **66.1** |
| Transport | 64.1 | 80.0 | 84.6 | **76.1** |
| Telecoms | 83.3 | 100.0 | 100.0 | **85.4** |
| Trade | 60.7 | 62.2 | 81.8 | **61.4** |
| Public Catering | 59.7 | 81.8 | - | **61.4** |
| Other Services | 66.5 | 78.9 | 87.8 | **72.7** |
| **Average** | **62.6** | **72.2** | **76.7** | **67.7** |

More companies felt (see Figure 19) that there was less legislative predictability in 2000 compared with 1999 (32% vs. 22%). Further, there were very few optimists, only around one company in 30 felt that the legislative and regulatory environment had gotten much more stable and predictable in 2000 compared with 1999. [25]

[25] Firms were given the choice of 'much less predictable', 'less predictable', 'no change', 'a little more predictable', and 'much more predictable'. For the purposes of Figure 19 the responses were aggregated into 'less predictable', 'no change' and 'more predictable.'



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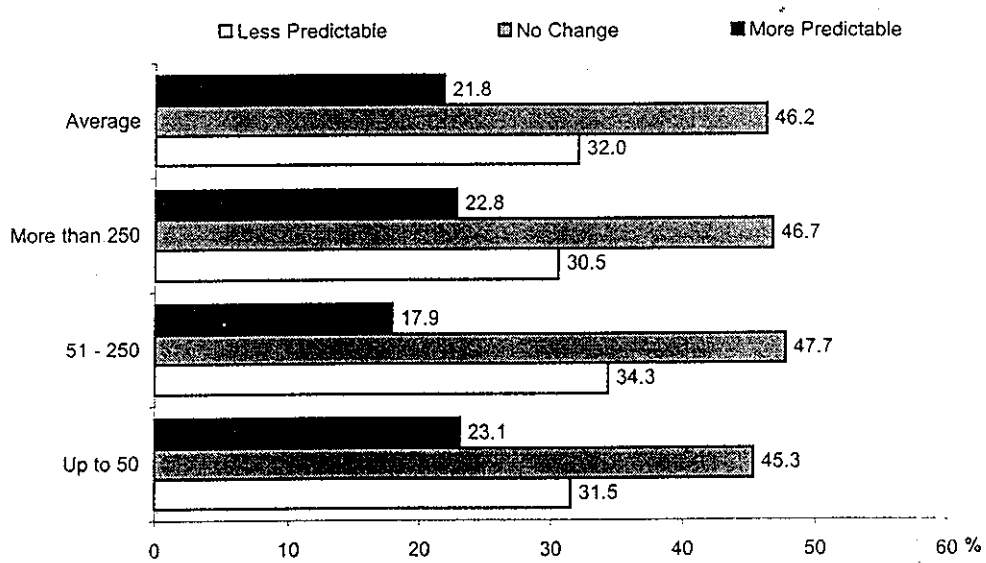
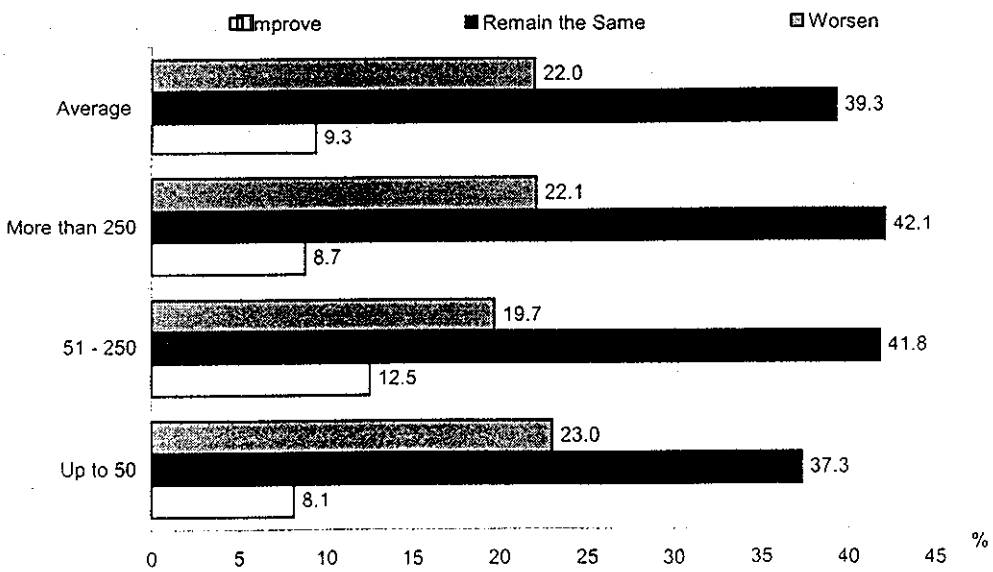
**Figure 19**
**Predictability of Legislative and Regulatory Environment in 2000 Compared with 1999**
*(% of all firms)*




Following on from this twice as many companies felt that the legislative and regulatory environment would deteriorate in 2001 compared with 2000 (see Figure 20.)

**Figure 20**
**Assessment of Projected Legislative and Regulatory Environment in 2001**
*(% of all firms in each size class)*



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## Import/ Export Operations

Among regulatory obstacles, customs procedures were rated second only to legislative instability. Around 44% of all surveyed companies were involved in foreign trade to some extent. Border customs checks and certification of imported goods were cited as the most significant barriers, and accreditation procedures were cited as the least important barrier to foreign trade transactions (see table below.) *In dealing with customs procedures in general,* 13% of respondents who were involved in export and import, stated they had to make unofficial payments, while 17% refused to answer claiming that this information was confidential (see Table 32.)

**Table 34**
**Main Barriers in Import/ Export Operations**
*(for all importers/ exporters)*

| | Average | | Firm Origin | | | | | | Firm Size | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | State-Owned | | Privatized | | Start-Ups | | Up to 50 | | 51 - 250 | | More than 250 | |
| | Score* | %** | Score | % | Score | % | Score | % | score | % | score | % | score | % |
| *Border Customs Checks* | 2.1 | 26 | 2.2 | 20 | 2.1 | 25 | 2.1 | 23 | 2.1 | 21 | 2.2 | 27 | 2.0 | 26 |
| Import Certification | 2.0 | 19 | 2.2 | 14 | 1.9 | 18 | 2.1 | 18 | 2.0 | 16 | 2.0 | 20 | 2.1 | 19 |
| Customs Declarations | 2.0 | 29 | 2.0 | 21 | 2.0 | 26 | 2.0 | 24 | 2.1 | 22 | 2.0 | 27 | 2.0 | 29 |
| Firm Accreditation by Government | 1.5 | 18 | 1.5 | 15 | 1.5 | 18 | 1.6 | 17 | 1.5 | 16 | 1.6 | 19 | 1.5 | 18 |

* average score for the respondents to whom certain regulation is applicable
** % of respondents to whom certain type of regulation is applicable

## Permits and Permissions

The problem cited in third place by severity in the rating of regulatory and administrative problems, that of obtaining permits and permissions is very acute in Ukraine. This covers both official permits from local bodies and formal and informal 'permissions' from local officials. The importance of this issue correlates well with the importance attached to corruption in general by companies in Ukraine. This issue is even more important than that of government inspections of business and business licensing which are ranked fourth and fifth respectively. This shows that with the exception of the legislative climate (which is mostly influenced by central bodies) most regulatory problems for businesses occur at the local level rather than at the national level.

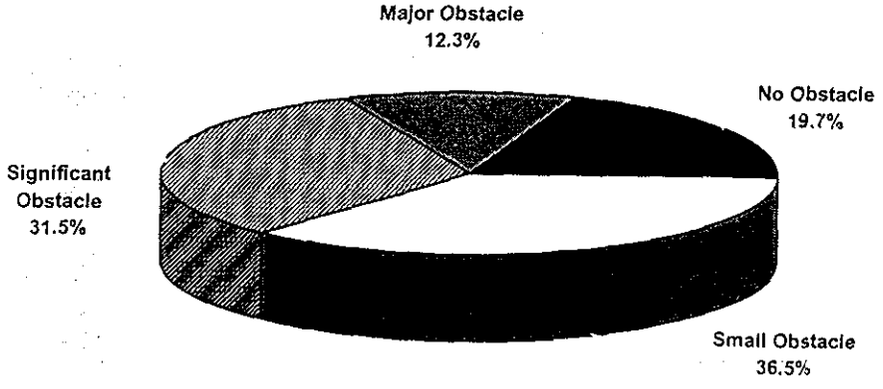
After registering a company needs to obtain not just the necessary licenses but various permits and formal and informal 'permissions' as well. The procedure for obtaining the necessary permits is not defined in national legislation (neither national laws or government resolutions), as for example company registration or licensing, but regulated through the internal rules and procedures of the relevant local authorities (city and oblast.) In addition to the necessary permits, enterprises often need to get unofficial permission and agreement from various local authorities. The whole procedure of receiving necessary permits and agreements, represents one of the most opaque, problematic and least predictable aspects of business activity in Ukraine, and as such can be associated with a monetary cost to the enterprise.

Permits and permissions include permits for advertising, location of shops and other outlets, construction, permit from road police, local health and safety agency, *etc.* However, almost

all activities have to be agreed with various local bodies as well, which typically entails just informing these bodies of proposed activities. There is no national legislation governing the issue of such permits and typically there are determined by city councils. Further, the bureaucratic nature of the issue of such permits and permissions as well as a lack of effective oversight, greatly adds to arbitrariness and possibilities for corruption.

The survey asked respondents to identify which of the main local permits that they are required to obtain as being a barrier to market entry. 86% of the entire sample faced the need to obtain permits/ permissions over 2000 (itself a powerful result indicating that over four fifths of all business are constantly engaged in these activities.) Further, the survey asked respondent whether they thought that permits and permissions were an obstacle to the development of their firms. The figure below gives the breakdown of responses only for those companies that did face the need to obtain permits and permissions and shows whether they felt that permits and permissions represented a barrier to business development. *Note that the survey did not seek to obtain specific information on unofficial 'permissions.'*

**Figure 21**
**Barriers Presented by Local Permits and Permissions**
*(% of firms that had to obtain permits and permissions)*




Of these companies 20% felt that obtaining permits did not present a problem. 44% reckoned that these permits and permissions constitute a significant to major barrier to market entry. The table below shows the breakdown of responses for the ten most important local state bodies that are obliged to provide permits to most firms. The percentages quoted refer to those companies that faced the need to obtain particular permits and permissions in 2000 listed in the table below, and shows the opinions of firms on the procedures for obtaining permits.

**Table 35**
**Barriers to Market Entry Presented by Various Local Permits and Permissions**
*(% of all firms who needed to obtain particular permits and permissions)*

| Type of Permit/ Permission | Firms Who Needed to Obtain Particular Permit/ Permission (% of all firms) | Easy to Obtain | Satisfactory | Difficult to Obtain | Very Difficult to Obtain | Demand for Unofficial Payments |
|---|---|---|---|---|---|---|
| Permit from State Sanitary Epidemiological Service | 52.3 | 19.0 | 55.8 | 19.1 | 6.1 | 5.0 |
| Permit from Fire Department | 63.4 | 18.9 | 52.3 | 20.7 | 8.1 | 5.9 |
| Permit from Health, Safety and Environment Department | 48.5 | 20.8 | 55.8 | 16.7 | 6.8 | 2.9 |
| Permission for Trade and Customer Service Outlet | 41.2 | 22.5 | 49.2 | 19.3 | 9.0 | 4.7 |
| Permission to Occupy Premises (close agreement for hire of communal property) | 38.3 | 33.8 | 44.4 | 13.9 | 8.0 | 3.3 |
| Permission to Refurbish Premises | 26.8 | 28.2 | 40.0 | 19.3 | 12.5 | 4.2 |
| Permission for Construction | 23.5 | 18.4 | 38.7 | 26.7 | 16.1 | 5.8 |
| Permit for Land Plot Allocation | 20.9 | 11.4 | 30.1 | 31.5 | 26.9 | 7.5 |
| Approval from Housing and Communal Property Department | 26.2 | 25.0 | 45.6 | 20.4 | 8.9 | 3.9 |
| Approval from Road Police | 37.6 | 20.1 | 53.7 | 17.8 | 8.4 | 5.8 |

As can be seen, the more difficult it is to get a permit the greater the number of companies that stated they faced the demand for making unofficial payments (*note: this data does not refer to whether firms made unofficial payments or not.*) It is then interesting to observe the breakdown by cities for those same respondents who had to obtain permits and permissions over 2000. The table below shows the proportion of these companies who felt that permits and permissions as a whole presented either a significant or major obstacle.

**Table 36**
***Proportion of Firms Who Felt That Obtaining Permits and Permissions Presented a Significant or Major Barrier***
*(% of all firms who needed to obtain permits and permissions)*

| | Up to 50 | 51-250 | More than 250 | Average |
|---|---|---|---|---|
| ***City*** | | | | |
| Vinnytsia | 34.1 | 45.5 | 18.2 | 33.3 |
| Dnipropetrovsk | 56.9 | 48.4 | 40.0 | 50.0 |
| Donetsk | 50.0 | 32.1 | 41.7 | 42.9 |
| Zhytomyr | 25.8 | 50.0 | 54.5 | 35.4 |
| Zaporizhya | 18.4 | 36.4 | 38.9 | 26.9 |
| Ivano-Frankivsk | 45.2 | 88.2 | 38.5 | 55.7 |
| Kyiv | 48.3 | 39.3 | 35.6 | 42.6 |
| Kirovograd | 42.1 | 16.7 | 54.5 | 39.3 |
| Lugansk | 57.8 | 30.0 | 54.5 | 53.0 |
| Lutsk | 37.5 | 27.3 | 16.7 | 32.7 |
| Lviv | 50.9 | 46.7 | 40.0 | 48.2 |
| Mykolayiv | 36.6 | 40.0 | 42.9 | 38.2 |
| Odesa | 46.2 | 43.8 | 33.3 | 42.4 |
| Poltava | 43.2 | 36.8 | 53.8 | 43.5 |
| Rivne | 40.0 | 53.8 | 37.5 | 45.8 |
| Simferopol | 62.0 | 52.4 | 50.0 | 58.2 |
| Sumy | 43.6 | 62.5 | 62.5 | 50.8 |
| Ternopil | 32.0 | 50.0 | 44.4 | 38.6 |
| Uzhgorod | 38.0 | 33.3 | 25.0 | 35.8 |
| Kharkiv | 45.5 | 54.2 | 40.0 | 46.2 |
| Kherson | 44.1 | 52.9 | 38.5 | 45.3 |
| Khmelnitsky | 46.9 | 53.8 | 55.6 | 49.3 |
| Cherkasy | 29.6 | 28.6 | 42.9 | 31.7 |
| Chernigiv | 47.2 | 57.1 | 33.3 | 46.2 |
| Chernivtsi | 45.7 | 35.7 | 58.3 | 45.9 |
| Average | 44.1 | 45.3 | 41.1 | 43.8 |

## Business Licensing

Licensing, in the opinions of entrepreneurs, takes fifth place in the overall ranking of regulatory and administrative barriers, though second place amongst just regulatory barriers behind permits/ permissions. Currently there are 58 different types of business activity subject to licensing. A genuine effort has been made over the last several years to ensure that business licensing does indeed only apply to activity that could be detrimental to public health, environment on national security. In June 2000 a new Law "On Licensing of Some Types of Economic Activity" was introduced which aims to further streamline and simplify the process of obtaining licenses. However, to date the government has still not introduced new licensing procedures in accordance with the law. Consequently the current situation regarding licensing is unclear.

Due to the fact that different types of business activity require different licenses, each with different procedures, this survey sought to examine the perceptions of company management as to whether they thought business licensing represented a barrier to business development. Overall only 28% of surveyed firms did not need to go through licensing procedures in 2000. Of those who did, 76% felt that it presented a barrier to business development in Ukraine (33% - small obstacle, 30% - significant obstacle and 13% - major obstacle). The table below shows the breakdown of responses by city for those respondents who stated that licensing was a significant or major obstacle.

**Table 37**
**Proportion of Firms Stating that Licensing Presented a Significant or Major Barrier**
*(% of all firms who needed to obtain licenses)*

| | Up to 50 | 51-250 | More than 250 | Average |
|---|---|---|---|---|
| **City** | | | | |
| Vinnytsia | 51.4 | 25.0 | 11.1 | **40.4** |
| Dnipropetrovsk | 61.2 | 37.5 | 51.7 | **52.9** |
| Donetsk | 46.3 | 52.0 | 52.2 | **49.4** |
| Zhytomyr | 32.0 | 62.5 | 30.0 | **37.2** |
| Zaporizhya | 25.7 | 30.0 | 44.4 | **29.6** |
| Ivano-Frankivsk | 34.5 | 64.7 | 45.5 | **45.6** |
| Kyiv | 38.6 | 40.4 | 38.9 | **39.2** |
| Kirovograd | 48.3 | 0.0 | 66.7 | **44.0** |
| Lugansk | 52.8 | 33.3 | 30.0 | **45.5** |
| Lutsk | 22.2 | 44.4 | 25.0 | **27.5** |
| Lviv | 42.6 | 61.5 | 36.4 | **45.1** |
| Mykolayiv | 43.8 | 42.1 | 20.0 | **41.1** |
| Odesa | 40.0 | 46.2 | 61.1 | **46.8** |
| Poltava | 56.3 | 33.3 | 54.5 | **50.9** |
| Rivne | 45.8 | 40.0 | 42.9 | **42.9** |
| Simferopol | 51.4 | 62.5 | 50.0 | **54.4** |
| Sumy | 41.2 | 81.8 | 28.6 | **48.1** |
| Ternopil | 35.0 | 71.4 | 25.0 | **40.0** |
| Uzhgorod | 27.0 | 33.3 | 28.6 | **27.7** |
| Kharkiv | 44.2 | 55.6 | 40.0 | **45.6** |
| Kherson | 40.7 | 33.3 | 0.0 | **30.4** |
| Khmelnitsky | 39.5 | 36.4 | 75.0 | **43.9** |
| Cherkasy | 33.3 | 20.0 | 33.3 | **31.4** |
| Chernigiv | 21.2 | 36.4 | 28.6 | **25.9** |
| Chernivtsi | 53.6 | 41.7 | 28.6 | **46.8** |
| **Average** | **41.8** | **44.7** | **40.9** | **42.3** |

Overall the proportions of firms in different firm size classes who stated that licensing presented a serious was roughly the same, however this masks a significant variation among cities. Cities like Chernigiv, Lutsk, Uzhgorod only had a quarter of firms



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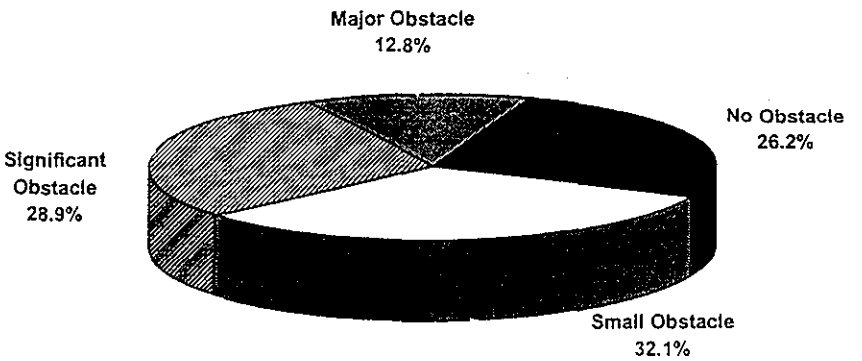
complaining about the licensing environment, whereas around half of firms in cities like Dnipropetrovsk, Dontesk, and Poltava stated that licensing presented a serious obstacle.

Licensing procedures are given in national legislation, however the issue of licenses is done by local bodies or local governments who have delegated authority from the relevant central authority. Some central bodies have their own local branches who handle licensing. Others delegate this process to oblast governments. Local authorities therefore have a large influence in establishing the environment for licensing locally.

## Product Certification

Certification ranked sixth out of the nine main regulatory and administrative barriers to market entry and growth surveyed in this report. 70% of all respondents had to undergo product or service certification and their responses on whether they felt certification proved to be an obstacle in their business operation are given in the figure below.

**Figure 22**
**Barriers Presented by Certification Procedures**
*(% of firms who underwent certification)*




74% of all firms who underwent certification felt that certification procedures were problematic. Of these firms, 19% (or 15% of all firms who underwent certification) had to make unofficial payments during the certification process. The table below shows the breakdown of firms who stated that product certification presented either a significant or major obstacle to their business operations.

**Table 38**
**Proportion of Firms Who Felt That Product Certification Presented a Significant or Major Barrier**
*(% of all firms who needed to certify products)*

| | Up to 50 | 51-250 | More than 250 | Average |
|---|---|---|---|---|
| **City** | | | | |
| Vinnytsia | 48.3 | 22.2 | 20.0 | **37.5** |
| Dnipropetrovsk | 55.8 | 52.0 | 59.3 | **55.8** |
| Donetsk | 44.4 | 53.6 | 33.3 | **44.0** |
| Zhytomyr | 32.3 | 87.5 | 27.3 | **40.0** |
| Zaporizhya | 24.3 | 33.3 | 54.5 | **31.7** |
| Ivano-Frankivsk | 22.2 | 47.1 | 54.5 | **36.4** |
| Kyiv | 49.4 | 47.4 | 50.0 | **48.9** |
| Kirovograd | 46.2 | 10.0 | 50.0 | **38.1** |
| Lugansk | 48.4 | 44.4 | 30.0 | **44.0** |
| Lutsk | 20.0 | 44.4 | 25.0 | **26.3** |
| Lviv | 35.6 | 42.9 | 44.4 | **38.2** |
| Mykolayiv | 46.7 | 61.5 | 14.3 | **46.0** |
| Odesa | 43.8 | 46.4 | 68.8 | **50.0** |
| Poltava | 56.7 | 23.1 | 10.0 | **39.6** |
| Rivne | 54.5 | 45.8 | 25.0 | **48.0** |
| Simferopol | 40.0 | 53.3 | 40.0 | **44.0** |
| Sumy | 41.9 | 80.0 | 20.0 | **47.8** |
| Ternopil | 17.6 | 30.0 | 25.0 | **22.9** |
| Uzhgorod | 32.4 | 33.3 | 14.3 | **29.5** |
| Kharkiv | 37.3 | 73.7 | 42.1 | **46.1** |
| Kherson | 28.0 | 14.3 | 25.0 | **23.4** |
| Khmelnitsky | 32.4 | 37.5 | 71.4 | **38.8** |
| Cherkasy | 36.4 | 60.0 | 33.3 | **39.4** |
| Chernigiv | 24.2 | 50.0 | 46.2 | **35.0** |
| Chernivtsi | 42.3 | 38.5 | 33.3 | **39.6** |
| **Average** | **39.5** | **46.5** | **41.0** | **41.6** |

11.3% of all firms surveyed had to undergo certification of imported goods. Around half (49%) stated that certification of imported goods is problematic for them. Out of all firms who had to certify imported goods 14 % had to make unofficial payments, 11% stating that information on unofficial payments is 'confidential' and the rest stating that they did not need to make any unofficial payments.

There is a relatively large number of classes of goods subject to mandatory certification – 37, which, according to the survey, creates additional obstacles to the business operations of Ukrainian firms. At present certification is considered to be another mechanism of state interference in businesses operations, a barrier to innovation and occasionally used for punitive purposes. The government should consider a further reduction in the number of goods subject to mandatory certification, adopting international and European certification standards, and simultaneously encouraging systems of voluntary certification of products.

In order to check how Ukrainian enterprises meet requirements of quality control, respondents were asked if they used any quality management systems that correspond to ISO 9000 or similar. The data below show the breakdown of responses across the whole sample and across sectors.

**Figure 23**
**Use of Quality Management Systems**
*(% of all firms)*

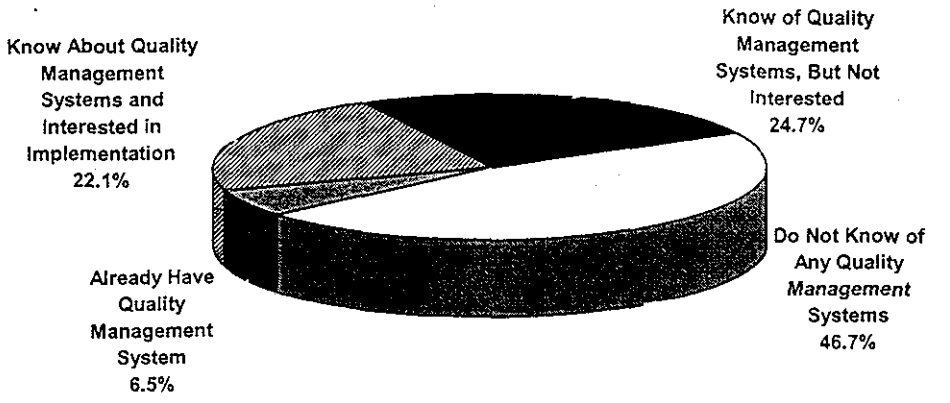



**Table 39**
**Use of Quality Management Systems**
*(% of all firms in each group)*

| | Already Have Quality Management System | Know About Quality Management Systems and Interested in Implementation | Know of Quality Management Systems, But Not Interested | Do Not Know of Any Quality Management Systems |
|---|---|---|---|---|
| ***Sector*** | | | | |
| Manufacturing | 8.5 | 33.5 | 22.2 | 35.7 |
| Construction | 10.1 | 24.1 | 22.8 | 43.0 |
| Transport | 3.7 | 5.6 | 36.1 | 54.6 |
| Telecoms | 4.5 | 11.4 | 54.5 | 29.5 |
| Trade | 3.8 | 10.6 | 25.9 | 59.7 |
| Public Catering | 1.5 | 4.4 | 23.0 | 71.1 |
| Other Services | 5.0 | 14.7 | 23.9 | 56.3 |
| **Average** | **6.5** | **22.1** | **24.7** | **46.7** |

What is surprising from the data is the number of firms who are ignorant of such systems, particularly in manufacturing. This could be as a result of such firms simply not needing to introduce such systems or genuinely not having enough information. For exporters (17.8% of the entire sample) the picture with introducing quality system was a little more optimistic than for the overall sample.

**Figure 24**
**Use of Quality Management Systems by Exporters**
*(% of all exporters)*

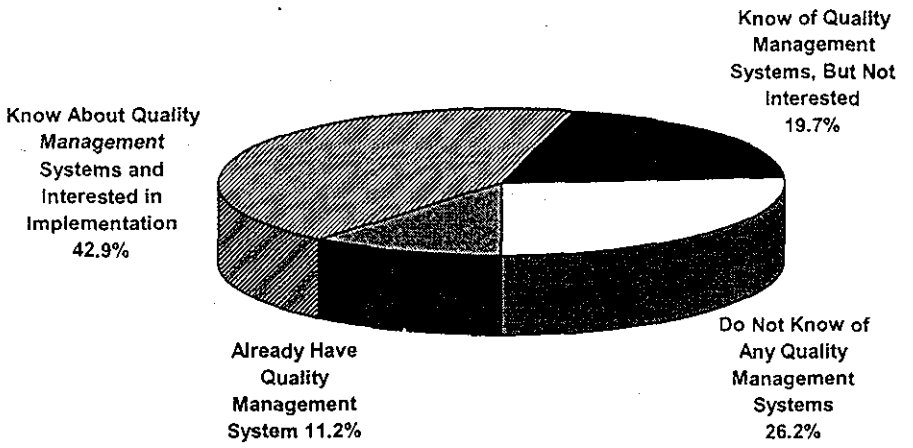



**Table 40**
**Use of Quality Management Systems by Exporters**
*(% of all exporters)*

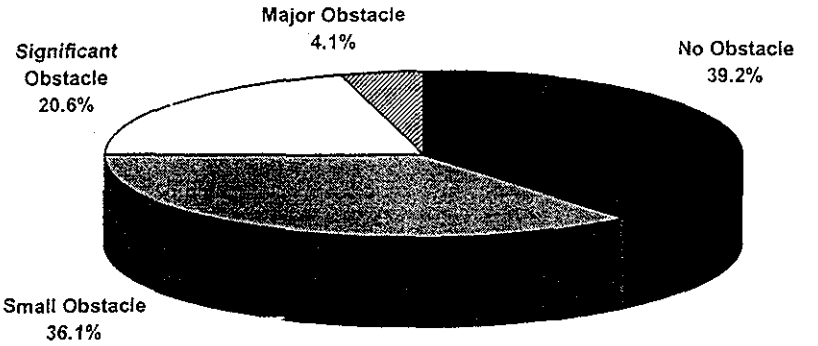
| | Already Have Quality Management System | Know About Quality Management Systems and Interested in Implementation | Know of Quality Management Systems, But Not Interested | Do Not Know of Any Quality Management Systems |
|---|---|---|---|---|
| **Sector** | | | | |
| Manufacturing | 12.1 | 47.0 | 17.8 | 23.1 |
| Construction | 0.0 | 30.0 | 30.0 | 40.0 |
| Transport | 11.1 | 5.6 | 38.9 | 44.4 |
| Telecoms | 0.0 | 0.0 | 66.7 | 33.3 |
| Trade | 11.1 | 38.9 | 16.7 | 33.3 |
| Public Catering | 0.0 | 0.0 | 0.0 | 100.0 |
| Other Services | 0.0 | 27.3 | 18.2 | 54.5 |
| Average | 11.2 | 42.9 | 19.7 | 26.2 |

## Registration

Company registration in Ukraine is neither straight forward nor entirely predictable at the local level (though all of the procedures are set out in law). As previous IFC surveys have shown, the registration process was a considerable obstacle faced by entrepreneurs. However, the government has scored a notable success in its attempts to simplify the registration process.

Business registration procedures were rated last out of the regulatory and administrative barriers presented in this survey (see Figure 18.) Comparing with the previous IFC survey the proportion of entrepreneurs listing registration as a major obstacle has fallen from 6.7% in 1999 to 4.1% in 2000. These figures only refer to the proportion of enterprises registered in each year.

**Figure 25**
**Barriers Presented by Registration Procedures**
*(% of firms that registered/ re-registered in 2000)*




Only 4.5% (97 firms) of the entire sample underwent registration/ re-registration in 2000. Of these, 25% (24 firms) felt that registration was an significant obstacle to market entry and business start up in Ukraine. 17 of these 24 enterprises were start ups with up to 50 employees.

### *State Business Inspections*

State regulation of the private sector is excessive in Ukraine, as indeed is official state harassment of private businesses. One of the many forms of harassment is that of official state inspections of business. There are numerous state agencies who have the authority to inspect companies (*see Box below*)

**Table 41**
**Average Number and Duration of Inspections**[26]
*(all firms)*

| | Firm Size | | | Firm Origin | | | Average Number of All Inspections over 2000 | Average duration of All Inspections |
|---|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | | |
| **Sector** | | | | | | | | |
| Manufacturing | 10.4 | 17.3 | 20.6 | 17.9 | 17.4 | 11.3 | 15.5 | 30.3 |
| Construction | 7.2 | 14.2 | 15.6 | 14.9 | 11.9 | 7.9 | 10.3 | 27.0 |
| Transport | 10.5 | 18.1 | 24.9 | 21.3 | 19.6 | 12.1 | 17.8 | 32.0 |
| Telecoms | 7.2 | 14.5 | 10.0 | 9.4 | 24.7 | 6.2 | 7.7 | 15.6 |
| Trade | 13.2 | 19.0 | 21.6 | 18.1 | 18.4 | 11.7 | 14.0 | 20.5 |
| Public Catering | 16.9 | 23.8 | - | 12.0 | 21.3 | 15.8 | 17.4 | 27.2 |
| Other Services | 9.8 | 12.8 | 16.8 | 14.9 | 13.1 | 8.4 | 11.4 | 23.1 |
| **Firm Size** | | | | | | | | |
| Up to 50 | | | | 11.1 | 14.7 | 10.1 | 11.5 | 19.3 |
| 51-250 | | | | 16.7 | 17.1 | 16.0 | 16.8 | 34.1 |
| More than 250 | | | | 21.7 | 20.6 | 11.6 | 20.4 | 43.8 |
| Average Number of Inspections | 11.5 | 16.8 | 20.4 | 16.9 | 17.1 | 10.9 | *14.4* | |
| Average Durations of all Inspections | 19.3 | 34.1 | 43.8 | 32.6 | 32.9 | 19.3 | | *26.6* |

The average number of inspections across all surveyed companies amounted to 14.4[27] over the course of 2000, consuming in total 26.6 days. However there was significant variation

[26] Results of 5% of the sample that quoted very high figures were excluded.
[27] A small number of firms reported the number of inspections running as a high 200 over the course of 2000.



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throughout the sample. In general the more state ties a firm has the more it is likely to be inspected. Both state-owned and privatized firms experienced more inspections than start-up firms.

### SME Inspections

The issue of inspections has lately become very topical in Ukraine. Whilst the average number of inspections by all inspecting bodies has decreased over the last several years, it is still very high. In order to provide a direct comparison with IFC's 1999 SME report (which surveyed only SMEs and only in 12 cities), an analysis of inspections for the same cites and same firm size is provided in the table below. The six cities that are included in both this and the 1999 report are Lugansk, Lutsk, Mykolayiv, Cherkasy, Chernigiv, Simferopol. Further for this analysis we also compared the same number of inspecting bodies. *Note: The averages below differ from the overall averages given in 1999 and 2000 due to a limited number of inspecting bodies being considered (who do however comprise the bulk of inspections), and limited number of cities.*

**Table 42**
**Average Number and Average Duration of SME Inspections***
(for all firms, 2000 vs. 1999)

| | 2000 | | 1999 | |
|---|---|---|---|---|
| | *Small Firms* | *Medium Firms* | *Small Firms* | *Medium Firms* |
| Number of Inspections | 10.2 | 14.9 | 9.6 | 12.0 |
| Duration of Inspections | 11.0 | 22.2 | 13.5 | 19.3 |

*Several firms with an extreme number of inpsections were excluded from the analysis.

As can be seen, in a direct comparison of the same cities there has been a slight increase in the number of inspections, for both small and medium sized firms (the 1999 report did not survey large enterprises). However, the average total duration of inspections for small businesses decreased over 2000.

*There are over 30 state bodies and their regional branches that have the power to inspect business activities of SMEs.*
*There are more than 30 Laws, imposed different type of inspections, and administrative responsibility for violation of inspecting regulation.*
*There is no one law clearly defines what an inspection is, its forms or procedures. Presidential Decree No.817 "On Several Measures on Deregulating Entrepreneurial Activity," - July 23, 1998, attempts to regulate inspection procedures for several state bodies, notably, State Tax Administration, Customs, State Control and Revision Service, State Treasury and defined two types of state inspections for these bodies:*

***Planned Inspection:*** *This is an on-site inspection of the financial and business activities of Subjects of Entrepreneurial Activity – SEA (i.e. any business) which is envisaged in the internal work plan of the inspecting body, and is conducted once per annum. The inspecting body is obliged to inform the SEA at least 10 days in advance of the inspection.*

***Unplanned Inspection:*** *This is an on-site inspection of the financial and business activities of an SEA, which is not envisaged in the internal work plan of the inspecting body and can occur at any time based on the following:*

- *Inspection of SEA has uncovered violations at another SEA*
- *SEA has not submitted compulsory reports on time*
- *Compulsory reports contain false information*
- *SEA claims violations of inspections procedure by inspecting body*

- *If SEA within three days has not provided a response to a written query from tax authorities that are checking information from another enterprise that had a legal relationship with the SEA*
- *SEA is being liquidated or restructured*

***3rd Party Inspection:*** *This is an on-site inspection of an SEA conducted at the request of another inspecting body (or regional branch) that is inspecting another SEA and has uncovered potential violations in the relationship between the two SEAs. A 3rd party inspection must be conducted within 10 days of receipt of a written query.*

***Operational Inspection:*** *This is an on-site inspection of an SEA to check that correct procedures are followed during cash and non-cash transactions with customers, check on the use of cash registers and invoices; financial and accounting documents; cash limits are observed (enterprises are severely limited in their cash transactions); registration documents; licenses; trade patents; excise duty stamps; any and all premises; and other aspects of business activity that current legislation allows inspecting bodies to check on.*

*The duration of an operational inspection must not exceed 30 days. For SEAs that have sales in excess of UAH20 million there are no limits on the duration of operational inspections.*

*In addition to the above, all bodies having the authority to inspect businesses have their own separate inspection definitions and procedures. For example, the State Control and Revision Service, in addition to inspections has the power to undertake a 'revision' of an enterprise which is regulated only by its internal procedures.*

**Table 43**
**Average Number and Average Duration of Inspections**

| | Up to 50 | 51 – 250 | More than 250 | State - Owned | Privatized | Start-Ups | Average Number of Inspections | Average Duration of Inspections |
|---|---|---|---|---|---|---|---|---|
| **City** | | | | | | | | |
| Vinnytsia | 16.0 | 17.4 | 20.2 | 23.0 | 17.7 | 12.1 | 16.9 | 27.6 |
| Dnipropetrovsk | 13.7 | 17.5 | 23.0 | 15.2 | 21.3 | 13.5 | 17.0 | 32.9 |
| Donetsk | 7.8 | 16.9 | 21.3 | 21.8 | 15.6 | 9.3 | 14.0 | 28.2 |
| Zhytomyr | 18.4 | 28.3 | 26.3 | 25.7 | 21.7 | 19.6 | 21.4 | 32.5 |
| Zaporizhya | 14.5 | 18.7 | 18.9 | 21.6 | 20.4 | 11.2 | 16.1 | 27.8 |
| Ivano-Frankivsk | 8.6 | 12.6 | 10.5 | 8.1 | 12.1 | 7.2 | 10.1 | 23.7 |
| Kyiv | 8.9 | 13.7 | 20.5 | 16.8 | 15.4 | 8.8 | 12.9 | 26.7 |
| Kirovograd | 11.6 | 21.1 | 27.2 | 16.1 | 21.9 | 10.3 | 16.0 | 26.1 |
| Lugansk | 11.3 | 15.5 | 23.5 | 23.5 | 17.4 | 7.7 | 14.0 | 24.3 |
| Lutsk | 7.9 | 13.5 | 14.1 | 12.3 | 10.3 | 8.5 | 9.7 | 19.6 |
| Lviv | 8.1 | 13.6 | 21.3 | 19.9 | 14.5 | 6.7 | 11.3 | 23.4 |
| Mykolayiv | 8.1 | 14.7 | 15.5 | 13.5 | 12.8 | 8.1 | 10.7 | 20.2 |
| Odesa | 12.4 | 18.8 | 19.8 | 20.4 | 17.1 | 12.8 | 16.0 | 33.2 |
| Poltava | 16.5 | 22.0 | 33.8 | 18.1 | 26.2 | 14.0 | 21.1 | 36.3 |
| Rivne | 13.5 | 18.0 | 24.5 | 22.6 | 17.1 | 13.9 | 16.3 | 31.3 |
| Simferopol | 11.6 | 18.8 | 24.2 | 17.1 | 21.5 | 10.5 | 14.8 | 27.3 |
| Sumy | 9.8 | 7.8 | 5.1 | 4.8 | 5.8 | 11.2 | 8.8 | 18.5 |
| Ternopil | 9.6 | 13.2 | 16.0 | 15.2 | 11.3 | 11.5 | 12.1 | 21.4 |
| Uzhgorod | 8.7 | 10.0 | 15.1 | 13.6 | 8.7 | 9.1 | 9.7 | 17.0 |
| Kharkiv | 12.7 | 21.7 | 17.6 | 12.6 | 22.0 | 12.8 | 15.7 | 27.7 |
| Kherson | 12.2 | 21.7 | 21.0 | 21.5 | 19.7 | 10.0 | 16.0 | 26.9 |
| Khmelnitsky | 10.9 | 23.5 | 21.4 | 8.2 | 19.8 | 12.7 | 14.3 | 29.9 |
| Cherkasy | 12.8 | 16.5 | 11.4 | 10.6 | 13.6 | 13.8 | 13.2 | 22.2 |
| Chernigiv | 12.0 | 17.9 | 22.3 | 20.3 | 21.9 | 10.2 | 15.6 | 28.0 |
| Chernivtsi | 17.4 | 13.2 | 22.8 | 10.8 | 19.2 | 16.0 | 17.3 | 26.4 |
| **Average Number of Inspections** | 11.5 | 16.8 | 20.4 | 16.9 | 17.1 | 10.9 | *14.4* | |
| **Average Duration of Inspections** | 19.3 | 34.1 | 43.8 | 32.6 | 32.9 | 19.3 | | *26.6* |



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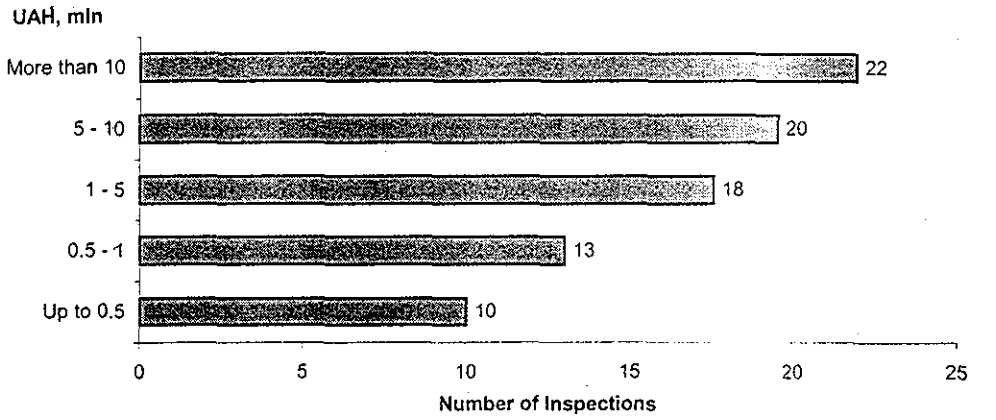
The regional picture regarding inspections is more complex, reflecting local priorities, and shows a wide regional variation, ranging from an average of 8.8 inspections in Sumy to over twice as much in Zhytomyr (21.4 inspections per year). This range in responses is an important result as it shows that local and oblast governments do indeed influence the inspection climates locally. As there are more than 30 national agencies that account for the bulk of inspections, it is unrealistic to expect them to coordinate their overall activities that closely, which implies that there is some other factor responsible for the overall level of inspections in a particular city. There are two hypothesis for the observed variation in the number of inspections. The first is that businesses tend to be city specific and share similar characteristics and regulatory infringements. The second is that local government has a larger influence on the level of inspections in a particular city than regulations governing the conduct of inspecting bodies would suggest. The authors of this survey favor the latter.

However, average figures for any particular city disguise a very large variation in responses. For smaller business there is a more than a two-fold difference between Zhytomyr (18.4 inspections) and Donetsk (7.8). A larger variance is observed with large firms, ranging from 33.8 inspections in Poltava to 5.1 in Sumy. Those cities that tend to have less inspections for smaller business also tend to have less inspections for larger business. This result does indeed demonstrate that local authorities wield a large degree of influence on the local inspections climate. A very small difference does exist between the number of inspections between state owned firms and privatized firms, though on average across the country they experience the same number of inspections. There is larger discrepancy between state owned firms and start ups, with state-owned firms experiencing one and a half times more inspections than start ups. Only in five cities did state owned firms experience less inspections than start ups.

State owned firms, rather than experiencing fewer state inspections, actually tend to have more than firms in the private sector, with the exception of Ivano Fraknkivsk, Sumy, Khmelnitsky, Cherkasy, and Chernivtsi where they had fewer inspections than private firms. The big anomaly is Sumy which bucked the trend across all parameters. Small businesses were inspected twice as much as large businesses and state owned firms experienced twice as few inspections as start ups.

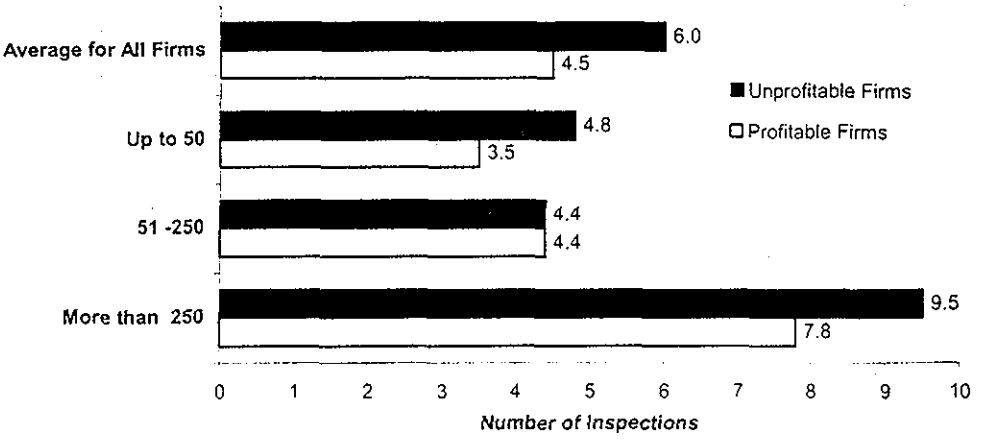
There is a positive correlation between company size and the number of inspections (*see Figure 26*). The larger the company the more the number of inspections. On average across the whole sample, a 10% increase in the number of employees leads to a 2% increase in the number of inspections. Figure 26 below shows the number of inspections by firm size (expressed in sales) and Figure 28 by number of employees.

**Figure 26**
**Average Number of Inspections per Firm by Sales**
*(all firms)*




As can be seen there is a positive correlation between firm size, expressed in terms of sales o number of employees, and the number of inspections. This should also logically imply that the more profitable a company the more inspections it should experience. In fact the data shows the exact opposite. Loss making enterprises experienced more inspections than profitable enterprises (though there is no link between different levels of profitability and number of inspections.) This result presumably reflects greater suspicion on the part of state officials of concealed sales and profits at poorer performing enterprises.

***Figure 27***
**Average Number of Tax Inspections by Profitability**
*(all firms)*




Notwithstanding the fact that the larger the enterprise the more inspections, smaller enterprises tend to experience disproportionally more inspections per employee than larger ones. The inspections burden per employee is higher with smaller companies than with larger companies – by more than 20 times.



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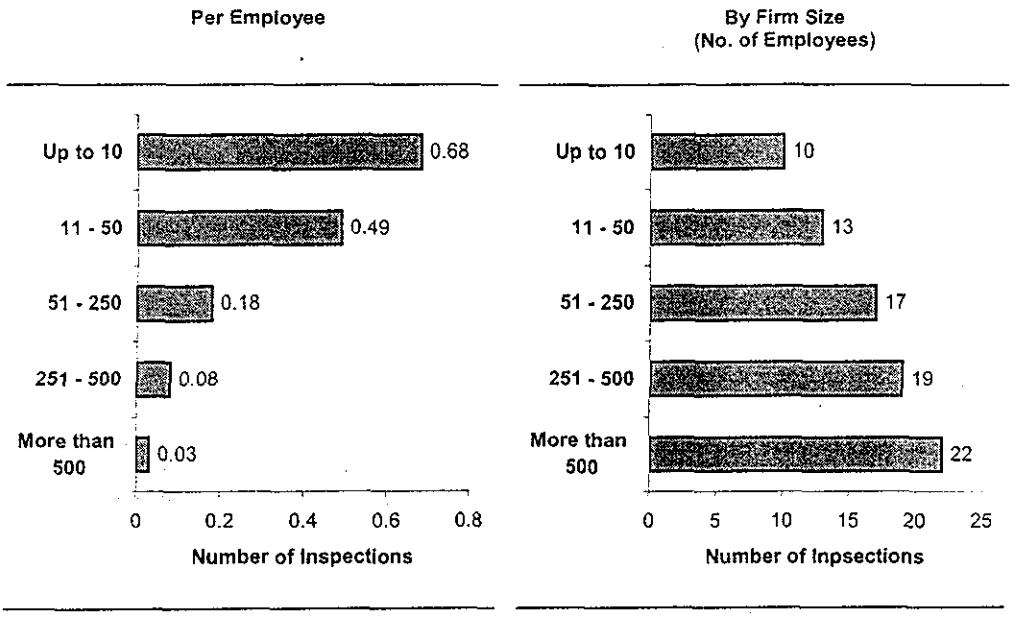
**Figure 28**
**Average Number of Inspections**
*(by firm size)*




## Inspections Perceptions

In addition to determining the number and duration of inspections experienced by companies in Ukraine it is also important to assess their perceptions of whether the inspections burden has changed or not as this provides a good indication of whether changes in inspection procedures are having an effect or not. In this context, what is probably more important is not whether there has been any reduction in the level of inspections, but whether company managers reckon that there has been a change or not.

Confirming the data that shows that there has not been a fall in the number of inspections, at least not for smaller businesses, the majority of businesses felt that number of tax inspections has not changed (57 % of respondents) in 2000. 17 % of all respondents thought that the number of tax inspections have increased during 2000. A similar picture is observed with respect to non-tax related inspections with the same proportion (57%) thinking that the level of inspections had not changed in comparison to 1999, and 21% stating that it had increased.



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**Table 44**
***Perceptions of Changes in the Number of Inspections for All Firms***
*(% of all firms)*

| | Have the Number of Tax Inspections Changed? (2000 vs.1999) | | | | Have the Number of Non-Tax Inspections Changed? (2000 vs. 1999) | | | |
|---|---|---|---|---|---|---|---|---|
| | Increased | Decreased | No Change | Don't Know | Increased | Decreased | No Change | Don't Know |
| **City** | | | | | | | | |
| Vinnytsia | 22.5 | 12.7 | 53.5 | 11.3 | 21.1 | 14.1 | 54.9 | 9.9 |
| Dnipropetrovsk | 18.6 | 15.5 | 61.2 | 4.7 | 23.3 | 11.6 | 58.9 | 6.2 |
| Donetsk | 20.8 | 13.1 | 59.2 | 6.9 | 25.4 | 6.2 | 60.8 | 7.7 |
| Zhytomyr | 16.7 | 25.8 | 53.0 | 4.5 | 22.7 | 16.7 | 51.5 | 9.1 |
| Zaporizhya | 17.7 | 20.3 | 53.2 | 8.9 | 21.5 | 15.2 | 55.7 | 7.6 |
| Ivano-Frankivsk | 15.6 | 20.3 | 51.6 | 12.5 | 23.4 | 15.6 | 53.1 | 7.8 |
| Kyiv | 14.6 | 16.8 | 58.4 | 10.2 | 17.3 | 10.6 | 62.4 | 9.7 |
| Kirovograd | 14.3 | 20.0 | 57.1 | 8.6 | 18.6 | 15.7 | 60.0 | 5.7 |
| Lugansk | 12.5 | 16.3 | 60.0 | 11.3 | 35.0 | 11.3 | 47.5 | 6.3 |
| Lutsk | 23.3 | 16.7 | 50.0 | 10.0 | 25.0 | 10.0 | 60.0 | 5.0 |
| Lviv | 22.0 | 18.0 | 48.0 | 12.0 | 16.0 | 16.0 | 52.0 | 16.0 |
| Mykolayiv | 12.0 | 14.7 | 60.0 | 13.3 | 20.0 | 6.7 | 64.0 | 9.3 |
| Odesa | 21.2 | 13.5 | 51.9 | 13.5 | 24.0 | 9.6 | 58.7 | 7.7 |
| Poltava | 13.2 | 5.3 | 75.0 | 6.6 | 17.1 | 6.6 | 67.1 | 9.2 |
| Rivne | 15.9 | 8.7 | 58.0 | 17.4 | 14.5 | 2.9 | 69.6 | 13.0 |
| Simferopol | 30.0 | 15.0 | 48.0 | 7.0 | 33.0 | 14.0 | 43.0 | 10.0 |
| Sumy | 7.1 | 18.6 | 55.7 | 18.6 | 18.6 | 15.7 | 51.4 | 14.3 |
| Ternopil | 6.0 | 34.3 | 50.7 | 9.0 | 11.9 | 37.3 | 46.3 | 4.5 |
| Uzhgorod | 16.9 | 21.1 | 57.7 | 4.2 | 19.7 | 11.3 | 62.0 | 7.0 |
| Kharkiv | 22.9 | 12.7 | 58.5 | 5.9 | 23.7 | 8.5 | 61.9 | 5.9 |
| Kherson | 11.4 | 12.9 | 64.3 | 11.4 | 17.1 | 12.9 | 61.4 | 8.6 |
| Khmelnitsky | 18.2 | 15.6 | 54.5 | 11.7 | 27.3 | 9.1 | 53.2 | 10.4 |
| Cherkasy | 17.4 | 17.4 | 54.3 | 10.9 | 17.4 | 13.0 | 56.5 | 13.0 |
| Chernigiv | 12.9 | 11.4 | 60.0 | 15.7 | 15.7 | 7.1 | 54.3 | 22.9 |
| Chernivtsi | 17.1 | 20.0 | 54.3 | 8.6 | 21.4 | 11.4 | 57.1 | 10.0 |
| **Average** | **17.2** | **16.3** | **56.6** | **9.9** | **21.4** | **11.9** | **57.4** | **9.3** |

Roughly the same number of companies thought that tax inspections had increased (17.2%) as decreased (16.3%). The survey asked those respondents who felt that inspections had increased to identify what they felt to be the main reasons for this increase. Table 45 below lists some of the more frequently encountered reasons for increase in the number of tax inspections. A quarter (26.3%) did not know why inspections had increased. The two biggest perceived reasons for increases in inspections (according to entrepreneurs themselves) were being caught unawares by changes in tax legislation and regulations and pressure from local government on inspecting bodies.

**Table 45**
**Firm Perceptions for Increase in the Number of Tax Inspections**
*(% firms that reported an increase in tax inspections)*

| | Up to 50 | 51 - 250 | More than 250 | State - Owned | Privatized | Start-Up | Average |
|---|---|---|---|---|---|---|---|
| Changes to Legislation and Regulations | 22.2 | 16.1 | 27.5 | 22.9 | 23.4 | 20.7 | 22.3 |
| Increased Pressure from Local Government | 17.6 | 19.5 | 22.9 | 27.1 | 16.8 | 19.3 | 19.6 |
| Enterprise Lodged Complaints Against Inspection Bodies | 6.8 | 3.4 | 10.1 | 11.4 | 4.2 | 8.1 | 7.0 |
| Worsened Relationship with Inspecting Bodies | 4.0 | 5.7 | 3.7 | 1.4 | 4.2 | 5.9 | 4.3 |
| Enterprise Switched to Simplified Taxation (only applicable for small firms) | 6.8 | 0.0 | 0.0 | 1.4 | 1.2 | 6.7 | 3.2 |
| Don't Know | 30.1 | 25.3 | 21.1 | 15.7 | 27.5 | 30.4 | 26.3 |

Out of the 16.3 % of the entire sample who felt that the number of tax inspections decreased over 2000, 40% were at a loss to explain why. Table 46 below shows the breakdown of the most frequently encountered answers.

**Table 46**
**Firm Perceptions for Decrease in the Number of Tax Inspections**
*(% of firms that reported a decrease in tax inspections)*

| | Up to 50 | 51 - 250 | More than 250 | State - Owned | Privatized | Start-Ups | Average |
|---|---|---|---|---|---|---|---|
| Changes to Legislation and Regulations | 21.1 | 13.4 | 26.3 | 24.2 | 19.4 | 20.1 | 20.2 |
| Enterprise Use of Inspections Journal | 7.5 | 14.6 | 24.6 | 21.2 | 13.7 | 7.6 | 11.9 |
| Enterprise Transferred to Simplified Taxation (only applicable for small firms) | 18.3 | 0.0 | 0.0 | 3.0 | 7.4 | 17.4 | 11.1 |
| Improved Relationship with Inspecting Bodies | 8.0 | 11.0 | 8.8 | 3.0 | 8.6 | 10.4 | 8.8 |
| Decreased Pressure from Local Government | 7.0 | 7.3 | 5.3 | 6.1 | 6.3 | 7.6 | 6.8 |
| Don't Know | 40.4 | 42.7 | 36.8 | 30.3 | 44.0 | 38.2 | 40.3 |

As can be observed, the most significant factor influencing the level of tax inspections, in the opinion of company managers, is the instability of tax legislation and regulations. Simplified taxation offers some measure of relief from this instability, as it is intended to simplify tax reporting requirements. In this context it is interesting to observe that 3% of companies who experienced an increase in the number of tax inspections felt that this was as a direct result of the switch to simplified taxation.

The picture for non tax related inspections is the following. 9% more respondents felt that non-tax inspections have increased as those that felt they had decreased over 2000 (21% vs. 12%.) Employing the same analysis as with tax-related inspections, respondents were asked to name the main reasons for the change. Overall the same number of firms felt that there was no change in the level of both tax and non-tax related inspections in 2000 (57%.) The tables below list some of the more frequently encountered reasons in our survey for the reasons in the changes to the number of non-tax related inspections.

**Table 47**
**Firm Perceptions for Increase in Non-Tax Related Inspections**
*(% of firms that reported an increase in non-tax inspections)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| Changes to Legislation and Regulations | 31.8 | 20.2 | 35.3 | 29.1 | 29.1 | 31.6 | **30.1** |
| Increased Pressure from Local Government | 22.3 | 28.4 | 24.1 | 27.9 | 21.6 | 25.4 | **24.2** |
| Enterprise Lodged Complaints Against Inspection Bodies | 5.9 | 7.3 | 12.0 | 11.6 | 7.0 | 7.3 | **8.0** |
| Worsened Relationship with Inspecting Bodies | 5.0 | 4.6 | 3.8 | 2.3 | 5.0 | 5.1 | **4.5** |
| Don't Know | 3.2 | 0.0 | 2.3 | 2.3 | 1.5 | 2.8 | **2.2** |

**Table 48**
**Firm Perceptions for Decrease in Non-Tax Related Inspections**
*(% of firms that reported a decrease in non-tax inspections)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| Changes to Legislation and Regulations | 28.6 | 24.2 | 29.3 | 27.6 | 27.6 | 27.6 | **27.6** |
| Enterprise Use of Inspections Journal | 13.6 | 27.4 | 43.9 | 41.4 | 25.2 | 12.4 | **21.8** |
| Improved Relationship with Inspecting Bodies | 13.6 | 21.0 | 22.0 | 10.3 | 19.5 | 15.2 | **16.7** |
| Decreased Pressure from Local Government | 11.0 | 12.9 | 12.2 | 10.3 | 12.2 | 11.4 | **11.7** |
| Don't Know | 3.2 | 3.2 | 0.0 | 0.0 | 2.4 | 3.8 | **2.7** |

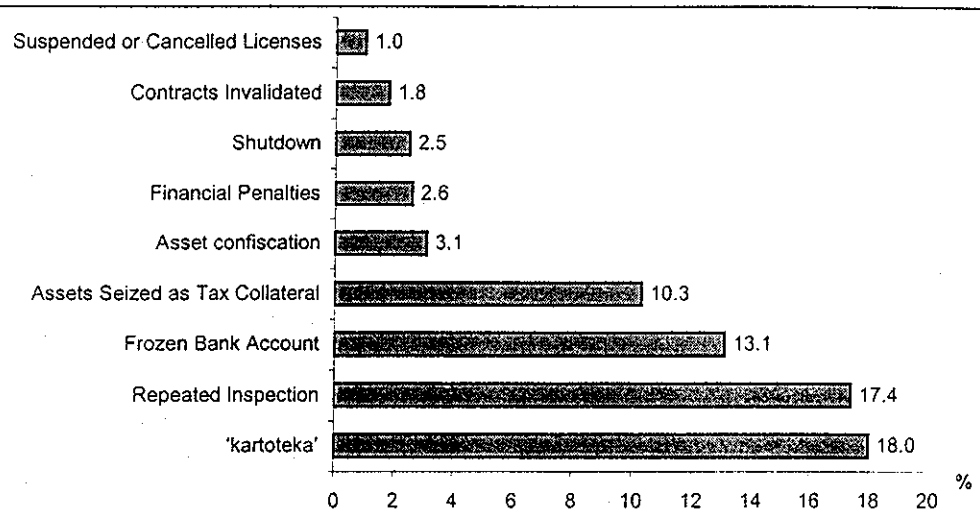
As far as firms are concerned the reasons behind changes in both tax and non-tax related inspections is the same. The major reasons for increases were changes in legislation and pressure from local governments and for decreases use of inspections journals and improved 'relationships' with inspectors. What is interesting though is that company managers feel a lot less confident about the reasons behind changes in the number tax inspections compared with other forms of inspections. The proportion of firms answering 'Don't Know' is much higher for tax inspections than for non-tax inspections, implying that the workings of the tax authorities are much more opaque.

## Inspection Consequences

Sate inspections of business in Ukraine are designed to uncover violations, occasionally for other reasons such as pressure from local governments or as a form of unfair competition. Consequently it is not surprising that 44% of all surveyed firms faced some form of negative consequences imposed by inspecting bodies. These can range from being just a

serious distraction from running a company to the 'kartoteka' system[28] to outright closure. Up until 2001, these measures were taken unilaterally by inspecting agencies without any court orders. Figure 29 below shows the breakdown of possible negative consequences for surveyed companies. *For full city breakdown of consequences please refer to Annex 6.*

**Figure 29**
**Inspection Consequences**
*(% of firms that had negative consequences)*




However the true scale of the problem with this form of state harassment of business becomes apparent in looking at the time that enterprises experience various sanctions. The average enterprise experienced more than a year's worth of sanctions over 2000 (some sanctions are concurrent.) Table 49 below shows the average duration of negative consequences for those respondents who experienced the four most popular forms of sanctions.

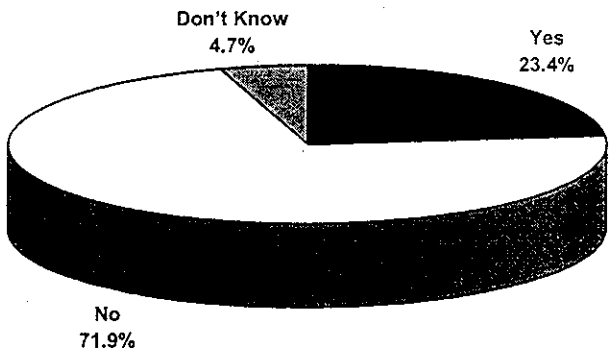
**Table 49**
**Average Duration of Inspection Consequences**
*(% of all firms who experienced inspection consequences, days)*

| | Repeated Inspection | Assets Seized as Tax Collateral | Frozen Bank Account | 'kartoteka' |
|---|---|---|---|---|
| ***Firm Size*** | | | | |
| Up to 50 | 15.5 | 119.5 | 52.9 | 105.6 |
| 51 – 250 | 15.6 | 202.9 | 132.1 | 207.0 |
| More than 250 | 11.7 | 171.6 | 99.6 | 198.3 |
| ***Sector*** | | | | |
| Manufacturing | 18.6 | 181.6 | 113.6 | 178.4 |
| Construction | 22.5 | 156.9 | 63.5 | 285.8 |
| Transport | 5.2 | 269.2 | 62.4 | 255.3 |
| Telecoms | 33.0 | | 120.0 | 49.0 |
| Trade | 4.3 | 14.0 | 26.3 | 40.0 |
| Public Catering | 5.8 | 38.0 | 58.4 | 61.0 |
| Other Services | 11.8 | 53.0 | 60.7 | 60.9 |
| ***Firm Origin*** | | | | |
| State –Owned | 14.0 | 147.4 | 118.1 | 235.9 |
| Privatized | 14.2 | 196.0 | 121.2 | 195.6 |
| Start-Ups | 15.2 | 100.8 | 29.3 | 77.7 |
| **Average** | **14.5** | **173.7** | **94.8** | **170.8** |

[28] The kartoteka 2 system, disbanded in 2001, allows inspecting bodies (in particular the State Tax Administration) to directly debit arrears to the state from a company's bank account, effectively stopping a firm's cash flow.

The widespread nature of confiscatory practices such as asset seizure, frozen bank accounts and kartoteka goes a long way towards explaining the size of 'shadow' activities and the reluctance to initiate bankruptcy or restructuring. If most of the perceived benefit of such activities will accrue to the state then enterprises are understandably going to be reluctant to initiate restructuring.

**Figure 30**
**"Have you ever contested the claims of inspectors, size of penalties, or other inspections consequences?"**
*(% of firms who experienced inspection consequences)*




The majority of respondents did not contest the claims of inspecting bodies, either because the claims were indeed justified, or because they felt they would not receive satisfaction. Less than one enterprise in four expressed any faith in the Ukrainian court system as given in the table below.

The firms surveyed were asked how often were the following statements justified in relation to the Ukrainian court system (*i.e.* how often they agreed or disagreed.) They were given options of 'always', 'almost always', 'often', 'sometimes', 'rarely', and 'never'. For the purposes of the table below those firms who said "always', 'almost always' and 'often' were aggregated.

**Table 50**
**Assessment of Ukrainian Court System**
*(% of all firms that agree with statements)*

| | Firm Size | | | |
|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | Average |
| Fair and Impartial | 16.9 | 23.4 | 29.3 | **20.9** |
| Honest and Uncorrupt | 14.3 | 17.1 | 23.0 | **16.6** |
| Quick | 12.1 | 15.7 | 19.5 | **14.4** |
| Affordable | 18.1 | 24.0 | 28.6 | **21.5** |
| Consistent and Reliable | 10.8 | 14.1 | 19.6 | **13.3** |
| Able to Enforce Decisions | 23.0 | 24.1 | 30.7 | **24.7** |
| Court system Can Defend My Rights Now | 15.4 | 20.6 | 25.4 | **18.6** |
| Court system Could Defend My Rights Two Years Ago | 13.5 | 18.6 | 23.2 | **16.6** |

There is a tendency for larger firms to have more trust in the court system than smaller firms. On a more optimistic note, more Ukrainian firms (though still very few) felt that the

court system could defend their rights and interests (18.6% expressed faith in the courts in 2000 vs. 16.6% in 1998.)

## Unofficial Payments During Inspections

Respondents were asked if they had to make additional 'unofficial' payments in connection with inspections by various bodies. Not surprisingly, as this is a very sensitive issue, more companies chose not to answer this question (replying that this was confidential information) than those that admitted to making these payments. *It must be stressed that this data was supplied by companies themselves in an anonymous questionnaire and represent their opinions only.*

The majority of companies replied that they had not made any unofficial payments over 2000. Table 51 below gives the breakdown of responses by particular inspecting bodies only for those companies who experienced inspections by those same bodies. As this is sensitive information, large proportion of companies stated that this information was confidential. The largest numbers of firms who made unofficial payments made them to the most active inspecting agencies.

**Table 51**
**Unofficial Payments During Inspections**
*(% of all firms who experienced a particular form of inspection)*

| | Made Unofficial Payments | Confidential Information | Did Not Make Unofficial Payments |
|---|---|---|---|
| Fire Department | 11.6 | 25.4 | 63.0 |
| Sanitary-Epidemiological Department | 10.7 | 23.7 | 65.6 |
| Tax Inspection Service or Police | 9.5 | 24.8 | 65.7 |
| Internal Affairs | 8.0 | 26.6 | 65.4 |
| Consumer Rights Protection Committee | 7.9 | 22.2 | 69.9 |
| Licensing Bodies | 6.6 | 24.6 | 68.8 |
| City Department of Industry and Consumer Market Development | 6.3 | 27.0 | 66.7 |
| Architecture Department | 6.2 | 22.2 | 71.6 |
| City Department on Issues of Business Development, Registration and Licensing | 5.6 | 26.4 | 68.0 |
| Prosecutors Office | 5.1 | 19.9 | 75.0 |
| Environmental Protection Ministry | 4.9 | 19.5 | 75.6 |
| Anti-Monopoly Committee | 4.6 | 18.1 | 77.3 |
| Health and Safety Committee | 4.5 | 19.1 | 76.4 |
| Price Control Inspection | 4.5 | 20.0 | 75.5 |
| Customs Service | 4.0 | 32.3 | 63.7 |
| Standardization, Certification and Metrology Committee | 3.9 | 19.6 | 76.5 |
| State Commission of Ukraine on Securities and Securities Market | 3.5 | 18.4 | 78.1 |
| Pension Fund | 3.2 | 17.0 | 79.8 |
| Employment Fund | 2.9 | 17.6 | 79.5 |
| Control Revision Service | 2.9 | 19.6 | 77.5 |
| City Financial Department | 2.3 | 20.4 | 77.3 |
| Social Security Fund | 2.2 | 16.6 | 81.2 |

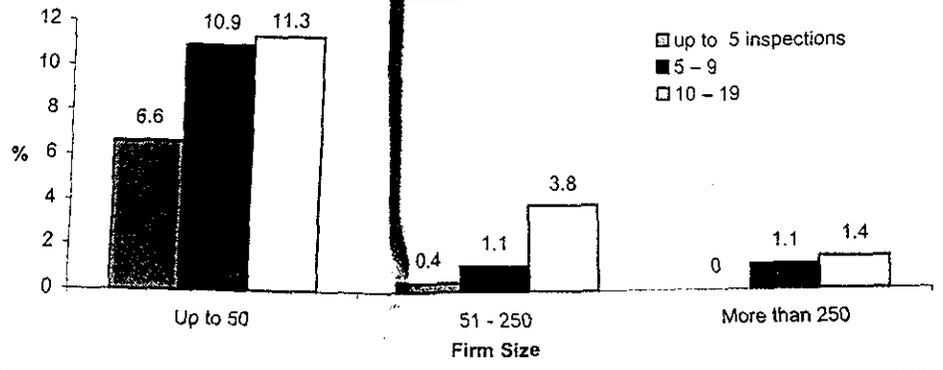
Examining this issue further, the data allowed for an analysis showing on whom the burden of unofficial payments fell the most. The figure below shows the firm size breakdown of all

of those firms that made unofficial ents (*i.e.* answered 'yes' in the table above) in 2000.

Whilst larger firms generally experi more inspections, smaller firms tend to make more unofficial payments. This coupled he fact that smaller firms have more inspections per employee means that they are much larger disadvantage compared with larger, more established firms.

Figure 31 shows the relationship bet the incidence of inspections and firms who make unofficial payments. For example, 6 of small firms who had up to 5 inspections made unofficial payments in relation th spections, whereas 11.3% of small firms who experienced up to 19 inspections ma nofficial payments. Overall, the picture is clear, a greater proportion of inspected smal ms make unofficial payments compared with larger firms, and incidences of unofficial p ents increase with the number of inspections.

**Figure 31**
**Unofficial Payments by Numbe Inspections**
*(% of firms that made unofficial paym ts)*




## Time Tax

An often overlooked consequence of frequently changing legislation, unstable business environments and a complicated regulatory and administrative environment is the amount of time that the management of a company needs to spend on coping with various changes and in dealing with the state in its many forms. This survey attempted to establish what percentage of senior management work time was spent on dealing with state officials on interpretation of laws and regulations (this covers almost all forms of interaction with the state and local government.) However, this is not just time spent, it is time spent away from managing an enterprise, and therefore has a monetary impact as well (lost contracts, worse management, etc.). In that sense it can be considered to be a tax on enterprises, whose value is calculated by considering the opportunity cost of management work time.



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**Table 52**
**Time Tax**
*(% of management work time, all firms)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | *Up to 50* | *51-250* | More than 250 | State-Owned | *Privatized* | Start-Ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 14.5 | 16.0 | 19.4 | 18.2 | 17.8 | 13.3 | **16.5** |
| Construction | 18.8 | 19.9 | 19.8 | 21.9 | 19.1 | 18.8 | **19.3** |
| Transport | 20.0 | 15.5 | 20.3 | 19.9 | 18.9 | 17.1 | **18.7** |
| Telecoms | 12.3 | 4.3 | 19.3 | 15.5 | 38.7 | 10.1 | **12.6** |
| Trade | 14.1 | 15.5 | 8.8 | 21.5 | 13.0 | 14.2 | **14.1** |
| Public Catering | 19.2 | 20.0 | - | 16.1 | 17.1 | 22.0 | **19.2** |
| Other Services | 11.6 | 10.9 | 23.7 | 19.3 | 14.1 | 9.6 | **13.4** |
| **Average** | **15.0** | **15.8** | **19.7** | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | 14.3 | 16.7 | 14.3 | **15.0** |
| 51-250 | | | | 16.0 | 16.4 | 14.0 | **15.8** |
| More than 250 | | | | 24.0 | 18.1 | 13.0 | **19.7** |
| **Average** | | | | **18.8** | **17.0** | **14.2** | ***16.1*** |

The measure that this survey used to assess time tax was very crude and offers respondents' subjective opinions on the amount of time spent dealing with state officials, without detailing particular areas of state involvement in companies or providing information on whether the state or firms initiate contact. A previous analysis[29] shows Ukraine to have the highest level of time tax on management in the CIS and Central and Eastern Europe.

Management of state owned enterprises faced the highest level of time tax with start ups the least. Large enterprise faced the highest level, and small enterprises the least, though there is no significant difference between small and medium enterprises. This means that, taking into account the difference in the amount of human resources available, and the opportunity cost of management time, small enterprises are hit hardest of all. This is a disappointing result as it is precisely the small business sector that should be the most dynamic and innovative. This level of state involvement, inspections and unfair competition all contribute to a poor public perception of private business and helps explain the low level of entrepreneurship in Ukraine. The table below shows the average proportion of work time that senior management needs to spend dealing with state officials for all firms in a given city.

[29] 'EBRD Transition Report 1999,' pp.124-126.

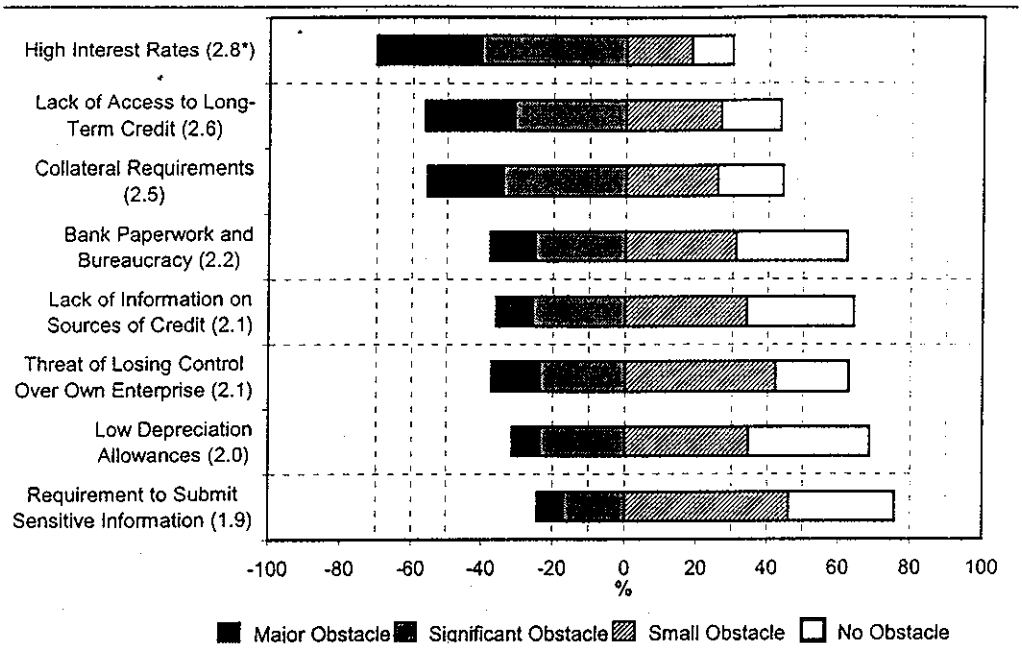
**Table 53**
**Time Tax**
*(% of management work time)*

| | Firm Size | | | |
|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | Average |
| **City** | | | | |
| Vinnytsia | 16.7 | 14.4 | 12.5 | **15.5** |
| Dnipropetrovsk | 17.9 | 14.2 | 24.2 | **18.5** |
| Donetsk | 14.6 | 15.6 | 14.6 | **14.9** |
| Zhytomyr | 13.4 | 6.1 | 11.8 | **12.2** |
| Zaporizhya | 22.7 | 11.0 | 15.7 | **18.8** |
| Ivano-Frankivsk | 14.2 | 23.0 | 30.0 | **19.7** |
| Kyiv | 14.6 | 15.3 | 17.5 | **15.5** |
| Kirovograd | 13.6 | 23.1 | 32.6 | **18.8** |
| Lugansk | 22.9 | 15.9 | 20.4 | **21.4** |
| Lutsk | 11.8 | 8.8 | 4.8 | **10.4** |
| Lviv | 12.9 | 22.3 | 27.0 | **16.9** |
| Mykolayiv | 14.7 | 17.1 | 23.3 | **16.2** |
| Odesa | 13.3 | 20.9 | 24.7 | **18.4** |
| Poltava | 16.7 | 23.0 | 22.4 | **19.7** |
| Rivne | 11.3 | 16.5 | 14.4 | **13.9** |
| Simferopol | 18.9 | 17.8 | 10.8 | **17.9** |
| Sumy | 10.9 | 13.8 | 18.7 | **12.4** |
| Ternopil | 11.7 | 9.4 | 13.0 | **11.2** |
| Uzhgorod | 7.3 | 4.7 | 22.0 | **9.0** |
| Kharkiv | 16.4 | 14.8 | 24.1 | **18.0** |
| Kherson | 19.0 | 13.4 | 30.6 | **19.7** |
| Khmelnitsky | 13.2 | 13.5 | 14.5 | **13.4** |
| Cherkasy | 13.8 | 11.9 | 3.0 | **11.8** |
| Chernigiv | 13.7 | 12.8 | 16.2 | **14.1** |
| Chernivtsi | 13.4 | 16.5 | 27.7 | **16.8** |
| **Average** | **15.0** | **15.8** | **19.7** | **16.1** |

## *Barriers to Receiving Financing and Credit*

The survey asked respondents to rate their main problems with obtaining financing, particularly credit. The figure below lists some of the more commonly encountered issues with obtaining financing in Ukraine and to what extent all surveyed firms felt they presented obstacles to their development.

**Figure 32**
**Barriers to Receiving Financing and Credit**
*(distribution of responses for all firms)*




*Figures in brackets refer to the overall average score for a given obstacle on a scale of 1 – no obstacle to 4 - major obstacle.

**Table 54**
**Barriers to Receiving Financing and Credit**

| | Average | | Firm Origin | | | | | | | | Firm Size | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | State-Owned | | Privatized | | Start-Ups | | Up to 50 | | 51 - 250 | | More 250 | |
| | Score* | rank | Score | rank | Score | rank | score | rank | score | rank | score | rank | score | rank |
| High Interest Rates | 2.8 | 1 | 2.6 | 1 | 3.0 | 1 | 2.7 | 1 | 2.7 | 1 | 2.9 | 1 | 3.0 | 1 |
| Lack of Access to Long-Term Credit (more than 1 year) | 2.6 | 2 | 2.4 | 2 | 2.6 | 2 | 2.5 | 2 | 2.5 | 2 | 2.6 | 2 | 2.7 | 3 |
| Collateral Requirements | 2.5 | 3 | 2.3 | 3 | 2.6 | 3 | 2.5 | 3 | 2.5 | 3 | 2.5 | 3 | 2.7 | 2 |
| Bank Paperwork and Bureaucracy | 2.2 | 4 | 2.0 | 4 | 2.2 | 4 | 2.2 | 4 | 2.2 | 4 | 2.2 | 4 | 2.2 | 4 |
| Lack of Information on Sources of Credit | 2.1 | 5 | 2.0 | 7 | 2.1 | 6 | 2.2 | 5 | 2.2 | 5 | 2.1 | 7 | 2.0 | 7 |
| Threat of Losing Control Over Own Enterprise | 2.1 | 6 | 2.0 | 5 | 2.1 | 5 | 2.1 | 6 | 2.1 | 6 | 2.1 | 6 | 2.1 | 5 |
| Low Depreciation Allowances | 2.0 | 7 | 2.0 | 6 | 2.1 | 7 | 2.0 | 7 | 2.0 | 7 | 2.1 | 5 | 2.1 | 6 |
| Requirement to Submit Sensitive Information | 1.9 | 8 | 1.6 | 8 | 1.9 | 8 | 1.9 | 8 | 1.9 | 8 | 1.8 | 8 | 1.8 | 8 |

*on a scale of 1 – no obstacle to 4 –major obstacle

The biggest barrier to obtaining commercial financing and credit, in keeping with most with transition economies, are high interest rates. Over and beyond this problem, SMEs are



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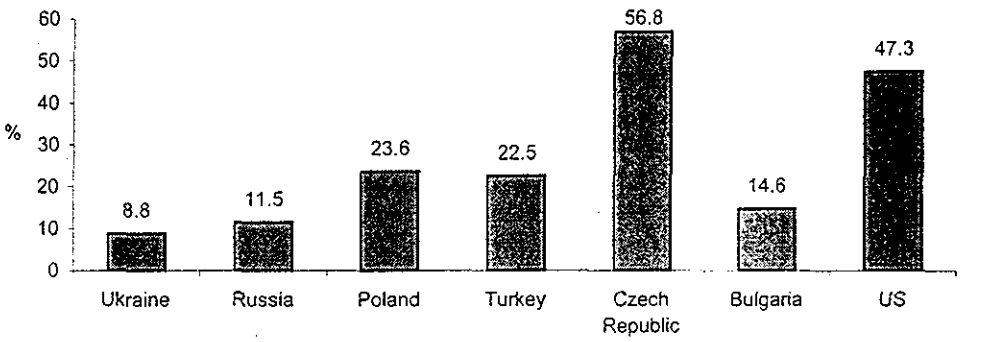
particularly hard hit by the lack of availability of longer term credit. Collateral requirements are in third place for all companies (except large companies which ranked this problem second.) Companies on the whole reckon that they are fairly knowledgeable on potential sources of credit and financing as this was rated as only the fifth biggest problem.

During 2000 the government and the National Bank of Ukraine (NBU) managed to reduce interest rates. The NBU discount rate was reduced from 45% in January to 27% in October 2000. Increasing money supply (M2 and M3 grew by 45% over the year) together with the relatively low NBU discount rates decreased commercial bank lending interest rates in nominal terms from 56.2% in January to 37.3%[30] in December (source: NBU statistics). In effect, real annual interest rates on bank credits in 2000 fell sharply – on average by 19% to around 18%. However, the cost of long term capital still remains restrictively high for long term business financing with the main reasons cited for high interest rates being high credit risks and an underdeveloped banking sector. The average spreads between annual interest rates on deposits and credits were 32.7% and 26.8% respectively in 1999 and 2000.

The upturn in bank crediting (as proportion of GDP) did not enhance investment activities, calculated as long-term loans. While in early 2000 8.9% of bank credit was used for investment, in early 2001 this had fallen to 5.6%. (Source: NBU Bulletin). In 1999 credit to the private sector was 8.8% of GDP growing by the end of 2000 to only 10.3% of GDP. For comparison, in 1999 this indicator for Poland was at 23.6% and for Czech Republic – at 56.8% of GDP.

**Figure 33**
***Bank Credit to Private Sector in 1999***
*(% of GDP)*




*Source: IMF International Monetary Statistics, December 2000*

## *Perceptions of the Effectiveness of Local Authorities and Infrastructure*

Surveyed firms were asked about their perceptions of the local authorities and local infrastructure. It must be stressed that that these questions were asked in an anonymous survey of a sample of firms in every oblast capital and represents their opinions only.

The survey asked firms to assess the business climate in their cities by posing several specific statements. Respondents were asked to indicate whether they agreed or disagreed

[30] National Bank of Ukraine Bulletin



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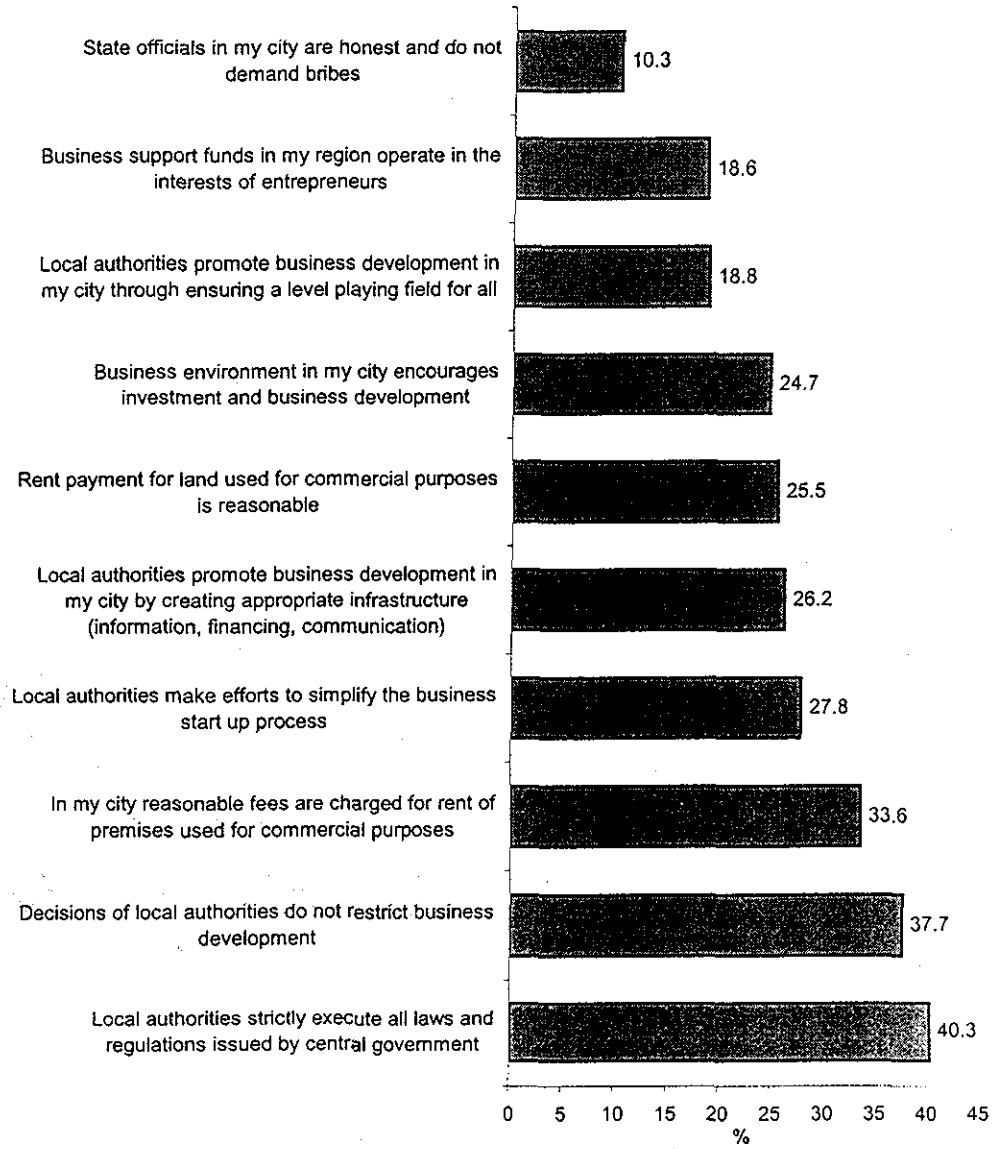
with the statements. Figure 34 below shows the proportion of all respondents who agreed with various statements. For a full breakdown of responses by city please refer to Annex 5.

**Figure 34**
**Assessment of Local Business Environments**
*(% of all firms who agree with statements)*




Analysing all of the statements across cities we looked at those cities where there were more responses of "agree with the statement" than with "disagree with the statement.", without taking into account the other three possible answers. In other words for what statements and in what cities were the opinions of respondents positive (*i.e.* more agreed than disagreed.)

- 'Local authorities strictly execute all laws and regulations issued by central government.' Cities that were positive: Donetsk, Ivano-Frankivsk, Ternopil, Khmelnitsky.

- 'Decisions of local authorities do not restrict business development.' Cities that were positive: Ternopil, Chernivtsi.
- 'Business environment in my city is better than in the majority of other Ukrainian regions.' (*not given in* figure) Cities that were positive: Dnipropetrovsk, Donetsk, Kyiv and Odessa.

The rest of the statements produced more negative responses than positive responses (*i.e.* more firms disagreed with the statement than agreed).

Finally, respondents were asked to assess the quality and effectiveness of local infrastructure. The figure below shows the breakdown of responses for providers of essential services. Please refer to Annex 5 for more details.

**Table 55**
**Assessment of Quality and Effectiveness of Local Infrastructure**

| | Very Bad | Bad | Probably Bad Than Good | Probably Good Than Bad | Good | Very good |
|---|---|---|---|---|---|---|
| Roads Department | 25.1 | 34.3 | 25.7 | 10.4 | 4.4 | 0.2 |
| Architecture department | 5.2 | 15.3 | 33.3 | 31.7 | 14.0 | 0.4 |
| *Land department* | 5.6 | 15.6 | 35.6 | 31.0 | 11.7 | 0.4 |
| Telephone service | 6.8 | 18.0 | 25.7 | 29.7 | 18.5 | 1.2 |
| Electricity enterprise | 7.3 | 14.9 | 25.3 | 28.8 | 22.6 | 1.2 |
| Water Service | 7.8 | 14.1 | 22.0 | 30.7 | 24.2 | 1.1 |
| *Obigas* | 6.1 | 13.3 | 23.8 | 29.7 | 25.6 | 1.5 |
| Teploenergo | 15.2 | 22.3 | 26.0 | 21.0 | 14.9 | 0.6 |
| Public Health Care | 13.4 | 25.7 | 30.7 | 18.4 | 11.2 | 0.7 |
| Education Institutions | 7.0 | 16.8 | 32.5 | 28.7 | 14.0 | 1.0 |

## *Barriers to Market Entry and Expansion - Conclusions*

Whilst general macroeconomic stability is very important in determining the business environment in Ukraine, it is still the role of the state in business (regulatory environment including taxation, formal and informal influence, ensuring a level playing field, *etc.*) that is most important for Ukrainian businesses. Business in Ukraine is unanimous that taxation is still the biggest problem in Ukraine with almost all firms ranking taxation as their biggest business problem. This degree of unanimity on one issue is a very strong message to policy makers that the biggest help they could provide to business is to tackle taxation problems, lower rates and make tax compliance easier.

According to surveyed firms, the most important taxation problem is the instability of tax legislation. The tax burden, as measured by the number of taxes paid and tax rates was rated as second. In 2000 surveyed firms paid on average 11 taxes and other compulsory payments to the budget and non-budget funds of all levels, whilst the average tax burden was very high at 53% of the value added generated by firms.

It is not so much high tax rates, but the overall tax environment comprising changing tax regulations, many different taxes and tax-like payments, accounting and reporting, and of course the power that tax bodies have to severely disrupt a business that poses problems. Further, the effects of the taxation environment are wider than just on a company's financial position. Taxation is also an important component of administrative corruption in Ukraine, and is also a large cause of shadow or unofficial activities which in turn contribute to unfair competitive practices, by effectively penalizing firms who are compliant as

compared to those who evade tax. The issue of tax privileges, exemptions, special economic zones, soft budget constraints, also contribute to unfair competitive practices by in effect providing hidden subsidies to firms who benefit from such favorable treatment.

All firms experienced some form of unfair competition in 2000. Only one fifth of all surveyed firms did not feel that the unfair competition that they experienced was a barrier for the further development of their business. The issue of unfair competition is even more important for surveyed companies than obtaining financing. The most problematic form of unfair competition is local governments granting preferential terms to competitors in issuing permits amd permissions, access to credit, subsidies, *etc.* This demonstrates the large degree of influence that local government and state bodies have on local business environments.

One topic that has been at the center of attention over the last several years, is the issue of business inspections. The survey shows that, at least for surveyed companies, the number of inspections has not fallen over 2000 compared with 1999. For smaller business, comparing with IFC's 1999 survey of small business, the average number of inspections has not decreased and has remained at around the same level. Further, smaller businesses bear a larger inspections burden than large enterprises and have fewer resources to deal with the consequences of inspections. Whilst the level of inspections has fallen compared with 3-4 years ago, it is still far too high. This issue, together with taxation, and frequently changing legislation helps to explain why Ukrainian firms have some of the highest time tax levels in the CIS (16% of management time is spent on dealing with the state in clarifying and interpreting laws and regulations) and a very significant shadow economy.[31]

Whilst there are those who consider a certain amount of shadow activities to be beneficial inasmuch as they provide a useful safety net (particularly for households), overall they are very much to the detriment private sector development. Shadow activities deprive the economy of much needed investment funds, are a major component of unfair business practices, reduce the incentives for enterprise restructuring (as compliance raises the cost of restructuring), provides a fertile environment for corruption, lowers budgetary revenues and deprives the government of economic feedback on policy matters.

Oblast and city governments have a large influence on businesses in Ukraine. Local governments are responsible for registering businesses, issuing permits, issuing licenses (at least those delegated to local governments), giving permissions for business, establishing local infrastructure. Perhaps their biggest role is indirectly influencing the behavior of local officials and state bodies, even if these bodies do not report locally. Overall, those cities that tend to have better administrative environments also tend to do better with unfair competition and have a better regulatory environment as well. National policy makers need to pay more attention to local business environments in Ukraine and how local governments interpret national laws and regulations. It is not that central government has no role to play, rather it is that most Ukrainian business is local in nature and are therefore most influenced by local business climates. In this regard, most survey respondents overall had a negative opinion of the effectiveness and quality of local governments.

Greater oversight and scrutiny is required over the work of local authorities (both city and oblast.) The central government should make more resources available to ensure deregulation at the local level, streamlining local regulatory and administrative procedures and ensure compliance by local officials with national laws and regulations. At the same time effective safeguards need to be introduced to ensure that firms have adequate redress in cases of rent-seeking or abuse of authority by local officials. This goes hand in hand with

[31] World Bank estimates that the size of the shadow economy in 1997 was more than 40% of the real economy. "Economic Growth With Equity", discussion paper 407, pp. 128-129.

improving the judicial system in Ukraine. The incidence of firms of using the courts to challenge unjust administrative decisions is still too low in Ukraine. However, until the judiciary achieves full independence from local governments, the court system will remain under-utilized in issues of conflict between the state and private business.

# Use of Information Technologies

## *Computer Use*

As a representative sample of Ukrainian enterprises were surveyed in all oblasts it was also interesting to establish a base line for computer and internet use in Ukraine. The survey shows that overall 76% of firms have at least one computer.

**Table 56**
**Proportion of Enterprises Having at Least One Computer**
*(% of all firms)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| ***Sector*** | | | | | | | |
| *Manufacturing* | 72.0 | 88.4 | 97.4 | 90.1 | 87.0 | 79.0 | **85.0** |
| Construction | 69.8 | 81.8 | 94.4 | 64.7 | 76.7 | 78.5 | **76.3** |
| Transport | 57.5 | 82.9 | 95.0 | 85.3 | 87.8 | 56.3 | **78.3** |
| Telecoms | 95.5 | 100.0 | 100.0 | 100.0 | 100.0 | 95.0 | **96.0** |
| Trade | 63.8 | 93.3 | 90.9 | 41.2 | 54.3 | 75.7 | **67.7** |
| *Public Catering* | 34.3 | 90.9 | - | 38.1 | 26.8 | 48.5 | **38.6** |
| Other Services | 59.9 | 79.3 | 100.0 | 81.0 | 58.3 | 74.3 | **70.7** |
| **Average** | **64.0** | **86.9** | **97.1** | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | 57.7 | 48.4 | 71.6 | **64.0** |
| *51-250* | | | | 79.5 | 85.6 | 95.7 | **86.9** |
| More than 250 | | | | 97.7 | 97.7 | 87.5 | **97.1** |
| **Average** | | | | **80.3** | **75.6** | **75.1** | ***76.0*** |

Of more interest is the number of computers per 100 people at various enterprises. This allows for a more refined measure of uptake of computers at the firm level rather than just measuring the number of companies that had one computer or more. The data shows that enterprises had on average one computer per for 20 employees. The following table shows the average number of computers for different groups of firms.

**Table 57**
**Average Number of Computers, per 100 employees**
*(weighted by number of employees)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 17.8 | 5.0 | 4.0 | 2.5 | 5.2 | 7.8 | **4.3** |
| Construction | 7.2 | 3.1 | 1.7 | 0.7 | 2.4 | 4.0 | **2.4** |
| Transport | 13.5 | 3.3 | 0.9 | 1.0 | 1.6 | 3.8 | **1.3** |
| *Telecoms* | 134.7 | 82.4 | 28.3 | 160.1 | 10.8 | 54.4 | **70.4** |
| Trade | 12.4 | 9.8 | 4.2 | 9.1 | 4.8 | 14.2 | **8.8** |
| Public Catering | 3.9 | 3.9 | - | 3.0 | 3.0 | 5.6 | **3.9** |
| Other Services | 18.0 | 21.3 | 5.9 | 3.7 | 12.7 | 32.0 | **8.4** |
| **Average** | **17.9** | **7.1** | **3.9** | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | 47.3 | 7.2 | 19.6 | **17.9** |
| 51-250 | | | | 5.7 | 5.7 | 13.6 | **7.1** |
| More than 250 | | | | 2.2 | 5.2 | 5.9 | **3.9** |
| **Average** | | | | **2.7** | **5.3** | **12.3** | ***4.7*** |

The probability of the presence of at least one computer increases with firm size, with almost all of large enterprises having at least one computer. However, in terms of computer penetration the reverse is true, the smaller the company the greater the ratio of computers to

employees. Not surprisingly telecom companies have the highest level of computer penetration with 24.1 computers per 100 employees, the least intensive users are transport enterprises with 1.3 per 100 employees.

The survey further sought to determine what computers were used for at the firm level. Respondents were given a choice of 10 management uses for computers and asked to select which they used most actively. Table 58 below shows the breakdown of responses. With the exception of the telecoms sector, there were no large sectoral or firm size variations observed. Uptake of information technology does not seem to be a function of company size or sector of the economy.

**Table 58**
**Proportion of Enterprises Actively Using Computers* to Perform Major Management Functions**
*(% of all firms who have at least one computer)*

| | Sector | | | | | | | Firm Size | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Manufacturing | Construction | Transport | Telecoms | Trade | Public Catering | Other Services | Up to 50 | 51-250 | More than 250 | Average |
| Financial Accounting | 77.4 | 72.4 | 71.1 | 85.4 | 83.4 | 66.1 | 73.6 | 74.6 | 77.1 | 82.0 | **77.1** |
| Managerial Accounting | 32.9 | 34.4 | 38.6 | 60.4 | 28.3 | 42.9 | 35.0 | 31.8 | 32.2 | 40.1 | **34.0** |
| Budgeting | 29.9 | 20.8 | 31.0 | 48.9 | 20.2 | 12.5 | 31.1 | 22.1 | 27.6 | 38.5 | **27.7** |
| Sales and Marketing | 51.1 | 28.8 | 22.1 | 53.2 | 56.8 | 30.4 | 34.1 | 45.2 | 41.2 | 54.1 | **46.3** |
| Servicing Clients | 55.0 | 45.6 | 43.7 | 91.7 | 59.1 | 39.3 | 72.9 | 57.2 | 50.1 | 64.2 | **56.9** |
| Production Management | 32.4 | 31.2 | 43.2 | 56.3 | 20.9 | 33.9 | 32.8 | 29.9 | 25.9 | 42.0 | **31.7** |
| Quality Management and Control | 15.1 | 8.8 | 9.3 | 43.8 | 8.7 | 5.4 | 12.8 | 13.0 | 11.0 | 17.3 | **13.5** |
| Inventory Management | 41.7 | 30.4 | 25.3 | 43.8 | 55.4 | 42.9 | 22.2 | 41.1 | 35.4 | 44.2 | **40.2** |
| Project Management | 14.0 | 17.7 | 8.1 | 33.3 | 7.6 | 3.6 | 14.4 | 13.0 | 10.3 | 16.8 | **13.2** |
| HR Management | 16.8 | 13.6 | 25.9 | 31.3 | 10.5 | 14.5 | 17.8 | 12.7 | 15.8 | 24.2 | **16.4** |

*Respondents were given a choice of 'do not use', 'to a small degree', and 'actively use'.

## *Internet Use*

Around a third of all enterprises had access to the internet in 2000. More larger firms had internet access (52%) than smaller firms (27%), probably reflecting poor understanding of internet possibilities and smaller ability to pay for connections. Public catering is easily the most indifferent sector to internet possibilities. Excluding telecoms and public catering, between quarter and just over a third of all enterprises who had a computer were connected to the internet.

**Table 59**
**Proportion of Enterprises Connected to the Internet**
*(% of all firms)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 29.6 | 29.9 | 55.3 | 37.7 | 36.4 | 39.0 | 37.4 |
| Construction | 24.0 | 21.8 | 27.8 | 5.9 | 13.7 | 36.7 | 23.7 |
| Transport | 17.5 | 11.4 | 22.5 | 20.6 | 12.2 | 21.9 | 17.4 |
| Telecoms | 84.1 | 50.0 | 75.0 | 71.4 | 33.3 | 87.5 | 82.0 |
| Trade | 24.9 | 53.3 | 72.7 | 5.9 | 18.6 | 35.7 | 29.2 |
| Public Catering | 5.2 | 27.3 | - | 0.0 | 5.4 | 10.3 | 6.9 |
| Other Services | 31.2 | 41.4 | 56.1 | 30.2 | 29.8 | 47.7 | 37.5 |
| **Average** | **26.8** | **31.1** | **51.7** | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | 14.4 | 12.2 | 34.8 | 26.8 |
| 51-250 | | | | 15.7 | 26.3 | 55.6 | 31.1 |
| More than 250 | | | | 48.5 | 51.9 | 66.7 | 51.7 |
| **Average** | | | | **29.0** | **28.4** | **38.3** | ***32.7*** |

Figure 35 below shows the frequency of internet use for those who do have access to the internet (*i.e.* a third of all firms.) Just over half of all firms (56%) use the internet on a daily basis, whilst another third (31%) several times per week. These firms can be considered to be regular internet users.

**Figure 35**
**Frequency of Internet Access**
*(% of all firms that have internet access)*

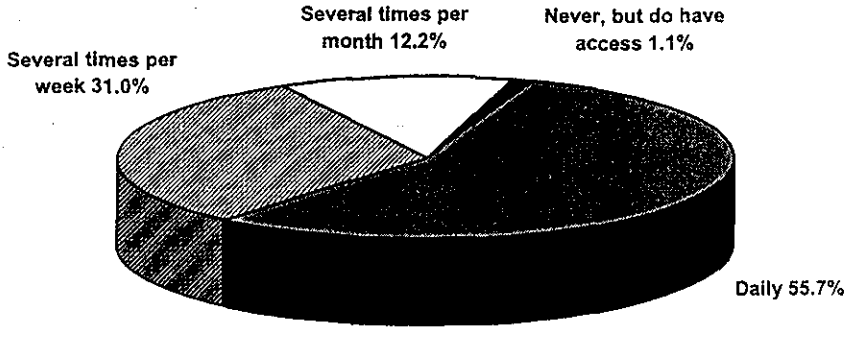





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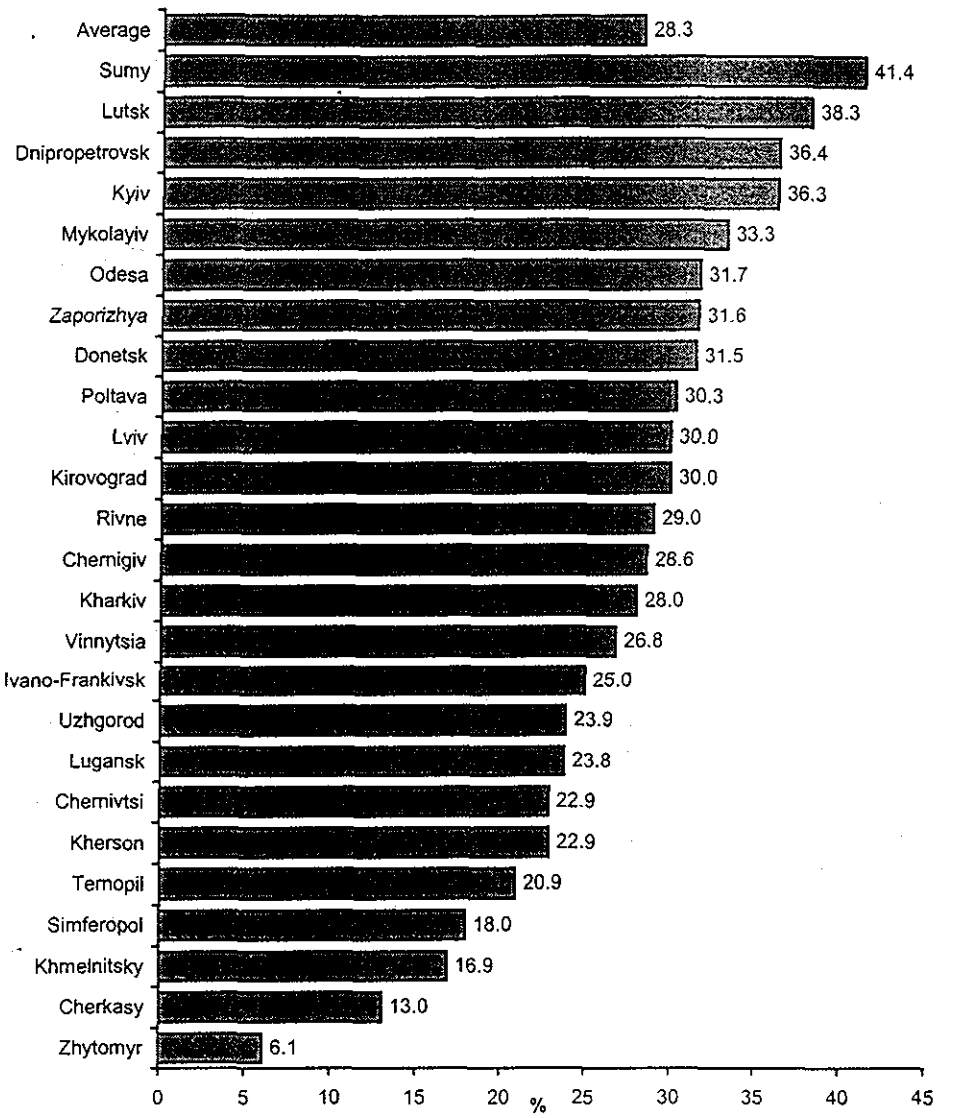
**Figure 36**
**Active Internet Users by City***
*(% of all firms)*




*Firms who stated that they used the internet daily or several times per week.

There is a large variation in the proportion of active internet users between various cities in Ukraine, ranging from 6% and 13% of all firms in Zhytomyr and Cherkasy to 38% and 41% in Lutsk and Sumy respectively. The very low figure in Zhytomyr is anomalous, possibly due to a sampling error. It should be treated with caution as representative of firms in Zhytomyr as a whole.

Connection to the internet was mostly through dial-up (70% of those with access to the internet), leased lines made up a quarter (27%) and a satellite connection was enjoyed by only 3% of enterprises. Dial up connections cost an average of UAH349 (median of UAH185) per month, leased lines – UAH1, 405 (median of UAH330) and satellite internet access – UAH1055 (median of UAH1000.)



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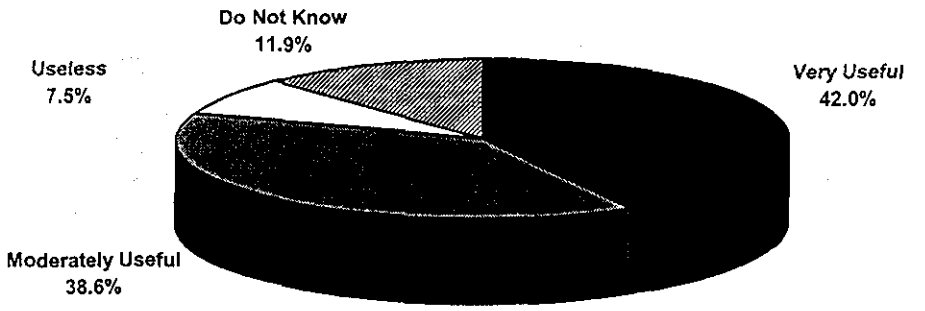
Figure 37 below shows, for those companies that have at least one computer, perception of usefulness of the internet to their business. On the whole, over 80% of businesses who had at least one computer (*i.e.* 61% of the entire sample) find the internet useful to some extent. With the exceptions of the telecoms sector there is no strong variance observed between sectors, firm size or origin. However only a third of enterprises had access to the internet. In other words, twice as many company managers feel that the internet is useful for their business as those that actually have access to the internet. This shows that the internet access gap in Ukraine is very high and demonstrates the latent demand for internet services.

**Figure 37**
**Perception of Benefit of the Internet**
*(% of firms who have at least one computer)*




The figure below shows barriers to internet use expressed by all firms who have at least one computer. The biggest perceived barriers to internet use in Ukraine are those related to access - low quality of phone lines and high prices for internet connections.

**Figure 38**
**Barriers to Internet Use**
*(distribution of responses for all firms who have at least one computer)*

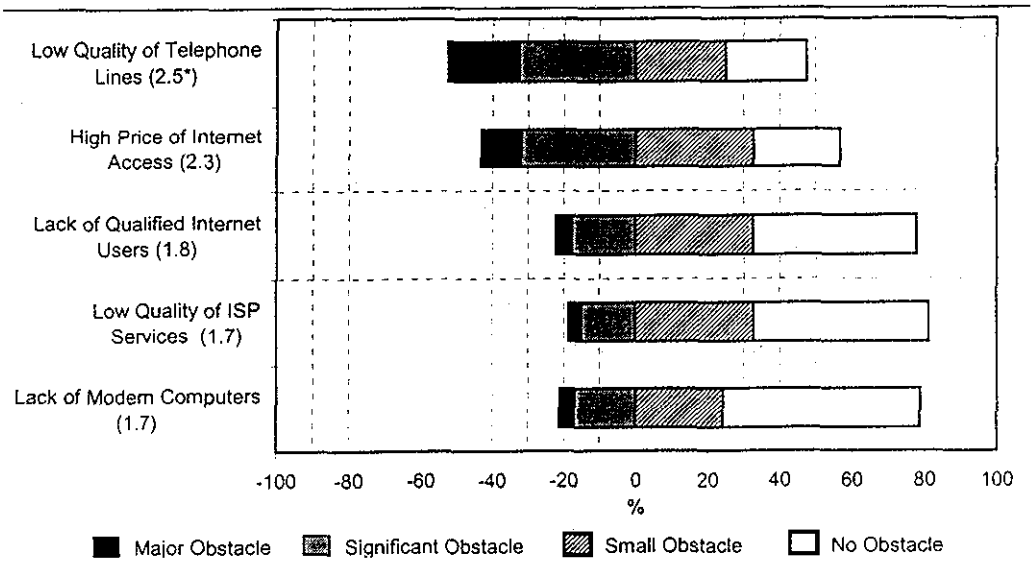



*Figure in brackets gives the average score across all firms on a scale on 1 – no obstacle to 4 – major obstacle for each obstacle listed



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Ukraine does not have high telephone penetration. The latest comparative figures released in EBRD's Transition Report 2000 shows Ukraine to have 19.1 main telephone lines per 100 inhabitants (figure unchanged over two years.) In comparison the Slovak Republic has 31 lines, Poland - 26 lines, and Lithuania 31.

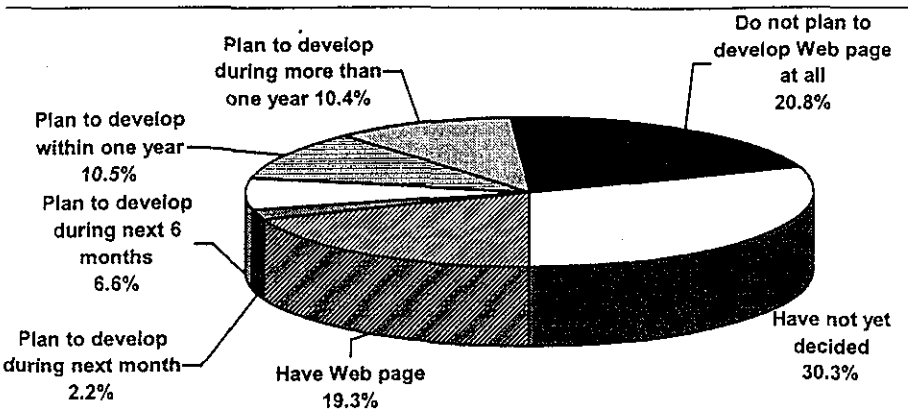
At this early stage of development of internet services in Ukraine the most common use for the internet is email (80% of firms that have access) and receiving general news and information. Search for good/ services and market/ industry specific information are ranked third and fourth. However, they could be a subset of '*obtaining news and other information*' category. Similarly, establishing and maintaining relations with clients is most probably a subset of email use.

On the whole there is little difference in usage patterns among small, medium and large enterprises and between different sectors.

**Table 60**
**What Internet Access is Used For**
*(% of firms that have internet access)*

| | Sector | | | | | | | Firm Size | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Manufacturing | Construction | Transport | Telecoms | Trade | Public Catering | Other Services | Up to 50 | 51-250 | More than 250 | Average |
| Send/ Receive Email | 81.4 | 85.0 | 65.0 | 80.5 | 76.2 | 50.0 | 80.2 | 81.5 | 73.5 | 81.4 | **79.6** |
| Obtain News and Other info | 77.7 | 90.0 | 80.0 | 75.6 | 69.7 | 80.0 | 79.2 | 75.6 | 75.3 | 80.9 | **77.2** |
| Look for Goods/ Services | 57.2 | 75.0 | 55.0 | 53.7 | 67.2 | 40.0 | 43.8 | 60.5 | 56.6 | 54.0 | **57.6** |
| Market Research | 46.8 | 42.5 | 25.0 | 53.7 | 36.1 | 10.0 | 30.2 | 40.1 | 41.0 | 44.7 | **41.7** |
| Purchase Goods/ Services | 23.9 | 35.0 | 25.0 | 36.6 | 27.0 | 20.0 | 14.6 | 24.7 | 25.3 | 23.7 | **24.5** |
| Advertise Goods/ Services | 53.7 | 52.5 | 20.0 | 56.1 | 34.4 | 30.0 | 39.6 | 45.4 | 52.4 | 46.0 | **47.2** |
| Establish/ Maintain Relations with Clients | 42.6 | 62.5 | 35.0 | 73.2 | 39.3 | 40.0 | 43.8 | 48.5 | 38.6 | 44.2 | **44.8** |
| Publish Corporate Info | 19.1 | 20.0 | 15.0 | 53.7 | 8.2 | 10.0 | 20.8 | 17.0 | 20.5 | 21.9 | **19.3** |
| Sell Goods/ Services | 30.6 | 32.5 | 20.0 | 46.3 | 21.3 | 10.0 | 20.8 | 29.0 | 24.7 | 29.3 | **28.1** |
| Hire Employees | 4.0 | 2.5 | 5.0 | 26.8 | 7.4 | 10.0 | 4.2 | 7.1 | 6.0 | 4.2 | **6.0** |

**Figure 39**
**Proportion of Enterprises that Have a Web Page**
*(% of all firms that have at least one computer)*




About 15% of surveyed firms claimed to have a web page (or just less than half of all those who access to the internet.) The probability of having a web page increases with firm size from 11% of small firms to about 26% of large firms. A larger proportion of start-ups have web pages than either their privatized or state-owned counterparts. The figure of one firm in seven that has a web page is very high and possibly misleading. Firms are possibly referring to free web site space that ISPs provide customers.

**Table 61**
**Enterprises Having Web Page**
*(% of all firms)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-owned | Privatized | Start-ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 12.0 | 13.7 | 27.8 | 15.9 | 17.6 | 17.5 | 17.3 |
| Construction | 3.1 | 10.9 | 16.7 | 0.0 | 5.5 | 10.1 | 7.1 |
| Transport | 10.0 | 5.7 | 5.0 | 5.9 | 6.1 | 9.4 | 7.0 |
| Telecoms | 72.7 | 100.0 | 75.0 | 71.4 | 66.7 | 75.0 | 74.0 |
| Trade | 7.2 | 11.1 | 36.4 | 0.0 | 3.1 | 11.4 | 8.4 |
| Public Catering | 0.7 | 0.0 | - | 0.0 | 1.8 | 0.0 | 0.7 |
| Other Services | 15.9 | 20.7 | 26.8 | 14.3 | 16.7 | 22.9 | 18.8 |
| Average | 11.3 | 13.5 | 25.7 | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | 8.2 | 3.9 | 14.9 | 11.3 |
| 51-250 | | | | 9.6 | 10.8 | 23.9 | 13.5 |
| More than 250 | | | | 18.5 | 28.2 | 37.5 | 25.7 |
| Average | | | | 12.9 | 13.2 | 16.6 | 14.6 |



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# External Business Assistance

## *Business Planning*

It is interesting to observe whether enterprises reckoned they had a business plan or not, though it has to be noted that the survey did not attempt to capture the quality of business plans (well thought out and reasoned organizational strategy versus a vague idea of firm development.) On the whole, with the question phrased in general terms, a surprisingly[32] large number of firms (44%) felt that they did indeed have a business plan. The larger the enterprise the greater the chance that they possess a business plan. The same proportion (49%) of state owned enterprises and privatized enterprises also had a business pan.

**Table 62**
**Have Business Plan**
*(% of all firms)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-owned | Privatized | Start-ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 43.5 | 53.7 | 72.6 | 58.4 | 60.2 | 46.0 | **55.5** |
| Construction | 27.1 | 38.2 | 55.6 | 35.3 | 34.2 | 32.9 | **33.7** |
| Transport | 45.0 | 37.1 | 45.0 | 44.1 | 44.9 | 37.5 | **42.6** |
| Telecoms | 45.5 | 50.0 | 75.0 | 57.1 | 66.7 | 45.0 | **48.0** |
| Trade | 27.3 | 33.3 | 36.4 | 29.4 | 30.2 | 27.2 | **28.2** |
| Public Catering | 30.6 | 54.5 | - | 38.1 | 26.8 | 35.3 | **32.4** |
| Other Services | 35.7 | 46.6 | 56.1 | 41.3 | 36.9 | 45.0 | **41.4** |
| **Average** | **35.0** | **48.5** | **66.6** | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | 35.1 | 34.1 | 35.4 | **35.0** |
| 51-250 | | | | 45.8 | 48.8 | 49.6 | **48.5** |
| More than 250 | | | | 61.7 | 69.0 | 66.7 | **66.6** |
| **Average** | | | | **49.0** | **49.1** | **38.0** | ***44.4*** |

The data presented above is not conclusive and demonstrates that the majority of firms do not have a clear understanding of the business planning process (*e.g.* almost a third of all cafes and restaurants reckon they have a proper business plan.) Experience suggests that company managers are confusing 'industrial-financial' plans (in the case of manufacturing enterprises,) or vague ideas which substitute for the planning process. In a lot of cases bank credit applications are considered to be business plans as well.

The vast majority of 'business plans' are compiled by enterprise employees with little recourse to outside assistance. Figure 40 below shows the breakdown among small, medium and large enterprises.

[32] IFC's own anecdotal evidence (based on 11 consulting centers and 7 years of business and investment planning experience in Ukraine) suggests that less than 2% of companies in Ukraine have anything approximating a proper business plan in the western sense.



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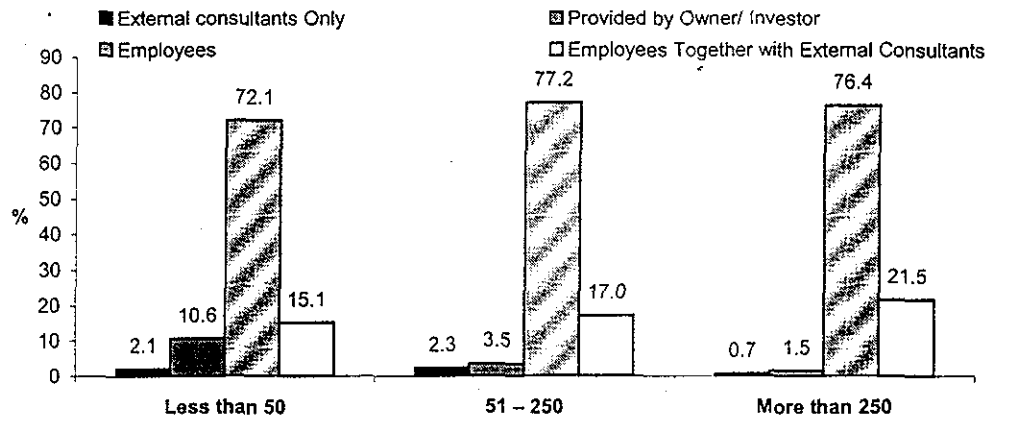
**Figure 40**
**Who Prepared the Business Plan?**
*(% of firms that have a business plan)*



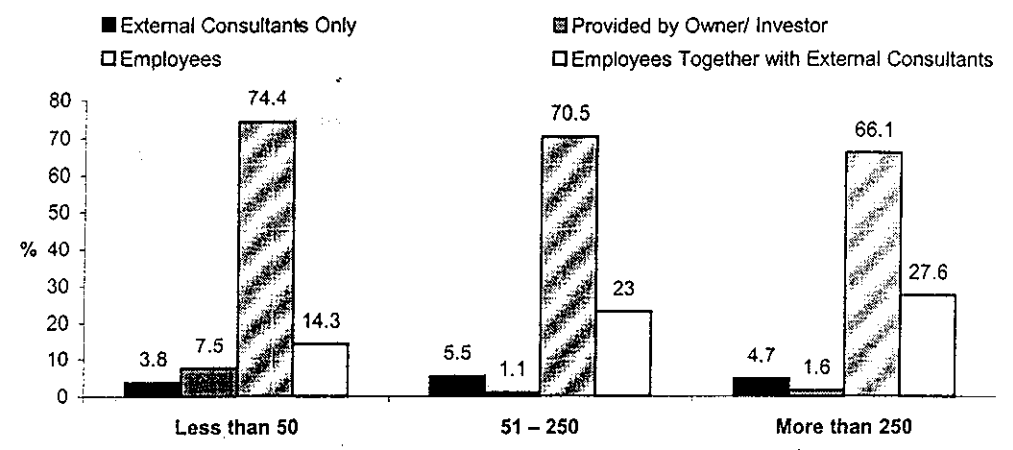

The incidence of the use of outside experts is very low, with most firms relying on internally generated plans. The breakdown is fairly similar among enterprises, implying little dependence on ability to pay or on company size, though three times as many small companies were willing to retain an outside consultant than large companies.

The survey also sought to establish whether companies had performed market research for their enterprises and their products prior to, or as part of the business planning process. 70% of surveyed firms who have a business plan stated that they had undertaken market research for their companies and for their products as part of the business planning.

**Table 63**
**Proportion of Enterprises Having Conducted Market Research as Part of Business Plan**
*(% of enterprises that have a business plan)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-owned | Privatized | Start-ups | Average |
| ***Sector*** | | | | | | | |
| Manufacturing | 74.7 | 75.0 | 71.6 | 67.4 | 73.3 | 77.9 | **73.6** |
| Construction | 53.8 | 61.9 | 70.0 | 50.0 | 56.0 | 65.4 | **59.6** |
| Transport | 61.1 | 53.8 | 66.7 | 46.7 | 59.1 | 83.3 | **61.2** |
| Telecoms | 85.0 | 100.0 | 100.0 | 75.0 | 100.0 | 88.9 | **87.5** |
| Trade | 73.5 | 66.7 | 75.0 | 20.0 | 74.4 | 75.3 | **72.6** |
| Public Catering | 60.0 | 33.3 | - | 50.0 | 53.3 | 60.9 | **56.5** |
| Other Services | 57.1 | 66.7 | 40.9 | 36.0 | 71.0 | 57.1 | **56.2** |
| **Average** | **69.3** | **70.7** | **69.1** | | | | |
| ***Firm Size*** | | | | | | | |
| Up to 50 | | | | 52.9 | 70.2 | 71.0 | **69.3** |
| 51-250 | | | | 57.9 | 69.9 | 81.0 | **70.7** |
| More than 250 | | | | 58.4 | 72.6 | 81.3 | **69.1** |
| **Average** | | | | 57.0 | 71.1 | 73.1 | ***69.6*** |

**Figure 41**
**Who Undertook the Market Research?**
*(% of firms who undertook market research)*




All in all a very similar picture with market research emerges as with business planning. The majority of Ukrainian enterprises think that they have a business plan and have undertaken market research. The majority of companies performed these duties in-house and this is confirmed by the very under developed nature of the Ukrainian commercial consulting industry in general.

## *Outsourcing*

Outsourcing is an acknowledgement by companies that certain business functions can be performed better and cheaper by outside specialists leaving the company to concentrate on key areas and running the business. Globally, more and more firms are outsourcing more activities that hitherto they would have performed in-house. Certain functions of course have to be outsourced, for example financial audits, advertising, etc.

As some of the more important tasks that are generally performed by outside specialists (business planning and market research) are generally performed in-house it is interesting to see what business functions Ukrainian firms typically outsource. The table below lists some of the more widespread outsourced functions and the percentage of all Ukrainian enterprises that outsource a particular business function.



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**Table 64**
**Outsourced Services**
*(% of all firms)*

| | Manufacturing | Construction | Transport | Telecoms | Trade | Public Catering | Other services | Average |
|---|---|---|---|---|---|---|---|---|
| Advertising | 57.6 | 53.3 | 40.0 | 72.0 | 59.6 | 41.4 | 53.5 | **55.5** |
| Audit | 52.4 | 41.4 | 41.7 | 32.0 | 29.2 | 20.0 | 37.1 | **42.0** |
| Transport services | 35.0 | 40.8 | 9.6 | 22.0 | 37.8 | 17.9 | 19.9 | **31.4** |
| Recruitment | 9.8 | 14.2 | 10.4 | 14.0 | 9.3 | 12.4 | 9.0 | **10.2** |
| Accounting | 9.4 | 7.7 | 10.4 | 20.0 | 13.4 | 11.0 | 6.6 | **10.1** |
| Marketing/Market Research | 9.9 | 7.7 | 4.3 | 14.0 | 7.4 | 2.1 | 8.2 | **8.3** |
| Executing foreign trade contracts | 6.8 | 6.5 | 1.7 | 0.0 | 2.2 | 0.0 | 3.9 | **4.6** |
| Payroll | 1.4 | 1.2 | 1.7 | 2.0 | 1.9 | 2.1 | 2.7 | **1.7** |
| Logistics | 1.1 | 0.0 | 1.7 | 4.0 | 2.6 | 0.7 | 0.8 | **1.3** |
| Other Business Services | 7.0 | 9.5 | 7.0 | 12.0 | 5.3 | 1.4 | 5.9 | **6.4** |
| Do Not Outsource Anything | 15.8 | 18.3 | 27.8 | 10.0 | 22.2 | 33.8 | 25.8 | **20.2** |

It is very important to note that the survey did not capture whether firms engaged in all of these business functions or not. The data above simply refers to the proportion of companies that paid outside specialists for particular services. As the survey did not produce data on what proportion of firms used these services at all it is difficult to comment on those firms that outsourced services.

The most popular outsourced business functions are advertising (56% of all firms), auditing (42%), and transportation services (31%.) In the case of auditing it is safe to assume that the remainder of firms (58%) just did not face the need to have audits of their finances. One fifth of all Ukrainian enterprises simply did not see the need to use outside specialists at all.

## *Training*

Just under half of all enterprises (45%) did not see any need to have their employees trained in any business area. For those who did express demand for training the topics most in demand are accounting and business planning, presumably explained by Ukraine's transition to new accounting standards and the need for investment. Telecoms firms, the most dynamic in our survey and with the best financial performance, have the greatest demand for training services They also had the highest proportion of business plans and completed market research.



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**Table 65**
**Demand for Business Training**
*(% of all firms)*

| | Manufacturing | Construction | Transport | Telecoms | Trade | Public Catering | Other services | Average |
|---|---|---|---|---|---|---|---|---|
| Accounting | 29.4 | 26.0 | 20.9 | 22.0 | 25.6 | 33.1 | 26.2 | 27.6 |
| Marketing | 30.0 | 20.1 | 13.0 | 42.0 | 23.4 | 19.3 | 16.8 | 25.0 |
| Business Planning | 22.9 | 20.7 | 18.3 | 28.0 | 16.5 | 17.9 | 21.9 | 20.9 |
| Financial Management | 22.5 | 16.0 | 13.0 | 28.0 | 16.5 | 11.0 | 18.8 | 19.2 |
| Sales | 19.5 | 13.0 | 4.3 | 24.0 | 23.7 | 13.1 | 8.6 | 17.4 |
| Information Technology | 18.7 | 20.1 | 10.4 | 36.0 | 10.3 | 12.4 | 17.6 | 16.6 |
| Human Resource Management | 14.6 | 19.5 | 7.8 | 28.0 | 13.9 | 15.2 | 16.4 | 15.1 |
| General Management | 14.0 | 12.4 | 9.6 | 24.0 | 11.2 | 13.1 | 11.3 | 13.0 |
| No Need | 41.3 | 43.2 | 54.8 | 38.0 | 46.7 | 54.5 | 47.7 | 44.8 |

## *Consulting*

Echoing the picture with training, the biggest demand for professional help is with accounting, business planning and marketing, though the overall proportion of Ukrainian companies willing to pay for these services is much lower than with training, at around one in ten. Manufacturing companies were the most willing to pay for outside professional help and cafes and restaurants the least.

**Table 66**
**Demand for Business Consulting**
*(% of all firms)*

| | Manufacturing | Construction | Transport | Telecoms | Trade | Public Catering | Other services | Average |
|---|---|---|---|---|---|---|---|---|
| Accounting | 11.9 | 15.4 | 11.3 | 8.0 | 12.4 | 8.3 | 10.5 | 11.8 |
| Business Planning | 12.6 | 11.8 | 7.0 | 14.0 | 6.9 | 4.1 | 7.4 | 10.0 |
| Marketing | 10.0 | 11.8 | 8.7 | 14.0 | 8.4 | 6.2 | 6.6 | 9.2 |
| Information Technology | 8.8 | 12.4 | 5.2 | 10.0 | 5.7 | 2.8 | 4.7 | 7.4 |
| Financial Management | 8.5 | 7.7 | 5.2 | 4.0 | 7.7 | 4.8 | 5.5 | 7.4 |
| Sales | 8.2 | 7.1 | 1.7 | 6.0 | 8.4 | 3.4 | 6.3 | 7.2 |
| General Management | 6.1 | 5.3 | 4.3 | 12.0 | 5.7 | 3.4 | 3.9 | 5.6 |
| Human Resource Management | 5.6 | 4.1 | 7.0 | 8.0 | 5.3 | 2.8 | 5.1 | 5.3 |
| No Need | 59.2 | 61.5 | 71.3 | 62.0 | 62.9 | 72.4 | 67.2 | 62.7 |



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## *Business Advocacy*

As is traditional in IFC surveys respondents were asked to comment on business advocacy in Ukraine. Specifically whether they belonged to any business associations that could advance their interests and what they felt were the most effective mechanisms for lobbying their interests.

### Table 67
### "Are you a member of a business association"?
*(% of all firms)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | Privatized | Start-Ups | Average |
| Yes, and satisfied with results | 6.3 | 10.1 | 18.5 | 9.5 | 12.4 | 6.6 | **9.5** |
| Yes, but not satisfied with results | 6.7 | 16.3 | 29.1 | 15.3 | 19.2 | 6.7 | **13.3** |
| No, because see no reason to join | 26.7 | 23.4 | 18.5 | 22.4 | 21.9 | 27.4 | **24.3** |
| No, because there are no adequate associations for my needs | 31.0 | 28.1 | 22.1 | 28.9 | 25.7 | 31.5 | **28.6** |
| No, because do not know of any associations | 29.4 | 22.1 | 11.8 | 23.8 | 20.7 | 27.9 | **24.3** |
| **Total** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** | **100.0** |

As can be seen there is generally a low level of participation in business associations and other groups that could collectively represent the interests of their members. Only 23% of Ukrainian firms actually belong to a business association, however less than one in ten firms actually feels that they receive any benefit. There is a very marked trend in membership in an association from small to large firms. Smaller firms are very under represented and only 6% of all small firms feel that they receive any benefit from business associations, whilst at the same time almost one in three small firms feel that there are no suitable associations that they could belong to.

Given that there is weak collective advocacy in Ukraine, it is interesting to find out what company directors feel is the best method that they employ to try and influence legislation and policy in their favor.

### Table 68
### Preferred Method for Influencing the Results of Legislative and Policy Changes that Impact on Own Enterprise
*(% of all respondents)*

| | Firm Size | | | Firm Origin | | | |
|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-owned | Privatized | Start-ups | Average |
| Business Association | 7.3 | 10.7 | 16.1 | 10.3 | 12.4 | 7.0 | 9.8 |
| Direct Ties with State Bodies and State Officials | 11.6 | 22.7 | 33.4 | 33.5 | 20.0 | 11.9 | 18.5 |
| Mass Media | 9.3 | 11.4 | 12.5 | 11.0 | 11.5 | 9.2 | 10.4 |
| Parliamentary Deputies/Political Parties | 5.6 | 9.2 | 14.2 | 9.4 | 10.3 | 5.6 | 8.2 |
| Other Methods | 7.7 | 6.7 | 8.9 | 7.7 | 7.5 | 7.9 | 7.7 |
| I have No Influence | 65.3 | 50.4 | 38.0 | 42.9 | 51.9 | 65.5 | 56.3 |

As can be observed the majority of Ukrainian firms feel that they have no influence on government policies that impact on them. This is particularly true for smaller firms and less so for larger firms. Larger firms (especially larger state owned firms) do indeed feel that they have some influence, particularly through direct ties with state bodies and key officials.

# Annex 1

## *Survey Methodology*

IFC's annual surveys have traditionally covered the SME sector. The 2000 survey has been expanded to include large and state owned enterprises as well in order to gain a better insight into the comparisons between different parts of the Ukrainian economy. In particular to give policy makers a better understanding of the differences between small and large enterprises.

### Firm Origin

*State Owned Firms*

To make the survey even more representative state owned enterprises have been included as well. These have been split into two groups, nationally owned enterprises and local municipal enterprises to provide more detail. State-owned enterprises are defined as those enterprises in which the stake of central government or municipal government is not less than 50%.

*Privatized Firms*

This survey also separated out of the sample privatized enterprises to gain a better understanding of their performance in relation to state owned enterprises and start ups. Privatized enterprises are those formerly state-owned entities in which the state transferred into private ownership more than 50% of shares. Privatized enterprises have been split into two groups, early privatized firms (privatized prior to January 1, 1996) and late privatized firms (privatized after January 1, 1996.) This division allows for observation of privatized enterprise performance over time. So called mass privatization started in 1994 and this first wave of enterprises should have already experienced major change, compared with later privatizations. 54.7% of all privatized firms in our sample were early privatizations.

*Start-Up Firms*

For comparison purposes the survey also included private firms that were newly created. Again, similar to privatized firms start-ups have been divided into two groups, early and late start-ups with January 1, 1996 as the cut off date. Start-up companies include all companies established from scratch since legislation permitted this and not just in 2000. 38.7% of all start-ups in our sample were early start-ups.

### Sectors

The sectors were selected to best reflect the make-up of business in Ukraine. Pure state financed sectors (health care, education, etc.) were not selected as they have practically no private sector competition. Further, firms engaged in primary agriculture were not selected as they are highly specific and are generally researched separately. The sectors were chosen to reflect the methodology used by the State Statistics Committee of Ukraine in their macroeconomic reports and is widely used in Ukraine in economic research. This allows the data in this survey to be compared with other research results. The sectors selected for this survey were:

- Manufacturing: This includes heavy and light industry, food processing and food industry, energy, construction materials.
- Construction: This refers to construction services companies. Producers of constructions materials are accounted for in Manufacturing.



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- Transport: Freight services, passenger transportation, public transportation.
- Telecoms: Paging services, internet providers, mobile telephony.
- Trade: Wholesale and retail.
- Public Catering: Restaurants and cafes.
- Services: General non-manufacturing services. This includes, hotels, tourism, financial services, domestic services, public utilities.

The telecoms sector was selected as a separate sector (generally state statistics combine telecoms with transport) to see how a new sector of the economy fares in comparison to more traditional sectors.

## Firm Size

Enterprise selection included small firms (up to 50 employees), medium sized firms (from 51 to 250 employees) and large firms (more than 250 employees.) Sole traders and micro enterprises (less than 5 employees) were not surveyed as this would have made comparative analysis difficult with medium and large enterprises.

## Sample Selection

A non-proportional stratified random sample of 2,200 enterprises was constructed. Enterprises were sampled in 25 oblast centers. Sample parameters for each city are stated below.

Manufacturing: 1,005 manufacturing enterprises were selected, distributed proportionately among oblast centers based on each city's share of manufacturing enterprises in Ukraine (but in any case not less than 20 firms in each city.) The distribution of firms surveyed within each city reflects the overall oblast composition of manufacturing sectors (using a stratified random sample.) The only exception to this was for Donetsk and Zaporizhzhya where the oblast centers' industry structure differed significantly from that of the whole oblast.

For non-manufacturing sectors, fixed quotas were used for each city, but also ensuring that the number of enterprises in each sector were representative of the sector as a whole. The fixed quotas were as follows:

- Construction: 6 enterprises;
- Trade: 16 enterprises including 4 wholesale and 12 retail firms;
- Public catering: 6 enterprises including 4 cafes and 2 restaurants;
- Transport: 1 freight and 4 passenger transportation enterprises;
- Telecommunications: 2 enterprises including an internet provider and a paging company. For Kyiv, two vehicular communication companies were added;
- Other services: 12 enterprises including hotel, travel agency, commercial bank, insurance company, domestic service firms and public utilities.

Due to the reluctance of some selected enterprises to be interviewed, not all sector quotas were completely filled. The following tables display the distribution of surveyed firms by sector, size, ownership status and region.

## Table 69
## Sample Distribution by Sector, Firm-Size and Firm Origin

| | Firm Size | | | Firm Origin | | | | | | Total |
|---|---|---|---|---|---|---|---|---|---|---|
| | Up to 50 | 51-250 | More than 250 | State-Owned | | Privatized | | Start-Ups | | |
| | | | | National | Municipal | Early | Late | Early | Late | |
| **Sector** | | | | | | | | | | |
| Manufacturing | 375 | 328 | 302 | 128 | 23 | 290 | 248 | 142 | 174 | **1005** |
| Construction | 96 | 55 | 18 | 14 | 3 | 45 | 28 | 40 | 39 | **169** |
| Transport | 40 | 35 | 40 | 12 | 22 | 22 | 27 | 7 | 25 | **115** |
| Telecoms | 44 | 2 | 4 | 7 | 0 | 1 | 2 | 14 | 26 | **50** |
| Trade | 362 | 45 | 11 | 10 | 7 | 72 | 57 | 76 | 196 | **418** |
| Public Catering | 134 | 11 | 0 | 18 | 3 | 26 | 30 | 26 | 42 | **145** |
| Other Services | 157 | 58 | 41 | 26 | 36 | 53 | 31 | 51 | 59 | **256** |
| Total | **1208** | **534** | **416** | | | | | | | |
| **Firm Size** | | | | | | | | | | |
| Up to 50 | | | | 69 | 28 | 167 | 170 | 285 | 489 | **1208** |
| 51-250 | | | | 63 | 20 | 187 | 146 | 59 | 59 | **534** |
| More than 250 | | | | 83 | 46 | 155 | 107 | 12 | 13 | **416** |
| Total | | | | **215** | **94** | **509** | **423** | **356** | **561** | **2158** |

## Table 70
## Sample Distribution by City and Sector

| | Sector | | | | | | | Total |
|---|---|---|---|---|---|---|---|---|
| | Manufac-turing | Construction | Transport | Telecoms | Trade | Public Catering | Other Services | |
| **City** | | | | | | | | |
| Vinitsya | 23 | 6 | 5 | 2 | 20 | 5 | 10 | 71 |
| Dnipropetrovsk | 80 | 10 | 5 | 3 | 15 | 6 | 10 | 129 |
| Donetsk | 79 | 11 | 6 | 1 | 17 | 6 | 10 | 130 |
| Zhytomur | 22 | 6 | 4 | 0 | 19 | 4 | 11 | 66 |
| Zaporizhzhya | 33 | 7 | 5 | 2 | 17 | 6 | 9 | 79 |
| Ivano-Frankivsk | 20 | 5 | 5 | 2 | 14 | 6 | 12 | 64 |
| Kyiv | 168 | 15 | 4 | 3 | 16 | 7 | 13 | 226 |
| Kyrovograd | 25 | 4 | 5 | 2 | 16 | 6 | 12 | 70 |
| Lugansk | 32 | 9 | 2 | 2 | 16 | 7 | 12 | 80 |
| Lutsk | 25 | 1 | 3 | 3 | 14 | 6 | 8 | 60 |
| Lviv | 47 | 7 | 6 | 2 | 24 | 4 | 10 | 100 |
| Mykolayiv | 31 | 5 | 6 | 2 | 14 | 7 | 10 | 75 |
| Odessa | 56 | 8 | 5 | 2 | 16 | 6 | 11 | 104 |
| Poltava | 31 | 6 | 5 | 2 | 17 | 7 | 8 | 76 |
| Rivne | 23 | 5 | 5 | 2 | 18 | 5 | 11 | 69 |
| Symferopol | 47 | 11 | 3 | 3 | 18 | 6 | 12 | 100 |
| Sumy | 26 | 8 | 5 | 2 | 14 | 6 | 9 | 70 |
| Ternopil | 26 | 4 | 6 | 1 | 16 | 6 | 8 | 67 |
| Uzhgorod | 17 | 10 | 5 | 2 | 19 | 7 | 11 | 71 |
| Kharkiv | 68 | 9 | 5 | 5 | 15 | 6 | 10 | 118 |
| Kherson | 26 | 5 | 4 | 3 | 16 | 5 | 11 | 70 |
| Khmelnytsky | 35 | 5 | 3 | 0 | 19 | 6 | 9 | 77 |
| Cherkassy | 13 | 4 | 2 | 0 | 14 | 4 | 9 | 46 |
| Chernigiv | 25 | 4 | 6 | 2 | 18 | 5 | 10 | 70 |
| Chernivtsi | 27 | 4 | 5 | 2 | 16 | 6 | 10 | 70 |
| Total | 1005 | 169 | 115 | 50 | 418 | 145 | 256 | 2158 |

## Table 71
## Legal Forms of Ownership

| | % |
|---|---|
| Private Enterprise | 20.0 |
| Closed Joint Stock Company | 13.3 |
| Open Joint Stock Company | 24.0 |
| Limited Liability Company | 24.1 |
| Mixed Partnership | 0.4 |
| Full Liability Company | 0.9 |
| Enterprise Owned by Public Organization | 0.9 |
| Municipal Enterprise | 2.9 |
| State Enterprise | 6.7 |
| Joint Venture | 1.6 |
| Branch | 3.2 |
| Cooperative | 0.7 |
| Leased Enterprise | 0.9 |
| Collective Enterprise | 0.6 |
| **Total** | **100.0** |

## Table 72
## Survey Respondents

| | % |
|---|---|
| Owner/ Entrepreneur | 9.2 |
| Director/ General Director | 39.0 |
| Deputy Director | 22.6 |
| Financial Director | 3.2 |
| Executive Director | 3.6 |
| Commercial Director | 4.1 |
| Chief Accountant | 18.3 |
| **Total** | **100.0** |

## Table 73
## Firm Origin

| | % |
|---|---|
| State-owned | 10.0 |
| Municipal | 4.4 |
| Privatized | 43.2 |
| Start-up | 42.4 |
| **Total** | **100.0** |

The proportion of exporters in the sample totals 19.5%, while only 11% of all surveyed enterprises sell more than 10% of their output outside of the country.

The figures below show distribution of sales, value added and employment of surveyed companies.

Figure 42
Sale Structure, by Firm Origin

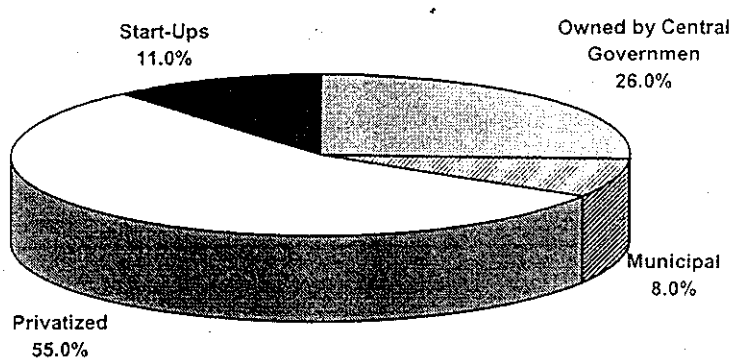



Figure 43
Value Added Structure, by Firm Origin

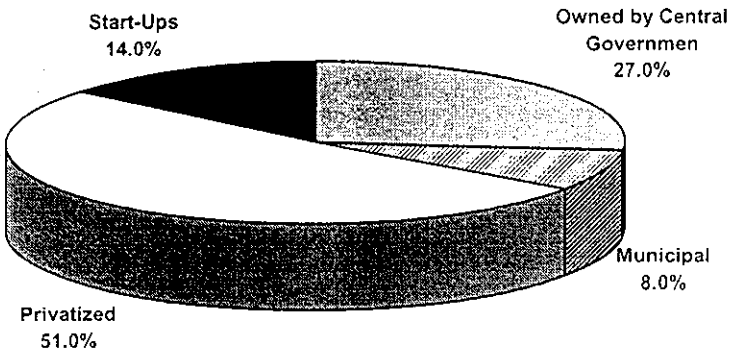
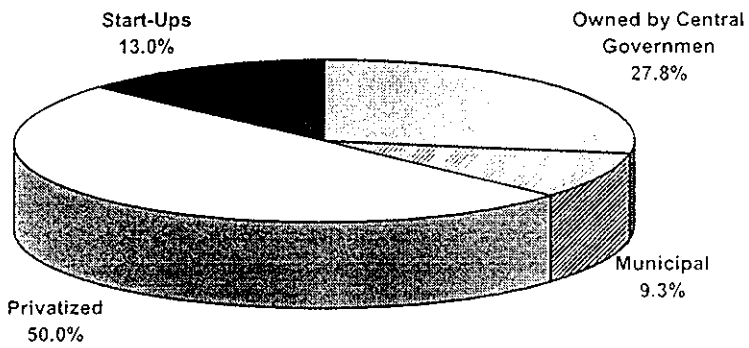



Figure 44
Employment Structure, by Firm Origin



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## Structure of the Questionnaire

The survey instruments were prepared in both Ukrainian and Russian and piloted at 12 Kyiv based enterprises to ensure that respondents correctly understood the questions. As a further quality control measure around half of all respondents were telephoned after interviews to check the consistency of responses on key questions.

Due to the complex nature of the questionnaire it was divided into three smaller questionnaires. The first questionnaire was used for the interview with the top manager of the company and filled in by an interviewer. It contained 50 questions related to legal status of enterprise, ownership status, sectors of major activity, markets at which enterprise operates, restructuring measures, investment and sources of its financing, business planning, use of computers and internet, barriers to market entry and expansion in particular related to taxation, regulations and financing.

The second questionnaire containing 31 questions was filled in by the company's top manager. The questions related to inspections, permits and permissions by different state agencies (number, duration, unofficial payments), quality and efficiency of government agencies, business association membership, local business climate, presence of tax and energy arrears, management turnover and demand for consulting services and business training.

The third questionnaire with 18 questions was devoted to enterprise performance (sales, shares of material inputs in sales, profitability, employment, exports, use of non-monetary instruments), tax system used, number of taxes and their volume as share of sales. The questionnaire was completed together with the firm's chief accountant.

# Annex 2

## *Factors That Influence Enterprise Performance and Restructuring*

The research presented in this report looked at short term measures of financial performance – one year changes in sales and value added. Real sales growth rations were obtained directly from the questionnaire presented to enterprises, while value added growth ratios were derived from the real sale ratios and the cost of inputs for 1999 and 2000. Other indicators such as productivity and profitability are also very important, however this survey did not measure them directly. For this reason the regression analysis did not look at either of these two indicators.

In selecting the possible variables that influence enterprise performance the same variables were used as in EBRD's 1999 Business Environment and Enterprise Performance Survey, namely: ownership status (state-owned, privatized, start-ups), market structure (number of foreign and domestic competitors), degree of softness of budget constraints (tax and energy arrears), and different kinds of restructuring activity. The influence of privatization on enterprise performance was not explored as no real data exists on pre-privatization performance. Further two regression analyses were run with the same variables, with the exception that the first looked at origin of strong competition (foreign or domestic) and the second analyses looked at intensity of competition (number of competitors).

In all of the tables below, the first figure refers to the estimated variable coefficient, whilst the second figure in brackets gives the standard error. The coefficients that are significant are marked with asterisks as follows:

- * significant at 1% confidence level
- ** significant at 5% confidence level
- *** significant at 10% confidence level

## Regression Analysis on Enterprises Performance
*(origin of competition)*

Weighted Least Squares (WLS) regressions with real sales growth ratio and value added ratio as dependent variables and dummies for competition intensity, ownership and restructuring measures as explanatory variables.

### Table 74

| Independent Variables | Dependent Variables: Real Sale Ratio | Dependent Variables: Value Added Ratio |
|---|---|---|
| **Competition** | | |
| Significant Pressure from Domestic Competitors | 0.117* (0.037) | 0.002 (0.038) |
| Significant Pressure from Foreign Competitors | -0.074*** (0.040) | 0.046 (0.040) |
| **Firm Origin** | | |
| Municipal | 0.089 (0.066) | 0.123*** (0.068) |
| Privatized | 0.087*** (0.047) | -0.039 (0.048) |
| Start-up | 0.271* (0.062) | 0.154** (0.061) |
| Soft budget constraints (presence of significant tax and/or energy arrears) | -0.086 (0.064) | -0.044 (0.067) |
| **Restructuring** | | |
| Developed New Products | -0.225* (0.040) | -0.241* (0.041) |
| Improved Existing Products | 0.140* (0.039) | -0.008 (0.040) |
| Ceased Old Production | 0.041 (0.047) | 0.085*** (0.049) |
| Changed Sales Channels | 0.228* (0.038) | 0.195* (0.038) |
| Attracted Major New Clients | -0.019 (0.037) | 0.083** (0.036) |
| Introduced New Technologies | 0.047 (0.034) | 0.002 (0.038) |
| Sold/ Leased Excess Assets | -0.160* (0.046) | -0.035 (0.045) |
| Purchased/ Rented New Assets | 0.077 (0.047) | 0.074 (0.045) |
| Changed Major Suppliers | -0.163* (0.043) | -0.186* (0.041) |
| Shed Excess Labor | -0.019 (0.038) | -0.115* (0.037) |
| Attracted New Employees | 0.013 (0.036) | 0.090** (0.036) |
| Trained Employees in New Technologies | 0.055 (0.041) | 0.091** (0.042) |
| Changed Organizational Structure of Enterprise | -0.052 (0.046) | -0.152* (0.048) |
| *Constant* | 1.161* (0.042) | 1.126* (0.045) |
| $R^2$ adj. | 0.087 | 0.083 |
| F | 9.605 | 8.047 |
| N | 1721 | 1483 |

* significant at 1% confidence level
** significant at 5% confidence level
*** significant at 10% confidence level



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## Regression Analysis on Enterprises Performance
*(level of competition)*

Weighted Least Squares (WLS) regressions with real sales growth ratio and value added growth ratio as dependent variables and dummies for market structure, ownership and restructuring measures as explanatory variables.

### Table 75

| Independent Variables | Dependent Variables: Real Sale Ratio | Dependent Variables: Value Added Ratio |
|---|---|---|
| **Competition** | | |
| 1-3 competitors | 0.066 (0.058) | -0.048 (0.060) |
| More than 3 competitors | 0.155* (0.048) | -0.080 (0.050) |
| **Ownership** | | |
| Municipal | 0.117*** (0.065) | 0.115*** (0.068) |
| Privatized | 0.101** (0.047) | -0.023 (0.048) |
| Start-up | 0.278* (0.063) | 0.180* (0.061) |
| Soft budget constraints (presence of significant tax and/or energy arrears) | -0.088 (0.064) | -0.036 (0.066) |
| **Restructuring** | | |
| Developed New Products | -0.256* (0.041) | -0.218* (0.041) |
| Improved Existing Products | 0.106* (0.040) | 0.008 (0.040) |
| Ceased Old Production | 0.042 (0.048) | 0.091*** (0.049) |
| Changed Sales Channels | 0.218* (0.039) | 0.194* (0.039) |
| Attracted Major New Clients | -0.020 (0.037) | 0.079** (0.036) |
| Introduced New Technologies | 0.047 (0.034) | -0.002 (0.038) |
| Sold/ Leased Excess Assets | -0.190* (0.045) | -0.029 (0.045) |
| Purchased/ Rented New Assets | 0.065 (0.047) | 0.083*** (0.045) |
| Changed Major Suppliers | -0.171* (0.043) | -0.178* (0.041) |
| Shed Excess Labor | -0.026 (0.038) | -0.114* (0.037) |
| Attracted New Employees | 0.024 (0.036) | 0.078** (0.037) |
| Trained Employees in New Technologies | 0.039 (0.041) | 0.099** (0.042) |
| Changed Organizational Structure of Enterprise | -0.011 (0.047) | -0.165* (0.048) |
| Constant | 1.098* (0.046) | 1.171 (0.052) |
| $R^2$ adj. | 0.086 | 0.095 |
| *F* | 9.557 | 8.128 |
| N | 1721 | 1483 |

* significant at 1% confidence level.
** significant at 5% confidence level.
*** significant at 10% confidence level



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## *Factors That Influence Enterprise Restructuring*

### Regression Analysis on Enterprises Restructuring
*(origin of competition)*

Logit regressions with certain types of restructuring as dichotomy dependent variables and dummies for ownership, origin of strong competitive pressure and presence of tax and energy arrears as explanatory ones.

**Table 76**

| Types of Restructuring | Estimated Variable Coefficients and Standard Errors (in brackets)[33] | | | | | | |
|---|---|---|---|---|---|---|---|
| | Firm Origin | | | Origin of Significant Competitive Pressure | | Presence of Significant Tax or Energy Arrears | *Intercept* |
| | Municipal | Privatized | Start-Ups | Domestic | Foreign | | |
| Developed New Product | -0.622** (0.291) | 0.369** (0.159) | 0.413* (0.161) | -0.117 (0.092) | 0.885* (0.135) | -0.238 (0.191) | -0.636* (0.148) |
| Improved Existing Products | -0.715** (0.282) | 0.219 (0.156) | 0.240 (0.157) | -0.064 (0.092) | 0.620* (0.133) | -0.545* (0.194) | -0.374* (0.144) |
| Ceased Old Production | -1.259** (0.495) | 0.191 (0.200) | -0.446** (0.213) | -0.033 (0.126) | 0.819** (0.151) | 0.405** (0.220) | -1.729* (0.188) |
| Changed Sales Channels | -1.432* (0.423) | 0.176 (0.171) | -0.043 (0.175) | -0.259** (0.104) | 0.751* (0.135) | -0.323 (0.219) | -0.991* (0.159) |
| Attracted Major New Clients | -0.782** (0.320) | -0.019 (0.165) | 0.328** (0.165) | -0.149 (0.096) | 0.564* (0.134) | -0.801* (0.232) | -0.730* (0.152) |
| Introduced New Technologies | 0.301 (0.276) | 0.192 (0.174) | 0.162 (0.176) | -0.164*** (0.101) | 0.612** (0.136) | -0.103 (0.203) | -1.113* (0.162) |
| Sold/ Leased Excess Assets | -0.382 (0.308) | 0.136 (0.174) | -1.459* (0.206) | 0.187 (0.119) | 0.505* (0.152) | 0.590* (0.194) | -1.255* (0.164) |
| Purchased/ Rented New Assets | 0.190 (0.482) | 0.325 (0.301) | 1.042* (0.294) | -0.032 (0.140) | 0.209 (0.199) | -0.263 (0.344) | -2.659* (0.282) |
| Changed Major Suppliers | -0.985** (0.501) | 0.333 (0.215) | 0.356*** (0.216) | 0.110 (0.115) | 0.324** (0.158) | -0.733** (0.302) | -1.818* (0.202) |
| Shed Excess Labor | -0.593** (0.263) | 0.082 (0.154) | -0.791** (0.159) | 0.204** (0.095) | 0.247*** (0.134) | 0.528* (0.184) | -0.336* (0.142) |
| Attracted New Employees | -0.234 (0.288) | 0.248 (0.166) | 0.670* (0.167) | -0.027 (0.093) | 0.307** (0.133) | -0.502** (0.208) | -0.862* (0.154) |
| Trained Employees in New Technologies | -0.164 (0.341) | 0.453** (0.193) | 0.448** (0.195) | -0.126 (0.105) | 0.295 (0.145) | -0.518 (0.243) | -1.466* (0.181) |
| Changed Organizational Structure of Enterprise | -0.160 (0.415) | 0.345 (0.242) | -0.567** (0.262) | -0.011 (0.150) | -0.477** (0.238) | -0.032 (0.282) | -2.068* (0.227) |

Number of observations in each regression is 2158.
* significant at 1% level.
** significant at 5% level.
*** significant at 10% level.

[33] National state-owned firms with no significant domestic and/or foreign competitive pressure are taken as a base line for comparisons.

## Regression Analysis on Enterprises Restructuring
*(level of competition)*

Logit regressions with certain types of restructuring as dichotomy dependent variables and dummies for ownership, intensity of competition and presence of tax and energy arrears as explanatory ones.

### Table 77

| Types of Restructuring | Variable Coefficients and Standard Errors (in brackets)[34] | | | | | | |
|---|---|---|---|---|---|---|---|
| | Firm Origin | | | Level of Competition | | Presence of Significant Tax and Energy Arrears | Intercept |
| | Municipal | Privatized | Start-ups | 1-3 competitors | More than 3 competitors | | |
| Developed New Product | -0.683** (0.293) | 0.263** (0.160) | 0.195 (0.163) | 0.998* (0.216) | 0.849* (0.193) | -0.173 (0.189) | -1.239* (0.215) |
| Improved Existing Products | -0.759* (0.284) | 0.141 (0.157) | 0.087 (0.160) | 0.794* (0.205) | 0.588* (0.181) | -0.501* (0.193) | -0.795* (0.201) |
| Ceased Old Production | -1.344* (0.495) | 0.187 (0.200) | -0.543** (0.215) | 0.259 (0.282) | 0.334 (0.247) | 0.476** (0.216) | -1.868* (0.269) |
| Changed Sales Channels | -1.495* (0.423) | 0.111 (0.171) | -0.199 (0.177) | 0.430*** (0.236) | 0.433** (0.209) | -0.264 (0.216) | -1.283* (0.228) |
| Attracted Major New Clients | -0.819** (0.320) | -0.078 (0.166) | 0.195 (0.168) | 0.451** (0.221) | 0.426** (0.196) | -0.756* (0.230) | -1.025* (0.215) |
| Introduced New Technologies | 0.222 (0.275) | 0.203 (0.175) | 0.114 (0.179) | -0.062 (0.213) | -0.018 (0.185) | -0.065 (0.201) | -1.046* (0.211) |
| Sold/ Leased Excess Assets | -0.374 (0.310) | 0.100 (0.176) | -1.570* (0.208) | 0.505*** (0.265) | 0.729* (0.232) | 0.661* (0.194) | -1.699* (0.249) |
| Purchased/ Rented New Assets | 0.189 (0.482) | 0.313 (0.303) | 0.997* (0.298) | -0.001 (0.342) | 0.169 (0.301) | -0.244 (0.343) | -2.750* (0.365) |
| Changed Major Suppliers | -0.985** (0.502) | 0.312 (0.217) | 0.290 (0.220) | 0.330 (0.285) | 0.397 (0.254) | -0.690** (0.302) | -2.055* (0.286) |
| Shed Excess Labor | -0.554** (0.265) | 0.037 (0.156) | -0.891* (0.163) | 0.376*** (0.209) | 0.656* (0.182) | 0.583* (0.184) | -0.734* (0.200) |
| Attracted New Employees | -0.241 (0.288) | 0.209 (0.168) | 0.587* (0.169) | 0.321 (0.211) | 0.331** (0.186) | -0.476** (0.207) | -1.085* (0.211) |
| Trained Employees in New Technologies | -0.205 (0.341) | 0.441** (0.195) | 0.409** (0.198) | 0.114 (0.230) | 0.019 (0.203) | -0.505** (0.242) | -1.481* (0.236) |
| Changed Organizational Structure of Enterprise | -0.132 (0.416) | 0.320 (0.244) | -0.546** (0.266) | 0.178 (0.298) | -0.064 (0.263) | -0.079 (0.281) | -2.102* (0.299) |

Number of observations in each regression is 2158.
* significant at 1% level.
** significant at 5% level.
*** significant at 10% level.

[34] National state-owned firms with no significant domestic and/or foreign competitive pressure are taken as a base line for comparisons.



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# *Factors That Influence the Attraction of New Outside Management*

## Regression Analysis on Management Turnover

Logit regression with the arrival of a new top manager from outside of the enterprise over last 3 years as a dichotomy dependent variable and dummies for market structure, ownership (origin, concentration, insider owner dominance) and presence of budget constraints as explanatory variables.

Table 78

| Independent Variables | Variable Coefficient estimates with standard errors in brackets |
|---|---|
| ***Competition*** | |
| 1-3 Competitors | 0.740*** (0.396) |
| More than 3 Competitors | 0.762** (0.353) |
| ***Firm Origin*** | |
| Privatized | -0.364 (0.399) |
| Start-Ups | -0.946** (0.426) |
| Dominance of Insider Owners | -0.582* (0.189) |
| 2-3 Major Owners | 0.230 (0.431) |
| More than 3 Major Owners | 0.020 (0.420) |
| Soft budget constraints (presence of significant tax and/or energy arrears) | 0.528*** (0.273) |
| **Constant** | **-2.466* (0.346)** |
| N | 2101 |

* significant at 1% level.
** significant at 5% level.
*** significant at 10% level.



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# Annex 3

## *Business Environment Indices*

*In order to provide comparative ratings for cities for several components of the business* environment, various indices have been calculated. These indices just sum several parameters (all assigned equal weighting) and rate cities according to the responses of firms themselves.

The indices should in no way be interpreted as an assessment of the business environment in any particular city. There is simply not enough information for objective assessments. All they capture is how respondents in one city answered questions relative to respondents in other cities and then ranked compared to an Ukrainian average.

### Index Calculation

Ratings were calculated for each parameter that is included in an index. The percentage of *firms in a city that stated whether a parameter was a significant barrier and were added to* the percentage of firms that stated that the same parameter was a major barrier to give a combined percentage. At the same time the percent of firms who needed to make unofficial payments in dealing with the same parameter was calculated. The combined percentage of those for whom a parameter was a problem was multiplied by the coefficient of those who needed to make unofficial payments. This provides a rating for a particular parameter. Different parameter ratings were then added together which then provided the general ratings for each index. For each particular index the ratings were compared to the average in Ukraine and arranged by difference from average (on a scale of –10 to +10).

All parameters below that were multiplied by a coefficient of unofficial payment are denoted by*.



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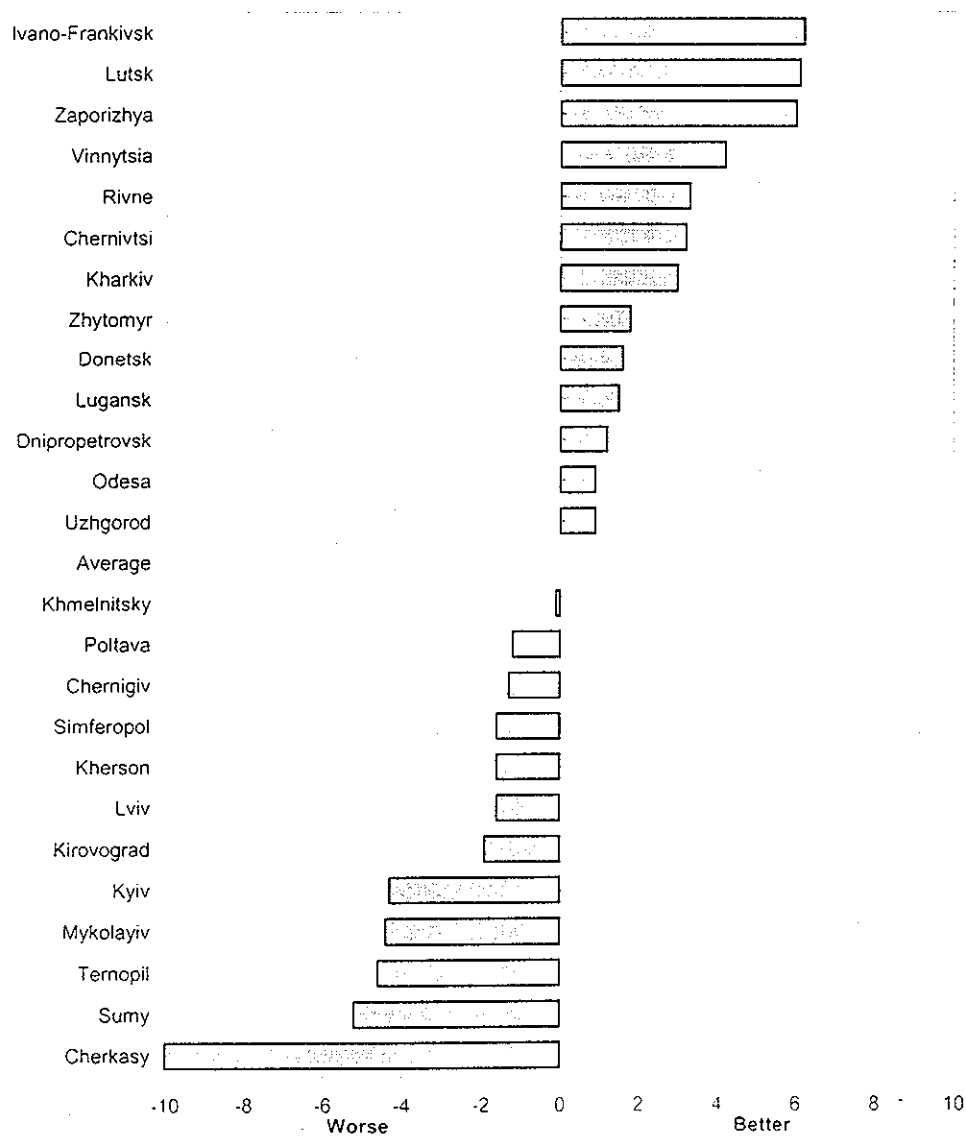
## Combined City Index of Unfair Practices

The figure below shows an index of cities rated by the unfair practices that this survey captured. The parameters in this index were taken from questions in the survey, specifically:

- competitors receiving privileged decisions from municipalities,
- preferential access to infrastructure,
- preferential access to land,
- preferential access to premises,
- subsidies from municipalities.

**Figure 45**
**Combined City Index of Unfair Practices**



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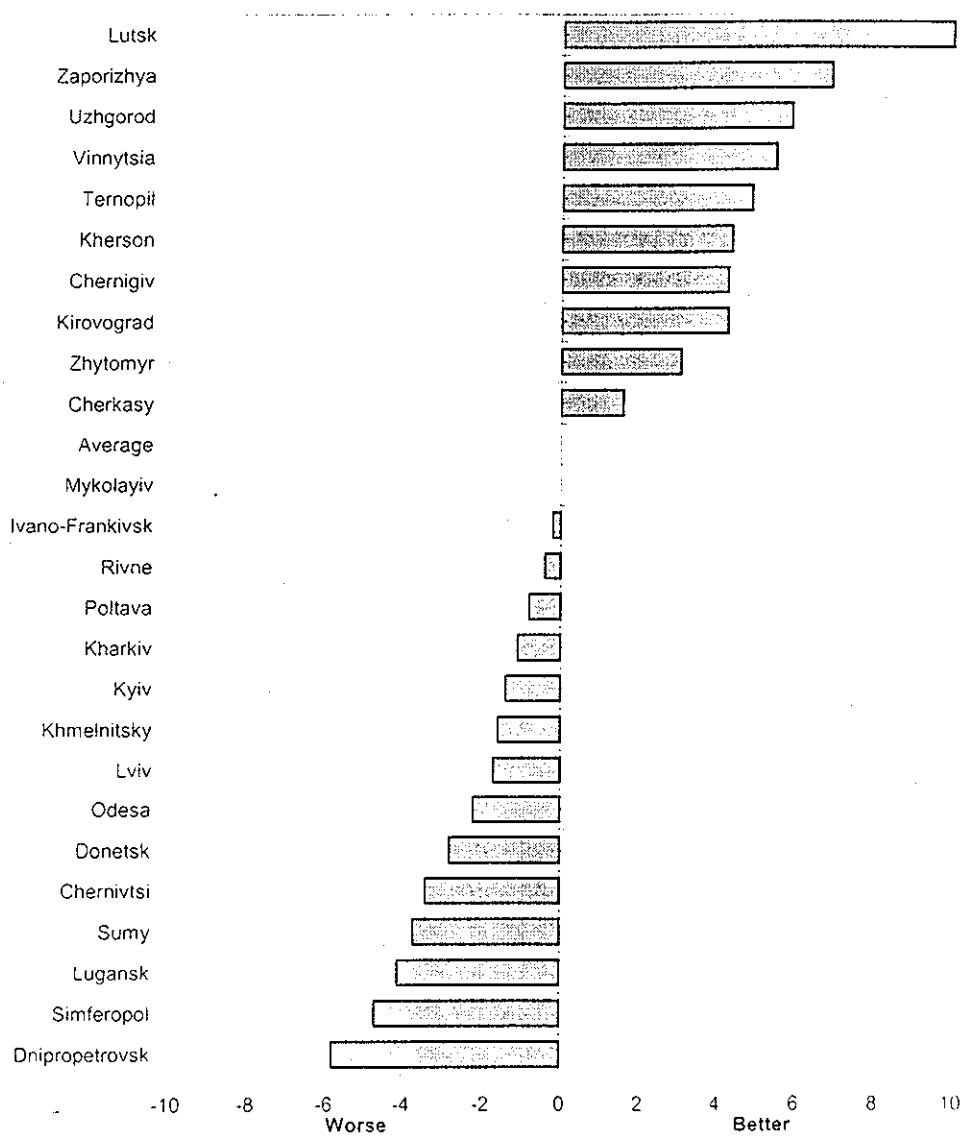
## Combined City Regulatory Index

Combining the main regulatory parameters surveyed in this report allows for the construction of a combined city regulatory index. The parameters used in this index were barriers to business development presented by:

- registration/ re-registration,*
- permits and permissions,*
- business licensing,*
- product certification,*
- customs.*

**Figure 46**
**Combined City Regulatory Index**



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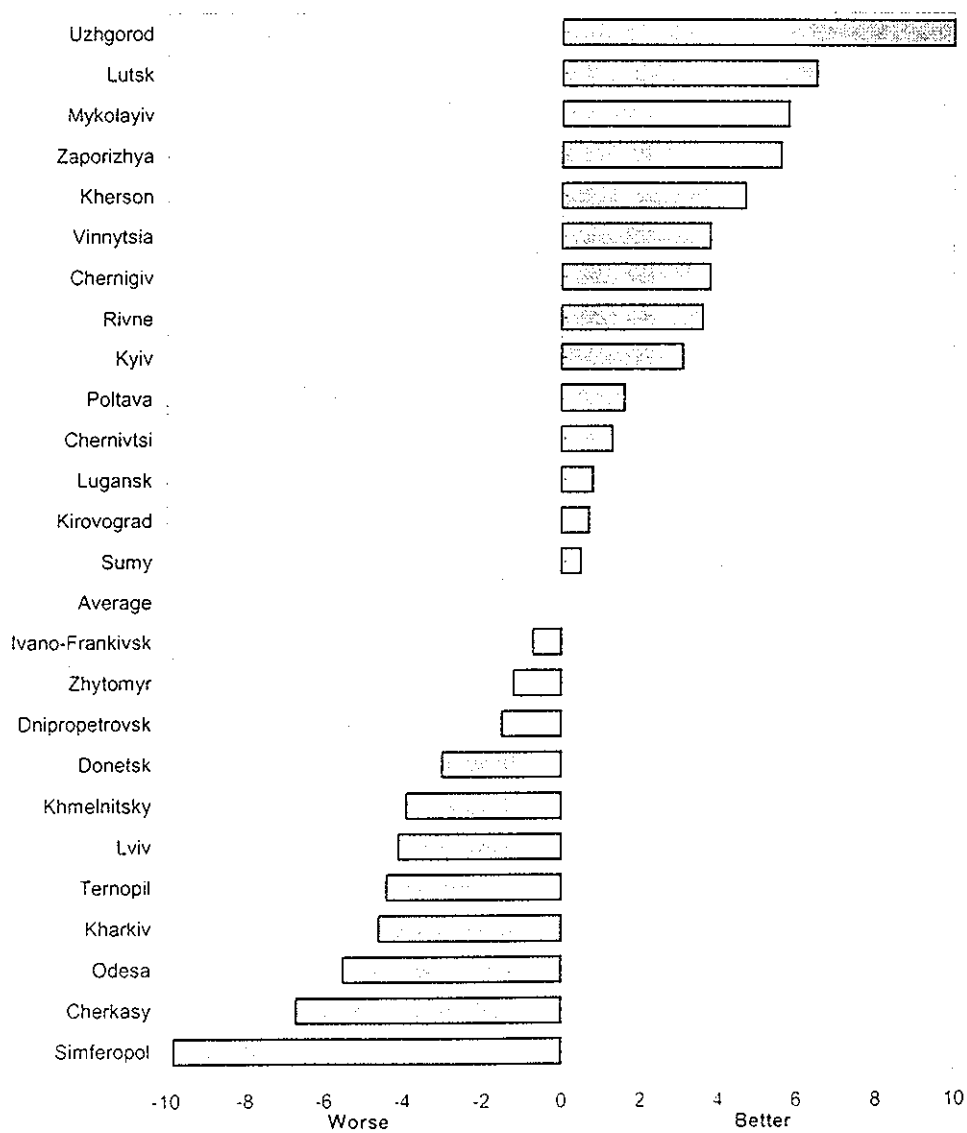
## Combined City Administrative Index

Using the survey data a combined city administrative index can be calculated for all cities in our survey. The following parameters were added together to generate this index:

- tax inspections (adjusted by coefficient of firms who stated that tax inspections had increased),
- non-tax inspections (adjusted by coefficient of firms who stated that non-tax inspections had increased),
- 'voluntary' contributions to non-budget municipal funds,
- local corruption,
- pressure from local government.

**Figure 47**
**Combined City Administrative Index**



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## Combined City Access to Financing and Infrastructure Index

A city index was calculated that arranges cities in Ukraine according to whether firms felt that obtaining financing (*note: obtaining financing does not necessarily reflect local conditions*) and access to local infrastructure were a serious barrier. The parameters used were the following:

- undeveloped infrastructure,
- access to external financing,
- internet access.

**Figure 48**
**Combined City Access to Financing and Infrastructure Index**

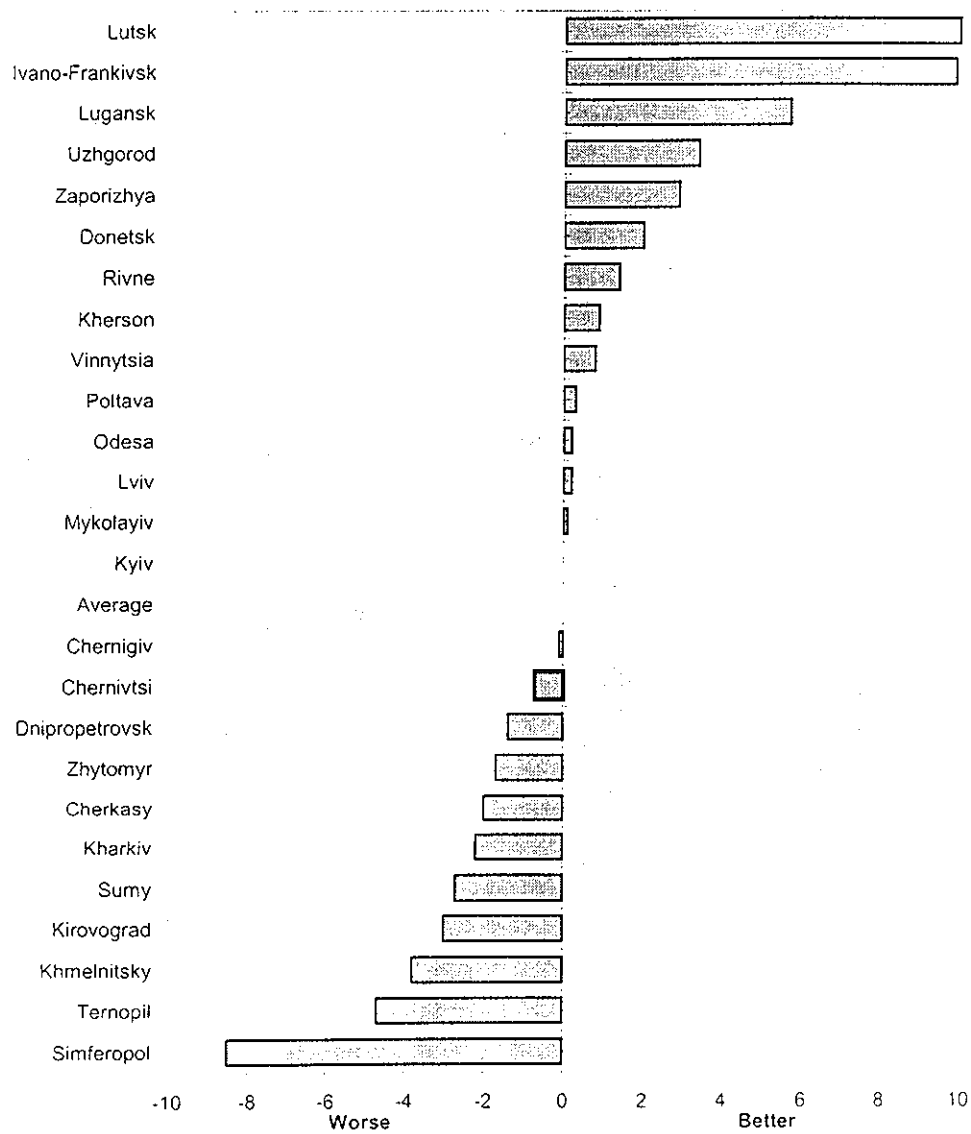




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**Table 79**
**Combined City Indices**

| City | Access to Finance and Infrastructure | Unfair Competitive Practices | Regulatory Environment | Administrative Environment |
|---|---|---|---|---|
| Vinnytsia | 0.8 | 4.2 | 5.5 | 3.8 |
| Dnipropetrovsk | -1.4 | 1.2 | -5.8 | -1.5 |
| Donetsk | 2.0 | 1.6 | -2.8 | -3.0 |
| Zhytomyr | -1.7 | 1.8 | 3.1 | -1.2 |
| Zaporizhya | 2.9 | 6.0 | 6.9 | 5.6 |
| Ivano-Frankivsk | 9.9 | 6.2 | -0.2 | -0.7 |
| Kyiv | 0.0 | -4.3 | -1.4 | 3.1 |
| Kirovograd | -3.0 | -1.9 | 4.3 | 0.7 |
| Lugansk | 5.7 | 1.5 | -4.1 | 0.8 |
| Lutsk | 10.0 | 6.1 | 10.0 | 6.5 |
| Lviv | 0.2 | -1.6 | -1.7 | -4.1 |
| Mykolayiv | 0.1 | -4.4 | 0.0 | 5.8 |
| Odesa | 0.2 | 0.9 | -2.2 | -5.5 |
| Poltava | 0.3 | -1.2 | -0.8 | 1.6 |
| Rivne | 1.4 | 3.3 | -0.4 | 3.6 |
| Simferopol | -8.5 | -1.6 | -4.7 | -9.8 |
| Sumy | -2.7 | -5.2 | -3.7 | 0.5 |
| Ternopil | -4.7 | -4.6 | 4.9 | -4.4 |
| Uzhgorod | 3.4 | 0.9 | 5.9 | 10.0 |
| Kharkiv | -2.2 | 3.0 | -1.1 | -4.6 |
| Kherson | 0.9 | -1.6 | 4.4 | 4.7 |
| Khmelnitsky | -3.8 | -0.1 | -1.6 | -3.9 |
| Cherkasy | -2.0 | -10.0 | 1.6 | -6.7 |
| Chernigiv | -0.1 | -1.3 | 4.3 | 3.8 |
| Chernivtsi | -0.7 | 3.2 | -3.4 | 1.3 |
| **Average** | **0.0** | **0.0** | **0.0** | **0.0** |

The table above shows that for the majority of cites regulatory and administrative indices tend to converge. This implies that there is a link between the regulatory and administrative indices surveyed in this report. For those cites that perform well in regulatory index tend to perform in administrative as well, and vice versa. One of the possible hypotheses is that city governments have quite large amount of influence on different types of regulation and therefore on local business environments.

# Annex 4

## *Barriers to Business Development*

The following tables show the breakdown of responses by sector for various business development barriers in Ukraine. Respondents were asked to rate various issues according to a four point scale:
1 - no obstacle
2- small obstacle
3 - significant obstacle
4 - major obstacle

The overall score for a particular barrier was calculated as a simple unweighted arithmetic average of the responses of all surveyed firms. For ease of comparison these scores have been ranked from highest (more problematic) to lowest (less problematic).

**Table 80**
**General Overview of Barriers to Market Entry and Expansion**

| | Average | | Sectors | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | *Manufacturing* | | *Construction* | | *Transport* | | *Telecoms* | | Trade | | Public Catering | | Other Services | |
| | *score** | *rank* | score | *rank* | score | *rank* | score | *rank* | score | *rank* | score | *rank* | score | *rank* | score | *rank* |
| Taxation | 3.1 | 1 | 3.2 | 1 | 3.2 | 1 | 3.2 | 1 | 2.9 | 2 | 3.1 | 1 | 3.0 | 1 | 2.9 | 1 |
| Low Demand | 2.9 | 2 | 2.9 | 2 | 3.0 | 2 | 2.6 | 4 | 3.1 | 1 | 3.0 | 2 | 2.8 | 3 | 2.9 | 2 |
| Inflation | 2.8 | 3 | 2.8 | 3 | 2.8 | 3 | 2.9 | 2 | 2.7 | 3 | 2.9 | 3 | 2.9 | 2 | 2.7 | 3 |
| Non-Level Playing Field/ Anti-Competitive Practices | 2.5 | 4 | 2.4 | 4 | 2.6 | 4 | 2.9 | 3 | 2.4 | 5 | 2.6 | 4 | 2.4 | 4 | 2.2 | 5 |
| Corruption | 2.3 | 5 | 2.3 | 5 | 2.6 | 5 | 2.5 | 6 | 2.2 | 7 | 2.5 | 5 | 2.2 | 6 | 2.2 | 6 |
| Regulations | 2.3 | 6 | 2.2 | 6 | 2.4 | 6 | 2.5 | 5 | 2.3 | 6 | 2.4 | 6 | 2.4 | 5 | 2.3 | 4 |
| Underdeveloped Infrastructure | 2.2 | 7 | 2.2 | 8 | 2.3 | 7 | 2.4 | 7 | 2.6 | 4 | 2.2 | 7 | 2.1 | 7 | 2.2 | 7 |
| Problems with Sourcing Necessary Inputs | 2.0 | 8 | 2.2 | 7 | 2.2 | 8 | 2.3 | 8 | 1.7 | 8 | 1.7 | 9 | 1.8 | 8 | 1.8 | 8 |
| Obtaining External Financing | 1.8 | 9 | 1.8 | 9 | 2.0 | 9 | 2.0 | 9 | 1.7 | 9 | 1.7 | 8 | 1.7 | 10 | 1.7 | 9 |
| Pressure from Criminal Elements | 1.6 | 10 | 1.5 | 10 | 1.7 | 10 | 1.7 | 10 | 1.5 | 10 | 1.6 | 10 | 1.7 | 9 | 1.5 | 10 |



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## Table 81
## Barriers Dealing With Taxation

| | Average | | Sectors | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Manufacturing | | Construction | | Transport | | Telecoms | | Trade | | Public Catering | | Other Services | |
| | score* | rank | score | rank | score | rank | score | rank | score | rank | score | rank | score | rank | score | rank |
| Unstable Tax Legislation | 3.3 | 1 | 3.3 | 1 | 3.3 | 2 | 3.3 | 1 | 3.2 | 1 | 3.3 | 1 | 3.3 | 1 | 3.2 | 1 |
| High tax rates | 3.2 | 2 | 3.3 | 2 | 3.3 | 1 | 3.2 | 2 | 3.0 | 2 | 3.2 | 2 | 3.2 | 2 | 2.9 | 2 |
| Large Number of Taxes | 3.1 | 3 | 3.2 | 3 | 3.2 | 3 | 3.1 | 3 | 2.7 | 3 | 3.1 | 3 | 3.1 | 3 | 2.9 | 3 |
| Tax Reporting & Accounting | 2.6 | 4 | 2.7 | 4 | 2.6 | 5 | 2.7 | 6 | 2.5 | 5 | 2.6 | 6 | 2.7 | 6 | 2.6 | 4 |
| Unfair Competition from Untaxed Shadow Activities | 2.6 | 5 | 2.6 | 5 | 2.9 | 4 | 2.7 | 5 | 2.3 | 7 | 2.8 | 4 | 2.7 | 4 | 2.3 | 6 |
| Tax Inspections | 2.6 | 6 | 2.5 | 6 | 2.6 | 6 | 2.6 | 7 | 2.3 | 6 | 2.6 | 5 | 2.7 | 5 | 2.4 | 5 |
| Different Tax Treatment of Competitors | 2.5 | 7 | 2.5 | 7 | 2.5 | 7 | 2.7 | 4 | 2.5 | 4 | 2.5 | 7 | 2.6 | 7 | 2.3 | 7 |

## Table 82
## Barriers Dealing With Unfair Competition

| | Average | | Sectors | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Manufacturing | | Construction | | Transport | | Telecoms | | Trade | | Public Catering | | Other Services | |
| | score | rank | score | rank | score | rank | score | Rank | score | rank | score | rank | score | rank | score | rank |
| Privileged Decisions from City Authorities | 2.4 | 1 | 2.3 | 2 | 2.7 | 1 | 2.6 | 1 | 2.5 | 1 | 2.5 | 1 | 2.2 | 1 | 2.2 | 1 |
| Favored Access to Credit | 2.3 | 2 | 2.4 | 1 | 2.4 | 4 | 2.4 | 2 | 2.2 | 4 | 2.4 | 2 | 2.2 | 2 | 2.1 | 2 |
| Favored Access to Clients | 2.2 | 3 | 2.2 | 3 | 2.5 | 3 | 2.1 | 5 | 2.4 | 2 | 2.2 | 4 | 1.8 | 8 | 2.0 | 3 |
| Subsidies from National Government | 2.1 | 4 | 2.2 | 4 | 2.3 | 5 | 2.0 | 6 | 2.0 | 6 | 2.0 | 7 | 1.9 | 6 | 2.0 | 5 |
| Market Collusion | 2.1 | 5 | 2.1 | 6 | 2.6 | 2 | 2.1 | 3 | 2.0 | 7 | 2.2 | 5 | 2.0 | 4 | 1.9 | 7 |
| Privileged Access to Land and Premises | 2.1 | 6 | 2.0 | 7 | 2.2 | 6 | 1.9 | 8 | 2.1 | 5 | 2.3 | 3 | 2.1 | 3 | 2.0 | 4 |
| Subsidies (and Hidden) from Local Authorities | 2.0 | 7 | 2.1 | 5 | 2.2 | 7 | 2.1 | 4 | 2.0 | 7 | 2.0 | 7 | 1.9 | 7 | 1.9 | 6 |
| Privileged Access to Infrastructure | 2.0 | 8 | 2.0 | 8 | 2.1 | 8 | 2.0 | 7 | 2.3 | 3 | 2.1 | 6 | 2.0 | 5 | 1.9 | 8 |

## Table 83
## Barriers Dealing with Business Regulations

| | Average | | Sectors | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | score* | %** | Manufacturing | | Construction | | Transport | | Telecoms | | Trade | | Public Catering | | Other Services | |
| | | | score | % | score | % | score | % | score | % | score | % | score | % | score | % |
| Frequently Changing Business Legislation | 2.9 | 94 | 2.9 | 95 | 2.8 | 95 | 2.8 | 97 | 2.9 | 98 | 2.8 | 94 | 2.8 | 93 | 2.8 | 93 |
| Customs | 2.5 | 44 | 2.5 | 48 | 2.6 | 39 | 2.5 | 49 | 2.6 | 48 | 2.4 | 41 | 2.5 | 34 | 2.3 | 40 |
| Permits/ Permissions | 2.4 | 86 | 2.4 | 86 | 2.5 | 85 | 2.4 | 85 | 2.3 | 84 | 2.3 | 85 | 2.3 | 85 | 2.4 | 91 |
| Inspections *(excluding tax* inspections) | 2.3 | 94 | 2.4 | 94 | 2.4 | 93 | 2.3 | 93 | 2.2 | 96 | 2.3 | 94 | 2.4 | 92 | 2.3 | 95 |
| Licensing | 2.3 | 72 | 2.3 | 72 | 2.4 | 70 | 2.3 | 68 | 2.2 | 78 | 2.2 | 73 | 2.3 | 76 | 2.3 | 73 |
| Certification | 2.3 | 70 | 2.3 | 74 | 2.4 | 68 | 2.2 | 70 | 2.1 | 76 | 2.2 | 66 | 2.3 | 62 | 2.2 | 69 |
| Requirement to Make 'Voluntary' Payments | 2.3 | 77 | 2.3 | 79 | 2.3 | 73 | 2.3 | 77 | 2.3 | 86 | 2.2 | 75 | 2.3 | 76 | 2.3 | 79 |
| Business Registration Procedures | 1.9 | 70 | 1.9 | 69 | 1.8 | 66 | 2.0 | 71 | 1.9 | 64 | 1.8 | 70 | 1.9 | 72 | 1.8 | 75 |
| **Foreign Trade** | | | | | | | | | | | | | | | | |
| Border Customs Checks | 2.1 | 26 | 2.0 | 29 | 2.7 | 15 | 2.1 | 27 | 2.5 | 24 | 2.1 | 18 | 2.5 | 13 | 2.2 | 18 |
| Certification of Imported Goods | 2.0 | 19 | 2.0 | 22 | 2.0 | 13 | 2.0 | 19 | 2.5 | 20 | 2.0 | 12 | 2.1 | 8 | 2.3 | 13 |
| Customs Declaraitons | 2.0 | 29 | 2.0 | 31 | 2.3 | 18 | 2.0 | 28 | 2.3 | 24 | 2.0 | 20 | 2.3 | 14 | 2.1 | 18 |
| Firm Accreditation by Government | 1.5 | 18 | 1.5 | 21 | 1.6 | 11 | 1.5 | 20 | 1.5 | 16 | 1.5 | 16 | 1.8 | 9 | 1.5 | 12 |

* - average score for the respondents to whom certain type of regulatory barrier is applicable
** - % of respondents to whom certain type of regulatory barrier is applicable

## Table 84
## Barriers to Receiving Financing and Credit

| | Average | | Sectors | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Score* | rank | Manufacturing | | Construction | | Transport | | Telecoms | | Trade | | Public Catering | | Other Services | |
| | | | score | rank | score | rank | score | rank | score | rank | score | rank | score | rank | score | rank |
| High Interest Rates | 2.8 | 1 | 3.0 | 1 | 2.9 | 1 | 2.8 | 1 | 2.6 | 1 | 2.7 | 1 | 2.5 | 1 | 2.5 | 1 |
| Lack of Access to Long-Term Credit (more than 1 year) | 2.6 | 2 | 2.7 | 2 | 2.8 | 2 | 2.6 | 3 | 2.5 | 2 | 2.5 | 2 | 2.3 | 3 | 2.3 | 2 |
| Collateral Requirements | 2.5 | 3 | 2.6 | 3 | 2.6 | 3 | 2.6 | 2 | 2.5 | 3 | 2.4 | 3 | 2.3 | 2 | 2.2 | 3 |
| Bank Paperwork and Bureaucracy | 2.2 | 4 | 2.2 | 4 | 2.3 | 5 | 2.3 | 4 | 2.0 | 8 | 2.2 | 4 | 2.1 | 4 | 2.0 | 4 |
| Lack of Information About Sources of Credit | 2.1 | 5 | 2.1 | 5 | 2.3 | 4 | 2.1 | 7 | 2.3 | 4 | 2.1 | 5 | 2.0 | 6 | 1.9 | 7 |
| Threat of Losing Control Over Own Enterprise | 2.1 | 6 | 2.1 | 6 | 2.1 | 6 | 2.1 | 6 | 2.2 | 5 | 2.0 | 6 | 2.1 | 5 | 1.9 | 5 |
| Low Depreciation Allowances | 2.0 | 7 | 2.1 | 7 | 2.1 | 7 | 2.2 | 5 | 2.2 | 6 | 2.0 | 7 | 1.9 | 7 | 1.9 | 6 |
| Requirement to Submit Sensitive Information | 1.9 | 8 | 1.8 | 8 | 1.8 | 8 | 1.8 | 8 | 2.1 | 7 | 1.9 | 8 | 1.8 | 8 | 1.8 | 8 |



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# Annex 5

## *Firm Perceptions of the State and Business Environments*

### Assessment of Local Business Environment

Respondents were asked whether they agreed or disagreed with 11 statements concerning their local business environment. For ease of analysis we compared the number of respondents in a given city who agreed with a particular statement with the number of respondents who disagreed. The table below indicates whether on balance respondents reacted positively to the statements or negatively. If a city has 'yes' for a particular statement then more people agreed than disagreed with that statement. *Note: The balance of the yes/ no answers was in most cases less than the number of firms who answered either one of the three options – 'yes', 'no', 'don't know'.*

Table 85

| Agreed or disagreed with the statements | Local authorities are strictly compliant with laws and regulations issued by central government | Decisions of local authorities do not restrict business development | Locat authorities make efforts to simplify the business start up process | Reasonable fees for rent of premises used for commercial purposes | Rental fee for land used for commercial purposes is reasonable | Local authorities promote business development in the city through ensuring equitable conditions for businesses | Local authorities promote business development in the city by creating appropriate infrastructure (information, financing, communications) | Business support foundations in my region serve the interests of local businesses | State officials in my city are honest and do not demand bribes | Business environment in my city encourage investment and invite business development | Business environment in my city is better than in most Ukrainian regions |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Vinnytsia | yes | yes | yes | no | no | no | no | no | no | no | no |
| Dnipropetrovsk | yes | yes | no | no | no | no | yes | no | no | no | yes |
| Donetsk | yes | yes | no | no | no | no | yes | yes | no | yes | yes |
| Zhytomyr | yes | yes | yes | yes | yes | no | no | yes | no | yes | no |
| Zaporizhya | yes | no | no | no | yes | no | no | no | no | no | no |
| Ivano-Frankivsk | yes | yes | no | yes | no | no | no | no | no | no | no |
| Kyiv | yes | yes | no | no | no | no | no | no | no | no | yes |
| Kirovograd | no | no | no | no | no | no | no | no | no | no | no |
| Lugansk | yes | no | no | yes | yes | no | no | no | no | no | no |
| Lutsk | yes | yes | no | yes | yes | no | yes | no | no | yes | no |
| Lviv | yes | yes | no | yes | yes | no | no | no | no | no | no |
| Mykolayiv | yes | yes | no | yes | no | no | no | no | no | no | no |
| Odesa | no | no | no | no | no | no | no | no | no | no | yes |
| Poltava | yes | yes | yes | yes | yes | yes | yes | yes | no | yes | yes |
| Rivne | yes | yes | no | yes | yes | no | no | no | no | no | yes |
| Simferopol | no | no | no | no | no | no | no | no | no | no | no |
| Sumy | yes | no | no | yes | no | no | yes | no | no | no | no |
| Ternopil | yes | yes | yes | yes | yes | yes | yes | yes | yes | yes | yes |
| Uzhgorod | yes | yes | yes | yes | yes | no | no | yes | no | yes | yes |
| Kharkiv | no | no | no | yes | no | no | no | no | no | no | no |
| Kherson | no | no | no | yes | no | no | no | no | no | no | no |
| Khmelnitsky | yes | yes | yes | yes | yes | no | no | no | no | yes | yes |
| Cherkasy | yes | yes | no | yes | no | no | no | yes | no | no | yes |
| Chernigiv | no | no | no | yes | yes | no | no | no | no | no | no |
| Chernivtsi | Yes | yes | yes | yes | yes | no | no | no | no | yes | no |



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## Assessment of Local Services

Respondents were asked to rate on a scale of 1 – 6 their assessment of various providers of local infrastructure service. The rating system used was as follows:

1 - very good
2 - good
3 - satisfactory
4 - unsatisfactory
5 - bad
6 - very bad

The following table shows the responses broken by cities and shows the average score for the city and for a particular local infrastructure service. For ease of analysis any rating of below 4 can be taken to mean a negative opinion of the listed state institutions, a rating of above 4 and above positive.

### Table 86

| City | Roads Department | Architecture Department | Land Resources Department | Telephone Service | Electric Supply | Water Supply | Gas Supply | Teploenergo | Public Health Care | Educational Institutions |
|---|---|---|---|---|---|---|---|---|---|---|
| Vinnytsia | 4.72 | 3.83 | 3.75 | 3.45 | 3.54 | 3.38 | 3.43 | 4.06 | 4.12 | 3.82 |
| Dnipropetrovsk | 4.81 | 3.69 | 3.82 | 3.80 | 3.23 | 3.23 | 3.48 | 4.31 | 4.30 | 4.06 |
| Donetsk | 4.76 | 3.53 | 3.59 | 3.62 | 3.22 | 3.08 | 3.34 | 3.40 | 4.21 | 3.75 |
| Zhytomyr | 4.23 | 3.66 | 3.55 | 3.40 | 3.65 | 3.83 | 3.62 | 4.80 | 3.89 | 3.52 |
| Zaporizhya | 4.71 | 3.93 | 3.72 | 3.59 | 3.29 | 3.39 | 3.94 | 4.27 | 4.38 | 3.76 |
| Ivano-Frankivsk | 4.72 | 3.44 | 3.60 | 3.39 | 3.47 | 3.25 | 3.23 | 3.80 | 3.61 | 3.37 |
| Kyiv | 4.12 | 3.46 | 3.79 | 3.30 | 3.10 | 2.82 | 2.63 | 3.18 | 3.90 | 3.69 |
| Kirovograd | 5.49 | 3.88 | 3.77 | 3.68 | 3.24 | 4.02 | 3.13 | 4.74 | 4.56 | 4.14 |
| Lugansk | 4.61 | 3.88 | 3.86 | 3.34 | 3.48 | 3.37 | 3.46 | 4.05 | 4.24 | 4.03 |
| Lutsk | 4.53 | 3.17 | 3.08 | 3.20 | 2.75 | 2.83 | 2.60 | 2.97 | 3.22 | 2.95 |
| Lviv | 4.90 | 3.73 | 3.89 | 3.64 | 3.59 | 4.16 | 2.99 | 3.72 | 4.19 | 3.60 |
| Mykolayiv | 4.92 | 3.83 | 3.96 | 4.14 | 4.20 | 3.80 | 4.42 | 4.87 | 4.24 | 3.52 |
| Odesa | 4.40 | 3.88 | 3.87 | 3.86 | 4.08 | 3.66 | 3.33 | 4.27 | 4.12 | 3.82 |
| Poltava | 4.01 | 3.25 | 3.43 | 3.30 | 3.62 | 3.83 | 3.48 | 3.93 | 3.99 | 3.78 |
| Rivne | 4.86 | 3.68 | 3.79 | 3.96 | 3.54 | 3.56 | 3.36 | 4.33 | 4.18 | 3.84 |
| Simferopol | 5.03 | 4.11 | 4.34 | 4.18 | 4.09 | 4.14 | 4.12 | 4.25 | 4.14 | 3.86 |
| Sumy | 4.91 | 3.35 | 3.36 | 4.23 | 3.72 | 3.58 | 3.13 | 3.90 | 4.21 | 3.50 |
| Ternopil | 3.52 | 2.99 | 3.07 | 3.01 | 2.91 | 3.01 | 2.91 | 3.21 | 3.30 | 3.11 |
| Uzhgorod | 4.63 | 3.37 | 3.51 | 3.51 | 3.69 | 3.77 | 2.77 | 3.61 | 3.90 | 3.32 |
| Kharkiv | 4.95 | 3.70 | 3.88 | 3.59 | 4.11 | 3.81 | 4.18 | 4.60 | 4.51 | 3.94 |
| Kherson | 5.11 | 3.82 | 3.65 | 3.54 | 3.77 | 3.49 | 4.46 | 5.06 | 4.10 | 3.89 |
| Khmelnitsky | 4.61 | 3.91 | 3.81 | 3.37 | 3.57 | 3.64 | 3.40 | 3.95 | 4.38 | 4.09 |
| Cherkasy | 4.24 | 3.46 | 3.71 | 3.35 | 2.83 | 2.71 | 2.60 | 3.09 | 3.84 | 3.74 |
| Chernigiv | 4.73 | 3.77 | 3.58 | 4.01 | 3.35 | 3.11 | 3.04 | 4.30 | 4.17 | 3.54 |
| Chernivtsi | 5.02 | 3.68 | 3.52 | 3.60 | 3.81 | 3.86 | 3.85 | 3.97 | 4.23 | 3.51 |
| **Average** | **4.65** | **3.65** | **3.71** | **3.60** | **3.51** | **3.47** | **3.40** | **4.00** | **4.10** | **3.71** |



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# Annex 6

## *State Business Inspections*

Table 87
The average number and duration of inspections by different state bodies

| Inspecting Bodies | Number of Inspections | Duration (days) | Average number of employees engaged during inspection |
|---|---|---|---|
| Fire Department | 4.9 | 9.2 | 4.2 |
| Sanitary-Epidemiological Department | 3.1 | 1.7 | 2.3 |
| Tax Inspection Service or Police | 4.3 | 1.7 | 2.8 |
| Internal Affairs | 3.5 | 3.1 | 5.6 |
| Consumer Rights Protection Committee | 2.4 | 1.6 | 2.2 |
| Licensing Bodies | 5.7 | 2.3 | 2.9 |
| City Department of Industry and Consumer Market Development | 2.5 | 1.8 | 2.3 |
| Architecture Department | 2.2 | 2.9 | 2.5 |
| City Department on Issues of Business Development, Registration and Licensing | 1.7 | 2.2 | 2.1 |
| *Prosecutors Office* | 1.9 | 1.6 | 1.9 |
| Environmental Protection Ministry | 1.9 | 1.7 | 2.3 |
| Anti-Monopoly Committee | 2.3 | 2.1 | 2.6 |
| Health and Safety Committee | 1.6 | 3.1 | 2.8 |
| Price Control Inspection | 1.8 | 2.1 | 2.0 |
| Customs Service | 1.5 | 1.5 | 1.8 |
| Standardization, Certification and Metrology Committee | 1.5 | 1.8 | 2.0 |
| State Commission of Ukraine on Securities and Securities Market | 2.9 | 3.8 | 4.2 |
| Pension Fund | 2.8 | 10.1 | 4.3 |
| Employment Fund | 1.9 | 3.0 | 3.3 |
| Control Revision Service | 2.0 | 1.5 | 2.1 |
| City Financial Department | 1.4 | 1.5 | 1.6 |
| Social Security Fund | 1.6 | 2.2 | 2.0 |



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## Table 88
## Incidence of Various Inspection Consequence
*(% of all firms)*

| | No Consequences | Repeated Inspection | Assets Seized As Tax Collateral | Frozen Bank Account | kartoteka | Suspended or cancelled license | Business Shutdown | Confiscation | Penalty | Contracts Deemed Invalid |
|---|---|---|---|---|---|---|---|---|---|---|
| **City** | | | | | | | | | | |
| Vinnytsia | 49.3 | 23.9 | 5.6 | 15.5 | 12.7 | 1.4 | 5.6 | 4.2 | 5.6 | 1.4 |
| Dnipropetrovsk | 61.2 | 17.8 | 15.5 | 18.6 | 22.5 | 0.8 | 3.1 | 1.6 | 0.8 | 1.6 |
| Donetsk | 56.9 | 14.6 | 18.5 | 19.2 | 21.5 | 0.0 | 1.5 | 5.4 | 2.3 | 3.8 |
| Zhytomir | 53.0 | 19.7 | 13.6 | 18.2 | 22.7 | 1.5 | 4.5 | 4.5 | 0.0 | 0.0 |
| Zaporizhya | 45.6 | 25.3 | 8.9 | 13.9 | 19.0 | 0.0 | 2.5 | 6.3 | 3.8 | 1.3 |
| Ivano-Frankivsk | 53.1 | 9.4 | 6.3 | 4.7 | 12.5 | 0.0 | 0.0 | 1.6 | 14.1 | 0.0 |
| Kyiv | 53.5 | 19.0 | 10.2 | 11.5 | 17.3 | 0.4 | 3.5 | 0.9 | 1.8 | 2.7 |
| Kirovograd | 64.3 | 8.6 | 2.9 | 8.6 | 12.9 | 4.3 | 1.4 | 2.9 | 5.7 | 0.0 |
| Lugansk | 47.5 | 20.0 | 12.5 | 10.0 | 20.0 | 1.3 | 3.8 | 5.0 | 3.8 | 0.0 |
| Lutsk | 61.7 | 18.3 | 5.0 | 5.0 | 13.3 | 1.7 | 1.7 | 1.7 | 0.0 | 8.3 |
| Lviv | 51.0 | 25.0 | 17.0 | 17.0 | 25.0 | 0.0 | 3.0 | 5.0 | 4.0 | 1.0 |
| Mykolayiv | 58.7 | 12.0 | 13.3 | 21.3 | 14.7 | 0.0 | 0.0 | 4.0 | 1.3 | 0.0 |
| Odesa | 44.2 | 22.1 | 17.3 | 20.2 | 32.7 | 1.0 | 1.0 | 1.9 | 6.7 | 1.0 |
| Poltava | 43.4 | 28.9 | 6.6 | 11.8 | 11.8 | 2.6 | 2.6 | 2.6 | 1.3 | 1.3 |
| Rivne | 53.6 | 18.8 | 11.6 | 15.9 | 23.2 | 0.0 | 0.0 | 4.3 | 1.4 | 0.0 |
| Simferopol | 63.0 | 20.0 | 6.0 | 11.0 | 12.0 | 3.0 | 2.0 | 6.0 | 2.0 | 0.0 |
| Sumy | 50.0 | 14.3 | 10.0 | 10.0 | 15.7 | 0.0 | 4.3 | 2.9 | 0.0 | 0.0 |
| Ternopil | 79.1 | 9.0 | 4.5 | 4.5 | 11.9 | 0.0 | 1.5 | 1.5 | 0.0 | 0.0 |
| Uzhgorod | 69.0 | 11.3 | 7.0 | 5.6 | 15.5 | 2.8 | 0.0 | 0.0 | 1.4 | 1.4 |
| Kharkiv | 59.3 | 15.3 | 10.2 | 14.4 | 19.5 | 0.0 | 6.8 | 0.0 | 0.0 | 5.9 |
| Kherson | 60.0 | 5.7 | 8.6 | 21.4 | 22.9 | 1.4 | 4.3 | 5.7 | 2.9 | 1.4 |
| Khmelnitsky | 70.1 | 7.8 | 13.0 | 9.1 | 13.0 | 0.0 | 1.3 | 3.9 | 1.3 | 0.0 |
| Cherkasy | 69.6 | 21.7 | 2.2 | 4.3 | 10.9 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Chernigiv | 60.0 | 12.9 | 11.4 | 10.0 | 11.4 | 1.4 | 1.4 | 4.3 | 4.3 | 2.9 |
| Chernivtsi | 44.3 | 25.7 | 0.0 | 10.0 | 18.6 | 2.9 | 2.9 | 2.9 | 2.9 | 5.7 |
| **Average** | **56.3** | **17.4** | **10.3** | **13.1** | **18.0** | **1.0** | **2.5** | **3.1** | **2.6** | **1.8** |



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## *Other Survey Results on Inspections*

In 1997 International Financial Corporation (IFC) conducted a survey aimed at studying business conditions for small business. In the same year, the Soros International Economic Advisory Group (SIEAG) carried out a survey of the regulatory climate for medium and large business. In 1998 IFC conducted a second survey of small businesses. A survey of the regulatory environment was conducted by the IRIS Regulatory Reform Project. In 1999 IFC conducted a third survey of small business. In the same year DAI NewBiznet carried out a legislative implementation survey which dealt with the actual implementation of five pieces of legislation aimed at improving the operating environment for small and medium businesses in Ukraine. In particular the implementation of Presidential Decree "On some deregulatory measures for business activities" aimed at reducing the level of state interference in the operations of private business by developing clearer and simpler rules for state business inspections. Further, MSI and the Kyiv International Institute of Sociology (KIIS) conducted a large-scale survey of business in Ukraine and one part of this survey dealt with inspections issues.

The table shows results from all of the above mentioned surveys and combines results to show the average number of inspections per one business entity in the period 1997-1999. In 1997 the total number of inspection per one enterprise was calculated by combining the data from the IFC survey of small businesses and the SIEAG survey of medium and large businesses. For 1998 the total number of inspection was calculated by combining the data from the IFC survey of small business and the IRIS Regulatory Reform survey of medium and large businesses. 1999 figures were derived from the IFC survey and the MSI/ KIIS survey.

**Table 89**
**The Average Number of Inspections**

| | IFC, SIEAG, IRIS data | | | DAI NewBiznet data | MSI/ KIIS data[35] | | | |
|---|---|---|---|---|---|---|---|---|
| | Average | Small Firms (IFC Surveys) | Medium and Large Firms (SIEAG and IRIS surveys) | Small and Medium Firms | Small Firms | Medium Firms | Large Firms | Average |
| 1997 | 20.5 | 16.3 | 26.7 | - | - | - | - | - |
| 1998 | 13.8 | 9.6 | 22.4 | - | - | - | - | - |
| 1999 | - | 9.6 | - | 9.4 | 7.1 | 13.2 | 19.4 | 10.6 |

[35] This is average number of inspections by state agencies for a six month period prior to the survey. If the six-month rate were maintained for 12 months, this would imply an annual average of 21.2 inspections per firm.