

Disposal of a Production Project in Russia

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Abstract—Starting and running a business in Russia is significantly different from the same process Europe or the United States: it is much more difficult to dispose of a business than to start it, especially for unquoted companies. The inconvenience of liquidating direct investments is a serious barrier for foreign investors who are interested in the production sector of the Russian economy. In this article I would like to highlight the main challenges for the company's owners while disposing of a project and to share my practical experience of solving them in a production company in Russia. Firstly, I consider spotting the optimal time for such disposal depending on the company's strategy. Secondly, I show how to develop the plan for complete or partial exit from the project and to find a buyer. Then, I analyze the methods of calculating the fair price of a business project in Russia and the ways of convincing the buyer. I also describe the local specifics of the due diligence of the project for sale and the methods of maintaining confidentiality when preparing the transaction. Finally, I consider various ways of finalizing the deal from the legal and tax points of view. This article gives an entrepreneur the instruments to develop the exit strategy from a project in order to secure his direct investments in Russia.

Keywords—*business, business project, conclusion of transactions, direct investment, investors, entrepreneur, market economy, strategies.*

I. INTRODUCTION

In this article I would like to highlight the main challenges for the company's owners while disposing of a project and to share my practical experience of solving them in a production company in Russia. Firstly, I consider spotting the optimal time for such disposal depending on the company's strategy. Secondly, I show how to develop the plan for complete or partial exit from the project and to find a buyer. Then, I analyze the methods of calculating the fair price of a business project in Russia and the ways of convincing the buyer. I also describe the local specifics of the due diligence of the project for sale and the methods of maintaining confidentiality when preparing the transaction. Finally, I consider various ways of finalizing the deal from the legal and tax points of view.

This article gives an entrepreneur the instruments to develop the exit strategy from a project in order to secure his direct investments in Russia.

II. RESULTS AND DISCUSSION

A. Reasons for Taking off a Business Project

The process of starting and running a business in Russia is very distinctive from Europe or the United States: it is much more difficult to stop participating in a business project than to start it, especially in the companies not listed on the stock exchange. Although there are lots of other hurdles for developing projects in Russia (such as bulky financial reporting, high level of corruption, unfavorable changes of legislation, etc.), the issues arising from the sale of business have formed the most serious barriers for the foreign investors interested in the production sector of the Russian economy.

When starting a project in any country, an entrepreneur should have the exit strategy, I mean the strict plan stipulating when, under what financial, production or other circumstances he should sell this business, and what are the best ways to do it. Unfortunately, many Russian businessmen do not care about exit plans, or they hope their businesses will grow eternally and further will be passed on by inheritance. I think that both Russian businessmen and foreign investors should consider several situations when they should dispose of a business even if they are reluctant to do it.

The variety of disposal decision triggers is huge: the most common are the continuing losses, lack of finance and diminishing market share, with a possibility to lose this business unless you manage to sell it. In addition, a businessman may simply get tired of his project, may find a new, more interesting, not necessarily business-related activity, may wish to change his place of residence, retire, enter the civil service¹, get full-time employment. There may be also reasons related to family and health, but the most positive reason is the businessman's desire to leave the project at the peak of its profitability, seeing no possibilities to develop it any further.

The ability to recognize this peak and to make the disposal decision on time requires great strategic skills and exceptional courage. This is akin to closing a growing positive position on the stock exchange, but much more sophisticated, as it entails a long series of complicated actions.

In this article I would like to highlight the main challenges that the company's owners will face while disposing of a project and to share my practical experience of solving them in a production company in Russia in 2017. I hope this article

¹ This is, by the way, a convenient explanation for the business sellers who do not want to disclose the true reasons of the sale. See for details the Federal Law of Civil Service № 79-FZ of 27.07.2004 with amendments of 16.12.2019, Article 17 paragraph 3.1. Computer Law system Consultant Plus

http://www.consultant.ru/document/cons_doc_LAW_48601/e7b86a940bc71a71af7b9288590f1ca92a69d878/ accessed on 11.06.2020

will give the entrepreneurs the necessary guidance to develop the exit strategy from a Russian project for securing their direct investments.

B. Benefits of Timely Project Disposal

From the seller's point of view, the timely disposal maximizes his profits from the project or minimizes his losses (depending on the project stage) and solves his personal issues. For the buyer it is an opportunity to enter the project at the most convenient moment at the fair price.

For the project itself, changing the proprietor on time either opens a new development stage or saves the project from waiving. The benefits for the corporate finance market are also obvious, because successful business sale deals increase the liquidity of the market and, as a result, boost its investment attractiveness. The business community of the entire country benefits from improvement of business disposal infrastructure, which attracts new businessmen and capitals to the market.

As the timely disposal of a business project gives nothing but benefits to all the interested parties, let us analyze the main issues impeding the process. In my opinion, there are seven of them.

C. Main Issues of the Disposal

The first issue is to determine the appropriate moment, that means to set up the project's key performance indicators (KPI) and their critical values that should lead to the disposal decision. Based on my own business experience I strongly recommend to form the KPI system before entering any business project and to revise it on a regular basis.

The second issue is to develop the clear exit plan if it was not set up at the beginning of the project. The plan should have the strict schedule, time limits for the negotiations per each prospective buyer and per the whole process. Upon setting up the plan can be changed in detail, but the time frame should be complied with thoroughly.

The third issue is to calculate the real value of the business project and to determine its sale price based on this value. At this stage the project owners should forget about the historical cost of investments and consider the market price affordable by a potential buyer. Setting up the price corridor could be the best way.

The fourth issue is to choose the buyer searching engines, to prepare the essential information for the engines, to find the prospective buyers and to conduct the preliminary negotiations with them.

The fifth issue is to conduct the due diligence of the project: to determine the optimal amount of information for sharing with the prospective buyers, to organize the due diligence process minimizing the risk of a hostile acquisition during the process.

The sixth issue is to maintain the confidentiality of the prospective deal from the company's staff, from the clients, suppliers and other stakeholders until the moment the sale is finalized.

The seventh issue relates to the process of the deal execution, transfer of the title deeds and the instruments of control.

D. Spotting the Right Moment

It is easy to decide on disposal of a business with the continuous losses for several years, or when its revenue and market share are declining, or when the business is under attack of a hostile buyer (raider) so that the owner has faced the "sell or lose" choice. This marks that the most appropriate moment for disposal has been missed.

To prevent such "easy" decisions the business strategy should be stated at the beginning of the project along with the project goals for quarters and years and with the KPIs. The strategy should describe the project parameters that stipulate the exit. The regular revision of the strategy helps the owner to catch the moment when the project passes its peak.

In the considered Russian project the strategy was formed at the beginning, but unfortunately it was not corrected according to the business environment changes. In 2005 a production of dry construction mixtures (DCM)² was established as a separate company on the premises of a financially unstable plant in the Krasnodar region (Russia). The risk underassessed by the founders was the sale of the main plant due to its financial problems.

The new owners of the main plant tried to improve its cash flow by means of increasing the rental rate for the successful tenant and threatening to take the project over aggressively. At that moment it was impossible to sell the DCM business to a third party because it would have inherited the dependence on the main plant.

In 2013 the DCM project's owners were forced to relocate the production line to another part of the region. Although the transfer was long, hard and expensive, the business was saved from the waiver or acquisition, but the owners did not think of its disposal because the new place offered the new opportunities.

In 6 months after the business relocation the DCM market conditions changed significantly as Russia incorporated the Crimea and thus the economic effect of the Sochi Olympic Games-2014 appeared lower than expected. The federal government investments were rearranged to the Crimea, the private investments declined due to the sanctions effect. That's why the DCM market of the Krasnodar region began to squeeze, and in the summer 2016 the sale of the considered project became essential.

E. Development of Exit Plan

In my opinion, the development of business disposal plan consists of: spotting the length of the process, the range of potential buyers, the length of negotiations for each buyer, considering the partial exit opportunity, calculating the fair price, choosing the buyers' search engine, quality check of assets and liabilities, adjustments for the materials' supply plan and the production plan.

In the considered project the initial exit strategy of 2005 was very simple: to sell all the raw materials, finished goods and equipment if the business is blowing up within 3 years from start. However, by the year 2016 the project became a

² Dry construction mixtures – a technology that became popular in construction industry in the second part of the XX century. The construction materials are produced mostly of cement, gypsum, sand and polymers as a dry mix and then mixed with water on the construction site just before their application.

complicated system with 12 types of products, 50 kinds of raw materials, 2 production lines and various intangible assets. It was not easy to sell all these assets fast and separately.

In the summer 2016 when DCM market conditions changed tremendously, the owners decided to sell the business. As this project was suffering the lack of finance most severely in winter, the length of the sub-project "Business disposal" was set up as 6 months.

The first prospective buyer appeared the next day after publishing the sale advertisement, but it was a big company with a slow decision-making. Having spent 2 months in useless contemplation, the project owners spotted the other 5 prospective buyers. All of them were from the construction industry: some were bigger production companies, and some were the wholesalers. The choice between producers and wholesalers was made in favor of the latter because they were less experienced in production issues, so they were not that afraid of the drawbacks of equipment and raw materials supply that the project suffered.

The next stage – the comparison and final selection of the potential buyers relates to the opportunity of partial exit from the project. It should be noted that some buyers were not interested in the complete takeover, because they needed the expertise of the current management in the production and technology issues. At the same time all partial exit opportunities implied the transfer of the controlling stake to the new owner and the change of CEO and chief accountant. In Russian business environment it would have caused the complete loss of control on the profit distribution, so the project owners refused partial exit in September 2016 and this narrowed the choice of the best buyers from five to two. Thus, the appropriate length of negotiations for each of them was set from 2 to 4 months.

F. Determination of Fair Price

During the 26 years of my business career I was involved in numerous mergers and acquisitions projects. I noticed that Russian business sellers usually tried to determine the fair price as based on the historical cost of their investment plus some profit. Hardly they perceived the market price as the price affordable by a potential buyer. That is why the sellers in Russia often used to miscalculate the lower edge of the price corridor and thus they have difficulties in proving this level to the potential buyers.

According to the official standards of business assessment in Russia³ the business shall be value by a licensed assessor using one of the following three treatments: discounted cash flow (or profit), comparative method and historical cost method.

It sounds strange, but discounted cash flow method gives the less precise result in Russia due to rapidly changing legal and political environment and to the weight of discount factor determined by the assessor at his sole discretion. The existence of signed contracts with major customers does not guarantee the future cash flows, because it is difficult to sue the customer for not buying the contracted amounts (if you are not a monopoly like Gazprom, of course).

Comparative method is also less reliable than it seems because it is hard to find the comparable enterprise being sold in the market. When you find such a business, you cannot prove its relevance as the published financial reporting does not give you all the relevant information. For unquoted companies (LLC) the published reporting can be out of date or they can avoid publishing it. Also, the real values of merger & acquisition deals are usually kept in secret for such companies.

That is why historical cost appears the most reliable method of business assessment in Russia and is commonly used. But does it give the fair price? Usually not, as the businesses are often being sold with risks which deteriorate the cost of initial investment. The historical cost is rather a benchmark for the seller indicating the lower edge of price corridor.

Setting up the price corridor makes the negotiations smooth, flexible and time-based. The only problem is that business buyers in Russia frequently have quite a different view on the corridor's lower edge. Traditionally, the minimum price of a business here is the market (disposable) value of fixed assets plus the market value of raw materials' and finished products' inventories. The higher edge of price corridor depends on the lack/surplus of finance for the project's current operations, on the risks hidden in the company's financial reporting and the depth of understanding these risks by the buyer.

G. Choosing Buyer's Search Engine

Before choosing the method of the buyers' chasing, the selling text should be written indicating the most attractive parameters of the project, except for those that can clearly identify the company. Although the secret will be revealed after the buyer's first visit to the production site, it is better not state the company's name in the selling advertisement, because it can deteriorate the company's reputation in the way that we will explain in the next chapters. In the considered Russian project the owners stated the city of the company's location, the distances to the main suppliers and customers, the production outline and capacity and the main intangible assets.

Then the project was offered for sale within the professional circle via a publication in the professional newspaper. At the same time, it was offered to the professionals interested in it the previous years, especially to those who used to have the joint projects with the company. Failing to reach the success within 3 months, the owners published the announcement first in the websites specializing on business sale. Surprisingly, the real buyer came only after the publication on Avito⁴.

H. Due Diligence

After acceptance of the preliminary price by the potential buyer the next stage is due diligence. This stage of business disposal, in my opinion, is the most tricky and controversial. First of all, what is implied by this term? According to the Cambridge dictionary definition, due diligence is the detailed examination of a company and its financial records, done before becoming involved in a business arrangement with it⁵.

³ The Order of the Ministry of Economic Development of Russia № 326 of 01.06.2015 on setting of the Federal Standard of business assessment № 8. Official site of the Ministry of Economic Development of Russia <http://economy.gov.ru/minec/activity/sections/corpmanagment/activity/201506101> accessed on 11.06.2020

⁴ Avito - the Internet service for posting sell/buy announcements of goods and services from individuals and companies, ranking second in the world and the first in Russia among online classifications

⁵ Cambridge dictionary, <https://dictionary.cambridge.org/ru/due-diligence> accessed on 11.06.2020

Although the process consists of financial audit, business assessment and legal assessment, Russian bidders are mainly concentrated on the risks of the target company, such as: the relationships with the authorities, the existence and amount of tax claims, the exposure to money-laundering risks and aggressive tax optimization risks, the possible ecological harm from the company's activities, the risks of the formation documents of the company, the relationships between the co-founders and their legal grounds. The importance of the abovementioned issues in Russia is justified because each and any of them can devalue the price of a company to nil due to the inadequate actions of the state authorities and the slowness of the litigation process.⁶

That is why in Russian due diligence the buyer would like to prove that the business really exists and is being run on the legal grounds and will not be demolished by the state authorities, creditors or third party claimers in the next 12 months. The aim of the target company is to finish the process as fast as possible without showing the confidential or vulnerable information about the business to the potential buyer. The considered Russian company has gained the negative experience of a due diligence being turned into a hostile acquisition.

As the buyers are usually under time pressure, they are starting the due diligence by themselves from the information that can be easily accessed online free of charge: the extract from the Unified State Register of Legal Entities (<https://egrul.nalog.ru/>), the amount of taxes paid, the amount of tax claims⁷ the participation in court proceedings (<http://arbitr.ru/>), in law enforcement proceedings (<http://fssprus.ru/>), professional reputation. Actually, these open sources do not give much to an amateur researcher, they just point to the existence or absence of the main legal, tax and money-laundering risks. Understanding what is underneath the figures needs some professional expertise, for example, using the tax calculator in "Transparent business" web-service one needs to know the average level of taxes paid by the companies of the same size of the same industry to decide whether the target company is underpaying the taxes.

The second stage of the due diligence (for some bidders it is the first stage) is the bidder's personal inspection of the of the company's headquarters (production site, office). Sometimes the target company's management is afraid to show the production line and warehouses to the bidder, trying to avoid the technological secret's disclosure. In my opinion, such a secrecy is useless, cause the know-hows are set by the properly made technical documents and cannot be seen in 10-15 minutes excursion. This personal visit of a bidder not only strengthens the trust between the parties of the future deal, but also shows the level of the production and service of the target company, its corporate culture, and the level of its personnel.

The third stage of due diligence depends on the level of trust between the parties and usually includes surrendering the financial documents from the seller: the necessary breakdowns to the balance sheet and profit and loss account (as these two reports made under Russian accounting standards do not give enough information), some management accounts related to profitability and liquidity of the business,

patents, product prices, fixed assets' purchase agreements. The seller has to agree for such a disclosure, because he understands that official financial reporting of a Russian firm is not designed for management information. At the same time, he is exposed to the hostile acquisition risk since the detailed profitability information can allow the bidder to copy the business model without buying it or to take over the business by means of misappropriation of its management information.

I. Methods of Keeping Confidentiality

The Commercial secrets Law was adopted in Russia in 2004, and a lot of court decisions based on it have appeared by the end of 2010s. According to this law any information can be deemed a commercial secret provided that it suits all of the following conditions:

- it must have a commercial value;
- it must be unknown to the third parties;
- the access to it should be restricted;
- a trade secret regime should be introduced in respect of this information by its possessor⁸.

It sounds strange, but a lot of Russian businessmen still do not believe that non-disclosure agreements in Russia can actually save the trade secrets in business-to-business cases, because they think it is very difficult to prove the leak of confidential information through your counterparty (e.g., prospective buyer). The recent arbitration practice in Russia proves the fallacy of such an opinion, as long as the possessor of a trade secret introduces the trade secret regime on his vulnerable information and stipulates it in any agreement which implies the transfer of such information to the counterparty.⁹

The other reason for the non-disclosure agreements' failure lies on the seller's personnel side. Your people can lose their motivation to work or can start searching for the same job with the competitors as soon as they notice their employer company is on sale. This situation will create the rumors of the future deal in the market and will affect adversely the market value of the project. So first you need to come up with a plausible legend for your employees (such as: attracting a new partner to your business, thinking about a tolling scheme, preparing for a bank loan, considering other forms of cooperation) and instruct the potential buyer to maintain the legend while he is communicating with your staff.

As for the clients of the business project on sale, the Russian contracts usually do not provide for any covenants to notify the counterparty about the change of the business ownership, so the clients of the seller will be the last ones to know about the deal. In order to minimize the risk of disclosure on the seller's side, the seller should not involve his employees in the preparation of the share purchase agreement and supplement documents.

J. Registration of Transactions

On the last stage of disposal process the parties should decide on the technique of the deal execution and the way of

⁶ See for details "Insufficient protection of land users' rights in Russia", the article in "International Journal of Civil and Trade Law", Moscow, Russia, #2 of 2019, pp. 36-45: ISSN 2449-2541

⁷ These two parameters can be found via the recently developed option on the Federal Tax Service web-site called "Transparent Business" - <https://pb.nalog.ru/> accessed on 11.06.2020

⁸ Article 10 paragraph 1 of the Federal Law of 29.07.2004 № 98-FZ "Commercial Secrets Law". Computer law system Consultant Plus accessed on 11.06.2020.

http://www.consultant.ru/document/cons_doc_LAW_48699/0ca1b144b64eaa68cd80ca51ad37ac4047c47775/

⁹ See for example the decision of Novosibirsk region Arbitral Court for the case A45-47738/2018 of 29.03.2019 <https://sudact.ru/arbitral/doc/mCA2tuzoidK/> accessed on 11.06.2020

transfer the title deeds, the money and the company's management tools. There are two major ways of passing the share in Russian limited liability company (LLC): acceptance of a new partner into the partnership with the consecutive release of the old one or selling the share from the old partner to the new one.

The second way appears to be the most convenient: the documents are checked by the notary whose obligation is also to register the deal with the State register, so all the process can take 7 days from the date of the parties' agreement. If we consider the first option, it will save the notary duty, but it will force the CEO of the company on sale to prepare and surrender all the documents to the State register by himself and this could last up to 1 month.

The share on sale should be first offered to the LLC itself and to its remained partners (if any) at the price of the proposed deal since their preemptive right is stated in the company's articles of association. The deal between the seller and the external buyer can proceed only if the LLC and the other existing partners refuse to buy the share within 30 days from the offer. In the considered Russian project this rule was easily evaded as the seller was the 100% owner of the company and he was its CEO at the same time, so the share was offered to the company one day and the next day the CEO signed the refusal, making the process of the deal smoother and faster.

The next barrier for the prospective deal is the obligation to notarize the share purchase agreement¹⁰ and, in case one of the parties is an individual, to receive the notarized spouse waiver before signing the agreement. The notarization of the deal has some benefits as well: the notary certifies the process of the consideration transfer (especially if it's cash which is quite common in Russia) and the registration of the deal with the state authorities is also the duty of the notary. During the 7 days stipulated by the law for deal registration the seller should surrender to the buyer the corporate seal, the electronic keys from the bank account and other e-signatures, the internal documentation and technological secrets. The deal becomes valid for the buyer and the seller as soon as it is notarized and for the third parties since the day of its official registration. At this day it's the right time for the seller's directors to resign.

The delicate point of the deal is whether to state its full amount in the share purchase agreement or not. Stating the full amount protects the buyer in case the deal being proclaimed null and void by any court later and also simplifies the financial accounting of investment cost. At the same time Russian sellers usually prefer not to show the full amount of the deal in order to reduce their own income tax. The Russian Tax Code relieves all the amount of money received by the seller from the income tax only if the sold share had been in his possession uninterruptedly for more than 5 years.¹¹

In order to resolve this controversy, the parties could agree to show lower amount in the share purchase agreement and account for all the rest in the supplement agreements, for example, as consideration for the internal loans' assignment or for the trade mark transfer.

III. CONCLUSIONS AND SUGGESTIONS

My business experience proves that taking off a non-listed production company in Russia is a long and difficult process. The most common reasons for taking off are the continuing losses, lack of finance and diminishing market share. The other reasons could be the businessman's tiredness of his project, change of residence, retirement or entering the civil service.

During the process of business disposal there are 7 major issues to solve:

- to determine the appropriate moment;
- to develop the exit plan with the tough schedule;
- to calculate the real value of the business project and to determine its sale price based on this value;
- to choose the buyer' searching engines, to prepare the essential information for the engines, to find the prospective buyers and to conduct the preliminary negotiations with them;
- to conduct the due diligence of the project;
- to maintain the confidentiality of the prospective deal;
- to execute the deal, to transfer of the title deeds and the instruments of control.

In my opinion, the most crucial issues are the determination of appropriate moment for sale and conducting the due diligence, avoiding a hostile acquisition at the same time. For improving the situation, I suggest the following.

Firstly, the business strategy should be stated at the beginning of the project describing the values of its key parameters that stipulate the exit. The regular revision of the strategy is necessary as the economic environment and legislation in Russia are changing too fast.

Besides that, Russian businessmen should rely more on the non-disclosure agreements, setting up the confidentiality treatment on the documents being passed in the process of due diligence. The official online services like "Transparent business" could show more relevant and up-to-date information about business counterparties, including the suggested average values of economic indicators (e.g. taxes paid) for the relevant businesses.

Thirdly, the process of deal execution should be accelerated by means of digitalization. It relates not only to the amount of documents presented by the buyers and sellers to the notaries (now mostly in paper mode), but also to the amount of paper documents presented to the Tax service in order to settle some disputes during the due diligence, to receive some confirmations or simply to waive a company inside the sold business structure that does not make the part of the deal.

I think these measures will change the business environment in Russia and remove the most serious barriers for the foreign investors interested in the production sector of the Russian economy.

¹⁰ Article 21 paragraph 11 of the Federal Law # 14-FZ on LLC of 08.02.1998 – Computer law system Consultant Plus accessed on 11.06.2020 http://www.consultant.ru/document/cons_doc_LAW_17819/0a525c7e819fb19114001672d79d782c72f55caf/

¹¹ Article 217 paragraph 17.2 of Russian Tax Code. Computer law system Consultant Plus accessed on 11.06.2020 http://www.consultant.ru/document/cons_doc_LAW_28165/625f7f7ad302ab285fe87457521eb265c7dbee3c/

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