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Content of this issue:

→ Law

Special features for using the “Drag-along” and “Tag-along” contractual structures according to the Kazakhstani Legislation

→ Accountancy

IFRS 16 “Leases” – changes in accounting of leased facilities

→ Audit

From experience: IFRS 9 “Financial Instruments”

→ About us

→ Law

Special features for using the “Drag-along” and “Tag-along” contractual structures according to the Kazakhstani Legislation

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The increased integration level of the Republic of Kazakhstan at the world market has largely led to development of the relations between Kazakhstan and foreign companies, and consequently to the increased number of the cross-border transactions using the foreign contractual structures. This article we cover the “Drag-along” and “Tag-along” contractual structures as widely used in English law, and turn the attention on permissibility for their using according to the Legislation of the Republic of Kazakhstan.

DEFINITION

“Drag-along” contractual structure enables a company majority shareholder (partner) to force the remaining minority shareholders (partners) to accept and join the offer from the third party for acquiring the whole company or its major part. The majority shareholder who is literally “dragging along” (English – “Drag”) other shareholders must give the minority shareholders the same price, terms, and conditions of the transaction, as those offered to the majority shareholder. Purpose of this contractual structure is to simplify the process of withdraw of the majority shareholder from the company. In many cases, the buyers are willing to acquire 100% (percent) of the business and do not agree to having a part of shares owned by the minority shareholders which complicates the company selling by a majority shareholder. It is also relevant to note that in many cases the foreign investors act as the majority shareholders, this significantly increases the relevance for using the “Drag-along” contractual structure for such investors. Thus, the “Drag-along” is aimed at protecting the rights of the majority shareholder, by enabling a majority shareholder to sell the whole amount of shares to a certain company. Meanwhile this tool protects the rights of the minority shareholders, by guaranteeing the same transaction conditions as stipulated for the majority shareholders.

There is also a contractual structure “Tag-along” which is converse to the “Drag-along”.

Principle of this contractual structure is that when majority shareholder sells their shares or equity share, a minority shareholder is authorized to join such a transaction on the same terms as those involved for the majority shareholder. Thus a minority shareholder is literally “tagging” (English – “Tag”) to the transaction of a majority shareholder. This contractual structure is aimed at protecting the rights of the majority shareholders, by enabling to invalidate the transaction of purchase and sale of the company shares against the claim filed by the concerned parties, if the rights of the minority shareholders have been violated during such transaction.



APPLICATION

There are no special provisions in the legislation of the Republic of Kazakhstan which specifically regulate the concepts of the Drag along deal (right to force for the joint sale) and the Tag along deal (the right to join the sale). However, the provisions are prescribed in the Law of the Republic of Kazakhstan “On the Joint-Stock Companies” as similar to the contractual structure of “Tag along”. Its principle is that if 30 percent or more of the shares of the joint- stock company are sold, the buyer of these 30 and more percent of the shares must publish an offer for selling the company shares owned for the remaining shareholders in the mass media. Shareholder has the right to accept an offer for sale; however this provision does not entail the ob-

ligation to sell the shares, as distinct from the requirements of the “Tag-along” contractual structure.

As a rule, these contractual structures considered are applicable to the joint-stock companies. However, they can also be used in relation to the economic partnerships, particularly the limited liability companies (partnerships) due to prevalence of this form of business entity. If it is prescribed in the constituent documents of the company that sale of shares to the third parties is permitted only subject to certain terms and conditions, we shall consider that the requirements above may be such conditions.

We are of the opinion, in this context it is also relevant to note the pre-emptive right of the shares alienated by the other shareholders of the company as provided by the legislation of the Republic of Kazakhstan. Thus, in case of sale of an equity share of the company to the third party, other company shareholders have the pre-emptive right for purchasing such share at the same price and on the same terms and conditions as offered to the third parties (except for the case at public auction).

SUMMARY

Drag along deal and Tag along deal do not have any identical analogues in the legislation of the Republic of Kazakhstan. However, this is allowed to use the considered contractual instruments in

Kazakhstan under the Article 25 of the Law of the Republic of Kazakhstan “On the Joint-Stock Companies” and the freedom-of-contract doctrine as prescribed by the Civil Code of the Republic of Kazakhstan. The said principle enables the parties to independently determine the terms of the contract and the contractual model not inconsistent with the requirements of the legislation of the Republic of Kazakhstan.

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→ Accountancy

IFRS 16 “Leases” – changes in accounting of leased facilities

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International Financial Reporting Standard (IFRS) 16 “Leases” became effective on January 01, 2019, and superseded the Standard, IAS 17 “Leases”. This article will provide a more detailed consideration of changes in relation to the lessee companies. We would like to note that there were no changes made in relation to the lessors.

GENERAL PROVISIONS

Entities shall apply this Standard to all leases, including leases of right-of-use assets in a sublease, except for the assets related to the exploration and use of the mineral resources, biological assets, service concession agreements, intellectual property licenses, including such items as films, video records, patents, and copyrights. In addition, IFRS 16 is not applicable to the leases for a period of less than twelve (12) months and low-value asset leases¹.

Entities those having any leased facilities, such as office, warehouse, vehicles, use the said assets for a long time. However, generally these entities intentionally sign the lease contracts for a term not exceeding twelve (12) months. Upon expiry of this period, a new contract is signed for a new period not exceeding twelve (12) months too. This allows entities considering such contracts to be short-term contracts, recognizing expenses of the lease payments as a part of the operating expenses and showing these expenses in the financial statements as and when such expenses are incurred.

IFRS 16 “Leases” appeals for increasing/improving transparency of financial information by showing the lease payment obligations for the entire expected lease period. In other words, if an entity has been renting an office space for several years and plans to stay in this office for several more years, then users of the fi-

ancial statements must be notified about the obligations of lease payments which will consistently be made in the next few years.

Thus, stakeholders will be able to reliably assess the financial condition of an entity, by understanding what part of the financial resources will be used to pay the rental expenses.

It is not only the obligations of future payments to appear in the Balance sheet, but also the assets in the form of right to use this lease facility (item).



IMPACT ON THE FINANCIAL STATEMENTS

Significant growth of assets and liabilities of an entity in applying the IFRS 16 may affect various performance indicators of concern to both the external and external users of the financial statements.

Thus, for example, the asset turnover ratio in cases of use of the assets value will be lower than when accounting lease under the IAS 17. Profitability ratio of the equity capital will also be lower in the first reporting periods, due to the decreased amount of net profits. Interest and depreciation expenses will increase quite materially in the comprehensive income statement, thereby reducing the operating lease expenses.

¹ Threshold of value is not determined in the Standard IFRS 16, however, it suggested to consider assets to be such, where value of assets is less than US Dollar 5,000.00.

The short-term part of lease liability which is considered as a part of the current liabilities of an entity will cause decrease of the current liquidity and amount of the working capital.

However, in this case the financial stability ratios will increase, as an amount of liabilities is used when calculating them, where a significant amount has been added.

Therefore, it will be critically important to determine the key performance indicators of an entity.

RECOGNITION ACCOUNTING

When introducing and implementing the IFRS 16, an entity must clearly determine: whether a contract or its components is a lease contract. To do this, an entity must understand whether a right to control the use of a leased asset is transferred under such contract in exchange for compensation, as follows:

- does an entity receive almost all economic benefits from the use of such asset and
- does an entity have the right to determine the method for using such asset.

It is important to analyze the potential exceptions to the scope of use of this Standard.

Initial recognition² of an asset and lease obligation shall be done on the first day of the contract term.

IFRS 16 suggests the use of one of two transition methods: full retrospective approach or retrospective approach with the cumulative effect.

In case of using method of full retrospective approach, it is necessary to review the financial position at the beginning of the comparative period, as if IFRS 16 had been applied from the beginning of the lease contract term.

Method of the retrospective approach with the cumulative effect is less expensive. The first day of the period where the IFRS 16 is used will be the date of initial application. This means that the data in the comparative period will remain unchanged. Although this method saves time, however the comparative data are incomparable, thus it is required to additionally disclose information about the impact of use of this approach in the notes to the financial statements.

As all companies and entities those declaring to keeping the accounting in accordance with the international standards are required to show the available assets and liabilities in a timely manner, it is recommended to introduce the accounting of the company's leased facilities using IFRS 16 "Leases" as soon as possible.

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² First of all, it is required to calculate the obligation which is measured in the amount equal to the present value of the outstanding lease payments during the contract period using the discount rate. Right-of-use assets is measured at initial cost which is determined as the amount of the initial measurement of the lease liability and any lease payments paid to the lessor on or before the start date of the contractual relations, any initial direct costs incurred by the lessee, and estimated measurement of costs for dismantling and liquidation minus the incentive payments received.

Generally, the discount rate is not specified in the lease contracts, and it becomes quite difficult to determine such discount rate. Therefore, it is necessary to use the borrowing rate with the same terms and conditions as in the lease contract. In other words, as if an entity/company had attracted the loan financing for acquiring of this asset.

→ Audit

From experience: IFRS 9 “Financial Instruments”

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Calculation and recognition of the of expected credit losses to be recognized is one of the major issues of the financial assets accounting, including the accounts receivable. Application of IFRS 9 will be covered in this article in terms of calculation of the expected credit losses.

Risk of non-payment is increasing in the light of the blurred economic prospects. In this regard, for example the business accounting is very critical and important, as the foreign subsidiaries have to present the actual cost of their local requirements as accurate as possible. This is why we would like to cover the Standard IFRS 9 in more details.

DEFINITION

IFRS 9 “Financial Instruments” has been introduced from January 01, 2019 which provides for a fundamentally new model of impairment of the financial instruments – a model of the expected credit losses.

According to this Standard, the companies are required to consider the historical, current and forward-looking information, including the macroeconomic data. This will result in an earlier recognition of the credit-related losses, as in this case the companies do not have to wait until the losses are actually incurred for their recognition.

New requirements for accounting for the impairment are aimed at eliminating the problems that arose during the financial crisis of 2008-2009 which is associated with the criticized approach of IAS 39. According to this Standard, impairment of the financial assets was not recognized until appearance of an objective evidence of such impairment. A model of the expected credit losses (ECL) is used in IFRS 9; this model comparatively differs from the incurred loss model as estimated according to the IAS 39.

The expected credit loss model (ECL) is more appropriate to the economic value of the financial asset; it is more relevant during the economic decline. However, the three-stage recognition of the credit losses requires the advanced modeling skills and high-quality data, and due to this reason – quite complicated and expensive task for the majority of banks, financial organizations and other companies.

APPLICATION

There are three different approaches distinguished for using the ECL model:

- *Simplified approach*, it is applied in relation to the trade receivables, lease receivables and contract assets;
- *General approach*, it is applied in relation to all the financial assets classified at amortized cost or fair value (through the comprehensive debts income), and issued loan liabilities and financial guarantees covered by the scope of new requirements;
- *Approach to the purchased impaired loans*, it is applied in relation to the financial assets which are an impaired loan at initial recognition.



According to the IFRS 9, the credit losses are recognized by showing a valuation allowance for expected credit losses for all items exposed to the credit risk. Valuation allowance is to be revised at each reporting date considering changes in the expected losses.

It is stated in some information and guidelines that according to the IFRS 9, allowance for the financial assets impairment must be accrued directly during the initial recognition. However, such requirement is not stipulated by the IFRS 9. According to the Paragraph 5.1.1, at initial recognition, an entity shall measure a financial asset at its fair value plus transaction costs that are directly attributable to the acquisition or issue of

the financial asset. In this case, allowance for impairment of the financial asset shall be recognized at each reporting date.

Such an approach is explained by the fact that at initial recognition of an asset, the expected credit losses are implicit in the initial measurement of the instrument. In the subsequent periods, the price shall not be adjusted for changes in the expected credit losses. Therefore, these changes are the economic losses of the financial asset in the period when an event occurred.

IMPACT OF THE GLOBAL CRISIS

Current market situation which resulted from the Covid-19 pandemic, massive drop in the oil prices and global response in the form of closing of the state boundaries will have severe social and economic impacts and consequences. Due to this reason, credit risk of many organizations will increase, which may lead to the default situations. Currently the companies must carefully evaluate all risk factors which may cause deterioration in the credit quality of the financial assets and recognize the

relevant allowances. Considering a global impact of the crisis on financial markets, it is reasonable to expect that the credit risks are increasing significantly.

Therefore, from our point of view in order to avoid bad debts, it makes sense to identify such risks at an early stage as part of a special purpose audit and to determine how a company life-sustaining activity may be affected by collapse of oil prices, volatility of the respective national currency and brewing economic crisis.

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→ About us

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Rödl & Partner assists you in Kazakhstan and Uzbekistan from our offices in Almaty and Tashkent. Our team of Kazakh, Uzbek and German attorneys, auditors and tax consultants has successfully supported our clients since 2009 in all investment and project-related matters in the two largest and promising markets of Central Asia – in German language and from a single source.

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