Franchising Road Map

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I Introduction

Discussion of key issues related to the business environment in Ukraine

A. HISTORICAL BACKGROUND

The first decade of independence in Ukraine has brought significant political, social and economic changes to the country. The transition from a communist-ruled and planned economy to a free, democratic and market-oriented economy has been marked by the introduction of new ideologies, business practices and social expectations.

Economic development in Ukraine has been erratic and unstable, which is consistent with the dynamics of a transitioning economy. Large-scale privatization of small and medium state enterprises and state-owned property effectively transferred ownership to the private sector, and stimulated the development of small and medium private enterprises. Exposure to western goods and services, as well as increased consumer market demand, generated an increase in domestic production of goods based on western technologies and stimulated the development of a service industry. Consumer demand for better quality and price value of goods and services created a healthy competitive environment between local companies.

Continued economic development has created a wide-range of business opportunities in all industry sectors with low wages and increased levels of unemployment in the public sector forcing much of the population to seek new opportunities in private industry. Most of the development has been in the area of small businesses and private entrepreneurship. Small shops, cafes, bars, restaurants, service providers, kiosks and small manufacturers account for the majority of all development. Unfortunately, most of the individuals managing these businesses have no formal business or management training, with most business knowledge acquired on-the-job. Additionally, the unstable and conflicting legal and tax infrastructures have made operating a private business complicated, cumbersome and problematic.

The above not withstanding, the evolution of the business environment in the last decade has resulted in significant positive changes. Furthermore, the very challenges faced by small businesses (such as the lack of proper training, lack of efficient bank financing and lack of basic knowledge on how to start and operate a small business), tend to make proven franchising models highly attractive as they can decrease risk while simultaneously meeting the needs of small business development in Ukraine.

B. LEGISLATION & BANKING SYSTEM

Franchising, as traditionally understood in the west, does not exist in Ukraine. In addition, although current legislation does not address franchising specifically, standard regulations governing commercial activity and intellectual property do provide a framework under which franchise-type commercial relationships can exist. Currently this is addressed by using two separate contractual documents, a franchise agreement and a license agreement. A franchise agreement specifies the terms and conditions of the business relationship as a standard commercial contract between two legal entities. It does not address "royalty" payments. A license contract gives the "franchisee" the right to use the intellectual property (trademarks, patents, designs, know-how, etc.) under specified terms and conditions, territory and duration, which in turn forms the legal basis for payment to the "franchisor" of the "royalty". These will be discussed in more detail in Section II.

Franchising has not yet developed in Ukraine as an active form of small business development due to an absence of a strong legal framework and an unstable political and economic climate. The Ukrainian Parliament is currently drafting legislation to better address the franchising issue. In June 2000, the Verkhovna Rada adopted the Draft on the Commercial Code of Ukraine in its first reading. This document contains Section 36 "Transfer of Exclusive Rights (Franchising) to Use in Entrepreneurial Activities", which describes the franchising agreement, its form and registration procedures as well as specifies the sub-franchising concept, the rights and obligations of the right-owners and right-users, the order of remuneration, etc.

In June 1999, the Draft on the Tax Code of Ukraine was submitted for consideration to Verkhovna Rada of Ukraine, which adopted it in the first reading in July 2000. The draft defines the royalty concept. Chapter 1 "General Conditions", Section 16 "Taxation of International Operations" includes the paragraph "Taxation of Nonresidents", which specifies the tax payment scheme and tax rate.

As early as December 1996, the Draft on the Civil Code of Ukraine was submitted for consideration to Verkhovna Rada of Ukraine. In March 1997, Verkhovna Rada adopted the draft as a basis and in June 2000 approved it in the second reading. Volume 4, Rights on Intellectual Ownership, chapter 3 "Rights on Individual Assets of Participants in the Civil Turnover of Goods and Services" specifies the legal issues on firms' attributes (legal name and address) and trademarks. As the core of franchising relations, these juridical issues are obligatory for use in the franchising agreement. In addition, volume 5, Commitment Law, chapter 3 "Types of Commitments" contains section 75 "Franchising", which specifies the principles of franchising relations in line with the principles of the Draft of the Commercial Code of Ukraine.

Ukraine's President has declared the critical importance of the above mentioned drafts. This means that much attention will be given to the adoption of these legal Acts.

Another significant impediment to the development of franchising in Ukraine is the banking system. Currently, long-term loans (in excess of three years) are unavailable, interest rates are unfavorable and loan security requirements are exorbitant. Problems with the banking system, combined with a lack of transparency of personal incomes, make it difficult for franchisers to properly qualify prospective franchisees. In short, those who have the money to invest are not interested in becoming owner-operators and those who would like to own and operate a franchise do not have enough cash, nor can they borrow sufficient amounts necessary to meet the requirements set by a franchisor.

C. STATUS OF FRANCHISORS CURRENTLY OPERATING IN UKRAINE

International companies operating in Ukraine are doing so in the form of an exclusive distributorship awarded to local Ukrainian companies, and have either opened fully corporate-owned operations in Ukraine or have entered into licensing contracts. Some examples of franchises include:

- McDonald's Ukraine (wholly owned corporate)
- Coca-Cola Ukraine (wholly owned corporate)
- Coca-Cola Beverages (bottling franchise agreement)
- Hertz Car Rental (Franchise Agreement)
- Fuji (exclusive distributorship)
- Baskin Robbins (license agreement)
- American Cleaners International (Joint Venture and Franchised; see Annex 6 for full case study).

Although several internationally renowned companies do have a presence within Ukraine, when one considers the size of the market and the broad range of international and potentially domestic franchise opportunities, Ukraine remains an untapped market for the development of franchising. However, for those franchisers interested in entering the Ukrainian market, the complexities of doing business in Ukraine and the ever-changing legal and economic environment make it advisable to seek professional business, legal and tax consultation. Conducting business in Ukraine is still challenging and demanding. However, that being said, the opportunities of a relatively open market can bring significant rewards in the future as well as assist franchisers in expanding their business internationally.

II Legal Forms of Business in Ukraine

A. JOINT STOCK AND LIMITED LIABILITY COMPANIES

Joint stock companies, limited liability companies and representative offices are the forms of business representation most commonly used by foreign investors in Ukraine. They also, currently, offer the most promising potential by which to establish a franchise long term. As such, they will be discussed first.

Joint stock companies

A joint stock company is a legal entity for which capital is divided into a specified number of shares and which must have at least two shareholders. The company owns the assets of the joint stock company, with shareholders enjoying certain rights from ownership of the shares such as the right to receive dividends, participate in management, and receive a share of residual assets upon liquidation or dissolution of the company.

There are two types of joint stock companies –"closed" joint stock companies and "open" joint stock companies. Shares of an open joint stock company are distributed by means of open subscription and are subject to purchase and sale at stock exchanges. Shares of a closed joint stock company are distributed privately among its founders and may not be sold on the stock exchange. However, a closed joint stock company may be converted into an open joint stock company by amending its articles of association and founding agreement followed by proper re-registration. In the West, open companies are commonly referred to as "public" companies and closed companies are referred to as "private" companies. Joint stock companies must register the issuance of shares with the State Commission for Securities and Stock Exchange.

As of 1 April 2001, the minimum capital requirement for a joint stock company was set at UAH 147,500 (approximately $27,900), requiring at least 50% of the share capital of the joint stock company be paid before the company is registered. Shareholders' liability is limited to the amount paid for the shares. The statutory bodies are the general meeting of shareholders and a Board of Directors, which is responsible for the day-to-day management of the company. The shareholders may also decide to appoint a supervisory board to oversee the actions of the directors. The appointment of a supervisory board is compulsory for companies consisting of at least 50 shareholders.

Limited liability companies

A limited liability company does not have shares in the usual sense. Participants in the company own a percentage of the company’s capital on the basis of a written agreement between at least two founding members. As of 1 April 2001, the minimum capital requirement was set at UAH 11,800 (approximately $2,230), requiring at least 30% be paid before the company is registered. The liability of the members in respect to the company's debts is limited to the value of their individual contributions. Limited liability companies are managed by an individual director or a Board of Directors, which are appointed by the general members.

Registration Procedures

The registration of the company must be made at the relevant department of local governmental authorities, and a registration certificate must be issued within five business days of the requisite documents being filed with the department. By election, an accelerated registration procedure is available, which can be completed within one business day.

To register a joint stock company or a limited liability company the following documents must be filed with the company registration department of a district authority:

- minutes of the founders meeting regarding the company's establishment;
- the founding agreement and company statute;
- documentary evidence of the registration of the founder, if a legal entity;
- evidence that the required minimum percentage of the statutory capital has been paid prior to registration;
- evidence that the registration fee was paid;
- a duly completed registration form; and
- Lease agreement, purchase agreement, etc. evidencing the legal address of the company.

In some cases, as outlined by Ukrainian legislation, approval from the Antimonopoly Committee of Ukraine is required in order to found a company.

B. REPRESENTATIVE OFFICES

A foreign company can set up a representative office in Ukraine, which is similar to an un-incorporated branch, subject to registration with the state authorities. A representative office does not constitute a legal entity and operates in Ukraine on behalf of the foreign company it represents. A non-resident company operating a representative office is deemed to be conducting business activity in Ukraine through a permanent establishment and may be subject to corporate profits tax unless protected by a double taxation treaty.

Registration Procedures

The procedure for setting up a foreign company's non-commercial representative office in Ukraine involves registering it with the Ministry of Economics. Registration is subject to a fee of USD 2,500 and requires a maximum of 60 days from the date when the following documents are submitted:

- a written application drafted in accordance with a prescribed format;
- Power of Attorney authorizing a representative to act on behalf of the founding company;
- documentary evidence of the company's registration;
- a letter of good standing from the bank; and
- Evidence that the registration fee has been paid.

The registration documents must be notarized according to the laws of the country of issue, translated into Ukrainian by a certified translator, and legalized by a Ukrainian embassy. After taking out a registration certificate, the preventative office must register with the local tax office and other relevant authorities.

In cases where a commercial representative office is being setup, which is supposed to constitute a taxable permanent establishment of a foreign company, registration with the Ministry of Economics is not required. Instead, such a representative office must be registered with the local tax authorities prior to undertaking profit-generating activities.

Setting up a representative office or a branch of an existing Ukrainian company does not require state registration; however, the founding company must adopt a charter governing its status. Where the representative office is located in the territorial community other than the head company, it may be treated as a separate taxpayer and should be registered with the local tax and other relevant authorities.

C. FRANCHISE AGREEMENTS

A franchise agreement is a contract entered into between the franchiser, the franchisee, any guarantors, and/or others, in which the relationship between the franchiser and franchisee (and others) is described in detail.

Selecting potential franchisees in Ukraine is a challenging and difficult process. Most local business people are not knowledgeable of the franchising concept. Therefore, the first step in the selection process is increased awareness, including a clear definition of the specific franchising concept, the identification of the requirements and responsibilities of both parties, and an explanation of the benefits and opportunities of the proposed system. Clearly defined criteria must also be established to meet the specific needs and skills of each type of proposed franchise, depending on the nature of the business. Fundamental business skills and sufficient financial resources are important, as is a high motivation to succeed and learn.

Many potential franchisees are already highly motivated and have existing business experience learned "on-the-job", while working in their own Ukrainian ventures. However, many of these businesses are struggling due to a lack of proper management training, insufficient financing and the complexities of operating a business in Ukraine. Franchisers, who can assist with business planning, management training and a systemizing an approach to business development, can expect to find eager and willing candidates. Business management training in all disciplines is already widely available in Ukraine. Business schools, universities, and technical assistance projects offer a wide range of business, financial, management, marketing and economic training. Utilizing these programs is highly recommended to assist in training franchisees.

Another critical selection factor is the availability of transparent financial resources from the potential franchisee. As mentioned earlier, the local banking systems do not offer long-term loans at efficient interest rates. Loan security is required at a level of 200% of the loan amount and is usually only secured with real estate or other highly liquid assets. These terms and conditions make local financing of ventures extremely restrictive for small start-up entrepreneurs.

Typically, franchise agreements will describe:

1. the parties to the agreement (name, address and other details of the franchisor, the franchisee, and any other parties to the agreement);
2. the business structure or format being licensed to the franchisee including, for example, business name, trademarks, trade secrets, patents, copyright, designs, procedures, techniques, business and operating manuals, accounting systems, employee uniforms, etc., and the products and/or services, which are the focus of the franchise;
3. the duration of the franchise (length of time during which the franchise is valid, and any renewals or options to renew the franchise at the end of the term);

4. the fee or fees payable by the franchisee to the franchisor, some of which may be one-time fees (payment of an initial franchise fee), and some of which may be ongoing fees (a periodic payment of a percentage of the gross periodic sales of the franchise);
5. any territorial limitations on the franchise;
6. any training and/or re-training requirements;
7. obligations of the franchisee to abide by the franchiser's business structure and standards (and the consequences of failing to do so);
8. obligations of the franchisee to modify the business structure and standards at the request of the franchisor;
9. obligations of the franchisee to introduce the franchiser's new products and services into the franchise, and any obligations to cease selling particular products and services in the franchise;
10. obligations of the franchisee to purchase products or services from the franchisor or from approved suppliers, and the price at which these products or services will be purchased;
11. obligations of the franchisee relating to the hours and days of operation of the franchise;
12. obligations of the franchisee to advertise or promote the franchise, or to contribute to the franchiser's advertising or promotional program;
13. obligations of the franchisee to participate in special promotions (for example, to redeem promotional coupons);
14. obligations of the franchisee regarding the maintenance of financial records, and any obligations of the franchisee to make these records available to the franchisor;
15. obligations of the franchisee relating to insurance policies;
16. restrictions on the sale of the franchise by the franchisee;
17. the method or methods by which a franchise may be terminated by the franchisor; and
18. continuing (post-franchise) obligations of a former franchisee;

Although not exhaustive, the above list is illustrative of the items required in a franchise agreement. Furthermore, leases, subleases, confidentiality agreements, security agreements and other documents may also form part of the franchise relationship, although these documents may be physically separate from the Franchise Agreement.

Registration Procedures

Before concluding the franchise agreement, the franchiser must register the objects of intellectual property (such as inventions, industrial samples, trade marks), on the territory of Ukraine. The intellectual property right to the invention, industrial sample is confirmed by the patent. The property right to a trademark for the goods and/or services is confirmed by a Certificate. It is also necessary to complete an additional license contract (which can also be integrated into the franchise agreement) and register both documents in the State Department of Intellectual Property of Ukraine.

Ukrainian legislation in general does not require, nor specifically define procedures for, registration of the franchise agreement. Presently in Ukraine, franchise agreements do not have to be registered with any governmental agency because they are a basic contract between two parties. As a result, the precise legislative mechanisms regulating franchising are currently absent. However, in order to receive payments for usage of intellectual property (ex, inventions, industrial samples, trademarks), which are transferred under the franchise agreement, it is necessary to register the agreement to prove a claim for intellectual property in order to receive a “royalty” payment.

The specified payments fall under the definition of "royalty" payments as compensations (indemnifications) for use of the intellectual property rights, including industrial property, as well as other property rights. These include such rights as those applying to literature, art, electronic recordings, copy and distribution of any patents or licenses, trademarks for goods/services, rights to inventions, industrial samples and use of copyrights or commercial experience (know-how).

For payments under the Franchise Agreement to be defined as "royalty" payments, the following two conditions must be complied with:

- Franchisor’s ownership of the intellectual property must be legally established in accordance with Ukrainian law;
- Authority granted to the Franchisee for the right to use the Franchisor’s intellectual property must be identified in the Franchise Agreement, which must be registered in the State Department of Intellectual Property of Ukraine.

The franchise agreement should specify the subject of the franchise agreement; parties of the contract; number of the patent/Certificate; name of the invention/trademark; obligation of the parties and legal addresses of the parties.

D. LICENSING CONTRACTS

There are two types of licensing contracts:

The non-exclusive license gives the licensee (buyer) the right to use an object of intellectual property based on specified conditions and defined territory during a stipulated fixed term. Thus the licensor (seller) reserves the legal right to also use the same object of intellectual property and may authorize its use to other third parties.

The exclusive license gives the licensee the exclusive right to use an object of intellectual property based on specified conditions and defined territory during a stipulated fixed term. Thus in the given territory and during the given term the licensor does not have the right to use the same object of intellectual property or authorize its use to other third parties.

The *Law of Ukraine on “Ownership”*, item 41 addresses intellectual property rights, by classifying intellectual property as the products of science, literature, art, inventions’ models, industrial samples, trademarks for goods and services, results of research and development and other products of intellectual work.

The owner of the patent or certificate has the right to give any person (licensee) the authority, or issue a license, for the right to use the object of the industrial/intellectual property on the basis of a license contract. For this right to use such property, the licensee pays to the proprietor (licensor) of the object industrial/intellectual property compensation, as determined in the contract (payment or periodic payments).

This process is regulated by an amendment to the *Law of Ukraine on “Protection of Rights on Inventions and Utility Models”*, ? 1771, adopted 01.07.2000. Clause 28 of Article 7 gives the Owner of the Patent the capability to license the rights to the property on the basis of the license contract. Licensing of trademarks is governed by the Law of Ukraine “About Protection of Rights on Trademarks and Service Marks” adopted 15.12.1993. Clause 16 of Article 5 gives the Owner of the Certificate the capability to license the use of trademarks on the basis of the license contract.

According to item 4.1.4 of the Law on Ownership, the received royalty payments are considered part of the gross income of the recipient and in accordance with item 5.4.2 is carried as an expense by the payee.

Registration Procedures

The following documents need to be presented to the State Department of Intellectual Property of Ukraine for contract license registration:

- 1 copy of the application for registration (in Ukrainian) of the license contract;
- 3 copies of the license contract;
- 1 copy of the receipt of payment of the tax for registration of the license contract.
- Application for registration of the contract (addition 1), submitted by the proprietor of the patent; and
- Application for registration of the license contract (addition 2), submitted by the proprietor of the patent or proprietor of the exclusive license.

The license contract should specify the subject of the license contract; parties of the license contract; number of the patent; name of the invention (useful model); volume of the rights to be transferred; kind of the license (exclusive or non-exclusive); obligation of the parties; license contract close date; territory of action of the license contract and legal addresses of the parties.

Detailed instructions, fees and assistance for filing patent, trademark and design applications can be obtained from a certified Patent Attorney, who can also file on behalf of the parties through a Power of Attorney. (See annex of Patent Attorneys).

Copyright protection is governed by the *Law of Ukraine on Copyrights and Associated Rights*. If an international contract with a Ukrainian resident stipulates rights other than those contained in Ukrainian legislation, then the international rules apply. In addition, Ukraine is participant of the Bern Convention. As such, international copyright procedures and markings apply.

Upon copyright registration, a certificate is issued. The Certificate is valid legal proof of the copyright registration, ensures copyright protection in Ukraine, and serves as the primary document in any legal proceedings.

E. MULTIPLE CONTRACT STRUCTURES

The use of Franchise Agreements and Intellectual Property license contracts are complicated and time intensive. Their use, however, offers the greatest legal protection for both parties and is the most effective approach in long-term franchise development. In lieu of using the more formal approach, alternative legally acceptable contractual forms exist by which both parties can achieve their defined business objectives.

Exclusive or non-exclusive distributorships can be awarded by firms desiring to territorially expand their business. Distributorship agreements address a full scope of issues, which regulate the relationship between the parties and include all generally accepted business contractual topics. This includes both rights and responsibilities of the parties, territories, use of trademarks and copyrights, financial arrangements, disputes resolution etc. In such a business relationship, the goods and service supply can also be vertically integrated where the distributor is obligated to purchase all supplies, goods and equipment from the parent company. As such, the parent company can build its profit into the sales price to the distributor. Training, management consultancy and technical assistance contracts between the parent company and the distributor are also possible and offer another legal mechanism by which the distributor can make payments to the parent company for services.

Foreign companies desiring to enter the Ukrainian market can register as wholly-owned subsidiaries of the parent company thereby establishing itself as a Ukrainian resident company. In this instance, the foreign company has full control of its operations and can therefore, establish and develop a base upon which to consider franchising as an expansion strategy in the future.

Another approach is to enter into a Joint Venture with an existing Ukrainian entity. This approach offers access to existing local market knowledge and experience, which can help expedite the business development and address and resolve many of the local cultural, procedural and technical issues that frequently arise.

ANNEX 1 BUSINESS ENVIRONMENT SUPPORT DOCUMENTATION

POLITICAL AND ECONOMIC CONTEXT

The presidential elections in November 1999 proved to be a resounding victory against the communists wanting to turn the clock back to the Soviet Union – a victory seen by many as a mandate for Ukraine's first, concerted reform.

The need to avoid formal external debt default and ensure continued multilateral financing has brought notable policy improvements. Since the appointment of a new Cabinet of Ministers in December 1999, the Ukrainian government has ensured relatively tight monetary and fiscal policy, and has launched administrative and regulatory reforms. As a result, the Ukrainian economy recorded growth of 6% in 2000. However, true economic recovery can only be achieved when structural reforms accelerate. Reported macroeconomic indicators for the year 2000 show a positive trend for the first time in 10 years. However, sustainable economic growth is contingent on many different factors. First and foremost is how strong President Leonid Kuchma's and the government's commitment is to carry out economic reform in the country.

Historical background

The history of Ukraine extends over 1,500 years. Kyivska Rus, the ancient state that encompassed parts of the territory of modern Ukraine, Belarus and Russia was formed in the ninth century. However, the Mongol invasion of 1238 and subsequent 200-year occupation destroyed Kyivska Rus as an independent state, and it fell under the control of the Polish-Lithuanian Commonwealth for three centuries. In the 17th century, Ukrainian Cossacks created a state east of the Dnipro River, and in 1648 a national liberation movement was launched to free Ukraine from Polish rule. In order to enlist Russia's help in its struggle with Poland, Ukraine signed a treaty with Russia. However, the country was partitioned between Russia and Poland in 1667 with the area east of the Dnipro River becoming part of Russia and western Ukraine being annexed by Poland. The territory under Russian control increased again following the partitions of Poland in 1793 and 1795.

After the 1917 October revolution, Ukraine became a founding member of the Union of Soviet Socialist Republics (USSR). In 1939, the Polish-occupied area of western Ukraine was annexed to Ukraine after Poland was partitioned between the Soviet Union and Germany under the terms of the Molotov-Ribbentrop Pact.

In June 1941, Hitler's troops invaded Soviet territory and Ukraine was under occupation until 1944. During the Second World War, an estimated six million Ukrainians lost their lives. At the end of the war, Ukraine re-gained its western territories from Poland; and in 1954, the Crimea was transferred to Ukraine.

A new history of Ukraine started on 24 August 1991, when Ukraine proclaimed its independence. The Republic of Ukraine was established as a founding member of the CIS, following the referendum regarding independence in December 1991. The vote in favor of independence was an overwhelming 90%.

POLITICAL CONTEXT

Institutions

Ukraine's constitution was adopted in June 1997, after ratification by the Ukrainian Parliament. The constitution defines Ukraine as unitary democratic state and guarantees human and property rights. It establishes a balance of power between the executive and legislature.

According to the constitution, the country is headed by a president elected by popular vote for a maximum of two consecutive five-year terms. Legislative power is exerted by a single-chamber parliament, the Verkhovna Rada, which comprises 450 deputies elected by popular vote for four-year terms. As part of the legislative power, Parliament acts as an overseer of the government's activities. The state budget and annual privatization program presented by the government and State Property Fund, respectively, must also be approved by the parliament.

The Cabinet of Ministers exercises executive power. The President nominates the Prime Minister, as well as the Governor of the National Bank of Ukraine (the central bank) and the Chairman of the State Property Fund with the approval of parliament. Ministers are nominated by the Prime Minister and appointed by the President. Key Cabinet appointments must be ratified by the parliament.

Presidential Elections

Presidential elections took place on 31 October 1999 with a second round of voting taking place on 14 November 1999. The incumbent president Leonid Kuchma was re-elected for the second term, defeating Petro Symonenko, the Communist Party leader. President Kuchma's win was a resounding victory against the communists, a victory seen by many as a mandate for Ukraine's first, concerted reform effort.

Since Leonid Kuchma was elected in 1994, he has pushed a comprehensive economic reform program, maintained financial discipline, and has taken actions to diminish control over prices and foreign trade. However, the actual implementation of President Kuchma's economic agenda has encountered considerable resistance from parliament, industrial groups and their bureaucratic allies, which are opposed to structural reforms.

Parliamentary Elections

The results of the March 1998 parliamentary elections were largely expected with a general shift to the left and a high voter turnout (about 70%). 0n 21 January 2000, the parliament split into two camps with the majority being represented by eleven right-centrist factions, and the minority being represented by four left-wing factions. The two camps rejoined weeks later, where upon majority member lvan Pliushch took his position as the Parliament's new speaker. New parliamentary elections are scheduled for March 31, 2002.

Appointment of a new Cabinet of Ministers

The appointment of a new Cabinet of Ministers in December 1999, under the leadership of Victor Yushchenko, boosted hopes of accelerated structural reforms. Two months after it was formed, the Cabinet of Ministers prepared a plan of action for the next few years called "Reforms for Prosperity". The new program focused on creating opportunities for economic growth. The key elements of the program are a balanced budget, price controls and the stability of the national currency, the hryvnia.

The appointment of Mr.Yushchnenko, a nominally Western-leaning reformer who headed the central bank for several years, ensured that Western-oriented polices would be enhanced. However, to achieve considerable improvement in the economy, the Ukrainian government needs to speed up the country's administrative reforms and privatization process, as well as improve taxation. Mr. Yushchenko was removed from office by a parliamentary vote of no-confidence in April 2001.

On 29 May 2001, Parliament confirmed the new Prime Minister, Mr. Anatoliy Kinach, who formed a new cabinet of “professional coalitionists” and has vowed to continue the reforms initiated by Mr.Yushchenko. Mr. Kinach is a former deputy Prime Minister, current Member of Parliament and President of the Ukrainian Union of Entrepreneurs and Industrialists

Foreign Policy

Ukraine focuses on fostering closer integration with the rest of the world while preserving its traditional links with the countries of the former Soviet Union. For defense purposes, Ukraine is aligned with neither Russia nor NATO. Soon after independence Ukraine proclaimed itself a nuclear weapons free state and dismantled or returned the large stock of Soviet tactical nuclear weapon installed on its territory.

Reflecting its importance and size, Ukraine is a member of the United Nations, the IMF, World Bank, EBRD, and Council of Europe. Also in 2000, Ukraine and NATO signed a joint statement on developing their co-operation under several NATO's programs.

The government has identified integration into the European Union as one of its foreign policy priorities. Nevertheless, the removal of Boris Tarasyuk the cabinet's most pro-Western member, in October 2000 and his replacement by Anatoly Zlenko signaled a shift in Ukraine's "multi-vector” foreign policy to the Russian dimension. However, joining the World Trade Organization this year, with the aim of accelerating Ukraine's drive to become an EU associate member, is expected to continue being the government's foremost task in the near and long-term future.

Greater ties with Russia have been one of the principle issues since the break-up of the Soviet Union. President Kuchma sees Ukraine's relationship with its northern neighbor as a strategic partnership that can strengthen the economies and enhance the democratization processes within two countries. The visit of Russian President Vladimir Putin to Ukraine in February 2001 called for the strengthening of this relationship and the promotion of economic co-operation. During this visit, the most critical areas of co-operation were discussed, including defense and defense industry problems, the aerospace area, power industry and other spheres.

The appointment in May 2001 of Victor Chernomirdin, former Prime Minister of Russia as Ambassador of Russia to Ukraine, signals the emphasis Russia is placing on developing closer trade and political ties with Ukraine and pulling Ukraine deeper into a Russian sphere of influence.

Political Risk

The appointments of a new Cabinet of Ministers led by Victor Yushchenko, and the formation of a center-right majority in the Parliament, have improved prospects for faster reforms. However, reform efforts risk being constrained by divisions in parliament and opposition from key constituents. With the removal of Mr. Yushchenko and the appointment of Mr. Kinach as the new Prime Minister in May 2001, the political stability in Ukraine is once again in question, which may affect the existing level of political risk.

ECONOMIC OVERVIEW

Economic Developments

The growth of real GDP in 2000, in particular real industrial production, has been the major positive development in the Ukrainian economy, and has been widely perceived as a turning point for the whole country. However, economic growth should not be attributed only to the new movement's restructuring efforts. There were a number of one-off factors, such as export benefits from the hryvnia's devaluation during 1999, a temporary boost to aggregate demand generated by forced monetary expansion and the movement's payment of pension arrears. A modest growth of household incomes and improvement of the bank's credit activities contributed to the revival of the investment activities.

Despite a number of progressive measures taken by Yushchenko's government, the Ukrainian economy is still largely exposed to significant structural imbalances and there is still much to be done in dismantling the economic and administrative structures inherited from the Soviet system. Hence, Ukraine still occupies the 9th position out of 9 countries in the CEE region[1] in terms of attractiveness of the business environment (Economist Intelligence Unit (EIU) estimates).

Dominant accomplishments of the new government during 2000 were the resumption of IMF financing and the re-scheduling of USD 2.6 billion in foreign debt that fell due in 2000-2001. The assumption of Extended Fund Facilities (EFF), with a USD 246 million tranche, signaled to the international investment community the impressive progress made by Ukraine's new government in economic restructuring and improvement of the investment climate. In March, over 90% of the western creditors stated that they supported Mr. Yushchenko's proposed restructuring program, in which holders of Ukrainian foreign commitments maturing in 2000-2001 would convert them into Eurobonds maturing over the next seven years.

Respected international lending institutions agree with the Ukrainian government's assessment that the country's economy will grow in 2001. Analysts predict Ukraine's macroeconomic environment rating and economic stability will substantially improve, mainly as a result of rectified monetary and exchange rate policies, healthy government finances and further economic restructuring. However, Ukraine will need significant foreign investment to achieve sustainable growth. The direction of economic growth will depend on the origin of the investments, such as whether investments come from Russian businesses, Western companies and financial institutions, or Ukrainian money returning to the economy from abroad.

MAJOR ECONOMIC INDICATORS GROSS DOMESTIC PRODUCT

Gross Domestic Product

Since independence, Ukraine has experienced a substantial decline in GDP, industrial output and agricultural production. In 2000, for the first time since independence, GDP grew by 6% and industrial production rose by 12.9% (compared to 1999)[3]. The growth in industrial production during 2000 was largely attributed to substantial improvements in export-oriented industries. Growth in wood processing and paper production reached 37.1%, non-ferrous metallurgy, 18.8%; chemical and petrol chemical industry, 5%; and ferrous metallurgy, 20.7%. Furthermore, during 2000 there was a moderate slow-down in the rate of fuel energy production decline. In October 2000 alone, industrial production grew 13.5%, compared with the same month last year.

Real GDP during 2001 was expected to increase 4-4.5%. The most optimistic forecasts for 2001-2003 period indicate a gradual improvement in real GDP, achieving up to 7% growth. However, more conservative analysts expect a slow down in the rate of real GDP growth to a moderate 3.1% in the 2001 - 2002 period, on the grounds of falling world demand for Ukraine's major exports, steel and chemicals.

Inflation

Shortly after gaining independence, tax monetary and fiscal policies resulted in exceptionally high consumer price inflation in Ukraine (e.g. inflation for 1993 exceeded 10,000%). However, the National Bank of Ukraine tightened monetary policy in 1995, and by 1996 inflation had fallen to just less than 40%. The annual inflation rate in 1997 was 10.1%, 20% in 1998 and 1921% in 1999.

In spite of substantial pressure to pay pension and wage arrears, extend credit to the agricultural sector and meet external debt obligations during 2000, the government still managed to execute prudent monetary and fiscal polices, as well as retain firm control over inflation. As a result, in 2000 the average inflation rate measured by CPI was 25.8% with the greatest monthly rise of 4.6% in January 2000. Assuming that in the short term currency stability and foreign currency inflows will improve analysts expect a gradual deflation. Analysts also forecast that consumer prices' average annual change will be slightly higher then the government's forecast of 16% in 2001 and 15% in 2002.

Exchange rate policy

On 21 February 2000, the Cabinet of Ministers and the National Bank of Ukraine officially announced the country would switch from a currency band to a floating hryvnia exchange rate policy. The strong currency policy and successful management of the external debt-service obligations implemented by the Cabinet of Ministers have facilitated the stability of the hryvnia as the country smoothly moved to an openly floating exchange rate. In 2000, the nominal hryvnia exchange rate devaluation against USD was only 4%[4]. According to Mr. Stelmah (the NBU Governor), in February 2001 the central bank's foreign currency reserves amounted to USD 1.78 billion and will remain at USD 1.7 billion level over 2001. Although analysts[5] forecast nominal hryvnia depreciation against the USD, the rate of devaluation will remain low assuming tighter controls on monetary issue, gradual economic growth and higher inflow of foreign direct investment. Analysts also stipulate that the higher pace of inflation rate growth in Ukraine compared to the US will result in gradual real appreciation of the hryvnia.

Unemployment

According to the information from the Ministry of Labor and Social Policy and UEPLAC estimates[6], Ukraine's unemployment rate in November 2000 stood at 5.26%. Reflecting an increase in macroeconomic activity, the official unemployment rate over the third quarter of 2000 marginally declined from 5.33% to 5.26%. In November 2000, on average, there were 15 unemployed persons per each vacancy. However, actual unemployment figures in Ukraine are believed to be much larger, since many Ukrainians do not formally register as jobless. Preliminary official estimates for 2000 indicate about 1.5 million[7] unemployed, as opposed to the unofficial estimates of 4.5 million. In addition, many cash-strapped companies have not paid salaries for months or have required some workers to go on unpaid leave. The lowest unemployment rates of around 0.8% are registered in Kiev and Sevastopol. The regions with highest recorded unemployment rates above 6% are Ternopil, Zhytomyr and Volyn.

Wages and incomes

The impact of the recession on real wages and incomes has been severe. Beginning in 1993, real wages were approximately one-third of their level in 1990 or the equivalent of USD 86 per month. This has led some Western manufacturers to substantially increase sub-contract manufacturing in Ukraine because of the low cost of a skilled workforce.

The devaluation of hryvnia after the 1998 crisis in Russia resulted in significant contraction of the average dollar wage to USD 46 level in 1999. However, following the increase in economic activity and hryvnia's stabilization in 2000, the dollar wage, as well as the real wage index, went up by 0.02% and 1.9%[8] respectively, compared to the previous year.

Following a significant 9.1% annual drop in real income in 1999, the Cabinet of Ministers' five-year plan formulates that the new government's first priorities will be to reduce poverty and unemployment and gradually increase the population's income.

During 2000, the Government paid off pension arrears, and also partly repaid overdue wages and social security arrears. In 2000, according to the State Statistics Committee, nominal household income grew by 40.4%, real income by 9.4%, while household expenditure rose by 40.6% compared to 1999.

Foreign Trade

Around one-half of Ukraine's trade is with the Commonwealth of Independent States (CIS). *Energy imports and unprocessed or as and chemical exports predominate* According to Intelnews, Ukraine had a foreign trade surplus of USD 616.5 million in 2000.

In 2000, Russia remained one of Ukraine's largest trading partners. Exports to Russia accounted for over 24% of Ukraine's total export in 2000, while imports from Russia were around 41.7% of Ukraine’s overall imports. Oil and gas represented almost 80% of total imports from Russia. Other significant trading partners were Germany, Turkey, the USA, Italy, Belarus and Turkmenistan.

In 2000, basic industries like ferrous/non-ferrous metal and chemical products were dominate in Ukraine's export structure at 35.1% and 10.7%, respectively. There was also a positive trend of growth in machinery and equipment exports, which reached 9.2%.

The forecasts for the 2001-2003 period stipulate that further increase in the current account surpluses is unlikely. The slowdown in global demand and unfavorable price trends for steel and chemicals, Ukraine's principal exports, will have a negative effect on Ukraine's current account balance over the 2001-2005 period. This, however, should be partly compensated by strong growth in the Southeast Asian economies, the second largest market for Ukrainian steel and chemical exports. To benefit from these favorable opportunities, Ukraine will have to overcome present capacity constraints of export industries.

On the import side, in light of recent agreements reached with Russia on gas supply and transit, the prices for gas imports should remain relatively stable. However, analysts expect that the current trend of rising prices for manufactured imports, oil and industrial raw materials will result in a moderate increase in Ukraine's import expenditure.

Foreign investment

In the months immediately prior to the presidential elections, foreign direct investment (FDI) ceased and a number of significant projects were postponed. However, following the elections in November 1999, new foreign investment resumed. Based on Ministry of Finance estimates, in 2000 net foreign direct investment inflow to Ukraine increased to USD 584 million, almost 1.5 times above the 1999 numbers.

The United States, Cyprus, the Netherlands, the Russian Federation and the United Kingdom are the largest investors in Ukraine. These five countries account for over 50% of the total FDI in Ukraine. Although, the structure of FDI in 2000 remained relatively unchanged compared to previous year, there were substantial annual increases in the share of FDI in the transport (46.3%) and wood, pulp & paper (42.4%) industries.

Since independence, Ukraine has received a total of USD 3.72 billion[9] in direct foreign investments, which is one of the lowest per capita FDI levels in Central and Eastern Europe. This can be attributed to the previously slow pace of reforms and trust rating bureaucracy. The new government is determined to deal effectively with both issues.

Table 1. Direct foreign investments (USD, million)

	1996	1997	1998	1999	2000
Ex-USSR states	5,799	11,710	8,628	7,785	8,900
Baltic States	685	1,144	1,863	1,158	1,200
Russia	2,479	6,639	2,761	2,890	4,000
Ukraine	***527***	***623***	***747***	***493***	***584***
D. CZECH REPUBLIC	1,428	1,300	2,720	5,108	6,000
Hungary	2,275	2,173	2,036	1,944	200
Poland	4,498	4,908	6,365	6,500	8,000
Central Europe total (10 countries)	8,717	8,879	118,552	13,965	16,500

Source: *"ARGO perspectiva"*

If the Ukrainian Government stays firm on the current path of economic reform and improvement of the investment climate, the perspectives of the EU enlargement are expected to have a strong positive effect on FDI inflow to Ukraine. Enrollment of the Central European countries to the EU will result in an adjustment of living standards in the new member states, and with it higher labor and production costs. Hence many businesses will be encouraged to relocate their production activities to the neighboring countries, such as Ukraine.

Taxation issues

Ukraine's tax system is undergoing reforms, which are expected to be incorporated when a new tax code is introduced. Currently, the main taxes include corporate profit tax, personal income tax and value added tax. There are also numerous special charges and local taxes.

Introduction

A major reform of the tax system was undertaken in 1997. The reform was aimed at increasing government revenues by reducing the number of special tax exemptions and simplifying and streamlining compliance procedures. The reform is expected to be completed when a new tax code is introduced. At the time of this writing, the principal taxes and compulsory payments in Ukraine were as follows:

- corporate profits tax
- personal income tax
- value added tax (VAT)
- payroll taxes
- excise tax
- land tax
- tax on owners of motor vehicles
- import duties

There is the possibility for a unified taxation system, i.e. 6% of the turnover (plus VAT), or 10% of the turnover (without VAT). Recently, many Ukrainian entrepreneurs have increasingly used this taxation scheme.

Other taxes and charges include stamp duty, royalties on oil and gas extraction, charges for the exploitation of natural resources and environmental pollution, and charges for retail trade patents. In addition, there are 16 different local taxes that may be levied at the discretion of the local authorities.

Corporate Profit Tax

The Corporate Profit Tax Law of 1997 introduced the current corporate profits tax regime. Under the law, a uniform tax at the rate of 30% applies to taxable profits earned by resident entities and permanent establishments of foreign companies. For domestic insurance companies, a tax is levied based on adjusted gross income at a rate of three percent.

Taxable profits

Taxable profits are defined as adjusted gross income (taxable income) less allowable gross expenses (deductible expenses) and depreciation charges. Gross income includes any sales or non-sales income received or accrued within a reporting period (i.e. quarter). Gross income is deemed as received either on the date goods were shipped or services rendered, or on the date payment was received from the customer, whichever is the earliest. Gross expenses include any expense actually incurred or accrued in respect to the taxpayer's business, excluding non-allowable expenses specified by the law. Gross expenses are recognized either on the date of payment to a supplier (contractor) or on the date when the goods or services were received, whichever occurs first.

Permanent establishments

The Ukrainian definition of a permanent establishment corresponds to the provisions of OECD Tax Convention Model of 1992 and includes:

- A fixed place of business through which the business activity of a non-resident entity is wholly or partly carried out in Ukraine. A permanent establishment includes, a place of management, a branch, an office, a plant, a factory, a workshop, a mine, an oil or gas well, a quarry or any other place of extraction of natural resource; and
- A Ukrainian resident business entity, which has the authority to act in the name of a non-resident entity and results in civil rights and obligations for the non-resident entity (e.g. conclude contracts in the name of a non-resident; maintain a stock of goods belonging to the non-resident for supply on behalf of the non-resident). A resident is defined as a legal entity or business entity without the status of an incorporated legal entity (e.g. branch, a representative office etc.) and which acts in accordance with Ukrainian legislation.

Taxable profits of a Ukrainian permanent establishment can be determined by applying:

- **Direct method** - the difference between the gross taxable income (i.e. income attributable to the permanent establishment received on or offshore) and allowable expenses incurred by the permanent establishment (i.e. expenses incurred onshore);
- **Allocation method** - based on data provided by the parent company about the permanent establishment's share of worldwide expenses, number of employees, fixed assets and working capital. (Used by non-resident entities, which operate both in Ukraine and in other countries and, which do not determine profits from activities of a permanent establishment in Ukraine); and
- **Notional method** – involves applying a notional margin of 30% to gross revenues earned from activities within Ukraine.

Depreciation

Quarterly depreciation charges are based on the reducing balance method and applied to the following three groups of fixed assets as follows:

- **Group 1**: Buildings –1.25%
- **Group 2**: Transport vehicles, furniture, office equipment, household equipment, optical, electronic and electrical appliances, information networks systems, including computers and telephone sets – 6.25%
- **Group3**: All other assets - 3.75%

For newly purchased Group 3 assets accelerated depreciation is allowed over a seven-year period by election.

Intangible assets may be depreciated by using the straight-line method over the asset's useful economic life, for a maximum of 10 years.

Transfer pricing

Transactions between related entities are subject to transfer pricing regulations. Related entities include:

- **legal entity** that exercises control over a taxpayer, is controlled by a tax payer, or is under common control with a tax payer;
- **individual** or a family member of that individual who exercises control over a tax payer; and
- **company official**, authorized to execute in the name of the company binding legal agreements or a family member of that official.

The exercise of control over a tax payer means holding, directly or indirectly through a number of related entities, the largest participating interest (shares) in the charter fund of the tax payer; control over the majority of votes in the governing body of the taxpayer; or possessing participatory interests amounting to at least 20% of the charter fund of the taxpayer.

For tax purposes, the following rules apply where the taxpayer is engaged in transactions with related entities:

- **income received** by a taxpayer from transactions with a lasted entity is determined based on contractual price, which cannot be less than usual market prices on the date of the transaction;
- **taxpayer's expenses in connection with the purchase of goods or services** from a related entity are determined based on contractual prices which cannot exceed the usual market prices on the date of the transaction;
- **service fee** paid to a related entity is tax deductible only if there is documentary evidence the fee was paid in respect of services actually rendered; and
- **taxpayer's expenses** in connection with payment of interest on deposits, rent and other contractual payments to a related entity cannot exceed the usual market prices (interest value on the date of the transaction).

The usual price is defined as the price that can be obtained by a seller from the sale of goods or services to non-related entities in the normal course of the seller's business. Tax authorities determine usual prices based on the price data derived from official Ukrainian statistical publications.

Losses carry forward

Resident taxpayers can carry forward losses incurred during the current reporting period over future reporting periods for a maximum of twenty quarters, commencing from the initial quarter when the loss was incurred.

Bad debts

Taxpayers are allowed to adjust the amount of gross income relating to the relevant reporting period by the amount of unpaid trade debts (i.e. debts older than 30 days from the date they were due for payment), provided that a claim against the debtor has been filed with the relevant court.

Tax accounting and reporting

Resident companies and non-resident entities that have a permanent establishment in Ukraine are obliged to keep accounts in accordance with Ukrainian accounting standards.

Tax returns must be filed both by resident and non-resident taxpayers on a quarterly basis within 40 calendar days following the last day of the reporting quarter (i.e. by 10 May, 9 August, 9 November and 9 February). Non-resident entities should pay taxes quarterly within 10 calendar days following the date when the tax return has to be filed. Resident taxpayers, except agricultural producers, are required to make tax payments in monthly advance installments, followed by the final payment, within 10 calendar days following the date when the tax return has to be filed.

Withholding tax

Income earned by non-residents from Ukrainian sources is subject to withholding tax at the following rates:

- **15%** on interest; dividends; royalties; insurance premiums and payments; payments for engineering services; rental (leasing) income from property; income from the disposal of real estate located in Ukraine; gains from securities trading; income earned by a joint venture not incorporated in Ukraine; income from long-term contracts; fees from cultural, educational, religious, sporting and entertainment activities; broker's or agent's fees in respect of services performed in Ukraine; income from lotteries and gambling businesses other than the state lottery; charitable donations payable to non-residents; other income from business activity in Ukraine except for sums payable to non-residents for goods or services supplied to Ukrainian residents;
- **30%** on income earned from investments on interest bearing bonds, treasury bills and discounted bonds issued by resident entities; insurance payments and premiums; and fees for rendering advertising services in the territory of Ukraine; and
- **6%** on income earned from freight services.
- **Income from government bonds** sold by authorized agents abroad and interest on loans granted to the government by non-resident creditors is exempt from withholding tax.

Transactions with entities based in tax haven jurisdictions

Expenses in respect of direct or indirect purchases of goods or services by Ukrainian entities from suppliers registered in tax haven jurisdictions are deductible for tax purposes equal to 85% of the amount incurred. The list of tax haven jurisdictions, which have been approved by the Cabinet of Ministers for the year 2001, includes: Andorra, Anguilia, Antigua and Barbuda, Aruba, Aldemey, Bahrain, Bahamas, Barbados, Bermuda, Belize, Caiman Islands, Campiogne, Cook Islands, Costa Rica, Cyprus, Dominican Republic, Gibraltar, Guernsey, Grenada, Hong Kong, Isle of Man, Jersey, Labuan, Liberia, Macao, Madeira, Malta, Mauritius, Marshall Islands, Monaco, Netherlands Antilles, Nauru, Mue, Panama, Saint Kittsand Nevis, Samoa, Seashell Islands, Singapore, Turksand Caicos, British and US Virgin Islands, Vanuatu.

Personal Income Tax

Ukrainian and expatriate individuals residing in Ukraine are subject to personal income tax on their worldwide income, which is levied at a number of marginal rates up to a maximum of

40%. Employers are required to deduct personal income tax and state pension and social security charges from employees' wages and salaries and pay them to the state authorities.

Residence for individual income tax purposes is defined as having a physical presence in Ukraine (for either a Ukrainian or foreign national) for 183 days or more within a calendar year.

Expatriate individuals working in Ukraine are subject to Ukrainian income tax on the following basis:

- an expatriate has a source of income in Ukraine, a withholding tax of 20% is applied at the source regardless of whether the individual is a resident of Ukraine for tax purposes or not; and
- an expatriate who is a resident of Ukraine for tax purposes (i.e. present in the country for 183 or more days in a calendar year) is taxed at the marginal rates, based on his or her worldwide income.

Tax returns are based on income received during the calendar quarters and year. Foreign nationals who are residents of Ukraine for tax purposes must submit quarterly returns within 40 days after the end of the reporting quarter, and an annual return, which is due by 1 April of the year following the reporting year.

Income tax is paid in advance in four installments, due 14 March, 14 May, 14 August and 14 November, based on an individual's estimated income. Final settlement of taxes owed must be made within one month after a payment order (tax assessment) is issued by the tax authorities after submission of the final tax return.

Value Added Tax (VAT)

VAT payers, whether residents or non-residents, include:

- entities whose volume of VAT qualifying transactions exceeded 3,600 non-taxable allowances (currently UAH 61,200) in any period during the previous 12 months;
- importers of goods or services;
- entities which engage in trade for cash, regardless of their monthly sales turnover; and
- entities which engage in the transport of cargo or passengers via the territory of Ukraine.

Any entity qualifying as a VAT payer is required to obtain a VAT registration number. Registered VAT payers must issue a VAT invoice in the prescribed format at the customer's request.

Taxable and non-taxable transactions

The following transactions are subject to VAT: sale of goods or services in Ukraine; import of goods or services into Ukraine; and export of goods or services from Ukraine.

The following transactions are not subject to VAT: the issue, sale and exchange of securities; depository, clearing and registrar activities concerning securities; transfer of property by a domestic lesser to a lessee and return of property upon expiration of the lease; lease payments under financial lease agreements and rental payments for an apartment which is main residence of the lessee; provision of financial loans and bank guarantees; exchange of foreign currency; insurance and reinsurance services specified in the law on insurance;

contribution of fixed assets to the statutory fund of a Ukrainian legal entity, both domestic and cross-border (import); payment of dividends and royalties in cash; funds under loan, deposit, insurance or proxy agreements; brokerage and dealer services in respect of securities transaction; purchase of a tax payer's property by another taxpayer in the course of acquiring a company; transit of cargoes and passengers through Ukraine.

Tax rates

VAT is levied at two rates:

- **20%** on domestic sales and imports of goods and services, and
- **0%** on export of goods and provision of works or services to be used out side Ukraine, as well as sales via duty-free shops.

Tax liability and credit

A taxpayer's VAT liability equals the total amount of VAT collected within a reporting period, and is incurred on the date the goods were shipped to the customer or the date payment was received from the customer, whichever is the earliest.

A VAT credit is the amount a taxpayer is entitled to, to offset the VAT liability within a reporting period. Rights to VAT credits are recognized on the date of payment to the supplier or the date the VAT invoice is received, whichever occurs first.

Tax reporting

The amount of VAT, payable to or refundable by the tax authorities, is defined as the difference between the VAT liability and VAT credit for the reporting period.

The reporting period for taxpayers whose volume of transactions qualifying for VAT during the preceding calendar year exceeded 7,200 non-taxable allowances (currently UAH 122,400) is a calendar month. Taxpayers, whose volume of these transactions is below this threshold, may opt for either a monthly or quarterly reporting period. Taxpayers may change their reporting period during a calendar year from quarterly to monthly.

The VAT return must be submitted to the tax authorities as follows:

- within 20 calendar days following the reporting month, by entities that pay VAT monthly;
- Within 40 calendar days following the last day of the reporting quarter, by entities that pay VAT quarterly.

VAT is payable to the state within 10 calendar days following the date when the tax return has to be filed.

Tax refunds

A VAT refund for zero-rated operations is available to exporters within 30 calendar days following the date of submission to the tax authorities of the following documents:

- Calculation of the VAT refund in respect to the taxable month;
- Customs declaration evidencing export of goods out of Ukraine; or statement evidencing provision of works or services designed for consumption outside Ukraine; and

- Copies of payment orders, certified by the bank evidencing transfer of funds to suppliers of goods or services; or customs declaration in respect of imported goods customs cleared for free circulation.

The exporter can claim a VAT refund based on the amounts of creditable VAT, provided full payments are made to the suppliers. VAT credit subject to refund is calculated as the percentage of export sales from the total volume of taxable transactions during the reporting period. VAT refunds for other than zero-rated operations may be offset against VAT liabilities arising during the three months following the reporting period. If not fully offset during these three months, the VAT must be refunded to the taxpayer within a month from the date of filing. A taxpayer may opt to offset the VAT refund against future VAT payments.

If the VAT is not refunded by the tax authorities, as required by the law, interest must be paid on the non-refunded amount. The interest is calculated based on the National Bank of Ukraine's prime rate increased by a coefficient of 1.2.

OTHER TAXES AND CHARGES

Payroll taxes

Employers are required to pay the following payroll based on their employees' gross salary:

- **32%** to the Pension Fund;
- **2.5%** to the Social Security Fund; and
- **2% (2.5 % from 1 July 2001)** to the Unemployment Insurance Fund.

Employee's contributions (withholding requirements apply) are as follows:

- **2%** to the State Pension Fund (1% if the monthly salary is less than UAH 150);
- **0.5%** to the Social Security Fund (0.25% if the monthly salary is less than UAH 150);
- **0.5%** to the Unemployment insurance Fund (for Ukrainian national employees only)

The taxable base for the above taxes is capped at UAH 1,600 per employee per month. It is expected that effective 1 April 2001 a new payroll tax will be introduced. The tax will be payable by employers to the Fund for Social Insurance regarding Accidents. The purpose of the tax is to accumulate funds for paying compensation to individuals who lost their ability to work due to accidents at work or professional diseases. The tax rate ranges from 0.84% to 13.8% of the gross payroll depending on the accident risk level for enterprises belonging to certain sectors of the economy.

Excise tax

Excise tax is applied to certain goods imported into, or produced in Ukraine. The list of taxable goods includes alcoholic beverages, beer, tobacco and tobacco products, cars, petrol, diesel fuel and jewelry.

Land tax

Land tax is paid monthly by the owners or users of land. The tax rate depends on the nature and location of the land.

Tax on owners of motor vehicles

Motor vehicle tax is paid quarterly by legal entities and individuals that own motor vehicles registered in Ukraine. The tax rate depends on the power output of the vehicle's engine and currently varies from 3 to 30 UAH per 100 cc of the engine displacement.

Special taxes

To raise funds for the payment of outstanding pensions, a number of special taxes payable to the State Pension Fund were introduced at the end of 1998, including:

- **1%** charge based on the value of a foreign exchange transaction. The charge is payable by legal entities and individuals purchasing foreign currency;
- **5%** charge based on the value of jewelry sales (except for wedding rings). The charge is payable by businesses involved in the jewelry trade; and a
- **3%** charge based on the transfer value of a car (except for cars designed for disabled people and cars that were inherited). The charge is payable by legal entities and individuals that acquire cars.

The above charges will be in force until the date when Parliament makes a decision that all debts on pension payments are settled.

Other special taxes payable to the State Pension Fund include:

- **1%** on the acquisition of real estate. Payable by individuals and legal entities (with certain exceptions), who purchase real estate. The tax base is the contractual value of the real estate;
- **5%** on sale of tobacco products. Payable by manufacturers and importers of tobacco products and based on the sales value or customs value of the goods, including excise duty (exclusive of VAT); and
- **6%** on mobile communication services. Payable by individuals and corporations that use mobile communications services. The tax base is the value of services charged by the operator of a mobile communications network.

These charges are in effect until 2002.

Double taxation treaties

At the time of this writing, Ukraine continues to honor the double taxation treaties of the former Soviet Union with the following countries: Cyprus, India, Italy, Japan, Malaysia, Mongolia, Spain, and Switzerland. These treaties will be in effect until new treaties replace them.

The list of new treaties, which are in effect at the time of this writing, includes treaties with Armenia, Austria, Azerbaijan, Belarus, Belgium, Bulgaria, Canada, China, Croatia, Czech Republic, Denmark, Estonia, Finland, France, Georgia, Germany, Hungary, Indonesia, Kazakhstan, Kyrgyztan, Latvia, Lithuania, Macedonia, Moldova, The Netherlands, Norway, Poland, Romania, Russia, Slovakia, Sweden, Turkey, Turkmenistan, the United Kingdom, the United States of America and Uzbekistan.

Operational Issues

To date the statutory accounts of most Ukrainian enterprises have largely reflected the tax and statistical reporting requirements of the Soviet era. In 1999, however, a new accounting law was passed, which came into effect on 1 January 2000. The new accounting law is intended to make it possible to adopt internationally accepted accounting principles. In addition, an increasing number of companies are employing western accounting firms to audit their accounts in accordance with International Accounting and Auditing Standards (IAS). Although banking regulations have developed over recent years, many banks are burdened with a large amount of bad and doubtful debt. Ukrainian companies are free to engage in foreign trade, under a system of import and export licenses.

FINANCIAL ISSUES

Accounting and financial reporting for commercial enterprises

Through 1 January 2000, Ukrainian financial statements and accounting records were prepared on the basis of a substantial body of regulations issued by the Ministry of Finance. The regulations were mainly geared toward providing information required for taxation and statistical purposes, and were significantly different from International Accounting Standards (IAS). However, a new law on accounting and financial reporting (which came into effect on 1 January 2000), provides for the introduction of new Ukrainian National Accounting Standards (UNAS), which are designed to not conflict with IAS. UNAS will consist of 25 separate standards altogether, however, at present, the Ministry of Finance of Ukraine has only approved eighteen and does not anticipate the complete framework to be approved before the end of 2001. Overall, standards combine the concepts found in, and appear to be broadly based upon, IAS. There are, however, significant areas for which no standards have been introduced. This lack of a full framework for the preparation of financial statements has inevitably caused some confusion in the accounting departments of many enterprises.

In regards to the preparation of financial statements, a quarterly corporate profits tax return and a monthly or quarterly VAT return are required to be filed with the State Tax Administration:. In addition, various reports containing financial information must be made available to the Ministry of Statistics, the National Bank of Ukraine (which is responsible for enforcing the foreign exchange regulations), and the State Pension Fund.

Banking system

The Ukrainian banking system is characterized by under-capitalization and a high incidence of bad and doubtful debt. For example, the total assets of all commercial banks in Ukraine, consisting of 158 operating banks, are less than any of the largest 10 banks in Central Europe. In addition, the total equity of all Ukrainian commercial banks combined is approximately equal to the largest banks in Central Europe. When inflation was extremely high, banks could make reasonable profits by speculating in foreign currency and purchasing treasury bills issued by the Ministry of Finance. Such opportunities for easy profits have largely disappeared since 1998. The National Bank of Ukraine (NBU) has gained a reputation as a staunch enforcer of a tight monetary policy and sound financial practices. It has resisted demands by state-owned enterprises for new credit, and has imposed a tough supervisory regime on the banks. Beginning in January 1998, all Ukrainian banks were required to introduce a new accounting system compatible with IAS. This move has helped increase the efficiency of banking and made the banking system more transparent.

Banking activities are regulated by the new *Law on "Banks and Banking Activities"*, which came into effect on 17 January 2001. According to this law, the banking system is comprised of the National Bank of Ukraine and other (commercial) banks. The National Bank of Ukraine serves as the country's central bank that pursues a uniform monetary policy and performs bank supervisory functions. Currently there are around 195 banks (including 158 operating banks) registered in Ukraine. Among these, 29 have some share of foreign capital, including 7 banks (per NBU statistical data), which are 100% foreign-owned.

By the nature of their activities banks can either be universal or specialized. Specialized banks include savings, investment, mortgage and clearing banks. Irrespective of their specialization, the bank's name must incorporate the word "bank" and reference to the type of legal entity.

Banks can be established in the form of a joint stock or limited liability company, requiring at least two founding members. Another option is a co-operative bank requiring at least 50 founding members. Banks can be also wholly owned by the state (currently there are two, Oschadny and Ukreximbank).

The minimum capital requirements for newly established banks are the Hryvnia equivalent of:

- EURO 1 million for local co-operative banks;
- EURO 3 million for commercial banks operating within 1 region (oblast); and
- EUR0 5 million for banks operating within the whole of Ukraine.

The NBU has the authority to establish minimum capital requirements higher than those indicated above for certain banks, depending on their specialization. Capital must be paid in cash only and direct or indirect acquisition of 10%, 25%, 50% and 75% of the bank's voting shares or capital requires prior permission of the NBU.

Establishment of banks with foreign capital or transfer of shares from existing banks to foreign entities or individuals requires prior permission from the National Bank of Ukraine. A bank with foreign capital is defined as a bank where foreign holding exceeds 10%.

Newly established banks and representative offices of foreign banks must be registered with the NBU. A bank can carry out banking activities only after obtaining the NBU License. The NBU approves the decision to issue the license within one month after receiving documents evidencing that the bank satisfied the following conditions:

- Share capital conforms to statutory requirements and is fully paid;
- The bank is fully equipped with banking equipment, computer hardware and software, and premises; and
- At least three individuals, who possess the necessary professional and educational qualifications, are appointed as board members.

Exclusive banking operations based on the banking license are:

- Acceptance of deposits from individuals and legal entities;
- Opening and operating client accounts; and
- Placement of attracted funds on own behalf and at own risk (e.g. provision of loans).

The latter two operations can be performed by entities other than banks, on the basis of a license issued by the NBU. Other banking activities, which can be conducted by non-banking entities, include transactions with currency values, securities and payment instruments (e.g.

checks, promissory notes, etc.); issue of guarantees; factoring; leasing; issue of payment cards; and safe deposit box rental.

Banks are restricted from performing manufacturing, trading and insurance activities. Specialized banks cannot attract deposits from individuals in amounts exceeding 5% of the bank's capital. The banks can own real estate up to a total amount of 25% of the bank's capital. However, this restriction does not apply to:

- Premises for performance of banking operations;
- Property acquired on the basis of mortgage agreements;
- Property acquired to avoid losses that would be disposed of within a one-year period.

Interest free loans are prohibited except for cases specified in legislation.

Payments

Ukrainian legislation requires companies to make all payments through the domestic banking system and imposes penalties for non-compliance. A modern nationwide electronic payment system has been set up and is considered to be among the best in the former Soviet Union. The main features of the regulations governing payment practices are as follows:

- Companies are allowed to operate an unlimited number of current bank accounts;
- Interest is levied on late payments by law, and
- Foreign currency cannot be used for cash payments between residents.

Domestic transactions can be settled by bank transfers, documentary collection and letters of credit. Although the government has encouraged the use of checks, promissory notes and bills of exchange, so far, these have not found favor with Ukrainian enterprises. Bills of exchange are coming into use for certain tax payments, such as customs duties, import VAT and payments for electricity supply. Although the non-payment of debts is causing severe financial difficulties throughout the economy, many state-owned enterprises (SOEs) continue to supply insolvent customers. The government is unwilling to force large SOEs into bankruptcy because it does not want to push unemployment up. Further, there is no proper legal procedure for creditors' claims to be enforced. In marked contrast to the state sector, most private companies operate on a pre-paid basis.

Types of accounts for representative offices

Current banking regulations distinguish between non-commercial and commercial local currency bank accounts held by the representative offices of non-resident entities:

- **"N" accounts** are available to representative offices, which are not engaged in commercial activity in Ukraine. Funds in such accounts may only be used to meet the operational needs of the representative office, such as the payment of salaries, rent, transport, insurance of property and maintenance of the office etc. This bank account cannot be used to receive payments from customers (except payments for sales of the representative office’s property);
- **"P" accounts** are available to representative offices, which are engaged in commercial activity in Ukraine. Such accounts have the same status as the current accounts of domestic companies and may be used for any lawful purpose with the exception of investment and credit transactions.

A license from the NBU is required to open a type "N" or type "P" bank account.

EMPLOYMENT ISSUES

Ukrainian staff

Conditions of employment in Ukraine are governed by the Labor Code. An individual labor agreement is defined as an agreement between an employee and employer; under which, the employee undertakes specified work and the employer, subject to the provisions of the law and terms and conditions of the agreement, agrees to pay a certain salary or wage and provide working conditions suitable to the performance of the task in question. Other terms and conditions may also be specified in an individual labor agreement as defined in the Labor Code. In certain circumstances, the individual labor agreement must be concluded in writing. The legislation also provides for a special form of labor agreement, known as a "contract", which can be conducted between an employer and employee. A contract only applies under certain legally defined circumstances.

The main requirements under Ukraine's employment legislation are as follows:

- Ukrainian labor legislation requires employers to follow statutory requirements as to the working time, overtime and time-off from work. In Ukraine, normal work hours are limited to 40 hours per week. An employer may introduce a six-day work week, in which case the working day may not exceed seven hours. Shorter work weeks are ensured for some categories of employees;
- The minimum monthly wage level established by the legislation in force, as of 1 July 2000, is UAH 118. Wages and all other payments made to employees shall be in UAH only;
- Employees may at any time terminate the employment relationship with a notice period of at least two weeks. In contrast, employers may terminate the employment relationship only in cases that are expressly outlined in the Ukrainian Labor Code and provided that all applicable formalities are met. The statutory termination notice is two months;
- An employee's minimum annual holiday entitlement is 24 calendar days. However, it may be longer depending on the number of years worked, working conditions and the employee's position; and
- Customary retirement age is 55 years for women and 60 years for men.

Expatriate staff

Ukrainian employers must obtain work permits for foreign nationals, who are either directly employed or seconded, to Ukraine, by foreign companies. A work permit may be issued for up to one year with subsequent opportunity for renewal. The overall time of employment in Ukraine may not exceed four years. After such term, it is only possible to reapply for a new work permit after six months. Non-compliance with the work permit requirements is subject to severe penalties, as well as potential deportation of the foreign national from Ukraine at the cost of the employer.

Upon arrival in Ukraine, all foreign citizens should have medical insurance. Only insurance polices that are issued by the state insurance company Ukrinmedstrakh (or insurance companies, which have agent agreements with Ukrinmedstrakh) and provide for urgent medical assistance to foreign citizens in the territory of Ukraine are valid.

International trade issues

The liberalization of foreign trade was a condition required of Ukraine in order for the country to participate in the World Trade Organization (WTO) and obtain financial assistance from the World Bank and International Monetary Fund (IMF). Ukrainian companies are free to engage in foreign trade without special permission from the authorities, however, a license issued by the Ministry of Economics is required to import or export certain products.

Import requirements

Import licenses are required for plant protection chemicals; veterinary preparations; cosmetics and personal care products; matrices and forms for manufacturing phonograms; postage, duty and similar stamps, officially stamped paper, check books, banknotes, shares, bonds and similar securities; ozone damaging substances, and products that can contain ozone damaging substances.

A compulsory certification procedure was introduced in 1993 with the purpose of ensuring that imported goods comply with national standards. The certification is provided by the Ukrainian certification authorities (UkrSEPRO), with respect to a wide range of imported goods, by issuing a Ukrainian Compliance Certificate.

Export requirements

Export contracts for certain categories of products, such as those falling under anti-dumping regulations, are subject to registration with the Ministry of Economics. The main items that can be exported from Ukraine, subject to applicable licensing and/or quotas, are precious metals and stones; rolled metal products exported to certain EU countries, USA and Indonesia; textile products exported to EU and USA; ferrous silicon manganese; ozone damaging substances; and products that can contain ozone damaging substances.

There is a general requirement that export prices are not lower than world prices for similar goods, and the Ministry of Economics is empowered to establish mandatory indicative export prices for certain categories of goods (e.g. metal products, ferrous silicon manganese, livestock and raw hides, sunflower seeds, etc).

Customs clearance procedures

Any business entity engaged in export/import operations is required to obtain accreditation from the customs office, which serves the area in which the company is located. Goods crossing Ukraine's border should be declared to the customs authorities, either by the importer or a licensed customs broker on behalf of the importer.

Import duties and taxes

The following import taxes and duties are payable by an importer when goods are imported into Ukraine:

- customs fees at the rate of 0.2% based on the customs value of the goods up to a maximum of USD 1,000 per customs declaration;
- Import duty in accordance with the Unified Customs Tariff. Currently there are two rates of duty: relieved rates and full rates. Relieved rates of duty apply to goods originating from countries that enjoy “Most Favored Nation” (MFN) trade status or

which have completed free trade agreements with Ukraine (see below). Full rates of duty apply to goods originating from other countries;

- excise duty is levied on a limited range of consumer goods (see Taxation issues section); and
- VAT on imported goods, services and works (currently 20%).

Import duty and taxes are payable by the importer in local currency before or upon customs clearance.

Import duties and taxes

Goods exported from Ukraine are subject to customs fees at the rate of 0.2% based on the customs value up to a maximum of USD 1,000 per customs declaration. There are no export duties except on livestock, raw hides and certain oil seeds. Exported goods and services are zero rated for VAT purposes.

Trade agreements

Ukraine has concluded free trade agreements, which allow duty-free import of goods originating from the following countries: Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, Kyrgyztan, Latvia, Lithuania, Moldova, Russia, Turkmenistan and Uzbekistan. Exemption from import VAT is available under the free trade agreement with Russia.

Countries that enjoy the MFN trade status include: Austria, Algeria, Argentina, Belgium, Bulgaria, Brazil, Canada, China, Croatia, Czech Republic, Cuba, Denmark, Egypt, Finland, France, Germany, Great Britain, Guinea, Greece, Hungary, India, Indonesia, Iran, Ireland, Israel, Italy, Japan, Korean People's Democratic Republic, Lebanon, Libya, Liechtenstein, Luxembourg, Macedonia, Mongolia, The Netherlands, Norway, Poland, Ponugal, Romania, Slovakia, Slovenia, South Korea, Spain, Switzerland, Sweden, Tunisia, Turkey, United Arab Emirates, USA, Vietnam and Yugoslavia.

[1] Bulgaria, Czech Republic, Hungary, Kazakhstan, Poland, Romania, Russia, Slovakia and Ukraine
[2] Ukrainian Country Report, Intel news, December 2000
[3] State Statistics Committee of Ukraine
[4] The economist Intelligent Unit, Country Outlook, February 9, 2001
[5] The economist Intelligent Unit, Country Outlook, November 2000
[6] Ukrainian – European Policy and legal Advice Center, November 2000
[7] Financial and economic forecast for 2001, "Ukraina-Bisiness", 01/01/01
[8] Ukrainian Economic Trends, UEPLAC, December 2000.

The contents of the above sections were extracted from "Ukraine: A Business and Investment Guide". Prepared and courteously provided by PricewaterhouseCoopers Kyiv. ***The content of these sections is for information purposes only and is not intended to be technically comprehensive. Professional advice should be sought before taking action or refraining from taking action on any item contained in these sections.***

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ANNEX 2 SAMPLE OF TRADEMARK LICENSE CONTRACT

THIS AGREEMENT is made the ___ day of _______ 2001

BETWEEN _____________________________ (hereinafter called the "Licensor") on the one part and _________________________ (hereinafter called the "Licensee") on the other part.

Whereas the Licensor is the Proprietor of the trademark short particulars of which are set out in the Schedule hereto (hereinafter referred to as the "Trademark").

And where as the Licensee desires to use the Trademark in the Territory of Ukraine (hereinafter referred to as the "Territory") in relation to the Goods mentioned in the Schedule hereto (hereinafter referred to as the "Goods of Permitted Use").

And where as the Parties desire that the Licensee shall be registered as a Licensee, have agreed that an application for such registration shall be made forthwith on the execution hereof.

It is hereby agreed as follows:

1. Authority to Use

(a) The Licensor hereby authorizes the Licensee to use the Trademark in the Territory upon or in relation to the Goods of Permitted Use.

(b) The authority hereby granted shall be *non-exclusive* in the Territory of ______

(c) The Licensor shall apply to the Registrar of Trademarks for the purpose of procuring the registration of the Licensee as a registered Licensee of the Trademark.

2. Standard of Quality

(a) The Licensee undertakes to use the Trademark only in relation to Goods of Permitted Use manufactured wholly in accordance with said specifications, directions and teachings agreed between the Licensor and the Licensee from time to time. The Standard of Quality shall not be changed capriciously but shall none the less remain in the control of the Licensor.

(b) The Licensee will permit the Licensor or his authorized representative at all reasonable times to enter the Licensee's premises where the Goods of Permitted use are fabricated, processed, or stored for the purposes of inspection thereof, and the Licensee shall at the request of the Licensor promptly submit random samples free of cost to the Licensor for inspection.

3. Duration and Termination

(a) This Agreement shall operate from the date hereof and shall continue, subject to the provisions for termination hereinafter contained, for the period that the Licensor remains and continues to be the registered Proprietor of the Trademark.

(b) Either party may terminate this Agreement by giving to the other six months notice in writing.

(c) Upon termination or expiration hereof, the Licensee shall cease to use the Trademark and will do all things reasonably necessary on its part to enable the Licensor to remove the Licensee's name from the Register of Trademarks and from any other published indication of the right to or actual use of the Trademark.

4. Governing Law and Jurisdiction

The validity, construction and performance of this Agreement shall be governed and construed in accordance with US law, and shall be subject to the rules of International Arbitration in the ___________________.

Schedule

The Trade Mark and Goods of Permitted Use

Mark:

Registration No:
Registration Date:
Next Renewal Due:
Goods of Permitted Use:

In Witness whereof the parties hereto have signified their entry into this Agreement by procuring this Agreement to be signed by authorized persons.

/signed/	/signed/
Licensor	Licensee

ANNEX 3 TREATY PARTICIPATION

Ukraine is a participant of the following major International Intellectual Property Treaties:

Convention Establishing the World Intellectual Property Organization, April 26, 1970

Paris Convention for the Protection of Industrial Property, December 25, 1991

Berne Convention for the Protection of Literary and Artistic Works, October 25, 1995

Patent Cooperation Treaty, December 25, 1991

Budapest Treaty on the International Recognition of the Deposit of Microorganisms for the purposes of Patent Procedures, July 2, 1997

Trademark Law Treaty, August 1, 1996

Madrid Agreement Concerning the International Registration of Marks, December 25, 1991

Protocol Relating to the Madrid Agreement Concerning the International Registration of Marks, June 1, 2000

Members of the Madrid Union (as of October 2000)

Albania (A)
Algeria (A)
Antigua and Barbuda (P)
Armenia (A&P)
Austria (A&P)
Azerbaijan (A)
Belarus (A)
Belgium* (A&P)
Bhutan (A&P)
Bosnia and Herzegovina (A)
Bulgaria (A)
China (A&P)
Croatia (A)
Cuba (A&P)
Czech Republic (A&P)
Republic of Korea (A&P)
Denmark (P)
Egypt (A)
Estonia (P)
Finland (P)
France (A&P)
Georgia (P)
Germany (A&P)
Greece (P)
Hungary (A&P)
Iceland (P)
Italy (A&P)
Japan (P)
Kazakhstan (A)
Kenya (A&P)
Kyrgyzstan (A)
Latvia (A&P)
Lesotho (A&P)
Liberia (A)
Liechtenstein (A&P)
Lithuania (P)
Luxembourg* (A&P)
Monaco (A&P)
Mongolia (A)
Morocco (A&P)
Mozambique (A&P)
Netherlands* (A&P)
Norway (P)
Poland (A&P)
Portugal (A&P)
Republic of Moldova (A&P)
Romania (A&P)
Russian Federation (A&P)
San Marino (A)
Sierra Leone (A&P)
Singapore (P)[1]
Slovakia (A&P)
Slovenia (A&P)
Spain (A&P)
Sudan (A)
Swaziland (A&P)
Sweden (P)
Switzerland (A&P)
Tajikistan (A)
Republic of Macedonia (A)
Turkey (P)
Turkmenistan (P)
Ukraine (A&P[2])
United Kingdom (P)

Uzbekistan (A)
Viet Nam (A)
Yugoslavia (A&P)

(A) indicates a party to the Agreement (52)

(P) indicates a party to the Protocol (49)

- Protection may not be requested separately for Belgium, Luxembourg or the Netherlands, but only for all three countries as a whole (Benelux), subject to payment of a single complementary or individual fee.

[1] In effect from October 31, 2000.

[2] In effect from December 29, 2000.

Ukrainian National Intellectual Property Legislation includes:

Law of Ukraine "On Protection of Rights in Inventions and Utility Models" (adopted on June 1, 2000);

Law of Ukraine "On Protection of Rights in Industrial Designs" (adopted on December 15, 1993);

Law of Ukraine "On Protection of Rights in Trademarks and Service Marks" (adopted on December 15, 1993);

Law of Ukraine "On Copyright and Related Rights" (adopted on December 23, 1993);

Law of Ukraine "On Protection of Rights in Topology of Integrated Circuits" (adopted on November 5, 1997);

Law of Ukraine "On Protection of Rights in Kinds of Plants" (adopted on April 21, 1993);

Law of Ukraine "On Protection Against Unfair Competition" (adopted on May 7, 1996).

ANNEX 4 DIRECTORY OF LEGAL SERVICE PROVIDERS

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ANNEX 6: AMERICAN CLEANERS INTERNATIONAL CASE STUDY

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June 2001

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1. ENTERING THE UKRAINIAN SERVICE MARKET

The company "American Cleaners International" (ACI), which specializes in dry-cleaning services, has an extensive long-term experience in the US service market. In every dimension of its activities, ACI follows the policy of using the most advanced technologies, modern equipment, and effective methods of business network governance.

1.1 Background

1.1.1 Search for new dynamic directions of business expansion. In 1994, company management had to report an embarrassing slowdown in profit growth. An in-depth analysis of relevant markets revealed worrying tendencies. First, the market, in which ACI primarily operated, was close to being saturated. Second, in a traditionally high concentrated industry, US dry-cleaning, has become increasingly difficult to find new opportunities for business development. Barriers for market entry into the respective markets of developed European countries were rather significant. Hence, it was necessary to find new dynamic business directions that would permit ACI to develop business rapidly and bring stunning financial gains. With a stable position in the US service market, ACI began examining opportunities for business growth outside the domestic market. ACI considered its entry potential to developing markets.

1.1.2. Market Prospects in the New Independent States (NIS). For ACI, markets within the former Soviet republics seemed to be the most promising for implementing its ambitious plans on business development and growth.

The historical processes related to the collapse of the former USSR and the ensuing independence of the former socialist republics have prompted development of market-oriented relations. These newly developed principles and virtues, inherently, were different from those, which the former administrative social-planning economy used to adhere.

Despite negative tendencies associated with rapid economic downturn in many of the former Soviet Union republics, such as extremely high rates of economic risk with high inflation, instability of the national currencies, significantly flawed tax and banking systems, and constrained long-term crediting, the barriers for market entry into these countries were considerably lower than those in developed economies. Although it was risky to enter unexplored developing markets, that challenge promised a large payback in the future.

Ownership restructuring and emerging private property rights on factors of production allowed to earn high returns to capital in traditional and newly emerged businesses. Deep restructuring of state-owned companies and an overall production decline led to an excessive supply in the labor market, and, consequently, large wage cuts. In addition, low quality produced goods and services, which were difficult to improve, because of inefficient production and management technology and underdeveloped procurement systems, could not satisfy the increasing consumer demand on goods and services, their quality and variety.

To implement deep policy reforms, the governments of these newly emerged countries made every effort to attract foreign direct investment to their economies. The establishment of their respective legislative and institutional frameworks supported these efforts. In transitioning economies, development of market relations and market-oriented legislation were prerequisites for the beginning and growth of small and medium businesses. During this time, early entrepreneurs with start-up capital and motivation to establish their own businesses surfaced in the market arena.

ACI used every possible source of information and data on the political and economic situations in transitioning countries including, the US mass media, and interviews with residents of these countries and American businessmen with experience in the region. The analysis of this rich data suggested Ukraine had high potential for realizing ACI's business goals. To select the target country, ACI's management developed the following criteria set of country factors, which influenced its choice:

- Geographical position;
- Social and cultural traditions;
- Political situation;
- Government control and market regulation;
- Service market development;
- Current and potential consumer demand on goods and services;
- Consumer potential.

The analysis of these criteria provided some tentative indications. First, it appeared Ukraine's market had favorable conditions in which to develop ACI's business. Second, ACI had an excellent opportunity to benefit from entering the market before its potential competitors.

Both objective and subjective factors drove the selection of Ukraine for ACI's business prospects. For ACI owners, who were of Ukrainian descent, the latter factors were instrumental. That they spoke Ukrainian, understood the culture and traditions, and had relatives and connections in Ukraine, largely influenced ACI decision to enter the Ukrainian market.

Another important issue was that the Ukrainian government, in an attempt to facilitate the entry of foreign investors into Ukraine's economy, had passed a series of laws with guarantees of privileged working terms for foreign investors. Of these laws, the most important are:

- Law of Ukraine on "Protection of Foreign Investment in Ukraine", adopted September 10, 1991;
- Law of Ukraine on "State Program of Foreign Investment Attraction in Ukraine", adopted March 1, 1994;
- Resolution of Ukraine's Cabinet of Ministers on "Terms of Foreign Investment", adopted May 20, 1993, No 55-93;
- Law of Ukraine on "Corporate Profit Taxation", adopted December 28, 1994, No 334/94-? ? .

Invariably, strategic investment projects in foreign markets are almost always associated with high risks. To minimize these risks, it is important not to make decisions based exclusively on general subjective information from the media, interviews, favorable business environment and foreign investment legislation, etc. Although ACI management initially decided in favor of Ukraine's market, it nevertheless proposed to conduct another detailed professional market study.

1.2 Market Entry Strategy

It is common knowledge that most companies cannot do adequate professional market research on their own, and, consequently, tend to hire outside experts. The costs associated with hiring high-quality professional market studies will pay for themselves in the future, as this expense helps avert huge losses, often unavoidable in the world of incomplete information. On the request of ACI management, the team of consultants with extensive experience in Ukraine's market scanned the business environment with respect to ACI's plans. Their research focused on several dimensions: the market study of Ukraine's service, equipment, and materials markets, all closely and professionally analyzed and evaluated. The consultants used reliable information from surveys and focus groups, Ukrainian law, social environment and mentality, estimates and forecasts of the effects of the social and political situation on Ukraine's market were considered when consultants came to drawing conclusions.

This research prompted development of a new ACI business strategy, which envisaged profit maximization through both consistent ACI expanding in traditional markets (*dry-cleaning and laundry)* and exploiting new directions and opportunities in developing markets, in particular, that of Ukraine. Among the most prospective business directions, ACI management selected the following ternary:

- *Creation of new enterprises* through advertisement and popularization of dry-cleaning and laundry services and *involvement into the project of local entrepreneurs* with own financial resources that would create the inside market of technological equipment and materials (demand from the project-involved enterprises).
- *Sale of technical equipment for other dry-cleaners and laundries* that would help to bring considerable and, more importantly guaranteed revenues.
- *Sale of materials.*

This business expansion strategy implied several advantages for ACI, which allowed it to minimize risks by diversifying ACI's activities in a new market. At the same time, the corporate strategy was in accord with available ACI financial and human resources. Although ACI had no experience working outside the US market, it was greatly experienced in operating more modern equipment and governing enterprise networks, factors equally important for the new strategy to become a success.

1.3 ACI Project Conception

Having decided in favor of Ukraine to expand its business internationally, ACI started developing its project conception. In this process, each step was based on the deep analysis of all findings from the market research and ACI's own experience in the service market. Every possible effort was made to account for likely barriers and positive factors in the project implementation.

Company management found the following factors largely beneficial for the project's implementation, and instrumental in attaining ACI's market goals:

- *Traditional nature of services.* For many years, it has been customary for Ukraine's population to use dry-cleaning and laundry services.
- *Decline in the number of dry-cleaners in Ukraine's market*. The number of Ukrainian companies, specializing in dry-cleaning and laundry, has fallen significantly in the last decade. A primary reason is that that the typically state-owned companies had to close a large number of its enterprises for the following reasons:
  - Inability to maintain efficient work while using out-dated equipment (made primarily in the former USSR and GDR);
  - Inability to buy accessories for equipment and materials sufficient to maintain efficient operations;
  - Inability to work in the new environment of a market-oriented economy without governmental assistance and centralized distribution of materials and accessories.

In addition, the service standards of state-owned enterprises did not comply with the international standards of dry-cleaning and laundry. Privatization of state-owned cleaners, which in most cases was accomplished by creating closed joint stock companies (JSCs) with participation of employees, failed to bring investment necessary to install new equipment and buy advanced technologies. At the same time, foreign companies – dry-cleaners and laundries – with high-quality standards of work and abilities to satisfy the current and potential demand of local consumers, had yet to emerge in Ukraine's market.

- *Demand.* Market research revealed that there is a segment of Ukrainian consumers whose demand international standards level services, and whose willingness to pay for such high-quality dry-cleaning and laundry is encouraging for prospective dry-cleaners.
- *Privileges.* In an attempt to attract foreign investment to Ukraine, the Ukrainian government granted corporate profit tax exemptions for companies with foreign capital for a five-year period. Imports of dry-cleaning equipment were classified as imported goods of critical importance for Ukraine, and hence were not subject to the VAT and excise taxation. The import duty for this equipment was only 5% of its declared customs value.

Aside from these positive developments, management found several factors that could become barriers for the project implementation in Ukraine, such as:

- *Significant economic risks.* Characterized by high inflation, national currency instability; undeveloped financial system and pale opportunities for long-term crediting; and limitations associated with the currency control.
- *Instability and inconsistency of the Ukrainian legislation*. Ukraine's legislation on regulating enterprise activities was subject to constant changes and modifications, since many of the former USSR laws, inherited from the Soviet era, conflicted with the laws of independent Ukraine. There was also a practice of preferential usage of some decrees and governmental resolutions, which were in contrast with the primary laws. The tax legislation also did not facilitate the process of business development in Ukraine.

- *Political instability*. Primarily related to the great power of bureaucrats and widespread corruption.
- *Rapid growth of income inequality*. Lack of institutions vital for a market economy to function and undeveloped public institutions for the protection of entrepreneurs' interests (associations, unions, etc.) have hampered business development in Ukraine.

Given these factors, ACI management decided to base the project conception on a cost minimization policy that would limit business operations of the company in a new market and minimize its risks in realizing the corporate globalization strategy.

Based on the ideology of this project, direct franchising was defined as the appropriate implementation strategy. Worldwide experience in the development of service businesses suggests that the best results are achieved through franchising. The century-long tradition of successful franchising expansion into domestic and foreign markets by American companies encouraged ? CI to predict successful implementation of its project. The company's management thought the franchising design the best to meet Ukraine's specific market environment because of the advantages it posed for the company and some implied guarantees for the project's success. For Ukrainian entrepreneurs with no specialized knowledge or experience in this business, the franchiser's vast experience, guaranteed operational assistance and management indicated very good prospects. Together, these factors would allow entrepreneurs to substantially decrease the period of opening their own businesses, avoid making typical mistakes of "beginners", and minimize costs.

Knowledge of franchising principles has permitted ? CI management to use standard approaches in identifying the project's strategy. It could benefit from observing the experiences of other franchising companies. At the same time, ACI clearly understood that the standard franchising scheme, which was acceptable for countries with developed market economies and regulated by the standardized international legal system, required some adjustment to Ukraine's environment and cannot be used blindly.

To ensure successful entry into Ukraine's dry-cleaning and laundry market, ACI identified a two-stage business development strategy:

- Implementation of the pilot project by the parent company;
- Creation of franchising networks.

This market entry strategy was expected to secure the greatest market share for ACI and bring the highest business profitability and return on investment.

2. “AMERICAN CLEANERS INTERNATIONAL” PILOT PROJECT

The pilot project proposed creating the parent company in Kiev, the center of Ukraine’s business and cultural life, based on the model of “American Cleaners”. Successful performance of this company was expected to generate great interest among Ukrainian entrepreneurs and companies and better reflect the advantages of business franchising. The effect of this type of demonstration on potential partners considerably exceeds other forms of advertising. This effect was reinforced since prospective partners, future franchisees, were clients of “American Cleaners” and therefore could learn the business and evaluate the quality of dry-cleaning from their own experiences.

When the first entrepreneurs showed interest in working with “American Cleaners”, ACI management planned to use the Kiev-based affiliate as a “demo-version” in negotiations and a training center to transfer technology and expert certifications. With the development of Ukrainian franchisees and the franchising network, it was planned to organize the Kiev-based office to support and coordinate activities of franchisee-enterprises, to ensure effective supply of materials and equipment, to provide consultative assistance, and so on. Focusing on promotion of franchise sale in Ukraine and involvement of local investors to the project, Kiev-based office has become the leader in the Ukrainian franchising system.

Besides, the pilot project allowed ACI to learn through practice Ukraine’s specificity in many dimensions, particularly:

- local legislation;
- taxation, customs and excise duties;
- marketing;
- standards of constructing production facilities;
- fire-protection standards;
- norms of health and work security protection;
- norms of city and land planning; and
- other institutional and production related factors.

To implement the dry-cleaning pilot project in compliance with the chosen business strategy, ACI management designed a two-stage activity plan, consisting of preparatory and primary stages.

2.1 Preparatory stage

In creation of the principal enterprise “American Cleaners”, the preparatory stage included several steps:

?) Identification of the enterprise legal status

The issue of identifying the enterprise’s legal status was unquestionably important for the company’s creation and every aspect of the company’s activities in the years to come. Management decided to register the company as an American-Ukrainian joint venture in the form of a joint stock company. This organizational form implied:

- Risk diversification of investment projects and attraction of additional investment to the project from the Ukrainian partner;
- Opportunities to gain a Ukrainian partner's experience and knowledge;
- Reduction of the time period necessary to register a company by employing the highly developed and widely-used practice of registering foreign companies in Ukraine in the form of joint ventures (JV);
- Tax privileges, which Ukraine's legislation of that time granted for a company with foreign investment for a five-year period from the date of its official registration.

b) Selection of Ukrainian partner

In the search for prospective partners, ACI management considered Ukrainian companies dealing primarily in the service market, particularly in the dry-cleaning and laundry segment.

In the Kiev-based office, ACI had several representatives empowered to negotiate and make final decisions. After a series of intensive negotiations, the company reached an agreement with a local firm specializing in laundry services. A former state-owned enterprise, this firm was reregistered as a joint stock company by the conclusion of a negotiated agreement. For a number of reasons, its financial position was unsatisfactory; however, this drawback was compensated for, since the potential partner had premises already equipped for a laundry, precisely conforming to the technical standards required for dry-cleaning facilities.

c) Company creation

Through extensive communications with representatives of Ukrainian service companies, ACI management obtained a favorable impression of the business reputation and honesty of its potential partner. Long negotiations were fruitful and the partners agreed on formation of the JV statutory fund designed to the following scheme:

American partner	*Ukrainian partner*
• Set of technological equipment • Automobile for company daily activities • Financial resources to set a venture and finance its forthcoming activities	• Production facilities to: - Accommodate and operate technological equipment - Place an office to receive orders - Accommodate office premises • Warehouse • Communication facilities

The founders considered the company name "American Cleaners" to be the most appropriate to reflect the essence and goals of the dry-cleaning business and attract potential clients.

As the partners agreed on all organizational issues, they requested a firm experienced in JVs registering legal advice firm to prepare documents for the venture registration.

d) Selection of equipment

In the process of selecting equipment, the driving principles were the importance of reliability and conformity to the most up-to-date technologies, more so than the costs. Management expected to ensure a ten- to fifteen-year period of effective utilization. Choosing equipment effectively is particularly important because the equipment costs account for the largest proportion of the capital investment.

In addition to the technical requirements, ACI management considered the manufacturer location, transportation expenses associated with purchasing the equipment, and the trademark reputation. Market research of equipment suggested that ACI management should decide in favor of German-produced equipment, in particular, Bowe Garment Care Systems GmbH and Veit GmbH.

Based on the findings from the market research, ACI management estimated demand for dry-cleaning, and identified the facilities' necessary production capacity for the Kiev-based pilot project. The pessimistic scenario of business development governed ACI's final choice. This scenario presumed that potential clients would consist entirely of the representatives from the richest strata of Ukraine's population. All calculations were grounded on the available statistical data on the number of mobile phone users, holders of recently-produced foreign automobiles, sales of luxury goods and so on.

These estimations allowed ACI's management to choose equipment with the most appropriate capacity and negotiate with the manufacturer a long-term contract, which incorporated the best possible discounts and exclusive rights on equipment delivery to Ukraine.

e) Choice of materials

Adhering to the dry-cleaning standards, ACI decided to use US-produced materials. It negotiated with a manufacturer of materials a long-term contract, similar to the equipment contract entered into, including discounts and exclusive rights on materials delivery to Ukraine.

f) Working scheme to deal with clients

The accepted working scheme was supposed to account for each requirement of the most demanding and fastidious consumers.

This scheme design was as follows. The dry-cleaning order is accepted subject to prepayment. The company automobile then collects clothes from receiving offices and/or directly from clients and delivers them to the central dry-cleaner, where qualified specialists process the clothing on first-rate equipment, using the most advanced production technologies. Cleaned clothes are then returned to clients in whatever manner they find the most convenient. Clean goods may be retrieved in any receiving office, the central dry-cleaning building or delivered directly to a client.

ACI used technology that allowed it to clean almost any kind of clothing ranging from light silk blouses and wool suits to raincoats and coats. This gives all clients interested in high-quality dry-cleaning an opportunity to obtain this service.

g) Recruiting

To ensure effective governance of the daily company performance, the founders announced a tender for the vacant positions of manager and chief accountant. The following criteria directed the selection of successful applicants:

- Managerial experience on enterprises;
- honesty and a good business reputation, supported by references and recommendations; and a
- well-demonstrated ability to learn.

An applicant having extensive experience working in the dry-cleaning industry was not a decisive factor in hiring him/her as the manager. A manager with prior experience could bring negative controlling habits, which conflict with ACI corporate ideology.

2.2 Primary stage

The primary stage consisted of implementing a package of practical measures on production facilities installation and the preparation for the company onset, including the following procedures:

?) Premises repair

According to the technical standards of equipment installation and the recommendations from ACI technical experts, the premises where "American Cleaners" was to begin operations were repaired and partially reconstructed.

b) Equipment installation

Subject to the contract terms, several specialists of the manufacturer came to Kiev to govern the equipment installation process.

c) Permission to establish a venture

The company management made every effort to get permission for designing a company to pass the sanitary, fire-protection and technical inspections.

d) Tariffs on services

The results from the previous market study and the financial plan largely shaped ACI strategy to set competitive tariffs on its services so they could ensure attaining the planned profitability levels.

e) Recruitment of personnel

The company management and some of the firm founders hired personnel to support company's activities from the company's launch.

f) Training

ACI representatives arrived in Kiev to hold a training seminar on equipment exploitation and standards of dry-cleaning. During this training, the experts exclusively used new inexpensive clothing and employees' belongings. No clothing belonging to clients were used during this training.

g) Advertisement campaign

An ACI marketing specialist, who came to Kiev to study the situation directly, designed the advertisement campaign. It was supposed to be launched before the company officially opened and maintained as the enterprise develops and grows. The main message of this promotional campaign was to inform the maximum number of prospective clients about the opportunity to get high-quality dry-cleaning in Kiev. The following methods were employed to accomplish the campaign goals:

- Publication of advertisements in the most popular press;
- Installation of outdoor advertisements in the form of well-located promotional boards, "big-boards", "light-boxes";
- Direct delivery of promotional materials, specifying the opening date and location of the new enterprise and invitations for the company presentation, to largest Ukrainian and foreign companies, diplomatic office and trade missions;
- Distribution of information "fliers" with the opening date and location of the newly-opening enterprise;
- Presentation of the pilot enterprise.

Each of the listed measures was undertaken to ensure that the "American Cleaners" pilot project became a success in Kiev.

2.3 Pilot enterprise activities

In Kiev, the company start-up was successful. From the beginning, "American Cleaners" managed to arrive at the planned volume of sales. The company benefited from several competitive advantages: other dry-cleaners located in Kiev were not able to provide dry-cleaning services at the same level of international quality. The number of orders and clients' comments on the quality of "American Cleaners" services vividly demonstrated that the personnel's training was effective and all preparatory actions were sound and rational.

Management realized that such a good beginning did not imply no further need of daily governance and control over "American Cleaners". Therefore, ACI designated a permanent Kiev-based representative to coordinate firm activities with the pilot enterprise's manager. The American specialist had extensive experience and specific knowledge, which positively influenced business development and company management. The first three-months of operation indicated that the main priority for the company should be sales growth associated with a steady increase in the number of customers. Therefore, it was essential to consistently maintain and increase the quality of provided services, follow every production and regulative requirement of the controlling authorities, utilize consumer data to closely track market trends, and promptly react to demands and comments of clients.

To attract additional customers, American Cleaners' management decided on a series of steps to promote the company's services and stimulate consumer demand:

- Organizing the service to collect and deliver orders directly to clients at their home or office. This scheme was aimed at providing the most convenient and diverse services to customers, which are consistently time-constrained.
- Creating a multi-branched network of American Cleaners "receiving offices" in various Kiev districts.

  Although this method is not typical for the US dry-cleaning business, it agrees greatly with the traditional Ukrainian scheme of cleaners operations. Locations with high customer traffic were chosen as locations for the American Cleaners' receiving offices, which guaranteed the imminent service for customers. For automobile delivery of orders, American Cleaners scheduled a regular route. In the first year of operation, three receiving offices were opened and currently this number has increased to 15.
- Placing promotional information on public transportation: trams and trolley buses. To maximize the effectiveness of advertisement at the largest possible area, American Cleaners selected the longest transportation routes.

These policies produced excellent results. The number of orders grew rapidly and the company reached full production capacity. Additional sales growth could possibly damage the ability to fulfill orders and/or damage the quality of service. At the same time, the corporate strategy to maximize American Cleaners' market share determined the management decision to continue an aggressive advertising campaign and expand the network of receiving offices.

Prompted by these developments, American Cleaners management hired additional personnel and organized a two-session production schedule. This decision stabilized the situation for a time, but failed to solve the problem. The number of orders increased. Moreover, the seasonal fluctuations and associated instabilities in the number of orders caused additional problems. Apparently, ACI experts made some mistakes in their estimation of the necessary production capacity, such as:

- Excessive caution in choosing the pessimistic scenario of sales growth and exclusive orientation on the wealthiest consumers;
- Insufficient estimations of the market non-concentration factor.

The market share maximization strategy did not permit American Cleaners to raise prices. The volume of orders far exceeded production capacities, which, in turn, caused problems with completing orders in due time. This conflicted with the philosophy of American Cleaners trademark and damaged the parent company's reputation. For the founders, this last factor was instrumental in making a decision to invest additional capital and buy an additional set of equipment.

This decision implied a need for more production space. The Ukrainian partner provided additional production space, in the form of additional investment. The second equipment purchase confirmed that ACI had serious plans to develop its business in Ukraine, a factor of particular importance for German equipment producers, which helped ACI gain substantial discounts on the purchase.

Increased production capacities stabilized the situation and ensured steady production up to all quality standards.

In 1996, the market situation in the country became considerably more complicated. A large number of foreign companies entered the market of dry-cleaning and thus strengthened market competition. Besides, some domestic dry-cleaners showed first indications of financial improvement. More importantly, the market entry strategy of newcomers was primarily based on active dumping sales that could attract clients.

American Cleaners' management closely scanned these worrying trends. It paid attention to not only market policies of its competitors but also the need to charge higher prices for its services. Given persistent devaluation of the Ukrainian currency, the latter was unavoidable for the company to maintain stable profitability.

Obviously, the low-price strategy of ACI competitors, associated with unacceptably low profitability levels, was an interim marketing measure. Therefore, ACI management decided not to involve into "price wars" and, instead, to maintain its pricing policy. The final decision was to fix prices temporarily. Along with these developments, ACI implemented the whole range of effective advertising measures: all aimed to ensure that the company maintains its leading position in the dry-cleaning market. To keep the image of its trademark sound, ACI launched an active advertising campaign that stressed the exclusive quality of ACI services. All these efforts worked to maintain the steady volume of orders and minimize the loss of clients, who in a period of increased competition abandoned using ACI services.

Rapid changes in the market implied some adjustments in the corporate strategy. As a result, ACI introduced measures to maintain planned levels of business profitability.

In 1997, several amendments to the Law of Ukraine "On the Regime of Foreign Investment" cancelled tax privileges for companies with foreign investment. Against all legislative norms, this government resolution was also effective for companies with the five-year privileged period yet to come to its end. New changes in the legislative framework and the existing tax burden have negatively affected the financial performance of many companies, including ACI, and largely damaged returns on investment. New institutional changes left no option for ACI but to raise prices to partially compensate for its losses from new tax payments. This decision hardly affected company sales because it came into force during a period of reported growth of Ukrainian's personal income. The financial analysis vividly demonstrated that launching highly profitable production processes and professionalism by every employee allowed ACI to reach excellent financial results. "American Cleaners", which still has the leading position in the Ukrainian dry-cleaning and laundry market, is a good example.

It has become obvious that, what is essential for developing a successful business plan to launch a new venture, is a sound understanding of the legislative and market environments of the country in question. To reduce the project implementation period, it would be more effective to use the method of simultaneous rather than consequent realization of each project stage. Apparently, there is every rational to attract local managers at the primary stage when a new company is set up in the foreign unexplored market. Every project assignment determines if there is a need for the parent company to involve its representatives directly in the project. In addition, during initial stages of foreign market entry, it is important to evaluate the potential negative impact of high economic risks and legislation instability on the relevant business and design the corporate strategy accordingly. This would leave sufficient room to implement measures to minimize costs from such negative effects.

3. FRANCHISING NETWORK CREATION

Transition to the second stage of Ukraine's market entry, creation of the franchising network, envisaged implementing a series of arrangements:

- Establishing of the trademark copyrights in accordance with the Ukrainian legislation;
- hiring of high-qualified personnel capable of realizing the project;
- developing the “franchise-package” to include the full list of ? CI services;
- estimating the franchise cost based on the “franchise-package” with subsequent franchise payments;
- developing the drafts of business contracts in accordance with the Ukrainian legislation;
- developing and implementing of the marketing plan on the “franchise-package” market entry;
- providing support to franchise enterprises in accordance with the terms of contract.

3.1 American Cleaners’ “Franchise-Package”

The “franchise-package” is a set of services for establishing American Cleaners in Ukraine, which the franchiser-company ? CI sells. That ? CI is interested in maximizing profitability of its franchisees reflects in the ways it offered its services. Design of the “franchise-package” unites all the listed factors in tandem. In developing the “franchise-package”, ? CI relied heavily on the experience it gained from launching the pilot enterprise in Kiev. The distinctive feature of the “franchise-package” is that it allows sales of the whole set of services rather than some of them. Before, it was impossible for a franchisee to buy a trademark, materials, or equipment and start its own business. Despite ? CI’s great interest in maximizing its sales in the Ukrainian market, such a policy would damage the project, discredit the near essence of franchising and have other significant negative results. The “franchise-package” approach guarantees that unified, i.e. the trademark conformable quality standards of service are used.

The “franchise-package” was designed so to include the following components:

- Rights to use the trademark and company logo in the franchisee business activities.
- Equipment with production capacity sufficient to satisfy the needs of the particular region in Ukraine.
- Materials and accessories to support the standard process, in the amount necessary for a 6-month production period and adjusted to the requirements of the region.
- Consultation support from the franchiser-company on some production issues:
  - Technical review of prospective production premises;
  - Marketing review of the location of prospective production premises.
- Design of engineering solutions on equipment installation. Adjustment of working designs.
- Managed equipment installation and adjustment.

- Technology transfer: technical personnel training at Kiev-based pilot enterprise “American Cleaners”.
- Management training at Kiev-based pilot enterprise “American Cleaners”.
- Design of advertising materials.
- Development of individual plans on launching the advertisement campaign (adjusted to the regional specificity).
- On-line consultation support.
- Transfer of technical and management expertise: training and workshops during the period of agreement.
- Delivery of materials and components for equipment at the franchisee cost during the period of agreement.

Design of the “franchise-package” adhered to the following principles:

?) Rights to use the trademark and company logo in the franchisee business

Granting the rights to use the trademark and the company logo, a typical feature of such transactions, is mutually beneficial for the franchiser and the franchisee. The franchiser, on the one hand, is willing to popularize its business at the foreign market to attract new customers and, consequently, earn higher profits. The franchisee, on the other hand, can use the franchiser image and reputation since it enters this business. Good reputation of a particular trademark largely contributes to ensuring high returns to investment.

Therefore, Ukrainian franchisees can benefit from using a good reputation of the well-known name in Ukraine, “American Cleaners”. This Kiev-based enterprise was the first in Ukraine to provide dry-cleaning services at high quality standards. The population of other cities could get such services when visiting Kiev. Customers not local to Kiev usually became clients of American Cleaners in their area.

b) Equipment

The following principles have driven the design of technological equipment sets:

- *Unification.* To ensure that all services are of equally high quality, it is essential to use the same technology. The franchiser can allow some disparity in the equipment’s capacity settings subject to the regional specificity of the franchisee.
- *Adequate sufficiency*. From its experience, the franchiser can effectively compare equipment production capacity with regional market demand. Excessive production capacities may impose extremely high costs on the franchisee because the cost of equipment accounts for the greatest share of the “franchise-package” cost. At the same time, insufficient production capacity would lead to violations of the quality standards, such as more time required to complete orders, over-employment, and so on. As such, the range of equipment settings was designed from “mini” to “extended”.
- *Modernization*. Capacities of equipment were up to the international standards of dry-cleaning. Common to a new generation of equipment, its computerization level prevents any possibility of breaking up a given

technological regime, and significantly increases productive efficiency. For example, productivity of a modern steam-mannequin corresponds to that of two ironing machines. The equipment is generally bought for a long period and the more modern equipment should correspond with the most advanced *technologies*.

- *Constructive reliability*. Trouble-free equipment operation ensures steady production and avoids shutdowns related to technological problems. Each item of equipment has its operational function, and its failure could ruin the operating process. Lost time associated with repair or replacement and the resulting inability to serve customers in time would damage the company's reputation and bring additional expenses.

c) Materials and accessories

The franchiser offers a set of materials and accessories, which consists of chemicals for dry-cleaning and packaging materials. The set is designated to ensure stable work of equipment with a given technological capacity. The franchise agreement specifies all terms. A single delivery of materials is supposed to satisfy production needs for a six-month period. From its experience, the franchiser evaluates the amount of materials required, adjusted to the regional specificity and market demand prospects. In this calculation, the franchiser accounts for the predicted market growth after the company's beginning and potential losses from inexperienced performance of employees during the initial stages of work. A six-month delivery interval allows the franchisee not to "stock" its funds for a long period, which in turn favors the financial position of the franchisee.

d) Consultation support of the franchiser-company on selection of production premises

The choice of production premises is one of the most important factors in ensuring performance successful. Errors in choosing production facilities could cause significant problems for the franchisee in the future. Generally, the franchisee has neither experience nor specific knowledge concerning business location. The franchiser experience may help the franchisee avoid making mistakes. Experts from the franchiser-company study the location for production facilities. The marketing specialist evaluates the location characteristics, as they would serve to attract customers. The level of business activity in the prospective area is also considered. The technical specialist evaluates premises for their compliance with equipment installation requirements, Ukraine's sanitary and engineering norms, communication standards, and reliability of construction structures. This professional review allows the franchisee to estimate expenses related with its decision to locate production in the specific premises.

e) Design of engineering solutions on equipment installation. Adjustment of working designs

Equipment installation requires that the franchisee have specific engineering knowledge and experience. At the same time, the franchiser is highly qualified to resolve the following issues:

- Location of equipment in a specific area in compliance with technical requirements, sanitary and engineering norms.
- Location of pipe and cable infrastructure facilities.
- Estimation of the amount of materials in addition to those supplied with the equipment (electrical cable, distribution and locking devices, pipes, etc.).
- Detailed budget on purchases of installation materials.

The franchiser does all the preparatory work, which allows the franchisee to avoid technical errors, minimize the number of problems with equipment operation and costs, and finally to reduce the installation period.

f) Managed equipment installation and adjustment

Managed installation implies that equipment is installed under supervision of franchiser-company specialists.

Once the equipment is installed by franchiser-company specialists, the cost of the "franchise-package" would grow substantially. In this case, the franchisee would have to cover the transportation cost and per diem of the franchiser-company specialists. Generally, the billing rates for experts in the franchisee region are low while the knowledge and experience of the franchiser-company specialist compensate for the gap in the specific skills. Installed equipment requires the choice of a standard work program and to adjust it accordingly. The franchiser-company specialist implements this adjustment and launches the trial process. At the final stage of installation, the expert develops a list and schedule for equipment servicing.

g) Technology transfer: technical personnel training at Kiev-based pilot enterprise "American Cleaners"

For a business to become a success, much depends on how effectively the franchisee personnel masters the production technology. The specificity of the dry-cleaning business does not allow a business to start work with unskilled and untrained personnel. Low-quality service at the initial stage would have a negative influence on long-term company performance and lead to the loss of customers. Therefore, the franchiser offers the most painstaking but effective approach for the company:

- In accordance with the requirements of the specific equipment set, the franchisee hires personnel. In doing so, it follows the franchiser recommendations on selection criteria.
- At its expense, the franchisee sends its employees to study at the Kiev-based enterprise for a period specified by the franchiser. In this particular case, a 30-day training course.
- Using a well-developed education methodology, the franchiser trains the participants at «American Cleaners» production sights. Every participant has an individual mentor. The education methodology implies that participants additionally master several related professions to ensure good interchanges between professions.
- In the end of the training course, the franchisee holds examinations for all participants.

- During the initial stages of the training course, the franchisee allows some participants to be replaced if their professional skills are unsatisfactory to cope with the course requirements.

Following a unified policy at all enterprises of the franchising network reinforces the effectiveness of this education method. For its technical characteristics and organizational methods, the franchiser-company is identical to the franchisee-enterprise. Those participants who successfully finish the training course can effectively work at their enterprises.

h) Management training at Kiev-based pilot enterprise "American Cleaners"

The experience that the franchiser gained in Kiev allowed it to develop several recommendations for the management of the franchisee-enterprise. Although not a standard business training course, this managerial training informed its participants (managers and chief accountants) about solutions to the standard issues:

- Coordination with regulative authorities.
- Business compliance with the legislative norms.
- Warehouse management and procurement planning.
- Audit and accounting specificity.
- Labor policies.
- Management of customer conflicts.
- Marketing.

The knowledge that management of the franchisee-enterprise gained in the form of ready-to-use practical solutions helped substantially in the future franchisee performance.

i) Design of advertising materials

Today for an enterprise to be successful in the service market, advertising plays an important role. Effective promotional activities include publishing of ad materials in the press, using advertising booklets and discount cards, outdoor ads, special working clothes with the company emblem, etc.

The franchiser, which offers the ready-to-use design solutions for every advertising tool, saves the franchisee time and money. At the same time, this service is necessary for the franchiser to ensure that the principle of unification is observed.

j) Development of individual plans on launching the advertising campaign (adjusted to the regional specificity)

Success of the franchisee business depends largely on the effectiveness of the initial advertising campaign. The franchiser's experience allows it to design the most effective advertising program, for which the franchiser sends its marketing specialist to the area of the franchisee. This specialist's expertise about the local specificity and the available mass media (the press, radio, TV, etc.), helps to develop the most effective methodology for launching an advertising campaign and offering several scenarios depending on different cost. The franchisee chooses the most appropriate scenario as it finds the latter based on the available financial resources and expected ad effectiveness.

k) On-line consultation support

The franchiser realizes that the franchisee might face non-standard situations and problems in its daily activities. For the franchisee, an opportunity to get on-line support from the franchiser substantially assists in decision-making. The franchiser's experience and specific skills ensure that it can consult the franchisee on every issue of the enterprise's activities.

l) Transfer of technical and management expertise: training and workshops

In developed dry-cleaning markets in the West, the franchiser works in a highly competitive environment. This ensures that it consistently tracks the most advanced achievements in the field of technology and management so that it can remain competitive. Newly emerged chemical products, accessories, methods of service promotional support drive the industry development. Technological innovations are tested at the franchiser enterprises. Based on the practical results of these tests, the franchiser evaluates technological and financial advantages of the new product. In cases where the findings are positive, the franchiser offers the franchisee the opportunity to use new products and methods at its enterprises. In using innovative products, practical experience has demonstrated that the greatest positive result can be achieved when additional training for the franchisee is provided. It is held for all franchisees in the form of the workshop. The workshop environment facilitates communication between franchisees from different regions, experience exchange, and establishment of personal contacts.

The pilot project experience gave an opportunity to design the "franchise-package" so that it included the most appropriate services for the franchisee to start its business, protect it from the beginner mistakes, and largely contribute to the enterprise becoming a success.

Standardization of all franchisee-enterprises (equipment, technology, and management) ensures that the unified trademark conformable standards of quality are used.

In essence, the "franchise-package" is a list of the franchiser responsibilities to the franchisee and it sets the framework of the franchise–contract in the "Responsibilities of Parties" section.

3.2 Selection criteria and franchisee choice

The careful examination of the worldwide franchising experience suggested that ACI management choose specific approaches in solving the issues, which might have a significant impact on the project's success.

Of these issues, the choice of the franchisee is among the most important. In essence, franchising is a partnership agreement, which imposes some responsibilities on the parties involved. Successful realization of these responsibilities largely depends on the fact that parties reach an agreement on most important issues of their joint activities.

The franchising ideology implies mutual commercial dependence of the parties. In foreign markets, distinct from the franchiser country's moral, ethnical and legal norms of business, the selection of a partner is particularly important. ACI experience in Ukraine's market showed that mutually benefit from agreement between the franchiser and the franchisee, based exclusively on the partners desire to get high profits, cannot be a sufficient condition for the project to become a success.

For choosing its potential franchisees, ACI management identified several selection criteria, which had priority over the company strategy to increase franchise sales, for matching the franchisee characteristics. Of the set selection criteria principles, compliance by ACI potential franchisees with existing business principles of the franchising association and the project profitability estimates were instrumental. Of the franchisee selection criteria, legal compliance, business reputation, high motivation, sufficient financial resources, willingness and ability to study, and other skills were the driving factors.

The selection problem was complicated because in practice only indirect factors, observable during negotiations and the initial stages of cooperation, could give some tentative indications of how well potential partners match the selection criteria. People directly negotiating the contracts were responsible for this assignment.

?) Legal compliance

This criterion implies that the prospective franchisee works in compliance with the legislative norms and laws. If a potential partner violates the law, that action would most probably have a negative impact on both its enterprise and the whole franchising network. In countries with transitioning economies, instability in the economic situation and legislation often imply a favorable environment for criminal practices when running businesses. To a large degree, this situation is characteristic of that in Ukraine.

It is hard to reveal how well a prospective partner will comply with this criterion, since potential franchisees typically hide such criminal activities. During numerous negotiations, the franchise manager collected any available data on the potential partner, such as its experience and market performance. From this information, it was possible to have some idea about the business reputation of the potential partner. References from companies, which worked in the similar market segments and/or regions, as well as comments of the former clients assisted in identifying the real situation.

b) Business reputation

This criterion reflects how well a prospective franchisee is able to keep agreements and follow ethical business principles. The franchising principle implies honest business relations between the parties in every term of the agreement. Failure of the franchisee to comply with this criterion may damage the financial position of the franchiser and hurt its business reputation.

In Ukraine, ACI has also had negative experiences with some franchisees violating this principle, and the resulting cost for the franchiser. This refers to when one of the franchisees bought material, inconsistent with the installed equipment, from a different supplier at a lower price. In addition, some franchisees violated the franchise agreement by conducting non-specified operations. In addition, some franchisees intentionally misinformed the franchiser about their unsatisfactory financial performance in order to obtain some privileges.

In discussions about contract terms, the franchisee's behavior may be indicative of its business reputation. Close analysis of all contract issues indicated the responsibilities of the potential partner. However, careless consideration of the contract suggested this party did not consider the terms of agreement necessary to follow.

c) Business motivation

This criterion reflects to what level the potential franchisee is interested in maximizing the results of its work. Inability to conform to this principle may produce poor results. At best, the franchiser could waste time on long negotiations with no contract in the end. In most cases, these were representatives of Ukraine's small and medium sized businesses willing to increase their capital in the project. Good business motivation to participate in the project showed those entrepreneurs who received bank credits to buy their first businesses - franchise.

Business motivation of prospective franchisees often became evident during initial negotiations, making this criterion easy to evaluate. In Ukraine, ACI has experience of selling its franchise to a large state-owned company, for which the project success was not a crucial factor. With no incentive for management to maximize profits, the company performance was unlikely to improve and the franchiser's efforts to improve the situation mostly failed. Poor motivation of such franchisees reflected in the pale financial records, which were inconsistent with the business reputation to be highly profitable. Damage to the business reputation had a direct negative influence on the franchiser-company that made every effort to popularize its business and involve new participants in the project.

d) Sufficient financial resources

Matching this criterion with the potential franchisee primarily determined its participation in the project. However, apparently a simple choice was often misleading. Taking into account the size of investment, the contract allowed for a possibility of a multi-stage payment system, even though this implied some risk for the franchiser.

ACI had experience in selling a franchise to a company that failed to find sufficient resources to pay for the second transfer. In addition, ACI sold its business to a large Ukrainian multifunctional company. Initially, its franchise business was successful. However, for adverse reasons outside the control of the franchise business, the financial situation of this company was critical since the moment of the franchise agreement. The bankruptcy of the prospective franchisee ruined the potentially successful project.

Analysis of the financial performance of the prospective franchisee was conducted during the preliminary negotiations. The franchiser representative had to make certain that the potential franchisee had sufficient funds to finance the project.

e) Willingness and ability to study

Given the specific nature of relations between the franchise partners, the division between “governing” and “governed”, this criterion is particularly important to match. In other words, the franchiser acts as the parent company, and the franchisee, its affiliate.

Several franchise managers were not willing to respect the international business principles and franchising norms, in particular. They rejected the significance of the international experience, and overestimated the Ukrainian market specificity. This attitude resulted in the franchiser inability to ensure full understanding by the franchisee. During negotiations, it became apparent that the agreement with such a franchisee, which conflicts with the ACI business concept, would not last long.

The franchisee’s choices based solely on the listed selection criteria did not guarantee project success. Insufficient information about a potential franchisee sometimes led to the selection of bad partners.

4. PROJECT IMPLEMENTATION

After successful implementation of the pilot project and development of the "franchise-package" and franchisee selection criteria, ACI launched its project.

Ukrainian mass media widely reported advances and progresses of the Kiev-based enterprise American Cleaners. Such successful business generated large interest among local companies and entrepreneurs. This created a favorable marketing environment to initiate franchise sales, and introduce a series of organizational measures for the project implementation, including:

?) Legal protection of the trademark and logo rights in accordance with the Ukrainian legislation

ACI submitted an application to register its logo and trademark to the State Patent Administration of Ukraine. To facilitate the decision-making process on this issue, ACI employed an Administration-registered patent attorney. Conformable to Ukraine's legislation and registration practice, the patent attorney conducted the rest of the procedure registration issues. Since its submission of the application to the Patent Administration, ACI has officially established the priority right to use its logo and trademark. Ukraine's Law "On Protection of Copyrights on Goods and Services", adopted July 1, 1994, legally supported this action. For its business within Ukraine, American Cleaners did not have any violation of its copyrights so there was no need to apply the Law.

b) Personnel employment

For project implementation, ACI employed personnel, who were managed by one of ACI managers, the coordinator of Kiev-based pilot enterprise, during the initial stages of the project. Qualified Ukrainian specialists increasingly participated in the project as it proceeded.

c) Negotiations on delivery of equipment

Responsible for the franchise project, the company representative negotiated the equipment purchase with Germany production companies Bowe and Veit. Close analysis of Ukraine's relevant markets and estimated business profitability prompted large interest among equipment producers in Ukraine's developing market. At the end of negotiations the following agreements were reached:

- ACI received exclusive rights to sell equipment in Ukraine's area;
- ACI gained discounts on equipment purchased for resale in Ukraine's market.
- The parties arranged every issue of the payment system.

d) Negotiations on delivery of materials

Company management negotiated the terms of delivery of materials with several American companies and the parties agreed on potential discounts for ACI's sales of materials in Ukraine. ACI received exclusive rights to sell materials in Ukraine.

e) Estimation of the franchise cost, based on the "franchise-package" and franchise payments

The amount of production costs, including costs of the franchiser services, equipment, materials, and economic profit, primarily drove franchise costs. The planned profitability level accounted for the poor financial resources of most potential customers and the probability of repeated transactions. Tentative cost estimations were compared to previous estimates of the financial project. Given vast discrepancies in equipment productivity, ACI determined the cost of four types of franchises.

f) Design of business contracts in accordance with Ukraine's legislation

Per ACI's request, the legal company investigated Ukraine's legislation and found that it does not specify precisely the terms of the franchise agreement. Constitutionally, however, every Ukrainian citizen has the guaranteed right to conduct entrepreneurial activities, which are not prohibited by Ukraine's legislation (article 42). Moreover, the Ukrainian Civil Code allows the conclusion of any contract, which does not violate the legislative norms (article 4, part 2). Hence, the franchise agreement was legal.

Based on worldwide franchising experience and its business strategy in Ukraine's market, ACI prepared a draft of the franchise agreement. Its content vividly reflected all issues of the future work and detailed the mechanisms of collaboration between parties. The draft of the agreement had the following structure:

1. Parties.
2. Definitions.
3. Franchisee rights.
4. Franchiser rights.
5. Franchisee responsibilities.
6. Franchiser responsibilities.
7. Payment system.
8. Property rights.
9. Copyrights protection.
10. Procurement.
11. Rights transfer.
12. Rejection from competition.
13. Rights reservation.
14. Force majeur circumstances.
15. Agreement cancellation or modification.
16. New franchisees.
17. A priori responsibilities.
18. Footnotes.
19. Notifications.
20. Independence.
21. Violation of terms of agreement.
22. Bankruptcy.
23. Period of agreement.

24. Conflict settlement.

The main part of the Agreement specifies general actions of the franchise agreement parties, which in most cases agree with the typical franchise agreement. Its distinctive features, which reflect ACI concepts on the franchise area and the amount of royalty, are reflected in the following articles:

- Resolution on the franchise area

  During negotiations of the franchise agreement, the parties actively discussed every issue related to the franchise area. The regional specificity of the franchisee largely influenced the choice of equipment and materials. To minimize competition pressure and create the most beneficial conditions for the newly established franchise enterprise, the franchiser declined any opportunity to sell further franchises in this area for an 18-month period, in case the available production capacities of the franchisee could not satisfy the regional market demand. At the end of this period, the franchiser could offer the franchisee the opportunity to increase capacities and install an additional set of equipment. If the franchisee declined this offer, the franchiser was authorized to negotiate and make contracts on equipment sales with other potential franchisees in the region.

- Resolution on fixed royalty payments

  Given the widespread Ukrainian practice to hide income to avoid or minimize tax payments, company management fixed the size of the royalty payments to production capacity and expected business profitability (specified in the financial project). The franchisee was required to transfer the first royalty payments no earlier than in a six-month period after the enterprise opened. The royalty system of fixed payments helped the franchiser to control the franchisee revenues more effectively.

g) Franchise sale

The most effective methods to attract potential franchisees were:

- Direct mail distribution of business-offers to prospective customers;
- Publishing promotional information on the franchise project and ACI's franchise offers in the specialized business press.

Specifically for its direct mail distribution, the company management developed the business-offer, which included:

- Market research on Ukraine's dry-cleaning;
- ACI corporate profile and information about its activities in Kiev;
- Study on franchising concepts that specified franchisee advantages in the case of the pilot project for American Cleaners;
- Franchise content and cost; and a
- Typical franchise-contract.

The idea of business-offers was to inform potential customers about the prospects of the dry-cleaning business in Ukraine, clearly and effectively state the advantages of the franchising scheme, and invite all interested parties to join in this business and buy a franchise.

When distributing business-offers, private Ukrainian companies with diversified areas of activities were considered the best prospective customers. ACI created a register of such companies. The source of information included, reference books, exhibition catalogues, and business-directories. Additional data was obtained from the analysis of advertisers in the press. Apparently, this approach was effective because the magazine (journal/newspaper) reputation and the volume of its issues, as well as the number of advertisements, indicated company performance, its activities, and location.

Simultaneously with business-offer distribution, ACI placed advertisements and promotional information in the most popular, central and regional, business-press. This aggressive advertising campaign brought immediate and positive results.

From different Ukrainian regions, ACI obtained a number of letters of interest, which in each case were followed by the preliminary negotiations. For future market analysis, ACI kept reference information on all contacts. To ensure the promotion of franchise sale was done most effectively, a qualified and experienced expert governed the process.

Active negotiations with representatives of Ukrainian companies allowed ACI management to draw the following conclusions:

- The project idea and implementation methods complied with market demand, generated much interest among potential customers and indicated good demand prospects;
- The franchise business scheme is entirely new to Ukraine. The majority of Ukrainian businessmen have never heard of this scheme;
- Ukraine’s franchising peculiarity is that the Ukrainian legislation does not specify franchising as a type of business activities, which in practice sometimes led to misunderstanding of ideas within the Agreement.

In the course of negotiations, the main reason for inadequate understanding of the franchise business scheme by some Ukrainian partners was the need to pay the franchiser royalty. Some explanations for this hesitation are:

- Ukrainian companies are not willing to accept long-term responsibilities, due to the instability of Ukrainian economy, high business risks and general uncertainty.
- Specificity of the human character in reluctance to be a source of income for someone else.
- Underestimation of the franchiser role and its support to the franchisee business development. It was rather common for Ukrainian businessmen to think that support services are not necessary for successful business development and are imposed by the franchiser.
- The amount of royalty payments was considered excessive over business profits.

- Problems associated with the non-traditional practice of royalty payments, with audit, bookkeeping and control from tax administration authorities. This problem was complicated by the franchisee regional location. In some areas, only traditional business activities were common, and tax administration and regulative bodies negatively viewed any new type of business.
- Insufficient experience of the franchiser, a non-resident in Ukraine, in conducting regular transactions in the foreign currency and associated problems.
- High attention of tax administration authorities to companies, which conduct currency-denominated transactions, and associated currency limitations.

Close examination of the listed factors indicated that ACI should make an instrumental decision to settle these issues. Neither reductions in royalty payments nor their relation to production volumes would solve the problem.

ACI decided to remove the term on royalty payments from the franchise contract and raise the cost of materials. Since the volume of materials used largely reflect the volumes of production, the franchisee does not have an opportunity to understate production results in order to reduce its royalty payments. This decision complied with the franchising ideology because it illustrated the franchiser’s interest in the successful performance of the franchisee. Primarily this decision was driven by the findings of Russian company “1? ”, which developed the franchising system of software sale in Ukraine. Its analysis showed that 1? ’s decision to replace royalty payments with the method of fixed software volumes was a success.

ACI’s decision brought immediate results. Franchise sales became more effective and finally led to creation of the eight-enterprise network with enterprises in Dnepropetrovsk, Zaporozhye, Kherson, Alchevsk, Chernigiv, Poltava, and Kremenchug.

ACI’s project implementation followed the following schedule in Ukraine:

- 1994 – decision on beginning business operations in Ukraine
- 1995 – establishment of the first Kiev-based pilot enterprise of American Cleaners
- 1996 – franchise network start-up: first franchise sale
- 1997 – franchise network grew to four franchise-enterprises.
- 1998 – seven franchise-enterprises.
- 1999 – eight franchise-enterprises.

Favorable market conditions explain the rather rapid development of franchising business in 1996-1998. Furthermore, today Ukraine's franchising network keeps expanding though not as vigorously and no franchise-enterprise has exited the network as yet.

Another important factor to promote ACI’s franchising business and increase its franchise sales in Ukraine was successful performance of the first franchisees. Prospective franchisees had an opportunity to visit the franchise-enterprise and to make certain of business profitability themselves.

The largest number of franchise sales, with rapid network development, was observed in the period before the financial crisis of August 1998. The crisis certainly affected much of Ukraine's economy. The overall economic decline had a large negative impact on personal incomes, which in turn damaged the franchisee profits. Given the difficult situation in the economy, the franchiser made every effort to improve financial performance of its franchisees. In this respect, the franchiser provided its partners with materials at preferential tariffs, cancelled charges associated with expenses on corporate advertising campaign, and extended consultation support. In doing so, ACI helped its franchisees minimize negative consequences of the crisis; and American Cleaners Enterprises did not suffer from the crisis as much as the rest of Ukrainian enterprises.

5. FACTORS THAT INFLUENCE FRANCHISING DEVELOPMENT IN UKRAINE

Successful performance of the franchising network American Cleaners and other franchising systems demonstrated that business prospects are good in Ukraine. At the same time, franchising remains an uncommon business in Ukraine's market and has yet to develop.

From its experience in developing the franchising network in Ukraine, ACI revealed some factors that influenced and promoted franchising development in the country, including:

- *Small and medium business development*

  Ukraine's transition to a market economy and rapid accumulation of private capital prompted many of Ukrainians to open their own business. A great number of people became entrepreneurs. However, lack of specific knowledge, skills, and experience often hampered their progress. Not surprisingly, many entrepreneurs tended to involve in their business an experienced franchiser-partner, which largely helped to create an extensive market of prospective franchisees. A large number of contacts with such entrepreneurs showed that many entrepreneurs were willing to participate in the project. The project would have become a success in every region in Ukraine quicker if there were no barriers to the franchising network development.

- *Advanced technologies.*

  Similar to other former Soviet republics, Ukraine urgently lacks modern production and management technology. In most cases, limited financial resources of newly emerged entrepreneurs hamper the spread of new technology to Ukraine's small and medium businesses. At the same time, franchising allows entrepreneurs preferential access to advanced technology and consequently improve enterprise performance. In this respect, a good example is dry-cleaning technology, which ACI effectively propagated. In Ukraine, where there is much room for technological development suggests great prospects for franchising success.

- *Ability to obtain bank loans.*

The level of credit rationing substantially influences performance of every company. In Ukraine, an average private entrepreneur, who generally lacks both a good credit history and funds to cover the amount of credit, finds it complicated to obtain bank loans. Long-term credit is invariably hard to secure. In this respect, the franchising system has the important advantage of a good reputation of the foreign franchiser, which increases the probability of the franchisee getting loans. Admittedly, Ukrainian banks feel more certain about the prospects of projects with foreign company participation.

- *Changes in consumer preferences.*

  High- and medium-income consumers increasingly prefer to buy high-quality goods and services. A well-known trademark associated with high quality allows its user, the franchisee, to sell such goods and services effectively and receive a high return on investment. The experience of American Cleaners in Kiev largely confirms this hypothesis.

  For example, two dry-cleaners (American Cleaners and the former state-owned enterprise) have their receiving offices in one building. The number of orders is 10:1 in favor of American Cleaners. Analysis of tariffs on dry-cleaning in Kiev demonstrates that the service cost at American Cleaners, for the most part, exceeds that of its Ukrainian competitors. However, the quality/cost ratio of American Cleaners' services is incomparably higher. This allows American Cleaners to maintain steady production and a leading market position.

The following factors present significant barriers for franchising development in Ukraine:

- *Instability of the legislation base.*

  Contrary to many other business forms, franchising implies long-term relations between the franchisee and the franchiser. Large instability in the legislative base reflects in the franchise system performance, which negatively affects the long-term business planning. In many cases, international franchising is subject to the influence of changes in the legislative framework.

  In Ukraine, ACI faces this problem daily. Withdrawal of technological equipment from the list of critical import goods has negatively affected the franchisee costs at customs by 20%, the level of the Value Added Tax (VAT). A good example here could be an increase of up to 20% of import customs duties on package polyethylene, one of the mandatory technological components. In 1999, the customs duty on paper package materials grew from 0% to 5%, while the duty on spot-removing chemicals increased from 5% to 10%. In the project, the franchiser imported equipment and materials on CIP terms of delivery. Hence, such changes in the customs legislation directly influenced the franchisee' interests and raised business cost. Obviously, rapid and frequent changes of "the rules of game" do not facilitate development of Ukraine's business on the whole and franchising in particular.

- *Lack of legislative norms to regulate franchising in Ukraine.*

There is no specialized legislation on franchising in Ukraine, which in an unstable environment, such as this, has a negative impact on franchising development in the country.

When working with its clients, ACI often observed a negative attitude from regulative, customs, and tax authorities towards franchise agreements (transactions). The problem was particularly harsh when financial transactions were in favor of the foreign franchiser (royalty payments, advertising dues, etc).

An important factor for franchising development in Ukraine was the President's Decree of July 15, 2000 ? 133 "On Measures to Support and Facilitate Entrepreneurship Development", which obliges regulative authorities and state bodies to facilitate franchising development in Ukraine. Also, the draft of the law "On Franchising" was designed and submitted to Ukraine's Parliament (Verkhovna Rada) for consideration.

- *Failure to maintain technological standards.*

Consistent maintenance of quality and technological standards is one of the most important issues of the franchise agreement. Failure to maintain these standards by the franchisee, which violates technological norms to obtain additional financial gains, discredits the idea of franchising. At the same time, a statement by the general manager of Lukoil-Ukraine Nikolay Kadeniuk said may be indicative of the situation:

> "Given our mentality, it is simply impossible to work on the franchising scheme. Any owner of the petrol station wants to sell whatever he desires under someone else's trademark. In Kiev, there is a great deal of firms to sell petrol #95 instead of petrol #98".

A franchiser's risks related to violations of technological standards by franchisees negatively affect the number of prospective franchisers, which then impedes franchising development.

- *Insufficient information about franchising and its advantages.*

Despite the century-long tradition of franchising development in many countries, this business is relatively new in Ukraine. Typical to most innovations, franchising often generates some skeptical attitude among Ukrainian businessmen. An explanation here is that Ukraine's developing market has a large number of network sale systems, which do not care about their business reputation. A significant number of representatives of small and medium business suffered from financial and trade trickery. Therefore, to create a favorable environment for franchising development in Ukraine it is necessary to inform potential clients about the real aspects of the franchising business.

In the course of project implementation, franchise specialists of American Cleaners estimated that no more than 1% of Ukrainian entrepreneurs was aware of franchising business. Given this lack of understanding, ACI included a specific section in its business-offers to explain the idea and principles of franchising.

A practical manual on franchising for entrepreneurs willing to become franchisees promotes an understanding of legislative, marketing, management, financial, ethnical aspects of franchising business. Experiences of franchise companies in international markets and Ukraine’s market, in particular, could help to design this manual most effectively. Both franchisees and franchisers are equally interested in having such a reference book. Poor knowledge of the market environment for franchisees on the one hand, and their inexperience on the other, may lead to significantly negative results.

6. CONCLUSIONS AND RECOMMENDATIONS

As a form of business, franchising has the potential to development and expansion of business development. The principles and concepts of franchising can be widely used in many types of business activities even though this it does not imply that any developed franchise will be a successful business.

Almost invariably, worldwide experience suggests that successful franchising systems developed driven by innovations such as development of new consumer products, equipment, technologies, and trademarks. The list of the British Franchising Association includes 46 types of franchise enterprises. In the US, the list of franchise companies is published annually. The analysis of business directions, which these companies perceive, indicates that franchising has the greatest prospects in consumer-oriented markets. Particularly impressive was franchising growth in the field of catering and services. The international practice of franchising is largely applicable to Ukraine's market.

Through its creation and successful performance of the enterprise network, American Cleaners demonstrates franchising viability and importance for Ukraine's business development.

ACI received gross revenues far above its costs on launching and developing the franchise network. Within the time-framework of the project, the level of business profitability floated from the one, which exceeded the planned estimates to precisely these planned levels. The highest profitability rates were reached in the period of 1996 to 1998. Overall, the franchise project American Cleaners was profitable in Ukraine.

Presently Ukraine's small and medium business sector is highly undeveloped, reflecting the high potential for franchising development in Ukraine.

The following factors should be closely analyzed when it comes to choose franchising as a business form:

- Despite high risks associated with economic, political and legislative instability, Ukraine's market has great potential for business development. Market entry into Ukraine requires a deep understanding of the specific market environment in the country and a close financial examination of the particular business prospects, allowing develop of a market strategy that most effectively could lead to successful entry into the market.
- Traditional franchising, as accepted in international practice, cannot develop in the current atmosphere within Ukraine. For a number of reasons previously mentioned, franchising is likely to develop in a way distinct from the international experience. Decision-making on the issues not regulated by the Ukrainian legislation will account for some of Ukraine's specificity and consequently should allow for some flexibility in developing franchising schemes.
- An analysis of all factors that might influence business development, positively and negatively, in the country should precede any decision on a project beginning. It might be irrational to consider only one factor as the instrumental one, which is why, the availability of preferential duties on

imports of equipment did not substantially influence ACI's decisions in 1994. However, in the current market situation in Ukraine, the role of tax and duty privileges is very important among the factors that shape the decision-making process.

- Franchising is relatively unknown and non-traditional in Ukraine. Private entrepreneurs are hardly aware of advantages and benefits associated with franchising business. There is an urgent need to popularize the idea and concepts of franchising using the network of centers on support of small and medium business development.
- The following criteria should drive the analysis of establishing a franchising system in the specific business area:
  - Market demand on goods and services of the franchiser-company;
  - Conformity of the franchiser goods and services to advanced technologies and quality standards;
  - Possibility to use the trademark, logo, technology, and business and management methods of the franchiser-company by the franchisees;
  - Mutually beneficial transactions for the franchiser and the franchisee.
- Significant regional disparity is typical of Ukraine's market. In developing franchise-packages and business-offers, it is important to take account of regional specificity in Ukraine.
- Opportunities and conditions to obtain banking loans often determine the franchisee's decision concerning project participation. Support, which the franchiser can provide to its prospective partners in preparing a qualified business-plan on banking loan, would largely promote successful franchising expansion in the country. The franchiser can effectively identify banking institutions, able to lend credits on franchise purchase. Then it informs financial institutions on the goals and prospects of franchising projects, which helps to ensure more preferable attitude toward potential franchisees.
- In Ukraine, imports of production materials are often associated with a number of problems with tax controls, complicated procedural issues, considerable transportation costs. The franchiser and the franchisee can unite their efforts to find domestic substitutes of imported materials, which conform to the technological requirements and will not damage the quality of goods and services produced.
- All issues that might arise on the franchisee activities in negotiations with regulative authorities, the franchisee settles directly without the franchiser involvement. It uses the generally admitted practice of resolving problems of this kind in Ukraine. The main conflict was related to regular payments (royalty) in favor of the franchiser. The franchiser decision to receive payments in the framework of the agreement on sales of materials to the franchisee resolved the problem. It also financially favored the franchiser's business interests. Successfully used in the American Cleaners project, such a practice is optimal for the franchiser.

ANNEX 7: SELECTED FRANCHISE SYSTEMS IN UKRAINE: REVIEW

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1. INTRODUCTION

Franchising is a long-term commercial relationship of firms, in accordance to which, a franchise user, or franchisee, works subject to the standards, principles and procedures developed and specified by a franchise owner, or franchiser; and in doing so, the franchisee gets assistance and support from the franchiser. The successfulness of the franchisee depends greatly on the ability of the franchiser to create a profitable business system and then inform the franchisee of the principles and objectives of this franchising system. Also important are the effectiveness of the franchiser's efforts to develop and improve the system, and ability to supervise and support the franchisee during the full period of the franchising agreement. For these services, the franchiser charges the franchisee a royalty, a fixed payment in the form of single or regular transfers.

The franchising agreement stipulates business relations, by which the franchisee-company obtains rights to run a specific kind of business and exclusive rights to use one or several forms of intellectual property. This opportunity for the franchisee to operate an already-established business distinguishes franchising relations from other business forms, such as the license, agent, commission agreements or the agreement on joint activities.

Franchising has three specific features:

- Licenses on the use of a standardized system;
- Long-term coordinated relations; and
- Maintenance of specified business principles.

2. FOREIGN FRANCHISERS IN UKRAINE

Despite the shortcomings of the legislative base and the absence of specific franchising legislation, many companies in Ukraine operate using franchising principles. There are three basic types of franchising: commodity, production, and business franchising. Each has its users in Ukraine's market. Dealer networks on car sales and brand gas stations are examples of commodity franchising. An excellent example of production franchising in Ukraine is soft drink production with the use of COCA-COLA chemicals, technologies and trademarks. However, most often franchising schemes are used in the services sector.

Below are several business schemes using franchising principles, involving foreign, Russian and Ukrainian companies in the Ukrainian marketplace.

2.1 Hertz Car Rental and Leasing

Company profile

An affiliate of *Ford Motor Company* and the largest international corporation in the area of car leasing and sales, Hertz was established over 80 years ago. Today, the firm has representatives in 150 countries throughout the world. Around 40% of the companies, which represent Hertz's interests, work under the franchising scheme.

In Ukraine, the firm representative and exclusive distributor of the company Hertz Europe is the firm CarRent Ukraine. The company has been working in Ukraine's car leasing and sales market since 1997. CarRent Ukraine is a private firm with complete foreign ownership. Its founders are American citizens.

Selection of Ukraine's market

The results of the market study, which the founders of CarRent Ukraine initiated, revealed several important market tendencies. First, existing car-leasing firms do not provide high-quality service; therefore the opportunities to work in this market segment are great. In Ukraine, the high cost of car rental significantly limits consumer demand and, as such, the type of potential clients. It is indicative that about 90% of CarRent Ukraine's clients are foreigners with relatively high income. The volume and type of Hertz customer has recently expanded by inflows of wealthy Ukrainian citizens who have used Hertz car services in other countries. In the conclusion of their study, CarRent identified good prospects for expansion in the Ukrainian car rental market and therefore, found it promising to enter this market in Ukraine.

Similarly, the management of Hertz Europe identified the underdevelopment of Ukraine's car rental market and therefore, showed considerable interest in signing a cooperation agreement with a Ukrainian partner. Almost simultaneously, similar agreements were signed in Moscow, the Baltic States and Kazakhstan.

Franchising agreement

Having identified the relevant field of activities and analyzed Ukraine's car rental market, the founders of CarRent Ukraine signed a franchising agreement with Hertz Europe, which granted CarRent Ukraine the exclusive right for a three-year period with the opportunity of a five-year extension. Subject to Hertz Europe's approval, the company CarRent Ukraine is also allowed to sign agreements with sub-franchisees.

In addition to typical conditions and procedures, like a two-year period of car depreciation with a subsequent car change, provision concerning personnel uniform, specific list of services, and so on, the agreement includes a mandatory appendix, the “Development Plan”.

The “Development Plan” of the company outlined an increase in the number of cars in Kiev and development of the network of representatives in Ukraine’s regions. For example, creation of CarRent Ukraine representatives in Yalta, Odessa, and Dnepropetrovsk are scheduled for this year. Currently under consideration are several projects to establish representatives of the franchise-company in Kharkov and L'vov.

The management of CarRent Ukraine found great opportunities for developing its business further and increasing the number of representatives in other domestic regions by creating sub-franchises.

Liabilities of the franchiser

The franchiser, Hertz Europe, was responsible for providing the franchisee, CarRent Ukraine, with a complete franchise package, including:

- The right to use the world-known trademark Hertz;
- Business technology transfer on car rental and leasing;
- Access to the car reservation system for clients in every company network;
- Update information on new products and technologies;
- Inclusion into the Hertz global marketing system; and
- Management training.

In addition to the specified responsibilities, the franchiser-company supported daily activities of the franchisee-system members by sharing its experience and the most up-to-date information in domestic and international conferences. Both parties study disputable and difficult problems and jointly develop ways to address these issues. Information on these procedures was distributed in the form of instructions or memos within the network. Development and distribution of such guidelines is undertaken on a weekly basis. The primary decision-maker in this respect was the Vienna office, which specified in detail the relevant procedures and instructions.

Although ongoing advertising support was not a part of the franchise package and therefore not required of the franchiser, the company “Hertz Europe” may conduct advertising campaigns of the Hertz trademark. In this situation, the franchisee is expected to provide information on advertising fees across various advertising agencies, conduct a preliminary analysis of the effectiveness of different advertising forms, identify prospective sites on advertising boards, etc. With this information the management of Hertz Europe decided how to run an advertising campaign, sign agreements with advertising agencies and controlled the implementation.

The franchiser supervised activities of the franchise-company with assistance of review inspections that Hertz Europe representatives conduct during their visits to Kiev.

Liabilities of the franchisee

It is expected that the franchisee operate a fair business, according to the rules, principles and procedures specified by the franchiser.

For the franchisee, the scheme of royalty payments stipulated a single fixed payment during the process of signing the franchising agreement with successive monthly or quarterly payments. Problems with royalty payments were not expected to arise, since by the mid-sixties the State Patent Agency (Gospatent) registered the trademark “Hertz” for the whole territory of the former Soviet Union. Therefore, today the franchisee only needs to confirm its right for using the trademark in Ukraine.

Furthermore, the franchisee was supposed to conduct regular advertising campaigns to support its business development.

2.2 FUJIFILM Photo Services and Photo Products Sale

Company profile

The world leader in the field of photo development and production, Fuji Photo Film Co, Ltd. was established in Japan in 1934. Around the globe, Fuji Photo Film has 165 representative offices.

With the newest technology and extensive experience in hand, the company develops professional and amateur products for everyday photo shooting. The company’s main goal is to ensure the high quality of company products in every market to create a universal Fuji Photo Film Co. image.

For this global purpose, Fuji Photo Film works under the partnership agreement FIS, which has the following objectives:

- Maximize popularity of the Fuji Photo Film brand name by selling its products at a larger number of photo retail outlets;
- Advertise and popularize the idea of quality Fuji Photo Film products;
- Inform customers of the variety of high-quality photo products and services offered by FIS photo stores;
- Increase sales volumes by raising the number of customers; and
- Utilize the quality control system of Fuji Photo Film to secure steady operation of all photo laboratories.

Every member of the FIS network is supposed to act under a partnership agreement, which aims to ensure Fuji Photo Film’s stable market position and consequently to expand possibilities for all participants. For successful implementation of the program, the partner should make its effort to support development of the official representative ideas.

Photo stores that comply with the quality standards of the program, obtain the right to use the Fuji Photo Film logo. The FIS program outlines the list of activities to secure the proper quality control over all mini-photo laboratories and stores.

In Ukraine, every program participant receives timely and reliable information on the working principles from the Fuji Film representative, JSC Image Ukraine.

JSC Image Ukraine was founded in 1996 as an affiliate of the large Japanese concern Marubeni to provide professional services concerning the organization of effective sales of Fuji Film photo products and promotion of its trademark in the Ukrainian market. The company deals with firms of various types of ownership. The authorized company capital is composed of 60% foreign capital.

The main partners of the official representative are Ugkontrakt, Universe, and Frikom, which have large dealer networks and operate in all regions in Ukraine.

JSC Image Ukraine delivers products directly from Fuji Film production facilities, which eliminates the probability of spreading sales of phony or low-quality Fuji Film goods.

Ukraine's market selection.

Along with Ukraine, other NIS countries were also considered for implementation of the FIS partnership program. Ukrainian customers showed considerable interest in high-quality pictures and service, a new phenomenon for that market, and in the variety of goods and services offered at acceptable prices, which largely influenced the decision in favor of Ukraine's market. However, another decisive criterion was the existence and development of personal contacts and connections by company management and the opinion of Ukrainian partners.

Partnership agreement

The basis for relations between partners is the partnership program FIS. The initial step is to design a complex of the joint measures and arrangements to address specific issues and objectives.

A partner signs an agreement with JSC Image Ukraine on partnership participation in the FIS program.

Liabilities of the representative

Under this agreement, JSC Image Ukraine acknowledges the following liabilities:

- Ensure timely and stable delivery of Fuji Photo Film products to a partner from the company storehouses or through its distributors;
- Provide a partner with technical service of photo equipment of the highest priority and at preferential discount tariffs;
- Supply advertisement materials, illuminated signboards, and sales uniforms in accordance with program standards;
- Run advertising campaigns to increase sales volumes of a partner-company to attract new customers and popularize the Fuji Film trademark;
- Support sales organization, commodities and equipment allocation;
- Provide a partner with marketing materials, advertising and technical information on emergence and development of new products in the Ukrainian and world markets;
- Train operators, engineers, and trade personnel;
- Ensure everyday control over the quality of service to customers, proper equipment of store outlets, assortment of Fuji Photo Film goods, and quality of pictures.

Liabilities of Partners.

For a partner, the mandatory conditions for participation in the FIS program include:

- Use Fujifilm or FujiHunt photo paper and chemicals, which are bought either from JSC Image Ukraine or from authorized distributors;

- Create prerequisites and conditions for best meeting the needs of customers and providing them with a sufficient assortment of photo products, complementary goods and services;
- Maintain quality standards in accordance with the Program requirements and improve the level of customers' service;
- Use exclusively Fuji Film advertising materials to arrange inside and outside interiors of retail store outlets;
- Conduct personnel training;
- Participate in every advertising campaign initiated by JSC Image Ukraine;
- Perform all necessary routine tests of equipment;
- Assist JSC Image Ukraine personnel in conducting examinations of the technical condition of photo laboratories, quality of pictures, and product assortments.

If a partner owns photo equipment from other than Fuji Film producers, but is willing to participate in the FIS program and agrees to all requirements, JSC Image Ukraine may consider a possibility of such participation. In this case, a Fuji Film representative has the right to decline all responsibility for service maintenance and technical service of equipment, while the partner is responsible for ensuring the quality of pictures and customer service in accordance with the FIS program requirements at its own expense.

2.3 Network Of Specialized Baskin Robbins Ice-Cream Cafés

Company profile

An American company Baskin Robbins is the world-largest network of specialized store-cafes that serve and sell ice cream, icy desserts and drinks. The Baskin Robbins network includes 4500 stores all over the globe, 97% of which work under the franchising scheme.

In Russia, the company Baskin Robbins opened a representative office to sell franchises to customers from the NIS countries. Baskin Robbins ice-cream cafes currently operate in Russia, Ukraine, Georgia and several other NIS countries.

Selection of Partners

Baskin Robbins sells franchises all over the world. The franchisee is supposed to comply with specific criteria and requirements of the franchiser, such as understanding the essence of franchising, availability of necessary financial resources, willingness to succeed while best serving customers, an ability to organize and manage companies, and so on. Firms that comply with all requirements of the company Baskin Robbins get admitted to the franchising network.

The search for partners is the franchisee's responsibility. Market studies done for Ukraine showed that there are no high-quality specialized ice-cream cafes in the market. This implies low barriers to entry and weak competition in this kind of business. At the same time, using an internationally known trademark will facilitate successful business development; therefore market conditions determined the choice of a specific business scheme. In this case, conducting business under franchising principles gives advantages to a franchisee, which can enter a new undeveloped market niche. The results of the undertaken studies further promoted the interest of Ukrainian entrepreneurs in developing this business in Ukraine's market and prompted them to ask a Russian representative of Baskin Robbins to consider their inclusion into the franchising network.

Franchising network

In Ukraine, the franchising network consists of four enterprises in Kiev, Kharkov and Odessa. First opened in Kharkov, two Baskin Robbins ice-cream cafes initiated development of the franchising network in Ukraine. Then Baskin Robbins cafes were opened in Odessa and finally in Kiev.

Franchising enterprises are independent and private Ukrainian firms.

Franchising agreement

In this case, one cannot talk about the franchising agreement in its neat form. Ukrainian enterprises contracted a license agreement with a representative of Baskin Robbins in Moscow, which granted them a five-year right to use the trademark; and Baskin Robbins provided a franchisee with exclusive distributing right to open ice-cream cafes in a specific region.

The concept of "royalty payments" was not defined in this agreement. To simplify financial relations between the franchisee and the franchiser, the aggregate royalty, which is determined by the franchiser, is included in the franchise cost and hence is paid once by the franchisee.

Liabilities of the franchiser

The franchiser is supposed to provide the franchisee with the complete franchise packet, including the following:

- The right to use the trade mark of Baskin Robbins specialized ice-cream cafes;
- Technology transfer; and
- Delivery of equipment and service materials.

The franchiser is also responsible for supervising over the franchisee activities, implying conducting examinations and check-ups by Baskin Robbins representatives.

Liabilities of the franchisee

The franchisee is responsible for training its personnel at an additional expense, namely 120 USD per person, as well as keeping performance in strict compliance with technological requirements, which otherwise may damage the trademark and business reputation of Baskin Robbins.

Moreover, the franchisee is supposed to cover advertising costs to the extent of 4% of its monthly revenues, not including VAT.

2.4 Hotel Complex Odessa-Kempinski

Company profile

The hotel network Kempinski incorporates 25 luxury hotel complexes in Europe, the Middle East, Australia, Africa, Asia and South America, which the company Kempinski either owns or manages. In 2000, the company reported that management of its existing hotel complexes was the primary activity and predicted further growth of this business direction. Usage of the most effective and modern management principles, which the company Kempinski developed and verified in the real-world market of hotel services, largely explains the successful development of this company area. This management is conducted according to the franchising scheme by which the principles and methods of business management are transferred from high-standard hotels to others by training and specific preparation of management executives and personnel.

The hotel complex Odessa-Kempinski was opened in Odessa in 2000. This structure was a result of a cooperation agreement between Odessa Sales Port and private firm Brooklyn-Kiev each with 80% and 20% of the company shares, respectively. The company is a member of the international franchising network of Kempinski. Its personnel include 235 employees while annual turnover at almost 5 million USD.

Selection of partners

The franchisees were selected on a tender basis.

Franchising agreement

The relations between partners are framed within the licensing agreement and the agreement on management franchising. Negotiations on these agreements were largely complicated by the absence of Ukrainian legislation on franchising. In practice this primarily implied a need to sign contracts with several parties in every business affair. The licensing agreement was signed with a Swiss-German company while the agreement on franchising management was settled with another firm. Furthermore, to minimize VAT payments, the agreement on service provision was legally settled and signed outside the country.

Liabilities of the franchiser

In accordance to the agreement on franchising, the franchiser provided the franchisee with the complete franchise-package, to include the following:

- The right for the use of the trademark, stipulated by the licensing agreement;
- Management technology transfer and ongoing updates, as stipulated by the management franchising agreement;
- Monthly training of company personnel. In addition, the personnel of the franchise company were given an opportunity to receive training in other hotels of the network, in order to ensure quality service standards in all network locations. At every hotel, there was a so-called taskforce that provided support to the franchising network members and gave an opportunity to receive invaluable hands-on experience;
- Insurance of hotel clients and personnel.

The general manager and financial auditor, who act on behalf of the franchiser, are responsible for the overall company governance, ongoing control over activities and performance of the franchisee and the network support.

Liabilities of the franchisee

The franchisee has the following responsibilities:

- Strictly observe all management technologies and procedures, which guarantee serving clients at high quality standards associated with the company trademark;
- Pay a monthly fixed royalty; and

- Transfer 4.5% of its gross income on advertising expenditures that also may include costs of centralized marketing services.

At the same time, the franchisee buys most of its materials and supplies in the domestic market, a tendency, which is clearly to grow in future.

3. RUSSIAN AND UKRAINIAN FRANCHISING

In addition to foreign companies, some Russian and Ukrainian firms have begun to use franchising schemes to develop their businesses in Ukraine's market.

3.1 Accounting Software Development and Support of The Firm "1S"

Company profile.

The firm 1S was established in Russia in 1991. As shown by numerous surveys, the firm is one of the leaders in the Russian industry of program software development, implementation and post-sale service. The firm 1S successfully operates in Russia, the NIS and Baltic countries. Their economic program software is widely used by enterprises in various industries to automate the accounting process. The most popular program products are 1S:Bookkeeping and 1S:Enterprise.

Ukraine's market selection

In the Ukrainian market, 1S has been operating for seven years, two years using franchising principles. Its entry into the market was not sudden. The former Soviet republics, Russia and Ukraine, had a great deal in common in both the economic and political development and legislative frameworks.

Developed under the framework of the Russian legislation and applied at Russian enterprises, program software was easily adjusted to Ukraine's local conditions. Moreover, 1S software products quickly demonstrated their reliability of functioning in the unstable business environment and undeveloped legislative framework.

Franchising network

For 1S business development outside the home country, in particular in Ukraine's market, the company management found the franchising scheme to be the most adequate to secure high-quality services; and combine the effectiveness, mobility and energy of small private firms with the power of a well-known trademark, high professionalism, technological achievements and guarantees of one of the leading program developers in Russia. On the one hand, small private franchisees may effectively address specific problems of every client. On the other hand, however, the availability of the firm 1S at the background of franchisees increasingly persuades clients that their plans and orders on automation of business processes will be well-served, supported and updated on a regular and long-term basis.

Development of the franchising network was done to adjust program software to the requirements of the Ukrainian legislation, which the firm 1S accomplished on its own. The locally adjusted versions of software products were sold in Ukraine through dealers. Gradually, the dealer network turned into a franchising network with dealers becoming franchisees.

At present, the firm 1S has certified 160 enterprises to operate under the trademark "1S:Franchising" and to provide a complex of services on automating accounting, business, and office processes on the platform of the 1S program software. Franchisees offer their customers a typical range of services from simple installation and basic adjustment of application configurations to the program integration with other software packages, training users, initiation and development of the complete accounting process at a company.

The sale-service network of the firm 1S includes distributors, franchisees, and dealers, which later may become franchisees. Three large distributors from Kiev and Odessa buy 1S program software with a discount of up to 60%. Franchisees work directly with distributors that allow them not to waste time and financial resources on software delivery from Moscow, and to devote all time and effort to pursuing one objective, providing high-quality service for final customers.

Franchisees operate in all regional centers and large cities of Ukraine. Around a third of them work in Kiev. A large number of partners come from the East of Ukraine while the Western part represents the minority. Kiev and Eastern Ukraine is home for the most existing and potential clients, users of 1S software products.

Franchisee selection

The firm 1S does not intentionally seek out franchisees. As a rule, company dealers become franchisees, small private enterprises willing and able to work with "1S" program products. In comparison to dealers, franchisees have several advantages, including:

- Higher discount rates of up to 55%. For dealers, these rates reach a maximum of 50%; and
- Possibility to work with a full assortment of "1S" software products. The firm 1S identified a range of software products, which can be sold, installed and supported exclusively by franchisee-firms. Normally, these are more advanced software products for which installation requires specific qualification skills and training. The firm 1S mandates that the franchisee certify at least two experts to work on installation of advanced program products. Dealers have no such requirement placed on them.

Franchising agreement

The franchising agreement is signed between the firm 1S and the franchisee, discussing the franchisee participation in the activities of the 1S franchising network.

The agreement specifies the franchiser and the franchisee liabilities, discussed in-depth below, and the terms of agreement.

Liabilities of the Franchiser

In its franchising activities in the Ukrainian market, the 1S acknowledges the following responsibilities:

- Conduct advertising campaigns using mass media and exhibitions indicating services provided by the franchisee;
- Provide the franchisee with technical support by giving technical information in compliance with specific parts of the agreement;
- Update free-of-charge software products bought by the franchisee;
- Compensate the franchisee advertising expenses up to 20% of quarterly revenues of the franchisee (an appendix to the agreement specifies this procedure);
- Render the franchisee discounts on software products up to 55%;
- Provide the franchisee with materials on the most important software products and economic and organization issues.

Liabilities of the Franchisee

The franchisee is responsible for the following:

- Certify at least two experts for each software program intended for sale. These are complex program products which require experience and training for installation;
- Acquire for internal usage one set of every software product intended for sale by the franchisee;
- Sell software programs for prices at or above those recommended by the firm “1S”;
- Not distribute economic program software of other than that of 1S, if it is similar that produced by 1S;
- Pay royalties on a quarterly basis. The agreement between the franchiser and the franchisee does not specify the royalty concept. Instead, it explains quarterly payments for “advertising, information and technological support” in the amount of 100USD. The franchisee pays it in national currency to the distributor. Then the distributor transfers money to 1S. This scheme simplifies the procedure of royalty payments for the franchisee because it implies:
  - the possibility to work using national currency, and
  - the absence of costs on currency exchange and money transfer outside the country.

There is an opportunity to waive royalty payments for the franchisee when quarterly sales of specific software reach a pre-established minimum.

3.2 Fast Food Restaurants “Pizza Chelentano” And “Kartopliana Khata”

Company profile

A Ukrainian company Pizza Chelentano was established in the form of Ltd in 1996 in L’vov. The company has registered two retail outlets to organize the network of fast food restaurants, Pizza Chelentano and Kartopliana Khata. Since 1999, it has been working using the franchising scheme. After unsuccessful attempts to find an investor (partner) to organize the network of fast food restaurants, the company’s management came up with the idea to develop and expand its business using franchising.

Franchising network

During the initial stage of the franchising network development, its own enterprises in L’vov served as vivid examples for potential franchisees where the latter could learn the specifics of the company’s activities.

At present, the franchising network includes 14 fast food restaurants Pizza Chelentano and Kartopliana Hata in Kiev, L’vov, Odessa, Sevastopol, Dnepropetrovsk, Vinnitsa, Nikolaev and Khmelnytskyi, nine of which are franchisees.

When selling a franchise to regions, the franchiser gives no exclusive rights to the franchisee and thus leaves the right to open its own restaurants. This is relevant for large cities such as Kiev, Odessa, Dnepropetrovsk where setting up several enterprises under one trademark is unlikely to strengthen competition considerably.

Two years successfully operating in the Ukrainian market helped management decide to enter international markets. The process of registering Pizza Chelentano and Kartopliana Hata trademarks in Russia and Poland should be completed soon.

Development of the franchise network largely depended on the availability of personal contacts and connections rather than the effects of extensive advertising campaigns.

Franchising agreement

The franchiser and the franchisee sign a license agreement on the right to use the trademark and other intellectual property for which the franchisee pays a royalty. Since the regions of Ukraine greatly differ in income levels and population size and structure, the franchiser developed a different approach to define royalty payments. Several types of royalty payments include monthly fixed payments; aggregate payments included into the franchise cost, monthly payments in the amount of 1-1.5% of the franchisee revenues.

The franchise cost also differs by the franchisee region. It varies from $1,000 to $10,000.

Liabilities of the franchiser

According to the license agreement, in addition to the right to use the trademark, the franchiser provides the franchisee with the following services:

- Design of premises and facilities in compliance with specific requirements and standards;
- Provision for recipes and technology and cost matrices for the basic product assortment;
- Training of the management and production personnel;
- Provision of advertising materials;
- Assistance in conducting advertising campaigns by partial compensation of advertising expenses; and
- Provision of information on new products and positive experiences of other enterprises of the franchising network. For example, the franchiser buys from the franchisee new recipes and distributes them at the network free-of-charge.

In addition, the franchiser recommends the franchisee suppliers of:

- Equipment, for which, guaranteed service is provided by the franchiser. However, the franchisee can agree with the franchiser on the use of equipment in addition to the listed in the franchise agreement;
- Restaurant accessories; and
- Personnel uniforms.

The franchiser is also responsible regular control over activities of the franchisee on its compliance with technology and quality standards of food preparation, sanitary conditions of production facilities, pricing and quality of service. The franchiser developed a special assessment scale to evaluate activities of the franchisee. Failure of the franchisee to comply with the evaluation criteria can result in a break of the agreement.

Liabilities of the franchisee

The franchisee is supposed to satisfy the following requirements of the franchiser:

- Maintain mandatory and pre-established corporate dishes in the product assortment;
- Satisfy technological and quality standards of food preparation;
- Maintain specific pricing level in accordance with the pricing policy of the franchiser and its market position;

- Conduct advertising campaigns at the regional level.

At the same time, the franchisee has some independence in its activities. Specifically, it is allowed to decide on the following activities:

- Introduction of new dishes into the assortment after coordinating with the franchiser;
- Use of additional equipment, when necessary.

4. CONCLUSIONS

Survey results and analysis of activities of the existing franchises in the Ukrainian market suggest poor development and deficiencies in Ukraine's legislation base, and absence of specific regulatory framework on franchising relations largely explain why franchising in its "neat form" is rarely used in Ukraine.

An important issue in the development of franchising relations in Ukraine is the system of royalty payments, especially when these payments have to be transferred outside Ukraine. The Ukrainian legislation in force does not specify the concept of "franchising", which implies many difficulties with bookkeeping and tax accounting. Therefore, to avoid misunderstanding and problems with Ukrainian fiscal authorities it is advisable to specify the subject of the agreement as the usage of intellectual property. Intellectual property is determined by Ukrainian legislation in accordance with Article 2 of the Stockholm Convention on establishing the World Organization of Intellectual Property. The Law of Ukraine on "Intellectual Property" specifies a complete list of establishments, which may be referred as intellectual property.

Essentially, the concept of royalty payments implies a payment for the usage of intellectual property. The Ukrainian tax legislation, notorious for its inconsistency, does not provide a well-defined concept of royalty payments that, along with the absence of the franchising concept, considerably complicates the process of bookkeeping and tax accounting, and causes misunderstanding of tax authorities. Moreover, in accordance with the Law of Ukraine on "Corporate Profit Taxation", royalty payments are considered under the category of nonresidential incomes, and therefore are subject of a 15% tax during income repatriation.

Partnership relations between the franchiser and the franchisee are governed on the basics and principles of franchising when this proves possible. When the usage of typical franchising procedures is either impossible or complicated, as mentioned above, special schemes ground development of partnership relations. Of these schemes, the most important is a license agreement that provides the rights to use the trademark, an agreement on exclusive distributor rights, and establishment of joint ventures. However, it is unlikely to determine the most preferable scheme. The franchiser chooses a particular business scheme depending on specific objectives and requirements of every case.

The majority of business schemes, irrelevant of the underlying regulatory bases of the relations between the franchiser and the franchisee, substitute regular royalty payments with aggregate royalty payments, which are included into the franchise cost. This practice does not contradict the Ukrainian legislation but does violate the principles of franchising. In some cases, royalty payments are replaced by payments for additional services of the franchiser in accordance with the supplementary agreement between partners. The franchising agreements, when used by partners, establish regular fixed royalty payments.

5. NEW LEGISLATION

In comparison to alternative business forms, such as joint ventures, franchising seems to be a more promising and acceptable option for foreign franchisers in the Ukrainian market. The current investment climate in Ukraine largely explains why franchising has an important advantage over establishing joint ventures. The issue of investment risks minimization, even their elimination, is important. However, until the law on franchising is passed and all norms, procedures and other specific issues are legally spelled, development of franchising relations in Ukraine is likely to be complicated and impeded. Therefore, establishing the relevant legislative framework has a primary significance for successful development of franchising in Ukraine.

In our surveys, many participants of franchising schemes emphasized the critical role of introducing new legislation, such as the Tax Code, Economic Code, and Civil Code, which determine the essence and principles of franchising relations specify a typical franchising agreement, and define the concept of royalty and the procedure of its payments. This fact should largely assist in development of franchising business relations in Ukraine.

ANNEX: CONTACT INFORMATION ON UKRAINE-BASED FRANCHISES

CarRent Ukraine, exclusive distributor of Hertz in Ukraine - vehicles rent and leasing
Ukraine, Kiev, Muzeiny Lane, 4
tel: (+380 44) 531-9999, 490-5556, fax (+380 44) 490-55-58
General manager: Andrei Lyushnyakov

FujiFilm Representative, **JSC Image Ukraine** - professional services on organization of photoproduct sales and promotion of the FujiFilm trademark in Ukraine's market.
12, Kontraktovaya Square, Kiev 04070, Ukraine
tel: (+380 44) 490-9075, fax: (+380 44) 490-9076
E-mail: imageukr@faust.kiev.ua
Manager: Aleksey Tscherban'

Baskin Robbins - specialized ice-cream cafes.
Representative of Baskin Robbins in Moscow, the franchiser
Tel.: (+7 095) 967 37 01
Ltd Kievtelekom, an exclusive distributor of Baskin Robbins in Kiev, the franchisee
3, Bratskaya St., Kiev, Ukraine
tel. (+38 044) 238 66 67
Manager: Nikolay Sibiryakov

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1S Ukraina, Ukraine's representative of the firm "1S"
14 Pobeda Blvr, office 504, Kiev, Ukraine
Tel.: (+38 044) 461-56-61
e-mail: 1c@1c.com.ua
Manager: Vadim Mazur

Pizza Chelentano and **Kartopliana Hata** - fast food restaurants.
Franchiser:
79000, Ukraine, L'vov, 16/2 Slovatskogo Str.
tel. (+38 0322) 971180
General manager: Mark Zarhim
Financial manager: Svetlana Vlasovich

Ltd Rinko - franchisee
49a Velyka Vasil'kovskaya, Kiev, Ukraine
tel.: (+38 044) 536-01-63
Executive director: Svetlana Katrich