

Risk accounting in Russian business valuation in times of sanctions

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Abstract. The West approved a number of packages of sanctions against Russian legal entities and individuals, which noticeably affected many sectors of the Russian economy and business of Russian entrepreneurs. In support of the USA, the countries of the European Union and other states unfriendly towards Russia have drawn up their sanctions programs. Thus, the following question is especially acute for the founders of various companies: “What risks should be taken into account in business valuation in today’s crisis caused by the current geopolitical situation and a number of sanctions?” The relevance of the chosen topic is due to the presence of demand for business valuation, which is growing exponentially in modern realities. Due to these factors, Russian entrepreneurs and their businesses found themselves under enormous pressure from the risks that have arisen, which will remain relevant in the coming years.

Keywords: Business risk · Financial risk · Liquidity risk · Entrepreneurs · Factors · Sanctions · Valuation · Risks.

1. Introduction

The main purpose of investing is to obtain profit in the future. The same is true when acquiring a new business. As with cash investments, buying a business is accompanied by a number of risks, and this issue is especially acute in the current Russian realities, when a large number of sanctions have been imposed on the Russian Federation from such addressees as the USA and the European Union. Thus, taking into account risks in business valuation in the current geopolitical situation is the most important element in business valuation and requires in-depth analysis due to the imposition of sanctions from countries unfriendly to Russia.

2. Materials and methods

The valuation ratio (also called the capitalization rate) is made up of many factors, including the company’s specific risk. Risk is an expression of the business valuation analyst’s judgment, since no database can exist to measure company-specific risk factors. In the current geopolitical environment, when considering risk, it is critical for the valuation analyst to identify these factors and evaluate their

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magnitude in order to estimate the additional rate of return the market will require and make up for the investor's additional risk taken. Factors may vary from company to company, across industries or over time within the same business entity. These factors include the depth of management, the importance of key personnel, industry stability, product or service diversification, geographic location, profitability, etc. (Ilyina, 2015)

Risks in business valuation can be classified into the following categories: business risk, financial risk and liquidity risk.

2.1. Business risk

Business risk refers to all factors that could prevent the realization of projected profits. Parameters affecting sales, cost of sales or administrative and operating expenses are a component of business risk. Business risk varies by company. When assessing business risk, a risk specialist must gain insight into the company in order to identify issues related to the industry, competition, depth of management, sufficient working capital, etc.

In the context of sanctions against Russia, it is extremely important in business valuation to take into account the risk of secondary sanctions for cooperation with a sanctioned person. This risk is a typical representative of the category of business risks. Sanctions programs of "unfriendly countries" contain a number of restrictive measures in the context of sectors of the Russian economy. With each introduction of new sanctions, the list of enterprises and sectors included in them increases in direct proportion. Accordingly, Russian business faces an extremely high risk of secondary Western sanctions. In this case, it is about being included in the sanctions lists for cooperating with individuals and/or legal entities on these lists through the conclusion of various transactions with them, making deals, mergers or acquisitions of sanctioned enterprises (Rusakova, 2016).

The conclusion that can be drawn in this case is that any potential counterparty, in particular, those associated with the sanctions sector of the economy, may be subject to sanctions, which entails secondary sanctions for the party to the transaction. This risk is almost impossible to eliminate, due to the fact that the sanctions lists are constantly expanded. It is also worth noting that at the time of the transaction, the counterparty may be out of sanctions, but in the future it may be under them. Thus, taking into account the risk of secondary sanctions for cooperation with a sanctioned entity in business valuation is extremely necessary, because when such a risk is identified, a business entity should carry out sanctions compliance to further reduce it, which will include the following algorithm:

- 1) Analysis of the counterparty for its presence on the sanctions lists.
- 2) Assessment of the corporate structure of the second party to the transaction for the presence in it of individuals and legal entities under sanctions.
- 3) Evaluation of the subject of the transaction in the context of its relationship to the sanctioned subject of the transaction.

2.2. Financial risk

Financial risk is a narrower concept specific to a particular company. Financial risk is associated with interest costs, a factor that can also reduce projected profits, which can seriously affect business in the face of sanctions. Financial risk can be assessed by how the company's asset base is funded. If the company is financed primarily by equity, the financial risk is minimal. But if the company is financed by debt, the financial risk can be significant.

When taking into account financial risks in business valuation during a crisis period, one can single out the risk of counterparties refusing to cooperate and the risks of bankruptcy. The general boycott of foreign companies and foreign sanctions programs have a negative impact on supply chains and consequently entail the suspension of many domestic organizations, as well as the freezing of active or stopping the launch of projects that have not yet begun. Among other things, it should be noted such a negative consequence as a violation of the deadlines for fulfilling the obligations of the parties or even refusing to fulfill them.

The above parameters of uncertainty and the risks of bankruptcy and refusal of counterparties to cooperate, without exception, bring business entities to inevitable financial losses. Financial losses provoke an increase in the number of lawsuits initiated by creditors against their debtors under contractual obligations. Taking into account modern realities, in business valuation it is important to consider such financial risk, since a wave of lawsuits and insolvency procedures initiated by creditors entail huge financial losses for a business.(Kemenov, 2015)

After identifying the described financial risk, it is necessary to assess the possibility of fulfilling contractual obligations and, in the event of a negative combination of circumstances, notify the counterparty that it is not possible to fulfill them in the necessary way and at the right time. As an example, one can take a supply contract and apply the following actions in case of delay in the delivery of the relevant goods:

- 1) Offer the other party to change the delivery time or freeze the contract for a period acceptable to both parties, using the condition of refusing to charge the counterparty a penalty for the entire period of delay or suspension of the contract.
- 2) Select offers of similar products in another market and agree on all necessary changes if the product is of foreign origin.
- 3) Make changes to the price of the relevant product, provided that it cannot be imported into the Russian Federation.

2.3. Liquidity risk

Unlike business risk and financial risk, liquidity risk is not company-specific. Liquidity risk is associated with the sale of a closely owned business at fair market value and arises from the uncertain length of the sale period (related to the time value of money). It occurs when an investor wishes to liquidate his investment, which has become widespread due to the imposition of sanctions on Russia. In public business, an investor's interest is liquidated when the sell order is executed. Further, these investments are converted into cash within a few days and liquidity risk is leveled. In closed business, a controlling stake is usually more liquid than a minority stake. Thus, a controlling stake has less liquidity risk.

The capitalization ratio is the most attractive for investors, as it represents the ratio of the price of an asset in the market to net income. For investors, this indicator shows what percentage of income they will receive from investments in a particular company.(Voiloshnikov, 2015)

In business valuation the capitalization ratio is used in the formula:

$$\frac{\text{Cash flow (or net income)}}{\text{Capitalization rate}} = \text{Business value.} \quad (1)$$

Business valuation using the capitalization approach is most appropriate when the company's current performance makes it possible to predict its future performance. In the current geopolitical environment, when Russian companies have not recovered from the coronavirus pandemic, foreign supply chains have been disrupted, the ruble has fallen and purchase prices have risen, it is not possible to predict the company's activities.

3. Results

The instability of the stock market caused by new packages of sanctions against Russia entails a drop in the capitalization of companies, which is reflected in Figure 1.

The Moscow Exchange Index reflects "price, market capitalization-weighted composite indices of the Russian stock market, which include the most liquid shares of the largest and fastest growing Russian issuers, which economic activities are related to the main sectors of the economy" (Moscow Exchange Index and RTS Index, 2022).

At the end of February 2022, there was a sharp drop in the index, and consequently the capitalization of the largest Russian companies, and to date, the index has not returned to its pre-crisis value.

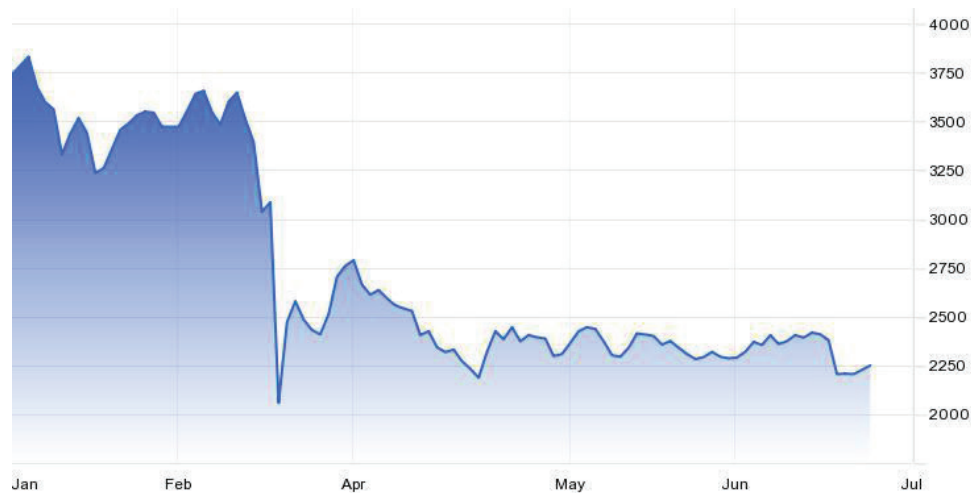


Fig. 1. Moscow Exchange Index for the period of January-July 2022.

4. Discussion

Thus, in modern Russian realities, the use of such approaches to valuation as capitalization and discounting of cash flows is not possible.

Business valuation has always been a popular procedure. Against the backdrop of the current geopolitical situation in relation to Russia, which arose from “unfriendly” countries, valuation has become even more valuable, since new risks have begun to appear in the plane of Russian entrepreneurs, which must be taken into account in business valuation. (Rutgaizer, 2010)

5. Conclusion

To date, there are three risks of different groups that need to be paid more attention to: business risks, financial risks and liquidity risks. In this case, it is about the risk of secondary sanctions for cooperation with a sanctioned entity, bankruptcy and refusal of counterparties to cooperate, the impossibility to approach business valuation in terms of capitalization and discounting cash flows. Taking into account these risks from various groups in business valuation can give Russian entrepreneurs a complete picture when buying a business and reduce or level out a number of possible negative consequences.

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