

# Financial Reporting in the Russian Energy Sector

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## Introduction

Measuring income and profitability in the Russian energy sector is not an exact science. According to official statistics, oil and gas account for less than 9 percent of GDP. Yet export revenue from oil and gas account for 20 percent of GDP. Transfer pricing is thought to be one of the major reasons for the apparent discrepancy (World Bank, 2004). Russian companies can avoid taxes by selling their products at below-market prices to trading companies, which then re-sell the products to customers at market prices. The trading companies are typically registered in a low tax or no tax jurisdiction, which enables them to take advantage of differential tax rates. Although it is possible to recompute profits by going back to the data and the macroeconomic input-output tables, this technique does not provide a perfect solution. Such recalculations are mere estimates.

Accounting measurement is not an exact science even when offshore companies are not involved and transfer pricing is not used. Companies in the same industry can show markedly different results from operations because of the accounting methods they choose to use to prepare their financial reports and tax returns. Russian Accounting Standards (RAS) are required by law. However, Russian companies that want to attract international capital are compelled to use accounting standards that are internationally recognized. The standards they usually choose are either International Financial Reporting Standards (IFRS) or U.S. Generally Accepted Accounting Principles (US GAAP), since these are the two sets of standards that international investors are accustomed to using. The standards chosen – US GAAP, IFRS or RAS – can make a big difference in operating results (McGee & Preobragenskaya, 2005).

This paper examines the financial statements of selected Russian energy enterprises to determine the level of transparency in financial reporting in the Russian energy sector.

## IFRS vs. U.S. GAAP

IFRS and U.S. GAAP are similar but the two sets of standards are not identical. U.S. standards are more comprehensive than IFRS. They cover more topics and they often go into more depth. Accountants cannot agree on whether having more complicated rules and more numerous regulations is a good thing or a bad thing. One criticism that has been made of U.S. GAAP is that they are too rigid. Another criticism is that they are too complicated and detailed. One strength of IFRS is that there is more flexibility and they are more principles based rather than rules based. That is not to say that U.S. GAAP does not have principles because it does. But detailed rules sometimes result in distorting actual results. Using IFRS does not produce distortion to financial reports, or so the argument goes.

There are good arguments to be made on both sides. However, the point is that there are advantages and disadvantages to both sets of standards and large Russian companies that want to attract foreign investors must choose one of the two methods for financial reporting purposes if they want to raise international capital from the debt or equity market. An examination of the financial statements of Russian companies in the energy sector revealed that both methods are being used. Table 1 includes a sample of Russian energy companies,

Table 1. Summary of Accounting Principles Used Russian Energy Sector

U.S. GAAP	IFRS
Lukoil	Gazprom
TNK-BP	RAO ES of Russia
Sibneft	Transneft
Rosneft	Novatek
	Itera
	Irkutskenergo
	Mosenergo

Source: Preobragenskaya (2006)

categorized by the accounting standards they use to prepare their financial reports.

Some Russian energy companies have chosen to use IFRS (in addition to RAS) while others have chosen U.S. GAAP. In at least one case (Mosenergo) a company switched accounting methods. Mosenergo used U.S. GAAP through 2001, then switched to IFRS in 2002 for the financial statements it made available to international investors.

Choosing one set of principles over another does not always make much of a difference as far as the financial statements are concerned. But sometimes the choice of accounting method can make a big difference to the bottom line and to financial statement ratios.

Several books have been published that compare the differences and similarities between U.S. GAAP and IFRS (PriceWaterhouseCoopers, 2004; Deloitte, 2005). These books provide a technical discussion of the differences between the two set of internationally recognized standards but do not say much about the difference the choice of standards can have on operating performance. But depending on the facts and circumstances, the choice of standards can have a major effect on a company's bottom line.

Studies have also been made that compare IFRS standards to those of other countries, including Russia. One such study was published by a group of accounting firms (Andersen et al., 2001).

### **Russian Energy Company Financial Statements**

Enterprises in the former Soviet Union have been criticized for providing inadequate disclosure in their financial statements. Part of the problem is cultural. Disclosure was something that was to be avoided, not applauded. But modern corporate governance rules require transparency, and that means that everything relevant from the perspective of investors must be disclosed. Russian companies are beginning to change their practices as a result, but some companies are moving faster down this road than others.

Disclosure has several aspects. Quantity is a factor. According to this theory, the more that is disclosed, the better. But that does not necessarily

solve the disclosure problem because companies may disclose a lot of information that is not of interest to investors. In the early days, shortly after the fall of the Soviet Union, when Russian companies first attempted to issue western-style financial reports, some companies were criticized for providing a lot of information that investors did not find useful. This criticism has been muted in recent years, as the individuals who prepare Russian financial reports have progressed up the learning curve and have gone increasingly in the direction of western-style financial reporting.

The large international accounting and audit firms have been helping Russian companies in this regard. As part of their audits of Russian companies these firms provide advice about financial reporting content and practices. A cursory look at some recent Russian energy company financial statements found that the Russian companies are disclosing more or less the same information that their western competitors are disclosing. A Standard & Poor's report (Kochetygova et al., 2004) asserted that transparency and disclosure are improving in Russia. Standard & Poor's 2005 report (Kochetygova et al., 2005) verified this trend.

Another aspect of transparency and disclosure is timeliness. In the not too distant past, some Russian enterprises were criticized for waiting too long to issue their financial reports. Some Russian companies did not issue their annual reports until a year or more after the end of the year. In some cases, Russian firms did not even have annual audits.

This situation is changing. The trend in Russia is now toward conducting annual audits by independent audit firms and issuing financial statements in a timely manner. Some Russian firms even post their financial information on their internet sites.

Below is some information that was found by looking at the websites of some Russian energy companies (Table 2). It provides some rough indication of the extent of financial disclosure and transparency that now exists in the Russian energy sector.

Although Gazprom issues IFRS statements, they could not be found on its website. The only statements posted were those using Russian Accounting Standards (RAS). The most recent annual financial statements posted in English on

Table 2. Selected Information on Disclosure Russian Energy Sector

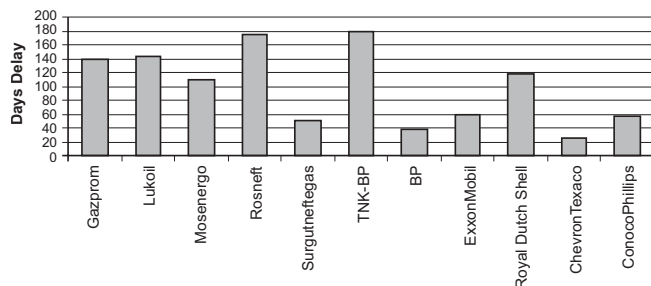
Company Name	Accounting Principles Used	Auditor	Days Delay in Issuing Financial Statements	Pages of Footnote Disclosure
<b>RUSSIAN COMPANIES</b>				
Gazprom (2004)	RAS	PricewaterhouseCoopers	89 + 139	17 + 23
Lukoil (2004)	US GAAP	KPMG	144	37
Mosenergo (2004)	IFRS	RSM Top-Audit	109 + 49	20 + 16
Rosneft Oil Company (2004)	US GAAP	Ernst & Young	175	45
Surgutneftegas (2002)	RAS	Aval	50	6
TNK-BP (2004)	US GAAP	PricewaterhouseCoopers	180	16
<b>NON-RUSSIAN COMPANIES</b>				
BP	UK GAAP and US GAAP	Ernst & Young	38	67
ExxonMobil	US GAAP	PricewaterhouseCoopers	59	36
Royal Dutch Shell Group	US GAAP and Netherlands GAAP	KPMG and PricewaterhouseCoopers	117	31 + 16
ChevronTexaco	US GAAP	PricewaterhouseCoopers	26	61
ConocoPhillips	US GAAP	Ernst & Young	56	26

the Surgutneftegas website were from 2002, although more recent quarterly statements were posted in English.

All the Russian companies included in Table 2 issued income statements, balance sheets, capital statements and cash flow statements. This was not always the case, either in Russia or in a number of other countries. Indeed, in some countries there still is no requirement to issue these four basic financial statements. The fact that all the companies in this brief survey included all of the four basic financial statements indicates a certain level of disclosure and transparency.

A few things need to be said about the content of Table 2. The time delay in issuing financial statements is one measure of transparency and disclosure. The more rapidly financial information is released to the public, the more valuable and timely the information is. Most U.S. companies publish their annual reports in January or February, which means the time elapsed between their December 31 year end and the publication of their financial statements is usually 59 days or less. The dates in Table 2 are the dates of the audit reports, which is not necessarily the same date the financial information was released to the public. However, release dates were not available, so the audit report date was used as a surrogate for information release date.

Chart 1. Days Delay in Issuing Financial Statements



The figures included in Table 2 are also conservative. For example, ChevronTexaco's 2004 Annual Report devotes 20 pages to a discussion of its financial information. These pages are not included in the footnote page count because, strictly speaking, they are not footnotes. Several other companies used a similar format. Thus, using only the pages devoted to footnote disclosure results in a conservative estimate of actual financial disclosure, although it also makes the comparison more homogeneous.

Table 2 shows the extent of the time delay between the December 31 year end and the publication of Russian company financial data. In some cases there are two dates. For example, in the case of Gazprom, it issued its financial statements for 2004 on 30 March, 2005, a delay of 89 days. But it did not issue its consolidated financial statements until 19 May, a delay of 139 days.

Chart 1 provides a comparison of Russian and non-Russian energy sector companies regarding the time lapse between year-end and the time the financial statements are issued. As can be seen, there is usually a longer delay for Russian companies, although Royal Dutch Shell also had a long delay.

The number of pages devoted to footnote disclosure provides an imperfect indication of the degree of disclosure and transparency. The size of the page and the font style and size all have an effect on the number of pages that will be required to disclose all the information that a company wants to disclose. However, page count is a method of determining the extent of disclosure and transparency. But it does not make any attempt at measuring the quality or content of disclosure. A company may take many pages to disclose information that is not of interest to shareholders or potential investors. Thus, mere page count can constitute only a rough attempt to measure the extent of disclosure and transparency.

Table 2 shows the number of pages devoted to footnote disclosure. In the cases of Gazprom and Mosenergo there are two numbers because these companies had two sets of financial disclosure posted on their website, one for the individual company and one for consolidated statements.

Table 2 also provides some comparable information about non-Russian energy companies for comparison purposes. ExxonMobil posted its 2004 financial information in two documents, a Summary Annual Report and a Financial Operating Review. The Summary Annual Report omitted much of what would otherwise be included in the footnote disclosure section of the annual report, and this information also was not included in its Financial Operating Review. However, its 10-K statement did include this information. Thus, it is the source for the data in Table 2.

Royal Dutch Shell Group disclosed its financial information using both US GAAP and Netherlands GAAP financial statements and supplementary information. It devoted 31 pages to US GAAP footnote disclosure and an additional 16 pages to Netherlands GAAP disclosure and supplementary financial information.

Chart 2 provides a comparison of Russian and non-Russian energy sector companies regarding the amount of space in their annual reports that is devoted to footnote disclosure. As can be seen, non-Russian companies generally provide more disclosure, although some Russian companies provide more disclosure than some non-Russian companies.

### Transparency

Although financial reporting practices are one way to have transparency, the issue is much broader than mere financial statement disclosure. Many issues of corporate governance go beyond mere transparency to include issues of corporate structure and policies.

Below are the results of the research conducted by Troika Dialog (2001), the largest Russian investment company, which assessed the consistency of the most liquid shares for 28 listed Russian companies' corporate governance practices using World Economic Forum (WEF) principles. In aggregate, the market capitalization of these issuers totals \$45 billion and represents around 85 percent of the total capitalization of the Russian market.

On the criterion "financial discipline," which was characterized by disclosure of accurate, consolidated, timely information using and verified by an independent audit, the 28 companies fared as follows:

Chart 2. Pages of Footnote Disclosure

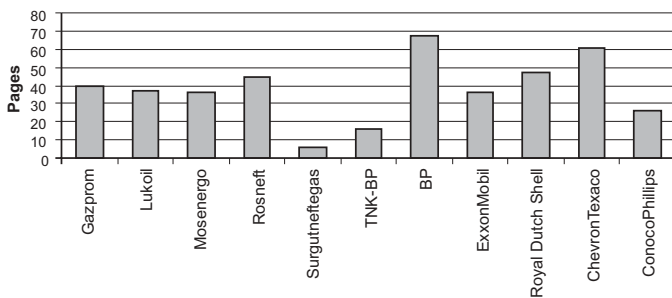


Table 3. Financial Discipline (Top Russian Companies)

Category	Number of Companies	Percent of Companies
Adequate to good	8	28
Fair to adequate	10	36
Poor to fair	10	36
Totals	28	100%

Table 4. Transparency of Russia's Largest Companies (2005)

Rank	Company	Score	Rank	Company	Score
1	MTS	84	29	Kalina	49
2	Rostelecom	82	30	MGTS	48
3	Mechel	79	31	Severstal	47
4	Wimm-Bill-Dann Foods	77	32	Tatneft	47
5	Golden Telecom	75	33	Kuzbassenergo	46
5	Vimpelcom	75	34	MMK	46
7	North-West Telecom	71	35	Sberbank	45
8	RosBusinessConsulting	69	36	Novatek	44
9	Lukoil	68	37	Pharmacy Chain 36,6	43
10	Southern Telecom	67	38	Yakutskenergo	43
11	Volga Telecom	65	39	KAMAZ	41
12	Uralsvyazinform	64	40	GAZ	41
13	Centertelecom	63	41	Samaraenergo	39
14	Sibirtelecom	63	42	AvtoVAZ	37
15	Severstal Avto	60	43	Lebedyanskiy	36
16	Gazprom	60	44	Krasnoyarskenergo	35
17	Power Machines	58	45	Surgutneftegaz	35
18	Norilsk Nickel	58	46	Irkutskenergo	34
19	Mosenergo	58	47	Sverdlovennergo	34
20	Sibneft	57	48	YUKOS	33
21	Dalsvyaz	55	49	Irkut	30
22	Sistema	54	50	Bashkirenergo	27
23	TNK-BP	54	51	Bashneft	23
24	OMZ	53	52	Evrasholding	21
25	Lenenergo	52	53	Pyaterochka	3
26	RAO UES	52	54	Rambler Media	2
27	Aeroflot	51			
28	Baltika	50			
				<b>Average Score</b>	<b>50</b>

Thus, less than half of the companies in the sample adequately comply with the principles of financial discipline. However, the experts did remark that the trend is clearly improving. Furthermore, since this study was conducted in 2001, it is reasonable to expect that financial discipline among Russia's leading companies has improved further.

A more recent survey of Russian company transparency was conducted by Standard & Poor's (Kochetygova et al., 2005). This survey measured and ranked transparency among Russia's 54 largest companies. Table 4 lists the companies' ranks and transparency scores. The list

includes a number of companies in the energy sector, which makes it possible to see how transparency in this sector compares to transparency for all sectors.

As can be seen, some Russian energy companies rank quite highly, while others do not. It is expected that overall scores will improve in future years because of the pressure being exerted on Russian companies in all industry sectors to improve their corporate governance practices and degree of transparency. This pressure is coming from the international investment community, the Russian government and internally, within the companies themselves.

## Concluding Comments

Financial reporting in the Russian energy sector has improved in recent years. There is more and better disclosure now than there was a few years ago. This upward trend is expected to continue. Although the state of financial reporting has improved, there is still some way to go.

Luckily, the fact that energy prices are increasing serves to attract investors regardless of the level

or degree of financial transparency. But in the long run Russian energy companies will be doing themselves a disservice if they do not continue to improve their financial reporting because they must compete globally. Energy companies in other countries have strong and highly regarded financial reporting practices. Russian companies will have to meet this standard if they want to continue to grow and compete for international capital.

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