CASE 8.8

OAO Gazprom

In February 2002, a lengthy *Business Week* article examined a major financial scandal swirling around one of the large international accounting firms. Key features of the scandal included the accounting firm allegedly "overlooking wildly improper deals" in its audits of a huge client that ranked among the "country's biggest energy firms," a company that had become a symbol "for the evils of crony capitalism."[1] The opening prologue for the article went on to note that the scandal involved "billions and billions" of dollars of losses as well as "leaked documents, infuriated shareholders, and threatened lawsuits."[2] Several major political figures had been caught up in the scandal, including the president. No, the article was not dissecting the sudden collapse of Enron Corporation in December 2001. Instead, the article focused on the international controversy sparked by the relationship between the largest energy producer in Russia, OAO Gazprom, and that company's independent audit firm, PricewaterhouseCoopers (PwC).

The commotion surrounding PwC's audits of Gazprom was ignited by the accounting firm's alleged failure to report candidly on a series of huge transactions involving that company and several smaller firms owned or controlled by Gazprom executives or their family members. Principal among these entities was Itera, a secretive company with U.S. connections. Criticism of PwC's audits of Gazprom became so intense that the prominent accounting firm was forced to purchase full-page ads in the major Moscow newspapers to defend itself.

Rogue Capitalism

Throughout the 1990s, the dominant international accounting firms pursued strategic initiatives to expand their worldwide operations. Many of these initiatives targeted Russia and the cluster of smaller countries carved out of the former Soviet Union when it suddenly disintegrated in 1991. *The New York Times* reported that the major accounting firms were among the first foreign firms to establish significant operations in Russia following the collapse of the Soviet Union.[3] In their "competitive rush" to establish an economic beachhead in Russia, these firms may have underestimated the many risks posed by that country's rapidly evolving business environment.

The massive reorganization of Russia's political, social, and economic infrastructure in the 1990s produced widespread chaos within the suddenly "new" country that had a proud history that was centuries old. Russia's political leaders wanted to quickly embrace capitalism. To accomplish this objective, Russia's new democratic government implemented a "privatization programme" intended to convert the country from communism to capitalism in a span of a few years. The first and most important phase of this enormous project gave Russian citizens the right to acquire

1. P. Starobin and C. Belton, "Russia's Enron?" *BusinessWeek Online*, 18 February 2002.

2. *Ibid.*

3. S. Tavernise, "U.S. Auditors Find Things Are Different in Russia," *The New York Times*, 12 March 2002, Section W, 1.

ownership interests in thousands of Russian firms at a nominal cost by using state-issued "privatization vouchers." These Russian firms were formerly state-owned companies or agencies that had established corporate governance structures equivalent to boards of directors to oversee their operations. From 1992 through 1999, more than 75 percent of Russian companies were handed over to the private sector, although the federal government retained a sizable minority ownership interest in the nation's largest and most important companies.

The privatization program succeeded in quickly converting Russia's controlled economy into a free market economy. However, the project was flawed in many respects. For example, more than one-half of the newly created companies were technically insolvent and able to survive only with subsidies and other economic support from the federal government. Complicating everyday life for these new firms and their managers was the rampant inflation in the Russian economy that exceeded 2000 percent annually.

Arguably the most pervasive weakness of the privatization program was that it allowed thousands of the individuals who had overseen the formerly state-owned businesses to acquire top management positions in the newly organized companies. The Russian press commonly referred to these individuals as "red directors," since most of them had been Communist Party "apparatchiks" or operatives. Not surprisingly, few of these corporate managers shared or even understood the capitalistic principles they were being asked to embrace. As *Business Week* noted, these individuals "cling to the view that the enterprise is an engine to generate wealth for themselves."[4] This pervasive attitude among the newly minted corporate executives spawned a rough-and-tumble version of capitalism in Russia that sparked widespread violence—including hundreds of murders and contract killings, kickbacks, bribes, and "organized robbery."[5] Critics of the privatization program often pointed to OAO Gazprom, a huge Russian company, as a prime example of this "rogue" capitalism.

Gazprom, a term that means "gas industry," was initially a privately owned company created by officials of the Soviet Union to assume control of the country's natural gas industry. The company's most important assets are enormous natural gas reserves discovered in Siberia following World War II. Gazprom was one of the first publicly owned firms created by Russia's privatization program. Fifteen percent of Gazprom's common stock was given to employees and 28 percent to customers, while the federal government retained a 40 percent ownership interest in the company. Most of Gazprom's remaining common stock was sold to foreign investors. To ensure that domestic investors maintained control of major Russian companies, foreign investors were permitted to buy only a small fraction of a Russian company's stock.

Gazprom's initial stockholders' meeting was held in 1995. At that meeting, the stockholders endorsed the board of directors' selection of PwC as the company's audit firm. Rem Vyakhirev, Gazprom's top executive at the time, reported that the world's largest audit firm had been chosen to enhance the credibility of his company's financial statements and financial disclosures.[6]

During the 1990s, Gazprom was arguably the most important Russian company and the largest by most standards. The massive company accounted for nearly 10 percent of Russia's gross domestic product and 20 percent of its exports and tax revenues. Gazprom had an estimated 400,000 employees and provided directly or indirectly a

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4. P. Starobin, "Russia's World-Class Accounting Games," *BusinessWeek Online*, 5 March 2002.
5. Tavernise, "U.S. Auditors Find Things Are Different."
6. P. Kranz, "Boris' Young Turks," *Business Week*, 28 April 1997, 52.

livelihood for more than 6 million Russians. The company's influence stretched far beyond Russia's borders. Gazprom supplied more than one-half of the natural gas used in Europe and controlled one-third of the world's natural gas reserves.

Gazzoviki

Victor Chernomyrdin was born 10 years following the Russian Revolution of 1917. Chernomyrdin's parents were peasants who worked on a Russian collective farm. As a young man faced with limited educational opportunities, Chernomyrdin decided to become a skilled craftsman, a machinist. Following World War II, he acquired a job working in his country's rapidly developing natural gas industry that was controlled by the Ministry of the Gas Industry. The Soviet Union citizens fortunate enough to have the relatively stable and lucrative jobs in this field became known as the gazzoviki.

Chernomyrdin gradually rose through the ranks of the gazzoviki. His career success was due to his hard work, dedication to the Communist Party to which he belonged, and, most important, his ability to foster mutually beneficial relationships with key superiors and subordinates. Chernomyrdin spent much of his long career with Gazprom in frigid Siberian oil and natural gas fields. For most of that time he worked side by side with Rem Vyakhirev, his most trusted ally and protégé whose first name was an acronym for "Revolution Engels-Marx," a common name given to Russian males in the years following the Russian Revolution. In a retrospective article examining the history of Gazprom, a British reporter commented on the company's culture and the close relationship that developed between Chernomyrdin and Vyakhirev, the two individuals who had the greatest impact on the company during its formative years.

> *Gazprom is a closed world obsessed by status and hierarchy, and disdainful of outsiders. It is dominated by the macho gazzoviki, lifelong gas workers, including Mr. Vyakhirev and Mr. Chernomyrdin, who speak an earthy slang. They are united by years of working and drinking together in production plants in Russia's most remote and inhospitable regions. "You can't believe how much they drank," says one company insider. "Life was simpler in Siberia. They knew what was expected of them."*[7]

In 1992, Boris Yeltsin became the new Russian republic's first president. Yeltsin chose Chernomyrdin, Gazprom's chief executive, to serve as the nation's prime minister, the second-highest-ranking position in the federal government. Before leaving Gazprom, Chernomyrdin appointed Rem Vyakhirev as the company's new chief executive. Despite being the senior member of Yeltsin's administration, Chernomyrdin kept a close watch on Gazprom's financial affairs and frequently communicated with Vyakhirev regarding the company's operations. Together, Chernomyrdin and Vyakhirev guided the company through its turbulent early years as a publicly owned company when it became known officially as OAO Gazprom. (The "OAO" prefix indicates that Gazprom is an open-stock or publicly owned company.)

During Yeltsin's administration, Russian journalists took advantage of their country's new freedoms to openly and harshly criticize top governmental officials. A common target of that criticism was Chernomyrdin. Gruff and terse by nature, Chernomyrdin was frequently derided by the Russian press for his unpolished social skills, his poor mastery of the Russian language, and his refusal to provide candid answers to questions posed to him by reporters.

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7. A. Jack, "Is Time Up for the 'Secret State'?" *Financial Times* (London) 25 May 2001, 33.

Chernomyrdin's critics charged that he used his political power to grant large tax concessions and other economic benefits to Gazprom. These critics also maintained that Chernomyrdin and Vyakhirev diverted billions of dollars of Gazprom's assets to themselves and family members. Allegedly, the two men and their colleagues established a network of private companies and then channeled Gazprom assets to those companies through an array of complex and clandestine transactions. The Russian press also claimed that Chernomyrdin routinely used Gazprom funds to finance the election campaigns of political candidates in his Our Home Is Russia (NDR) political party. Likewise, although Chernomyrdin frequently insisted that he had cut all ties to his Communist background, he reportedly used Gazprom funds to finance the election campaigns of several longtime colleagues running for office under the banner of the still active and powerful Communist Party.

In responding to the persistent stream of allegations and innuendos directed at him by the Russian press, an indifferent Chernomyrdin typically resorted to a brief phrase that is the Russian equivalent of "that's nonsense."[8] Another tactic Chernomyrdin used to rebuff allegations that he and his former subordinates at Gazprom were misusing corporate funds was to point out that the company's financial affairs were being closely monitored by a prestigious CPA firm, namely, PwC.

Chernomyrdin's relationship with Boris Yeltsin deteriorated over the years. In 1998, Yeltsin forced Chernomyrdin to resign as prime minister. Later that year, Chernomyrdin failed in his bid to replace Yeltsin as Russia's president. Following Yeltsin's resignation in 2000, former KGB intelligence agent Vladimir Putin was elected the new Russian president. In the meantime, Chernomyrdin had returned to Gazprom, assuming the position of chairman of the board while his close friend Rem Vyakhirev remained the company's chief executive.

Putin had campaigned as a reform candidate, promising to clean up the fraud and bribery that pervaded Russian business. Putin realized that for the Russian economy to become viable, Russia's major companies had to raise large amounts of debt and equity capital from foreign investors. But as long as self-interested "red directors" were in charge of those companies, Putin knew that foreign investors were unlikely to make major financial commitments to the Russian economy.

Putin singled out Gazprom and its management team as prime examples of what was wrong with the Russian economic system. He was particularly offended that Gazprom's executives viewed themselves as being "above the law"[9] and not accountable to the Russian public or elected officials. In fact, while serving as Gazprom's chief executive, Vyakhirev had his company acquire Russia's only independent television network, ostensibly to silence his critics.

Vyakhirev took pleasure in bragging about the power that he exercised as Gazprom's top executive. Vyakhirev "liked to boast of dispatching flunkies in the company jet to pick special tundra grass to feed the reindeer on his private Moscow estate."[10] A British periodical claimed that such abusive practices were commonplace and carried out "under the noses" of the firm's independent auditors.

> *Under . . . Rem Vyakhirev, Gazprom resembled a badly run country more than it did a publicly traded energy company: it had its own intelligence service, fleet of aircraft, hotels, media outlets and even a yacht club. Under the noses of its Western auditors,*

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8. *Global News Wire* (online), "Gazprom Denies Making Contributions to Election Campaigns," 24 January 2000.

9. *The Irish Times* (online), "Russian Gas Chieftain Pushed Out by Putin," 8 June 2001.

10. *Ibid.*

> *billions of dollars of cash and assets leaked to companies where ownership was at best murky, at worst startlingly close to Gazprom's chiefs.*[11]

True to his word, shortly after becoming president, Putin began forcing large numbers of red directors of major Russian companies to resign. Among the first such executives to lose their lucrative positions with major Russian firms were Vyakhirev and Chernomyrdin who were allowed by Putin to voluntarily "retire" from Gazprom.[12] Unlike most Russian retirees, Chernomyrdin and Vyakhirev would not have to rely on a meager government pension for their retirement income. In 2001, *Forbes* reported that the two former Russian peasants were among the 500 richest individuals in the world. *Forbes* pegged Vyakhirev's personal wealth at $1.5 billion, while Chernomyrdin's more modest fortune was estimated at $1.1 billion.[13]

Accounting and Auditing on the Fly

Banishing corrupt corporate executives was an important first step in Vladimir Putin's campaign to entice foreign investors to provide desperately needed debt and equity capital for large Russian companies. However, Putin also realized that his country's accounting and financial reporting practices had to be revamped before foreign investors would commit significant funds to those companies. The new country's existing financial reporting framework was a holdover from the system used in the Soviet Union, a system that was poorly suited for the needs of a free market economy.

> *In the chaotic early years of new Russian capitalism, accounting standards here were poorly suited to market economics. They were built around reporting to tax authorities, not gauging a company's financial health for investors. Oversight was all but nonexistent and the legal system was undeveloped, leaving room for manipulation and theft.*[14]

Russia's move toward a Western-style accounting and financial reporting system actually began shortly after the creation of the new Russian republic in 1991, well before Putin became the nation's top elected official. In 1992, Russia's new federal government approved "Regulation on Accounting and Reporting in the Russian Federation," an administrative decree intended to provide a blueprint for radically changing the nation's accounting and financial reporting system. The primary responsibility for implementing this decree would rest with the Ministry of Finance, the government agency charged with overseeing the country's financial infrastructure. Several organizations, among them the United Nations, the European Union, and the World Bank, pledged to help the Ministry of Finance implement the decree. The international accounting community, including the major international accounting firms and professional accounting organizations in leading industrialized nations, also offered to help the Ministry of Finance in its effort.

The most important feature of the plan to overhaul Russia's accounting and financial reporting system was adopting the fundamental accounting concepts and procedures that had become generally accepted in major industrialized countries over the previous two centuries. Even before the break-up of the Soviet Union, Russian accountants had recognized the concept of "fair presentation." However, an entity's

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11. *Economist.com*, "Last Night at the Gazprom," 31 May 2001.

12. Although Chernomyrdin had to give up his position with Gazprom in 2001, a few months later Putin appointed him Russia's ambassador to Ukraine. This appointment surprised foreign journalists since the two men had been fierce political rivals over the previous several years.

13. *The Russian Business Monitor* (online), "Eight Russians Put on Billionaires List," 22 June 2001.

14. Tavernise, "U.S. Auditors Find Things Are Different."

financial statements were considered to be "fairly presented" if they complied with the arcane taxation, reporting, and administrative requirements of the federal government. The new accounting framework introduced into Russia in the early 1990s required companies to adopt such revolutionary concepts as recognizing revenues when earned and realized, properly matching revenues and expenses each accounting period, invoking the historical cost principle for most assets, and applying the going-concern principle to discontinued operating units.

Because Russia did not have a rigorous rule-making process for the accounting domain, the major international accounting firms and other influential parties encouraged the Russian federal government to endorse the accounting standards being promulgated by international rule-making bodies. In 1999, the Ministry of Finance announced that Russian companies could apply either the loose amalgamation of "Russian accounting principles" that had developed over the previous several years or the much more comprehensive and logically consistent International Accounting Standards (IAS), which are now known as International Financial Reporting Standards (IFRS).[15] The latter standards are issued by the London-based International Accounting Standards Board (IASB), which was created in 1973 with the long-range goal of developing a uniform set of worldwide accounting and financial reporting standards. In 2001, the Ministry of Finance, with the full support of Vladimir Putin, made another bold and progressive decision when it announced that publicly owned Russian companies would be required to adopt IFRS over a transitional period running generally from 2001 through 2005.

In addition to higher-quality accounting and financial reporting practices, Putin and other leading reformers in Russia realized that their nation needed a rigorous independent audit function to enhance the credibility of publicly issued financial data. The large international accounting firms that established practice offices for the first time in Russia during the early 1990s found that most large Russian companies required so-called statutory audits. Statutory audits were effectively "compliance" audits intended to determine whether a given company's periodic financial reports and internal accounting functions complied with the various governmental decrees and regulations to which they were subject. (In the Soviet Union, "independent audits" intended to enhance the credibility of publicly released financial statements in the minds of investors and creditors had not been necessary since the federal government controlled practically all economic resources.) Exhibit 1 presents an example of a statutory audit report issued by PwC in April 2000 for one of its large Russian clients, the Joint-Stock Commercial Savings Bank of the Russian Federation.

EXHIBIT 1

Example of a Russian Statutory Audit Report Issued by PricewaterhouseCoopers

To the Shareholders of Joint-Stock Commercial
Savings Bank of the Russian Federation (an open joint-stock company):

1. We have audited the accompanying 1999 statutory accounting reports of Joint-Stock Commercial Savings Bank of the Russian Federation (open joint-stock company) (hereinafter—the Bank). These statutory accounting reports were prepared by the management of the Bank in accordance with the Chart of Accounts for credit institutions prescribed by the Bank of Russia and other regulatory documents. These statutory accounting reports differ significantly from financial statements prepared in accordance with International Accounting Standards mainly in areas of valuation of assets and capital, period of recognition of revenues and expenses, recognition of liabilities and disclosures.

15. The IASB adopted the phrase "International Financial Reporting Standards" in 2001.

EXHIBIT 1—*continued*

EXAMPLE OF A RUSSIAN STATUTORY AUDIT REPORT ISSUED BY PRICEWATERHOUSE-COOPERS

2. Preparation of the statutory accounting reports is the responsibility of the management of the Bank. Our responsibility as statutory auditors is to express an opinion on the trustworthiness in all material respects of these statutory accounting reports based on our audit.

3. We conducted our statutory audit in accordance with:

   The Temporary Rules of Audit Activity in the Russian Federation adopted by Decree of the President of the Russian Federation of 22 December 1993, No. 2263;

   The Regulations on Audit Activity in the Banking System of the Russian Federation No. 64 approved by the Order of the Bank of Russia of 10 September 1997, No. 02-391;

   The Regulations of the Bank of Russia "On the order of compiling and presenting to the Bank of Russia the audit report on the results of checking the credit institution's activity for the reporting year" of 23 December 1997, No. 10-P;

   The rules and standards on auditing approved by the Commission on Audit Activity under the President of the Russian Federation;

   The standards of Banking Auditing approved by Expert Committee under the Bank of Russia;

   International Auditing Standards; and

   Internal standards of the firm.

   These standards require that we plan and perform the statutory audit to obtain reasonable assurance about whether the statutory accounting reports are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the statutory accounting reports. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the statutory accounting reports in order to assess compliance with laws and current regulations of the Russian Federation. We reviewed a sample of business transactions of the Bank for compliance with the effective legislation solely to obtain sufficient assurance that statutory accounting reports are free of material misstatements. We believe that our statutory audit provides a reasonable basis for our opinion.

4. In our opinion, the audited annual statutory accounting reports are prepared in all material aspects in accordance with legislation and statutory requirements regulating the procedure of accounting and preparation of statutory accounting reports in the Russian Federation and the principles of accounting accepted in the Russian Federation. On this basis, the proper preparation of the balance sheet and of the profit and loss account is confirmed.

5. Without qualifying our opinion, we draw attention to the fact that the operations of the Bank, and those of similar credit organisations in the Russian Federation, have been affected, and may be affected for the foreseeable future by the economic instability of the company.

PricewaterhouseCoopers
28 April 2000

Notice that the third section of the report indicates the various rules, regulations, and standards that PwC followed in performing the given audit.

International accounting firms encouraged Russian federal officials to adopt an audit model patterned after the independent audit function in Western countries. These firms generally supported a move toward the British audit model, which requires independent auditors to decide whether a given client's financial statements present a "true and fair" view of its operating results and financial condition. A Moscow-based PwC audit partner reported that his firm had encountered major resistance to this radical change.

> *Companies say, "I don't need this. I want you to check our compliance with the law and regulations and that is all." If the local law does not require something, it is difficult to persuade clients to buy it. They don't understand the process of [conforming] to a true and fair view.*[16]

In 1999, the Institute of Professional Accountants of Russia (IPAR), a leading professional organization roughly comparable to the American Institute of Certified Public Accountants (AICPA), applied for admission to the New York-based International Federation of Accountants (IFAC). The IFAC's website notes that it is "an organization of national professional accountancy organizations that represent accountants employed in public practice, business and industry, the public sector, and education." More than 150 professional accountancy organizations are IFAC members, including the AICPA. A major thrust of the IFAC is developing International Standards of Auditing (ISAs) that can be readily applied in developing countries without a formal rule-making body for the auditing domain. The IFAC's auditing standards tend to be broad conceptual guidelines rather than detailed rules. Nevertheless, ISAs are generally consistent with the professional auditing standards applied in the major free market economies, including Great Britain and the United States.

The IPAR became an IFAC member in 2000. In the fall of that year, the first official Russian translation of ISAs was made available to the Russian accounting profession and the foreign accounting firms with practice units in Russia. At that point, the Big Five accounting firms, each of which had a major presence in Russia, began encouraging their clients to obtain ISA-based audits and began lobbying government officials to formally endorse the ISAs.

A key factor that impeded the spread of Western-style auditing in Russia during the 1990s was the existence of so-called "pocket auditors." Many, if not most, new Russian companies created in the early 1990s retained accounting firms run by friends and relatives of their executives to audit their financial statements and provide related professional services. These accounting firms allegedly helped their clients "cook their books" and "evade taxes and disguise asset-stripping."[17] Executives of Russian companies feared that PwC and the other international accounting firms would not be as cooperative or compliant as pocket auditors. However, the controversy spawned by PwC's audits of Gazprom caused many critics to suggest that the prestigious accounting firm was firmly "in the pockets" of Gazprom's top executives.

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16. PricewaterhouseCoopers, "Russia: Hammering Out Standards, Hitting a Mindset," *WorldWatch*, March 2000, 14–15.

17. Starobin, "Russia's World-Class Accounting Games."

Wildest Dream or Worst Nightmare?

In July 1997, a reporter for the London-based *Financial Times* interviewed Bruce Edwards, the PwC audit partner who had just completed supervising his firm's first annual audit of Gazprom. The reporter noted that, "to most auditors, Gazprom would rank as their wildest dream—or their worst nightmare."[18] The "dream" feature of the engagement was that it provided instant credibility for PwC in the Russian audit market. Another "dream" feature of the engagement was the $12 million annual fee that the accounting firm earned for the audit. On the downside, the Gazprom audit required the 70 PwC personnel assigned to the engagement to travel the length and breadth of Russia. To accomplish their audit objectives, the PwC auditors had to inspect many of the company's more than 1,000 operating units, which included slaughterhouses, media outlets, hospitals, a yacht club, and dozens of other ventures unrelated to the company's primary line of business.

In the *Financial Times* interview, Edwards downplayed the suggestion that audits of large Russian companies were markedly different from audits of comparable U.S. firms. "There is nothing mystical about Russian accounts. There is a huge misconception that Russia is somehow different, but I do not see it being much different to anywhere else."[19] Edwards did admit that Gazprom executives and employees were initially reluctant to share information with PwC auditors. However, that reluctance was "short-lived," Edwards assured the newspaper reporter and then went on to maintain that the quality of financial information Gazprom personnel provided to PwC auditors "was extremely high."

One feature of the Gazprom audit on which Edwards did not comment was the company's extensive related-party transactions. During the late 1990s, major Russian newspapers and other media outlets charged that Gazprom's top executives were routinely siphoning off enormous amounts of assets to related-party entities that they or their family members controlled.

According to press reports, Gazprom officials sold a huge amount of natural gas at nominal prices to Itera, a privately owned company based in the Netherlands that has major operating units in Russia and the United States. Throughout the 1990s, Itera's top executive was Igor Makarov, a former Gazprom employee and Olympic biking champion for the Soviet Union. Makarov had been taught the intricacies of the natural gas industry by his close friend and mentor, Rem Vyakhirev. In one confirmed case, Gazprom sold a large volume of natural gas to Itera for $2 per cubic meter, which Itera then resold to European customers for more than $40 per cubic meter. In another transaction, Gazprom sold its 32 percent ownership interest in a gas-producing subsidiary, Purgas, to Itera for $1,200. Industry insiders estimated that the market price of that ownership interest was approximately $400 million. Thanks to such transactions, Itera grew from a small, unknown entity to the world's seventh-largest natural gas company in a span of only seven years during the 1990s.

Although Itera appears to be the company that has profited the most from Gazprom's generosity, several other firms have been the beneficiaries of similar sweetheart deals. Among these firms is Stroitransgaz, a pipeline construction company that landed a large number of lucrative contracts with Gazprom during the 1990s. According to the Russian press, Stroitransgaz's principal owners include Viktor Chernomyrdin's two sons and Rem Vyahkirev's daughter.

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18. J. Thornhill, "Behind the High Walls at Gazprom," *Financial Times* (London), 11 July 1997, 24.
19. *Ibid.*

In 2001, Boris Fedorov, who had previously served as the head of the Ministry of Finance, was appointed to Gazprom's board of directors. Shortly after joining the board, Federov told the *Moscow Times* that Gazprom was losing the equivalent of $2 billion to $3 billion each year due to "corruption, nepotism, and simple theft."[20] That same newspaper went on to report that its own five-week investigation had uncovered evidence that Gazprom assets "have been systematically handed over to company managers—including Vyakhirev, his deputy Vyacheslav Sheremet, and former Prime Minister Viktor Chernomyrdin—throughout Vyakhirev's tenure."[21]

The increasingly revealing and hostile reports focusing on Gazprom's business dealings with Itera and other related companies outraged the international investment community and foreign political officials whose countries had provided billions of dollars of aid to jumpstart the fledgling Russian economy. Even more outraged were foreign investors who owned Gazprom stock. Among these investors were the stockholders of Hermitage Capital, Russia's largest private equity fund, which held a large minority ownership interest in Gazprom's outstanding stock. Most of Hermitage's stockholders were U.S. citizens.

William Browder, Hermitage's chairman and a former partner with the Wall Street investment banker Salomon Brothers, had begun accumulating Gazprom stock for Hermitage in the mid-1990s. Browder, an American citizen whose father had served decades earlier as a top official of the Communist Party in the United States, recognized that the huge natural gas reserves owned by the company were not properly impounded into Gazprom's stock market price. He expected that the stock's market price would rise dramatically when Western investors realized the massive resources controlled by the company. Unfortunately for Browder and his fellow Hermitage investors, Gazprom's stock price stubbornly refused to move higher.

A frustrated Browder reported in 2001 that if Gazprom's petroleum reserves were valued by the stock market on approximately the same basis as the comparable reserves of Exxon Mobil, the company's stock price would be 132 times higher.[22] Browder attributed the lack of interest in Gazprom's common stock to the fact that the company was literally "giving away" huge chunks of its natural gas reserves each year to Itera and other privately owned companies controlled by Gazprom executives, their family members, and their close friends and associates.

The growing controversy surrounding Gazprom's bizarre deals with Itera, which was fueled by the Russian press, forced the company's board to call for a "special audit" of the Gazprom-Itera transactions in January 2001. Ironically, that announcement sparked even more controversy and negative publicity for the company. When Gazprom's board announced that PwC had been retained to perform the Itera audit, critics immediately charged that PwC would effectively be auditing "itself," since the firm had given its implicit approval to the suspicious Itera transactions during its prior audits of Gazprom. Most galling to critics was that PwC had failed to even require Gazprom to disclose Itera as a related party in the footnotes to the company's financial statements over the previous several years.

Boris Fedorov, the sole Gazprom board member who voted to retain an accounting firm other than PwC to perform the special audit, publicly criticized the board's decision. "There is no way you can believe in an assignment which asks an auditor to check their own figures. It is spitting in the face of investors."[23] PwC's appointment

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20. *Moscow Times*, "Time to Say Farewell to Vyakhirev," 22 May 2001, 12.

21. *Ibid*.

22. W. Browder, "Gazprom Investors Are Sold Short," *Moscow Times*, 30 July 2001, 8.

23. A. Jack and A. Ostrovsky, "Gazprom Vote Raises Concerns," *Financial Times* (London), 24 January 2001, 32.

to perform the special audit even caused dissension among the accounting firm's partners. *Business Week* reported that several senior PwC partners in the firm's Moscow office believed "that any self-review [of the Itera transactions] would lack credibility."[24]

Shortly after Gazprom's board hired PwC to investigate the company's business deals with Itera, a group of minority stockholders led by Federov appointed Deloitte & Touche to perform a parallel investigation of those same transactions. The other members of Gazprom's board squelched that effort by refusing to provide Deloitte access to the company's accounting records. Federov responded by claiming that the board's decision "showed that it [Gazprom's management] had something to hide."[25] Federov went on to demand that PwC rigorously interrogate Gazprom's executives and family members known to have ties to Itera. Within days, Federov found himself the target of anonymous threats by hostile adversaries. Accustomed to the often treacherous business environment of his country, Federov dismissed the threats and insisted that he would continue demanding that Gazprom provide more transparent and reliable financial reports to investors, creditors, and other third parties.

No Smoking Guns

PwC completed its four-month investigation of Gazprom's business dealings with Itera in the summer of 2001 and filed a 67-page confidential report of its findings with Gazprom's board. Within days, much of PwC's report had been leaked to the press. According to the *Financial Times*, PwC did not identify any "deals in which Itera benefited at the expense of Gazprom."[26] Subsequent press reports undercut the credibility of PwC's investigation. These reports indicated that PwC's investigation had been severely hamstrung by a lack of cooperation on the part of both Itera and Gazprom officials. Itera's management had refused to provide documents requested by PwC auditors, while 19 executives and former executives of Gazprom, including Rem Vyakhirev, had refused to answer questions posed to them by the auditors.

Not surprisingly, the results of the PwC investigation failed to placate Boris Federov, William Browder, and other critics of Gazprom's management. Instead, the tepid PwC report served to focus increasingly harsh criticism on the large accounting firm. In early 2002, Gazprom's board announced a "contest" to retain an accounting firm to audit the company's financial statements for the fiscal year ending June 30, 2002. Although Gazprom invited PwC to prepare a bid for the 2002 audit, the Russian and international business press indicated that there was little chance PwC would be selected given the adverse publicity that continued to plague the firm. Diminishing even further PwC's chances to retain the Gazprom engagement was a recommendation issued in early 2002 by the Russian Securities Commission, a federal agency equivalent to the U.S. Securities and Exchange Commission. That agency strongly encouraged large Russian companies to change their auditors periodically.

A few days after Gazprom announced the auditor contest, PwC purchased full-page ads in major Russian newspapers. These ads attempted to rebut much of the criticism that had been directed at the firm over the previous two years for its Gazprom audits. The ads suggested that PwC had been singled out for criticism based on "an inaccurate understanding of the roles and responsibilities of auditors."[27]

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24. Starobin and Belton, "Russia's Enron?"
25. "Gazprom Won't Permit Audit by Deloitte," *National Post*, 21 March 2001, C2.
26. A. Jack, "Auditors Find No Evidence of Deals That Aided Itera," *Financial Times*, 6 July 2001, 22.
27. A. Jack, "PwC Acts to Defend Itself in Russia," *Financial Times* (London), 28 February 2002, 20.

In April 2002, Hermitage Capital filed multiple civil lawsuits against PwC in Russian courts alleging, among other charges, that the accounting firm had performed "deliberately false" audits of Gazprom. At the same time, Hermitage filed a request with the Ministry of Finance to suspend PwC's license to practice in Russia. A PwC spokesperson maintained that the allegations in the lawsuits were "completely unfounded" and that the firm's audits had "met all applicable legal and professional standards."[28]

The Hermitage lawsuits were the first such lawsuits filed against a major international accounting firm in Russia. Many legal experts questioned whether there was a valid basis for the lawsuits under the emerging but scanty Russian securities laws and legal precedents. Nevertheless, the Hermitage lawsuits startled PwC and the other major accounting firms operating in Russia. The lawsuits raised in a new context a slew of "old" issues that had pestered audit firms since the inception of the independent audit function.

> *Whatever the truth, the audit profession in Russia faces the same difficulties as elsewhere in arguing that it is "watchdog not bloodhound"—with a remit to verify information, but not to actively sniff out fraud, and not to assume greater responsibility than management itself for errors they have committed. But the profession is also caught in a conflict of interest. Each firm is nominally charged with reporting to all shareholders whether a company's financial statements are "true and fair." In reality, it is appointed, paid by, and reports to executive management, which may be involved in activities to the detriment of outside investors.*[29]

The inherently problematic nature of the auditor-client relationship is made even more problematic within Russia by two key factors. *The New York Times* reported that "fierce competition" among the major accounting firms to acquire and retain the relatively few large and lucrative Russian audit clients had resulted in auditors feeling pressured to "sign off on questionable practices by such clients to avoid alienating them."[30] A former Ernst & Young employee who had been assigned to that firm's Moscow office was more blunt. "A big client [in Russia] is god. You do what they want and tell you to do. You can play straight-laced with minor clients, but you can't do it with the big guys. If you lose the account, no matter how justified you are, that's the end of a career."[31]

The second factor complicating the quality of independent audits in Russia has been the haphazard, if not ragtag, nature of the country's auditing rules. Critics of independent auditors in Western countries have long suggested that professional auditing standards are too "flexible," which ultimately results in less rigorous audits and lower-quality financial statements. This problem has been exacerbated in Russia over the past decade by the lack of consensus on what auditing rules should be applied.

The evolving nature of Russia's professional standards have allowed auditors in that country to interpret their mission too narrowly, according to one former governmental official. Auditors "check that the paperwork was done correctly, but look right past the corrupt heart of the matter."[32] One former PwC auditor provided an example of this mindset in an interview with *The New York Times*. This individual reported that a large automobile manufacturer that was a PwC audit client effectively gave away

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28. S. Tavernise, "Shareholder in Gazprom of Russia Sues Auditor," *The New York Times*, 16 April 2002, W1.
29. A. Jack, "Testing Times for Auditors in Russia," *Financial Times* (London), 17 April 2002, 27.
30. Tavernise, "U.S. Auditors Find Things Are Different."
31. *Ibid.*
32. *Ibid.*

huge amounts of inventory by routinely shipping cars to supposed "dealers" who never paid for those shipments. The former PwC auditor recalled thinking, "'What's going on? You aren't getting paid—no guarantees, no nothing. Are you stupid?' It was clear to me that it was organized robbery."[33] In its audit report, PwC commented on the fact that the client was using different methods to account for certain domestic sales and sales made to foreign customers. But, according to *The New York Times*, the firm failed to convey in its audit report "what was actually going on at the company."[34]

A PwC spokesperson refused to respond directly to the charges made by his firm's former employee but did insist that PwC "stood by its audits" of the given client. *The New York Times* reporter then asked an audit partner with Arthur Andersen about an Andersen client that routinely sold merchandise to related parties at deeply discounted prices. The nature of these sales was not disclosed in the company's financial statements or in Andersen's audit reports on those financial statements. When asked why such disclosures were not made, the Andersen audit partner replied that Russian law did not require them. This attitude on the part of major international accounting firms operating in Russia has proven to be extremely detrimental to domestic and foreign investors.

> *In this environment, Western auditing firms could have and should have held their Russian clients to higher standards of behavior, investors in Russian companies are now saying. But, instead . . . the auditors chose to play by Russian rules, and in doing so sacrificed the transparency that investors were counting on them to ensure.*[35]

Profit after Stealing and Subsidies

Despite earlier reports that Gazprom would likely retain a new audit firm, in May 2002 the company issued a press release indicating that PwC would remain its independent auditor. Of 29 accounting firms that had submitted bids for the Gazprom engagement, the company's board reported that PwC was the firm that best met its "requirements." Throughout the late spring and summer of 2002, PwC received more good news as one by one the Russian courts dismissed the lawsuits filed against the company by Hermitage Capital. The Russian courts ruled that under existing Russian law only the audited entity could sue its accounting firm for defective audits. Since the majority of Gazprom's board of directors and stockholders refused to side with the plaintiffs in the lawsuits, the courts' only alternative was to rule that the lawsuits were invalid. The Ministry of Finance also denied Hermitage's request that PwC's license to practice be rescinded.

William Browder reacted angrily to the dismissal of the lawsuits his firm had filed against PwC and the news that the accounting firm would remain Gazprom's auditor. Browder argued that, at a minimum, PwC and Gazprom officials should provide more detailed disclosures regarding the company's key operating results. For example, Browder suggested that in the future the company report in its income statements, "Profit after Stealing and Subsidies" and "Profit If Stealing and Subsidies Are Eliminated."[36]

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33. *Ibid.*
34. *Ibid.*
35. *Ibid.*
36. M. Waller, "Fingered," *The Times* (London), 12 July 2002, 27.

Questions

1. List the challenges that a major accounting firm faces when it establishes its first practice office in a foreign country. Identify the key factors that accounting firms should consider when deciding whether to establish a practice office in a new market.
2. Suppose that a U.S.-based accounting firm has a major audit client in a foreign country that routinely engages in business practices that are considered legal in that country but that would qualify as both illegal and unethical in the United States. What specific moral or ethical obligations, if any, would these circumstances impose on this accounting firm? Explain.
3. What responsibilities, if any, do you believe PwC had to Gazprom's minority investors?
4. In your opinion, should PwC have agreed to perform the "special audit" of the Itera transactions? Defend your answer. In your answer, identify the specific ethical issues or challenges that the engagement posed for PwC.
5. In the United States, what responsibility do auditors have to determine whether or not "related parties" exist for a given audit client? Explain.
6. Explain how the British "true and fair" audit approach or strategy differs from the audit philosophy applied in the United States. In your opinion, which of the two audit approaches is better or, at least, more defensible?
7. In recent years, there has been an ongoing debate in the accounting profession focusing on the quality of the accounting standards issued by the International Accounting Standards Board versus those issued by the Financial Accounting Standards Board. Research and briefly explain the key philosophical difference between those two important rule-making bodies that significantly affects the nature of the accounting standards promulgated by each.