OAO GAZPROM

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SHORT REVIEW

2022: Business Week talks about financial scandal of Pricewa-houseCoopers (PwC)

CRONY CAPITALISM

PwC had overlooked grossly improper dealings in audits of OAO Gazprom.

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PROBLEM: ITERA

Alleged failure of the audit firm to report candidly on huge transactions involving the company and smaller companies owned or controlled by Gazprom executives or their relatives.

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WHAT HAPPENED?

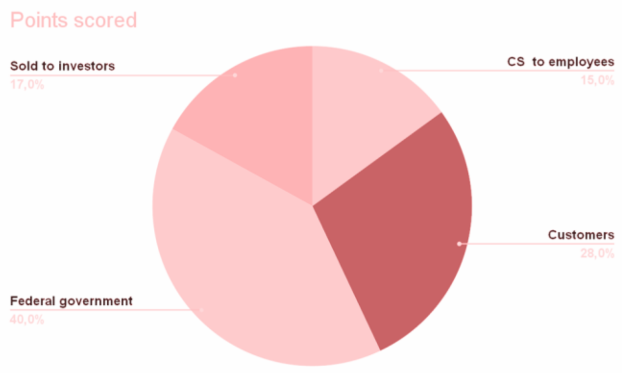
Criticism of PwC's audits of Gazprom was so intense that the prominent accounting firm was forced to buy full-page ads in major Moscow newspapers to defend itself.

STORY OF GAZPROM

Gas industry

- Initially: Private company of the Soviet Union
- It was one of the first publicly owned companies by Russia´capitalization system.

Its most important assets are the huge natural gas reserves



During the 1990s it was the most important Russian company and the largest most standard:

- 10% Russia´GDP
- 20% of its tax revenues
- It employed almost 6 millions russians.
- Supplied more than half of natural gas used in Europe
- Controlled ⅓ of the world´s natural gas reserves.

Situation in Russia

1990s

Dominant international accounting firms expand operations

They focused on Russia after the collapse of the Soviet Union, however, they underestimated the risks by the russian environment.
The political leaders intended to quickly adopt capitalism and to this end pursued a privatization program. The first and most important phase of the project was the possibility given to citizens to acquire shares in Russian companies (which came from state bodies equivalent to boards of directors) using privatization bonds.

1992-1995

More than 75% of the enterprises went to the private sector

Shortcomings of the project:

- More than half of the companies created were insolvent (they could only live on subsidies).
- There was high inflation exceeding 2000% per year.
- It allowed individuals who had supervised the formerly state-owned enterprises to acquire top management positions in the newly organized enterprises. (“Red directors”).

Situation in Russia

- ❖ Victor Chermomyrdin
- ❖ Rem Vyakhirev

} Gazzoviki (cityzen who work in the gas industry)

1992: Boris Yeltsin became 1st president of Russian Republic

- He chose Chermomyrdin to become the nation´s first minister
- Chermomyrdin before leaving Gazprom appointed Vyakhirev as the new general director of the company.

Russian journalists took the opportunity to criticize government officials:

- Used his power to grant tax concessions and economic benefits to Gazprom.
- Used Gazprom funds to finance election campaigns of his communist party.
- Diverted millions from assets to themselves and their relatives.
- Established network of private companies and channeled assets to those companies through transactions.

1995

1st Gazprom Shareholder´s meeting

PwC was to be the company´s audit firm

1998

Yeltsin forced Chermomyrdin to resign as prime minister

He returned to Gazprom and became chairman of the board of directors.

2000

Yeltsin resigned as president of the republic. Vladimir Putin was elected as the new president.

The new president realized that things had to change:

- Clean up fraud and bribery in Russian business.
- Companies need large amounts of debt and equity capital from foreign investors.
- **He pointed to Gazprom as an example not to follow.** He allowed Vyakhirev and Chermomydin to retire.
- Country's accounting and financial reporting practices needed to be revamped before foreign investors give them funds.
  - ➔ Their financial reporting framework was not adapted to a free market economy.
  - ➔ Oversight was almost non-existent and the legal system underdeveloped, leaving room for manipulation and theft.
- Achieve a rigorous independent audit function to increase the credibility of published financial data.

Dream or nightmare

1997: A journalist from the Financial Times interviewed Bruce Edwards, the PwC audit partner who had just supervised the company's first annual audit of Gazprom.

Topics which were discussed

Edwards downplayed the differences between Russian audits and those in the rest of the world such as the US.

He initially admitted that Gazprom employees and executives were reluctant to share information but later participated.

Topics which were not discussed

Transactions between related parties of the company. Gazprom's top executives were diverting huge amounts of assets to entities related to them or their relatives (the biggest example was Itera).

ITERA:

- Gazprom sold for $2 per cubic meter of gas when it should have sold for more than $40.
- It sold a 32% stake to Itera for $1,200 when it was approximately $400 million.
- Huge gas reserves were not well valued in the stock market share price.

2001:

Increasingly problems forced the company to request a "special audit" of the Gazprom- Itera transactions.

- PwC was auditing itself: the auditor had not required the company to declare Itera as a related party in the footnotes.

A parallel investigation of these transactions was conducted by Deloitte but no information was provided by management.

2002:

PwC bought newspaper advertisements to defend that Gazprom held a tender to get an auditor, and against all odds was chosen.

Hermitage filed multiple lawsuits against PwC alleging that its audits were false and requesting the suspension of its license to practice.

The courts dismissed all of them since under Russian law only the audited entity can sue the firm for defective audits. In addition, the Ministry of Finance denied the request to rescind the license to practice.

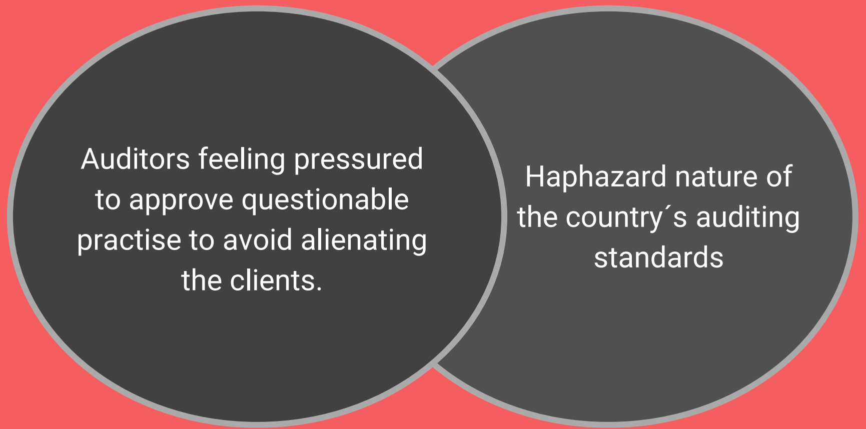
The president of Hermitage suggested following this news: that in the future the company will report in its income statements "profit after theft and subsidies" and "profit if theft and subsidies are eliminated´´.

Summary of audit issues

It is a "watchdog, not a bloodhound”.
The mission is to verify information, but not to actively sniff out fraud, and not to take greater responsibility than management itself for mistakes made.

The profession is caught in a conflict of interest.

The problematic nature of the auditor-client relationship is made even more problematic in Russia by two key factors:



This results in flexible, less rigorous audits and poorer quality financial statements.
Check that the paperwork has been done correctly, but overlook the corrupt core of the matter.
This attitude of the major international audit firms operating in Russia has been very detrimental to both domestic and foreign investors.

QUESTIONS

QUESTION 1 (I)

List the challenges that a major accounting firm faces when it establishes its first practice office in a foreign country.

- Make a decision regarding the company's hiring and/or relocation requests for employees.
- Learn about the rules and legislation that apply to business operations there, especially those that pertain to accounting.
- Become familiar with the various standards and customs of the other nation, and incorporate these factors into your business organization.
- Make the connections required to start up new consumer relationships.
- Create a comprehensive business plan for the company that outlines its funding requirements, office and staffing requirements, signed and anticipated commitments, as well as other sources of income and expenses.

QUESTION 1 (II)

Identify the key factors that accounting firms should consider when deciding whether to establish a practice office in a new market.

- Is the choice financially viable, will the office be financially self-sufficient, or will it eventually offer value to the company as a whole?

- What are the obstacles to entering the concerned nation? This covers things like concerns about the local business climate, licensing requirements and/or other rules that can make it difficult for a foreign company to operate abroad, etc.

- Is it preferable to start from scratch or is it possible to acquire or partner with a local accounting firm?

QUESTION 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.

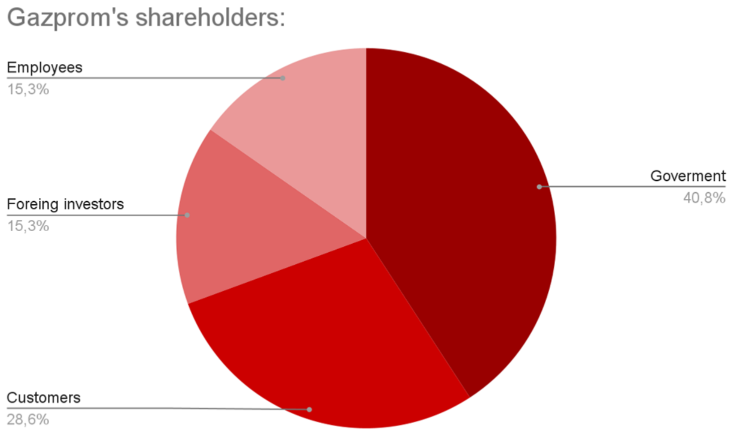
What specific moral or ethical obligations, if any, would these circumstances impose on this accounting firm? Explain.

If an Assurance client's practices are considered unethical and illegal in the United States, it means they do not meet the requirements of International Financial Reporting Standards (IFRS)and the US General Ledger.

Therefore, US accounting firms are not authorized to accept this client. Otherwise you will be breaking the law.

QUESTION 3

What responsibilities, if any, do you believe PwC had to Gazprom's minority investors?



A stakeholder of a firm who does not have voting control over the company is said to be a minority investor (national investors were intended to have a higher percentage than foreign investors).

Responsibilities:

- Disclosure Itera as a related party
- Minor responsibility- so called "Itera transactions"

QUESTION 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.

No, they shouldn't have accepted it since it implied that the business was auditing itself. It need to have mentioned Itera as a linked party in the financial statements of the company's footnotes.

Specific ethical issues or challenges: for PwC in Russia, two important aspects make the already challenging nature of the auditor-client relationship even more problematic:

1. There is a lot of pressure on the major accounting firms to win and keep the select few highly valuable Russian audit clients.

2. The character of national auditing standards (they are too "flexible", too lax).

QUESTION 5

In the United States, what responsibility do auditors have to determine whether or not "related parties" exist for a given audit client? Explain.

1. Checking whether there were some illegal transactions
2. Checking whether there was a fraud in the company to be audited

If the auditing firm discovered it after entering into an agreement with its client, a disclaimer should be given.

When the auditor is unable to affirm that the financial accounts are overall presented fairly, a disclaimer is made. It can only result from the auditor's ignorance, whereas the auditor must be aware that the financial accounts are not correctly stated in order to express a negative opinion.

QUESTION 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?

VS

US accounting standards have evolved in the context of the country's business environment rising litigiousness. Due to this, US accountants are under pressure to be very specific about what is and is not acceptable in corporate accounting.

Auditor truthful and fair (UK): The financial accounts accurately reflect the entity's financial performance and condition and are free from serious misstatements.

- True: There are no substantial misstatements that could cause users to be misled in the financial statements, which have been factually accurate and prepared in compliance with the relevant reporting system, such as IFRS. Inaccuracies or omissions of transactions and balances in the financial accounts can lead to misstatements.

- Fair: denotes that the financial accounts reflect the economic essence of transactions rather than just their legal form and provide facts fairly, without any indication of prejudice.

QUESTION 6

The British approach is more **classical and outdated**. Additionally, UK accountants do not always act honestly and fairly (due to the long standing relationship between clients and accountants among many other things).

QUESTION 7

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.

The International Accounting Standards Board (IASB) responsible for International Financial Reporting Standards (IFRS)

Financial Accounting Standards Board (FASB), responsible for US Generally Accepted Accounting Principles (US GAAP).

While the FASB focuses on creating standards for accounting firms in the U.S., the IASB focuses on accounting standards for international firms.

IASB → IFRS

FABS → GAAP

FABS VS IASB

- FASB is an independent nonprofit organization that establishes financial accounting and reporting standards for both public and private companies.

- Helps improve financial reporting for the professionals that use this information in U.S. capital markets.

- FASB accomplishes this by setting high standards for the Generally Accepted Accounting Principles (GAAP) and providing users with clear and relevant financial information.

- The IASB establishes global accounting standards by pursuing the IFRS's technical agenda, issuing reporting standards and approving the interpretations made by the IFRS Interpretations Committee.

- These international accounting standards help set a unified code of financial ethics that countries can follow despite cultural differences.

- The international accounting standards can make it easier to simplify and resolve disputes between companies in diverse parts of the world.

IFRS VS US GAAP

IFRS	US GAAP
110 Countries Worldwide	US Only
LIFO Inventory Prohibited	LIFO or FIFO Allowed
Specific rules for intangibles recongition	Intangibles at current market value

THANK YOU FOR YOUR ATTENTION!