



# Institute of Corporate Law and Corporate Governance

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## Managing Corporate governance risks in Russia

May, 2002

# Russia: Investment risks

- **Corporate governance**

There are a lot of stories of corporate conflicts and abuse of investor rights:

- Concerns about possible asset stripping in the relationship between Rosneft and Purneftegas, Gazprom and SIBUR etc.

At the same time: not all Russian companies abuse shareholders rights – there are companies with good governance practices

- **Audit reports**

- Concerns about quality of PWC audit of Gazprom

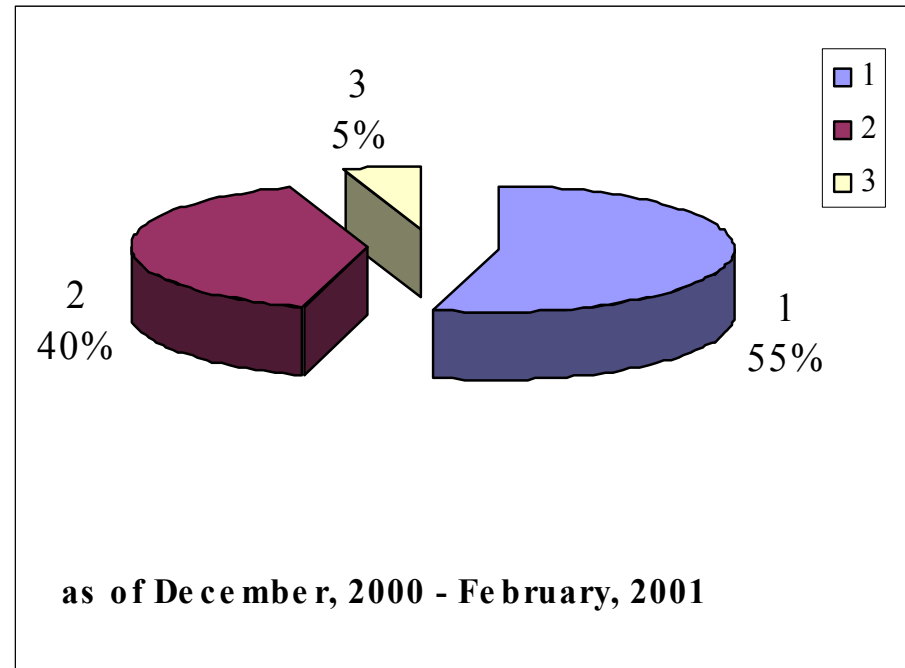
# Investors in Russia market often undervalue corporate governance risk because:

*Most investment analysts' research do not take corporate governance (CG) risks into account*

## Number of reports

- Total number of reports =77
- Group 1: no CG analysis (42)
- Group 2: unsystematic CG analysis (31)
- Group 3: systematic CG analysis (4)

***Situation do not change until now!***



# SOME BROKERS' RECOMMENDATIONS AND REAL RISKS INVESTORS FACE IN RUSSIA\*

	Company was strongly recommended by brokers as a 'good investment'	Position, rank by CORE-rating	Some problems with the company identified by ICLG
1	<u>Purneftegas</u>	32 (41.45)	<ul style="list-style-type: none"> <li>- risks of transfer pricing and huge volume asset stripping</li> <li>- unequal access to information for shareholder</li> </ul>
2	Surgutneftegaz	30 (44.20)	<ul style="list-style-type: none"> <li>- unlawfully broad rights enjoyed by management, possibility of affiliated party transactions</li> <li>- BoD is under management control</li> </ul>
3	YUKOS	26 (48.33)	<ul style="list-style-type: none"> <li>- undisclosed capital structure</li> <li>- risks of transfer pricing and asset stripping</li> </ul>
4	Tatneft	31 (42.44)	<ul style="list-style-type: none"> <li>- an unlawful provision in the company charter</li> <li>- low transparency</li> </ul>

\* for 01.01.2002

*Example:* Troika Dialog had persistently recommended to “strong buy” the stocks of Purneftegas during February 2002 – April 2002. During the same period RTS index had gained 16%, while the common stocks of Purneftegas had fallen by 47%.

## Certain auditor's reports and actual risks faced by investors in Russia (on the basis of research by the ICLG)

No.	Company	Auditor's opinion on financial statements for 2000 prepared in accordance with the Russian Accounting Standards	Auditor opinion on financial statements for 2000 prepared in accordance with IAS or US GAAP	Certain problems identified by the ICLG on the basis of analysis of financial statements and financial and business operations of the company
1.	OAO Sibneft	<p><b>ZAO Arthur Andersen</b></p> <p>Qualified report; in particular, the following comments are made therein:</p> <ul style="list-style-type: none"> <li>- the notes do not contain all required data which is subject to disclosure under the existing regulations;</li> <li>- part of expenses (including those relating to payment of interest on loans) was reflected as expenses which had been effectuated out of the company's available funds and was not reflected in Form No. 2.</li> </ul>	<p><b>ZAO Arthur Andersen</b></p> <p>(consolidated statements in accordance with US GAAP)</p> <p>Unqualified report.</p>	<ul style="list-style-type: none"> <li>- unsatisfactory structure of the company's balance sheet with borrowed funds being thrice as much as the company's own funds;</li> <li>- transfer pricing practices and asset stripping on a large scale basis;</li> <li>- the notes to the Russian financial statements do not correspond to the existing rules.</li> </ul>
2.	OAO LUKoil	<p><b>ZAO KPMG</b></p> <p>Unqualified report</p>	<p><b>ZAO KPMG</b></p> <p>(consolidated statements in accordance with US GAAP)</p> <p>Unqualified report</p>	<ul style="list-style-type: none"> <li>- transfer pricing practices and asset stripping on a large scale basis;</li> <li>- the notes to the Russian financial statements do not correspond to the existing rules.</li> </ul>

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3.	OAO Rosneft-Purneftegaz	<p><i>ZAO Arthur Andersen</i></p> <p>Unqualified report</p>	None	<p>- almost all production of the company is sold at transfer prices to of OAO Rosneft;</p> <p>- almost all fixed assets of the company have been transferred to the balance sheet of OAO Rosneft;</p> <p>- the notes to the Russian financial statements do not correspond to the existing rules.</p>
4.	OAO Gazprom	<p><i>ZAO PricewaterhouseCoopers Audit</i></p> <p>OAO Gazprom</p> <p>Unqualified report</p> <p>Consolidated financial statements</p> <p>Unqualified report</p>	<p><i>ZAO PricewaterhouseCoopers Audit</i></p> <p>(consolidated financial statements in accordance with IAS)</p> <p>Unqualified report</p>	<p>- unsatisfactory structure of the company's balance sheet;</p> <p>- transfer pricing practices and asset stripping on a large scale basis;</p> <p>- the notes to the statements do not disclose material information on transactions with Itera.</p>

# **ICLG-research as a tool to evaluate risks**

ICLG produced the ratings and researches during the whole 2001.

In April of 2002, ICLG has completed the ratings and corporate governance reports for the 34 largest Russian companies (approximately 90% of market cap).

Our findings were the following:

# Changes in Quality of Corporate Governance of Russian Companies through the Scope of CORE-Rating

	ISSUE	SITUATION IN 25 COMPANIES AS EVALUATED BY ICLG		QUALITY OF CHANGES
		01.01.2001	01.01.2002	
1	<b>Unequal treatment of shareholders in Company Charter</b>	<b>In 24% of companies Charters make such treatment possible</b>	<b>In 46% of companies Charters make such treatment possible</b>	- (↓)
2	<b>BoD structure (more than 50% of the BoD are company employees)</b>	In 24% of companies	In 13% of companies	+ (↑)
3	<b>Shareholder access to minutes of BoD meetings</b>	Over 50% of the companies provide such access	Over 65% of the companies provide such access	+ (↑)
4	<b><u>Do managers enjoy unlawfully broad rights and powers at the company?</u></b>	<b><u>They do in 25% of the companies</u></b>	<b><u>They do in 33% of the companies</u></b>	- (↓)
5	<b>Poor quality of financial information</b>	In 70 % of the companies	In 33% of the companies	+ (↑)

# Some interesting implications drawn from latest ICLG research for investors:

1. **Substantial variances were identified in the quality of corporate governance.**

**Instead of leveling, the differences across companies, are growing.**

- in the CORE-rating the highest score is almost 2.1 times higher than the lowest score

VimpelCom (the best) – 83.30%

Avtovaz (the worst) – 40.08%

2. **Big differences are also observed within industries, for example within**

**Telecommunications (8 companies) (January 2002):**

1 <sup>st</sup> place	(the best)	VimpelCom	- 83.30%
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22 <sup>th</sup> place	(the worst)	Kubanelectrosvyaz	- 49.51%
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# Some interesting examples:

## 1. Information Disclosure:

*Bad:* Surgutneftegas did not provide any information to ICLG

*Good:* RostovTelecom disclosed information about manager salaries

## 2. Dilution Risk:

*Bad:* GAZ has approved the authorized but unissued shares representing more than 350,000 % of issued capital

*Good:* Sibneft has voided the authorized but unissued stocks

# Some interesting examples:

## **3. Transfer pricing risk:**

*Bad:* Sibneft sold their products by low price (close to costs).

*Good:* Surgutneftegas doesn't use transfer pricing.

## **4. Evaluation of quality of auditor reports:**

*Bad:* Arthur Andersen provided its unqualified auditor report in respect of Sibneft statements without mentioning its unsatisfactory financial condition.

*Good:* PWC correctly pointed out, in its auditor report in respect of Purneftegas statements, that transfer pricing didn't give possibility to Purneftegas to pay its debts.

(R.S. After that, angry Purneftegas broke contract with PWC)

# Conclusion:

1. Russia and West are now closer than before: not only politically, but economically

For example, there are some scandals in West and in Russia.

- Enron and Gazprom
- Arthur Andersen (USA) and PWC (Russia)
- Merrill Lynch high-tech recommendation and Troika-Dialog Purnaftegas recommendation

2. Corporate governance matters!

You can manage corporate governance risks by using ICLG research and rating