Auditing in Russia

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Abstract

This paper presents an overview of the current state of auditing in Russia. International Standards on Auditing (ISA) are in the process of being adopted and implemented but this task is far from complete. Furthermore, there is resistance to ISA adoption and there is less than a widespread perception that they are needed or desirable. Russia has adopted some auditing rules that are not included in ISA and the focus of audits in many companies is tax compliance or minimization rather than attestation. Lack of full compliance with ISA makes it more difficult to attract investment capital, since foreign investors do not place much confidence in financial statements that do not comply with International Accounting Standards and that were not audited using ISA.

Introduction

Audit reform is one of the Russian government's key priorities. Russia needs an infusion of capital to replenish the erosion of the capital base that has taken place since the start of the communist regime in 1917, but capital is not readily forthcoming, for a variety of reasons. For one, there is competition for the world's capital. Russian investments have to compete with investments in more than 100 other countries and many investors see Russia as a relatively undesirable place to invest.

The *Index of Economic Freedom*, published jointly by the Wall Street Journal and the Heritage Foundation, is a key reference for international investors who are trying to decide where to invest. The most recent annual edition (2003) shows that Russia ranked 135 in terms of economic freedom, out of 156 countries whose statistics were included in the study (Table 3). Its overall score for 2003, which averages ten categories, is 3.70, on a scale from 1 to 5, where 1 is the most free. That score has remained constant since 2000 but is somewhat worse than the scores it received in earlier years (See Table 1).

One of the relative bright spots was the score it received for foreign investment (3.0), which was the second best score of the ten categories included in the study (See Table 2). Although a score of 3.0 is not good enough to excite foreign investors, it is one of the best things the Russian economy has going for it at present. So it makes sense from a policy perspective to do things that will enhance the desire to invest in Russia. Russian President Putin's decision to adopt a low, flat tax (Klebnikov 2001) has helped to attract foreign capital as has the spread of the rule of law (Williams 2001), which calms investors' anxieties. But that is not enough to attract capital.

Financial transparency is important to foreign investors (Radoutsky 2001). The credibility of financial statements is crucial. If the financial statements cannot be trusted, it is extremely difficult to attract foreign investment because investors cannot be confident of what they are investing in. Furthermore, the evidence shows that Russian financial statements do not inspire much confidence (Rozhnova 2000; Currie 1996). One way to enhance financial statement transparency is to use some internationally recognized system of financial reporting. Russia is making moves in that direction by adopting International Accounting Standards (IAS), which are recognized in dozens of countries. But merely stating that a company uses IAS is not sufficient to win investor confidence. A reliable, trustworthy audit system must be in place to verify that the standards are actually being used. That is where the audit function comes in. An auditing system based on International Standards of Auditing (ISA) provides the much needed oversight of commercial and government activities that is needed to instill confidence in the reliability of financial information (Ichizli and Zacchea 2000).

Russia's transformation from a centrally planned economy to a market system has been difficult in a number of ways. The government decided several years ago to adopt IAS but the process is still incomplete (ICAR 1999). Some standards have been adopted while others have not (Ramcharran 2000). Furthermore, even where a standard on a particular topic has been adopted, the Russian standard is not identical to the international standard (ICAR 2000a, b).

Another problem with adopting IAS is that the Russian accountants, auditors and bookkeepers who must implement and use the new rules are not always as knowledgeable about the rules as they should be. Educating a whole nation takes time and is complicated by the fact that there is a shortage of people who are qualified to teach the new accounting (Shaw et al. 2000) and there is a shortage of good course material (Coyle and Platonov 1998; Anon. 1994). The education process has been ongoing for more than ten years but is far from complete (Cheney 1990). Although Russia adopted a new chart of accounts (Paliy 2000), the chart of accounts is the least of Russia's problems. What it needs is accountants, bookkeepers and auditors who know the rules and know how to apply them. The United States Agency for International Development (USAID) and other organizations (Anon. 2002a) have provided funding to train members of the Russian accounting profession, but the funding to date has been small and piecemeal (Anon. 2001a; Cornish 1999).

The State of Auditing in Russia

Auditing is a relatively new profession in Russia. The first audit company (Inaudit) was founded by special decree (Postanovlenie) by the Soviet Ministry of SSSR in 1987. Since 1992 the income tax law required companies having foreign investments or foreign companies to present an independent auditor's opinion as part of their financial statements that must be submitted to the Tax Revenue Service. There are now thousands of audit firms in Russia.

Russian auditors face many of the same problems that Russian accountants and bookkeepers face. The rules have changed since many auditors left school, so they must learn the new rules. The problem is that there aren't enough qualified instructors to teach the new rules and the quality of teaching materials is not always as good as it could be. Until recently, accounting and auditing materials had to be translated from other languages, since materials like the International Accounting Standards (IAS) and International Standards on Auditing (ISA) were not available in the Russian language. Those materials, as well as several good textbooks have now been translated. But what is more important, Russian authors have started writing their own textbooks and course materials, a development that is significant, since it eliminates the translation problems that invariably occur when foreign texts have to be translated into another language.

Another problem Russian auditors face is that many companies either use only some IAS, or they use not only IAS but also Russian Accounting Standards (RAS), which are not always the same as IAS (Vysokov 2000). Russian tax rules rely on RAS, whereas financial reports are often constructed using at least some of the IAS. Furthermore, the accounting software is not always able to convert RAS to IAS and vice versa. So auditors are faced with the task of trying to verify different sets of books that utilize two different sets of accounting standards.

Russian auditors face other problems as well. For example, the Russian business culture, after three generations of communist rule, has become corrupt. There is also a lack of disclosure and transparency. Many transactions between related parties are not disclosed. Money laundering is common and widespread. Western banks and stock markets sometimes participate in the money laundering process (Burns 1999). Russian auditors somehow have to deal with these structural problems and widespread practices. Methods have to be found to deal with these problems and auditors have to be trained so that they know what to look for and what to do when they find it.

The prevalence of barter is another roadblock in the path of good audits. Barter is popular, especially since the devaluation of the Ruble in 1998. Russia's oil and gas industry resorts to barter quite frequently. The problem with the widespread use of barter is that barter can obscure financial results and weaken the implementation of IAS. Foreign investors want to have confidence in the fairness of financial statements, and having the widespread use of barter does not bolster that confidence (Lindberg 2002).

Audit procedures in Russia have tightened up in recent years. It used to be that different auditors applied different standards, and while that is still true to a certain extent, audit standards are becoming more uniform and harmonized as more Russian audit firms adopt and implement ISA (Anon. 1997). On July 29, 2002 the Council on Audit at the Russian Finance Ministry approved drafts of audit standards that are similar to ISA (Anon. 2002b). Some Russian firms have been using ISA for several years, but now that the Finance Ministry has approved international standards, they will become increasingly widespread. However, having some government issue a decree that such standards must be used does not mean that they will be used in every case. It will take some time for the new audit standards to permeate the system and the minds of Russian auditors.

The approach to audits in Russia is also different than the approach used in the West. Before the collapse of the Soviet Union there were no auditors, in the Western sense of the term (Enthoven et al. 1998). Accounting glossaries as recent as 1990 did not even include the word "auditor." The traditional Russian approach, going back to the time of the Tsars, had more to do with control and inspection than with checking and verifying in the Western sense (Bychkova 1996; Enthoven et al. 1998). That approach is now changing.

Perhaps it is not fair to compare audits in Russia to audits in Western market economies such as the United States. However, comparisons have been made. Current and former employees of Arthur Andersen, Deloitte Touche Tohmatsu, Ernst & Young, KPMG International and PricewaterhouseCoopers have cited the lack of accounting standards and oversight that exists in Russia. They have said that firms engage in auditing practices in Russia that would be considered unethical or illegal if done in the United States. Disguising company profits is one practice that was mentioned (Tavernise 2002).

Western audit firms have also come under criticism because of questionable audits. PricewaterhouseCoopers' audit of Gazprom, a Russian petroleum and natural gas company, is only the most prominent of several such audits that have come under fire (Chazan and Whalen 2002). One question that arose during the course of this audit was whether Gazprom executives were enriching themselves at the expense of their shareholders. The evidence suggests that they were. The problem, from an audit perspective, is that prior year audits by PWC failed to uncover such conduct. As a result, PWC is being sued (Anon. 2001b)

Russian Audit Standards

Russian audit standards are similar, but not identical to International Standards on Auditing (ISA). A detailed study comparing the Russian rules to ISA found that many differences exist, some of them substantive (Bychkova and Lebedeva 2001). There are several reasons for the differences. For one, The 1999 ISA bound volume was the one that was translated into Russian, so any changes to ISA that took place after that volume was published are not automatically a part of the Russia audit rules. Second, Russia has adopted at least six audit rules that are not included in ISA (Danilevsky et al 2001). These six extra rules incorporate specific features of the Russian audit system. These rules are:

- Description of Related Services and Their Requirements,
- Requirements for Internal Standards of Audit Firms,
- Rights and Obligations of Audit Firms and Audited Entities,
- Procedures for entering into Audit Engagement Contracts,
- Written Information on Audit Results Provided by the Auditor to the Management of Economic Entity, and
- Auditor's Education.

These six Russian rules either are not covered in ISA or are imbedded in various other standards. There are good and valid reasons for these six extra rules. For example, the rule on "Rights and Obligations" was made because of the widespread perception on the part of some clients that the audit rules do not apply to them (Danilevsky et al 2001).

In a sense, it can be said that the Russian rules are more comprehensive than ISA because Russian auditors have six rules that ISA does not have. But on the other hand, Russian auditors do not have any of the rules that were added to ISA after the 1999 translation into Russian, unless the Russian government or other private group translated the post-1999 rules into Russian.

The fact that the Russian rules are not identical to ISA causes at least two problems. For one, the financial reports that companies issue cannot state that ISA were applied unless *all* International Standards on Auditing were applied. That causes a credibility problem in international capital markets because investors cannot place full confidence in financial statements where only some International Accounting Standards were applied.

Secondly, the fact that Russia does not think it is important to have rules that mirror IAS means that it is unlikely that Russia will have audit rules that are substantially identical to ISA any time soon, which means the problem will persist, thus placing Russian enterprises at a competitive disadvantage in international capital markets.

Another structural problem with the Russian auditing system is that there is a time lag between the time an ISA is adopted or amended and the time that word of the change is disseminated to the Russian audit community. In the case of the Russian translation of the 1999 ISA bound volume, for example, the translation was not completed until October 2000 (Remizov 2001), so there was a lag of about one year between the time the latest ISAs were published in English and the time they appeared in Russian. This information time lag was actually more than a year, since the Russian audit community did not instantaneously absorb the contents of the newly published Russian version. It took time to publish and distribute the Russian version and many Russian auditors did not see any pressing need to buy the book, since there was the perception on the part of many Russian auditors that they didn't need it.

This brings to mind another, related problem with the adoption and implementation of ISA. Many Russian auditors think that they are complying with ISA even though they have not actually read them and do not understand them. The same can be said of the Russian audit rules. Many Russian auditors have not read the Russian rules either, yet they are confident that they comply with them. Many Russian auditors feel that if their clients are satisfied and if there are no claims filed against them, then they have complied with the rules. Other Russian auditors think that they do not need to comply with ISA because Russia has its own audit rules (Remizov 2001).

A substantial segment of the Russian financial community still believes that ISA should not be implemented. Most Russian clients are more interested in minimizing their taxes than in abstract concepts of attestation and fair presentation of financial information. Furthermore, it is advantageous to issue untrue and unfair statements for tax purposes. Many clients do not see the need to pay fees for Western style audits, since they are perceived has having limited value and can result in actually increasing tax liability (Remizov 2001),

One solution to this dilemma would be for auditors to issue an audit opinion only if they comply with all (or most) ISAs, and refer to any other kind of audit engagement as a review or something else, but not an audit. Not all Russian companies need to attract international capital, so this suggestion would alleviate at least part of the problem, unless some government decree requires ISA audits.

Another problem with adopting and implementing ISA is that ISA audits are more complicated and expensive than traditional audits. Russian auditors who want to perform an audit in compliance with ISA are at a competitive disadvantage because of price and they often have to persuade clients that such an audit is worth the extra cost.

Some commentators have advocated the use of coercion to speed the adoption and use of ISA (Remizov 2001), However, coercion is the opposite of the market. Markets develop and prosper because of some consumer need, in the absence of some government impediment. If ISA audits are to become popular and widespread, first there must be a demand for them. In an economy that is attempting to throw off the old, centrally planned system and replace it with markets, using coercion is a step in the wrong direction.

Another question that must be raised, if coercion is decided upon as the solution to the lack of demand for ISA audits, is who will do the coercing. The two options are the government or some quasi-private group of accountants or auditors. In either case, the individuals doing the coercing probably will not be adequately versed in ISA. Russian auditors themselves are not yet fully versed in ISA, partly because the Russian translation only recently appeared and also because the Russian translation does not include all of the ISAs, but only some of them. It is also unlikely that the individuals chosen to do the coercing will be the most intelligent auditors from the available pool. Just like government bureaucrats in the West are usually not as intelligent as the individuals they are called on to regulate and coerce, it is likely that the Russian bureaucrats chosen to do the job of coercing will not be as intelligent as the individuals they will be checking.

That can lead to at least two problems. Intelligent individuals in the private sector can fool the coercive bureaucrats because they are more familiar with the rules. But also, and perhaps more importantly, the bureaucrats, because they may not have a firm grasp of the rules, may pressure firms to do things that are in violation of the rules. Thus, their attempts at coercion would be counterproductive. Not only would they be using coercion, but also they would be using it in a way that defeats the purpose of the coercion in the first place.

Concluding Comments

Russian auditors face a number of problems. There is a time lag between the time a new ISA is passed and the time it is translated into Russian. There is another time lag between the time the new rule is translated and the time auditors can get their hands on it, read it, understand it and start implementing it. Furthermore, there is less than total agreement on the value of ISA in the first place, so the incentive to fully and rapidly implement ISA is lacking. Many clients don't want ISA audits, both because of the perception that such audits are not worth the cost and because such audits could increase their tax liability. Many auditors do not see the value in them, either. If there is little demand and only a small supply of audit firms willing and able to do ISA audits, then few audits will get done.

Then there is the problem that Russian audit rules are not identical with ISA. Russia has some rules that are not present in ISA and ISA has some rules that have not yet been adopted in Russia. That fact does little to reassure international investors that the financial statements they are reading are credible and transparent.

In spite of all these drawbacks, barriers and structural problems, the Russian stock market performed rather well in recent years, compared to those in Western Europe and the United States. So the fact that the current state of Russian auditing leaves something to be desired does not mean that Russian enterprises will not be able to raise capital. It will just make the job more difficult and will raise the cost of capital.

Table 1
Russia's Economic Freedom Score

Year	Score
2003	3.70
2002	3.70
2001	3.70
2000	3.70
1999	3.50
1998	3.35
1997	3.55
1996	3.50
1995	3.40

Table 2
Score for Each Category
(2003)

Trade Policy	4.0
Government Intervention	2.5
Foreign Investment	3.0
Wages and Prices	3.0
Regulation	4.0
Fiscal Burden	3.5
Monetary Policy	5.0
Banking and Finance	4.0
Property Rights	4.0
Black Market	4.0

Table 3
Russia's Relative Ranking

Year	Russia's Rank	Countries in Survey
2003	135	156
2002	131	156
2001	127	155
2000	122	161
1999	110	161
1998	95	156
1997	106	150
1996	93	142
1995	69	101

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