

## Setting sights on the long term

### In Brief

#### Will New Opportunities Emerge?

Starting in the late 1980s, the reality of a vast untapped commercial market in the former Soviet Union, particularly Russia, was seen by an increasing number of Western companies as a distinct possibility. Western international accounting firms likewise saw huge potential and arrived in Moscow before 1990.

Now, after some 10 years of watching and waiting for a surge in economic growth, the firms face a period of significant declining growth in the wake of the August 1998 financial crisis. Their continued presence is being driven in the short term by the local operations of their large Western clients and their need for ongoing accounting services. In the long term, the possibility remains that the huge potential commercial market in Russia will awaken, although this prospect may take 10-15 years.



# Western Accounting Firms in the Aftermath of the Russian Financial Crisis

By Thomas C. Taylor and Jack E. Wilkerson, Jr.

**T**he front-page headline of the *Moscow News* read "Banks Go Bang." On August 17, 1998, the Russian financial collapse was official. The government declared its inability to service its domestic and foreign debt: In essence, Russia was bankrupt. The financial drag of rapidly expanding government debt during the preceding months had been exacerbated by a pyramid of short-term government bonds known as GKO's. Coming on the heels of the Asian crisis, the government default on the GKO's precipitated the collapse. The Russian banks left holding these defaulted instruments immediately froze all payments.

By 1998, Western international accounting firms had spent a decade establishing a firm foothold in Russia. All the then Big Six firms had opened offices in Moscow to be in a position to share in the potential fruits of Mikhail Gorbachev's perestroika. After the fall of the Communist Party, Russia and most other territories of the former Soviet Union set their sights on moving toward a market economy, creating capital markets, reforming the system of taxation, privatizing state enterprises, and promoting an environment favorable to creditable accounting practices. Until the August 1998 financial crisis, the firms had experienced substantial growth in Russia as the economy underwent major restructuring and conditions became attractive to foreign investors.

## The Aftermath

In the ensuing months after the August 1998 crisis, the ruble was devalued by 75%, making imported goods pro-

hibitively expensive for most Russians, the banking system was thrown into turmoil, the Russian stock market plummeted 90%, and the flow of foreign investment into Russia ground to a virtual halt. Western banks reported major losses; for example, Chase Manhattan Bank and Citicorp estimated losses of \$200 million each and Credit Suisse First Boston, \$250 million.

For the Western accounting firms, the overwhelming result was a dramatic downturn in business, especially in the banking sector, where many clients disappeared, in consulting engagements, which were either curtailed or pushed back, and in due diligence work. Of course, the severity of impact varied among firms depending on their mix of business. One firm, which had mostly Russian clients and "admittedly failed to see the crisis coming," was forced to slash its budget by \$20 million (almost 30%). Another firm, whose banking practice had been a major strength prior to the crisis, saw a 30-40% reduction in volume. The firm's multinational practice went from approximately 50% of its total billings before the crisis to 60-70% afterward. A third firm, which had a large portion of its business with multinational entities with operations in Russia and other parts of the former Soviet Union, suffered less because the multinationals stayed, albeit with plans for growth generally put on hold.

How have the accounting firms weathered the effects of the financial crisis? What changes have been brought about by the crisis? What is the current outlook for Russia? During a visit to Moscow in October 1999, the authors discussed these topics with the managing partners and their associates



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at each of the Big Five accounting firms.

### Cost Containment

With the decline in billings resulting from both lost clients and depressed fees, Western accounting firms had little choice but to reduce costs. This meant a reduction in the size and cost of professional staffs. One firm redeployed about 60 professionals, mostly seniors and managers representing 20% of its total staff in Russia, to U.S. offices. The firm also took advantage of the crisis to "do some pruning, since we had had little turnover." Another firm, while cutting its budget by almost 30%, avoided layoffs by cutting salaries approximately 25% (salaries had been higher than those in New York City) and assigning about 100 staff members to U.S. offices. In the case of two other firms, there were layoffs of newly hired staff as well as redeployments of up to 50 people to locations in Europe and North America.

Expatriates, which currently constitute 10-15% of the professional staffs, were especially subject to relocation. At one firm, for example, the ratio of nationals to expatriates increased from 5:1 before the crisis to 9:1 today as the firm becomes "more Russian." At another, expatriates constitute only 35 of 1,200 professionals.

### Becoming More Russian

The large percentage of Russians on the professional staffs reflects the fact that the firms are hiring more and more Russians, beginning at the intern level, and developing them within the firm up to the partner level. Almost every partner interviewed was enthusiastic about the abilities of the Russian hires, which are bright, have a genuine desire to learn, and are interested in opportunities for international travel. These qualities no doubt made the postcrisis staff redeployments easier. Nevertheless, some concern was expressed over

the potential disillusionment of the young Russian staff "who had been exposed to a new way of life" and now were faced with the unsettling impact of the August 1998 crisis.

The Western accounting firms maintain ongoing recruiting relationships with two or three leading academic institutions in Moscow, including the State Finance Academy and the prestigious Moscow State University. The Russian recruits are judged to have a broader, less specialized educational background than is typical of Western European or U.S. hires, but their education is sorely lacking in the areas of accounting, law, and business.

Firms then have the task of providing training programs dealing with Western and Russian accounting and auditing and the operation of business enterprises in a market economy, or, as one partner put it, "how to think as a businessperson. Developing business savvy is a slower process with Russian hires than with, say, U.S. college graduates." One firm sends new hires to a central training facility in Skovia, Spain, for 3-4 weeks of intense accounting training.

It is logical for the firms to become more Russian. After all, Russians understand their country better than outsiders. Furthermore, although the firms were originally in Russia to provide services for Western multinationals, the financial crisis has generally dimmed hopes for continued growth in this market segment for the foreseeable future. According to one managing partner, "the Western view of the crisis was one of great shock, followed by a pull back and a 'wait and see' attitude." (On the other hand, a partner with another firm is finding that "Westerners are expressing more interest now that the cost structure is lower, making risk-return ratios more favorable.") In order to enjoy significant growth, at least for the time being, firms must turn increasingly to Russian clients. As one partner remarked, "The issue is now growth

and Russianization." Another partner said, similarly, "We're in Russia and our business should be Russian."

The good news is that the precipitous fall of the ruble and the concomitant increase in the prices of imports have reduced foreign competition and favored Russian enterprises. (To illustrate, the December 8-14, 1999, issue of *Moscow News* reported that sales of local brands of toothpaste are up 130% since the crisis, while imported brands are down 46%. Sales of Russian-made detergents have nearly trebled, while those of Western brands have declined 50%.) There are indications of a resurgence among Russian companies that survived the crisis, and some partners have observed that since early fall 1999 there has been an upturn in business activity. Another firm indicated that Russian companies not connected to the established oligarchs and conglomerates are starting to spring up.

The overall business that Western accounting firms have developed with Russian clients during the 1990s is not insignificant. Consulting work has ranged from approximately 10% to 15% of total revenues, although it has declined since the crisis. Audit and tax work continue to be the primary lines of services, though the balance varies from roughly equal to as extreme as 70% and 12%, respectively. In all but one firm, audit engagements have consisted mostly of Russian companies. In the case of one firm, 95% of its extensive practice in the energy field is Russian, and its banking practice was about 75% Russian even before the crisis. In the four firms in which there is a preponderance of audit work for Russian clients, audit work for multinationals is low because their local operations are often not material to the parent corporations' financial statements.

On the other hand, tax work has been mainly in the form of tax consulting or tax planning for Western subsidiaries (or representative offices),

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ranging from corporate and individual income taxes (both Russian and foreign) to value-added taxes, customs duties, and payroll taxes. Given the slowdown in foreign investment, the outlook portends a decline in tax consulting work. Until the Russian tax system is made more decipherable and collection more effective, it is not likely that the demand for tax consulting for Russian companies will be significant. As one partner put it, "Russian companies are not paying taxes; only the multinationals comply fully with the tax system." The prevailing attitude is "We don't pay taxes anyway, so why should we do tax planning?"

### Maintaining a Presence

With the challenges and decline brought on by the August 1998 crisis and the depressing outlook generally associated with Russia, why are the firms staying? How can they justify their considerable ongoing investment under such gloomy conditions? The answer is familiar: the tremendous potential of the Russian market. Despite the uncertainty they face in Russia and throughout the former Soviet Union, Western accounting firms and multinationals are looking beyond the short run to a longer horizon of 10-15 years. As one managing partner put it, "The challenge is to not lose money while waiting for better times." Although the investment is a gamble, the firms continue to be willing to invest to maintain a presence in such a large potential market. For the time being the question, "What if we are not there?" is enough to keep them on the scene.

One partner argued that the gloomy picture misrepresents the real situation in Russia, where markets are currently rising and professional personnel are in demand. Besides, according to a managing partner at another firm, most of the large Western companies have not left, and some are even building new plants

in Russia. "The Western companies are not necessarily losing money now, whether with reference to Russian tax filings or GAAP, and some are making lots of money." The recovery now under way in the Far East, the boost to Russian domestic production from the devalued ruble, the recent rise in world oil prices (a major source of export revenue), and the perception that "most Russian people, excluding the elderly, are on board" add to the sense of optimism.

Nonetheless, important changes will have to be made over the next 10 or 15 years if this risky investment is to produce an acceptable return for the multinationals and accounting firms. Political stability is seen first and foremost as the necessary ingredient to a business climate conducive to attracting and retaining foreign investment. The quality of current leadership—emerging from the parliament (Duma), after the December 1999 national elections, and especially from the presidency, after the sudden resignation of President Boris Yeltsin on December 31, 1999, and the election of his designated successor Vladimir Putin on March 26—is deemed crucial.

Early impressions of the new Duma indicate a major shift in the makeup of the parliament from one often at odds with the executive branch toward the prospect of a more conciliatory legislature. Putin's victory behind a surge of popular support (stemming from his prosecution of the conflict in Chechnya) likely assures continued cooperation from the legislature. However, Putin is relatively unknown to Western observers. He spent 15 years with the KGB before entering politics; his quick rise through the government means his track record is a short one. For now, the political picture is far from certain.

Greater stability and better cooperation between the Duma and the president are key to establishing a rational system of taxation, clear stockholders'

and creditors' rights, production-sharing agreements between natural resource companies and the state, and bankruptcy. Also of major importance is the need for Russia to embrace international accounting standards (IAS), thereby creating transparent and credible financial information pertaining to Russian entities.

### Accounting Reform

The flow of capital to countries like Russia remains inhibited by the lack of proper accounting. Although the gap between Western accounting and Russian accounting is slowly being narrowed, the Russian accounting structure, according to one managing partner, is still "a cash-based, tax-based, legal-document-based model. For the government, tax legislation is more important than accounting reform." Russian statutory accounting is essentially a tax system, devoted to providing documentation to show compliance "with legal rules rather than reporting real economic effects of business activity, reflecting a mind-set of form over substance. Financial statements were not meaningful even in the bidding that went on in the privatization of state-owned enterprises."

Partners were in strong agreement that real progress will depend on serious accounting reform in line with IAS. Given that the government's predominant concern is tax compliance, progress toward IAS will be slow. Accounting transparency is absolutely critical for any hopes for substantial foreign investment in Russia and the other regions of the former Soviet Union.

### The International Center for Accounting Reform

Karl Johansson, managing partner for the Ernst & Young practice in Moscow, helped arrange a visit with Donald Beskine, managing director of the International Center for Accounting Reform



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(ICAR) in Moscow. ICAR is a nonprofit, nongovernmental lobbying organization whose aim is to influence Russian accounting reform toward international accounting and auditing standards. It serves as a means of coordinating the concerns of such constituents as members of the international oil industry, the World Bank and IMF, the international accounting firms in Russia, and the Institute of Professional Accountants, an AICPA-like Russian organization established by the Russian Ministry of Finance (MOF).

According to information obtained from Beskine, the past few years have seen significant progress in the movement of Russian accounting in the direction of IAS. (There has been less progress in addressing international auditing standards.) During the 1994-96 period the MOF, which has the primary authority for accounting regulation in Russia, issued four accounting regulations analogous to IAS. For example, one promulgated the requirement that enterprises should adhere to certain accounting principles such as emphasizing the economic substance of a transaction over its legal form. And a regulation first instituted for 1996 year-end reporting requires the use of accrual accounting in the determination of income. In March 1998, a government decree launched a comprehensive program for Russian accounting reform, establishing a three-year timeline to year 2000 with three major objectives:

- Providing meaningful financial reports to users, particularly investors.
- Following an IAS basis, albeit with some caveats.
- Including the development of effective self-regulating organizations for accountants and auditors, the involvement of Russia in the world's accountability bodies, and the use of ICAR.

In May 1999, the MOF issued Order No. 364, permitting companies to prepare consolidated financial statements

not in accordance with MOF regulations provided the statements are in accordance with IAS and contain explanatory notes regarding departures from MOF regulations. This is an important commitment to the essential principle underlying the development of IAS, namely that sound accounting is critical to investment decisions. (However, it should be noted that Order No. 364 is limited to consolidated statements, meaning there is no explicit commitment to IAS for reporting by small and medium-sized companies. Until there is, Beskine recommends that small and medium-sized companies should be permitted to follow the European Union's Fourth Directive, which is deemed substantially compatible with IAS.)

Despite these official steps toward meaningful Russian accounting reform, implementation is not so simple. Thus, according to Beskine, adhering to the substance over form principle is "difficult or impractical because other elements of accounting regulations require accounting entries to be based strictly on documentary evidence. Therefore, even though this regulation was issued more than two years ago, it has apparently not had a significant impact." And the entrenched preference toward form over substance continues to obstruct the application of accrual accounting. It is still possible to delay recognition of a transaction "if certain documents have not been received or stamped on a timely basis." In addition, year-end provisions are still not allowed for such items as estimated returned goods, warranty claims, pending litigation, and decline in value of unquoted investments.

In the report of the Foreign Investment Advisory Council regarding its 11th session, held in Moscow this past October, ICAR presented a statement of "Accounting Reform Key Issues" that included the following: "In ICAR's opinion there has been insufficient

progress in 1998/99 and much remains to be achieved if Russian accounting reform is expeditiously to empower Russian enterprises to provide financial statements to international standards." The statement went on to recommend steps to facilitate and remove barriers pertaining to the reform effort.

Beskine sees Russian accounting reform as fundamentally a political challenge stemming from the fact that accounting reform is simply not high on the MOF's agenda. However, in the early summer, according to Beskine, a more optimistic picture has emerged. Russian accounting reform in the direction of IAS for key industries is a definite feature of current economic reform proposals designed to foster foreign investment and appropriate industrial restructuring.

### Looking Forward

The willingness and ability of Western accounting firms to stay on the scene depends largely on the success of Russian efforts to build an institutional infrastructure—including a system of laws, defined and protected property rights, and a stable and effective tax system—conducive to capital markets. Absent such an infrastructure, the uncertainty of doing business in Russia, no small part of which is due to the inadequate, nontransparent accounting currently permitted in financial reporting, may create such high levels of risk as to make even the current minimal-investment, wait-and-see posture of the firms unacceptable. □

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