Profile: Igor Kozyrev

The Russian Financial Reporting Expert

The deputy chief accountant of Russian oil giant Lukoil provides his views from a Russian perspective on the progress, challenges, and opportunities in the business reporting supply chain.

Intro

Igor Kozyrev is accomplished and well versed in the areas of Russian corporate governance, financial reporting, and financial auditing, and is well suited to identify the next steps for further improvement in these areas. He has first-hand experience with multiple segments of the business reporting supply chain in Russia—the government, various audit firms, and a multinational company of Russian origin—and has participated in various key Russian accounting and auditing reforms and other initiatives during a time of significant change in the Russian social and economic environment. In this interview, Mr. Kozyrev illustrates how the Russian business community is adapting to various international standards and good practices, taking into account specific Russian circumstances.

About Lukoil

Lukoil is one of the world’s leading vertically integrated oil and gas companies. The main activities of the company are exploration and production of oil and gas, production of petroleum products and petrochemicals, and marketing of these outputs. Most of the company’s exploration and production activity is located in Russia. Lukoil owns modern refineries, gas processing and petrochemical plants located in Russia, Eastern and Western Europe, as well as in other countries. The company’s products are marketed in Russia, Eastern and Western Europe, the US, and other countries. Lukoil is the second largest private oil company worldwide by proven hydrocarbon reserves. At the beginning of 2010, the company's marketing network encompassed 26 countries and included 199 tank farm facilities as well as 6,620 filling stations.

- From www.lukoil.com
Corporate governance recommendations

Russian companies are adopting good corporate governance practices

What are the main issues with respect to corporate governance in Russia? What should be done to solve these issues?

“One of the peculiarities of Russian corporate governance is that many large companies are governed by their majority owners. Their structure of governance is often more authoritarian or commanding than in companies elsewhere. This is not specifically bad, this is not specifically good—it is just a fact. Sometimes this works and sometimes it doesn’t. For example, when you are trying to build a large, vertically integrated company, a more authoritative leadership style works very well because it can facilitate the consolidation of different parts with different ideas and different ways of doing business. This authoritarian structure and way of doing business worked very well in the 1990s here in Russia.

“Now the situation is changing in Russia and managers running businesses are also changing. These new managers are trying to change the way companies are governed and they have already introduced a lot of international good corporate governance practices, such as the introduction of independent directors and audit committees. A few years ago, we did not have any independent directors in Russia. Now it is gaining in popularity and there are even requirements developed by the Russian Federal Securities Commission regarding the appointment of independent directors, as written in the Russian Code of Corporate Governance. If you look at Lukoil, for example, we have a board of 11 directors and five of them are now independent directors. Nevertheless, the fact remains that many companies are still run by their original owners from before the company went public.”

 Doesn’t that pose a problem for minority shareholders?

“I am going to play the devil’s advocate here by stating that in some cases paying too much attention to the minority interest can hurt the interest of a company in a long run. When I was with KPMG 20 years ago and when I started at Lukoil, I also had that view. But now I see that there is another side to the coin. For example, some of the minority shareholders are not interested in the long term goals of the business, but they try to manipulate the management. So in some cases, too many rights given to minority stakeholders may hurt the business. This is not only true for Russian companies, but for the western-run companies as well. But, of course, protection of minority shareholder rights remains very important. As a minority shareowner of several Russian companies myself, I was not always happy with their management style!”

A truly independent director is better for the company

How would you do to ensure that the independent directors are also truly independent?

“That still happens in Russia, but over time the situation is changing. Management and original owners are starting to understand that having a truly independent director is better for the company than
having someone who is affiliated. A company needs different points of views and different opinions in order to make sound management decisions. So management and owners understand the value of independent directors, and they would probably even consider transferring more responsibility to those independent directors. However, the challenge is to find the proper people.”

**Higher demands should be imposed on people who take up a position in a board or audit committee**

*What would be your recommendations with respect to improving the quality of directors?*

“To my mind, it would be good to impose higher demands on people who take up a position on a board or, more specifically, in an auditing committee. They should be financially literate and understand the business and business reporting. Maybe we should introduce some formal requirements for audit committee members so that audit committees become working institutions instead of only having a formal function.”

**Is liability an issue for Russian company directors in Lukoil? If yes, how could that be addressed?**

“Like in other countries, directors at Russian companies are liable to some extent, but that is usually covered by some form of indemnity insurance. That also applies to, for example, foreign directors we have on our board, so they can speak out freely.”

**Do Russian companies like Lukoil have issues with respect to executive remuneration, and what should be done to solve those issues?**

“Remuneration, and not only executive remuneration, is always an issue in Russia. But I don’t think it is a focus of public opinion. However, one should realize that the remuneration differences are not so big here as in the United States, for example.”

**Regulators should step up environmental requirements**

*Do you think Russian companies like Lukoil should—in addition to economic performance—take social and environmental performance into account?*

“My vision is that development in Russia with respect to social performance is completely opposite as it is in the Western world. Historically, companies in the USSR were focused on social aspects rather than on financial performance. Russian companies generally had, and have, many social assets (houses, entertainment centers, hospitals and so on). So, companies have a lot of costs related to these social obligations and they need to maintain those obligations. The situation is changing—companies are transferring social assets to the government—but a lot of these assets are still there.

“Some of our foreign investors think that this social involvement is too much. However, often these kinds of facilities are essential because many Russian companies such as Lukoil do business in so called mono towns, which are completely centered on the company. Without social services, such towns would not be able to subsist.”
“With respect to environmental considerations, Russian legislation is still quite weak in terms of penalties. Until regulation becomes tighter in this area—through legal requirements with respect to environmental care and introduction of a system of significant sanctions for companies that do something wrong—most Russian companies will not do much in this area, other than the absolute minimum as required by law.”

**Risk management and internal control should form an integrated part of corporate governance**

*How could Russian organizations like Lukoil improve their risk management and internal control functions?*

“Obviously, risk management exists in Russian organizations, otherwise they would already have been forced out of business. The main challenge in many Russian companies is that they have good risk management and internal control in various areas, such as production, finance and accounting, human resource management, legal, etc., but there is no coordination in the top. It is a bit like a pyramid but without the top. Our company also is integrating various risk management and internal control elements into the overall governance system of the organization.”

**Business reporting recommendations**

**Russia is in the process of adopting IFRS**

*Where does Russia stand with respect to the adoption of the International Financial Reporting Standards (IFRS)?*

“Russia recently adopted the use of IFRS. As of 2015, Russian companies will be required to use IFRS as the basis for the preparation of consolidated accounts.

“Some Russian companies are aiming for an earlier conversion. Lukoil currently prepares its consolidated financial accounts on the basis of US GAAP. Therefore, we will wait with until the conversion in 2015, and in the meantime we hope that the convergence project between IFRS and US GAAP will make some progress so there will be fewer differences to reconcile by 2015.”

**Financial reporting requirements should be more unified**

*What should be done to further improve the financial reporting process in Russia?*

“At present, Russian companies, especially large ones, are carrying out at least three types of accounting and compile three types of financial reporting: the statutory financial report, the Russian tax report, and, finally, the consolidated financial report on the basis of IFRS or US GAAP. All of this consumes considerable financial and human resources.

“Therefore, one of the main tasks of reform and innovation in the fields of financial reporting and taxation, in my opinion, should be the restoration of a unified framework for the preparation of financial
reporting and tax reporting, as it was in the USSR and more in line with how it is done in accordance with the international practice.

“In my opinion, all financial reporting should be prepared on the basis of IFRS. This is due to the fact that, despite the need to improve these standards, they are the best tool to objectively reflect the activities of companies in market conditions.”

**IFRS should also be the reporting basis for tax purposes**

“If we consider IFRS as the most appropriate standard to accurately reflect the financial performance of an organization, then it would only seem fair that the tax reporting system should also be based on the same standards. In today’s Russia, we construct some artificial accounting standards for taxation purposes, and in some instances we pay taxes over losses and in the other instances we do not pay taxes over profits. In my view, it would be better for everybody—the government, the community, the company, and its shareholders—if taxation is also based on clear financial statements, which are audited. Right now, tax reporting is not being audited.

“I think, however, that adoption of financial statements prepared under IFRS as the basis for taxation is not a technical but a political issue, because of a possible arbitrary situation. The final say about IFRS content will inevitably rest outside of Russia with the IASB, and Russian regulators will no longer have a say on that. And they don’t like to be in such position, perhaps just as regulators in any other country. To my mind, however, it would not only be fairer, but also more effective for a country to have such a system, because it would help, for example, to fight corruption. Being a governmental auditor for almost 10 years, I know very well that if there are loopholes in legislation, providing an opportunity to distort information—we will find instances where such situations will occur.”

**Transition to IFRS should be properly managed**

*What challenges need to be addressed for a proper implementation of IFRS?*

“The main challenge that needs to be addressed during the transition period is the change of all relevant legislation: civil, tax, and arbitration, as well as other regulations.

“The only additional major challenge, apart from changes in legislation, is the education and training of relevant personnel in using IFRS:

- For business, almost all major Russian companies have already solved this problem by preparing consolidated financial statements according to international standards.

- With regard to government agencies, including tax authorities, the practice shows that they can get specialists who know the basics of international standards in the timeframe of one to two years, and to prepare certified professionals in three to four years.

- In addition, it should be noted that even now the tax authorities apply a number of concepts of modern accounting. For example: using estimates in calculating taxes by using market prices and
independent evaluations, defining interrelated parties, etc. The only problem is that now these methods are used selectively while it should be done on a systematic basis.

“Other issues to be resolved are related to the fact that the center of decision-making about the formation of international accounting standards will be located outside Russia:

- the need to develop the process of official adoption (or rejection) in the Russian Federation of specific IFRSs, similar to that which exists in the European Union; and
- the need to intensify the process of Russia's accession to the IASB through membership of the Russian representative of the professional community, as currently the membership in the Committee is based on an individual basis rather than geographical one. I am pretty sure, however, that in time a geographical principle for the appointment of members will be adopted, like with other international organizations such as the UN, the World Bank, etc.”

Financial literacy of the users of financial reports should be increased

**Should financial reporting become more relevant and understandable?**

“I fully agree that financial reports should become more relevant and understandable because my experience with the various investment and analyst communities is that nobody actually reads them, apart from a couple guys, like me, who prepare or audit those reports!

“The main problem is that the complexity of financial reports is growing, whereas the time that users can spend on reading and understanding the report is being reduced. So, the gap is growing from both sides. We, the preparers, are becoming like the high priest, speaking a language that is totally incomprehensible to the layman. Even worse, none of the users seem to care either! They seem to take more interest in alternative sources of business information, such as financial summaries, press releases, and rumors, but not the financial reports themselves.

“Preparers of financial reports fill many, many pages with information that is often incomprehensible for the readers of those reports. So they are alienating their audience. That is very bad for the world as we have seen in the latest financial crisis. If the investment community no longer reads the financial reports...

“Therefore, we should not only increase the competence of the preparer of financial information, but also the competence or financial literacy of the users of financial reports. Otherwise it will be increasingly difficult for them to understand the many nuances and pitfalls in modern financial reporting.”
Financial reports have to be simplified

What would be your recommendations to increase the relevance and understandability of financial reports?

(Joking) “Only release the bottom line profit or loss, just like in a standard press release, because it seems that most people are only interested in that number!

“In all seriousness, I understand that the underlying business is getting more and more complicated, but for financial reporting purposes, we have to make some simplifications. Otherwise financial reports will no longer be understandable. For example, we should not want to reflect fair value changes in derivatives on a daily or hourly basis. Sometimes, I think we are not following the substance of these financial transactions, but rather the form. We are trying to capture every particularity to put into our accounts, which makes us lose our overview. I think that not every transaction detail should be reflected in financial reports in order for our financial statements to remain relevant and understandable.”

Management commentary can be biased

What are your views on management commentary, in addition to reporting the financial statements?

“Our company produces such reports. They become more voluminous, but I didn’t receive any feedback from investors regarding their preference for such reports over the financial statements themselves. ) Maybe they do not read the management commentary, just as they don’t read the financial statements!

“One of the challenges with management commentary is that these reports are generally not audited and, therefore, can be biased.”

Fair value is the best measurement system that we have now

Could fair value accounting be further improved?

“I think fair value is the best measurement system that we have now. Like Winston Churchill said, if I am not mistaken, ‘Democracy is a bad thing, but it is the best thing we have now.’ I have been involved in many discussions here in Russia, especially after what happened during the financial crisis, in which people argue that we should go back to historical cost accounting. But I think that is a bad idea because historical cost accounting often doesn’t make sense. For example, if we would value some of our oil and gas facilities that were build in the 1950s, their historical cost would be equal to next to nothing. But that would not at all portray the economic reality!

“I can understand the opponents, because fair values can be manipulated, but we don’t have many alternatives. If companies want to present historical data because they think it is useful, no problem. They can add those numbers in the notes to their financial report.”
Financial auditing recommendations

Migrating from compulsory to voluntary audits would make auditors more alert to the needs of the owners/shareholders

How could Russian audit firms increase their audit quality?

“In general, we have a good audit practice here in Russia, with competent auditors who are knowledgeable and experienced in using Russian standards on auditing, which are based on the International Standards on Auditing (ISAs).

“Some people in Russia argue that we should get rid of the compulsory statutory audit requirements for public companies, and replace that with so called initiative audits in which the owners/shareholders of a company must decide for themselves whether or not they need an audit. That would also make the auditors more alert to the needs of the owners/shareholders. But from the other hand, users also must have rights to call for audits, especially for public companies.”

Making business reporting a broader communication tool:

More timely reporting is required

How could business reports of the future look like?

“Preferably nice and glossy!

“In all seriousness, we live in the internet age, so, in my view, financial reports should be available online, and perhaps even at the intermediate stages of their preparation.

“The current presentation of the financial statement is somewhat like a ceremonial procedure and that is that. Especially now, timeliness is everything. If a company provides a handful of figures today, that is more useful than providing hundreds of figures three months from now. Therefore, it would be useful if stakeholders could have access to a series of online, real-time financial and non-financial performance ratios about the company. In addition, I expect a trend toward more continuous reporting, so stakeholders can see on the company website how the company is doing now, instead of how the company was doing three months ago.”

Integrated reporting is the way forward

From your experience in engaging with the different stakeholders, do you think that an extended, integrated reporting framework should be developed integrating the social, environmental, and economic performance of the business?

“That would be a good idea, but there are a number of considerations. First of all, how do we measure the various performance objectives, for example the performance with respect to social care? Do we
need to develop some sort of satisfaction index? In addition, how should we audit this data? As a former financial auditor, it is difficult to imagine how the various statements in such an integrated report could be audited.”

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<th>Key recommendations from Igor Kozyrev</th>
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<td>2. A truly independent director is more beneficial to a company than a director who is affiliated with the company, as independent directors may bring different points of views and different opinions that can contribute to sound management decisions.</td>
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<td>3. Stricter prerequisites, such as requiring financial education and a fuller understanding of the business, should be imposed on those who assume positions on boards or audit committees.</td>
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<td>4. Regulators should step up legal requirements with respect to environmental considerations and introduce a system of significant sanctions for company violations.</td>
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<td>5. Risk management and internal control should be integrated with the organization’s overall governance scheme.</td>
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<td>6. Statutory financial reporting, tax reporting, and consolidated financial reporting should all be held to the same set of standards, preferably IFRS, as they are the best fit to accurately reflect the financial performance of an organization.</td>
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<td>7. The transition to IFRS should be properly managed to address the various regulatory, educational, and other challenges.</td>
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<td>8. Even though the underlying business is getting more and more complicated, financial reports should become more relevant and understandable, as the time users have to spend on reading and understanding them is decreasing. On the other hand, the financial literacy of users of financial reports needs to be increased, because otherwise it will be increasingly difficult for them to understand the many nuances and pitfalls in modern financial reporting.</td>
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We welcome your feedback on these recommendations. To provide us with your feedback, please complete this brief survey.