

ACCOUNTING ASPECTS OF FOREIGN DIRECT INVESTMENT IN RUSSIA

Galina G. Preobragenskaya*
Robert W. McGee

Abstract

More than 100 countries are competing for foreign direct investment. One of the factors that adversely affects the ability to attract foreign capital is the lack of credibility of reported financial information. This barrier is especially prevalent in transition economies, since they have not developed the financial reporting infrastructure that developed countries already enjoy. Adopting International Accounting Standards (IAS) is seen as one way to overcome this barrier and many transition economies are adopting or have already adopted IAS as a means of giving credibility to corporate financial statements. All of the former Soviet republics have made some attempt to have their enterprises convert to IAS. Some have been more successful than others, for a variety of reasons. This paper focuses on Russia's attempt to adopt IAS and the problems Russian firms face with the adoption and implementation of IAS.

* Galina G. Preobragenskaya is Executive Director of Locia, an audit and consulting firm in Omsk, Russia. Robert W. McGee is on the faculty of the Andreas School of Business, Barry University, Miami Shores, Florida, USA. An earlier version of this paper was presented at the Thirteenth International Conference of the International Trade & Finance Association, Vaasa, Finland, May 28-31, 2003. The authors would like to thank the two anonymous referees for their comments.

INTRODUCTION

Perhaps Frits Bolkestein, European Commissioner for the Internal Market, sums it up best when, referring to the adoption of International Financial Reporting Standards (IFRS), he says that:

"investors and other stakeholders will be able to compare like with like. It will help European firms to compete on equal terms when raising capital on world markets."
(BDO et al 2002)

He might just as easily have said Russian firms rather than European firms. More than 100 countries are competing for foreign direct investment. One of the factors that adversely affect the ability to attract foreign capital is the lack of credibility of reported financial information. This barrier is especially prevalent in transition economies, since they have not developed the financial reporting infrastructure that developed countries already enjoy. Adopting International Accounting Standards (IAS) is seen as one way to overcome this barrier and many transition economies are adopting or have already adopted IAS as a means of giving credibility to corporate financial statements. Adoption will also have a beneficial effect on the cost of capital and will lead to a degree of cultural convergence (Damant 1999).

The Eurasian Association of Accountants and Auditors suggested that transition economies adopt International Financial Reporting Standards (IFRS) for the following reasons (ICAR May/June 2001):

- IFRS are aimed at providing the transparency of accounting and reflecting the real economic situation, which will enable users of financial statements to make the right decisions.
- In developing IFRS, experts use the best internationally recognized principles. That is why International Financial Reporting Standards are logically clear from the economic standpoint.

- IFRS are sufficiently simple to be understood by all users of financial statements worldwide who have the adequate knowledge of business, economics, accounting and finance.

Vorushkin (2001) gives the following reasons why Russian firms should adopt IAS. Some reasons have more to do with managerial efficiency than transparency.

- The preparation of group accounts would be cheaper and quicker because all segments of the enterprise would be using the same accounting system rather than different systems, which is the way many Russian firms now operate.
- Accounting expertise within Russian multinationals would become transferable between subsidiaries in different countries.
- Internal control will improve because the enterprise would operate in a standardized environment.
- Firms could obtain improved access to funds and lower cost of capital because of increased transparency and the harmonization of standards.
- The cost of upgrading and training in accounting software would be reduced because IAS rules change less frequently than the more volatile Russian Accounting Standards (RAS).
- Adopting IAS would provide less scope for management abuses and minority shareholder rights would be better protected.
- Establish equal and trustworthy international business relationships because foreign firms feel more comfortable dealing with Russian companies that use the same accounting principles.
- Make better management decisions that are based on economic reality, which will result in the more efficient use of capital.

While there are many good reasons for adopting accounting standards that are recognized internationally, there are also

problems or impediments involved in adopting such standards. A survey of partners of the six largest accounting firms in 59 countries found the following impediments to achieving IFRS convergence:

**Concerns Expressed about Impediments to Achieving IFRS Convergence
Survey of Six Large Accounting Firms in 59 Countries**

Problems Mentioned	Percent of respondents
Complicated nature of particular standards	51
Tax-driven nature of the national accounting regime	47
Disagreement with certain significant IFRS	39
Insufficient guidance for first-time application of IFRS	35
Limited capital markets	30
Satisfaction with national accounting standards among investors/users	21
Translation difficulties	18

Source: BDO et al (2002), p. 10.

Transparent financial information is a crucial factor in achieving economic growth and stability (Radoutsky 2001) and adopting IAS is seen as a way to achieve the level of transparency needed to satisfy the information needs of the international investor market. A report issued by the European Bank for Reconstruction and Development in October 2000 stated that it is impossible to assess the performance of large enterprises in need of restructuring because of a lack of financial statements prepared in accordance with IAS (ICAR Nov/Dec 2000a).

One would think that countries that have transparent financial reporting standards like those incorporated in IAS would have higher growth rates than countries that do not have transparent standards, all other things being equal (Larson and York 1996). Studies have shown this to be the case. However, one study (Larson 1993) that included data from 35 African countries found that growth rates were significantly higher for countries that adopt and modify IAS than for countries that either adopted IAS without modification or did not adopt IAS. It is not clear why this

is the case, since many factors are involved in a country's economic growth (Arndt 1987; Bauer 1991, 1976 Lal 2001, 1986; Hanke and Walters 1991). It would be interesting to see the result if someone replicated the Larson study, using data from the countries of the former Soviet Union and Eastern Europe.

ADOPTING IAS

All of the former Soviet republics have made some attempt to have their enterprises convert to IAS. Some have been more successful than others, for a variety of reasons. However, merely adopting IAS is not enough. They must be implemented and the audits of companies that adopt IAS must be sufficiently strong to foster confidence in the international investment community (ICAR March/April 2001a). On July 25, 2002 Russia's Prime Minister Mikhail Kasyanov announced that all Russian companies and banks must prepare their financial statements in accordance with IAS starting January 1, 2004. In March 2001 the European Union gave a 2 million euro grant to enhance the competence of Russian auditors and to support audit regulation reform aimed at making local companies more transparent (ICAR March/April 2001b) This paper focuses on Russia's attempt to adopt IAS and the problems Russian firms face with the adoption and implementation of IAS.

The Russian economy needs foreign investment to ensure a high and stable rate of growth. But the lack of transparency of most Russian companies creates risks for potential investors and reduces the attractiveness of investing in the Russian economy, thus placing an obstacle in the way of foreign investment and financial inflows. Informational transparency, based on trustworthy, timely corporate financial statements that use International Financial Reporting Standards (IFRS) and principles, and that are verified by independent qualified audits, is one of the most important components of corporate governance, the mission of which is, first of all, to protect owners' interests.

In the interests of completeness, it should be mentioned that transparent financial reporting rules, although necessary to make

investment in Russia more attractive, is not sufficient. The Foreign Investment Advisory Council lists the following factors needed to attract international investment capital (ICAR Nov/Dec 2000):

- Accelerating the full transition to International Accounting Standards;
- Accelerating the adoption of PSA (Production Sharing Agreements) legislation and enabling regulations;
- Removing regional and interregional barriers restricting investment and business activities;
- Improving tax, customs and currency laws;
- Improving the banking system;
- Improving the protection of investors' rights, including the stock market; and
- Adding value to commercial activities of enterprises.

TRANSPARENCY OF FINANCIAL REPORTING

Below are the results of the research conducted by Troika Dialog (2001), the largest Russian investment company, which assessed the consistency of the most liquid shares for 28 listed Russian companies' corporate governance practices using World Economic Forum (WEF) principles. In aggregate, the market capitalization of these issuers totals \$45 billion and represents around 85 percent of the total capitalization of the Russian market.

On the criterion "financial discipline," which was characterized by disclosure of accurate, consolidated, timely information using IAS and verified by an independent audit, the 28 companies fared as follows:

Financial Discipline

Category	Number of Companies	Percent of Companies
Adequate to good	8	28
Fair to adequate	10	36
Poor to fair	<u>10</u>	<u>36</u>
Totals	28	100%

Thus, less than half of the companies in the sample adequately comply with the principles of financial discipline. However, the experts conducting the survey did remark that the trend is clearly improving. Another survey of 1040 accountants from average sized Russian companies found that 71 percent of the respondents did not think that financial statements adequately reflect the company's economic reality (Rozhnova 2000).

What is wrong with the financial information that Russian companies produce? Why do even the people who participate in creating the financial information think that the information quality of what they create is low? There are several reasons. To understand what Russian accounting represents, it is necessary to take a look at the recent past. The present state of Russian accounting can only be understood by looking at what went before and how it has evolved.

Soviet accounting played a dual role in the tight, centrally planned economy up until the last decade of the twentieth century (Enthoven 1992). First, it functioned to provide the country's top management with the information necessary to control the economy and meet the plan targets. Second, it was used as a mechanism to protect socialist property. The accountant's function was one of bookkeeping rather than what those in the West think of as accounting. Every step was prescribed by numerous and specific instructions. As a result, most of accounting consisted of filling out forms, mostly statistical in nature. The reports were summarized, but not consolidated, at each successively higher level of the hierarchy. So the State, in the person of its representatives at different levels, was the only user of accounting information.

The beginning of the 1990s was commemorated not only by privatization, the appearance of private property and private owners, but also by a revolution in Russia's tax system (Shleifer and Treisman 2000). Accounting data was used to determine the amount of taxes that companies should pay. The system of penalties for violations of the tax law stipulated that, for example, the failure to pay 100 rubles in tax would result in a 10,000 ruble

penalty. A company's existence became dependent on the accuracy of accounting. The value of a qualified accountant, who was able to avoid problems with Russia's Internal Revenue Service, has increased incredibly. The prestige of the accounting profession has also increased considerably.

Since the start of conversion from central planning to a market economy, the business community increasingly regards the accounting function as a tool of communication with the tax authorities, and through them, with the State. This new way of looking at the role of accounting has been evolving in the mind of the business community for slightly more than ten years.

As a consequence, there have been changes in legislation, including tax legislation. Taxation and accounting are now legally separated from each other. As of 2003, only one tax, the real estate tax, is based on accounting rather than separate tax data. But even now most people consider Russia's Internal Revenue Service as the only user of accounting information. Furthermore, the Tax Code still stipulates punishment for breaking the accounting rules, even in cases where the violation does not affect the amount of taxes paid (Tax Code of Russian Federation, Prov. #120).

Some Russian companies have started to realize that the poor quality of their financial statements is making it more difficult to attract foreign capital. They find it difficult to borrow funds internationally or to place their stock on foreign stock exchanges. Their present financial statements do not meet the needs of investors, either current or potential. As a result, some Russian corporate executives have come to the realization that they must transform their financial statements, which are now prepared according to Russian Accounting Standards (RAS), into statements that satisfy IFRS requirements. However, in order to do that, Russian companies have to incur additional expenses. They have to prepare two sets of financial statements, those that comply with RAS and another set that complies with IFRS. They have to double the cost of audits, since one audit looks at RAS and another one must comply with International Standards on Auditing (ISA). The Troika Dialog research mentioned above found that, out of 34

companies having effective ADR programs, 8 converted their financial reports to comply with U.S. GAAP and 9 companies prepared financial statements in conformity with IAS. In other words, only half of the companies examined prepared financial statements that followed some kind of internationally recognized financial statement principles (GAAP or IAS).

At this point, one may ask the question: What is the essence of the fundamental differences between RAS and the standards used by developed market economies (GAAP or IAS)? What is wrong with RAS that international investors of capital hesitate to place trust in RAS?

One reason why international investors hesitate to place much confidence in RAS is because of lack of familiarity. Investors feel much more comfortable reading financial statements that are prepared in accordance with a set of standards they are familiar with, whether those standards are U.S. GAAP or IAS. But their lack of confidence in RAS cannot be blamed solely on lack of familiarity with RAS.

IFRS has a user orientation. Indeed, that is the basis of IFRS. In *Framework for the Preparation and Presentation of Financial Statements* (IASB 1989) it is stated that the objective of financial reporting is to provide information regarding an entity's financial position, performance, and changes in financial position to a broad spectrum of users to enable them to make rational and informed decisions (Epstein and Mirza 2003: 72).

IFRS set requirements and principles for financial reporting -- nature, measurement, presentation, substance over form, materiality, etc. Relying on these principles, accountants use their professional judgment to construct financial statements. The Russian system, on the other hand, is based on strictly regulated rules. Instructions, rather than professional judgment and principles, underlie accounting and financial reporting. When Western accountants encounter a situation that requires them to determine how a particular event should be recorded, they go to generally accepted accounting principles and exercise professional judgment to arrive at an answer. Russian accountants, at best, think

about the instructions that might describe it. At worst, they pick up the telephone and call the auditor.

The Russian accounting environment has not yet adjusted to market-oriented accounting and the thought processes involved. They are not yet ready to accept the possibility that accountants can exercise professional judgment and can arrive at conclusions that result in financial statement figures that are not identical. Also, most accountants are not ready to make significant business decisions. One of the questions asked in the Rozhnova study (2000) that surveyed accountants at 1040 companies was whether accounting rules should be detailed, prescribed and unambiguous. Fifty-eight percent of the accountants who answered that question said yes, indicating that the majority of Russian accountants are still hesitant to assume responsibility or exercise professional judgment. With this kind of mindset, it will take some time before Russian accountants are fully prepared to use Western, market oriented accounting systems, regardless of what the Russian legislature (Duma) says.

Even in the cases where the legislature offers a choice of different options, the first choice of many Russian accountants is to use the method that corresponds to the tax rules. Their second choice is to select the method that is least costly in terms of time and effort. Their last concern is how their choice will affect the financial statements.

One of the reasons why Russian accountants try to avoid expressing an opinion or making a decision regarding the preparation of financial statements is due to the Russian accounting mentality that has become ingrained over several generations of Soviet communist rule. Their thought process is rooted in the more than 70 year practice of "execution of commands from the top," coupled by a decade of recent experience of "walking over the precipice" with the threat of getting punished for making mistakes on a tax return.

Another factor that prevents the transformation from the "following instructions" approach to principles based accounting is the fact that none of the current regulations provide any concept of

principle based accounting, the very concepts that underlie accounting systems in developed market economies. There are no definitions for assets, liabilities or capital in any Russian legislative act.

Coming back to the conceptual distinctions between IAS and RAS it is necessary to stress the differences in disclosure. Despite the fact that Russian standards have made a big step forward in this respect -- today they require an amount of disclosure that was impossible to imagine not long ago (Shneydman 2002) -- it still is not good enough to provide sufficient transparency to satisfy most financial statement readers. Furthermore, in practice accountants often disdain disclosure requirements. For Russian accountants, notes do not play an important role as part of the financial statements. The reason is partly because of a lack of working experience where there is a possibility of having a choice or making a decision based on professional judgment. Another reason is because the main reader of financial statements, the Tax Service, pays almost no attention to footnotes. Despite all these reasons and factors, disclosure in Russian financial statements has improved greatly in recent years. Although the amount of disclosure given in Russian financial statements is still considered insufficient by market economy standards, the differences between Russian disclosure and disclosure in advanced market economies has narrowed considerably.

The beginning of the move toward heightened quality of financial statement disclosure was the adoption of the *Programme for the Reformation of Accounting in accordance with International Accounting Standards* in 1998. It was declared on the State (national) level that accounting systems should provide useful information to users, primarily investors. This document proposed that accounting reform should be focused toward the harmonisation of accounting standards at the international level and that methodological assistance should be rendered to enterprises in the comprehension and introduction of the reformed accounting model.

Of course the mere fact that such a program exists on paper does not mean that the task has been accomplished. In fact, the views of business owners toward the relevance and content of financial statements has changed very little since this Programme was launched.

Five years have passed since 1998. What has been done? New terms that had not been used before in Russian accounting practice were introduced into accounting legislation. Examples include contingencies, segment information, materiality, discontinued operations, deferred tax assets and liabilities. New accounting standards based on IAS were adopted. Most of them stipulate a scope of disclosure that is sufficient to consider the financial statements to be transparent.

The Cash Flow Statement and the Statement of Changes in Equity became a part of annual reports. The format of reporting is not mandatory but recommended. Enterprises are free to change it, following general reporting rules. Groups of companies (with subsidiaries) are supposed to prepare consolidated financial reports.

Another important point to mention is that IAS have been translated into Russian. Readers who can read English might not appreciate this point, since they are accustomed to reading accounting rules, whether IAS or U.S. GAAP, in their own language. Try to put yourself into the shoes of a Russian accountant. How would you, as an English speaker, like it if your government passed a law requiring you to construct your financial statements using Russian accounting rules if those rules were available only in Russian?

Translating IAS into Russian was a big step forward, since it would be impossible to adopt and implement IAS if no Russian version were available. However, problems remain, even with the Russian translation. The translation was made in 1999 and several important changes have been made since then. Russian translations have not kept up with these changes in the English version. Furthermore, the Russian translation contains some ambiguities and some substantive errors. For example, one of the important

rules leaves out the word "not," leaving the Russian reader to believe that the rule says exactly the opposite of what it actually says.

Since IAS have been translated into Russian they have become an obligatory part of the accounting curriculum at Russian universities. However, unlike in the West, there is not yet a strong secondary literature that provides explanations and examples of how the IAS should be applied (Alexander and Archer; Epstein and Mirza). This problem will be solved in time, as Russian professors publish their class notes and write textbooks. Various Russian accounting associations are also creating literature that both students and professionals can refer to when they have questions about IAS. The International Center for Accounting Reform [www.icar.ru] is one such organization.

Although Russia has more or less decided to move toward IAS, it is unfair to characterize Russian accounting legislation as fully complying with IFRS requirements as of today. There is also a problem of sticking to IAS once they have been adopted. There is evidence to suggest that banks tend to abandon IAS when their operating results decline (Vysokov 2000). This countertrend does not help to improve the reliability of financial statements and tends to reduce the confidence international investors place in Russian financial statements.

Above we have attempted to describe the conceptual differences between the two systems. Below we will examine certain differences in the accounting for specific assets, liabilities, equity, income, expense and loss accounts. These differences can result in very different figures being reported in financial reports, since some important differences between RAS and IFRS have not yet been resolved.

It might also be pointed out that a company cannot state that its statements comply with IFRS unless they comply with *all* IFRS [IAS1.11, p. 16] Thus, any Russian company that follows IFRS to the extent possible, but either has not adopted all IFRS or has diverged here and there to comply with RAS where the two standards conflict cannot honestly say that it complies with IFRS.

As a result, an honest Russian company cannot announce to the international capital market that its financial reports follow IFRS even in cases where such rules are followed completely, except for minor inconsequential exceptions.

Much of the information used in this section below was taken from *GAAP 2000: A Survey of National Accounting Rules in 53 Countries* (Andersen et al 2000) supplemented by more recent data (Arthur Andersen et al 2001; BDO et al 2002). One area of difference that authors frequently examine is the difference between RAS and IFRS in the area of allocating administrative overhead costs (Ramcharran 2000; Enthoven 1999). Experts point out that the Russian accounting system uses a different approach than that used in the West. Russian legislation allows companies to spread these costs among the various categories of inventory, whereas Western rules require companies to treat these costs as period costs and deduct them at the end of the period. As a result, profits are overestimated in one period and underestimated in another period. The cost of renting production facilities is not included in the cost of production, either, which distorts profits and profitability ratios. (Ramcharran 2000). An alternative method that recognizes period costs as incurred has been permitted since 1991 but has not been widely practiced, mostly because companies generally structure their accounting rules to parallel the tax rules. Russian accounting systems tend to be tax driven. Tax rules do not permit a company to decrease taxable income by including overhead costs at the time they occur.

Another major difference between RAS and IFRS is that RAS allow a kind of fund accounting system for liabilities that permits Russian companies to set up reserves against expenses and losses (Enthoven 1999). This practice can result in distorting income, since expenses that were incurred in one year may be deducted in another year. Also, the Russian accounting mentality has not yet erased the old methods from their memory banks and accounting practices. Before 1992, the only acceptable accounting method in Russia was the cash method. However, although it is now possible to use the accrual method, the cash method still

dominates. Another difference between RAS and IFRS is that RAS classify bonds under equity, whereas they are classified as liabilities under IFRS. (Ramcharran 2000).

Sometimes it is possible to reconcile these differences. The problem is that doing so is burdensome and time consuming. It is also not always possible to convert RAS to IFRS because financial analysts do not have sufficient information to perform the calculations. If the goal of financial reporting is to attract foreign direct investment, Russian companies that do not follow IFRS are placing themselves at a competitive disadvantage. Why should financial analysts have to take the time and trouble to convert RAS to IFRS when they can look at the financial statements of any number of non-Russian firms without having to make any conversion calculations?

Another problem with RAS is the lack of guidance on how to deal with inflation. The result is often misleading or distorted financial statements. According to IAS 29, one hyperinflationary sign is a cumulative inflation rate over three years approaching 100 percent. Taking into account that, for 1991-2001, prices rose by about 92 percent, according to State Statistic Committee data, financial statement figures would be subject to correction.

At the time this paper is being written (May 2003) there are no rules regulating the following items according to RAS:

- the classification of business combinations between acquisitions and unitings of interest (IAS 22.8),
- provisions in the context of business combinations accounted for as acquisitions (IAS 22.31),
- the translation of the financial statements of hyperinflationary subsidiaries (IAS 21.36),
- the recognition of operating lease incentives (IAS 17.2; SIC 15),
- accounting for defined benefit pension plans and some other types of employee benefits (IAS 19.52),
- the treatment of exchange differences resulting from severe devaluation or depreciation of a currency (IAS 21.21; SIC 11),

- the notion and definition of cash equivalents (IAS 7.6),
- detailed guidance on preparation of cash flow statements (IAS 7),
- consolidation of special purpose entities (SIC 12).

In RAS there are no specific rules requiring disclosure of:

- a primary statement of changes in equity (IAS 1.7) and a primary statement of cash flows (IAS 7),
- the FIFO or current cost of inventories valued on the LIFO basis (IAS 2.36).

Other differences concern the valuation of goodwill; methods of fundamental error correction; non-monetary transaction revenue recognition rules; lessors' income recognition; provisions recognition; conditions and rules of preparing consolidated reports, etc.

Since the large accounting firm reports of 2000 and 2001 (Arthur Andersen et al 2000; Andersen et al 2001) many differences have been eliminated. Impairment of assets, regulated by IAS 36, is stipulated by PBU 5/01. Accounting for deferred tax, regulated by IAS 12, has been introduced by PBU 18/02 for financial reporting starting in 2003. With the adoption of PBU 19/02, "Accounting for Investment Activity," most differences concerning accounting for financial instruments have been overcome. PBU 16/02 includes provisions for discontinued operations and related disclosures (IAS 35). Distinctions between principles of the determination period of depreciation of property, plant and equipment (IAS 16) are eliminated by PBU 3-6/01.

As a result of the recent adoption of these additional accounting rules, Russian accounting rules are moving closer to IFRS in terms of reliability and transparency of financial reporting information. Financial reports prepared in accordance with RAS are getting closer to reports prepared on the basis of IFRS. This convergence allowed one of Russia's Finance Ministers (Shatalov 2003) to say that, whereas a few years ago if a Russian company or bank could make a profit of 100 according to RAS and, at the same

time lose 20 according to IAS, today this proportion is about 100-85.

As can be seen, Russian accounting regulation cannot be said to be in full compliance with IFRS. However, there are several opinions regarding where to go from here. Some experts, including Ministry of Finance authorities, are inclined to favor a gradualist approach. RAS should move toward IAS bit by bit. Supporters of this position reasonably argue that accounting is a component part of the national environment, including the economy, culture, history, etc. Accounting development cannot pass ahead of other parts of the economy. For example, the problems with fair value implementation cannot be solved in one hour because the market in Russia is not sufficiently developed, especially the stock market. The disadvantage of following this gradualist approach is that Russia's planned regulatory changes will trail behind the changes made to IFRS.

Another approach might be labeled the shock approach. This approach involves adopting all IAS in a single day. One advantage of this approach is that it would bring to an end the constant changes that Russian accountants have had to deal with for the last decade. One potential problem with this approach is that instantaneous adoption of IFRS might not be followed by support in implementation. It is one thing to change an entire set of rules and quite another to have the accounting profession snap to attention to implement them, especially when many members of the accounting profession are not familiar with the new rules or with some of the more sophisticated aspects of a market economy.

The second approach -- shock treatment -- seems to be the more efficient option. But this approach can be successful only if the transition to IFRS is comprehensively prepared. Methodological manuals, explanations and practical examples must be developed and clarified for accountants *before* the date when the new Standards go into effect, not after. Current legislation should be adjusted to the new rules. As for insufficient development of present market instruments in Russia's economy, the delay of introducing advanced market oriented accounting rules

might serve to impede their evolution. Preparing the way by having the rules in place could serve to facilitate the transition to a modern economy. Failure to have market oriented financial reporting rules in place could lead to a Catch-22 situation, where the old rules impede economic progress and lack of economic progress vitiate the need for new and better rules.

It is believed that the creation of legislative base is a guarantee of successful reform, including accounting reform. But, to draft and adopt a new law or regulation is not sufficient. Passage does not guarantee that the new law will work in practice. Financial reports that comply with IFRS will come into existence only if the accountants who prepare the reports follow the rules of financial reporting. Otherwise, the beauty, elegance and rigor of the rules will be useless. For accountants to execute all requirements properly, it is necessary to:

- be knowledgeable and to understand them,
- be qualified to apply them, and
- be willing to follow them.

There is a very real possibility that, to solve this problem of what may be called the human factor, the solution to this aspect of the problem may be more difficult than to change legislation. There are several reasons for this difficulty. We have attempted to examine some of them above. There is the perception that tax officials are the main users of financial reporting information. That is, by the way, the reason why many provisions of the new standards are just ignored by accountants. There is a tendency to think that "if the tax inspector doesn't need it, I don't, either." Accountants just don't take notice of some new rules.

Other human problems exist as well. An accountant's mentality is one of them. Accountants are not accustomed to making decisions. In the old days they didn't have to. They just followed the rules. They have difficulty understanding the new standards in the absence of manuals. They are just plain tired of the constant changes that have been made to the accounting and tax rules since the introduction of the market economy. A similar thing happened to accountants during the 1980s, when Congress was

passing major tax reform legislation practically every year and the Financial Accounting Standards Board was issuing numerous complicated financial reporting rules. The terms used to describe this phenomenon and the effect it had was accounting standard overload. Russian accountants have been experiencing the same thing.

Another factor to consider is that, in order to succeed with the implementation of any policy is that there must be support at the micro level. Company accountants must support the changes if they are to be implemented effectively. And last but not least, there must be demand for quality financial information.

RUSSIA'S COMPETITIVE POSITION FOR FOREIGN DIRECT INVESTMENT

A survey conducted by the large accounting firms found that more than 90 percent of the world's major economies plan to adopt or converge with IFRS (BDO et al 2002). That being the case, it becomes imperative that Russia adopt IFRS in order to compete for international capital. Doing that will be problem enough, as we have pointed out. However, that is not the only problem that Russia must solve to be internationally competitive for foreign direct investment. Russia must compete with more than 100 other countries for foreign capital.

For each of the past few years the Heritage Foundation and the Wall Street Journal have published a study that measures economic freedom for more than 150 countries, which are ranked based on the scores they receive in a number of areas. A score of 1.0 is best; 5.0 is worst. Their *2003 Index of Economic Freedom* ranks Hong Kong as the world's most free economy with an overall score of 1.45. Russia's overall rank was 135 out of 161 countries with an overall score of 3.70. What this ranking means is that, all other things being equal, there are 134 countries that investors would probably find more attractive for investment purposes than Russia, if one begins with the premise that investing in a free economy is more attractive than investing in an economy that is

not free. That is bad news for the Russian economy, which needs massive injections of foreign capital in order to grow.

Table 1 shows Russia's overall ranking compared to other former Soviet republics. Ten of the 15 former Soviet republics had higher overall scores than Russia, with Estonia, Lithuania, Latvia and Armenia doing quite well by world standards. Only four former Soviet republics had lower overall rankings than Russia. That is bad news for Russian companies that are seeking foreign capital because this statistics shows that Russia is not a very desirable place to invest. More than half of the former Soviet republics are better overall, in terms of economic freedom.

One set of factors in the Heritage study measures the freedom to invest. To receive a good score in this category, countries must maintain liberal policies regarding capital flows and investment. Their foreign investment code must be transparent and open. Foreign investments must be treated impartially and there must be an efficient approval process. Any restrictions on foreign investment must be few and economically insignificant.

Measuring Russia's ranking in this category (freedom to invest) involves some calculations and value judgment. Russia's score was 3.0. Fifty-two countries had higher scores. Twelve received a score of 1.0 and forty had scores of 2.0. Seventy-five countries received scores of 3.0. So Russia is tied with 74 other countries. Twenty-four countries received scores of 4.0, five countries had scores of 5.0 and five countries were unranked in this category. If one had to pick a number to rank each country included in the study, it might be reasonable to rank as #6 all those countries that had a score of 1.0, since 12 countries had this score and 6 is about the midpoint. If we use this methodology to rank countries in terms of desirability for foreign investment, then the 40 countries that had a score of 2.0 would each be ranked 32 [$12 + 0.5(40)$], and the 75 countries receiving a score of 3.0 would be ranked 89 [$52 + 0.5(75)$]. The 24 countries that had a score of 4.0 would each be ranked 139 [$127 + 0.5(24)$] and the five countries with scores of 5.0 would be ranked 154 [$151 + 0.5(5)$]. Table 2 shows where Russia stands in the rankings compared to the other

former Soviet countries. Table 3 shows the number of countries in each of the five categories.

As can be seen in Table 2, four of the 15 former Soviet republics ranked higher than Russia and 7 ranked lower. Three other former republics were in the same category as Russia. Estonia was the only former Soviet republic to earn a score of 1.0. Latvia, Lithuania and Armenia had scores of 2.0. None of the republics had a score of 5.0.

CONCLUDING COMMENTS

Based on the statistics in the Heritage study, combined with the fact that Russia has not yet fully adopted accounting standards that international investors trust, one might conclude that nobody wants to invest in Russia. Luckily, such is not the case. Billions of dollars are pouring into the Russian economy for some reason, in spite of the fact that there are many more desirable places to invest and despite the fact that the integrity of Russian financial reports often leaves much to be desired. Exploring the reasons for this foreign investment would take us beyond the scope of this paper.

What this paper shows is that financial transparency is desirable if the goal is to attract foreign investment, that financial transparency is difficult to achieve in a country where accountants are not accustomed to disclosing financial information and that Russia is making progress in adopting and implementing accounting standards that are internationally recognized and trusted. However, Russia has a long way to go before the financial statements its companies publish are considered as trustworthy as the statements issued by more mature market economies. Russia must complete the IFRS adoption process, educate accountants and auditors about their importance as well as their technical aspects and implement them throughout the economy. A good start has been made but it will be a few years before the goal is reached.

REFERENCES

- Alexander, David and Simon Archer. 2003. *Miller International Accounting Standards Guide*. New York: Aspen Law & Business.
- Andersen, BDO, Deloitte Touche Tohmatsu, Ernst & Young, Grant Thornton, KPMG and PricewaterhouseCoopers. *GAAP 2001: A Survey of National Accounting Rules Benchmarked against International Accounting Standards*. The Russian Federation is covered at pp. 110-113. Available at [www.pwcglobal.com]
- Arndt, H.W. 1987. *Economic Development: The History of an Idea*. Chicago: University of Chicago Press.
- Arthur Andersen, BDO, Deloitte Touche Tohmatsu, Ernst & Young International, Grant Thornton, KPMG and PricewaterhouseCoopers. *GAAP 2000: A Survey of National Accounting Rules in 53 Countries*. The Russian Federation is covered at pp. 89-91. Available at [www.pwcglobal.com]
- Bauer, Peter. 1991. *The Development Frontier: Essays in Applied Economics*. Cambridge, MA: Harvard University Press.
- Bauer, Peter. 1976. *Dissent on Development*, revised edition. Cambridge, MA: Harvard University Press.
- BDO, Deloitte Touche Tohmatsu, Ernst & Young, Grant Thornton, KPMG and PricewaterhouseCoopers. *GAAP Convergence 2002: A Survey of National Efforts to Promote and Achieve Convergence with International Financial Reporting Standards*. Available at [www.pwcglobal.com]
- Damant, David. 1999. *IASs and the Capital Markets*. *Accountancy: International Edition*, Vol. 123, No. 1269 (May), p. 80.
- Enthoven, Adolf J.H. 1992. *Accounting in Russia: From Perestroika to Profits*. *Management Accounting* (October), 27-31.
- Epstein, Barry J. and Abbas Ali Mirza. 2003. *IAS 2003: Interpretation and Application of International Accounting Standards*. New York: John Wiley & Sons.
- Hanke, Steve H. and Alan A. Walters, editors. 1991. *Capital Markets and Development*. San Francisco: ICS Press.

- Heritage Foundation and Wall Street Journal. 2002. *2003 Index of Economic Freedom*
[www.heritage.org/research/features/index/2003/index.html]
- IASC (International Accounting Standards Committee). 1989. *Framework for the Preparation and Presentation of Financial Statements*. London: IASC.
- ICAR (International Center for Accounting Reform). 2001. *Recommendations for Accounting Reform in the CIS Countries*. ICAR Newsletter, May/June.
[www.icar.ru/eng/newsletter/22/6/2001.html]
- ICAR. 2001a. *Poor Compliance and Poor Auditing Undermines Achievements on International Accounting Standards*. ICAR Newsletter, March/April
[www.icar.ru/eng/newsletter/4.4.2001.html]
- ICAR. 2001b. *EU Takes Important Step in Support of Russia's Auditing Reform*. International Center for Accounting Reform Newsletter March/April.
[www.icar.ru/eng/newsletter/15.4.2001.html]
- ICAR. 2000. *Communique of the Thirteenth Session of the Foreign Investment Advisory Council in Russia*. International Center for Accounting Reform Newsletter. November/December.
[www.icar.ru/eng/newsletter/2.12.2000.html]
- ICAR. 2000a. *ERBD Calls for Use of IAS*. International Center for Accounting Reform Newsletter, November/December.
[www.icar.ru/eng/newsletter/4.12.2000.html]
- Lal, Deepak. 2001. *Unintended Consequences: The Impact of Factor Endowments, Culture and Politics on Long-Term Economic Performance*. Cambridge, MA: MIT Press.
- Lal, Deepak. 1986. *The Poverty of Development Economics*. Cambridge, MA: Harvard University Press.
- Larson, Robert K. and Sara York. 1996. *Accounting Standard-Setting Strategies and Theories of Economic Development: Implications for the Adoption of International Accounting Standards*. *Advances in International Accounting*, Vol. 9, pp. 1-20.

- Larson, Robert K. 1993. International Accounting Standards and Economic Growth: An Empirical Investigation of Their Relationship in Africa. *Research in Third World Accounting*, Vol. 2, pp. 27-43.
- Radoutsky, Alexander. 2001. Transparent Financial Information as a Factor of Economic Stability and Intensive Growth. *International Center for Accounting Reform Newsletter*, March/April. [www.icar.ru/eng/newsletter/17.4.2001.html]
- Ramcharran, Harri. 2000. The Need for International Accounting Harmonization: An Examination and Comparison of the Practices of Russian Banks. *American Business Review* 18:1 (January): 1-8.
- Rozhnova, Olga. 2000. The Problem of Perception of the New Russian Accounting Standards. *International Center for Accounting Reform Newsletter*, November/December [www.icar.ru/eng/newsletter/13.12.2000.html]
- Russian Federation. 1998. Programme for the Reformation of Accounting in Accordance with IAS. Decision of Government of Russian Federation #283, March 6.
- Shatalov, S. 2003. Russian Standards Approach IFRS. Prime-TASS. Business type. 01.23.03.
- Shleifer, Andrei and Daniel Treisman. 2000. *Without a Map: Political Tactics and Economic Reform in Russia*. Cambridge and London: The MIT Press.
- Shneydman, L. 2002. Introduction of IAS in Russia. *ICAR Newsletter*, April 1 [www.icar.ru/rus/newsletter/1/4/2002]
- Tax Code of the Russian Federation, Provision #120.
- Troika Dialog. 2001. Corporate Governance Principles. Review for WEF. [www.troika.ru]
- Vorushkin, Vladimir. 2001. IAS Benefits for Russian Enterprises: Managerial Issues. *International Center for Accounting Reform Newsletter*, March/April. [www.icar.ru/eng/newsletter/19.4.2001.html]
- Vysokov, V. 2000. Center-invest: Banking in Russia using International Accounting Standards. *Euromoney*, Issue 377 (September), 117.

Table 1
Overall Ranking in Terms of Economic Freedom
Russia Compared to other Former Soviet Countries

Former Soviet Country	Rank (out of 161 countries)	Score 1 to 5, where 1 is best
Estonia	6	1.80
Lithuania	29	2.35
Latvia	33	2.45
Armenia	44	2.65
Moldova	92	3.20
Azerbaijan	104	3.35
Kyrgyz Republic	104	3.35
Georgia	113	3.40
Kazakhstan	119	3.50
Ukraine	131	3.65
Russia	135	3.70
Tajikistan	143	3.95
Turkmenistan	146	4.15
Uzbekistan	149	4.25
Belarus	151	4.30

Source: Heritage Foundation and Wall Street Journal, *2003 Index of Economic Freedom* [www.heritage.org]

Table 2
Ranking in Terms of Foreign Investment
Russia Compared to other Former Soviet Countries

Former Soviet Country	Rank (out of 161 countries)	Score 1 to 5, where 1 is best
Estonia	6	1.0
Lithuania	32	2.0
Latvia	32	2.0
Armenia	32	2.0
Moldova	89	3.0
Kyrgyz Republic	89	3.0
Georgia	89	3.0
Russia	89	3.0
Azerbaijan	139	4.0
Kazakhstan	139	4.0
Ukraine	139	4.0
Tajikistan	139	4.0
Turkmenistan	139	4.0
Uzbekistan	139	4.0
Belarus	139	4.0

Source: Heritage Foundation and Wall Street Journal, *2003 Index of Economic Freedom*
 [www.heritage.org]

Table 3
Foreign Investment
Frequency Distribution

Score	Number of Countries	Cumulative	Rank
1.0	12	12	6
2.0	40	52	32
3.0	75	127	89
4.0	24	151	139
5.0	5	156	154
unranked	5	161	