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Good corporate governance contributes to a company's competitiveness and reputation, facilitates access to capital markets, and thus helps develop financial markets and spur economic growth. With this in mind, the International Finance Corporation and the U.S. Department of Commerce have combined their efforts to provide Russian managers, directors, and shareholders with a practical tool to implement good corporate governance practices – the Russia Corporate Governance Manual. This Manual refers to and is based on the principal laws and regulations that apply to open joint stock companies. It follows the recommendations of the FCSM's Code of Corporate Conduct and refers to internationally accepted principles of good corporate governance.

*“Corporate governance is vital to the interests of every economy, and government has a role to play in establishing the framework for reform - but it is companies that have the tough job of putting governance reform into practice. This is where the Corporate Governance Manual can provide excellent help. It offers a comprehensive workbook for company directors, officers, and advisers in taking up the challenge of corporate governance improvement. Shareholders and stakeholders alike should applaud IFC for bringing practical, and professional advice within reach of every boardroom.”*

**Anne Simpson**, Manager,  
Global Corporate Governance Forum

*“Corporate governance reform in Russia is the continuation of the more general processes of change affecting the country as a whole. Taken together, these developments have created a new environment, new rules regulating the relationships between the market and regulators, between shareholders, shareholders and managers, etc. In the business community there is a growing awareness of the benefits of corporate governance reform, and companies are now working on improving the quality of their corporate governance ...”*

**Ruben K. Vardanian**, President of Troika Dialogue; Chairman of the Board,  
OJSC Rosgosstrakh; and Chairman of the RSPP Corporate Governance Committee

*“Good corporate governance is a key driver of financial transparency and managerial accountability, essential ingredients for national prosperity in a global economy. We congratulate the U.S. Department of Commerce and the International Financial Corporation of the World Bank for their initiative in bringing about the publication of the Russia Corporate Governance Manual.”*

**Andrew B. Somers**, President,  
American Chamber of Commerce in Russia

Questions on corporate governance should be addressed to the IFC Russia Corporate Governance Project, via [CGPRussia@ifc.org](mailto:CGPRussia@ifc.org)

An electronic version of the Manual is available on the website of the International Finance Corporation under [www.ifc.org/rcgp](http://www.ifc.org/rcgp) and the U.S. Department of Commerce under [www.mac.doc.gov/ggp](http://www.mac.doc.gov/ggp)

# The Russia Corporate Governance Manual

## IV Part IV Information Disclosure and Transparency

Prepared and Published by the International Finance Corporation and the U.S. Department of Commerce

In Partnership with the Agency for International Business and Cooperation of the Dutch Ministry of Economic Affairs and the Swiss State Secretariat for Economic Affairs



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# The Russia **Corporate Governance** Manual

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## Part IV

### **Information Disclosure and Transparency**

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# Chapter 13

Information

**Disclosure**

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## **The Chairman's Checklist**

- ✓ Does the company have a written disclosure policy? Does the policy fully express the company's commitment to transparency? Is the disclosure policy easily available to market participants and other interested parties?
- ✓ Does the company fully comply with its legal disclosure obligations? What systems are in place to ensure that full and timely disclosure of material information occurs?
- ✓ Are executives and directors fully aware of the personal and corporate repercussions of false or incomplete disclosure? Do executives and directors act accordingly to ensure good disclosure?
- ✓ Is the company's ownership structure transparent?
- ✓ What steps are being taken to ensure that the company's financial position is communicated clearly to the markets?
- ✓ Is the disclosure fair? For example, does the company ensure that all investors receive information at the same time, not giving special access to a privileged few individual or institutional investors?
- ✓ Does the company have a policy on insider trading and does it enforce this policy? What systems are in place to manage the flow of insider and other sensitive information?
- ✓ Does the company appreciate that it is in its own interest to make voluntary disclosures to the market? If so, how does it ensure the veracity of this information, and that its disclosure is not merely for marketing or public relations purposes?
- ✓ Does the company truly understand the definition of commercially sensitive information? Or, does the company hide behind protections provided for sensitive information in order to withhold important material facts from the markets?
- ✓ How does the company's disclosure compare to international disclosure requirements, for example, the OECD Principles of Corporate Governance?

There are two basic forms of market regulation: 1) substantive rules-based regulation, and 2) disclosure-based regulation. Both regulatory approaches seek to protect shareholders and provide for fair and stable financial markets. Rules-based regulation sets down what companies can and cannot do, and seeks to establish a wide-reaching set of regulations that cover a number of potential circumstances. Disclosure-based regulation relies more heavily upon market mechanisms to punish and reward certain types of corporate behavior, and shifts part of the responsibility for protecting investors to market participants, according to the motto *caveat emptor* or buyer beware. Disclosure-based regulation is partly predicated upon the faith that markets are better at policing corporate misconduct than regulatory agencies, and that disclosure is an effective and inexpensive substitute for substantive regulation. In practice, the two approaches are almost always used in combination with one another, though, some countries rely more heavily on disclosure than others.

The effectiveness of disclosure-based regulation must be considered with caution, especially in the Russian context. In the absence of substantive checks upon managers or owners, its value may, in fact, be quite limited. The early years of Russia's financial markets have an unfortunate history of insiders, controlling shareholders, and related parties freely tunneling company assets under the glare of the Russian and international press.

For disclosure-based regulation to work effectively, a number of elements and incentives need to work together. These include a proper legal and regulatory environment, combined with effective enforcement mechanisms such as regulators that screen financial information for misstatements and courts that provide effective redress. Independent External Auditors also play an important role, providing assurance to the markets, as does an active and interested media that questions company strategies and communications. Finally, a competent and vigilant Supervisory Board is crucial. It is broadly accepted that even the best disclosure system cannot thwart individuals who are intent upon defrauding a company and its shareholders. Without a Supervisory Board that is uniformly intolerant of obfuscation, disclosure cannot be fully effective.

While disclosure based-regulation may function imperfectly in an emerging financial market such as in Russia, disclosure is nevertheless important and is only likely to grow in importance as Russia's financial markets mature. Among the broad palette of disclosures, particular importance must be attached to financial and operating results, related party transactions, and ownership structures.

## A. An Introduction to Information Disclosure

### 1. Definition and Rationale

Disclosure is ensuring access to information by all interested parties, regardless of the purpose of obtaining the information, through a transparent procedure that guarantees information is easily found and obtained.<sup>1</sup>

Timely and accurate disclosure is essential for shareholders, potential investors, regulatory authorities, and other stakeholders. Access to material information helps shareholders protect their rights and improves the market participants' ability to make sound economic decisions. Disclosure makes it possible to assess and oversee management, as well as to keep management accountable to the company and shareholders. Disclosure benefits companies since it allows them to demonstrate accountability towards shareholders, act transparently towards the markets, and maintain public confidence and trust.<sup>2</sup> Good disclosure policies should also reduce the cost of capital. Finally, information is also useful for creditors, suppliers, customers, and employees to assess their position, respond to changes, and shape their relations with companies.

The power of a sound disclosure regime is expressed clearly and eloquently in the following quote:

*“Requiring disclosure of information can be a powerful regulatory tool in company law. It enhances the accountability for and the transparency of the company’s governance and its affairs. The mere fact that, for example, governance structures or particular actions or facts have to be disclosed, and therefore will have to be explained, creates an incentive to renounce structures outside what is considered to be best practice, and to avoid actions that are in breach of fiduciary duties or regulatory requirements, or could be criticized as being outside best practice. For those who participate in or do business with companies, information is a necessary element in order to be able to assess their position and respond to changes that are relevant to them.”<sup>3</sup>*

<sup>1</sup> Law on the Securities Market, Article 30, Clause 1.

<sup>2</sup> Federal Commission for the Securities Market’s Code of Corporate Conduct (FCSM Code), Chapter 7, Introduction.

<sup>3</sup> Report of the High Level Group of Company Law Experts on a Modern Regulatory Framework for Company Law in Europe, Brussels, 4 November 2002. (See also: [http://europa.eu.int/comm/internal\\_market/en/company/company/modern/consult/report\\_en.pdf](http://europa.eu.int/comm/internal_market/en/company/company/modern/consult/report_en.pdf))



### 2. Principles of Disclosure

A more everyday and practical expression of what constitutes good disclosure follows in these four basic principles:

**Best Practices:** Good disclosure should be:

1. Provided on a regular and timely basis;
2. Easily and broadly available;
3. Correct and complete; and
4. Consistent, relevant, and documented.

### 3. Confidential Information

Securities legislation require publicly held companies to disclose a broad range of financial and non-financial information. At times, information disclosure required by regulations can adversely affect a company's business and financial condition because of the competitive harm that could result from the disclosure. Despite the fact that many Russian companies often consider the most mundane information commercially sensitive, in reality, competitive harm only arises under a limited number of circumstances. Some examples of truly sensitive information include pricing terms, technical specifications, and milestone payments. To address potential disclosure hardship, legislators and regulators develop systems for allowing companies to request confidential treatment of information.

In Russia, information is deemed commercially sensitive if:<sup>4</sup>

- It has real or potential commercial value due to its uncertainty to third parties;
- There is no free access to it on legal grounds; and
- The owner of the information undertakes steps to keep it confidential.

However, if left to the interpretation of the company, this definition could yield a never-ending number of exceptions. Fortunately, legislation defines what information can and cannot be treated as confidential.<sup>5</sup> For example, the law

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<sup>4</sup> Civil Code (CC), Article 139, Clause 1.

<sup>5</sup> Decree of the RF President No. 188 on the Approval of the List of Information of Confidential Nature.

considers personal data confidential information, and forbids the collection, storage, usage, and dissemination of private information without the person's consent, unless otherwise provided by a court decision.<sup>6</sup> Accessibility to confidential information is limited, its public disclosure is prohibited, and persons who act in breach of rules may be held liable.<sup>7</sup> This provision can be re-enforced by concluding confidentiality agreements with such persons.

→ *For more information on how to implement confidentiality agreements, see the model contracts with a non-executive director and the General Director in Part VI, Annexes 13 and 14, respectively.*

**Best Practices:** Today's corporate governance problems are related less to excessive transparency and over-disclosure than under-disclosure and lack of transparency.

Companies should be clear on what truly constitutes confidential information and should not interpret the broad definitions provided for by law so widely as to withhold relevant information from investors. To guide practices with respect to commercially sensitive information, companies are well advised to develop written policies and procedures, and define what should be considered confidential in internal documents or by-laws.<sup>8</sup> These policies must be consistent with the list of confidential information approved by Presidential Decree on the one hand,<sup>9</sup> and the list of information that may not be deemed commercial secrets under Governmental Resolution, on the other.<sup>10</sup>

### 4. Insider Information and Insider Dealing

Insider trading encompasses both legal and prohibited activity. Insider trading takes place legally, every day, when corporate insiders (officers, directors, or em-

<sup>6</sup> Law on Information and Protection of Information, Article 11, Clause 1.

<sup>7</sup> CC, Article 67, Clause 2; Article 139, Clause 2; Labor Code, Article 81, Clause 5, Section c; Article 243; Law on Joint Stock Companies (LJSC), Article 71, Clause 2, Paragraph 1.

<sup>8</sup> FCSM Code, Chapter 7, Section 4.1.1, Paragraph 3.

<sup>9</sup> Decree of the RF President No. 188 on the Approval of the List of Information of Confidential Nature.

<sup>10</sup> Resolution of the RSFSR Government No. 35 on the List of Information which Cannot be Deemed as Containing a Commercial Secret. [Note: A draft law on Commercial Secrets was being considered, but had not yet been passed by the State Duma as of this Manual's completion.]

ployees) buy or sell shares in their own companies within the confines of company policy, law, and regulation.

There is also an illegal variety of insider dealing. It is the dealing that takes place when those with access to privileged and confidential information use their knowledge to reap profits or avoid losses on the stock market. Investors lacking access to privileged information often pay the costs of insider dealing.

Another, and far greater, cost of insider dealing is the damage done to the credibility of securities markets. One of the main reasons that capital is easily available in the world's most successful stock markets is that investors largely trust them to be fair. The common belief in some countries that privileged investors should be allowed to profit from their access to confidential information may explain, in part, relatively low public share ownership in these countries. Governments cannot afford to ignore insider dealing if they hope to promote an active securities market and attract international investment. The same holds true for Supervisory Boards that wish to protect shareholders and attract investment.

In Russia, insider information is defined as any information about a company and its securities, which is not easily accessible and which provides privileges to those who have access to it due to their official position, contractual obligation vis-à-vis (or agreement with) the company in comparison to other participants of the securities market.<sup>11</sup> Individuals with access to insider information include:<sup>12</sup>

- Members of the company's governing bodies or securities market professionals with a contractual agreement with the company;
- The External Auditor of the company or securities market professionals having a contractual agreement with the Auditor; and
- Officials of regulatory agencies having legal rights to control or monitor the company.

**Best Practices:** Disclosure of insider information may substantially affect the market value of shares and other securities of a company. Therefore, per-

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<sup>11</sup> Law on the Securities Market, Article 31. [Note: A draft law on Insider Information was being considered, but had not yet been passed by the State Duma as of this Manual's completion.]

<sup>12</sup> Law on the Securities Market, Article 32.

sons who have access to insider information may not use it to execute transactions, nor may they transfer insider information to a third party.<sup>13</sup> Illegal use of insider information can damage shareholder interests and adversely affect the financial position and reputation of the company as well as securities markets overall. The company should have a written insider dealing policy in place, and vigorously enforce it. The Internal Auditor should monitor whether directors, managers, and other officers comply with the law, regulation, and internal rules on insider dealing.<sup>14</sup>

### 5. Disclosure in Listed *Versus* Closely Held Companies

Disclosure requirements are different for publicly listed companies, open and closed joint stock companies, and private companies. Private and closed joint stock companies usually need only to comply with minimal disclosure requirements. More stringent rules apply to listed open joint stock companies. Tight regulation of disclosure among listed companies is needed because of the greater impact of potential fraud when a company may have many thousands of shareholders. Given the importance of capital markets in a modern economy, governments are, understandably, keen on ensuring the integrity of the financial system. The increased number of disclosure obligations for listed companies is the price to be paid to access the large funds available on the capital markets.

Russia's two leading stock exchanges, the Russian Trading System (RTS) and Moscow Interbank Currency Exchange (MICEX) have specific listing rules. For example, companies listed on Tier-A, Level 1 on any of these exchanges must provide documents confirming their full compliance with the FCSM Code (or, if listed on MICEX, with their internal company-level code of corporate governance that is based on the FCSM Code). Companies listed on RTS' Tier-A, Level 1 are further required to disclose their financial statements according to both Russian and International Financial Reporting Standards. On the other hand, companies listed on Tier-A, Level 2 must simply provide documents confirming their compliance with Chapter 7 of the FCSM Code on information disclosure. RTS requires that companies additionally report on specific material events, for example, on issuing, splitting, consolidating, or retiring securities; on transferring the register to

<sup>13</sup> Law on the Securities Market, Article 33, Clause 1.

<sup>14</sup> FCSM Code, Chapter 4, Section 4.2.

another External Registrar; on the date of the General Meeting of Shareholders (GMS); on the record date; and on the total number of shareholders.<sup>15</sup>

→ *For more general information on the differences between forms of joint stock companies, see Part I, Chapter 2, Section A.2.*

### 6. Disclosure *Versus* Transparency

Disclosure is sometimes confused with transparency. Unfortunately, these two terms are frequently and erroneously used interchangeably. While disclosure and transparency would, at first glance, appear to be the same, they are not. Companies may disclose an enormous amount of information that is of no particular value to the users of such information. Important pieces can be withheld. Disclosure can be irrelevant or, worse, appear to be manipulated in such a way as to conceal the true picture of the state of the enterprise.

**Company Practices in Russia:** The disclosure of ownership in Russian companies highlights how disclosure and transparency may diverge. While most companies properly disclose their ownership, the true owners and the extent of their control often remains hidden behind complex legal structures such as Special Purpose Entities (or Vehicles), off-shore holding companies, and trusts. For example, most companies in Russia's regions comply with general disclosure requirements. However, 91% fail to provide information on a variety of issues, including major shareholders.<sup>16</sup> Few companies thus have transparent ownership structures.

### 7. Personal Liability for Non-Disclosure

As a rule, companies are liable for damages caused to shareholders denied legitimate access to information. Companies are also liable when they cause damages to third parties by providing false, incomplete, or distorted information.<sup>17</sup> Members

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<sup>15</sup> To view the complete set of listing rules, visit RTS's and MICEX's websites under: [www.rts.ru](http://www.rts.ru) and [www.micex.ru](http://www.micex.ru).

<sup>16</sup> IFC Survey on Corporate Governance Practices in Russia's regions, Section 2.2.1, page 25, August 2003 (see [www.ifc.org/rcgp](http://www.ifc.org/rcgp)).

<sup>17</sup> CC, Article 1068.

of the company's governing bodies, in particular the executive bodies, are personally liable for losses caused to the company through their fault.<sup>18</sup> The company (or a shareholder owning 1% or more of common shares) may seek compensation for losses.

The failure to disclose information to the securities markets, provide reliable information, and/or follow disclosure procedures is also subject to liability.<sup>19</sup> Persistent non-disclosure of information or provision of false information causing material damage to individuals, legal entities, or the state is subject to criminal prosecution.<sup>20</sup>

Executive bodies, typically the General Director, are legally responsible for proper disclosure.<sup>21</sup> Some documents, such as the prospectus and quarterly report, must be signed by more than one person, e.g. by the General Director and the Chief Accountant, financial consultant, and the External Auditor. These persons are jointly and severally liable for the reliability and completeness of the disclosed information. They also bear subsidiary (secondary) liability with the company for any damages caused to shareholders due to incorrect, incomplete, and/or false information in such documents.

### B. Disclosure Items

The OECD Principles of Corporate Governance (OECD Principles) suggest that

*“...timely and accurate disclosure be made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.”<sup>22</sup>*

The key concept that underlies the OECD's recommendation is the concept of materiality. Material information is information, the omission or misstatement of which could affect economic decisions taken by the users of information. Materiality may also be defined as a characteristic of information or an event that makes it sufficiently important to have an impact on a company's share price.

<sup>18</sup> LJSC, Article 71, Clause 2.

<sup>19</sup> Law on the Securities Market, Articles 22.1, Clause 3; Article 30, Paragraph 11.

<sup>20</sup> Criminal Code, Articles 185 and 185.1.

<sup>21</sup> LJSC, Article 88, Clause 2.

<sup>22</sup> OECD Principles, Principle IV on Disclosure and transparency. See also: [www.oecd.org/dataoecd/32/18/557724.pdf](http://www.oecd.org/dataoecd/32/18/557724.pdf).

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The application of the materiality concept allows companies to avoid overly detailed disclosure that is ultimately irrelevant to shareholders. For example, damage to RUR 150,000 (approximately U.S. \$ 5,000) worth of paper in a large, publicly traded company is, clearly, of little importance to the investor. It may, on the other hand, be material to a small family-owned print shop. Materiality is, consequently, a relative concept that depends on the context. It is often difficult to define with great precision in practice. Companies and auditors may sometimes apply certain numerical thresholds (such as, for example, 5% of earnings) to simplify its application. However, these thresholds can only serve as a starting point for a more rigorous application of the concept of materiality.

**Best practices:** The OECD Principles call for disclosure of all material information in the following areas:

- Financial and operating results of the company;
- Company objectives;
- Shareholdings and ownership structure;
- Directors and key executives, as well as their remuneration;
- Material foreseeable risk factors;
- Material issues regarding employees and other stakeholders; and
- Governance structure and policies.

This list is comprehensive, if general. The Technical Committee of the International Organization of Securities Commissions (IOSCO) has developed more detailed, high-level principles for ongoing disclosure and material development reporting for listed entities. These principles are:<sup>23</sup>

- Materiality of information for an investor's investment decision;
- Disclosure on a timely basis — immediate or periodic;
- Simultaneous and identical disclosure in all jurisdictions where the entity is listed;
- Dissemination of information by using efficient, effective, and timely means;
- Disclosure criteria fairness, without misleading or deceptive content and containing no material omission;
- Equal treatment of disclosure — no selective disclosure to investors and others before public disclosure; and
- Compliance with disclosure obligations.

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<sup>23</sup> Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities, OICU-IOSCO, October, 2002. See also: [www.iosco.org](http://www.iosco.org).

Russian legislation covers these essentials in considerable detail. The following sub-sections discuss Russian requirements and disclosure practices with respect to the above-mentioned OECD disclosure items.

### 1. Financial and Operating Results

#### a) Presenting Financial Information

Information about financial results, performance, and situation, as well as operations of the company, is of utmost importance for shareholders, potential investors, creditors, and other stakeholders. The following list constitutes the most typical forms of, and additions to, financial reporting:

- *The balance sheet* provides a snapshot of the company's assets, capital, and liabilities on a particular date. To skilled analysts, it provides important information on, *inter alia*, the degree of risk an investment in the company carries or the company's ability to pay creditors.
- *The income statement* provides information on the company's performance over a specified period of time. Income statements may be organized in a number of different ways. According to internationally recognized practice, income statements must show: 1) revenues or sales; 2) the results of operating activities; 3) financing costs; 4) income from associates and joint ventures; 5) taxes; 6) profit or loss from ordinary activities; and 7) net profit or loss. The income statement demonstrates business sustainability.
- *The statement of changes in owners' equity* shows all changes in the charter, additional paid-in, and reserve capital, as well as retained earnings. In addition, it provides information on changes in statutory and additional funds, and briefs on net assets.
- *The cash flow statement* illustrates a company's sources and uses of cash. It lists all changes affecting cash in three areas: 1) operations; 2) investments; and 3) financing. For example: net operating income increases cash; the purchase of a plant is an investment that decreases cash; and the issuance of shares or bonds is a financing activity that increases cash.
- *The notes to the financial statements* help explain the company's financial statements by providing important details and insight into how the company prepared its accounts.
- *Explanations to financial statements* briefly describe features of the company's activities, its main performance indicators and factors that affected the



company's financial results, as well as decisions of the review of financial statements and distribution of net profits. This refers to any relevant information that would enable users to receive a complete and objective picture of the company's financial condition, financial results for the reporting period, and any changes in its financial position.

**Best Practices:** International practice also calls for the Management's Discussion and Analysis (MD&A), which provides management's view of the performance and future prospects of the company. The MD&A, which is typically disclosed in the company's annual report, should: 1) complement as well as supplement financial statements; 2) have a forward-looking orientation; 3) focus on long-term value creation; 4) integrate long- and short-term perspectives; 5) present information that is significant to the decision-making needs of users; and 6) embody the qualities of reliability, comparability, consistency, relevance, and understandability. The MD&A presents a more analytical and qualitative view than the rest of the financial statements.

Finally, *the External Auditor's report with conclusions* enables an independent External Auditor to express an opinion on whether or not the company's financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework, and whether they are reliable. This provides shareholders, managers, employees, and market participants with an independent opinion about the company's financial position and — if performed properly — should attest to the accuracy of the statements. Russian companies are further required to publish the Revision Commission's report.

→ *For more information on the role of the External Auditor and Revision Commission, see Part IV, Chapter 14, Section B and A, respectively.*

### b) Preparing Financial Information

Russian legislation regulating financial reporting recognizes the following basic concepts and principles:<sup>24</sup>

- **Accrual based accounting**, according to which revenues and expenses are booked over time and not at the point of payment or receipt of funds. This requires that sales and expenses relating or pertaining to a particular period

<sup>24</sup> Russian Accounting Standard 1/98, Accounting Policy of the Company, Section 6.

be recorded in the period of occurrence irrespective of when the amount was received or paid;

- **Going concern assumption**, i.e. that financial statements are prepared on the assumption that the company is operating and will continue to operate for the foreseeable future, and that it has neither the intention nor the necessity of liquidation or of materially curtailing the scale of its operations. The going concern assumption is a fundamental principle in the preparation of financial statements. For this reason, it is recognized that management has a responsibility to assess the entity's ability to continue as a going concern. However, management's assessment may not always involve detailed analysis, particularly when there is a history of profitable operations and ready access to financial resources.

**Company Practices in Russia:** Not all companies in Russia follow the going concern principle when preparing financial statements. Some are on the verge of bankruptcy, while others cannot guarantee the stability of company's operation in the future. Additionally, a poor financial picture is often presented to minimize tax payments.

- **Consistency**, which states that the presentation and classification of items in the financial statements shall be retained from one period to the next unless a change is justified either by a change in circumstances or a requirement of a new accounting standard; and
- **Separation of assets and liabilities**, meaning that the assets and liabilities of the company shall be separated from those of its owners and other organizations.

In addition, company accounting policies should ensure:<sup>25</sup>

- **Completeness of information disclosure**, meaning that information contained in the company's financial statements should disclose all material business facts and results (actually and potentially) influencing economic decision-making by the users of these financial statements both from the standpoint of materiality of such information and from the standpoint of the cost of its preparation (an omission can cause information to be false

<sup>25</sup> Russian Accounting Standard 1/98, Accounting Policy of the Company, Section 7. Russian Accounting Standard 4/99, Financial Statements of the Company, Section 33.

or misleading and thus unreliable and imperfect from the standpoint of its relevance);

- **Timeliness**, i.e. the company needs to publish reports quickly, as up-to-date information is of much more value to users than older information that may have been superseded by events;
- **Conservatism**, requiring a company to make prudent accounting choices and estimate when future events would have negative effects on its financial conditions;
- **Substance over form**, meaning that for the faithful presentation of information in the financial statements it is necessary that transactions and events are accounted for and presented in accordance with their substance and economic reality (which should prevail) and not merely their legal form;
- **Analytical**. The sum of analytical accounts should be equal to the synthetic account;
- **Balance between benefit and cost**, which, given the complexity and breadth of certain reporting requirements, allows smaller companies to tailor their financial information to be cost-effective. This concept, however, should not be used to deny information to users. The presumption must be that information required by law and accounting standards should be provided to users unless there is a clear indication that the cost outweighs the benefit; and
- **Matching**. Expenses are matched to related revenues in determining earnings for the period.

Legislation, accounting, and other standards will determine the specific content and format of financial statements. Taken together and compared over time, the financial statements and the MD&A should provide a well-rounded picture of the company's operations and financial position.

**Best Practices:** If companies plan to access international capital markets or, simply, to improve upon the quality of financial reporting, they will need to prepare financial statements according to an internationally accepted body of accounting standards. The two most recognized standards are the International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (U.S. GAAP).<sup>26</sup>

<sup>26</sup> U.S. GAAP are available on the Financial Accounting Standard Board's website under: <http://www.fasb.org>. A summary of IFRS is available on the International Accounting Standard Board's website under: <http://www.iasb.org>.

In addition to standard financial reporting according to the Russian Accounting Standards (RAS), a company should consider reporting in accordance with IFRS for the following reasons:

- IFRS have clear economic logic and provide better information to the company's management than the current RAS do, allowing for a better comparison with a peer group of international companies;
- There is global convergence of national standards towards IFRS;
- Russian companies will likely need to report using IFRS in the future due to the convergence of Russian standards with IFRS;<sup>27</sup> (The Russian Ministry of Finance has issued statements regarding its intent to adapt RAS to IFRS.)
- All listed companies in Europe with consolidated accounts will be required to present their consolidated financial statements using IFRS as of 2005;<sup>28</sup>
- Unification of standards will allow users of financial statements to “read” financial statements under common rules; and
- Implementing IFRS could help Russian companies decrease expenses in attracting investment.

Applying IFRS typically has the following impact on the balance sheet of a standard Russian company:

- The need to prepare consolidated financial statements (IAS 27.7/11);
- Inventories can no longer be generally carried at cost, but at the lower of cost or net realizable value (IAS 2.6);
- A significant change in the value of fixed assets;
- Use of fair market valuation rather than the historical cost approach for many assets and liabilities;
- The appearance of new financial instruments, derivatives in particular; and
- Recognition of assets and liabilities, the control over which does not stem directly from participation in equity.

Additional items are included in the income statement, such as fair value adjustment for financial instruments, and recognition or recovery of asset impairment, among others. Disclosures also become more informative and user-oriented.

Depending on where the company intends to list, statements will likely need to be prepared according to one of these two standards.

<sup>27</sup> Research released by the world's six largest accountancy firms shows that an overwhelming majority of countries — over 90% of a total 59 countries surveyed — intend to converge with IFRS; see GAAP Convergence 2002 from <http://www.ifad.net>.

<sup>28</sup> Regulation (EC) 1606/2002 of the European Parliament of the Council of 19.7.2002 on the Application of International Accounting Standards. See also: [http://europa.eu.int/eur-lex/pri/en/oj/dat/2002/1\\_243/1\\_24320020911en00010004.pdf](http://europa.eu.int/eur-lex/pri/en/oj/dat/2002/1_243/1_24320020911en00010004.pdf).

### c) Disclosing Financial Information

Financial information will typically be presented in different forms and at different times throughout the financial year. Financial and operating results will appear in the prospectus, and annual and quarterly reports. The Law on the Securities Market requires that the following information on the last five operating years and the last reporting period be disclosed in these documents:<sup>29</sup>

- Major areas of company activity;
- Results of the financial and business activity, as well as any major factors affecting revenues;
- Financial and economic ratios of the company;
- Market capitalization, liquidity, and its obligations;
- Capital structure, including working capital;
- Composition, structure, and value of fixed assets;
- Total amount of export; and
- Inventory of the company's property.

**Best Practices:** Companies should disclose all material information, and do so on a timely basis and in such a manner as to make the information as clear and understandable to users as possible. Companies should adhere to the spirit of the law, not just the letter, and should not limit themselves to the minimum standards of statutory disclosure. Some examples of additional disclosures that are encouraged by the FCSM Code:

- The quarterly report for the fourth quarter should include additional financial information, in particular data about the company's operations over the entire previous reporting year rather than for the fourth quarter only;<sup>30</sup>
- The annual report should also disclose information that will enable shareholders to understand the results of the company's activities during the reporting year;<sup>31</sup> and
- Any of the material events defined by the FCSM Code.<sup>32</sup>

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<sup>29</sup> Law on the Securities Market, Article 22, Clauses 4 and 6.

<sup>30</sup> FCSM Code, Chapter 7, Section 2.2.

<sup>31</sup> FCSM Code, Chapter 7, Section 3.3.

<sup>32</sup> FCSM Code, Chapter 7, Section 2.3, Paragraph 6.

### d) Financial Information in Groups of Companies

Complete disclosure of intra-group relations, transactions, and their financial terms, and consolidated accounts is a crucial pre-requisite to make the group's functioning transparent.

**Best Practices:** When preparing consolidated accounts, companies should follow uniform accounting policies for the parent and its subsidiaries or, if this is not practicable, the company must disclose that fact and the proportion of items in the consolidated financial statements to which different policies have been applied. In the parent's separate financial statements, subsidiaries may be shown at cost, at revalued amounts, or using the equity method. According to IFRS, a company's consolidated accounts should include, *inter alia*:<sup>33</sup>

- The name, ownership, and voting percentages for each significant subsidiary;
- The reason for not consolidating a subsidiary;
- The nature of the relationship if the parent does not own more than 50% of the voting power of a consolidated subsidiary;
- The nature of the relationship if the parent does own more than 50% of the voting power of a subsidiary excluded from consolidation;
- The effect of acquisitions and disposals of subsidiaries during the period; and
- In the parent's separate financial statements, a description of the method used to account for subsidiaries;

→ For more information on the importance of disclosing financial information in groups of companies, see Part V, Chapter 15, Section B.2.

## 2. Company Objectives

It is important for markets, shareholders, and other stakeholders to be aware of the company's objectives. The communication of company objectives can be either in response to legal requirements or it can be voluntary.

Legislation requires that company objectives (such as the issuance of securities, acquisition plans, replacement and sales of assets, or research and development) be disclosed in the prospectus.<sup>34</sup> In addition, quarterly reports must contain forward-

<sup>33</sup> Excerpt from International Accounting Standard No. 27. See also: <http://www.iasb.co.uk>.

<sup>34</sup> Law on the Securities Market, Article 22, Clauses 4, 6 and 9.

looking information including sources of revenue, plans for new production procedures, expansion or reduction of production, new product development, substitution of old products, modernization or repair of fixed assets, and modification of the types of company activities.<sup>35</sup> In addition, the annual report must outline the company position in the industry, priority areas of activity, and development trends.<sup>36</sup>

Voluntary disclosure may cover issues such as a company's policies concerning corporate governance, business ethics, environmental issues, and other public policy commitments. This information can help to properly evaluate the prospective performance of the company, its relationship with various stakeholders and communities in which it operates, and the steps that the company has taken to implement its objectives. As with other types of disclosure, the quality of information provided to the public is greatly enhanced by adhering to a widely accepted standard.<sup>37</sup>

**Best Practices:** Companies may choose to voluntarily disclose their objectives in the charter, company-level corporate governance code, and/or ethics code, as well as annual report. Regardless of the form, companies should ensure that this information is readily accessible to the public, for example, on their websites.

### 3. Major Share Ownership and Voting Rights

#### a) Major Share Ownership

It is important that shareholders are informed about company ownership structures to understand their rights, role and authority in governing the company, and influence its policy. Depending on the size of ownership, shareholders have varying degrees of influence over decision-making in a company. Legislation provides greater rights to shareholders with larger holdings.

→ *For more information on the rights of shareholders according to their ownership percentage, see Part III, Chapter 7.*

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<sup>35</sup> FCSM Regulation No. 03-32/ps on the Disclosure of Information by Security Issuers (FCSM Regulation No. 03-32/ps), Annex 11, Section 3.4.

<sup>36</sup> FCSM Regulation No. 17/ps on Additional Requirements to the Procedure of Preparation, Calling, and Conducting the General Meeting of Shareholders (FCSM Regulation No. 17/ps), 31 May 2002, Section 3.6.

<sup>37</sup> For a general discussion of non-financial disclosure, see the OECD's Guidelines for Multinational Enterprises. See the OECD website at [www.oecd.org](http://www.oecd.org) or consult the Guidelines directly under: [www.oecd.org/dataoecd/62/58/2438852.pdf](http://www.oecd.org/dataoecd/62/58/2438852.pdf).

Clearly, it is vital to know who is in a position to make (or influence) decisions within a company. For this reason, full information on the amount of the issued capital, its increases and decreases, the rights attached to shares of different types and classes, and the number of shareholders is crucial.

Shareholders with large stakes have the opportunity to exercise control over decision-making in a company. These opportunities are summarized in Table 1.

Table 1: The Influence on Decision-Making Relative to the Ownership	
Ownership	Influence on decision-making
25% plus 1 vote	The shareholder can block major decisions that require $\frac{3}{4}$ -majority, e.g. to amend the charter or reorganize the company.
50% plus 1 vote	The shareholder can unilaterally take decisions that require a simple majority, e.g. to declare dividends and approve the External Auditor.
75% plus 1 vote	The shareholder can unilaterally decide all issues.

In practice, lower thresholds may suffice to exercise control over a company. In particular, in companies with dispersed ownership it is not necessary for a shareholder to hold the percentages of votes outlined in Table 1 above since the quorum for decisions of the GMS is counted based on votes cast. Since it is rare for all shareholders to vote at the GMS, a lesser percentage of shares usually provides the same degree of influence. In any event, the larger the ownership stake, the greater the ease with which shareholders can control the company.

Legislation requires disclosure of ownership once its size reaches or exceeds specific thresholds. What, where, when, and to whom disclosure needs to be made depends upon ownership thresholds. These thresholds are summarized in Table 2.

Table 2: Ownership Disclosure Thresholds			
Threshold	Who Should Disclose	What Should be Disclosed	To Whom and Where to Disclose
One share	Nominal holders	Beneficial owners	Notification to the Registrar of the company. <sup>38</sup>

<sup>38</sup> Law on the Securities Market, Article 8, Clause 2.



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Table 2: Ownership Disclosure Thresholds			
Threshold	Who Should Disclose	What Should be Disclosed	To Whom and Where to Disclose
5% of the charter capital or 5% of common shares <sup>39</sup>	The company	Personal data, the size of the stake in the charter capital, and the amount of common shares, the dynamics of changes in the list of owners of 5% and the size of holdings	To the FCSM. In the prospectus and quarterly reports, and on the company website.
5% of the charter capital or 5% of common shares if shareholders are legal entities	The company	Information on the owners of 20% of the charter capital or common shares in the company-shareholder, as well as the size of the stake in the charter capital and the amount of common shares (chain shareholding)	To the FCSM. In the prospectus and quarterly report, and on the company website.
20% of voting shares	The company	Information on the owners of 20% of voting shares	To the FCSM. In the List of Related Parties and on the company website.
20% and more of securities other than non-convertible bonds <sup>40</sup>	The owner	The holding of securities/the acquisition of securities	To the FCSM, not later than five days after the thresholds are reached; <sup>41</sup> as well as to the antimonopoly body. <sup>42</sup>
20% of voting shares	The legal entity — owner	On legal entities that own 20% of voting shares in the company	To the Supervisory Board, Revision Commission, and External Auditor.
The acquisition of any 5% of securities above 20% as well as the sale of 5% if the remaining stake is higher than 20%	The owner	On the acquisition and/or sale	To the FCSM not later than five days after the thresholds are reached. A special notification form is used for this purpose.
Owning 25% of securities of any type <sup>43</sup>	The company	The holding of securities	To the FCSM. In the material events reports.

<sup>39</sup> Law on the Securities Market, Article 22, Clause 8; Article 30, Clause 5.

<sup>40</sup> Law on the Securities Market, Article 30, Paragraph 14.

<sup>41</sup> Law on the Securities Market, Article 30, Paragraph 15.

<sup>42</sup> Law on Competition, Article 18, Clause 1.

<sup>43</sup> Law on the Securities Market, Article 30, Paragraph 12.

Information about the identity of “formal” shareholders is a prerequisite since they can exercise voting and dividend rights related to the shares they hold. But it may not be sufficient to work out the actual ownership and control structure because, if the “formal” shareholder is controlled by another person (the beneficial owner), it is the beneficial owner who can influence the behavior of “formal” shareholders and eventually control voting rights. Even more important, several “formal” shareholders can be controlled by the same beneficial owner. In such case, the real voting power of the beneficial owner consists of the sum of voting rights held by several “formal” shareholders. It is therefore necessary to know the identity of the beneficial owner and then attribute all the stakes held by the “formal” shareholders to him.

**Best Practices:** Companies seeking to disclose their ownership structure may wish to follow examples under U.S. and EU regulations.

U.S. regulations define a beneficial owner as any person who, directly or indirectly, through any contract arrangement, understanding, relationship, or otherwise has or shares:<sup>44</sup>

- Voting power, which includes the power to vote, or to direct the voting of, such a security; and/or
- Investment power that includes the power to dispose, or direct the disposition of, such security.

U.S. securities law states that any person who is directly or indirectly the beneficial owner of more than 5% of any equity security of a class, shall notify the issuer and each exchange where the security is traded of such acquisition within 10 days, as well as of any increase or decrease by 1% of more.<sup>45</sup> If the beneficial owner acts in concert with other institutions or persons, their names and the relationship with the beneficial owner must be disclosed.

The EU Transparency Directive of 2001 provides a framework for disclosure.<sup>46</sup> In summary:

1. Article 9 stipulates that investors must disclose the acquisition or disposal of major shareholdings in listed companies, based on thresholds starting at 5% continuing at intervals of 5% until 30% of voting rights, or charter capital or both.

<sup>44</sup> 17 Code of Federal Regulations (CFR), 240/ 13d-3(a).

<sup>45</sup> U.S. Securities and Exchange Act 1934, Sec. 13d-1,2; 17 CFR 240, 13d-2.

<sup>46</sup> See also: [http://europa.eu.int/eur-lex/en/consleg/pdf/2001/en\\_2001L0034\\_do\\_001.pdf](http://europa.eu.int/eur-lex/en/consleg/pdf/2001/en_2001L0034_do_001.pdf).

2. Article 11(2) shortens the reporting obligation of the acquirer to the company and the competent regulatory authority from seven calendar days to five business days on the one hand and, on the other, of the company to the public from nine calendar days to three business days.
3. Article 2 extends the definition of “security holder” to include custodians and those holding securities for clearing and settlement purposes.
4. Finally, Article 11(5) extends notification requirements to various classes of shares, such as warrants and convertible bonds if the holdings reach or fall below the thresholds defined in Article 9.

Six Member States have already introduced this Directive by law or regulation. In addition, the EU Takeover Bids Directive’s Article 10 regulates transparency issues, including the disclosure of beneficial ownership structures, and listed companies in the EU are thus required to disclose information in their annual report on, *inter alia*:

1. The structure of their capital;
2. Any restrictions on the free transferability of securities;
3. Significant direct and indirect shareholdings (including pyramid schemes and cross-shareholdings);
4. The holders of any securities with special control rights;
5. The system of control of any employee share scheme where the control rights are not exercised directly by employees;
6. Restrictions on voting rights;
7. Shareholder agreements that are known to the company;
8. The rules governing the appointment and replacement of Supervisory Board members;
9. Significant agreements made by the company that take effect upon a change of control; and
10. Compensation agreements between the company and its directors in the case of a successful takeover bid.

Russian legislation requires timely disclosure of information regarding beneficial owners. In particular, the Company Law requires the nominal shareholder to disclose information to the company on persons on whose behalf he holds shares for the purposes of compiling the shareholder list for the GMS and distributing dividends.<sup>47</sup>

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<sup>47</sup> LJSJ, Article 51, Clause 2; Article 42, Clause 4, Paragraph 2.

**Best Practices:** Opaque ownership structures continue to preoccupy the corporate governance debate since a considerable percentage of shares of Russian companies remain offshore with their true — or beneficial — owners hidden.

Offshore structures can have legitimate uses. However, they are often used to conceal the identity of the owners of interests in underlying pools of assets and related parties, and tend to be associated with perceptions of tax-fraud, self-dealing, money laundering, illicit capital export, and other generally recognized unsavory business practices. International accords are making it increasingly difficult to use such structures for illegitimate purposes.

Russian companies wishing to comply with good corporate governance practices should disclose their ownership structure, including beneficial owners, in a transparent manner.

### b) Indirect Control

Shareholders owning less than the majority of shares can exercise indirect control over the company through pyramid structures and/or cross shareholdings. Relationships with related parties may also alter the control structure of the company. For these reasons, information on indirect ownership, related parties, and related party transactions should be fully disclosed, specifically in the annual report,<sup>48</sup> quarterly reports,<sup>49</sup> material events report,<sup>50</sup> and other notifications to regulators or creditors.<sup>51</sup> Legal requirements are summarized in Figure 1.

<sup>48</sup> FCSM Regulation No. 17/ps, Section 3.6.

<sup>49</sup> Law on the Securities Market, Article 22, Clauses 8 and 11; FCSM Regulation No. 03-32/ps, Annex 13.

<sup>50</sup> Law on the Securities Market, Article 30, Paragraph 12; FCSM Regulation No. 03-32/ps, Section 11.4.

<sup>51</sup> LJSC, Article 15, Clause 6, Paragraph 1; Law on Competition, Article 18, Clause 1.

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**Figure 1: Disclosure of Indirect Ownership, Related Parties, and Related Party Transactions**

	Quarterly Report	Material Events Report	Annual Report	Notification of Regulators and Creditors
<b>Interest of Supervisory Board and executive body members in the charter capital</b>	✓	Acquisition of securities (see Table 2)	✓	Buyback of securities (see Table 2)
<b>Dependent companies with 5% or more participation</b>	✓	Not applicable (n/a)	n/a	n/a
<b>Owners of 20% + of shares in a company – shareholder who, in turn, own 5% + of the company's charter capital or common shares (chain shareholding)</b>	✓	n/a	n/a	n/a
<b>Reorganization of the company, its subsidiaries, or dependent companies</b>	n/a	✓	n/a	To creditors: reorganization of the company
<b>Related party transactions</b>	✓	n/a	✓	n/a
<b>Related parties</b>	Only if related parties are debtors of the company	n/a	n/a	n/a
<b>Acquisition of the company's assets or rights to determine the conditions of the company's business activities</b>	Transactions that impose obligations covering 10% or more of the company's assets	<ul style="list-style-type: none"> <li>• Acquisition of assets entailing a one-time increase/decrease in the value of the company's assets by 10% and more;</li> <li>• A one-time transaction involving 10% and more of the company's assets</li> </ul>	List of extraordinary and similar transactions	<ul style="list-style-type: none"> <li>• Acquisition of assets if their book value exceeds 10% of the book value of the selling company's fixed and/or intangible assets;</li> <li>• Acquisition of rights providing the possibility to determine the conditions of the company's business activity or to act as its executive body</li> </ul>

Source: IFC, March 2004

**Best Practices:** In addition to the above-mentioned statutory requirements, companies should disclose the following material events related to beneficial shareholdings:<sup>52</sup>

- Transactions involving company property, the value of which is equal to, or in excess of, 2% of the non-current assets and/or which can materially influence the market price of the company's shares;
- Buyback by the company of its shares (unless connected with the reduction of the charter capital); and
- Other transactions that can materially affect shareholder interests.

Companies should further disclose information regarding the buyback of company shares and the most important transactions in the annual report.<sup>53</sup>

Finally, a list of the company's related parties should be submitted by the company to the FCSM on a quarterly basis.<sup>54</sup>

→ *For more information on the procedure to disclose the company's related parties, see Section C.5 of this Chapter.*

### c) Shareholder Agreements and Voting Caps

Shareholder agreements, voting caps, and caps of shareholdings can also affect control. Shareholder agreements typically oblige parties to vote as a block and may give first-refusal rights for the purchase of shares to another shareholder. Shareholder agreements can cover many issues including which candidates to nominate for the Supervisory Board or the selection of the Chairman.

**Best Practices:** Russian legislation does not provide for the disclosure of shareholder agreements. Shareholder agreements, however, are clearly of material interest to shareholders. While difficult to detect, companies should make reasonable efforts to obtain information about the existence of shareholder agreements and to disclose such information to all shareholders.<sup>55</sup> In principle, parties to shareholder agreements should voluntarily disclose this information themselves.

<sup>52</sup> FCSM Code, Chapter 7, Section 2.3.

<sup>53</sup> FCSM Code, Chapter 7, Section 3.3.2 and 3.3.4.

<sup>54</sup> LJSC, Article 93, Clause 4; FCSM Regulation No. 03-19/ps on the Disclosure of Information about Affiliated Persons of Open Joint Stock Companies (FCSM Regulation No. 03-19/ps), Section 4.

<sup>55</sup> FCSM Code, Chapter 7, Article 2.1.4

Voting caps limit the number of votes that a shareholder may cast regardless of the number of shares he actually possesses. As such, caps go against the principle of one share — one vote and control that is proportional to ownership. Voting caps are often used to either entrench the position of existing controlling shareholders or management, and are rarely supported by good faith investors.

Russian law allows voting caps and caps of shareholdings to be established, however, requires the company to disclose such caps in its charter.<sup>56</sup> Caps should also be disclosed in the prospectus and quarterly reports.<sup>57</sup>

### 4. Information on Directors and Executives

#### a) Personal Data

Investors and shareholders should have access to relevant information about Supervisory Board members and key executives to evaluate their experience and qualifications. Educational background, current occupation, and professional experience of directors and senior executives should be disclosed and readily accessible to interested parties. It is also important that shareholders and investors have information about any (existing or potential) conflicts of interest that may affect the independence and decision-making capacity of the Supervisory Board and Executive Board.

Shareholders should also be able to assess whether or not Supervisory Board and Executive Board members dedicate sufficient time to their duties and properly carry out their responsibilities. Accordingly, companies should disclose all other Board positions held by Supervisory or Executive Board members in other companies (domestic and foreign), and the meeting attendance records.

Table 3 summarizes the legal disclosure requirements for members of the Supervisory and Executive Boards in the quarterly report,<sup>58</sup> annual report,<sup>59</sup> the list of related parties,<sup>60</sup> and in notifications to regulators.<sup>61</sup>

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<sup>56</sup> LJSC, Article 11, Clause 3.

<sup>57</sup> Law on the Securities Market, Article 22, Clause 8.

<sup>58</sup> Law on the Securities Market, Article 22, Clause 7; Article 30, Paragraph 5; FCSM Regulation No. 03-32/ps, Annex 11, Section V.

<sup>59</sup> FCSM Regulation No. 17/ps, Section 3.6.

<sup>60</sup> FCSM Regulation No. 03-19/ps, Section 4.

<sup>61</sup> Law on Competition, Article 18, Clause 6.

Table 3: Disclosures on Supervisory and Executive Board members				
	Quarterly Report	Annual Report	List of Related Parties	Notification of Regulators
Full name of all individuals	✓	✓	✓	n/a
Current positions	✓	n/a	n/a	Election of an individual into executive bodies and Supervisory Board of two or more companies
Positions for the last five years	✓	n/a	n/a	n/a
Brief biographical data	n/a	✓	n/a	n/a
Kinship of Supervisory and Executive Board members and the Internal Auditor	✓	n/a	n/a	n/a

**Best Practices:** Legal disclosure requirements clearly fall short of best practices. According to the FCSM Code, companies should also disclose the following information in its annual report:<sup>62</sup>

- Other key officials of the company, including their curriculum vitae;
- Information about all transactions between these other key officials and the company;
- Age, profession, employment, and citizenship of each Supervisory Board member, as well as all other positions, the date of initial appointment, and the current term of appointment; and
- Information on all claims filed in Russian or foreign courts (or arbitration tribunals) against Supervisory and Executive Board members and/or the General Director.

### b) Remuneration

Incentive remuneration schemes are common in many countries and come in many varieties. Few companies have such arrangements that are identical to one another.

Executive remuneration plans are usually put in place in an effort to motivate executives, and better align their interests with the interests of shareholders. They

<sup>62</sup> FCSM Code, Chapter 7, Article 3.3.3.



normally include performance based bonuses. Incentive remuneration schemes may not be the most effective way of alleviating inherent conflicts of interests and, in any event, should always be subject to careful legal and financial examination and the approval of both the Supervisory Board and the GMS.<sup>63</sup> Remuneration plans for non-executive directors will differ considerably.

In Russia, companies must disclose aggregate data on the amount of remuneration for each governing body during the last completed fiscal year in the prospectus and quarterly report, as well as existing agreements regarding such payments in the current fiscal year.<sup>64</sup>

**Best Practices:** The remuneration of Supervisory Board members and key executives is disclosed on an individual basis in some countries, putting shareholders in a better position to assess the extent to which an individual's remuneration is justified in view of his responsibility and/or performance. It also allows shareholders to hold executives and Supervisory Board members fully accountable for the performance of their duties.

- With respect to executive remuneration plans, shareholders and investors should have sufficient information to properly assess their costs and benefits to the company, and the relation between the performance of the company, on the one hand, and the level of executive remuneration, on the other.
- At some point, the independence of non-executive directors may be compromised if they earn a significant amount of their total income from their Board activities. Some countries have monetary thresholds that serve as convenient “rules of thumb” or warning signals. While numerical thresholds may be a reasonable starting point, judgments on independence will, of course, require a much more sophisticated analysis. The disclosure of a non-executive director's remuneration remains critical in order to judge the extent to which their independence may be compromised.

Companies should not only be transparent with respect to the levels of remuneration but also the methods for determining remuneration. The criteria for determining the amount of remuneration for Supervisory Board members, the General Director and/or Executive Board members — as well as the total amount

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<sup>63</sup> FCSM Code, Chapter 4, Section 5.1.2.

<sup>64</sup> Law on the Securities Market, Article 22, Clause 7; FCSM Regulation No. 03-32/ps, Annex 11, Section V.

of remuneration paid or to be paid depending on the results of the reporting year — must be disclosed in the annual report.<sup>65</sup>

**Best Practices:** To adhere to the spirit of full disclosure of remuneration, companies may find it necessary to disclose information regarding the remuneration of other company officials who are not part of the Executive or Supervisory Boards.<sup>66</sup>

→ *For more information on non-executive and executive remuneration practices, see Part II, Chapter 4, Section H and Chapter 5, Section G, respectively.*

### 5. Material Foreseeable Risk Factors

Risk (along with return) is one of the most important considerations for any investor. Risks may include particular industry risks as well as political, commodities, derivatives, environmental, market, and interest and currency fluctuation risks. In short, risk is an omnipresent feature of business activity.

Risk is, by its very nature, forward looking and extremely difficult to quantify. Nevertheless, companies are required to describe material risks in their annual reports.<sup>67</sup> Specific industry, country and regional risks, as well as financial and legal risks all need to be disclosed in prospectuses and quarterly reports.<sup>68</sup>

→ *For more information on how to manage risk, see the model by-law on risk management in Part VI, Annex 27.*

### 6. Employees and Other Stakeholders

Russian law requires the prospectus and quarterly reports to contain information on the following issues regarding employees, creditors, and other company stakeholders:<sup>69</sup>

<sup>65</sup> FCSM Regulation No. 17/ps, Section 3.6.

<sup>66</sup> FCSM Code, Chapter 7, Section 3.3.3.

<sup>67</sup> FCSM Regulation No. 17/ps, Section 3.6.

<sup>68</sup> Law on the Securities Market, Article 22, Clause 4; FCSM Regulation No. 03-32/ps, Annex 11, Article 2.5.

<sup>69</sup> Law on the Securities Market, Article 22, Clauses 7–8; FCSM Regulation No. 03-32/ps, Annex 11, Sections 5.7, 5.8, 2.1, 2.3.

- Number of employees, and any material changes in that number;
- General or aggregated data on educational background, composition of personnel, salaries and wages paid, and social insurance;
- Employee share ownership and stock option plans;
- List of debtors whose debts exceed 10% of accounts receivable; and
- Amount and structure of accounts payable.

Company employees and creditors are further entitled to access information on reorganization, bankruptcy, and liquidation issues.<sup>70</sup>

Strictly speaking, most of the information on employees and other stakeholders may not be “material” according to the accounting or financial definitions of the term. On the other hand, information about the company’s employees, creditors, and suppliers, as well as the company’s relationship with local communities, can be “material” to other constituencies. Employees are also users of information, and disclosure helps them to make better employment decisions, protect themselves in the workplace, and participate in other aspects of company life. Stakeholder disclosure is becoming increasingly common as an issue of interest and attention worldwide.

**Best Practices:** While some forms of stakeholder disclosure are required by law, it is good practice to provide stakeholders with other relevant information. For example, stakeholder disclosure might include the health protection of employees, safety conditions in the workplace, and environmental or community impact statements.<sup>71</sup>

→ *For more information on the importance of stakeholder issues, see Part I, Chapter 1, Section A.2. See also Part VI, Annex 5 for a model company code of ethics.*

## 7. Corporate Governance Structures and Policies

When assessing a company’s governance structure, market participants may want to obtain information on the company’s governing bodies, including the division of authority between shareholders, directors, and executives, as well as on the

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<sup>70</sup> On information disclosure to employees, see Labor Code, Article 53.

<sup>71</sup> FCSM Code, Chapter 7, Section 3.3.5.

company's corporate governance policy, its commitment to corporate governance principles, and compliance mechanisms.

The charter is the document that sets the rules and procedures of the company's governance system. It is a fundamental document of the company that is to be made publicly available. Company-level corporate governance codes also serve to highlight general corporate governance concepts and structures. By-laws finally provide more detailed guidance on processes.

→ *For more information on the charter, see Part I, Chapter 3, Section A. See also Part VI, Annex 2 for a model company charter.*

Most recently, Russian companies are required to disclose whether they follow FCSM Code provisions in their annual reports on a “comply or explain” basis.<sup>72</sup> Comply or explain means that while compliance is not mandatory, the reasons for non-compliance with the FCSM Code should be explained.

**Best Practices:** It is necessary to disclose information about corporate conflicts resulting from improper implementation by the company of those FCSM Code recommendations that the company declared binding upon itself in one form or another.<sup>73</sup>

### a) Commitment to Corporate Governance

Markets are keenly interested in understanding the level of a company's commitment to good governance practices. They wish to determine whether a company sees governance as a public relations, “box-ticking,” or “window-dressing” exercise, or whether the company is in fact willing “to do right” by shareholders, and to institute and implement real change as necessary and appropriate. While good disclosure, in and of itself, is not sufficient to consistently and uniformly ensure good corporate governance, it is clearly one way of demonstrating the commitment a company is willing and able to make to its shareholders and to its other stakeholders.

<sup>72</sup> FCSM Regulation No. 17/ps, Section 3.6; FCSM Instruction No. 03-849/r on Methodological recommendations on the content and the form of disclosure of information on the compliance with the Code of Corporate Conduct in Annual Reports of joint Stock Companies, 30 May 2003, Section 5; FCSM Code, Chapter 7, Section 3.3.6.

<sup>73</sup> FCSM Code, Chapter 7, Section 3.3.6.

→ For more information on how a company can properly express its commitment to corporate governance, see the IFC corporate governance progression matrix in Part VI, Annex 1.

### b) Corporate Governance Structures

Companies must describe their governance structures, including the authority of each governing body and internal control mechanisms, in their prospectus and quarterly reports.<sup>74</sup> Companies must also describe the procedures for calling and conducting their GMS in these documents,<sup>75</sup> and disclose GMS decisions in material events reports.<sup>76</sup>

**Best Practices:** Companies should disclose information about changes in the identity of (or contractual arrangements with) the company's External Auditor, Registrar, or depository in their material events reports.<sup>77</sup>

### c) Corporate Governance Policies

Companies should disclose their corporate governance policies, and provide interested users with easy and inexpensive access to this information.

**Best Practices:** The FCSM Code recommends companies to develop disclosure policies that should be approved by the Supervisory Board and be binding upon the company.<sup>78</sup> Some of the provisions suggested by the FCSM Code for inclusion in company policies include:<sup>79</sup>

- List of information the company intends to disclose;
- Rules for communicating with the mass-media, as well as the sources and regularity of communications;
- Media contacts, including press conferences, publications, brochures, and booklets;

<sup>74</sup> Law on the Securities Market, Article 22, Clause 7; FCSM Regulation No. 03-32/ps, Annex 11, Section 5.4.

<sup>75</sup> FCSM Regulation No. 03-32/ps, Annex 11, Section 8.1.4.

<sup>76</sup> Law on the Securities Market, Article 30, Paragraph 12; FCSM Regulation No. 03-32/ps, Section 6.2.1.

<sup>77</sup> FCSM Code, Chapter 7, Section 2.3.

<sup>78</sup> FCSM Code, Chapter 7, Section 1.1.1.

<sup>79</sup> FCSM Code, Chapter 7.

- The requirement for executive bodies to conduct meetings for shareholders and analysts;
- Procedures for answering questions from all shareholders;
- List of information, documents, and materials to be provided to all shareholders for the GMS;
- List of confidential information; and
- Procedures for the identification and treatment of insider information.

In addition, companies should consider disclosing other internal policies or by-laws such as a code of ethics, environmental policies, and the by-laws for the Supervisory Board and its committees among others.

→ *For more information on company policies and by-laws, see Part I, Chapter 3. For a model code of ethics, see Part VI, Annex 5. For a set of model by-laws for the Supervisory Board, as well as its committees, see Part VI, Annexes 6 through 10.*

### C. Mandatory Disclosure

Russian legislation provides different forms and procedures for mandatory disclosure. Companies will, at various times, have to report to regulatory authorities, respond to information requests from shareholders or other stakeholders, or disclose the occurrence of specific events. This section describes the procedural requirements for the following forms of mandatory disclosure:

- Disclosure during securities placement, specifically the prospectus;
- Quarterly reports;
- Material events reports;
- Providing documents and information to shareholders through the annual report;
- List of related parties;
- Notification of regulators;
- Notification of creditors; and
- Providing information to the company's employees.

### 1. Disclosure During the Placement of Securities

#### a) The Prospectus

Companies must prepare and register prospectuses under certain circumstances.<sup>80</sup> A prospectus provides material information on the company so that investors can make informed decisions on the merits of potential investments. Prospectuses set forth the nature and object of shares, debentures, or other securities, and the investment and risk characteristics of the issue. Investors must be furnished with a prospectus before purchasing securities.

→ *For more detailed information on the prospectus, see Part III, Chapter 11, Section C.*

#### b) Decisions and Events to Be Disclosed

Russian legislation and regulations impose certain disclosure requirements on companies when issuing securities. The FCSM requires a number of events to be disclosed in the mass media:<sup>81</sup>

- The decision to place securities;
- The decision to issue securities;
- State registration of the issue;
- Start and completion of the placement; and
- State registration of the report on the results of the issue.

Figure 2 summarizes events that the company must disclose on its corporate website,<sup>82</sup> website ticker,<sup>83</sup> in the mass media,<sup>84</sup> and to interested parties.<sup>85</sup> Similar requirements apply to the disclosure of amendments or suspension of issues.<sup>86</sup>

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<sup>80</sup> Law on the Securities Markets, Article 19, Clause 2.

<sup>81</sup> FCSM Regulation No. 03-32/ps, Section II.

<sup>82</sup> FCSM Regulation No. 03-32/ps, Sections 1.6, 2.2.2, 2.3.2, 2.4.2, and 2.5.2.

<sup>83</sup> FCSM Regulation No. 03-32/ps, Section 1.4. The FCSM has authorized the Interfax and AK&M agencies whose website tickers must be used for disclosure.

<sup>84</sup> FCSM Regulation No. 03-32/ps, Section 1.7. In the case of an open subscription, the company must publish an announcement in a journal with a circulation of not less than 10,000 copies. In the case of closed subscription, in a publication with a print run of not less than 1,000 copies. Additionally, the announcement must be published in the Supplement to the Vestnik of the FCSM.

<sup>85</sup> FCSM Regulation No. 03-32/ps, Section 1.9.

<sup>86</sup> FCSM Regulation No. 03-32/ps, Section 2.5.

**Figure 2: Disclosure During Security Placements**

Events	Website Ticker	Mass Media	Corporate Website	Access to Copies
<b>Decision to place securities</b>	One day after the date of the minutes	Not later than five days after the date of the minutes	Not later than three days after the date of the minutes	Within seven days of the request
<b>Decision to issue securities</b>	One day after the date of the minutes	Not later than five days after the date of the minutes	Not later than three days after the date of the minutes	Within seven days of the request
<b>State registration of securities issue</b>	One day after the date of state registration	Not later than five days after the date of state registration	Not later than three days after the date of state registration, incl. prospectus	Within seven days of the request
<b>Start of the placement</b>	Not later than five days before the date of placement	Not applicable (n/a)	Not later than four days before the date of placement	n/a
<b>Completion of the placement</b>	Next day from the date of placement of the last security or the last day of placement	Not later than five days after the date of placement of the last security or the last day of placement	Not later than three days from the date of placement of the last security or the last day of placement	n/a
<b>State registration of the report on the results of the issue</b>	One day after the date of the report's registration	Not later than five days after the date of the report's registration	Not later than three days from the date of the report's registration	Within seven days of the request

Source: IFC, March 2004

## 2. Quarterly Reports

Companies that have registered a prospectus must file quarterly reports.<sup>87</sup> The content and amount of information in the quarterly report must be consistent with the requirements established for prospectuses. The law does not require the quarterly report to include information regarding the procedure and the terms of placement of securities, as such information is included in the prospectus itself.<sup>88</sup>

<sup>87</sup> Law on the Securities Market, Article 30, Paragraph 4.

<sup>88</sup> Law on the Securities Market, Article 30, Paragraph 5.



### a) Signatories of the Quarterly Report

Both the General Director and Chief Accountant must sign quarterly reports to attest to their reliability and completeness.<sup>89</sup>

### b) Filing Quarterly Reports

Quarterly reports must be submitted to the FCSM or its regional agencies no later than 45 days after the last day of the reporting quarter.<sup>90</sup> The company must also provide access to a copy of the quarterly report at the location of its executive bodies. Copies of quarterly reports must further be provided to the owners of the company's securities at their request, within seven days from the day of the request, for a charge not exceeding the costs of copying.<sup>91</sup> Finally, the company must also publish the quarterly report on the company's website no later than 45 days after the last day of the reporting quarter.<sup>92</sup>

## 3. The Material Events Report

Companies that register a prospectus must file material events reports when significant incidents, circumstances, or events affect their activities.<sup>93</sup>

### a) Signatories of the Material Events Report

The General Director must sign the material events report. The Chief Accountant should also sign reports on material market transactions, changes in net profits; or changes in company assets.<sup>94</sup>

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<sup>89</sup> Law on the Securities Market, Article 30, Paragraph 11; FCSM Regulation No. 03-32/ps, Section 5.4.

<sup>90</sup> Law on the Securities Market, Article 30, Paragraph 10; FCSM Regulation No. 03-32/ps, Section 5.6.

<sup>91</sup> Law on the Securities Market, Article 30, Paragraph 11; FCSM Regulation No. 03-32/ps, Section 1.9.

<sup>92</sup> FCSM Regulation No. 03-32/ps, Section 5.7.

<sup>93</sup> Law on the Securities Market, Article 30, Paragraph 4; FCSM Regulation No. 03-32/ps, Section 6.

<sup>94</sup> FCSM Regulation No. 03-32/ps, Section 6.1.4.

### b) Codification of Material Events

Each material event should be reported separately.<sup>95</sup> For statistical purposes, the FCSM codifies material events reports and requires that every report be marked with a relevant code.<sup>96</sup>

### c) Filing Material Events Reports

Companies must file the material events report with the FCSM within five days of the event's occurrence. The report must also be disclosed on the website ticker the day after the event, on the corporate website no later than three days after, and in the mass media no later than five days after the day of its occurrence.<sup>97</sup>

Companies must provide access to a copy of material events reports at the location of its executive bodies. Copies of reports must be provided to the owners of the company's securities at their request within seven days from the day of the request, for a charge not exceeding copying costs.<sup>98</sup>

## 4. Information for Shareholders Through the Annual Report

Companies are obliged to provide shareholders with access to corporate documents, regardless of the number of shares owned.<sup>99</sup>

Arguably, the most important document to be provided to shareholders is the company's annual report. It is a formal record of a company's financial condition that must be distributed to shareholders under the Company Law and FCSM regulations. Included in the report is a description of company operations as well as a balance sheet, income statement, and the other items listed above (in this Chapter's Section B.1 on Financial and Operating Results).

<sup>95</sup> FCSM Regulation No. 03-32/ps, Section 6.1.6.

<sup>96</sup> FCSM Regulation No. 03-32/ps, Section 6.2.

<sup>97</sup> Law on the Securities Market, Article 30, Paragraph 13; FCSM Regulation No. 03-32/ps, Sections 6.3.1 and 6.3.2. Additionally, the report must be published in the Supplement to the Vestnik of the FCSM. (FCSM Regulation No. 03-32/ps, Section 1.7).

<sup>98</sup> Law on the Securities Market, Article 30, Paragraph 11; FCSM Regulation No. 03-32/ps, Section 1.9.

<sup>99</sup> LJSC, Article 91.

The annual report is a shorter and more easily digestible version of more detailed financial information filed with the FCSM. Annual reports increasingly include forward-looking and qualitative information that is important to readers. They must be signed by the company's General Director and the Chief Accountant, and must receive the preliminary approval of the Supervisory Board before being submitted to the GMS for final approval.<sup>100</sup>

→ *For more information on shareholder rights and the GMS, see Part III, Chapters 7 and 8 respectively. For more information on the annual report, see Part VI, Annex 29.*

### 5. The List of Related Parties

All companies must disclose information on related parties on a quarterly basis, including personal data, grounds, and duration of affiliation.<sup>101</sup>

#### a) Signatories to the List of Related Parties

The General Director must attest to the reliability and completeness of the information included in the list of related parties by signing this list.<sup>102</sup>

#### b) Disclosure of the List of Related Parties

Companies must submit the list of related parties to the FCSM or its regional agencies no later than 45 days after the last day of the reporting quarter. The FCSM is, in turn, required to disclose these lists by posting them on its website.<sup>103</sup>

#### c) The List of Related Companies

Companies which have securities listed on either RTS or MICEX are additionally obliged to disclose the list of related parties (as well as any changes to the list for at least the last three years) on their corporate website with subsequent notification to the FCSM.<sup>104</sup>

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<sup>100</sup> FCSM Regulation No. 17/ps, Section 3.7.

<sup>101</sup> LJSC, Article 93, Clause 4; FCSM Regulation No. 03-19/ps, Section 4.

<sup>102</sup> FCSM Regulation No. 03-19/ps, Section 7.

<sup>103</sup> See [www.fcsm.ru](http://www.fcsm.ru). FCSM Regulation No. 03-19/ps, Section 5.

<sup>104</sup> FCSM Regulation No. 03-19/ps, Sections 3 and 8.

→ For more detailed discussion on the importance of disclosing related party transaction, see Section B.3 in this Chapter, as well as Part III, Chapter 12, Section C.

### 6. Notification to Regulators

Companies must notify regulatory bodies such as the FCSM and the Ministry of Antimonopoly Policy and Support of Entrepreneurial Activities (MAP).<sup>105</sup>

#### a) Notification to the FCSM

The owner of securities must notify the FCSM about changes in his shareholdings beyond 20% of voting shares within five days from the date of the change. The notification should include general information about the owner and securities under consideration.<sup>106</sup>

#### b) Notification to the MAP

Notification is required if the total book value of the assets of the acquirer and acquired company exceeds 100 thousand times the minimum monthly wage. The MAP must be notified within 45 days from the date of purchasing 20% and more of voting shares.

The company is also required to notify the MAP within 45 days of the election of an individual to the executive bodies or Supervisory Board of two or more companies with a total book value of assets exceeding 100 thousand times the minimum monthly wage. The same holds true for companies included in the register of companies having more than 35% of the market share of certain goods.<sup>107</sup>

In practice, the book value thresholds are so low that virtually any combination of publicly traded companies, or election to the Supervisory Board, triggers notification requirements.

Notification must include the formal application of the interested person. The notification must also include information about the company's main activities, its production volumes and the distribution of its products in corresponding goods markets, as well as other information required by the MAP.<sup>108</sup>

<sup>105</sup> Law on the Securities Market, Article 30; Law on Competition, Article 18.

<sup>106</sup> Law on the Securities Market, Article 30, Paragraph 15.

<sup>107</sup> Law on Competition, Article 18, Clause 6.

<sup>108</sup> Order of MAP No. 276 on the Adoption of the Regulation about the Procedure of Submitting Notifications and Petitions to Antimonopoly Bodies in accordance with Articles 17 and 18.

## 7. Notification to Creditors

Creditors are notified through personal notification and publication of announcements in the press. Figure 3 summarizes the requirements for the notification of creditors when the company decreases its charter capital,<sup>109</sup> reorganizes,<sup>110</sup> liquidates,<sup>111</sup> or enters into bankruptcy proceedings.<sup>112</sup>

**Figure 3: Notification to Creditors**

		Decrease in Charter Capital	Reorganization	Liquidation	Bankruptcy
Form of Notification	Individually	✓	✓	✓	✓
	Via Press	✓	✓	✓	✓
Deadlines		30 days	30 days	not defined	Three days
Responsible Body		General Director	General Director	Liquidation Commission	Bankruptcy Administrator

Source: IFC, March 2004

## 8. Providing Information to Company Employees

Employees represent a specific class of information users. One of their rights is to receive information affecting their interests. The representatives of the company's employees, usually members of the local trade union (but other representatives may be elected by employees) have the right to receive information from their employer regarding the following issues:<sup>113</sup>

- Reorganization and liquidation of the company;
- Introduction of technological changes leading to changes in labor conditions;
- Continuous professional education (CPE) to advance professional skills; and

<sup>109</sup> LJSC, Article 30, Clause 1.

<sup>110</sup> LJSC, Article 15, Clause 6, Paragraph 1.

<sup>111</sup> LJSC, Article 22, Clauses 1 and 3.

<sup>112</sup> Law on Insolvency, Article 54.

<sup>113</sup> Labor Code, Article 53, Clause 2.

- Other issues stipulated by Russian legislation, internal corporate documents, and collective bargaining agreements.

Employee representatives are entitled to make suggestions on these issues to the governing bodies and participate in their meetings when these issues are considered.<sup>114</sup> Finally, the company is required to provide employee representatives with full and reliable information needed for the conclusion of collective bargaining agreements and the supervision of their fulfillment.<sup>115</sup>

### D. Voluntary Disclosure

It is good practice for companies to voluntarily disclose material information beyond formal legal requirements. This holds particularly true for companies operating in emerging markets that are often marred by weak legal and regulatory environments, and, moreover, poor enforcement mechanisms. To the extent possible, companies are encouraged to use existing forms of disclosure (e.g., prospectuses, and quarterly, annual, and material events reports) and adhere to the same quality standards that are demanded for these forms of reporting. They are also encouraged to use existing channels of communication, such as the internet and the print media. This section describes disclosure practices of Russian companies in the mass media and the internet.

#### 1. Corporate Websites

Corporate websites are easily accessible to the public at low cost, and can be an exceptionally powerful means of communication. At present, the internet is beginning to be accepted as an official disclosure channel. Web-based disclosure is being studied closely by securities commissions worldwide.

**Best Practices:** The following information should be placed on the company's website:<sup>116</sup>

- The company's charter and amendments thereto;
- Information on the company's development strategy;
- Quarterly reports;

<sup>114</sup> Labor Code, Article 53, Clause 3.

<sup>115</sup> Labor Code, Article 22, Clause 2.

<sup>116</sup> FCSM Code, Chapter 7, Article 1.1.2.

- Prospectuses;
- External Auditor's reports;
- Information on material events;
- Information regarding the GMS; and
- Important Supervisory Board decisions.

The company should also place the annual report on its website.

The internet is an effective tool for rapid and cost-effective communications and is increasingly used by Russian companies for voluntary disclosure.

**Company Practices in Russia:** Some Russian companies place their annual and financial reports, and governance information (such as information on Supervisory Board members and key executives) on their websites. The better websites have special sections devoted to corporate governance and include contact addresses and telephone numbers for inquiries.

Some Russian companies are already following best practices and disclose additional information on their websites, including:<sup>117</sup>

- Financial statements for the last three years;
- Financial ratios for the last three years;
- Internal corporate documents;
- Structure, authorities, and composition of the governing bodies;
- List of affiliated persons for the last year;
- Annual and quarterly reports for the last three years;
- Materials and results of the GMS for the last three years;
- Information on corporate securities; and
- Corporate news ticker.

## 2. SKRIN "Emitent"

**Company Practices in Russia:** Russian companies are increasingly disclosing information through the Internet using SKRIN ("System of Complex Disclosure of News Information"). SKRIN was founded by the National Association of Stock Market Participants (NAUFOR), which is now part of the RTS Group.

<sup>117</sup> Based on the results of the 6th all-Russia competition on annual reports and corporate websites. See also: [www.rts.ru/?tid=394&mtid=10000](http://www.rts.ru/?tid=394&mtid=10000).

The heart of SKRIN is a database called SKRIN “Emitent” (“Issuer”).<sup>118</sup> Companies contract for SKRIN’s services and furnish it with corporate information. SKRIN subscribers are then granted access to the following company-specific information:

- Company charters;
- Quarterly reports;
- Accounting reports, drawn up in accordance with RAS and IFRS; and
- Material events reports.

Some companies pay SKRIN for the expenses related to the dissemination of information and in this way allow users to access their information free of charge.

### 3. Mass Media

The print media are an additional channel for disclosure. Although publication may entail additional costs, it is a recognized legal channel for disclosure and (unlike the internet, which is passive) ensures the active dissemination of information among the public.

Most companies disclose information about new products, major contracts, acquisitions, financial results, production plans, and securities issues in the print media.

**Best Practices:** The FCSM Code considers financial statements to be the most important document for shareholders and potential investors to understand the financial position of the company. In this respect, companies with 10,000 or more shareholders should publish their financial statements in at least two newspapers with a circulation of not less than 50,000 each. In principle, these newspapers should be accessible to the majority of the company’s shareholders.<sup>119</sup>

## E. Summary of Mandatory Disclosures

Table 4 summarizes mandatory disclosure requirements for Russian companies.

<sup>118</sup> See also: [www.skrin.ru](http://www.skrin.ru).

<sup>119</sup> FCSM Code, Chapter 7, Clause 1.1.2.



Table 4: Mandatory Disclosure									
Details/ Forms	Disclosure during placement	Quarterly report	Material events reports	List of related parties	Annual report	Notification to regulators	Notification to creditors	Info to employees	
<b>Responsible person</b>	General Director (GD)	GD after signing by Chief Accountant	GD, and Chief Accountant in particular cases	GD	GD, Corporate Secretary, or specially appointed executives	GD	GD/ Liquidation Commission/ Bankruptcy Administrator	GD or specially appointed executives	
<b>Recipients</b>	Any interested person	Any interested person	Any interested person	Any interested person through the FCSM	Shareholders	Interested persons through the FCSM, MAP	Stakeholders/ creditors	Employees	
<b>Deadline/ frequency</b>	Next day/within three and five days depending where disclosed	Not later than 45 days after the last day of the reporting quarter	Next day/ within three and five days depending where disclosed	Every quarter	Within seven days upon request/ 20 days prior to GSM	Five days — the FCSM; and 45 days — MAP	30 days, liquidation — not defined	Not applicable (n/a)	
<b>Place of disclosure</b>	Website ticker, corporate Website, mass- media	Submission to the FCSM, company's office, corporate website	Submission to the FCSM website ticker, corporate website, mass- media	Submission to the FCSM	Office of the company executive body	Notification of the FCSM and/ or MAP	Publication in mass media and personal notification	Place of employment	
<b>Financial and operating results</b>	n/a	Financial statements, ratios, composition of assets/capital	10% and more increase/ decrease of the assets value, large-scale transactions	n/a	Not defined: results of the development	n/a	n/a	n/a	

Table 4: Mandatory Disclosure								
Details/ Forms	Disclosure during Placement	Quarterly report	Material events reports	List of related parties	Annual report	Notification to regulators	Notification to creditors	Info to employees
<b>Company objectives</b>	n/a	Commercial objectives only	n/a	n/a	Commercial objectives and priority activities	n/a	n/a	n/a
<b>Major share ownership and voting rights</b>	n/a	Owners of over 5%, chain shareholding, related party transactions	Owners of more than 25% of the company's securities	List of related parties	Related party transactions	Owners/ acquirers of 20% and more of any type of securities (FCSM+MAP)	n/a	n/a
<b>Supervisory Board and key executives, remuneration</b>	n/a	Info about each member, remuneration in aggregate, size of interest	n/a	Included in the list	Biographical data, share ownership, amount of remuneration in aggregate	Directors and executives holding more than one appointment (MAP)	n/a	n/a
<b>Risk factors</b>	n/a	Risks of industry, region, currency rate fluctuation, other potential risks	n/a	n/a	Major risks affecting activity of the company	n/a	n/a	n/a

**Table 4: Mandatory Disclosure**

Details/ Forms	Disclosure during Placement	Quarterly report	Material events reports	List of related parties	Annual report	Notification to regulators	Notification to creditors	Info to employees
<b>Issues regarding employees and other stakehold- ers</b>	n/a	General information regarding employees, suppliers, debtors, and creditors	n/a	n/a	n/a	n/a	Decrease in the charter capital, reorganization, liquidation	Reorganiza- tion, liqui- dation, tech- nological reorganization, changes, CPE, foundation documents, collective bargaining agreements
<b>Governance structures and policies</b>	n/a	Authority of each governing body	n/a	n/a	Compliance with recom- mendations of the FCSM Code	n/a	n/a	n/a

The background of the page is a teal color with a faint, semi-transparent image of a magnifying glass and a pen nib. The magnifying glass is positioned in the upper left, and the pen nib is in the upper right. The text 'Chapter 14' is overlaid on this background. The word 'Chapter' is in a white, sans-serif font, and the number '14' is in a white, sans-serif font inside a dark teal square.

# Chapter 14

## Control **and Audit Procedures**

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## **The Chairman's Checklist**

- ✓ What is the relationship between the Revision Commission, Supervisory Board's Audit Committee, Internal Auditor, and/or Control and Revision Service? Have their roles and responsibilities been properly defined to avoid overlap and conflict?

### **The Revision Commission:**

- ✓ Is the Revision Commission fulfilling its function and duties? Has the Revision Commission ever found, and reported on, possible misstatements or other violations to the General Meeting of Shareholders?
- ✓ Who are the members of the Revision Commission? Are any employees members? Are the members fully independent from management?
- ✓ Does the Revision Commission meet regularly and respond to all shareholder requests and inquiries?

### **The External Audit:**

- ✓ Does the company have an independent External Auditor? Does the External Auditor provide other, non-audit services to the company that could compromise his independence? Are audit partners rotated?
- ✓ How is the External Auditor selected? Does an open tender process take place? If so, who organizes this tender process?
- ✓ To whom does the External Auditor report?
- ✓ Does the External Auditor participate in the Annual General Meeting of Shareholders and answer all questions posed by shareholders?

### **The Audit Committee:**

- ✓ Should the company's Supervisory Board have an Audit Committee? What are the costs and benefits?
- ✓ If the company has an Audit Committee, is it staffed with individuals who are independent, able, and willing to do the job properly and effectively?
- ✓ Does the Chairman of the Audit Committee have the requisite professional and human relations skills? Are Audit Committee members publicly recognized financial experts?
- ✓ Does the Audit Committee meet often enough to perform its duties effectively? Does it place the necessary and appropriate issues on the agenda?

- ✓ Does the Audit Committee add value to the Supervisory Board's discussion of audit, risk, internal control, and financial reporting?
- ✓ Does the Audit Committee receive the necessary information to perform its duties effectively? Does it have resources to hire outside accounting or legal advice?
- ✓ Does the Audit Committee perform self-evaluations on a regular basis?

### **Internal Control:**

- ✓ Does the company have a system of internal control in place? Does the company have a formal document that regulates the internal control system and procedures? Is this document periodically reviewed?
- ✓ Does the company have a risk management system in place? Does this system cover risk at the subsidiary level as well? How are business, operational, and financial risks identified?
- ✓ Does the Internal Auditor report to management or the Supervisory Board? To whom should the Internal Auditor report? Are there barriers that could discourage the Internal Auditor from reporting problems to the company?

A system for internal and external audit is an important tool both in the management and oversight of a company, and also contributes to transparent and sound financial reporting. There are a number of internal structures and external agents involved in the management and oversight of company finances and operations. These bodies are diverse in their nature, functions, and reporting lines. Some are mandatory, while others are optional.

The *Revision Commission* focuses on controlling financial and business activities of the company and monitoring compliance with laws and regulations. The mission, scope, and duties of the Revision Commission are narrower than that of the Audit Committee. The Revision Commission may: monitor compliance with regulations governing the company's business operations; express an opinion on whether reports and financial statements provide a true and accurate picture; and ascertain whether business and financial transactions are recorded properly. The Revision Commission reports to shareholders.

The *independent External Auditor* examines a company's financial and accounting records, as well as supporting documents, in all material respects. Shareholders depend upon the External Auditor to express an independent opinion that the financial statements of an enterprise are reliable.

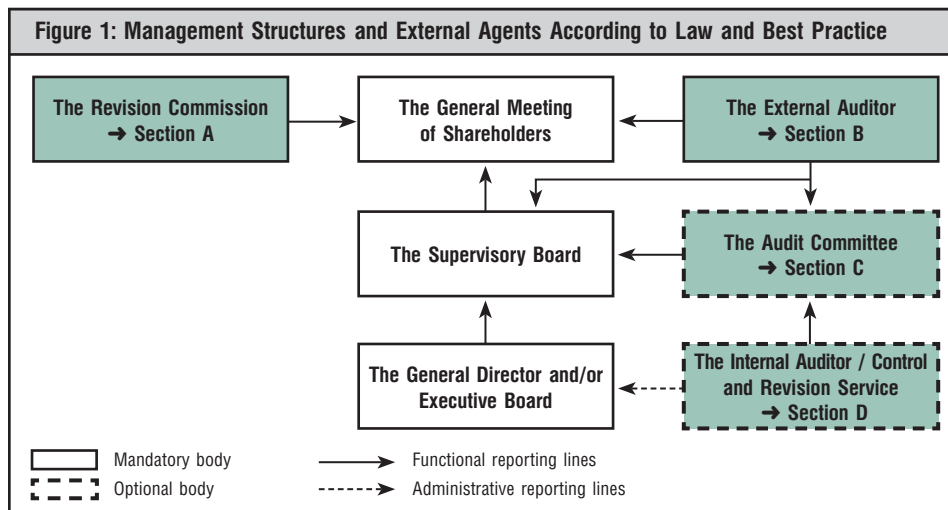
The *Supervisory Board's Audit Committee* safeguards the company by questioning executive bodies regarding the way in which financial reporting responsibilities are handled, as well as by ensuring that corrective actions are being taken. The Audit Committee oversees the Internal Auditor and the company's relations with the External Auditor. It may consider the appointment of an External Auditor, review the internal audit plan, review the effectiveness of internal control systems, consider major findings of internal audit investigations and management responses to these, and promote co-ordination between the Internal and External Auditors. Finally, the Audit Committee may consider the draft annual accounts and review the External Auditor's conclusions on annual financial statements. The Audit Committee is part of the Supervisory Board, and as such, develops recommendations for the Board's consideration; the Audit Committee consequently has no independent decision-making authority.

The *Internal Auditor* (or *the Control and Revision Service*) is responsible for the ongoing daily appraisal of the financial health of a company's operations. Company employees carry out this function. During an internal audit, Internal Auditors evaluate and monitor a company's risk management, reporting, and control practices, and make suggestions for improvement. Internal auditing not only covers the finance function, but also the company's operations and systems. The Internal Auditor reports to the Supervisory Board, ideally to its Audit Committee, on a functional basis, and to the General Director on an administrative basis.

**Best Practices:** Audit committees have only recently been introduced in Russia, where there is more experience with Revision Commissions. Questions may arise over the extent to which the responsibilities of these two bodies overlap, and which is best able to oversee the preparation of financial information and assess the systems of internal controls. At present, it appears that given the differences in their mandate, they could fulfill complementary functions. However, many experts will argue that the function of the Revision Commission does indeed overlap with the External Auditor and the Audit Committee; most countries throughout the world have chosen to strengthen the latter two, and many have chosen to abolish the Revision Commission.

This chapter discusses the role, authority, and duties of these various bodies in detail, and how they specifically contribute to company transparency and information disclosure. For an overview of these agents and their reporting lines, see Figure 1.





Source: IFC, March 2004

## A. The Revision Commission

The Revision Commission controls the operations and financial activities of the company.<sup>120</sup> Any company, regardless of its legal form (open or closed), must have a Revision Commission. Its primary function is to provide an independent opinion on the reliability of the company's financial information to the company's shareholders, as well as the company's compliance with laws and regulations during business operations.

### 1. The Composition and Requirements for Members

Revision Commissions may take a number of forms. They may be composed of a single individual or a number of individuals.<sup>121</sup>

**Best Practices:** Because Company Law does not determine the number of Revision Commission members, companies should specify the number in the charter.

<sup>120</sup> Law on Joint Stock Companies (LJSC), Article 85, Clause 1, Paragraph 1.

<sup>121</sup> When this Manual makes reference to the Revision Commission, this also includes any individual who is performing the function of a Revision Commission.

Revision Commission members should be independent of the company's management, and may not be:<sup>122</sup>

- A Supervisory Board member;
- The General Director;
- An Executive Board member; or
- A Counting Commission member.<sup>123</sup>

**Best Practices:** Revision Commission members should be neither company officials nor Supervisory Board members, the General Director, or an Executive Board member of a competing legal entity.<sup>124</sup>

Generally, Revision Commission members should be chosen based on their financial background and expertise. The Federal Commission for the Securities Market's Code of Corporate Conduct (FCSM Code) advises that only persons with impeccable reputations be elected to the Revision Commission.<sup>125</sup> The charter and by-laws can provide additional requirements for Revision Commission members such as proficiency in accounting and financial reporting.<sup>126</sup>

## 2. Authorities

The Revision Commission has the authority to:

- Conduct an annual inspection of the company's finances and operations before the Annual General Meeting of Shareholders (AGM);<sup>127</sup>
- Undertake extraordinary inspections of the company's finances and operations;<sup>128</sup>
- Review the accuracy of the company's annual report and annual financial statements;<sup>129</sup>

<sup>122</sup> LJSC, Article 85, Clause 6, Paragraph 1.

<sup>123</sup> LJSC, Article 56, Clause 2.

<sup>124</sup> FCSM Code, Chapter 8, Section 1.3.4.

<sup>125</sup> FCSM Code, Chapter 8, Section 1.3.3.

<sup>126</sup> FCSM Code, Chapter 8, Section 1.3.2.

<sup>127</sup> LJSC, Article 85, Clause 3.

<sup>128</sup> LJSC, Article 85, Clause 3.

<sup>129</sup> LJSC, Article 88, Clause 3, Paragraph 1.

- Demand an Extraordinary General Meeting of Shareholders (EGM);<sup>130</sup>
- Demand a Supervisory Board meeting to discuss items under its authority;<sup>131</sup>
- Request and receive minutes of Executive Board meetings;<sup>132</sup>
- Request and receive documents regarding the company's finances and operations from the executive bodies;<sup>133</sup> and
- Request and receive information concerning related parties and related party transactions.<sup>134</sup>

In addition, shareholders are provided with great flexibility in defining additional authorities of the Revision Commission in the charter.<sup>135</sup>

**Best Practices:** Additional authorities and duties of the Revision Commission should include the authority to:

- Investigate cases of using insider information;
- Check the timeliness of payments to contractors and mandatory budget payments;
- Check the timeliness of the accrual and payment of dividends, as well as the timely meeting of the company's other financial obligations;
- Check the appropriateness of using the company's reserve and other funds;
- Check the timeliness of payment for the company's issued shares;
- Review the financial condition of the company, specifically its solvency, the liquidity of its assets, and creditworthiness; and
- Oversee the timeliness of the valuation of the company's net assets.

### 3. The Nomination of Members

The procedure for nominating candidates to the Revision Commission is identical to the procedure for nominating candidates to the Supervisory Board, the

<sup>130</sup> LJSC, Article 55, Clause 1, Paragraph 1; LJSC, Article 85, Clause 5.

<sup>131</sup> LJSC, Article 68, Clause 1.

<sup>132</sup> LJSC, Article 70, Clause 2, Paragraph 2.

<sup>133</sup> LJSC, Article 85, Clause 4.

<sup>134</sup> LJSC, Article 82.

<sup>135</sup> LJSC, Article 85, Clause 2, Paragraph 1.

Executive Board, the Counting Commission, and for nominating the General Director.<sup>136</sup>

→ *For more information on the nomination process, see Part III, Chapter 8, Section B.1.*

The charter can require that additional information about candidates be included in the proposal for their nomination.

### 4. The Election and Dismissal of Members

The agenda of the AGM must include the election of the Revision Commission.<sup>137</sup> This means that Revision Commission members are elected for a one year term and serve until the next AGM. The GMS cannot elect the Revision Commission by written consent.<sup>138</sup>

Revision Commission members are elected by a simple majority vote of participating shareholders.<sup>139</sup> It is important to note that Supervisory Board members, the General Director, and Executive Board members are not entitled to vote on the election of the Revision Commission.<sup>140</sup>

The authority of individual members of the Revision Commission can be terminated at any time by a simple majority vote of participating shareholders.<sup>141</sup>

**Best Practices:** Although the Company Law does not prohibit Supervisory Board members, the General Director, or Executive Board members from voting on the early termination of the Revision Commission, such a prohibition would be consistent with the prohibition on their election in the first place. Accordingly, it is good practice for company officials not to vote in such cases.

<sup>136</sup> LJSC, Article 53.

<sup>137</sup> LJSC, Article 47, Clause 1, Paragraph 3; Letter from the FCSM No. IK-07/883, 28 February 2000.

<sup>138</sup> LJSC, Article 50, Clause 2.

<sup>139</sup> LJSC, Article 49, Clause 2, Paragraph 1.

<sup>140</sup> LJSC, Article 85, Clause 6, Paragraph 2.

<sup>141</sup> LJSC, Article 48, Clause 1, Section 9; Article 49, Clause 2, Paragraph 1.

### 5. Contracts with Members

Companies may conclude an employment contract<sup>142</sup> or a civil law contract<sup>143</sup> with Revision Commission members.

**Best Practices:** Employment contracts are typically entered into with company employees who report directly to management. A company should thus conclude civil law contracts with Revision Commission members, underlining their independence from management.

The charter or by-laws should specify who signs the contract on behalf of the company. In principle, the Chairman of the General Meeting of Shareholders (GMS) or the Supervisory Board (who are often one and the same person) should do this. If, on the other hand, the General Director or another executive signs the contract, this would likely affect the independence of the Revision Commission, either in appearance or in fact. Of course, the authority to sign the contract does not imply the authority to negotiate or alter contract terms. Key elements and terms of the contract, for example, remuneration, are subject to the GMS' approval.

### 6. The Remuneration of Members

The GMS decides whether Revision Commission members are compensated for their work and reimbursed for expenses.<sup>144</sup> The Supervisory Board, ideally through a Remuneration Committee, if established, should recommend the amount of remuneration for GMS approval. A shareholder (or a group of shareholders) owning at least 2% of voting shares has the right to propose such agenda item.<sup>145</sup>

### 7. Operating Procedures

A Revision Commission's operating procedures can be specified in the charter or, preferably, in the company's by-laws for the Revision Commission, approved by

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<sup>142</sup> Labor Code, Article 59.

<sup>143</sup> Civil Code (CC), Articles 779–783.

<sup>144</sup> LJSC, Article 85, Clause 1, Paragraph 2.

<sup>145</sup> LJSC, Article 53, Clause 1.

## Chapter 14. Control and Audit Procedures

the GMS.<sup>146</sup> Revision Commission members usually elect their Chairman during their first meeting. The charter or by-laws may provide the Chairman of the Revision Commission with the responsibility to:

- Call, organize, and preside over Revision Commission meetings;
- Prepare and sign the minutes of meetings and other decisions;
- Represent the Revision Commission in meetings with third parties; and
- Cast a deciding vote at meetings in case of a tie-vote.

The charter or by-laws must specify what constitutes a quorum and define the voting procedures.<sup>147</sup>

**Best Practices:** The quorum should not be less than half of the Revision Commission members, and decisions should be approved by a simple majority vote.<sup>148</sup>

In addition to annual inspections of finances and operations, the Revision Commission may carry out extraordinary inspections at its own discretion, or be required to do so upon:<sup>149</sup>

- A decision of the GMS;
- A request of the Supervisory Board; or
- A request of a shareholder (or a group of shareholders) owning at least 10% of voting shares.

**Best Practices:** Extraordinary inspections should start no later than 30 days, either after the Revision Commission receives a shareholder request, or after the respective minutes of the GMS or the Supervisory Board meeting containing a request to carry out an extraordinary inspection have been signed. These inspections should take no more than 90 days to complete.<sup>150</sup>

<sup>146</sup> LJSC, Article 85, Clause 2, Paragraph 2.

<sup>147</sup> LJSC, Article 85, Clause 2, Paragraph 2.

<sup>148</sup> FCSM Code, Chapter 8, Section 3.1.2.

<sup>149</sup> LJSC, Article 85, Clause 3.

<sup>150</sup> FCSM Code, Chapter 8, Section 3.1.3.

The Revision Commission must prepare a written report on the findings of each inspection.<sup>151</sup>

**Best Practices:** The Revision Commission should present the results of the extraordinary inspection to the Audit Committee (if established) and the initiator of the extraordinary inspection with the assistance of the company's Corporate Secretary not later than three days after finalizing the inspection.<sup>152</sup>

### 8. Reporting

#### a) Inspection Report

The Revision Commission must prepare a report on the results of each annual inspection and present:<sup>153</sup>

- Its conclusions on the accuracy of the company's operations, financial reports, and other documents; and
- Information regarding any violations of accounting and financial reporting procedures, disclosure rules, and relevant laws and regulations.

**Best Practices:** All Revision Commission members should sign the report and:<sup>154</sup>

- Those who have not signed the report explain why they have not done so; or
- Indicate that a member refused to sign and was unwilling to provide an explanation for such refusal.

Revision Commission members who attend the GMS should provide shareholders the opportunity to ask questions and discuss inspection results.<sup>155</sup>

#### b) Presenting the Inspection Report

The Revision Commission's conclusions should be attached to the company's annual report. Because the Supervisory Board must preliminarily approve the

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<sup>151</sup> LJSC, Article 87.

<sup>152</sup> FCSM Code, Chapter 8, Section 3.1.5.

<sup>153</sup> LJSC, Article 87.

<sup>154</sup> FCSM Code, Chapter 8, Section 3.1.4.

<sup>155</sup> FCSM Code, Chapter 2, Section 2.1.2.

annual report no less than 30 days before the AGM,<sup>156</sup> it is good practice for the Revision Commission to give the Supervisory Board at least ten days to review and discuss the inspection report. Thus, the Revision Commission should submit their inspection report to the Supervisory Board at least 40 days before the AGM. The annual inspection report must also be distributed to shareholders as a separate document before the AGM.<sup>157</sup>

### **B. The Independent External Auditor**

An independent audit conducted by an External Auditor is an important element of the company's control framework. The objective of an audit is to enable the External Auditor to express an opinion on whether or not the financial statements of the company are prepared, in all material respects, in accordance with an identified financial reporting framework, and whether they are reliable. It gives shareholders, managers, employees, and market participants an independent opinion about the company's financial position and, if performed properly, should attest to the accuracy of the statements. An independent audit conducted by a publicly recognized accounting firm normally enhances the company's credibility, and accordingly, its prospects for attracting investment.

Three key points about the independent audit are:

1. Management remains responsible for preparing and presenting the company's financial statements;
2. The External Auditor is responsible for forming and expressing an opinion on the financial statements prepared by management; and
3. The audit of the financial statements does not relieve management of any of its responsibilities.

#### **1. When an Annual Audit Is Required**

The Law on Auditing provides that companies must have an annual, independent audit conducted by a certified independent External Auditor (or a licensed audit company), when the company:<sup>158</sup>

<sup>156</sup> LJSC, Article 88, Clause 4.

<sup>157</sup> LJSC, Article 52, Clause 3, Paragraph 1.

<sup>158</sup> Law on Auditing, Article 7, Clause 1, Paragraph 2.

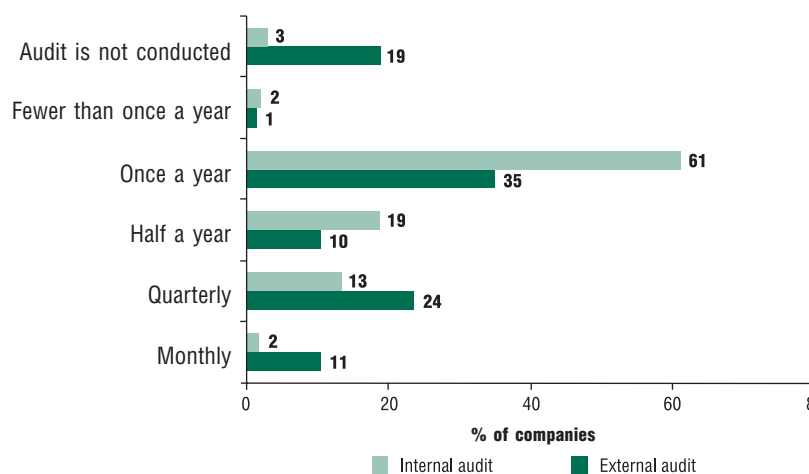


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- Is incorporated as an open joint stock company; or
- Has revenues for the reporting year greater than 500 thousand times the minimum wage;<sup>159</sup> or
- Has a book value of assets that, as of the end of the year, exceeds 200 thousand times the minimum wage.

**Company Practices in Russia:** Figure 2 shows that 61% of regional companies are audited by an External Auditor at least once every year.<sup>160</sup> 34% have external audits conducted more frequently. However, more than one-third violate the procedures set out for the election of the External Auditor in the Company Law in that they are not elected by the GMS. There is also serious concern regarding the independence of the External Auditor (and, by extension, the quality of the assurances provided) in at least one-third of Russian companies.

**Figure 2: Frequency of Internal and External Audits**



Source: IFC Survey on Corporate Governance Practices in Russia's regions, August 2003

<sup>159</sup> The Law on the Minimum Amount of Payment for Labor, Article 4. Currently, the minimum monthly wage is set at RUR 100.

<sup>160</sup> IFC Survey on Corporate Governance Practices in Russia's regions, Section 2.2.2, page 29, August 2003 (see [www.ifc.org/rcgp](http://www.ifc.org/rcgp)).

## 2. The Rights and Duties of the External Auditor

The External Auditor has the authority to:<sup>161</sup>

- Determine the method of conducting the audit;
- Examine the documentation, as well as uncover and confirm assets of the company;
- Receive oral and written explanations on any issues that arise during the audit;
- Refuse to carry out the audit or provide an opinion about the reliability of financial statements if the company does not provide all required documents or when circumstances arise that have an effect on the Auditor's opinion;
- Have access to the charter, including amendments and any restated charter;<sup>162</sup>
- Request an EGM;<sup>163</sup>
- Request a Supervisory Board or an Executive Board meeting;<sup>164</sup>
- Receive minutes of Executive Board meetings;<sup>165</sup>
- Receive information from interested parties on related parties and related party transactions;<sup>166</sup> and
- Provide other services as specified by legislation.<sup>167</sup>

→ See Section B.4 in this Chapter for a discussion on conflicts of interests when External Auditors provide non-audit services to their audit clients.

The External Auditor must:<sup>168</sup>

- Carry out the audit in conformity with Russian (and any applicable foreign) laws;
- Provide the company with relevant information on the legal requirements for conducting the audit, as well as any legal acts on which the comments and conclusions of the External Auditor are based;

<sup>161</sup> Law on Auditing, Article 5, Clause 1.

<sup>162</sup> LJSC, Article 11, Clause 4.

<sup>163</sup> LJSC, Article 55, Clause 1, Paragraph 1.

<sup>164</sup> LJSC, Article 68, Clause 1.

<sup>165</sup> LJSC, Article 70, Clause 2, Paragraph 2.

<sup>166</sup> LJSC, Article 82.

<sup>167</sup> Law on Auditing, Article 1, Clause 5.

<sup>168</sup> Law on Auditing, Article 5, Clause 2.

- Provide the audited company with the audit report within the time specified by the contract between the External Auditor and the company;
- Ensure the safekeeping of documents received or developed during the audit, and not permit the disclosure of the contents of these documents to any unauthorized persons without the consent of the company, except when such disclosure is required by law; and
- Carry out other duties that derive from the nature of the legal relationship specified by the contract between the External Auditor and the company, as long as such duties do not contradict Russian (and any applicable foreign) laws.

**Best Practices:** The External Auditor will often submit, and companies seeking to implement good corporate governance should demand, what is referred to as a ‘management letter’ in addition to the audit report. This management letter typically covers all material weaknesses in the company’s internal control, accounting, and operating procedures. The purpose of the letter is to provide constructive suggestions to management concerning improvements for such procedures.

The findings contained in the management letter are considered to be “non-reportable” to third parties, yet require corrective action by management. Companies wishing to attract external finance should be aware that investors will typically request a copy of the management letter.

### 3. The Rights and Duties of the Company

The company has the right to:<sup>169</sup>

- Receive from the External Auditor relevant information on the legal requirements related to the audit, as well as any legal acts on which the comments and conclusions of the External Auditor are based;
- Receive the audit report within the time specified by the contract between the External Auditor and the company; and
- Exercise other rights that derive from the nature of the legal relationship specified by the contract between the External Auditor and the company,

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<sup>169</sup> Law on Auditing, Article 6, Clause 1.

as long as the existence of such rights does not contradict Russian (and any applicable foreign) laws.

The audited company is obligated to:<sup>170</sup>

- Conclude a contract with the External Auditor for carrying out the statutory audit within the time specified by Russian law;
- Assist the External Auditor in every way in successfully completing the audit, including: providing all necessary information and documentation, furnishing full explanations and confirmations, and, when necessary, securing information from third parties;
- Not hinder the successful completion of the audit in any way;
- Pay for the External Auditor's services, even when the conclusions of the audit report conflict with the opinions of the company's officials; and
- Carry out other duties that derive from the nature of the legal relationship specified in the contract between the External Auditor and the company, as long as such duties do not contradict Russian (and any applicable foreign) laws.

### 4. The Appointment of the External Auditor

The External Auditor is approved by a simple majority vote of shareholders participating in the GMS.<sup>171</sup>

**Best Practices:** The Supervisory Board should propose candidates for the External Auditor and provide its recommendation to the GMS.<sup>172</sup> However, it is widely considered an even better practice for the Supervisory Board to conduct an open tender for the provision of audit services on a regular basis. The Audit Committee of the Supervisory Board should oversee the selection process, and assess the qualification, expertise, resources, effectiveness, and independence of the External Auditor.<sup>173</sup>

<sup>170</sup> Law on Auditing, Article 6, Clause 2.

<sup>171</sup> LJSC, Article 48, Clause 1, Section 10; Article 49, Clause 2, Paragraph 1.

<sup>172</sup> FCSM Code, Chapter 8, Section 4.1.7.

<sup>173</sup> Audit Committees, Combined Code Guidance, Sir Robert Smith group. Paragraph 5.17. See also: [www.ecgi.org/codes/country\\_pages/codes\\_uk.htm](http://www.ecgi.org/codes/country_pages/codes_uk.htm).

A shareholder (or a group of shareholders) owning 2% or more of voting shares can propose items related to the approval of the External Auditor for inclusion on the AGM agenda.<sup>174</sup>

The AGM agenda must always include the appointment of an External Auditor.<sup>175</sup> Therefore, an External Auditor must be approved for one year until the next AGM. The GMS cannot approve the External Auditor by written consent.<sup>176</sup>

### a) Who Can Be an External Auditor

Any individual certified as an individual auditor, or a legal entity with a license to perform auditing services, can be an External Auditor.<sup>177</sup> The External Auditor must be independent of the company and its management. In particular, an audit cannot be conducted by an audit organization if:<sup>178</sup>

- The External Auditor is the founder, the General Director, the accountant, or other official of a firm responsible for the bookkeeping or accounting of the company;
- The External Auditor is a relative of the founders of the company, its officials, accountants, and other persons responsible for the bookkeeping or accounting of the company;
- The General Director and other officials of the audit firm are the founders of the audited company or its accountants, or are responsible for the bookkeeping and/or accounting of the audited company;
- The General Director or other officials of the audit firm are relatives of the founders of the company, its officials, accountants, or other persons responsible for the bookkeeping or accounting of the audited company;
- The audit firm has been established by the audited company or is its founder (this also applies to subsidiaries, branches, or representative offices of the audited company);
- The audit firm and the audited company have common founders or shareholders; or

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<sup>174</sup> LJSC, Article 53, Clause 1, Paragraph 1.

<sup>175</sup> LJSC, Article 54, Clause 2.

<sup>176</sup> LJSC, Article 50, Clause 2.

<sup>177</sup> Law on Auditing, Article 3, Clause 1; Article 4, Clause 1.

<sup>178</sup> Law on Auditing, Article 12, Clause 1.

- The audit firm provided other services related to the restoration of the bookkeeping and the preparation of financial statements to the audited company during the last three years.

The External Auditor may not have any proprietary interest in the company or its shareholders.<sup>179</sup> All large international accounting firms normally have strict rules that preclude their staff from having a proprietary interest in any of their audit clients.

**Best Practices:** In the U.S., the 2002 Sarbanes-Oxley Act prohibits public accounting firms from providing non-audit service to their audit clients including: (1) bookkeeping or other services related to the accounting records or financial statements of the audit client; (2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; and (9) any other service that the Board of Directors determines, by regulation, is impermissible.<sup>180</sup>

An exception to this rule is made should non-audit services that are not listed above be pre-approved by the Supervisory Board's Audit Committee. The Audit Committee should, however, disclose these services to investors in periodic reports. Another exception is made when the non-audit services constitute less than 5% of the total amount of revenues paid to its auditor, these services were not recognized to be non-audit services at the time of engagement, and the Audit Committee promptly approves these services prior to the completion of the audit.

### b) The Contract with the External Auditor

The company must enter into a contract with the External Auditor once he has been approved by the GMS. The Company Law does not specify who must sign the contract on behalf of the company. In practice, this is often the General Director. The contract with the External Auditor stipulates the rights and duties of the External Auditor and the company, and may include any additional terms that the parties agree upon.

<sup>179</sup> LJSC, Article 88, Clause 3.

<sup>180</sup> The Sarbanes-Oxley Act of 2002, Section 201(a). See also: [www.sarbanes-oxley.com](http://www.sarbanes-oxley.com).

### 5. Compensation

The company pays for the External Auditor's services. The Supervisory Board has the authority to determine the amount of the External Auditor's compensation.<sup>181</sup> Clearly, the procedure for the payment of compensation and the amount of compensation must not be made dependent upon audit results.<sup>182</sup>

**Best Practices:** The amount of compensation for the services of the External Auditor should be disclosed to shareholders.

### 6. Reporting

The External Auditor presents conclusions on the reliability of the company's financial statements and compliance with accounting procedures.<sup>183</sup> The opinion paragraph of the auditor's report should state the auditor's opinion as to whether the financial statements give a true and fair view (in all material respects) in accordance with the financial reporting framework used by the company and, where appropriate, whether the financial statements comply with statutory requirements.<sup>184</sup> The External Auditor must prepare a report on the annual audit that includes:<sup>185</sup>

- Conclusions on the accuracy of the company's reports and other financial documents; and
- Information on violations of accounting or financial reporting procedures, disclosure rules, and relevant laws and regulations.

**Best Practices:** The External Auditor should divulge (potential) errors, misconduct, and violations of legislation or the company's internal rules during audits, and report them immediately to the Supervisory Board or its Audit Committee.<sup>186</sup> The External Auditor should make the company aware, as soon as practical

<sup>181</sup> LJSC, Article 65, Clause 1, Paragraph 2, Section 10; Article 86, Clause 2.

<sup>182</sup> Law on Auditing, Article 12, Clause 2.

<sup>183</sup> Law on Auditing, Article 10, Clause 1.

<sup>184</sup> The International Federation of Accountants' International Standards on Auditing (ISA) 700, The Auditor's Report on Financial Statements.

<sup>185</sup> LJSC, Article 87.

<sup>186</sup> FCSM Code, Chapter 8, Section 4.1.3.

and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems, which have come to the Auditor's attention.<sup>187</sup> The Supervisory Board or Audit Committee should take appropriate steps to remedy these problems.

The format and contents of and procedures for submitting the audit report to shareholders and the GMS are specified by the Federal Standards of Auditing.<sup>188</sup>

**Best Practices:** The External Auditor should participate in the AGM and answer shareholder questions with respect to the audit report.<sup>189</sup> Moreover, the Audit Committee should evaluate:<sup>190</sup>

- Whether the audit was made in accordance with the established procedures and whether the External Auditor omitted any matters in carrying out the audit; and
- The opinion of the External Auditor before it is presented at the GMS.

If the company plans to seek access to international capital markets, the External Auditor should prepare the report in accordance with the International Standards on Auditing (ISA) issued by the International Federation of Accountants (IFAC).<sup>191</sup>

### 7. The External Auditor's Liability

Since the External Auditor is liable for civil, administrative, and criminal infractions,<sup>192</sup> he should be adequately insured by a reputable (domestic or international) insurance provider with appropriate coverage.<sup>193</sup>

<sup>187</sup> ISA 400, Risk Assessment & Internal Control.

<sup>188</sup> Law on Auditing, Article 10, Clause 2; LJSC, Article 52, Clause 3, Paragraph 1.

<sup>189</sup> FCSM Code, Chapter 8, Section 4.1.2.

<sup>190</sup> FCSM Code, Chapter 8, Section 4.1.5.

<sup>191</sup> International Standards on Auditing are available on the International Federation of Accountants' website under: [www.ifac.org](http://www.ifac.org).

<sup>192</sup> Law on Auditing, Article 21, Clause 1.

<sup>193</sup> Law on Auditing, Article 13.



### a) Civil Liability

The grounds and terms of civil liability are usually specified in the contract between the External Auditor and the company. The External Auditor must keep information confidential about company operations.<sup>194</sup> If the External Auditor divulges confidential information, the company may seek compensation for the resulting losses.<sup>195</sup>

### b) Administrative Liability

The Law on Auditing states that the External Auditor bears administrative liability if he provides the company with an obviously false opinion.<sup>196</sup> In such cases, the Auditor's license may be revoked.

### c) Criminal Liability

The Criminal Code stipulates that when the External Auditor uses his authority for his own purposes and violates the rights of a company or related parties, the External Auditor may be prosecuted.<sup>197</sup>

## C. The Audit Committee

The Supervisory Board is not legally required to establish an Audit Committee, though it is increasingly seen as an essential element of the corporate governance structure in some countries. While still optional in Russia, the FCSM Code and this Manual recommend that companies establish an Audit Committee.

**Key Practices:** The Audit Committee typically focuses on three main areas: financial reporting, risk management, and internal and external auditing (see Figure 3).

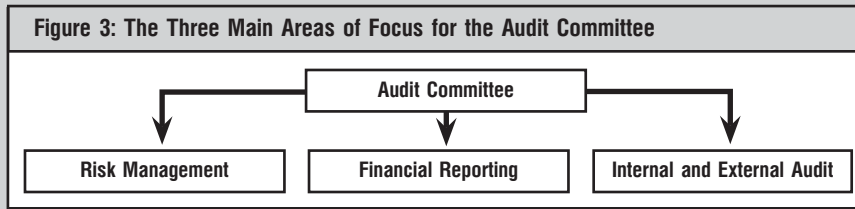
International best practices suggest that the Audit Committee develop and maintain an internal document, for example a by-law for the Audit Committee,

<sup>194</sup> Law on Auditing, Article 8, Clause 1.

<sup>195</sup> Law on Auditing, Article 8, Clause 4.

<sup>196</sup> Law on Auditing, Article 11, Clause 2. The Article defines an “obviously false report” as a report on an audit that was: 1) drawn up without actually carrying out the audit; or 2) based on conclusions that are clearly inconsistent with the audited documents. The report can be deemed “obviously false” only by a court. A false report can also give rise to criminal liability.

<sup>197</sup> The Criminal FCSM Code, Article 202.



Source: IFC, March 2004

that addresses its purpose, duties, and responsibilities. The following are suggested by the New York Stock Exchange (NYSE):<sup>198</sup>

- The purpose of the Audit Committee is to assist the Supervisory Board to oversee the integrity of the company's financial statements, the company's compliance with legal and regulatory requirements, the independent Auditor's qualifications and independence, and the performance of the company's internal audit function and independent Auditors, on the one hand; and, on the other, to prepare the report that Securities Commission rules require be included in the company's annual proxy statement.
- The duties and responsibilities of the Audit Committee are to, *inter alia*:
  - At least annually, obtain and review the report by an independent Auditor;
  - Discuss the annual audited and quarterly financial statements with management and the independent Auditor;
  - Discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;
  - As appropriate, obtain advice and assistance from outside legal, accounting, or other advisors;
  - Discuss policies with respect to risk assessment and risk management;
  - Meet separately, at least quarterly, with management, with Internal Auditors, and with independent Auditors;
  - Review with the External Auditor any audit problems or difficulties and management's response;
  - Set clear hiring policies for employees or former employees of the independent Auditors; and
  - Report regularly to the Board of Directors.
- Conduct an annual performance evaluation of the Audit Committee.

<sup>198</sup> New York Stock Exchange Corporate Accountability and Listing Standards Committee, 6 June 2002 (see also: [www.nyse.com](http://www.nyse.com)).

### 1. Functions

The Audit Committee should:

- Develop recommendations for the Supervisory Board on selecting an External Auditor;<sup>199</sup>
- Interact with the company's External Auditor and Revision Commission;<sup>200</sup>
- Control financial and business operations, and oversee the implementation of the financial and business plan of the company;<sup>201</sup>
- Monitor the Control and Revision Service;<sup>202</sup>
- Evaluate the efficiency of internal control procedures;<sup>203</sup>
- Develop internal control and risk management procedures in cooperation with management;<sup>204</sup> and
- Develop recommendations for the Supervisory Board's approval of non-standard operations.<sup>205</sup>

**Best Practices:** The National Association of Corporate Directors' (NACD) Blue Ribbon Commission on Audit Committees has identified the following indicators of risk that the Audit Committee should monitor and closely examine:<sup>206</sup>

- Complex business arrangements appearing to serve little practical purpose;
- Large last-minute transactions that resulted in significant revenues in quarterly or annual reports;
- Changes in Auditors over accounting or auditing disagreements;
- Overly optimistic news releases in which the CEO (General Director) seeks to cajole investors into believing in future growth;

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<sup>199</sup> FCSM Code, Chapter 3, Section 4.9.

<sup>200</sup> FCSM Code, Chapter 3, Section 4.9.

<sup>201</sup> FCSM Code, Chapter 8, Section 1.1.2, Paragraph 2; Chapter 8, Sections 2.2 and 2.3.

<sup>202</sup> FCSM Code, Chapter 8, Section 1.1.2, Paragraph 3.

<sup>203</sup> FCSM Code, Chapter 8, Section 1.2.

<sup>204</sup> FCSM Code, Chapter 8, Section 1.2, Paragraph 1.

<sup>205</sup> FCSM Code, Chapter 8, Section 1.4.

<sup>206</sup> The Report of the NACD Blue Ribbon Commission on Audit Committees. See also: [www.nacdonline.org](http://www.nacdonline.org). Reprinted with permission of the NACD, 1133 21-st Street, NW, Suite 700, Washington, DC 20031, [www.nacdonline.org](http://www.nacdonline.org).

- Widely dispersed business locations with decentralized management and a poor internal reporting system;
- Inconsistencies between Management's Discussion and Analysis (MD&A), the President's letter, and the underlying financial statements;
- Insistence by the General Director or Chief Financial Officer (CFO) that he be present at all meetings of the Audit Committee and Internal or External Auditors;
- A consistently close or exact match between planned results and reported results, and managers who always achieve 100% of their bonus opportunities;
- Hesitancy, evasiveness, and/or lack of specifics from management or Auditors regarding questions about the financial statements;
- Frequent differences of views between management and External Auditors;
- A pattern of shipping most of the month's or quarter's sales in the last week or last day;
- Internal audit operating under scope restrictions, such as the Internal Auditor not having a direct line of communication to the Audit Committee;
- Unusual balance sheet changes, or changes in trends or important financial statement relationships such as, for example, receivables growing faster than revenues, or accounts payable that are continually delayed;
- Unusual accounting policies, particularly for revenue recognition and cost deferrals such as, for example, recognizing revenues before products have been shipped ("bill and hold"), or deferring cost items that are normally expensed as incurred;
- Accounting methods that appear to favor form over substance;
- Accounting principles/practices at variance with industry norms; and
- Numerous and/or recurring unrecorded or "waived" adjustments raised in connection with the annual audit.

### 2. Composition

The charter should set forth special professional qualifications for Audit Committee members. Of particular importance is that members have relevant and real expertise in accounting and financial reporting.<sup>207</sup> As a guideline, the qualifications

<sup>207</sup> FCSM Code, Chapter 8, Section 1.3.2.

of Audit Committee members should inspire confidence that they are able and willing to detect accounting irregularities, and act in the best interests of the company and its shareholders. It is, therefore, recommended that only persons of an impeccable reputation be elected to the Supervisory Board and appointed to the Audit Committee.<sup>208</sup>

Because the Audit Committee is an internal structure of the Supervisory Board, it consists solely of Supervisory Board members. The Audit Committee should have at least three members, though this may be difficult for small Supervisory Boards. Other individuals will likely participate in Audit Committee meetings (such as the External Auditor or Revision Commission members). They may not, however, be Committee members.

**Best Practices:** An experienced individual should chair the Audit Committee. The independence, aptitude, and leadership skills of the Chairman are crucial for the Committee's success.

The Audit Committee should further be composed entirely of independent directors as recommended by the FCSM Code.<sup>209</sup> If this is not practically possible, it is recommended that an independent director chair the Audit Committee, and that the Committee be composed solely of non-executive directors.

→ *For more information on independent and non-executive Supervisory Board members, see Part II, Chapter 4, Sections C.4 and D.2.*

### 3. Meetings

If a Supervisory Board meeting considers matters pertaining to Audit Committee activities, a meeting of the Audit Committee should take place before the Supervisory Board meets. This meeting should occur sufficiently in advance of the Supervisory Board meeting to allow the Audit Committee to communicate its conclusions and allow the Supervisory Board to thoroughly consider them.

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<sup>208</sup> FCSM Code, Chapter 8, Section 1.3.3.

<sup>209</sup> FCSM Code, Chapter 8, Section 1.3.1.

The Audit Committee should also:<sup>210</sup>

- Regularly inform the Supervisory Board about violations of procedures and legislation by the company's officers;
- Inform the Supervisory Board about individuals who are responsible for irregularities, the circumstances under which they took place, and how errors can be prevented in the future; and
- Analyze and give recommendations to the Supervisory Board regarding risks associated with transactions and operations of the company.

The Audit Committee should conduct meetings at least once a month to prepare recommendations for the Supervisory Board.<sup>211</sup>

**Best Practices:** However, meeting once a month may be regarded as onerous and burdensome, as well as costly. The new U.K. Combined Code suggests that Audit Committee meetings be held to coincide with key dates in the financial reporting and audit cycle, with no fewer than three formal meetings per year.<sup>212</sup> The Audit Committee's Chairman will likely call additional meetings to establish an ongoing and informal contact with the Supervisory Board Chairman and General Director.

### 4. Access to Information and Resources

The Supervisory Board should be provided with information on the financial and operating results of the company.<sup>213</sup> In addition, Audit Committee members will need to have unfettered access to documents and corporate information to allow them to fulfill their functions. The Corporate Secretary often plays a crucial role in this respect, facilitating a free flow of information.

It is further recommended that the Audit Committee be authorized, and be provided with resources to hire outside audit, financial, legal, and other professional advisors without seeking permission from the Supervisory Board or executives.

<sup>210</sup> FCSM Code, Chapter 8, Section 2.3.2.

<sup>211</sup> FCSM Code, Chapter 8, Section 1.4.

<sup>212</sup> The U.K. Combined Code on Corporate Governance, Section 2.7. See also: [www.frc.org.uk/combined.cfm](http://www.frc.org.uk/combined.cfm).

<sup>213</sup> FCSM Code, Chapter 8, Section 2.3.1.

### D. Internal Control Function

Internal control is a process conducted jointly by the Supervisory Board, management and the company's employees, the aim of which is to provide a reasonable guarantee that the following company objectives are attained: financial reporting is reliable and accurate, operations are efficient and effective, and the company complies with legislation, and its own internal rules and guidelines.

In fact, an effective internal control structure can help the company:<sup>214</sup>

- Make better business decisions with higher quality and more timely information;
- Gain (or regain) the trust of investors;
- Prevent loss of resources;
- Provide security over its assets;
- Prevent fraud;
- Comply with applicable laws and regulations; and
- Gain a competitive advantage through streamlined operations.

The FCSM Code defines the internal control system as control over the conduct of the company's financial and business operations (including the implementation of its financial and business plan) by the company's divisions and bodies.<sup>215</sup>

#### 1. Internal Control Principles

A company's internal control system should be based on the following principles:

- The internal control system should function at all times and without interruption. A system that functions on a permanent basis allows the company to identify deviations on a timely basis, and helps predict deviations in the future;
- Each person involved in the internal control process should be held accountable. The performance of each person carrying out control functions should consequently be managed by yet another person in the internal control system;
- The internal control system should segregate duties. Companies should prohibit duplication of control functions, and should distribute functions

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<sup>214</sup> Moving Forward — A Guide to Improving Corporate Governance Through Effective Internal Control: A Response to Sarbanes-Oxley, Deloitte & Touche, January 2003.

<sup>215</sup> FCSM Code, Chapter 8, Section 1.1.1.

- among the employees so that one and the same person would not combine functions relating to the authorization of operations with certain assets, recording of such operations, ensuring and safe-keeping of assets, and inventory of these same assets;
- Proper authorization and approval of operations. Companies should establish procedures for approving financial and business operations by authorized persons, within the scope of their authority;
  - Companies should ensure the organizational separation of its subdivision responsible for internal control, and moreover, ensure that this subdivision is accountable directly to the Supervisory Board (commonly through its Audit Committee). This organizational separation ensures that internal controls are verified by an independent authority, in this case the Supervisory Board, which is not involved in the implementation or maintenance of internal controls;
  - All units and departments of the company should integrate and cooperate to allow the internal control system to be properly implemented;
  - A culture of continuous development and improvement needs to be put in place. A company's internal control system should be structured to allow it to flexibly address new issues, and easily be expanded and upgraded; and
  - A system for timely reporting on any deviations should be put in place. Ensuring the timeliness of reporting on deviations with the shortest possible deadlines allows authorized persons to act swiftly to correct problems.

### 2. Elements of the Internal Control System

The internal control system includes the following inter-related elements:<sup>216</sup>

1. **Control environment:** The control environment sets the tone of an organization, and influences the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values, and competence of the company's employees and officers; management's philosophy and operating style; the way management assigns authority and responsibility, and organizes and develops its staff; and the attention and direction provided by the Supervisory Board.

<sup>216</sup> Internal Control — Integrated Framework, COSO. See also: [http://www.coso.org/publications/executive\\_summary\\_integrated\\_framework.htm](http://www.coso.org/publications/executive_summary_integrated_framework.htm).



**Best Practices:** An essential element of an effective internal control system is a strong control culture.<sup>217</sup> It is the responsibility of the Supervisory Board and senior management to emphasize the importance of internal control through their words and actions. This includes the ethical values that management displays in their business dealings, both inside and outside the organization. The words, attitudes, and actions of the Supervisory Board and senior management affect the integrity, ethics, and other aspects of the company's control culture.

2. **Risk assessment:** Every entity faces a variety of risks from external and internal sources. A precondition to risk assessment is setting the company's objectives. Risk assessment is the identification and analysis of relevant risks to achieve company objectives, forming a basis for determining how risks should be managed.
3. **Control activities:** Control activities are the policies and procedures that help ensure that management directives are carried out. They help ensure that necessary actions are taken to address risks to achieve the entity's objectives. Control activities occur throughout the organization, at all levels, and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties.

**Best Practices:** Control activities should be as strict on the top as on the bottom of the company's operations, lending credibility to the control environment and the tone at the top.

4. **Information and communication:** Pertinent information must be identified and communicated in a form and within a timeframe that enables employees to carry out their responsibilities. Information systems produce reports containing operational, financial, and compliance-related information that make it possible to run and control the business. They not only deal with internally generated data, but also information about external events, activities, and conditions necessary to informed business decision-making and external reporting. Effective communication also must occur in a broader sense — flowing up, down, and

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<sup>217</sup> Framework for Internal Control Systems in Banking Organizations, Basel Committee Publications No. 40, September 1998, <http://www.bis.org/publ/bcbs40.pdf>. Note that this document is for banking organizations. However, some of its provisions are equally applicable to companies in the real sector.

across the organization. All personnel must receive a clear message from senior management that control responsibilities must be taken seriously. Further, they must understand their own role in the internal control system, as well as how individual activities relate to the work of others. Of particular importance is that management not limit itself to communicating on a control measure in and of itself, but properly emphasize the meaning and purpose of the particular control element. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as customers, suppliers, regulators, and shareholders.

5. **Monitoring the efficiency of the internal control system:** Internal control systems need to be monitored over time in order to assess the quality of the system's performance. This is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Ongoing monitoring occurs during the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations depend primarily on an assessment of the risks and effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with the most serious matters reported directly to senior management and the Supervisory Board. Senior management and the Supervisory Board need to clearly formulate sanctions to be imposed as a result of control violations on an *ex ante* basis.

### 3. Bodies and Persons Responsible for Internal Control

Internal control is, to some degree, the responsibility of everyone in an organization and should be an explicit or implicit part of everyone's job description. Virtually all employees produce information used in the internal control system or take other actions needed to effect control. Also, all personnel should be responsible for communicating upward problems in operations, noncompliance with an internal code of conduct or company-level corporate governance code, should such documents exist, or other policy violations or illegal actions.

**Best Practices:** The company's department responsible for corporate training programs should ensure that all employees and executives receive training on the company's control culture and system.

Further, although each company has its own specific internal control system and bodies, there are some general rules that a company should follow. Internal control

always starts at the top of the company, at the level of the Supervisory Board and executive bodies. In particular, the Supervisory Board and executive bodies are responsible for establishing the proper internal control environment and maintaining high ethical standards at all levels of the company's operations. Further, the approval of internal control procedures falls within the competence of the company's Supervisory Board, commonly through the Audit Committee. The Supervisory Board's Audit Committee is also assigned to review and evaluate the efficiency of the internal control system as a whole, and prepare proposals on how to improve it. Finally, the implementation of internal control procedures is the responsibility of the executive bodies.

**Best Practices:** The General Director is ultimately responsible for and should assume ownership of the system.<sup>218</sup> More than any other individual, he sets the 'tone at the top' that affects the integrity and ethics of a positive control environment. In a large company, the General Director fulfills this duty by providing leadership and direction to senior managers and reviewing the way they are controlling the business. Senior managers, in turn, assign responsibility for establishing more specific internal control policies and procedures to personnel responsible for the unit's functions. For example, controls for the company's IT system should fall under the responsibility of the Chief Information Officer or manager responsible for IT. Of particular significance are financial officers and their staff, whose control activities cut across, as well as up and down, the operational and other units of a company.

The executive bodies, in particular the General Director or the Finance Director would further create structures (services or departments), or assign persons to be responsible for carrying out specific control activities on a daily basis. The Control and Revision Service, as recommended by the FCSM Code, or the Internal Auditor are two such structures.

#### 4. Internal Auditing

Internal auditing is an integral part of a company's internal control system. While internal control is wider in scope, the internal audit can be defined as an independent, objective assurance and consulting activity designed to add value and improve

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<sup>218</sup> Internal Control — Integrated Framework, COSO. See also: [www.coso.org/publications/executive\\_summary\\_integrated\\_framework.htm](http://www.coso.org/publications/executive_summary_integrated_framework.htm).

an organization's operations.<sup>219</sup> It helps an organization accomplish its objectives by introducing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and corporate governance processes.

More specifically, internal auditing reviews and ensures the reliability and integrity of information, compliance with policies and regulations, safeguarding of assets, economical and efficient use of resources, and attainment of established operational goals and objectives. Internal audits encompass financial activities and operations including systems, production, engineering, marketing, and human resources.

**Company Practices in Russia:** A recent survey of internal audit practices in the Commonwealth of Independent States (CIS) lists typical internal audit tasks:<sup>220</sup>

- Appraise compliance of business activities with internal policies and procedures;
- Provide advice in setting up internal policies and procedures;
- Appraise controls over the safeguarding of assets;
- Appraise compliance with laws and regulations;
- Appraise internal controls over financial information;
- Appraise internal controls over business processes;
- Appraise the process for identifying, evaluating, and managing business risks;
- Appraise operational efficiency;
- Appraise compliance with contractual obligations;
- Conduct audits of information technologies;
- Investigate fraud; and
- Audit of subsidiary companies.

Similar tasks have been identified in research conducted by the Russian chapter of the Institute of Internal Auditors and the Russian Institute of Directors in 2003:<sup>221</sup>

- Conduct traditional internal audits;
- Help safeguard the company's assets;
- Assist management in setting up and maintaining internal controls;
- Consulting services; and
- Fraud investigation.

<sup>219</sup> The Institute of Internal Auditors. See also: [www.theiia.org](http://www.theiia.org).

<sup>220</sup> 2002 Internal Audit Survey — Russia and the CIS, Ernst & Young, 2002, pages 9 and 11.

<sup>221</sup> Internal Audit in Russian Enterprises, the Institute of Internal Auditors — Moscow, and the Russian Institute of Directors; 2003.

According to a recent survey on internal audit in Russian companies, over 2/3 of respondents indicated that their internal audit function reports to executive bodies,<sup>222</sup> raising concerns over the organizational independence of the internal audit function. Moreover, the survey found that professionals carrying out the internal audit function often lacked necessary knowledge and skills.

In order to function properly, the Internal Auditor should enjoy a reasonable degree of independence. This can be attained by making him accountable to the Supervisory Board (through the Audit Committee) rather than an executive of the company (the General Director or Finance Director).

**Best Practices:** In reality, it is difficult for the internal audit function to be entirely independent of management. Indeed, the internal control function is a key management tool. It would lose a great deal of its utility if it did not report to management. Cognizant of the need to maintain independence while working closely with management, the Institute of Internal Auditors suggests that the Internal Auditor report administratively to the executive bodies and functionally to the Supervisory Board's Audit Committee.<sup>223</sup>

### 5. The Control and Revision Service

The internal control function can be implemented by different structures within the company, such as the Internal Auditor or Internal Audit Department. In Russia, the FCSM Code recommends the establishment of a Control and Revision Service.<sup>224</sup> The Control and Revision Service is responsible for the daily internal control of the company's finances and operations, and may also carry out the functions of the Internal Auditor.

**Company Practice:** In most Western companies, the internal control function is typically carried out by a control department on a daily basis, while the internal

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<sup>222</sup> Internal Audit in Russian Enterprises, the Institute of Internal Auditors — Moscow and the Russian Institute of Directors; 2003.

<sup>223</sup> The Institute of Internal Auditors, Standards for the Professional Practice of Internal Auditing. See also: [www.theiia.org](http://www.theiia.org).

<sup>224</sup> FCSM Code, Chapter 8, Section 1.1.1.

audit function is carried out by an Internal Auditor on a periodic basis. Internal control and audit are separate, both in terms of authority and organization. In Russia, it appears that the Control and Revision Service is to play a hybrid function, taking on some of the duties typically carried out by the Internal Auditor, but functioning on a daily basis as if it were a Control Department. In practice however, the Control and Revision Service only sporadically carries out the functions of the Internal Auditor as defined by the Institute of Internal Auditors, at least in the few Russian companies that have created this control body.

### a) Authorities

The Control and Revision Service should fulfill the following tasks:<sup>225</sup>

- Develop policies and procedures for internal control in cooperation with the executive bodies and Audit Committee;
- Attend those meetings of the Audit Committee in which implementation of the finance and business plan, compliance with internal control and risk management procedures, and the approval of non-standard operations are discussed;
- Examine documents and materials regarding their compliance with internal control procedures, including the existence of required approvals of relevant department heads, as well as the existence of funds in the financial and business plan sufficient for fulfilling certain operations;
- Exercise daily control over the financial and business activities of the company;
- Analyze and evaluate non-standard operations and prepare recommendations for the Supervisory Board; and
- Help the Audit Committee to obtain information.

The FCSM Code introduces the concept of “non-standard operations”, not defined by legislation.<sup>226</sup> Non-standard operations are operations that go beyond the scope of the financial and economic plan of the company. Non-standard operations should receive Supervisory Board approval. Procedures for approving non-standard operations should be set forth in the charter and internal documents.

<sup>225</sup> FCSM Code, Chapter 8, Sections 1.2–1.4; 2.1–2.3.

<sup>226</sup> FCSM Code, Chapter 8, Sections 2.2.1 and 2.2.2.

The Control and Revision Service should evaluate the need for and feasibility of non-standard operations before they are conducted, and report its conclusions to the Supervisory Board.

To fulfill its tasks, the Control and Revision Service should have the authority to:<sup>227</sup>

- Receive all documents and materials that are necessary to reasonably and unequivocally monitor whether the financial and business operations undertaken by the management are consistent with the financial and business plans, and the procedures set forth by the company for such operations;
- Check whether all financial documents and materials comply with the company's internal control procedures, such as the approval by department heads of certain documents; and
- Collect all information on (possible) errors and violations that have occurred during company operations, and report all such errors and violations to the Audit Committee.

### b) Reporting

To be effective, the Control and Revision Service should report directly to the Audit Committee.<sup>228</sup> It is recommended that the Control and Revision Service hold regular meetings with the Audit Committee to report on the performance of the financial and business plan, and deviations from it.

### c) Composition

The head of the Control and Revision Service and not less than  $\frac{2}{3}$  of his staff should hold a higher degree in the fields of finance, accounting, business, law, or economics. The head of the Control and Revision Service should also have at least five years of experience in a similar function.

The contract with the head of the Control and Revision Service should be signed by the Chairman of the Supervisory Board to protect the independence of the Control and Revision Service.<sup>229</sup> Contracts with employees of the Service should also be signed by the Chairman of the Supervisory Board and not by a member of the executive bodies.<sup>230</sup> The FCSM Code recommends that the com-

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<sup>227</sup> FCSM Code, Chapter 8, Section 2.1.

<sup>228</sup> FCSM Code, Chapter 8, Section 1.1.2.

<sup>229</sup> FCSM Code, Chapter 8, Section 1.3.5.

<sup>230</sup> FCSM Code, Chapter 8, Section 1.3.5.

pany outline the organization and staffing of the Control and Revision Service in its by-laws.<sup>231</sup>

### 6. Management's Report on Internal Control over Financial Reporting

**Best Practices:** In May 2003, the U.S. Securities and Exchange Commission (SEC) approved a rule to implement requirements of Section 404 of the Sarbanes-Oxley Act of 2002.<sup>232</sup> Section 404 of the Act directs the SEC to adopt rules requiring each annual report of a company to contain (1) a statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) management's assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting. Section 404 also requires the company's External Auditor to attest to, and report on management's assessment of the effectiveness of the company's internal controls and procedures for financial reporting in accordance with standards established by the Public Company Accounting Oversight Board.

Under the final rules, management's annual internal control report will have to contain:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- A statement identifying the framework used by management to evaluate the effectiveness of this internal control;
- Management's assessment of the effectiveness of this internal control as of the end of the company's most recent fiscal year; and
- A statement that its auditor has issued an attestation report on management's assessment.

Russian companies wishing to follow best corporate governance practices should report on these items in their annual report.

### E. Summary

Table 1 summarizes the main features of bodies involved in the internal and external audit of the company.

<sup>231</sup> FCSM Code, Chapter 8, Section 1.3.2.

<sup>232</sup> The Sarbanes-Oxley Act of 2002, Section 404. See also: [www.sarbanes-oxley.com](http://www.sarbanes-oxley.com).



Table 1: Summary of Audit Functions				
	Revision Commission	External Auditor	The Supervisory Board's Audit Committee	Internal Auditor (Control and Revision Service)
<b>Status</b>	A controlling body of the company, independent from management	A certified auditor, typically an audit firm, that is independent from management and major shareholders	A committee of the Supervisory Board	Typically, an employee or a subdivision of the company
<b>Main Functions:</b>	<ul style="list-style-type: none"> <li>Conducts annual inspections of financial and business activities;</li> <li>Conducts extraordinary inspections; and</li> <li>Reviews the annual report and financial statements.</li> </ul>	<ul style="list-style-type: none"> <li>Audits the financial statements prepared and presented by the company; and</li> <li>Conducts extraordinary audits.</li> </ul>	<ul style="list-style-type: none"> <li>Develops recommendations for the Supervisory Board on the selection of the External Auditor;</li> <li>Interacts with the External Auditor and Revision Commission;</li> <li>Oversees financial and business operations of the company;</li> <li>Oversees the budget process;</li> <li>Works with the Internal Auditor and/or Control and Revision Service;</li> <li>Supervises the development of the internal control and risk management procedures;</li> <li>Develops recommendations for the Supervisory Board's approval of "non-standard operations;" and</li> <li>Liaises between all auditing functions, both internal and external.</li> </ul>	<ul style="list-style-type: none"> <li>Develops policies and procedures for internal control;</li> <li>Ensures compliance with policies and procedures, as well as with local laws and regulations;</li> <li>Designs and operates controls to safeguard assets, and over financial and business data; and</li> <li>Assists in enhancing the efficiency of operations.</li> </ul>
<b>Reports to:</b>	Shareholders	Shareholders via the Supervisory Board or its Audit Committee	The Supervisory Board	The General Director and/or the Financial Director administratively and the Supervisory Board's Audit Committee functionally

Table 1: Summary of Audit Functions				
	Revision Commission	External Auditor	The Supervisory Board's Audit Committee	Internal Auditor (Control and Revision Service)
<b>Regulated by:</b>	The Company Law	Accounting and audit legislation, the Company Law, and the contract with the company	The charter, by-laws, internal documents, and employment contracts	The charter, by-laws, internal documents, and employment contracts
<b>Liabilities:</b>	Civil and labor legislation, employment contracts	Civil and audit legislation, civil contracts	Civil and labor legislation, employment contracts	Internal documents, labor legislation, employment contracts
<b>Composition:</b>	Supervisory Board members and executive bodies cannot be members. Members may be employees or shareholders of the company	The External Auditor must be independent from the company in all respects	Audit Committee members should be independent directors	Staffed by company employees

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