

# THE GOLDEN PATH OF INTEGRITY

## DOING TRANSPARENT BUSINESS IN RUSSIA



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### CAN INTERNATIONAL COMPANIES BE TRANSPARENT IN DOING BUSINESS IN RUSSIA?

White Paper based on a seminar organized by IRS CIS & CEE in November 2009 on the subject: *“Corporate Governance, Business Ethics and Transparency in Russia”*

### **Integrity in Russia: the Golden Path of Integrity, Narrow but Straight**

#### **Summary**

In November 2009, IRS CIS & CEE organized a breakfast meeting on the subject of “Corporate Governance, Business Ethics and Transparency in Russia”, chaired by Arthur Docters van Leeuwen, former head of the Financial Markets Authority in the Netherlands and former chairman of the Committee of European Security Regulators (CESR). Some 20 CEO’s and CFO’s of larger, multinational companies gathered to discuss the question we all want to see answered: *can international companies do business in Russia in a transparent manner and in according to their corporate governance standards?*

At the same time Transparency International announced their new Corruption Index, indicating only a slightly improved position for Russia, which in another survey was named as the country where most economic crime takes place.

Interestingly, the answer is: Yes. Yes, it is possible to be successful in Russia, and to comply with all international corporate governance standards. Even more interesting: international companies indicated that they are, in comparison to their operations other emerging markets, often equally or more profitable in Russia. Hence their frustration of limited support from their head offices in their plans to expand. Whereas other BRIC countries are top priorities in the strategic planning of many multinational companies, Russia seems to be hindered by its poor reputation. Clearly, this situation is not good for Russia, and not good for these multinationals, which are missing out on good opportunities.

*It is the role of IRS to promote good corporate governance and integrity in Russia, while enhancing enterprise value.*

We therefore hope that this white paper will help corporations in making a more balanced decisions about doing transparent business in Russia.



*Enabling Real Trust*

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## In the beginning.....

Of course, the current situation of corporate governance in Russia is the result of less than 20 years experience, and experimentation. Russia came from a position where minority shareholders rights were brutally violated e.g.: banning shareholders from shareholders meetings and denying voting rights, to a situation where Russian companies are listed on foreign stock exchanges and are fully compliant with international corporate governance standards.

Three main institutions played important roles here. First of all, organizations who fought for shareholder's rights, such as the Association of Independent Directors who paved the way towards better corporate integrity. Secondly, early equity investors, mainly private equity funds, investing in fast growing, often regional companies. Together with their investees, they prepared Russian companies in enhancing transparency and improving corporate governance. Thirdly, banks and other financiers who made companies understand that having better corporate governance and transparency is beneficial for obtaining financing at lower rates.

## The situation for multinational companies

Is there a difference between the situation for local companies compared with multinational companies? Yes, there is. Where local companies had to grow their way into enhanced corporate governance and transparency, multinational companies were forced to comply with their corporate standards which seemed to be non-flexible and theoretical, especially in the rough markets of Russia. But there is no middle way for them, there is no such thing as an orange light in integrity. The examples we have heard all show this.

Of course we are referring to "privately owned," Russian companies, not government owned or controlled companies. Note that if your business model is mainly focusing on selling to government or budget dependent organizations, these organizations require a completely different ball game and are outside the scope of this paper.

## Strategy

Let's focus on multinational corporations. The companies we spoke with realized that they could only be effective in doing business in Russia, if they keep to their corporate standards on integrity and corporate governance. Any deviation from this position would expose them to serious risks. One participant mentioned that they walked away from a very large business deal because of integrity issues, as they saw the market potential which could be reached a normal way, and also without this partner. They walked away from a potential dream deal, but did great business anyway, without exposing themselves to the risks of breaching their corporate ethics. Before coming to the Russian markets, companies need to understand that there are reasons why Russia has a tainted reputation in transparency and integrity.

*Lesson 1: Long term strategy is essential, because it will be easier to say no to short term, but "dirty" profit. Long term financial success will come, eventually. Most companies reported they are more profitable in Russia than in many other emerging markets.*

*"We walked away from a very large deal, because of integrity issues"*

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## **Role of Management**

The role of the management was discussed in-depth. Management, both local and expat, need to give the right example. First of all, integrity starts at the top. Top managers need to have ongoing discussions with employees on the decisions they have made and their rationale. Integrity is sometimes choosing from two bad options: either not to stick to the truth, or to walk away from profit. Make sure that employees understand why you can walk away from short term profit, and that this will not jeopardize the future of the company, or their career.

Being successful, and enhancing integrity, is not just about staff signing off the corporate ethics handbook, and that is it. There needs to be a full program on enhancing awareness around integrity and ethics. Various international surveys show that internal fraud and corruption are mostly being reported by their own staff. In Russia, this will be more difficult, as this would often mean that staff will have to report about their own management. Whistle blowing systems and compliance officers are either not available, or not trusted. One company mentioned that the most 'tips' they got were from the idea box, which was emptied not by line management but by HR.

*Lesson 2: Integrity management is not a manual - staff integrate new learning by practical examples ideally from Top Management, as well as Training, on compliance and ways to report deviations.*



## **Recruiting**

Recruiting plays an important role in enhancing integrity. Most top managers mentioned that they do recruiting themselves, and not only for key jobs. Some companies actually use integrity cases to discuss situations with candidates, and how they would react. Potential CFO's who are proud in discussing with you how to evade tax are probably not the right candidates. Or in the case of the potential corporate council, who mentioned a CEO of a multinational company that paying 'facility payments' was the best way of settling disputes. Obviously, this lawyer was not hired. Breaches of integrity often play at lower levels in the company and therefore, it is important in recruitment that integrity questions will be asked also at lower staff.

*Lesson 3: hire staff which you can trust on the basis of your assessment of their integrity e.g. : do background checks, test potentials and ensure they understand the spirit and operation of integrity.*

## **Implement controls**

Trust is a fundamental pre-requisite but controls are also essential. We have heard (and investigated) many cases where CEO's had business on the side, thus reducing the profits of their employer, or were violating the corporate governance regulations of their companies in order to improve short term profit, realize budgets and, obviously, increasing their bonus. There needs to be in place a good system of checks and balances, and administration. One the one hand, Russian bookkeeping rules are unnecessary complex and laborious. On the other hand, payments cannot be made without the signature from both the chief accountant/CFO and the General Manager. Use this structure to implement a system of checks and balances. Avoid any payments in cash for your services of products, if possible. Availability of cash is a high risk factor.

*Lesson 4: Trust your people, but also: control them. Use the Russian bookkeeping legislation to implement a system of checks and balances. Stay away from cash as much as possible, as it is very difficult to control.*

***“Potential CFO's who are proud in discussing with you how to evade tax are probably not the right candidates”***

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## ***Compliance, compliance, compliance***

Talking about bookkeeping: Russia is a country of compliance. It is not about substance over form, but about formalities. Comply with them. Do not take any shortcuts, neither in migration issues (visa, work permits); tax issues, permits, or any other risk issue likely to result in investigation. This works two ways. First of all, if you have nothing to hide, no inspection can find anything. Which makes companies less vulnerable to pressure from authorities. Secondly, as we have heard from one of the participants, it can work the other way as well. After making complaints to a senior civil servant about a decision made by another civil servant, this multinational was 'suddenly' checked by the tax authorities. Having nothing to hide, the company fully cooperated and indeed, nothing wrong was found (after eleven months of investigation). After that, the complaint was taken into consideration and a solution about the dispute was agreed. We all complain about the ambiguity of legislation in Russia, but to be honest, in which country is legislation 100% clear? In case of doubt, document decisions you make beforehand, to avoid being confronted with the questions and explanations afterwards.

*Lesson 5: Make Compliance Top Priority. Full compliance, reducing even the most remote chance of doing wrong, or getting into trouble with the authorities.*

## ***Stay away from courts***

Unfortunately, it will not always be the case that disputes will be settled by negotiation, multinationals can be taken to court as well. Although it is a fact that multinationals are often discriminated by courts, and being seen as local against foreign (and small versus big). In our experience, often lower ranked officials use court decisions to prevent themselves from making decisions. One study showed that the Russian tax authorities are losing the majority of cases against foreign companies. When prepared well, courts should not be something to fear. Participants reported on having received calls from people claiming to represent judges, in order to facilitate a positive outcome. However, as this will not have any decisive result and uncertainty remains also for the counterparty, multinationals have nothing to lose from going to court. Generally, we advise our clients to avoid courts if possible, especially in commercial disputes.

*Lesson 6: try to stay away from court cases, but if you need to fight, "fight with all your might!". If possible, try to get into commercial arbitration and mediation, as it is likely to result in a better solution and helps preserve the commercial relationship, if necessary.*



***“After eleven months of investigation, the complaint was taken into consideration and a solution about the dispute was agreed”***

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## Permits

Reliable studies show that obtaining permits and keeping permits is a big hindrance in doing transparent business in Russia. Again here: understand the rules, comply with all formalities and take your time. One participant reported a situation where they applied for a permit to start building a new factory. Obviously, this was strategic for the company and time to market is important. Although the period to issue the permit is legally 3 weeks, the company waited for more than half a year before the permit was issued, clearly with an intention from the issuer to put pressure on the company. Not giving in, the company finally received their permit, signed indeed three weeks after application. It was just lying on a desk for six months, waiting to create 'opportunities'. Ensure you have a reputation for being professional, understanding the rules and that you can only work in Russia by complying 100% to your corporate governance and ethics standards. The only reputation you want to have is a reputation which will make them work with you, not against you. In the end, foreign investments create jobs, and everyone will be happy. If you need to hire subcontractors in the process of obtaining any official document, organize a tender and make this a transparent process.

*Lesson 7: the only way to get and keep permits, is to be professional (or to hire professionals), and have enough time, so that you will not be pressurized to speed up the process.*



## Business benefits

Transparency and integrity pays off, especially in the long term. Participants were complaining about competitors who seemed to have different standards in corporate governance, and were therefore able to create a competitive advantage. However, this is mainly a short term advantage. Increasingly the market will get into a level playing field. Companies, who know how to play a fair, but tough game, will be the winners in these markets.

As mentioned, many participants in our meeting stated that the Russian market is often as or even more profitable than other emerging markets, while complying fully with international corporate governance standards. Russia is now and is potentially a good market emerging market to build a leading position. We understand the frustration which some participants expressed about the fact that corporate planning and headquarters were focusing on the bad reputation of Russia, rather than the fact that being transparent and complying with all standards of business integrity can certainly be realized allowing to be profitable at the same time.

Is there no downside? Of course there is. We are not naïve and have been involved in solving very delicate and sensitive cases. Russia is an emerging market, with a history of less than 20 years in market economy. In such markets, games are played rough. Some play unfair. Government control is still very high, although reducing. Many people we spoke with mentioned that the most difficult part of doing business in Russia is the uncertainty and this feels uncomfortable. As a result, multinationals and their managers are preparing themselves much better than local players or the government. As we see now, local players are becoming more aware of corporate governance issues as well, and the government has started a big campaign against corruption, the playing field indeed will become more even.

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## Closing remarks

According to Arthur Docters van Leeuwen, all examples which were mentioned in the discussions are not new for him. He had seen and heard them in his previous roles as General Prosecutor, Financial Markets supervisor and also in his European role: Judges can be influenced; corruption exists at all levels; economic fraud happens in all countries; violation of shareholders' rights is nothing new and issuing permits is always sensitive to facility payments. Although, his impression is that the magnitude of such incidents might be higher, and the frequency might be more often than in developed economies, it is part of the characteristic of an emerging market.

As we have heard from the participants, integrity pays off. This is what Docters van Leeuwen called: the Golden Path of Integrity, narrow but straight.

A Golden Path? Indeed. Difficult to navigate? Perhaps. But IRS will help companies to stay on this narrow and straight path.

The vision of IRS is to help its clients to invest in transparency and integrity in doing business in Russia and CIS.

IRS is a business advisory firm, trusted by corporations, law firms, governments and financial institutions. We are dedicated to helping our clients to protect and to enhance enterprise value in complex and sensitive financial, legal, regulatory and economic situations. We combine these advisory services with daily, hands-on problem solving in situations such as investigations, disputes, mergers and acquisitions, compliance enhancement, improving corporate governance and restructuring.

*“The Golden Path of Integrity, narrow but straight”*

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IRS sets the standard in independent and professional solutions for complex and sensitive issues, performance improvement and value creation for the stakeholders of its clients.

## IRS Clients

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