

# I. Introduction

## 1. Study Background

The 1997-1998 Asian financial crisis exposed structural weaknesses in the banking and corporate sectors of affected countries owing largely to poor governance, a lack of transparency, and weak supervision and regulation.<sup>3</sup>

Asian Development Bank (ADB) has been taking a number of initiatives to assist Developing Member Countries (DMCs) to overcome these structural problems. The focus on improved governance includes enhancing the effectiveness of public administration and development management at the sector level and in national institutions. Where appropriate, institutional development of the local and provincial agencies and the private sector is also covered. A sound regulatory financial framework and its enforcement, capable institutions, skilled human resources, and effective monitoring and supervision are important prerequisites to an efficient financial structure.

In 2000, under ADB Regional Technical Assistance (RETA) 5877<sup>4</sup>, Diagnostic Studies of Accounting and Auditing (DSAAs) were prepared and published for Cambodia, Mongolia, Pakistan, Papua New Guinea, People's Republic of China, Uzbekistan and Viet Nam. ADB approved RETA 5980—*Diagnostic Study of Accounting and Auditing Practices in Selected DMCs*<sup>5</sup>—for the purpose of carrying out initial studies to identify gaps and weaknesses in accounting and auditing arrangements and to recommend courses of action to overcome these problems. It extends the work conducted under RETA 5877.

## 2. Objectives

ADB has demonstrated its stand on the importance of good governance, through effective financial management, for sustained economic development. This RETA involved a diagnostic review of the existing accounting and auditing support and standards available in the selected

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<sup>3</sup> Zhuang, Juzhong, David Edwards, David Webb and Ma. Virginita Capulong. 2000. *Corporate Governance and Finance in East Asia: A Study of Indonesia, Republic of Korea, Malaysia, Philippines and Thailand*. Manila: ADB.

<sup>4</sup> *Strengthening Financial Management and Governance in Selected DMCs*.

<sup>5</sup> For \$230,000 approved on 20 March 2001.

DMCs. After carrying out this diagnostic review, the study assessed the need for assistance to improve the current situation. Objectives were to:

- (i) assess the capability and capacity within each country to provide efficient and effective accounting and auditing support to meet international standards and best practices and address the issue of training and capacity enhancement
- (ii) determine the existing accounting and auditing standards of each selected country
- (iii) assess the degree of deviation from International Accounting and Auditing Standards while identifying weaknesses and possible corrective options
- (iv) discuss the fieldwork findings and introduce the concepts of the international standards through workshops, and
- (v) determine the level and type of assistance needed by each country in order to provide acceptable accounting and auditing support to the private and public sectors.

### **3. Scope**

The RETA involved an indepth study of the key issues relating to accounting and auditing support in the selected DMCs, identified gaps and weaknesses that need to be addressed to improve accounting and auditing support, and developed assistance programs in collaboration with other donors to rectify the identified weaknesses. Azerbaijan was one of four countries that participated in the RETA.

### **4. Country Case Studies and Workshop**

The first part of the study examined the current accounting and auditing structure and systems adopted in Azerbaijan. It also: (i) analyzed the political, institutional, and regulatory and legal framework on accounting and auditing practice and the level of enforcement of existing laws, rules, and regulations; (ii) identified gaps and weaknesses in accounting and auditing support available and deviations from international standards; and (iii) identified alternative options to remedy the identified weaknesses, with the objective of eventually doing away with these.

The second part of this study disseminated the country-research findings through in-country workshops. Each workshop provided a cross-section of views on the research findings and established ways to move forward to improve financial management and governance in the country.

After carrying out the assessment of accounting and auditing support in Azerbaijan, the study findings and recommendations were discussed at a workshop in Baku on 5-6 December 2001, and at an international workshop at ADB Headquarters in Manila from 5-6 March 2002. This report incorporates feedback from both workshops. Appendix 3 provides further information on the study process and the Baku workshop.

## 5. Azerbaijan

### General

The Caucasus Mountains form a geological, cultural and political boundary between Asia and Europe. Azerbaijan, Armenia and Georgia comprise the South Caucasus region, which is sandwiched between the Black and Caspian Seas to the West and East, and bordered by Russia to the north, and Turkey and Iran to the south.

Azerbaijan is the largest and most populous of the South Caucasus countries—recent estimates indicate a population of approximately 8 million of whom a quarter live in the capital Baku. This population comprises different ethnic groups, including Azeris (90 percent), Dagestanis (3.2 percent) and Russians (2.5 percent).

In the 19th century, Azerbaijan—then part of the Russian empire—experienced an unprecedented oil boom, which attracted international investment. By the beginning of the 20th century, it was supplying almost half of the world's oil. After a brief period of independence, Azerbaijan became a socialist republic within the Soviet Union in 1922.

The oil-rich country gained independence from the Soviet Union in 1991 amid war and political turmoil. A 1994 ceasefire ended an armed conflict with Armenia. However, about one seventh of Azerbaijan's territory remains occupied, while around 800,000 refugees and internally-displaced persons (IDPs) are scattered around the country.

Azerbaijan is a presidential republic. The President and the Parliament (*Milli Mejlis*, which has 125 members) are elected every five years. The national language is Azeri, spoken by 89 percent of the population. Most people also speak Russian. In addition to oil and gas reserves, Azerbaijan's assets include a well-educated population. However, almost 70 percent of the population lives below the poverty line (i.e., less than a dollar a day)—the worst affected are the refugees and internally-displaced persons. Major exports include oil and gas (70 percent), machinery, cotton and foodstuffs. Major imports are machinery and equipment, metals and chemicals. Table

It presents key indicators for Azerbaijan and for other selected countries.

In 1994 Azerbaijan signed a 30-year contract worth \$7.4 billion with a British Petroleum-led consortium. A number of production-sharing arrangements (PSAs) have since been negotiated with foreign firms, which have thus far committed \$60 billion to oil and gas field development. Production under the first PSA began in November 1997.

Table 1: Key Indicators for Selected ADB DMCs<sup>6, 7</sup>

Indicator	Azerbaijan	Fiji Islands	RMI	Philippines	Sri Lanka
<b>General</b>					
Population ( <i>thousands, 2000</i> )	8,049.0	811.0	51.6	78,400.0	19,359.0
Population density ( <i>people per km<sup>2</sup>, 2000</i> )	93.0	44.0	282.0	263.0	295.0
Urban population ( <i>% of total, 2000</i> )	57.3	42.3	71.9	58.6	23.6
Average annual pop. growth rate ( <i>%, 1995-2000</i> )	1.0	1.1	1.5	2.2	1.3
<b>Social</b>					
Under-five mortality rate ( <i>per 1000, 1999</i> )	16.0	18.0	63.0	31.0	15.0
Life expectancy at birth ( <i>years, 1999</i> )	71.0	67.0	65.0	69.0	74.0
Adult literacy rate ( <i>15-yr+, %, 1999</i> ):					
– Females	96.0	90.0	97.0	95.0	89.0
– Males	99.0	95.0	97.0	95.0	94.0
Population in poverty ( <i>%, 1995-99</i> )	68.1	25.5	...	40.0	26.7
Human Development Index ( <i>1999</i> )	0.74	0.76	0.56	0.75	0.74
<b>Economic</b>					
Gross National Product ( <i>\$ million, 1999</i> )	3,705.0	1,848.0	99.0	77,967.0	15,578.0
GDP per capita ( <i>\$, 2000</i> )	654.0	1,978.0	1,890.0	959.0	842.0
GDP growth rate ( <i>%</i> ):					
– 2000	11.4	-9.3	-2.3	4.0	6.0
– 1999	7.4	9.6	0.8	3.4	4.3
– 1998	10.6	1.4	-16.0	-0.6	4.7
– 1997	8.8	-0.9	-9.4	5.2	6.3
Consumer Price Index ( <i>Annual % change, 2000</i> )	1.9	1.1	-1.9	4.4	6.2
Fiscal Balance / GDP ( <i>%, 2000</i> )	-1.0	...	-35.5	-4.2	-9.9
Total External Debt / GNP ( <i>%, 1999</i> )	30.0	9.3	...	64.8	60.3

<sup>6</sup> Asian Development Bank (ADB). 2001. *Key Indicators of Developing Asian and Pacific Countries*. Volume XXXII. Manila: ADB.

<sup>7</sup> Asian Development Bank (ADB). 2001. *Asian Development Outlook 2001*. Manila: ADB. pp. 139-140.

Table 1: Key Indicators for Selected ADB DMCs (*continued*)

Indicator	Azer- bajjan	Fiji Islands	RMI	Philip- pines	Sri Lanka
<b>Official Development Flows</b>					
US\$ million (1999)	207.2	23.2	62.9	295.0	343.6
Dollars per capita (1999)	25.7	28.6	1,219.0	3.8	17.7
Percentage of GNP (1999)	5.6	1.3	63.5	0.4	2.2

### Recent Economic Trends<sup>8</sup>

Azerbaijan shares all the transition problems of other Former Soviet Union (FSU) countries. Due to the unstable domestic situation, it embarked on economic reforms later than most other FSU countries. Since the mid-1990s Azerbaijan has made progress on establishing a market economy and restoring macroeconomic stability. A privatization program was introduced in September 1996—within three years, over 21,000 small enterprises had passed into private hands. Inflation of 1,500 percent in 1994 declined to 160 percent in 1995 and to just six percent in 1996.

Economic performance was strong in 2000, with real GDP growth accelerating to 11.4 percent from 7.4 percent in 1999. The major contributing factor was the 20-plus percent upsurge in the oil and oil-related sectors in the first half of 2000, which benefited from rising world oil prices. In contrast, the agriculture sector grew by just 6 percent. Growth in other labor-intensive sectors was also weak. Consequently, unemployment was estimated at 18 percent in 2000.

Government adopted a tight fiscal stance in 2000 and reduced the fiscal deficit to 2.3 percent of GDP in 2000, from 5.4 percent in 1999. Improved budget revenues and lower levels of public expenditures contributed to a fiscal surplus in the first quarter of 2001 (1.1 percent of GDP).

Estimates are that GDP grew by 9.9 percent in 2001; largely due to oil sector development and improved agricultural performance.

### Financial Governance: Issues and Challenges

The unresolved conflict impedes economic progress and deters foreign investment. Long-term prospects depend upon world oil prices, the

<sup>8</sup> Primary Source: Asian Development Bank (ADB). 2001. *Asian Development Outlook 2001*. Manila: ADB.

location of new regional pipelines and Azerbaijan's ability to manage its oil wealth. Maintaining the competitiveness of non-oil exports in world markets is also a serious long-term challenge.

The Government has initiated structural reforms and has substantially liberalized domestic markets and foreign trade. Another government priority is the recently rejuvenated privatization program for medium- and large-scale organizations—the privatization law was passed by parliament in 2000.

The Government established the State Oil Fund in November 1999 (an intergenerational trust fund, similar to those established by several Pacific island nations). The Fund will enable better management of oil revenues. In addition, progress has been made in implementing policy reforms, such as the passage of the *Civil Code* (effective 1 September 2000) and the amended *Tax Code* (effective 1 January 2001). However, structural reforms, particularly in the banking sector, have lagged behind. Crucial reforms are needed in this sector to improve supervision and strengthen enforcement of prudential regulations in line with international best practice.

The amended *Tax Code 2000* is expected to increase fiscal revenues. However, increasing social expenditures while maintaining fiscal discipline remains a challenge, as does managing projected oil revenues and developing the non-oil sectors.

To maintain investor confidence, the Government needs to make a serious effort in implementing structural reforms. Important areas include privatization, financial sector restructuring, and good governance to establish institutions and the rule of law conducive to a market-based economy. The increasing dependence on oil exports is a concern—developing the non-oil sectors is critical to achieving a balanced external account position and sustainable growth. Understanding this, the Government has prioritized non-oil sector advancement in its recent medium-term development strategy.

The principal elements of the medium-term development strategy include: (i) maintaining fiscal and monetary policies that support macroeconomic stability; (ii) implementing aggressive programs to strengthen energy sector governance and financial discipline; (iii) maintaining the liberal trade regime; (iv) accelerating structural reforms; and (v) implementing measures that will improve the legal and regulatory environment for private sector development.

As part of the government's overall effort to enhance governance, a comprehensive anticorruption program is being developed and the Azerbaijan Accounting Chamber (AAC)—Azerbaijan's Supreme Audit

Institution (SAI)—has been established. The AAC has the authority to audit all government bodies, including all budgetary and extra-budgetary organizations and funds, and must publicly report its findings.<sup>9</sup>

## 6. ADB Operational Strategy

ADB's interim operational strategy for Azerbaijan focuses on reducing poverty and raising living standards in a sustainable manner. Operations will initially: (i) enhance human development; (ii) promote sustainable growth, including private sector development; and (iii) support good governance and institutional strengthening. Two operational areas are prioritized: direct assistance to the poor, and poverty reduction through non-oil sector development.<sup>10</sup>

## 7. International Guidelines and Surveillance<sup>11</sup>

The international community is supporting the development of guidelines, standards, and codes to assess financial management and governance practices (see Table 2). Where relevant, this report compares Azeri arrangements and practices against these benchmarks.

These guidelines, standards and codes—to varying extents—all involve accounting and auditing arrangements. Furthermore, in an attempt to identify and avoid potential crises before they occur, the IMF and the World Bank have together embarked on a series of *Reports on the Observance of Standards and Codes (ROSCs)*. These reports summarize the extent to which countries observe certain internationally recognized standards.<sup>12</sup> Although ROSCs are intended to be voluntary, the information provided by each country (or not provided, as the case may be) is likely to influence country dealings with International Financial Institutions, and the level of

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<sup>9</sup> International Monetary Fund (IMF). 15 June 2001. *Azerbaijan Republic: Memorandum of Economic and Financial Policies for 2001-02*. Washington DC: IMF. URL: <http://www.imf.org/external/np/loi/2001/aze/01/index.htm>

<sup>10</sup> Asian Development Bank (ADB). 2001. *Regional and Country Highlights: Azerbaijan*. Manila: ADB. p 14.

<sup>11</sup> Narayan, Francis B., Ted Godden, Barry Reid, and Maria Rosa Ortega. 2000. *Financial Management and Governance Issues in Selected Developing Member Countries: A Study of Cambodia, People's Republic of China, Mongolia, Pakistan, Papua New Guinea, Uzbekistan, and Viet Nam*. Manila: ADB. pp. 12-13.

<sup>12</sup> International Monetary Fund (IMF). September 2000. *Experimental Reports on Observance of Standards and Codes (ROSCs)*. Washington, DC: IMF. URL: [www.imf.org/external/np/rosoc](http://www.imf.org/external/np/rosoc)

confidence that investors and the international financial community have in a country.

**Table 2: Selected International Guidelines, Standards and Codes**

International Guideline, Standard or Code	Promulgated By
<ul style="list-style-type: none"> <li>Principles of Corporate Governance</li> </ul>	Organisation for Economic Cooperation and Development (OECD)
<ul style="list-style-type: none"> <li>Code of Good Practices on Fiscal Transparency</li> </ul>	International Monetary Fund (IMF)
<ul style="list-style-type: none"> <li>Code of Good Practices on Transparency of Monetary and Financial Policies</li> </ul>	International Monetary Fund (IMF)
<ul style="list-style-type: none"> <li>Implementation of the Objectives and Principles for Securities Regulation assessment surveys</li> </ul>	International Organization of Securities Commissions' (IOSCO)
<ul style="list-style-type: none"> <li>International Accounting Standards (IASs)</li> </ul>	International Accounting Standards Board (IASB)
<ul style="list-style-type: none"> <li>International Standards on Auditing (ISAs)</li> </ul>	International Federation of Accountants (IFAC)
<ul style="list-style-type: none"> <li>Draft Banking Supervision Guidelines</li> </ul>	Basel Committee on Banking Supervision (BCSB) of the Bank for International Settlements (BIS)

## 8. Report Structure

This report examines financial management and governance issues in Azerbaijan, with a focus on accounting and auditing arrangements. In addition to this introduction, the report has the following chapters:

- Chapter II—**Accounting and Auditing in Azerbaijan**—presents an overview of Azeri accounting and auditing arrangements. It provides context for the following chapters on professional infrastructure, accounting and auditing standards, accounting and auditing training, and government budgeting and accounting arrangements.
- Chapter III—**Professional Infrastructure**—describes Azerbaijan's professional accountancy infrastructure.
- Chapter IV—**Accounting and Auditing Standards**—describes the accounting and auditing standards that govern the preparation of external financial reports and the audit of those reports.

- Chapter V—**Accounting and Auditing Training**—describes accounting and auditing education and training, including coordination of accountancy education.
- Chapter VI—**Government Budgeting and Accounting**—describes government budgeting and accounting arrangements.
- Chapter VII—**Donor Assistance**—reviews donor coordination mechanisms and discusses donor activities in relation to financial management and governance arrangements.
- Chapter VIII—**Issues and Recommendations**—presents the issues and recommendations that are associated with gaps or weaknesses in accounting and auditing arrangements.
- Chapter IX—**Country Action Plan**—summarizes deficiencies and actions to address these deficiencies. Recommendations are divided into actions that would be better achieved with external assistance; and actions that may be achieved without the need for external assistance.