

II. Accounting and Auditing in Azerbaijan

This chapter presents an overview of Azerbaijan 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. The chapter comprises eight sections as follows:

Part One: Accounting

- 1 – Introduction—identifies historical factors that have influenced accounting arrangements.
- 2 – Issues and Responses since 1991—describes the issues that faced Azerbaijan in 1991 when the transition process to a market economy began. It also summarizes the actions that were taken in response to these issues.
- 3 – The ‘Azerbaijan Accounting System’—describes Azerbaijan accounting arrangements, which include the legislative and institutional framework, financial reporting requirements, accounting bases, accounting information systems and record-keeping arrangements.

Part Two: Auditing

- 4 – Introduction—introduces Azerbaijan auditing arrangements.
- 5 – Governing Laws and Regulations—describes the laws that govern Azerbaijan auditing practices and audit requirements.
- 6 – Public Sector Auditing: The Azerbaijan Accounting Chamber (AAC)—briefly describes the establishment of the AAC, Azerbaijan’s Supreme Audit Institution (SAI).
- 7 – Accounting and Auditing Firms—describes the presence of domestic and international accounting firms in Azerbaijan.
- 8 – Issue Synopsis: Azerbaijan Accounting and Auditing—summarizes the issues identified in this chapter.

Part One. Accounting

1. Introduction

Accounting in the Soviet Union, which included Azerbaijan, catered to the needs of statistical and tax authorities. It did not provide the information required by securities markets or company managers in a market economy. Nor did it support an economically rational system of enterprise taxation, since many production costs were not deductible for tax purposes (e.g., certain payroll and interest expenses).

In common with other former Soviet Union (FSU) countries, Azerbaijan has little history or tradition of using market-based accounting concepts such as going concern, consistency and substance over form. In particular, the Soviet accounting system strictly applied the historical cost convention to record assets—assets that were never revalued. Moreover, provisions for doubtful debts or obsolete inventories were not estimated—doubtful accounts were written off only when they were clearly not collectable. In essence, a risk-free environment was assumed where no thought need be given to valuation of assets or determination of profit. Goods were not bought and sold in a free market and there was no risk of a decline in value. Enterprises did not answer to investors, bankers or regulators for their performance.

Accounting consisted of adhering to prescribed charts of accounts (Uniform Accounting Systems: UASs) that were designed to meet the requirements of the central planning system. The primary function of accounting was to record the factual data necessary to assess plan accomplishments, rather than to assess an enterprise's financial situation. The focus of Soviet accounting was more on bookkeeping than on the process of accounting. In fact, they were considered the same thing. Accounting, however, involves much more than bookkeeping. Bookkeeping only entails the recording of economic events while the accounting process includes application of generally accepted accounting standards to identify, measure, record and report those events and their effect on an enterprise.

Upon independence in 1991, Azerbaijan found itself in the same position as other Former Soviet Union (FSU) countries concerning accounting arrangements. However, the Soviet accounting system created a sound basis on which to build—the system used many concepts of modern accounting including accrual measurement and double entry bookkeeping. Moreover, large numbers of bookkeepers were trained in these concepts and were proficient in their application.

2. Issues and Responses since 1991

In the decade since the beginning of the transition, Azerbaijan has made some progress in developing an accounting infrastructure suitable to the needs of a market economy. However, financial management reforms were slow-tracked due to emphasis on the conflict and oil and gas sector developments. Consequently, Azerbaijan's accounting and auditing reforms lag those of many other FSU countries.

However, the magnitude of these accomplishments is best viewed by examining the 1991 situation. First, although there were tens of thousands of bookkeepers, there were no qualified Certified Practising Accountants (CPAs) let alone a professional accounting body. Second, financial information on the performance and position of organizations was not publicly available. In any case, this information did not meet international standards nor did it cater to the needs of investors or lenders. Third, the users of financial information (investors and creditors) were unfamiliar with what they should demand from organizations. Fourth, financial information was not independently verified (audited) to international standards and could not be relied upon. Fifth, the entire legal framework was geared to central planning and specified exactly what information should be produced, how it should be produced, and to whom it should be provided. Finally, the regulatory entities that generally exist in market economies to oversee financial disclosure practices, such as securities exchange commissions, did not exist.

At the beginning of the transition, many FSU accountants believed that transforming accounting to a market-oriented system could be accomplished simply by modernizing the UASs (charts of accounts, supported by detailed instructions) according to internationally accepted accounting principles. However, this was not sufficient—international accounting standards (IASs) and practices must be underpinned by the exercise of professional judgment—the development of a strong accountancy profession whose members are equipped to understand the conceptual underpinnings of IAS, and who are able to exercise judgment in their application, is now seen as critical to the effective establishment of international accounting standards and practices.

The adoption of the *Accounting Law 1995* and the 1996 introduction of new UASs brought the Azerbaijan accounting system closer to IASs. In particular, (i) market-based accounting concepts were introduced (e.g., leasing); (ii) enterprises were allowed some freedom over asset accounting; (iii) enterprises may now provide for doubtful debts; and (iv) financial statement formats were revised.

3. The ‘Azerbaijan Accounting System’

Legislative and Institutional Framework

Articles 120–125 of the *Civil Code 1999* govern accounting and auditing arrangements in Azerbaijan. In particular, the *Civil Code 1999* stipulates the structure of financial statements. The Ministry of Finance (MOF) administers the *Law on Accounting 1995*, which regulates the maintenance of accounting records and the preparation of balance sheets by business entities and organizations in both the private and the public sectors. It also sets out financial reporting requirements.

Other relevant laws include the *Joint Stock Companies Law 1994* (Appendix 16), the *Enterprises Law 1994* (see Appendix 15), the *Banking Law 1996* (see Appendix 14) and the *Tax Code 2000*. These laws conflict in places regarding accounting and reporting arrangements. At the same time, the prescriptive nature of the *Civil Code 1999* conflicts with the flexible provisions of the *Tax Code 2000*.

The main reporting requirements for legal entities are the quarterly tax return and statutory accounting annual reports that are filed in March–April. The accounting arrangements for relevant foreign companies usually exempt these companies from following Azerbaijan accounting practices.

Accounting and reporting arrangements in the banking sector have developed further than those of other sectors. The MOF has recently prepared a five-year *Accounting Reform Plan* to develop accounting arrangements for other sectors (see Appendix 4, Appendix 5 and Appendix 6). This plan is currently being considered and covers accounting standards, certification, ethics and training.

Accounting Bases and Principles

Revenues can be recorded on either the cash or accrual basis. Expenses must be recognized on the accrual basis, except where the cash basis has been used for revenues, in which case direct costs must be recorded on the cash basis (*Tax Code 2000*, Articles 130–134). Budgetary organizations use the accrual accounting basis.

Accounting Information Systems

The books of many organizations and enterprises are maintained manually. However, computerized accounting information systems are becoming

prevalent, particularly in the oil and gas, and in the banking sector. The IMF and World Bank are supporting the development of computerization of government accounting. Furthermore, it appears that the *Accounting Reform Plan* (See Appendix 5) envisages a national computerized accounting system.

Record-Keeping Arrangements

With the exception of organizations operating under Production Sharing Agreements (PSAs), all entities established under Azerbaijan laws must maintain their books and records in Azeri, in local currency, and in accordance with accounting legislation. This includes using the appropriate UAS.

Part Two. Auditing

4. Introduction

Up until 1991, auditing in the Soviet Union, which included Azerbaijan, reflected the highly prescriptive nature of the underlying accounting system. It was primarily a verification exercise, with the final accounts being compared to bookkeeping records by accountants from another enterprise within the same group. It is not surprising that a fully functioning and competent audit profession has not been created within the short timeframe of 10 years. With the exception of a few large international firms, auditing in accordance with International Standards on Auditing (ISAs) is a relatively new concept.

5. Governing Laws and Regulations

The *Auditing Services Law 1995* governs auditing activities in Azerbaijan. Other laws stipulate audit requirements. In general, all organizations must be audited. The *Auditing Law 1995* describes the ‘Audit Conclusion’ as an estimation of an organization’s financial state.

6. Public Sector Auditing: The Azerbaijan Accounting Chamber (AAC)

The Government has recently moved to establish a Supreme Audit Institution (SAI)—the Azerbaijan Accounting Chamber (AAC). The AAC

will have the authority to audit all government bodies, including all budgetary and extra-budgetary organizations and funds, and will be obligated publicly report its findings. The AAC Chair was appointed at the end of 2001. The Chamber is currently in the process of hiring staff, developing capacity and preparing a work program.

7. Accounting and Auditing Firms

As of April 2001, the Chamber of Auditors of Azerbaijan (COAA) had issued audit licenses to 27 local firms and five foreign firms. Four of the ‘Big Five’ international accounting firms have offices in Azerbaijan: PricewaterhouseCoopers, Ernst & Young, Arthur Andersen and KPMG. Deloitte Touche Tohmatsu maintains a presence through an associated firm. The five licensed foreign accountancy firms earned 78 percent of total fees during the first half of 2001—their fee structures are about 23 times higher than domestic counterparts.¹³

8. Issue Synopsis: Azerbaijan Accounting and Auditing Arrangements

Chapter IX—*Issues and Recommendations*—identifies and describes constraints and proposes corrective actions. These include the following issues from this chapter:

- With exceptions—particularly in the banking and the oil and gas sectors—Azerbaijan’s accounting and auditing arrangements remain largely consistent with the Soviet accounting arrangements.
- In some places where reforms have been made, conflicts have been created between laws and regulations.
- To this end, the MOF has prepared an *Accounting Reform Plan*—the Cabinet of Ministers is currently considering the plan.

¹³ *Azeri Business News*. 2001 August 29. Interview with the Chairman of Chamber of Auditors of Azerbaijan. Newspaper Article.