

V. Accounting and Auditing Practices in Azerbaijan

1. Challenges and Responses

The Azerbaijan Government established the State Oil Fund—an intergenerational trust fund—in November 1999. The Fund will enable better management of oil revenues. Progress has also been made in implementing policy reforms, such as the passage of the *Civil Code* (effective 1 September 2000) and the amended *Tax Code 2000* (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, government will need to implement structural reforms, including privatization, financial sector restructuring, and the establishment of institutions and the rule of law that are conducive to a market-based economy.

The principal elements of government's medium-term 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.

A comprehensive anticorruption program is being developed as part of government's overall effort to enhance governance. To this end, 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 will publicly report its findings.

2. Accounting and Auditing in Azerbaijan

Azerbaijan developed its Soviet-based accounting system throughout the 1920s and 1930s. The 'Soviet accounting system' catered to the needs of

central planning, in particular, the system provided accounting information, including: (i) financial information; (ii) tax information; and (iii) statistical information. It emphasized standardization and uniformity so that information could be compared across sectors and industries.

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. Furthermore, large numbers of bookkeepers were trained in these concepts and were proficient in their application.

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 development of the oil and gas sector. Consequently, Azerbaijan's accounting and auditing reforms lagged behind those of many other FSU countries.

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 Azeri 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*, the *Enterprises Law 1994*, the *Banking Law 1996* 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 annual accounting reports that are filed in March–April. The accounting arrangements for relevant foreign companies usually exempt these companies from following Azeri accounting practices. The MOF has prepared a five-year program to develop accounting practices. This program is currently being considered and covers legislation, accounting standards, certification, ethics and training.

Auditing in the FSU reflected the highly controlling nature of the underlying accounting system. It was primarily a verification exercise, with the final accounts being compared to the bookkeeping records by accountants from another enterprise, or from the control and revision board.

Moreover, with the state undertaking controlling, crediting and investment functions, there was no need for a fully functioning audit profession. The auditing profession has only been created within the short time frame of 10 years.

The *Auditing Services Law 1995* governs auditing activities in Azerbaijan. Other laws stipulate audit requirements. In general, all organizations must be audited. The *Auditing Services Law 1995* describes the 'Audit Conclusion' as an estimation of an organization's financial state. As of April 2001, 160 individuals and 32 firms were licensed to conduct audits in Azerbaijan (five of these firms were foreign).

3. Professional Infrastructure

The Soviet accounting system required neither professional accountants nor an accountancy profession. This changed with Azerbaijan's transition to a market economy, following independence in 1991.

The Chamber of Auditors of Azerbaijan (COAA) began operations in 1996 in accordance with the provisions of the *Auditing Services Law 1995*. Under these provisions, the Chamber is responsible for: (i) overseeing auditing activities in Azerbaijan; (ii) issuing auditing instructions, standards and guidance; (iii) licensing individual auditors and auditing firms; (iv) considering complaints against individuals and auditing firms; (v) consulting the profession on relevant legislative issues; (vi) reviewing the compliance of foreign individuals and foreign audit firms with the *Auditing Services Law 1995*; and (vii) conducting audits. The COAA may also establish auditing firms and, until January 2001, it also conducted fee-paying audits on its own behalf in competition with its members.

The Supreme Council of Azerbaijan appoints the Chamber's Chairperson and Deputy Chairperson. Individual auditors and auditing firms are required to pay membership fees to COAA. The Chamber holds memberships in several international and regional bodies, including those for SAIs, but it will be relinquishing the SAI memberships in favor of the recently established AAC.

As of April 2001, the COAA had issued renewable five-year audit licenses to 160 individuals, 27 local firms and five foreign firms. Auditing firms must comprise at least three qualified individuals. Individuals must be Azerbaijan citizens, although the Chamber may accept the qualifications of foreigners, who are licensed to practice in their own countries. To qualify for an audit license, individuals must: (i) have completed higher education in accounting, finance, economics or law; (ii) pass the auditor's license examina-

tion set by a COAA-appointed Commission; and (iii) have at least three years practical experience related to their education field. CPE is not mandatory.

The COAA has also created a local chapter of the US-based Institute of Internal Auditors (IIA). More recently, the nongovernment, not-for-profit Association of Certified Accountants of Azerbaijan (ACAAz) was established in 2000. The Association currently has 18 active practitioner members, all of whom have completed training in international accounting standards and practices. Nineteen other specialists are undergoing certification and around 80 others are undertaking courses.

The International Regional Federation of Accountants and Auditors Eurasia is not an Azerbaijan-based professional accountancy body, but influences accountancy developments within the FSU and within Azerbaijan. This Federation was established in 1999—its members include 20 professional accountancy organizations from 10 FSU countries. The Federation’s mission is to develop and strengthen the accounting and audit profession, promote the implementation of international professional standards and professional standards on ethics as developed by IFAC and IASB through its member bodies.

The Federation provides support and assistance to national organizations of accountants and auditors in the following areas: (i) developing national organizations in preparation for IFAC recognition; (ii) ensuring high quality accounting and audit services; (iii) developing the theory and practice of accounting and audit based on international standards; (iv) preserving the professional independence of accountants and auditors; and (v) developing and strengthening professional contacts at the regional and international levels. Azerbaijan is represented on each of the Federation’s five standing committees: accounting standards, auditing standards, legal reform, membership and ethics, and professional education and certification.

The Azeri accountancy profession is in its infancy. Not surprisingly, COAA has noted that fees charged by foreign auditors are around 23 times higher than those charged by domestic auditors. The profession can narrow this gap over time by pushing accountants to higher certification standards.

4. Accounting and Auditing Standards

In common with most other countries transiting from the Soviet accounting system, Azerbaijan continues to emphasize uniform accounting systems. These comprise sector-specific charts of accounts supported by detailed accounting rules and instructions.

In the 1990s, while government focused on the conflict and on developing the oil and gas sector, accounting reform was accorded a low priority. Moreover, the MOF worked, and continues to work, within tight resource constraints (it has received no external technical assistance to date for accountancy reform). Consequently, Azerbaijan's transition towards IAS-based accounting standards has generally been slower than other FSU countries.

The *Accounting Law 1995* and the *Banking Law 1996* assign accounting-standard-setting responsibilities to the MOF and to the Azerbaijan National Bank (ANB). Neither law explicitly refers to IAS. Furthermore, the oil production sharing agreements exempt relevant foreign companies from following Azerbaijan accounting standards; most of these companies use IAS.

Substantial progress has been made towards implementing IAS-based financial reporting in the banking sector. The MOF recently presented an *Accounting Reform Plan* to the Cabinet of Ministers for consideration and approval. The draft plan reflects objectives that are largely inconsistent with accounting in a market economy. For instance, a primary purpose of financial accounting is considered to be the provision of information, in a standard format, that is needed to prepare consolidated country financial statements, which incorporate all entities, both private and public sector. The plan also emphasizes the continued development of UASs.

COAA promulgates auditing instructions in accordance with regulations issued under the *Auditing Services Law 1995*. These instructions are directly based on ISAs. The development process is consultative. Once approved by the COAA Board, auditing standards are registered with the Ministry of Justice. As of December 2001, the Chamber had reviewed, amended and promulgated about 24 of the 30 ISAs.

5. Education and Training

Together with other FSU states, Azerbaijan has a high literacy rate and comparatively high educational standards. Indeed, Azerbaijan education was renowned within the Soviet Union and more widely (particularly education related to the oil and gas sectors).

However today, most higher education institutions suffer from resource constraints and infrastructures have deteriorated considerably. Moreover, post-independence difficulties have constrained the development of quality academic materials including textbooks. Furthermore, computer hardware and software is lacking and high Internet

fees exclude most academics and students from accessing web-based information resources.

One state institution—the State University of Economics—offers undergraduate and postgraduate accountancy programs. As of November 2001, 1,100 students were enrolled in its accountancy-based bachelor programs and 90 were undertaking Masters programs. The state specialist schools, for instance the Oil and Gas Academy, also teach specialist accountancy studies.

Eight private tertiary institutions offer accountancy programs, two of these teach predominantly in English. Furthermore, practical accountancy training is given by 26 vocational schools and the newly-established Azerbaijan Banking Training Center provides specialist education in banking and finance. The ACAAz, the Azerbaijan Association of Entrepreneurs and COAA also conduct accounting and auditing training.

The quality of higher education is constrained by *ad hoc* curriculum development and a general absence of continuing education for accountancy lecturers and professors—the latter is critical in the dynamic environment of transitional Azerbaijan. The move towards the Azeri language further exacerbates problems. For accountancy in particular, there is a chronic lack of textbooks and other teaching materials. Moreover, those that are available are either outdated or unsuitable in the Azeri context.

6. Government Budgeting and Accounting

Although government finances are in deficit, projected revenues from the oil and gas sector make the current situation sustainable. Indeed government has established a significant Oil Fund and has indicated a medium-term intention to substantially reduce reliance on external assistance. The Oil Fund will support the competitiveness of the non-oil sectors and contribute to intergenerational fiscal stabilization.

However, public sector management arrangements have been characterized as inefficient, ineffective and nontransparent. In the past two years, the Government has prioritized public expenditure management reforms. These include: (i) the ongoing development of a Medium-Term Expenditure Framework (MTEF) for use in budget preparation. Future budget submissions will provide reference to the MTEF, as well as detailed information on expenditure classifications, contingent liabilities, extra-budgetary activities, and the consolidated and general government budgets outturns for the previous year; (ii) drafting amendments to the *Budget Systems Law* and revisions to budget regulations; (iii) beginning in 2001, the

publication of quarterly reports on the consolidated government budget execution, including revenues, expenditures, expenditure arrears, stock of government and government-guaranteed debts, and new loans contracted or loan guarantees issued prepared by the MOF; (iv) integration of extra-budgetary activities into the state budget beginning with the 2002 budget; and (v) strengthening the MOF internal audit function.

Government activities are generally accounted for on an accrual accounting basis at the organizational level and on a cash basis for consolidated budgeting and reporting—the cash basis was introduced with support from international institutions, particularly the IMF and the World Bank.

Government organizations prepare monthly cash reports and quarterly accrual reports that are submitted to the MOF. In 2001, the MOF began publishing consolidated quarterly reports incorporating revenues, expenditures, expenditure arrears, stock of government and government-guaranteed debts, and new loans contracted or loan guarantees issued. A revised *Budget Systems Law* has been drafted and is currently being considered.

Although government organizations are staffed with ‘accountants’ and bookkeepers, these personnel have received little ongoing training. Moreover, concerns over the suitability of their qualifications have been raised, given the changed economic environment and the transition from the centrally planned to the market economy.

7. Donor Assistance

Government has announced its intention to significantly reduce its reliance on external assistance within five years. Azerbaijan joined ADB in December 1999. Although no active or planned loan projects are directly related to improving financial governance arrangements, Technical Assistance (TA) No. 3661: *Capacity Building for Strategic Economic Policy Formulation in the Ministry of Finance* (\$0.762 million: 2001-2002) includes: (i) assisting the development of a Macroeconomic Policy Group (MPG); (ii) providing strategic policy advice on structural reform and macroeconomic policy; (iii) improving the information base for MOF economic policy development; (iv) enhancing MOF forecasting and program design capacity and improving fiscal analysis; and (v) developing a macroeconomic framework and public investment program criteria in coordination with MPG and the MOF’s Debt Management Department, and strengthening the Project Evaluation Unit.

The European Bank for Reconstruction and Development (EBRD) emphasizes programs and activities that support privatization, financial reforms, industrial restructuring, the creation and strengthening of infrastructure, foreign investment inflows and environmental rehabilitation. EBRD also provides assistance to organizations to improve their accounting and financial reporting capabilities. Furthermore, EBRD is currently considering providing assistance to the State Securities Committee to align securities laws and regulations with international practices. The IMF has provided assistance to improve macroeconomic policies and to strengthen central bank functions.

The World Bank is the key player in supporting improved financial governance arrangements. In addition to strengthening executing agency accounting arrangements and financing external financial audits, the following projects are relevant:

- Pipeline: *Institution Building Technical Assistance Project II* (\$16.0 million: 2002–). This project has two components: Public Sector Reform (PSR) and Financial Sector Reform (FSR). The PSR component is intended to: (i) improve public resource management; (ii) strengthen the accountability, efficiency and policy implementation capacity of the central government; (iii) improve public service delivery; and (iv) develop the legal system and an independent judiciary. The FSR component will focus on: (i) assisting the Government to privatize state banks; (ii) assisting the ANB to strengthen banking supervision; and (iii) strengthening the legal and regulatory environment.
- Project P055131: *Second Structural Adjustment Credit Project* (\$60.0 million: 2002–). This project will support the Government's public sector reforms. In doing so, it is intended to contribute to improved public financial management, including: (i) better management of public resources—human, financial and natural; (ii) improved delivery of public services; and (iii) an enabling environment for private sector development
- Loan 35180: *Financial Sector Technical Assistance Loan Project* (\$5.4 million: 2001–2006). This project supports implementation of the Government's financial sector development strategy, including: (i) introducing IAS-based National Accounting Standards for commercial banks; (ii) establishing IAS-compatible National Accounting Standards; (iii) passing laws and regulations to reinforce these National Accounting Standards; (iv) developing commercial bank financial reporting based on ANB-prescribed standards, and (v) preparing a banking manual of procedures and guidelines for accounting practices.

- Loan 27690: Institution Building Technical Assistance Project (\$18.0 million: 1995–2001). This project had four focal areas: (i) assisting privatization and enterprise reform; (ii) strengthening macroeconomic management; (iii) developing the financial sector; and (iv) providing legal technical assistance. Among other things, the assistance supported the development of accounting and auditing systems and standards for enterprises and banks, and the implementation of a computerized accounting system within ANB.

European Union—Technical Assistance to the Commonwealth of Independent States (EU-TACIS) assistance includes: supporting institutional, legal and administrative reforms; and supporting the private sector and assisting economic development. Particular attention is focusing on developing internationally-acceptably accounting standards. The United States Agency for International Development (USAID) is providing assistance to support the introduction of IAS and to develop qualified financial experts in order to facilitate a countrywide transfer to international standards of financial reporting (through assistance to the ACAAz).

8. Issues and Recommendations

This part presents the issues and recommendations that are associated with gaps or weaknesses in Azerbaijan’s accounting and auditing arrangements. These recommendations are intended to supplement and support existing strategies and projects. Where actions are already planned or underway, no recommendations are made.

The study concludes that—with some exceptions—much remains to be done to align Azerbaijan accounting and auditing arrangements with international practices and with the needs of the mixed market economy. These changes include developing a supportive and appropriate legislative and institutional environment, reforming accounting standards and strengthening the accounting and auditing profession. Internationally-compatible arrangements can only be successfully implemented with the support of a strong profession comprising skilled accountancy professionals.

Azerbaijan is now in a position to closely examine other countries’ efforts and—by doing so—to develop a comprehensive road map for accountancy reform that (hopefully) will enable it to avoid the errors made by other countries. To this end, this DSAA recommends that a coordination group be established to: (i) develop a strategic plan for accountancy reform; and (ii) design and agree a legislative and institutional framework that will support implementation of the strategic plan.

Each study recommendation—and the issues that it is intended to address—is summarized below. The Azerbaijan DSAA report provides further detail.

Establish Coordination Group, Develop Strategic Plan and Review Framework

In addition to conflicts between governing legislation, some laws will impede development of accounting arrangements. Moreover, assignments of institutional responsibilities are inappropriate in some cases. Finally, there is much to be done regarding accountant certification and general accounting training.

Although the MOF has prepared the draft *Accounting Reform Plan* covering legislation, management accounting, internal auditing and external auditing, it has done so within its limited resources. In general, the development of financial management arrangements is fragmented with several organizations taking initiatives. A high-level, representative coordination group could do much to ensure that these efforts are mutually supportive and do not overlap or conflict.

It is **recommended** that assistance be provided to support financial management developments, through establishment of a Coordination Group. It is also **recommended** that assistance be provided to assist the Coordination Group to prepare a strategic plan for the development of Azeri accounting and auditing. The project would involve: (i) researching Azerbaijan accounting and auditing arrangements; (ii) identifying and analyzing existing problems; (iii) examining and drawing useful lessons from regional and international experience in terms of developing financial management arrangements; and (iv) using this information and the associated analyses to formulate a medium to long-term development plan for Azerbaijan financial management. It is further **recommended** that assistance be provided to assist the Coordination Group to review the legislative, regulatory and institutional framework and to identify necessary changes to this framework.

Amend Laws and Regulations

Among other things, the prescriptive provisions of the *Civil Code 1999* conflict with the adoption of international accounting practices. Several laws are currently under revision including the *Accounting Law 1995* and the *Banking Law 1996*. It is **recommended** that assistance be provided to develop a

legislative base that is conducive to the adoption of international accounting and auditing practices.

Clarify Accounting Standard-Setting Arrangements

The MOF and ANB both promulgate Azeri accounting standards in accordance with a Presidential Decree. It is **recommended** that the *Accounting Law 1995* be revised to support the development of accounting standard-setting arrangements.

Clarify Legal Status of Auditing Standards

Relevant Azeri laws are largely silent regarding auditing standard requirements. It is **recommended** that all laws requiring audited financial statements be amended to stipulate that these audits must be conducted in compliance with Azeri auditing standards and practices.

Clarify Auditing Standard-Setting Arrangements

COAA sets Azeri auditing standards. However, the standard-setting process is not enshrined in law. For instance, the composition of the standard-setting body should be legally established (regulators and financial statement users should be strongly represented). It is **recommended** that the *Accounting Law 1995* be revised to provide for the development of auditing-standard-setting arrangements.

Broaden and Strengthen Accounting Qualifications

COAA issues audit licenses to individuals and to auditing firms. The licensing process could be strengthened significantly. The revised accounting law, prepared by the MOF, envisages that this responsibility would be assigned to the MOF. Furthermore, while the Chamber has one membership category (licensed auditor), it is common international practice for professional bodies to have a range of membership categories with differing qualification criteria including Accounting Technicians, Management Accountants, Government Accountants and CPAs. The establishment of additional membership categories, with appropriate qualification criteria, would strengthen the Azeri accounting profession and broaden the Chamber's membership and revenue base. It is **recommended** that assistance be provided to establish additional

accounting qualifications including Accounting Technician, Management Accountant, Internal Auditor, Government Accountant and CPA. It is also **recommended** that assistance be provided to: (i) review existing licensing procedures and requirements (e.g., education, practical experience and professional examinations); (ii) develop improved licensing procedures and requirements, and (iii) implement these new licensing procedures. It is further **recommended** that individuals already holding audit licenses be required to re-qualify under the improved qualifications when their existing licenses expire.

Develop Training Materials

The COAA has developed training materials with EU-TACIS assistance. However, the rapidly changing environment and need for professional development present major challenges. Multimedia and Internet-based technologies present options to prepare effective interactive training materials that are easily redeveloped to reflect the changing environment and can easily be distributed to far-flung regions. It is **recommended** that assistance be provided to develop training materials for accountant continuing professional education. Similar ongoing ADB-supported initiatives for the People's Republic of China, Nepal and the Philippines are directly relevant. The project would involve: (i) studying options for preparing and providing training materials to CPAs; (ii) developing a medium- to long-term plan for developing continuing professional education; (iii) studying options for developing and delivering training materials using modern technology, and (iii) developing training materials and training trainers.

Develop Accounting Curriculum and Materials

The move towards Azeri-language instruction combined with the rapidly changing accounting environment means that quality accounting educational materials are not generally available. Moreover, the academic curriculum has not kept pace with environmental changes. It is **recommended** that assistance be provided to: (i) review the accounting curriculum; (ii) revise the accounting curriculum; (iii) prepare suitable accounting textbooks and other training materials, and (iv) implement the new curriculum in universities.

Provide Continuing Training to Professors and Lecturers

Azerbaijan has extremely competent accounting professors and lecturers due to the country's legacy of high educational standards. However, not all these professors and lecturers are conversant with the changes in the accounting environment. It is **recommended** that assistance be provided to design and implement a continuing education program for accounting lecturers and professors.

Establish Government Accountant and Auditor Certifications

As described above, professional qualifications for government accountants should be established. Furthermore, the recently established AAC intends to develop certification procedures and associated training programs for its auditors. It is **recommended** that assistance be provided to develop certification procedures and associated training programs for government accountants and auditors.