

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC) Azerbaijan Republic

ACCOUNTING AND AUDITING

September, 2006

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Executive Summary

Enhancing the reliability and availability of financial reporting is conducive to economic growth and helps mitigate against financial system instability. In furthering these objectives, this report provides an assessment of accounting and auditing standards and practices in Azerbaijan. It uses International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) as benchmarks and draws on good practices in the field of accounting and audit regulation to assess the quality of financial information and provide policy recommendations.

Corporate Sector Accounting and Auditing are at a Crossroads

The role and regulation of corporate sector accounting and auditing are shaped by the economic context in which they take place, and the structure of the market which they serve. With less than 15 years of history, Azerbaijan's modern economy is still very young. The privatization process, which started in the mid-nineties, is still far from being complete: some of the most important sectors of the economy (such as oil and gas) still mostly remain state property. Thus, the current Azerbaijani economy includes a spectrum of economic subjects. This spectrum ranges from newly established, privately financed enterprises with little or no experience in using the tools offered by the market economy, to State Owned Enterprises (SOEs), which continue to depend on government subsidies.

Previously in Azerbaijan, financial reporting information was not considered a public good provided to meet the needs of business, but rather a resource to which access was restricted to those having the power to require its provision. Bank lending decisions were not dependent on a borrower's financial statements, but rather on collateral and other sources of information about the enterprise. These circumstances do much to explain the current state of accounting and auditing practices in Azerbaijan.

Until recently, accounting and auditing requirements were uncoordinated. Different agencies (e.g., the tax authorities, banking regulators) had been independently developing accounting and auditing requirements based on each agency's specific needs. There were minimal requirements for the publication of financial information, and the concept of general-purpose financial statements that met the needs of several stakeholders was effectively unknown. Likewise, there was little recognition that an independent financial statement audit performed by qualified professionals could lend credibility to the financial information provided to the marketplace.

This report was prepared by a team from the World Bank on the basis of the findings from a diagnostic review carried out in Azerbaijan in May and June 2005. The staff team was led by Frédéric Gielen and comprised Ida N. Muhoho (ECSPS) and Svetlana Klimenko (OPCFM), as well as Alfred Borgonovo of Certified General Accountants, Canada. The review was conducted through a participatory process involving various stakeholders and led by the country authorities.

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At the same time, progress is being made: Azerbaijan is transitioning from a country in which state intervention in the economy was very significant to one in which the market plays a much greater role. Finally, Azerbaijan's increased global economic integration and access to global financial markets has made essential greater transparency of financial information and its consistency with international standards. To adequately serve the emerging needs of the market and help the economy grow, the accounting and auditing professions will need to change accordingly, and radically. Adoption of the new Law on Accounting in 2004 could signify the beginning of reform; however, much remains to be done for Azerbaijan to achieve compliance with international standards and practices.

Aligning the Statutory and Institutional Framework with International Standards

This report highlights significant shortcomings in the legal and regulatory framework that currently support accounting and auditing in Azerbaijan. Addressing these shortcomings is necessary for the country to create a robust legal foundation that will pave the road to economic reform by establishing financial information as a necessity that is required to meet the needs of market participants in a healthy market economy. The following pervasive issues stand out:

- The legal framework supporting auditing in Azerbaijan is outdated. This framework cannot provide a foundation that would enable the current auditing profession to be guarantors of publicly available financial information. Significant reform is required. The ROSC team recommends the development and adoption of a new Law on Auditing Services, which would cover such critical areas as:
 - regulation of the profession;
 - rights and responsibilities of auditors;
 - audit quality assurance; and
 - liability and disciplinary provisions.

Significant enhancements regarding the Chamber of Auditors' structure, oversight and due process are needed to improve its success and legitimacy. The CoAA should only retain its right to regulate the statutory audit profession if it successfully addresses these issues.

In addition, the Law should specify auditing standards to be used in Azerbaijan, utilizing the "ISA Plus" model for that purpose, whereby ISA would be adopted in full. Additional standards and audit procedures should only be imposed if they follow from specific requirements relating to the scope of the statutory audit.

Development of a transparent system of auditing, conducive to the improved quality of audit work, would also require amendments to harmonize and regulate current auditing practices:

- Transparent procedures for the appointment, selection, and dismissal of auditors should be clearly defined to firmly establish the objectivity and independence of auditors.
 - The fees for statutory audits and other services provided by auditors should be disclosed, thus ensuring further transparency of auditors' work.
- The need for accounting reform was recognized and confirmed with the adoption of the new Law on Accounting (2004). The Law is focused on changing the role and significance of accounting and financial reporting in Azerbaijan and aligning it with good international practices. For example, the Law introduced the notion of Public Interest Entities (PIEs), which are required to apply IFRS while preparing their financial information; it also set the foundation for the development of National Accounting Standards (NAS), based on IFRS, for medium-sized enterprises.

This report endorses the focus of the Law; however, it highlights the need for further clarification in certain areas. The following supplementary measures are recommended to augment the Law:

- The Advisory Council for Accounting must continue to play a significant role in the implementation of accounting reforms; it should have sufficient rights, independence and dedicated resources to perform its duties.

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- In addition to the necessary normative-legal laws for enforcing the Law on Accounting, practical measures for the enforcement of the Law should be developed.
- The fragmented approach to regulating accounting, financial reporting, and auditing must give way to a single system consistent with the requirements of the new Law on Accounting. This would result in a harmonized, robust accounting and assurance system that would establish disclosure and transparency as public goods available to all market participants. To achieve this would require analysis, amendment, and harmonization of the variety of legislative acts currently regulating accounting, financial reporting, and auditing. Contradictions between previously existing and new regulations should be identified and eliminated to the extent possible. Amendments should be clearly explained to accounting practitioners. Harmonization should be promoted at the highest level. For example, the Ministry of Finance and the Ministry of Taxation should work together to develop a reconciliation methodology between tax and financial accounting.

Implementing Accounting Reform Introduced by the Law on Accounting

The Law on Accounting created a legal basis for large-scale, comprehensive accounting reform. The challenge of implementation is immense and the timeframe for the transition is short. The following steps (involving both institutional and capacity building measures) should be given priority:

- Establishment of a permanent group within the Ministry of Finance to take responsibility for IFRS translation and NAS development. In the future, this group could also assume responsibility for the development of implementation guidelines and for the technical and methodological support of practitioners during the transition period.
- Design and roll-out of a transition training program. Current Azerbaijani accounting rules and practices are derived from the old Soviet system. Thus, part of the training program should include a profound change of the “professional mind-set.” In addition to educating practitioners on how the new accounting rules should be implemented, this training program should stress why the adaptation of new regulations is necessary, and why new roles and responsibilities have been assigned to different governmental authorities.
- Facilitation of a transition process for state-owned companies operating in the most strategic areas of Azerbaijani economy. Through promptly conducting gap analyses and preparing detailed plans for embedding IFRS in SOEs, the appropriate measures for implementing IFRS in the SOEs must be enforced.

Enforcing Financial Reporting and Auditing Requirements

The overall transparency and disclosure levels of Azerbaijan’s top companies are still low and, in general, bankers and other potential users of financial information do not feel they can “trust” the financial statements presented by potential borrowers.

The report suggests the following actions:

- The Chamber of Auditors of Azerbaijan (CoAA) should play an important role in monitoring and enforcing legal requirements pertaining to the role of the auditor as a guarantor of the quality of financial information. This will foster the creation of a profession able to meet the new needs of the reformed economy. To achieve this, the CoAA’s operational focus should be revamped, ensuring that it endorses and follows its mandate. A comprehensive quality assurance system, able to effectively monitor and enforce auditor compliance with relevant auditing and ethical standards and independence requirements, should be developed and implemented as part of this effort. The CoAA should have adequate resources to achieve its objectives.
- The monitoring and enforcement functions of the State Committee for Securities (SCS) should be strengthened. The SCS is one of the main financial reporting regulators for companies which issue securities. In 2004, the SCS issued a “Regulation on preparation and presentation of the annual reports of issuers of securities,” requiring all such companies to include audited financial statements in their annual report. This is a significant step towards strengthening financial reporting requirements; however, its importance would be lost without proper implementation, including the application of

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enforcement mechanisms when needed. It should be ensured that the SCS has adequate resources to meet its responsibilities.

Enhancing Academic Education, Professional Training, and “Retooling” of Accountants

There is a strong need to improve the capacity of the accounting and audit professions so that they are able to enhance the quality of financial statements and statutory audits, and promote public trust. The genuine understanding and adoption of these new accounting and auditing requirements is dependent on adequate education and training for preparers, auditors, and regulators. Although there will continue to be the need for training in the requirements of Azerbaijani tax reporting, there must be a greater focus on general purpose financial reporting. This report makes a number of recommendations to address capacity issues, including:

- Encouraging “chief accountants” and other preparers of financial statements in Azerbaijani companies to improve their understanding and application of accrual accounting and IFRS.
- Assisting vocational and academic education institutions with the development of an IFRS and ISA compliant syllabus and training materials, and enhancing the relationships between the accounting profession and universities.
- Strengthening the professional qualification requirements for all individuals who wish to obtain the right to conduct statutory audits in Azerbaijan, drawing upon International Education Standards.
- Articulating and enforcing Continuous Professional Development (CPD) requirements.

From Diagnosis to Reform

These recommendations require a holistic, multi-disciplinary approach to implementation. Azerbaijan should establish a multidisciplinary National Steering Committee (NSC) for accounting and auditing reform. The NSC should advise policymakers and regulators regarding the implementation of the recommendations. Based on the successful experience of other countries, the report recommends that the NSC develop a Country Strategy and a detailed Country Action Plan (CAP) to enhance the quality and availability of financial reporting in Azerbaijan.

MAIN ABBREVIATIONS AND ACRONYMS

ABTC	Azerbaijan Bank Training Center
ACAA	Association of Certified Accountants of Azerbaijan
ACCA	Association of Chartered Certified Accountants (United Kingdom)
ANB	Azerbaijan National Bank
BSE	Baku Stock Exchange
CAP	Country Action Plan
CoAA	Chamber of Auditors of Azerbaijan
CPD	Continuing Professional Development
FDI	Foreign Direct Investment
GNI	Gross National Income
IASB	International Accounting Standards Board
IAASB	International Auditing and Assurance Standards Board
IAPS	International Auditing Practice Statement
IASC	International Accounting Standards Committee
IBA	International Bank of Azerbaijan
IDF	Institutional Development Fund
IES	International Education Standard
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPSAS	International Public Sector Accounting Standards
ISA	International Standards on Auditing
NAS	National Accounting Standards
NASBO	National Accounting Standards for Budgetary Organizations
NASCO	National Accounting Standards for Commercial Organizations
NSC	National Steering Committee
PIE	Public Interest Entity
PPE	Property, Plant and Equipment
PSA	Profit Sharing Agreement
ROSC	Report on the Observance of Standards and Codes
SCS	State Committee for Securities
SEU	State Economic University
SME	Small and Medium-Sized Enterprises
SMO	Statements of Membership Obligations
SISD	State Insurance Supervision Department
SOCAR	State Oil Company of Azerbaijan Republic
SOE	State Owned Enterprise
SOFAZ	State Oil Fund of Azerbaijan Republic
USAID	United States Agency for International Development

I. INTRODUCTION

1. This assessment of accounting and auditing practices in Azerbaijan is part of a joint initiative of the World Bank and International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSC). The assessment focuses on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting. The ROSC involves a review of both mandatory requirements and actual practice. It uses International Financial Reporting Standards (IFRS)¹ and International Standards on Auditing (ISA)² as benchmarks, and draws on international experience and good practices in the field of accounting and auditing regulation.

2. Azerbaijan has a population of 8.3 million and gross national income (GNI) per capita of US\$ 940 as of the end of 2004.³ The collapse of the Soviet Union and the war with Armenia caused a sharp decline in output and led to hyper-inflation. A stabilization program was introduced in 1995 and rapid growth commenced in 1997, mainly owing to large-scale Foreign Direct Investment (FDI) into the oil and gas sector. Real GDP growth since 2000 has averaged over 10 % per year. By 2003, average consumer price inflation had dropped to 2.1 %; however, FDI inflows started to have an impact on consumer price inflation towards the end of 2004. The growth of the money supply has been partly curbed by securing most earnings from the oil sector in the State Oil Fund of Azerbaijan Republic (SOFAZ). Another characteristic of the post-transition period is the emergence of a more narrowly-based economy. While the oil and gas industry thrives, large swathes of the industrial sector — such as plastics, chemicals and manufacturing — have all but closed down. There has been a long-term decline in the relative importance of agricultural and non-oil-related services industries. To revive the economy, many reforms have been introduced in a number of areas, including the banking sector, taxation and financial reporting. However, further reforms are needed for the private and financial sectors to fulfill their role in strengthening the economy.

3. Large-scale privatization has been relatively slow in Azerbaijan. Structural reform has not occurred in many sectors. Although privatization of small and medium-sized enterprises (SMEs) is almost complete, there has been only limited progress in the sale of large-scale enterprises. Many of the largest entities are still state-owned. Restructuring has been slow and high levels of inter-enterprise arrears and non-performing loans owed by State Owned Enterprises (SOEs) have inhibited financial sector development, as well as foreign investment in the non-oil sector. Rapid development of the hydrocarbon sector, combined with high oil prices, enable the Government to spread the benefits of the oil boom and allow it to avoid restructuring the highly inefficient state sector. Assessing state-owned enterprise financial reporting requirements and practices was deemed important in the context of this report and consistent with the Government's objective to improve the governance of these enterprises.

¹ International Financial Reporting Standards are issued by the International Accounting Standards Board (IASB), an independent accounting standard-setter based in London, United Kingdom. The IASB announced in April 2001 that its accounting standards would be designated "International Financial Reporting Standards" (IFRS). Also in April 2001, the IASB announced that it would adopt all of the International Accounting Standards (IAS) issued by the International Accounting Standards Committee (IASC). For simplicity's sake the term IFRS will mean both IFRS and IAS in this report.

² International Standards on Auditing are the standards issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC).

³ Gross national income per capita 2004, Atlas method, World Development Indicators database, World Bank, April 18, 2006..

4. Azerbaijan's banking sector, still at a relatively early stage of development, is in the process of reform. The sector contains too many small, under-capitalized banks with poorly performing loan portfolios.⁴ The sector is dominated by two state-owned banks — Kapital Bank (formerly known as BUS Bank) and International Bank of Azerbaijan (IBA) — which together account for over half of the banking sector's total assets. Trade finance products and credits are in particular demand in Azerbaijan. Firms engaged in import or export businesses require a banking partner with a reputation and credit-worthiness in international markets, with importers requiring letters of credit and guarantees.⁵

5. The role of the non-banking financial sector is still very limited. The insurance sector, comprising around 60 companies, accounts for less than 0.5% of GDP. The leasing sector is still in its infancy, but is a promising vehicle for business financing.

6. The securities market in Azerbaijan, regulated by the State Committee for Securities (SCS) is at an early stage of development. The Baku Stock Exchange (BSE) was designed to have two levels of listings. Level One is designated for enterprises with active securities trading exceeding preset volume thresholds and presenting regular price-quotations. Level Two envisages more sporadic trading, with no volume thresholds stipulated and prices quoted periodically. Currently, the most actively traded stocks on the Level One segment are notes issued by the Azerbaijan National Bank (ANB) and other commercial banks' debt securities. The Level Two segment is very thin, including Government securities and a few securities issued by commercial enterprises. Lack of protected investor rights, transparency, and accountability has curtailed foreign and domestic portfolio investment. The recently enacted Accounting Law, mandating conformity with IFRS for *public interest entities*, including publicly-traded companies, is aimed at strengthening the corporate financial reporting regime, improving transparency, corporate governance and accountability, and ultimately leading to the development of the securities market as an alternative source of funding.

7. These considerations should shape the arrangements for corporate sector accounting and auditing in Azerbaijan, which need to be reorganized to meet the new needs of an economy undergoing radical transformation. Azerbaijan is moving away from state interventions in the economy (with most enterprises being state-controlled, offering very little accountability to other stakeholders) to one in which the market plays a much greater role. Where hyperinflation once distorted the mobilization of domestic savings in Azerbaijan, greater price stability, controlled inflation, and fiscal discipline, have brought the benefits of the financial markets to the private sector. Finally, Azerbaijan is increasingly integrated itself into the global economy. This means greater needs and opportunities in terms of financial, technical, and intellectual cooperation. This increased access to global financial markets will set new standards in quality of financial information, requiring much greater transparency and consistency with international standards. The accounting and auditing professions will need to change radically to adequately serve the needs of providers and users of financial information and help the market economy grow.

⁴ At the end of 2004, there were 42 operating banks in Azerbaijan.

⁵ Transparent financial reporting is a prerequisite to achieve international recognition in the banking sector.

II. INSTITUTIONAL FRAMEWORK⁶

A. Statutory Framework

8. **Since it gained independence in 1991, Azerbaijan has adopted a Civil Law system, but is still in the process of establishing a comprehensive legal framework.** The supreme legislation is the Constitution and the principles contained therein are elaborated in the Civil Code (2000), which includes provisions pertaining to company law. Development of the Azerbaijan Civil Code was influenced by the German model, as well as by the Civil Code of the Russian Federation and the closely-related Model Civil Code of the Commonwealth of Independent States.

9. **The Civil Code defines various legal structures, which can be used by businesses operating in Azerbaijan.** The most common types of legal entities currently used include co-operatives, general partnerships, limited partnerships, limited liability companies, and joint-stock companies (open joint-stock companies and closely-held joint-stock companies). The key characteristics of limited liability companies and joint-stock companies are as follows:

- **A limited liability company** is the most common form of incorporation in Azerbaijan. It can have one or several owners. The main benefits for the owners of this company are not being liable for obligations of the company; having their losses limited to their capital contribution; and being subject to fewer regulations and reporting requirements than joint-stock companies.
- **Joint-stock companies** are companies with equity capital divided into a certain number of shares. Shareholders of a joint-stock company are not responsible for liabilities of the company, and their risk is limited to their capital contribution. The main difference between open and closely-held joint-stock companies relates to their ownership structure. The ownership of a closely-held joint-stock company is restricted to a total of 50 shareholders and their shares cannot be traded freely, or offered to the public, unlike those of open joint-stock companies.

From the beginning of privatization until July 1, 2004, some 40,000 small enterprises and facilities were privatized, adopting various legal forms. In 1997, conversion into joint-stock companies of medium-sized and large enterprises was initiated, and as of July 1, 2004, around 1,500 large state-owned enterprises had been restructured into joint-stock companies. However, in some of these joint-stock companies, the state still retains 100 % ownership.

Enterprises with foreign capital are generally established in the form of joint-stock companies or limited liability companies, or represented through branches or representative offices.

10. **The Civil Code sets forth the governance structures of limited liability companies and joint-stock companies as follows:**

- The general meeting of participants is the “supreme body” of the limited liability company. The general meeting of participants appoints an executive body (either individual or collegial, and non-participants may be elected to the executive body), which is responsible for the day-to-day management of the company. The general meeting of participants is exclusively responsible for appointing and removing management,

⁶ This report outlines the legal principles applicable with regard to accounting, auditing and financial reporting and does not attempt to give anything more than an introduction to the issues. This report is not meant to be an exhaustive rendition of the law nor is it legal advice to those reading it.

approving the annual report and financial statements, and electing a Revision Commission.⁷

- The general meeting of shareholders is the “supreme steering body” of a joint-stock company. It amends and approves the charter and equity capital of a company; elects members to the board of directors (supervisory board) and of the Revision Commission. The general meeting is also responsible for appointing and dismissing executives of a company;⁸ approving the annual financial statements; and making decisions on the distribution of profit and losses. The next level of company management is the board of directors (supervisory board), which is mandated for joint-stock companies with more than 50 shareholders. Its decisions are adopted by a simple majority of votes. The final level is the executive body, which is responsible for the company’s day-to-day operations.

Even though these rules lay out a detailed corporate governance framework, the decision-making and management of joint-stock companies is often dominated by the controlling shareholder (with the exception of banks, whose supervisory board is more strictly regulated). The supervisory board’s duty to act in the interests of the company as a whole is not provided for in the Civil Code, and companies with less than 50 shareholders are exempted from having one altogether. With concentration of ownership being the norm in Azerbaijan, the corporate governance framework should take this reality into account rather than mandate the creation of several artificial levels of supervision and management which will not serve the purpose for which they are intended.⁹

11. **Azerbaijani accounting regulation is currently in transition. The previously existing system was governed by the Civil Code (2000), the Tax Code (2001), the outgoing old Law on Accounting (1995), as well as various manuals and regulations.** The economic context of the country created an environment where different agencies (e.g., tax authorities, banking regulators, various ministries, and committees) were developing fragmented and uncoordinated accounting and auditing regulations without regard to each other. As a result, adopted rules often lacked consistency and clarity and, at the same time, were rigid and prescriptive, leaving very little room for judgment.

12. **The new Law on Accounting (2004) introduced a conceptually new approach to accounting and financial reporting aligned with good international practices.** The new Law creates four categories of reporting entities:

- *Public Interest Entities* (PIEs), which are required to apply IFRS;
- Commercial organizations other than PIEs and Subjects of Small Entrepreneurship, which are required to apply National Accounting Standards (NAS) in their consolidated and legal entity financial statements;

⁷ Article 107-11 of the Civil Code provides for the establishment of a “Revision Commission,” whose duties and responsibilities differ from those traditionally attributed to an audit committee. There is no prohibition against a joint-stock company establishing an audit committee (in addition to a “Revision Commission”) with duties and functions one normally attributes to a true audit committee. Furthermore, Article 27 of the Law on Banks requires that commercial banks establish audit committees with duties and responsibilities more akin to an audit committee as opposed to those of a “Revision Commission” under the Civil Code.

⁸ Article 107.1.3 of the Civil Code provides that this is not the sole right of the general meeting of shareholders because this authority may be delegated to the Supervisory Board by a company’s charter.

⁹ Refer to the CG ROSC at [www.worldbank.org/ifa/Azerbaijan%20ROS%20\(final\).pdf](http://www.worldbank.org/ifa/Azerbaijan%20ROS%20(final).pdf).

- Non-commercial organizations, which are required to apply NAS for Budget Organisations (NASBOs) based on IPSAS; and
- Subjects of Small Entrepreneurship, which are required to apply simplified accounting rules.

In parallel with these requirements, the legislation defines the notion of accounting standards acceptable in Azerbaijan and sets the legal basis for their development. It designates the Ministry of Finance as the main regulator of accounting, charging it with the leadership and coordination role. In addition, it clearly states the requirements for the consolidation of financial statements, as well as rules for their submission and publication, thus securing transparency of financial information and its availability to users. Application of the Law on Accounting provisions starts as early as January 1, 2006 (for the Subjects of Small Entrepreneurship), with January 1, 2008 being the transition date for the majority of the companies. Existing rules on accounting remain in force until the transition date.

13. **The Law on Accounting (2004) provides a broad definition of PIEs, including credit organizations, insurance companies, investment funds, non-state social funds, publicly-traded companies, and commercial organizations exceeding certain pre-set thresholds.**¹⁰

14. **Neither the Law on Audit Services (1994), nor any other legislative act defines which audit standards are to be used by auditors.** The existing Law on Audit Services defines the notions of audit, independent auditor, and audit firm; specifies the requirements to become an auditor; and outlines the rights, responsibilities, and liability of the auditor. However, this law does not make any reference to auditing standards. In the absence of a clear legal requirement, the Chamber of Auditors is issuing national auditing standards based on a translation and adaptation of ISA.¹¹ However, as discussed in Paragraph 38 below, in the absence of appropriate legal backing, these standards are not enforceable.

15. **There are no detailed legal provisions which clearly outline the responsibilities and liability of auditors.** The reference included in the Law on Audit Services states that individual auditors and audit firms performing their functions “improperly” may be held liable in accordance with the legislation of Azerbaijan and the provisions of the contract with the client.¹²

16. **There are additional legal requirements concerning financial reporting and audit of banks.** Traditionally, the banking sector in Azerbaijan has been at the vanguard of financial reporting reforms. The Law on Banks (2004) required banks to use IFRS. Even earlier, the National Bank of Azerbaijan issued 26 accounting regulations “based on IFRS,” which had to be followed by all banks,¹³ and conducted a well-orchestrated and thorough implementation effort.¹⁴

¹⁰ This provision is in line with current international good practices defining PIEs as being those entities in which the general public has an interest by virtue of the nature of their business, their size, or their range of stakeholders. The Cabinet of Ministers’ Decree dated June 20, 2005, implementing the new Accounting Law, sets out the following thresholds: annual revenue of 150 billion Manat (circa US\$ 30 million), average number of employees amounting to 1,200, and total balance sheet of 500 billion Manat (circa US\$ 100 million)

¹¹ As of May 31, 2005 the Chamber of Auditors has prepared and issued 35 general standards, three supplementary standards, and seven specialized audit programs.

¹² The Law on Audit Services does not define the term “improper audit.”

¹³ Following requirements of Article 43.1 of the Law on Banks, the National Bank of Azerbaijan accounting department issued an official letter to the banks requiring them to keep accounting books in accordance with the full set of IFRS even if not all standards have been translated into Azeri and

As a result, the banking sector is one of the most transparent sectors in Azerbaijan.¹⁵ It employs accounting and financial specialists broadly familiar with international practices, and produces and publishes financial statements generally compliant with IFRS. Its experience should be leveraged by other sectors as the nation-wide accounting reform is implemented.

17. **While the Law on Banks requires each bank to be audited by an external auditor, it does not specify the auditing standards to be applied.** The NBA recommends that banks have their audit done in accordance with ISA.¹⁶ Any auditor or audit firm certified to practice in Azerbaijan can be engaged to perform an audit of a bank. It is not mandatory for the banks to inform the NBA upon termination of the audit engagement. The NBA may require a bank to replace its auditors and conduct an additional audit if the original audit does not meet its requirements; however, no such request has been officially documented by the NBA. According to the data received from the USAID Bank Supervision Project, 24 out of the 42 existing banks have chosen one of the “Big 4”¹⁷ as their auditors in 2004.

18. **Banks are required to submit audited consolidated financial statements to the NBA, not later than five months following the end of the fiscal year.** Banks are also required to publish audited consolidated financial statements in the mass media and on their websites. Banks also prepare and submit annual reporting packages to the tax authorities and the State Statistics Committee.

19. **While the insurance sector has good potential for development in Azerbaijan, its legal and institutional reform has been slower than that of the banking sector.** The Law on Insurance was adopted in 1999, but little attention was paid to issues of accountability and financial reporting. The Law requires insurance companies to prepare annual consolidated financial statements. However, it does not specify the accounting and financial reporting standards to be used, and instead refers to the general requirements discussed in Paragraphs 11 and 12 above. There are no industry-specific accounting standards. The Law on Insurance states that the financial and business activities of insurers must be reviewed by an independent auditor chosen and appointed by the insurers. Audited financial statements must be submitted to the State Insurance Supervision Department (SISD) of the Ministry of Finance and to the tax authorities. There are no specific requirements on the choice of independent auditor or audit firm. The Chamber of Auditors has issued specialized guidance on the audit of insurance companies.

enacted in the form of official NBA accounting regulations. The letter states, that from now on, the banks bear responsibility for compliance with IFRS.

¹⁴ Since the Banks are now required to fully comply with IFRS, the NBA plans to review its previously issued accounting regulations, to make sure that they do not contradict IFRS and to change their status from regulations to accounting manuals.

¹⁵ While the banking sector should be commended for its progress in implementing IFRS, there is still need for improvement. A study performed under the USAID Bank Supervision Project at the NBA showed that in those banks where an ISA audit of the 2003 IFRS financial statements was undertaken, the audit adjustments were material enough for one to question the reliability of the monthly prudential reports that the banks submitted to the NBA. Hence, the auditors were doing much of the IFRS accounting that should have been undertaken by the banks’ internal accountants. While the situation has reportedly improved in 2004 and 2005, Section III of this report points to a need for improvement in the day-to-day accounting at commercial banks in Azerbaijan.

¹⁶ This is done in the form of methodological recommendation and does not have legally-binding force.

¹⁷ The “Big 4” comprise the local member firms of the following international audit firm networks: Deloitte and Touche, Ernst & Young, KPMG and PricewaterhouseCoopers.

20. **The three main sources of regulation for the securities market in Azerbaijan are the Civil Code, various regulations issued by the State Committee for Securities, and the rules issued by the Baku Stock Exchange.** In December 2004, the SCS issued the “Regulation on preparation and presentation of the annual reports of issuers of securities,” requiring all companies issuing securities to include audited financial statements in their annual report. The annual report must be filed with the SCS within 15 days following its approval by a company's supreme management body, and published in the mass media within 60 days. Within 15 days following submission of the annual report, the SCS may submit its comments to the company. There is no requirement for filing semi-annual or quarterly reports. As this regulation has just been adopted, there is not yet sufficient evidence to verify compliance with its requirements. However, there is a serious concern that because of limited enforcement mechanisms and staff available to the SCS, the level of compliance with the new regulation might be low (see Section II.E, *Enforcing Accounting and Auditing Standards*).

21. **Following the transition date of January 1, 2008, all PIEs and commercial organizations which prepare consolidated financial statements will be required to post them, along with the auditor’s report, on their websites and to publish them in the press.** Previous regulations contained minimal, fragmented requirements for the publication of financial information, and the concept of published, general-purpose financial statements meeting the needs of several user groups is effectively unknown at present.

22. **SOEs still prevail in some of the most important sectors of the Azerbaijani economy, such as oil and gas extraction and transmission, electricity generation and transmission, shipping, etc.** These companies are required to prepare and submit numerous reports to various governmental authorities, including the Ministry of Taxation, the State Statistics Committee, their respective sponsoring ministries, social funds, etc. However, in spite of their importance to the state economy, some of them still do not produce consolidated financial statements, have very rudimentary accounting systems, and were never subject to an audit of their consolidated financial statements. The majority of these companies are classified as PIEs, and according to the new Law on Accounting, will have to prepare IFRS financial statements.

23. **The Ministry of Taxation has undergone considerable reform in the last few years.** Currently, for the majority of enterprises, tax requirements are the major influence on their accounting. With the emergence of the new financial reporting rules dictated by the Law on Accounting, it is extremely important to develop reconciliation mechanisms bridging the calculation of general-purpose financial results with the calculation of taxable profit and explaining the differences between the two.

24. **The Profit-Sharing Agreements (PSA) widely used by the foreign companies participating in the oil and gas sector of Azerbaijani economy deserve special mention.** The PSAs are signed by the members of the PSA, agreed at the highest Government level, and finally ratified by the National Parliament. Signed PSAs have the weight of State law. The PSAs set forth financial and accounting reporting requirements, and provide that in case of conflicts with national legislation, current or future, the provisions of the PSAs prevail.

B. The Profession

25. **Responsibility for licensing individual auditors and audit firms in Azerbaijan rests with the Chamber of Auditors of Azerbaijan (CoAA).** The Chairman and Deputy Chairman of the CoAA are appointed by the National Assembly of Azerbaijan. The Chamber began operations

in 1996 in accordance with the provisions of the Law on Audit Services (1994). Under these provisions, its mandate includes the following:

- Overseeing auditing activities in Azerbaijan;
- Issuing auditing instructions, standards, and guidance;
- Licensing individual auditors and audit firms;
- Considering complaints against individuals and audit firms;
- Consulting the profession on relevant legislative issues;
- Reviewing the compliance of independent auditors and audit firms with the provisions of the Law on Audit Services; and
- Representing the profession internationally.

In Azerbaijan, it is possible to practice auditing either as an independent auditor or in an audit firm. Audit firms are required to employ at least one licensed auditor and to pay an audit firm license fee. The local member firms of international audit firm networks are also required to employ locally licensed auditors and to pay a license fee, which is significantly higher than the fee paid by local audit firms.¹⁸ Registration as an independent auditor can be obtained by citizens of Azerbaijan who are not prohibited from holding a position in business by a court decision or have had judgments against them, and who complete the CoAA's certification program. As of June 2005, there are approximately 200 individuals holding a five-year renewable audit license, 50 local audit firms, and five local member firms of international audit firm networks.

26. The Azerbaijani audit profession can be stratified into three groups:

- Local member firms of the international audit firm networks, which audit IFRS-based financial statements in accordance with ISA. Their clients operate mostly in the banking and oil sectors. These firms conduct mostly contractual (voluntary) audits for banks, utility companies, local subsidiaries of foreign companies, PSAs, and joint-ventures. Most of these firms also perform statutory audits (in accordance with the forms and procedures set out by the CoAA and required for tax and regulatory reporting) for these clients, but only if requested, and are generally not interested in the statutory audit market in itself.
- A few local audit firms whose level of expertise would enable them to audit IFRS compliant statements in accordance with ISA, with some additional training and practice. In practice, these firms conduct mostly statutory audits, including those for clients which employ the local member firms of international audit firm networks for contractual audits.
- The vast majority of local audit firms and independent auditors, which conduct statutory audits only. There is evidence that many of the audits they conduct are a mere formality.

27. The biggest obstacles to high quality financial information are lack of capacity, weakness of market demand, an inadequate statutory framework, and the absence of mechanisms to enforce accounting and auditing standards.

- **Lack of capacity.** The accounting and auditing culture and practices are still very much influenced by practices of the Soviet and post-Soviet era (during which most of the current policymakers and regulators gained their professional experience), even though there is visible acceptance of change. The accounting systems used outside the banking sector are designed to provide mostly statistical and tax information required by the various regulators and ministries.

¹⁸ The license fees equate to roughly US\$15,000 for the local member firms of international audit firm networks, US\$7,000 for local audit firms, and US\$ 1,500 for independent auditors.

- **Weakness of market demand.** The tax authorities are the sole user of financial information of most companies. While tax regulations require submission of the audit opinion along with financial information, there is no evidence of further analysis, use, or reference to it. Outside the banking sector, where the regulator has required IFRS and made the renewal of banking licenses conditional upon compliance, and the oil and gas sector, where attracting foreign investment has been critical, there is little incentive for companies to comply voluntarily with IFRS or to obtain a quality audit.
- **Inadequate statutory framework.** The Law on Audit Services (1994) does not provide sufficient details on the operation of the CoAA, the process for accreditation of its members, disciplinary provisions, and sanctions. Embedding these elements in the legislation would provide greater legitimacy and authority to the CoAA.
- **Absence of mechanisms to enforce accounting and auditing standards.** This issue is discussed in Section II.E, *Enforcing Accounting and Auditing Standards*.

28. **Due to an initial misunderstanding of its role as regulator, a lack of capacity and a mandate which is far too broad, the CoAA has not been an effective regulator of the audit profession.**

- **The CoAA has an inadequate structure and due process.** The CoAA does not have a body providing it with adequate oversight. The National Assembly of Azerbaijan does not have sufficient technical expertise to monitor a body charged with adopting auditing standards and regulating auditors. Proper oversight should come from a body or system that is comprised of representatives of bodies having an interest in high quality financial reporting in Azerbaijan, and which draws on professional expertise while limiting auditors to a minority of its members. Additionally, the activities of the CoAA are subject to inadequate due process and transparency, which negatively affects its legitimacy.
- **Role as regulator is misunderstood.** In accordance with the Law on Audit Services (1994), the CoAA has the authority to conduct audits;¹⁹ however, it claims to have abandoned these activities. The CoAA considers the monitoring of financial statements to be one of its responsibilities, and the power to conduct re-audits is included in its Statute.
- **Lack of capacity.** The staff of the CoAA has been working diligently to adopt international practices, but without the proper training or experience, the implementation remains inadequate. Implementation of external quality control is still in its infancy.
- **Mandate is too broad.** The development and enforcement of auditing standards in a country that has moved to a market-economy in the last ten years was always going to be challenging. Adding to those responsibilities the issuance of instructions and guidance notes, the provision of certification and Continuing Professional Development (CPD) courses, as well as the representation of the profession, has put a strain on the resources of the CoAA and has contributed to its difficulties in meeting its core responsibilities. Responsibility for forming a local chapter of the US-based Institute of Internal Auditors, which has been recently assumed by the CoAA, is another activity which affects its ability to deliver on its core mandate by diverting already limited resources to ancillary activities.

29. **In July 2000, the non-governmental, not-for-profit Association of Certified Accountants of Azerbaijan (ACAA) was created. ACAA's stated purpose is to unify the professional accountants of Azerbaijan and to provide assistance with the accounting**

¹⁹ Article 7 of the Statute of the Chamber of Auditors of the Azerbaijan Republic approved by the National Assembly of Azerbaijan on March 12th 1996.

reform aimed at introducing IFRS in Azerbaijan. The Association conducts training courses on IFRS, U.S. Generally Accepted Accounting Practices, and bookkeeping for accounting practitioners, auditors, and enterprises; it has signed a memorandum of understanding with the Ministry of Finance to provide assistance with the development of National Accounting Standards. The Association currently has around 400 members.

C. Professional Education and Training

30. **Accounting education and training lag behind the needs of Azerbaijan in preparation for the implementation of the new Law on Accounting.** Among 42 academic institutes and universities in Azerbaijan, 16 teach accounting; of which three are state institutions (State Economic University, State Oil Academy, and University of Cooperation). The largest of the 16 institutions is the State Economic University (SEU). This institution sets the basis of the accounting curriculum for other universities and colleges in Azerbaijan. The main weaknesses of the University are its resource constraints, its outdated teaching methods, and a curriculum that is still mostly based on old reporting requirements. A new course is being introduced in 2005 on IFRS, which until now were addressed in one lecture within an accounting and auditing course only.

31. **"Special Talented Groups" programs within public universities and the programs of some private universities have been recognized in the marketplace as delivering more competent graduates, but still fall short of the standards required to cope with the transition to the new Law on Accounting.** In practice, these programs are not fully based on IFRS/ISA, but rather address those standards as separate areas of study. The private universities, while better funded than the State ones, still suffer from resource constraints and the absence of a critical mass of professionals and educators capable of delivering competency-based programs. The marketplace does not recognize substantial differences between graduates from public and private universities.

32. **Extra-curricular accounting courses are provided in around 10 private higher education institutions and at over 20 vocational schools, as well as by the Azerbaijan Bank Training Center (ABTC) and the Association of Certified Accountants of Azerbaijan.** The ABTC offers short-term courses in accounting and auditing and has introduced a 12-hour/3-day course on IFRS. Due to the lack of availability of high quality courses on IFRS, the ABTC is planning to introduce an 80-hour course, which would take about three months to complete. The ACAA also delivers a series of courses, which appear to be modeled on the education program of the United Kingdom Association of Chartered Certified Accountants (ACCA). Individuals applying for ACAA certification who have not achieved an internationally-recognized professional certification need to pass an eight-level training course delivered in Russian by the Association. There are no academic requirements for admission into the program.

33. **Professional education is not sufficient to ensure that would-be auditors acquire adequate professional capabilities and competence.** Benchmarked against the International Federation of Accountants' (IFAC) International Education Standards (IES), professional education requirements and processes are as follows:

- *The entry requirements to the program to become a licensed auditor with the CoAA generally comply with IES 1, Entry requirements to a program of professional accounting education.* The CoAA requires that candidates complete a degree in the area of Accountancy, Economics, Finance, or Law from a recognized university. However, as

discussed in Paragraph 30 above, there are significant concerns about the quality of university education in this field.

- ***The scope of the CoAA’s current certification program does not provide would-be auditors with sufficient knowledge to undertake an audit.*** The program does not meet the requirements of IES 2, *Content of Professional Accounting Education Programs*, IES 3, *Professional Skills*, and IES 4, *Professional Values, Ethics, and Attitudes*. Topics such as organizational and business knowledge, information technology knowledge (listed as required content by IES 2), organizational and business management competencies, and interpersonal and communications skills (listed as requirements in IES 3) are absent from the program curriculum. The sections of the program which deal with accounting, finance, and related knowledge are also weak in the areas of management accounting, professional values and ethics.
- ***The CoAA’s practical experience requirement falls short of IES 5, Practical Experience Requirements.*** Candidates are required to have a minimum of three years’ experience in their area of expertise. However, there is no written guidance for employers, mentors, and trainees regarding the program of practical experience, clarifying their roles and responsibilities, nor a mechanism for approving employers as suitable for providing the appropriate experience for trainees.

34. **The CoAA’s Continuing Professional Development requirements are in place but their effectiveness is questionable.** Upon being admitted to membership, auditors are required to attend CPD sessions (around 50 hours per year) organized by the Chamber, and to obtain a pass mark in three of the five years of membership in order for their license to be renewed. However, by monopolizing the delivery of CPD, the CoAA is not allowing the development of a competitive market for training programs. There is anecdotal evidence that the contents of the CPD program are not entirely relevant to the current needs of the profession, nor are they being updated.

D. Setting Accounting and Auditing Standards

35. **Accounting standard setting practices have been completely changed with the introduction of the new Law on Accounting. The new legislation (2004) designates the Ministry of Finance as the state regulator of accounting.** The Ministry of Finance is responsible for organizing the translation of IFRS into Azeri. It also is responsible for the development and approval of National Accounting Standards (NAS) based on IFRS,²⁰ explanations and recommendations for their application, and the simplified accounting rules for the subjects of small entrepreneurship. This process has just begun.

36. **The Law on Accounting (2004) established the Advisory Council for Accounting as the body primarily responsible for advising the Ministry of Finance on matters of accounting and financial reporting.** For the Council to be able to fulfill its mandate and operate efficiently, it is critical to have sufficient degree of institutional independence and full commitment of its members to the task at hand. It is envisaged that the Council will be

²⁰ Article 6.0.2 of the Law on Accounting elaborates on what “based on IFRS” means in this context. “...These standards prepared on the basis of IFRS shall cover all subjects regulated by IFRS. If it is necessary not to incorporate into the “National Accounting Standards for Commercial Organizations” any of the IFRSs as whole or any provision of it, or to modify them before incorporating the relevant executive authority shall disclose the reasons on which the IFRS has not been used in its original formulation and any other existing differences between the National Accounting Standards for Commercial Organizations and IFRS in an appendix to the relevant National Accounting Standards”.

established as a simple structure legally separate from the Ministry of Finance and financed through the State budget. Its members are expected to have a high degree of knowledge of IFRS and a commitment to accounting reform. In addition, they should be able to advise and assist the Ministry of Finance in the process of developing NAS and in implementing other aspects of accounting and financial reporting reform. At a minimum, the Chairman of the Council needs to be a full time employee. The charter and membership of the Council have been finalized by the Government. Properly; the issue of Council membership is critical for the success of its mission and can be a real challenge in Azerbaijan, which still experiences severe shortages of experienced, trained professionals, familiar with the latest developments in international accounting and auditing.

37. **The Ministry of Finance does not have permanent staff or a sufficient budget to support the development of the National Accounting Standards and guidelines on their implementation.** This function is currently performed by a group of international and local consultants working under the auspices of the Ministry of Finance and financed with donor funding. With a limited budget and no permanent staff, progress in the development of the NAS and supporting guidance has been quite slow. So far, the group has prepared 12 draft NAS based on IFRS; 3 NAS based on IFRS have been approved. In addition to budgetary and resource limitations, the working group faces obstacles such as first-time development of a standardized accounting and financial reporting terminology in Azeri; the challenge of reaching a common understanding of definitions currently used by numerous Government authorities; and the introduction of entirely new concepts.

38. **As of the writing of this report, the Chamber of Auditors of Azerbaijan has issued 35 auditing standards.** In addition, ten guidelines have been issued (for example, specialized guidance on the audit of insurance companies). Most of the standards issued were derived from ISA. Audit standard setting is an ongoing process. To develop a new standard, the Chamber of Auditors selects an ISA for consideration and translates it into Azeri. Then the translation is analyzed for compatibility with the specific needs of Azerbaijan and is presented to the Chamber Board. The Board makes a final decision on the acceptability of the suggested standard, its compliance with the existing laws and regulations, and recommends amendments if necessary. Once the draft is approved, it is submitted to the Ministry of Justice, which only registers those standards which it considers compatible with the Constitution and other laws. To date, only five of the 35 auditing standards have been registered.

39. **In December 2001, the CoAA approved its Code of Ethics, which was inspired by the IFAC Code of Ethics (1998).** Unlike the IFAC Code of Ethics, it does not differentiate assurance assignments from other audit services and does not contain sections on professional appointments, second opinions, gifts and hospitality, application of the framework to specific situations, preparation of reporting information, and inducements.

40. **Like the rest of the profession, the capacity of Azerbaijan's audit standard-setters is hindered by a severe shortage of qualified professionals familiar with the latest international developments in the area of audit.** While the CoAA makes a commendable effort to increase its level of professional awareness and keep abreast with these changes, the Chamber still does not have any internationally certified accountant on its staff. The task at hand — reforming the audit profession, redefining its functions and role — is challenging and can only be achieved through a simultaneous expansion of professional capacity and an inflow of a new generation of professionals, trained according to international standards.

E. Enforcing Accounting and Auditing Standards

41. **The National Bank of Azerbaijan has played a significant role in enforcing accounting and financial reporting standards and prudential reporting requirements in the banking sector.** All banks are required to submit audited IFRS financial statements to the NBA. The NBA's monitoring and enforcement authority is legally backed by the Law on Banks (2004). The NBA has the authority to revoke banking licenses on the basis of non-submission of financial statements, false statements, or failure to comply with an order or any other instruction imposed on a bank. In general, the NBA has been proactive with respect to the implementation and practical enforcement of the accounting and financial reporting requirements. As part of this effort it has hired and trained qualified staff; worked constructively with the donor agencies and the Ministry of Finance; provided training and support to commercial banks; provided support for the reform; and exercised its powers to withdraw licenses from non-compliant banks.

Despite being more successful in attracting and retaining qualified accounting professionals than many other Government agencies and enterprises, the NBA is still subject to the capacity constraints which affect the country as a whole.

It should be noted that the relative success of the banking sector in complying with the requirements of the Law on Banks should be attributed not only to the NBA's monitoring and enforcement authority and capacity, but also to the financial strength of the larger individual banks, which enabled them to hire qualified staff and to acquire or develop adequate management-information systems.

42. **The State Insurance Supervision Department within the Ministry of Finance is responsible for monitoring and enforcement of the accounting and financial reporting requirements in the insurance industry.** All insurance companies are required to submit annual audited consolidated financial statements to the SISD. SISD's monitoring and enforcement authority is established by the Law on Insurance (1999). The SISD has the right to review financial information received from the insurance companies, and, in case a breach of the legal requirements is discovered, to apply a set of measures, up to a temporary revocation of the insurance license. However, as was noted earlier in the report, the Law does not clearly specify financial reporting requirements and accounting standards to be applied by the insurance companies. Consequently, legal requirements are not specific enough to be effectively enforceable. In addition, the SISD's capacity is low and requires significant strengthening through attracting qualified professionals and obtaining additional budget.

43. **In accordance with the SCS regulations, issuers of securities are required to file their audited financial statements with the SCS, starting 2005.** The State Committee for Securities has a legal authority to enforce these requirements; however, measures that can be applied for non-compliance, are based on the provisions of the Code of Administrative Violations, and are not sufficient to foster conformity with the filing requirements. It is often easier or cheaper for the companies to pay the penalty than to comply. In addition, the SCS human resource capacity is insufficient, with no internationally certified accountants amongst its personnel and the lack of financial means to hire and train qualified staff.

44. **As defined in the legislation, the Ministry of Finance and the National Bank of Azerbaijan have a role in disseminating new financial reporting requirements and enforcing compliance with the new Law on Accounting. In addition, the Ministry of Taxation has at its disposal a large network of tax inspectors regularly communicating with taxpayers, and believes that it has a role in disseminating new financial reporting requirements.** However, the mandate of the tax inspectors is to enforce the provisions and rules

of the Tax Code, which are not the same as financial reporting requirements. Tax inspectors have extensive experience reviewing calculations of taxable profit and taxes, but not the general-purpose financial results. There is no current reconciliation mechanism bridging the differences between taxable and general-purpose financial results. There is recognition of the need to develop and disseminate a reconciliation mechanism between tax and financial accounting rules. However, collaboration between the Ministry of Taxation and the Ministry of Finance has been limited to date.

45. **The CoAA is responsible for conducting inspections of audit firms and individual auditors. However, the quality control process is at an embryonic stage and falls short of international good practice.** The CoAA has initiated a program of “peer review.” A list of auditors interested in conducting peer reviews has been drawn up, as well as criteria that would be used in the process. Auditors subject to a review are made aware of the criteria in advance. So far, the few peer reviews that have been conducted have not resulted in negative evaluations. In addition, the National Audit Standard on Quality Control of Audit Work charges the CoAA with the responsibility of performing an annual review (at least) of all audit firms and independent auditors. The CoAA does have the authority to enforce compliance. However, the focus of the conducted reviews is inadequate. The CoAA does not evaluate risk assessment procedures, human resources factors, monitoring of audit field work, quality of the audit working papers or the processes relied upon in reaching final audit opinion. Instead, it requires audit firms and individual practitioners to complete forms including details of audit clients, opinions issued, and fees charged. As such, the quality control procedures fall short of international good practices and the requirements of IFAC.

46. **As the architect of the current accounting reform, the Ministry of Finance is in the difficult position of having the greatest interest in the enforcement of the requirements of the new Law on Accounting and the improvement of auditing practices, but being limited in its capacity to play this role effectively.** There is a consensus that the Ministry of Finance will need to work with the Ministry of Taxation, the Ministry of Justice, the Ministry of Economic Development, the Chamber of Accounts, the National Bank and the Chamber of Auditors on developing not only applicable sanctions, but also effective enforcement strategies and mechanisms, involving active coordination amongst the various ministries and agencies.

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

47. **The purpose of this section is to perform the *accounting standards gap analysis*, (i.e., comparative analysis of the local standards versus IFRS), and the *compliance gap analysis* focusing on the compliance of the financial statements with the requirements of local accounting standards and IFRS, respectively.** The Azerbaijani accounting profession is currently undergoing significant changes. The new Law on Accounting mandated development and implementation of NAS based on IFRS, as well as the direct adoption of IFRS by PIEs. As this process has just begun, the development of new standards is still at a very early stage. So far, no methodological recommendations have yet been published or discussed. However, the Law on Accounting states that until the new accounting standards have been adopted, existing legal acts will remain in force. Based on this, in place of a customary comparative gap analysis, this report reviews existing accounting requirements and focuses on the most challenging areas and issues which need to be addressed as part of the transition to the new system.

48. A common characteristic of all current accounting requirements (refer to Paragraph 11 above) is their rigidity, leaving very limited room for judgment. The rules tend to dictate detailed

requirements and contain strict definitions and instructions which have to be followed. As this situation has existed for years, Azerbaijani accountants are not used to, and do not understand, an approach involving the application of judgment based on generally accepted principles.

- The previous Law on Accounting (1995) outlines the overall framework and principles of accounting (e.g., the double-entry method); it provides strict definitions and composition of financial statement categories and prescribes the use of depreciation ratios approved by the state executive authorities, and finally, it defines procedures for the submission of financial (accounting) reports.
- The new Accounting Law requires companies to use either IFRS or National Accounting Standards (NAS), based on IFRS, which are currently being developed by the Ministry of Finance. Accountants will need a lot of assistance in applying the new standards.
- Methodological materials issued by the tax authorities are usually limited to recommendations on the calculation of the tax base and taxes due.

49. **Major differences exist between the financial position and performance of an enterprise prepared in accordance with the existing accounting requirements as opposed to those under IFRS.** IFRS financial statements are prepared for the purpose of providing information that is useful in making economic decisions (e.g., the evaluation of enterprise performance). In practically all cases, the main purpose of the financial information prepared by Azerbaijani companies is to support tax calculations. Therefore, financial accounting is closely linked with and follows the principles and rules of the tax code. Given the limited scope of preparation, the broader needs of potential users of financial statements are not met. Disclosures are extremely limited, further reducing the transparency of financial statements. Under these circumstances, it is not surprising that in some cases, local accounting rules either entirely omit areas covered by IFRS or treat them very differently. Some of the major requirements of the IFRS are virtually unknown to accounting practitioners. Illustrative differences and their implications are outlined as follows:

- Cash Flow Statements are not required and not produced. The absence of adequate disclosures prevents users from understanding fully the basis of preparation of the financial statements, and makes financial statements of limited use for decision making.
- IAS 16, *Property, Plant and Equipment* requires that the depreciable amount of an asset be depreciated over its useful life. Existing practice is to apply depreciation rates mandated for tax calculation purposes, which may not necessarily reflect the useful life of the asset.
- IAS 24, *Related Party Disclosures* has not been defined, and related party activities, which could be very substantial given the Azerbaijani environment, are not adequately disclosed.
- IAS 27, *Consolidated Financial Statements and Separate Financial Statements* has no equivalent under the local practices. Hence, consolidated financial statements are not presented. Given the complex relationships of companies in Azerbaijan, this represents a significant obstacle for third parties to gain a full understanding of the economic relationships that exist between companies and the resulting consequences for a group of companies.

50. **The ROSC team made assessments of the compliance gap sampling six sets of financial statements, which purport to be prepared in accordance with IFRS, and seven**

sets that purport to be prepared in accordance with local accounting requirements.²¹ For the sample review, the ROSC team sampled six enterprise sector companies, and seven banks.²² The team noted that the quality of the IFRS financial statements is inconsistent and there is non-compliance with specific standards by some companies, which led to the issuance of qualified or disclaimer audit opinions (refer to footnote 22). There is a significant difference in the quality of financial information prepared by enterprise sector companies and banks, with the latter being of a much higher quality. With respect to financial statements prepared in conformity with local accounting requirements, the companies presented a standard set of forms that were prepared for submission to the tax inspection, along with the tax declarations. These forms are no longer in force following the Ministry of Finance declaration of April 18, 2006; National Accounting Standards based on IFRS have replaced them at that date.

With respect to IFRS financial statements, the ROSC team noted the following non-compliance issues:

- **The IFRS consolidated financial statements of two enterprise sector companies do not comply with IFRS.** Both companies disclose major areas of non-compliance with IFRS and the auditors of both companies express the opinion that the financial statements do not comply with IFRS. The areas of non-compliance disclosed by the companies and referred to by the auditors are:
 - ***the failure to determine recoverable amount of property, plant and equipment when there were indications of impairment:*** In both instances, management believes that a number of facts indicate that the recoverable amount of property, plant and equipment may have declined below the carrying values of the respective assets. The financial statements explain that no suitable cash flow forecasts have been prepared in order to estimate the recoverable amount of property, plant and equipment. This conflicts with IAS 36, *Impairment of Assets*. In both cases, the issue is made yet more complex due to the failure to restate the financial statements for changes in the measuring unit during periods of hyper-inflation.
 - ***the measurement of obsolete, slow-moving, or damaged inventories:*** In one instance, the financial statements state that the company did not properly account for obsolete, slow-moving or damaged inventories. They also state that a number of facts indicate that the net realizable value of inventory might have declined below cost. However, the company has been unable to determine the extent of any impairment; accordingly no adjustment has been made. This does not comply with IAS 2, *Inventories*.
 - ***the measurement of trade receivables:*** In both instances, the accounting policy for trade receivables correctly states that the amount of the provision for impairment is the difference between the carrying amount and the present value of expected cash flows discounted at the market rate of interest for similar borrowers. However, the basis for preparation states that the company does not

²¹ The ROSC team used stratified random sampling to select the companies that were analyzed in this report. However, due to the sample's small size, it cannot be considered to be representative of all listed companies. Hence, the findings, although useful for illustrating potential problems in financial reporting, pertain to shortcomings found in the financial statements of specific companies. The findings are not meant to reflect systemic problems that would apply to listed companies in general.

²² Among these 13 sets of financial statements, seven were audited by local firms and six by local member firms of international audit firm networks. Four of the six IFRS financial statements had unqualified opinions (one report included an emphasis of matter paragraph) while the other two had a disclaimer of opinion.

consider the timing of the future expected cash flows when considering the recoverable amount of accounts receivable, which does not comply with the accounting policy or IAS 39, *Financial Instruments—Recognition and Measurement*.

The financial statements state that the law requires that accounts receivables from dissolved enterprises, enterprises in the process of agricultural reform, and enterprises in occupied regions should be written off. However, the receivables have not been written off or impaired because management “believes” the accounts receivable will be offset against payables to the State budget. Furthermore no impairment provision is recognized for trade receivables from households. While the impairment provision for these receivables may be correct, the limitation on the provision does not comply with IAS 39 and may conflict with the accounting policy. The financial statements acknowledge that insufficient impairment losses have been recognized.

The ROSC team is particularly concerned about the above issues, since they appear to be systemic issues, which are likely to have a pervasive effect on most *public interest entities* as they adopt IFRS in compliance with the new Law on Accounting (2004). Furthermore, audit reports also point to a major additional scope limitation because the enterprises’ accounting systems were designed to produce information necessary for statutory reporting purposes, which are materially different from IFRS. In several instances, the systems were not adequate to provide the auditors with sufficient records and analysis to satisfy themselves about the proper measurement, presentation and disclosures required under IFRS for a significant proportion of the group’s balances and transactions. This limitation affects the opening balances of PPE, additions, disposals, inter-group transfers and depreciation of PPE, billing and receivables, current and deferred taxes payable and equity.

- **The IFRS consolidated financial statements prepared by banks generally complied with IFRS.** The financial statements are generally of a high standard with adequate disclosures.

With respect to financial statements prepared in conformity with local accounting requirements, the ROSC team noted the following:

- **Companies used the standard format officially approved by the Ministry of Finance and agreed to by the State Statistics Committee, which consists of the following forms:**
 - Form No. 1, *Enterprise Balance Sheet*;
 - Form No. 2, *Financial Results and their distribution*; and
 - Form No. 5, *Changes in balance sheet items*: This form provides information on changes during the reporting period in enterprise capital and other equity items, debts, accounts receivable and payable, short-term and long-term investments, and intangible assets.

There are no required disclosures attached to the reporting package. The informative value and quality of such financial statements is very low and reflective of the deficiencies noted above. These forms are no longer in force following the Ministry of Finance declaration of April 18, 2006; National Accounting Standards based on IFRS have replaced them at that date.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

51. **National auditing standards are effectively an abbreviated, incomplete version of ISA. Some of the important provisions contained in the international auditing standards are either omitted or modified.** These differences stem from several factors, including:

- Departures from the original ISA were made when developing the related national standard.
- As of the time of writing of this report, only five of the 35 national standards adopted by the CoAA were registered by the Ministry of Justice, giving them explicit legal backing (refer to Paragraph 14 above). Even though compliance with all standards issued by the CoAA is mandated by Article 2.2 of the Statute on the rights and duties of the members of the CoAA, the enforceability of those not registered by the Ministry of Justice is uncertain.
- There is no formal hierarchy of standards to enable auditors to resolve any contradictions between standards; however former ISA 120, *Framework of International Standards on Auditing*,²³ is referred to in the introductory section of all three supplementary standards and the national auditing standards are referred to as the “main” standards.

52. **Consequently, audit work conducted according to national auditing standards may result in conclusions different from those under ISA, thereby misleading users of audited financial statements.** The following differences were noted by comparing national auditing standards with ISA.

A number of national auditing standards depart from the equivalent ISA:

- *Fraud and error.* The Standard does not make reference to the concern auditors should have for fraudulent acts that may cause a material misstatement in the financial statements. It does, however, specify that the auditor cannot be held responsible for the detection of fraud and error. By stating only that the auditor might take actions to detect fraud and error, without making reference to materiality, it may be impossible to establish those fraudulent acts which an auditor could reasonably be expected to detect. This, in effect, would absolve the auditors from any responsibility. Furthermore, while the standard states that management is responsible for revealing and eliminating fraud and error, it does not require auditors to obtain management representations regarding the assessment of fraud and error.
- *Audit planning.* The standard does not make reference to the going concern assumption at the audit planning phase, nor does it require auditors to obtain and evaluate management’s assessment of the entity’s ability to continue as a going concern. This is a significant issue especially in the context of many economically significant groups, which may face going concern issues as a result of material impaired trade receivables, etc. Auditors should review the question of solvency at the planning phase of the audit.
- *Using the work of an expert.* Unlike ISA 620, the national standard’s requirement to assess the expert’s competency specifically states that this can be achieved by relying on the expert’s qualifications and does not require that the expert’s experience and reputation also be considered. This limitation can potentially lead to misleading conclusions for users of financial information. This issue is especially worrisome in the

²³ It should be noted that the IAASB withdrew ISA 120, *Framework of International Standards on Auditing*, in December 2004 when the International Framework for Assurance Engagements became effective.

context of the use of valuation specialists, determining the fair value of property, plant, and equipment.

The following ISAs are not reflected in national auditing standards, primarily because of a one- to two-year delay in the adoption of standards by the CoAA:

- *International Framework for Assurance Arrangements* (formerly ISA 120): The absence of this standard leaves a big gap in the organization and hierarchy of auditing requirements in Azerbaijan.
- *Communications of Audit Matters with those Charged with Governance* (ISA 260): This omission means that guidance is lacking on communications with management and supervisory boards, shareholders (including minority shareholders), etc. While these matters should also be covered in legislation, ISA 260 provides a useful benchmark for statutory auditors (e.g., communications on accounting policies, material risks, disagreements with management).
- *Understanding the Entity and its Environment and assessing the Risks of Material Misstatements* (ISA 315), and *The Auditor's Procedures in Response to Assessed Risks* (ISA 330): Instead there is a standard on Risk Assessment and Internal Control (equivalent of ISA 400, which was withdrawn in December 2004).
- *External Confirmations* (ISA 505), which superseded ISA 500, Part B. As a consequence, national audit standards still require compliance with the old ISA 500 requirements.
- *Auditing Fair Value Measurements and Disclosures* (ISA 545): The absence of this standard is reflective on one of the gaps in accounting standards, discussed earlier. Currently, there is no methodology or recommendations addressing the fair value concept and rules of its calculation. This gap would have significant consequences in the context of the audit of financial statements prepared under IFRS.

Finally, there are several national auditing standards which are not based on ISA. For example the standard on the “auditor’s final documentation” outlines the Azerbaijan-specific format and content of the auditor’s report. These differ significantly from the ISA requirements. This discrepancy is especially concerning as it goes to the heart of the purpose and quality of audit opinions issued, and the confidence which users can have in the quality of the financial information audited.

53. **National auditing standards are not consistently practiced and enforced, thus even further jeopardizing users’ ability to rely on the quality of audited financial statements.** The CoAA is focusing on the completion of the statutory audit forms and audit contracts during its review of audit firms instead of emphasizing the importance of pervasive quality assurance mechanisms and the need to adhere to the issued audit methodology. It appears that the two audit standards most severely enforced by the CoAA are *Audit contract agreement* and *Auditor’s final documentation*, both of which contain prescribed forms and wording which differ from ISA.

54. **There is clear evidence that auditors are sometimes expected to prepare IFRS financial statements or at a minimum make adjustments prior to conducting the audit.** The supply of technically competent professionals with the ability to prepare financial statements in accordance with increasingly technical and complex accounting requirements has not kept pace with demand. This has created a situation where the staff in many companies is unable to fully prepare the financial statements according to IFRS. This has implications for auditor independence and the ability of the market to rely on such audited financial statements. Given, the skills’ gap, which is expected to remain at current level in the near future, training of highly educated accounting professionals is a priority.

V. PERCEPTION OF THE QUALITY OF FINANCIAL REPORTING

55. **The quality of financial reporting in Azerbaijan is perceived as being divided into two categories and closely linked to the perception of the company’s audit firm and the accounting standards applied:**

- The companies that are audited by the local member firms of international audit firm networks are perceived to have good quality financial information, compliant with IFRS. These companies have the ability, and either the obligation or an incentive, to pay the price required to obtain a quality audit. However, as noted in Section III above, a significant number of companies cannot obtain an unqualified audit report and have not actually “embedded” IFRS. In addition, market perceptions are somewhat influenced by over-reliance on the audit process even though financial reporting, internal controls, and financial management practices within these companies have yet to evolve.
- Other companies, which are not required to prepare financial statements compliant with IFRS, and which are not audited by the local member firms of international audit firm networks, are perceived to have low-quality financial information. Most of these companies only submit to audit to meet their legal obligations. They are believed to seek the lowest audit fee and generally expect no substantial audit work to be done in return.

VI. POLICY RECOMMENDATIONS

56. **The principal objective of this ROSC assessment is to assist the Government of Azerbaijan and other stakeholders in strengthening the corporate sector’s accounting, financial reporting and auditing practices, as a means to support certain relevant strategic objectives for Azerbaijan, including:**

- Enhancing the business climate and bolstering domestic and foreign direct and portfolio investment in the private sector;
- Stimulating growth in the SME sector by facilitating the SMEs access to credit from the formal financial sector by shifting gradually from collateral-based lending decisions to lending decisions based on the financial performance of the prospective borrower;
- Supporting the stability of the banking sector and mitigating the risk of crises due to loan collection problems and helping mobilize domestic savings;
- Achieving greater financial transparency in the corporate sector, both state and private-owned, thus allowing shareholders and the public at large to assess management performance and influence its behavior; and
- Improving the assessment and collection of taxes on corporate profits.

Without attempting to provide a detailed tactical design for reforms, this report sketches the policy recommendations to support the implementation of accounting reform and ultimately enhance the quality of corporate financial reporting. Azerbaijan should establish a multidisciplinary National Steering Committee (NSC) for accounting and auditing reform to advise policymakers, regulators, and other stakeholders regarding implementation of the recommendations. Based on the successful experience of other countries, the report recommends

that the NSC develops a country strategy and a detailed Country Action Plan (CAP) to enhance the quality and availability of financial reporting in Azerbaijan.

57. **The NSC will be essential to the reform process, given the diversity of legislation, regulatory authorities, and the fragmentation of the financial reporting framework.** In this context, NSC membership would need to include the tax authorities, users, and preparers of financial statements in order to reflect as many stakeholders in the accounting reform process as possible. It is critical that all members possess demonstrated technical competency and knowledge of accounting, auditing, and financial reporting; high level analytical skills; integrity, objectivity and discipline; and commitment to accounting and auditing reform and the public interest.

58. **The policy recommendations set forth in this report are predicated on the notion that transforming the accounting and auditing professions based on good international practices, and developing a corporate environment able to produce transparent financial information compliant with the international standards, are the long-term objective of Azerbaijan.** As set forth in this report, such an objective requires extensive reforms to Azerbaijan's legal framework, institutions, accounting, and auditing professions, as well as change in its accounting, auditing, and business culture and education system. However, policies should not be developed and enacted without giving due regard to a country's ability to carry out such policies (both in terms of capacity and resources); a relatively lenient rule that is robustly and consistently enforced is preferable to a good, rigorous one that is unenforceable, as the lenient rule can be progressively made more rigorous as the circumstances allow. The policy recommendations below, while challenging, can be carried out in the short- to medium-term and are conducive to Azerbaijan's long-term objectives. They fall into four major areas:

- Statutory framework (refer to Paragraphs 59 to 67);
- Institutional and capacity building measures (refer to Paragraph 65);
- Monitoring and enforcement mechanisms (refer to Paragraph 66); and
- Accounting education (refer to Paragraph 67).

59. **As a matter of priority, there is a need to revisit the statutory framework pertaining to accounting and auditing.** Following the establishment of market institutions, a considerable legal basis has been developed, including the Civil Code, the Law on Banks, and the new Law on Accounting. Such active legislative activity has left some gaps that will need to be addressed in legislation and the regulatory framework.

60. **The following areas should be adequately addressed in an updated Law on Audit Services to efficiently enhance auditing practices and improve the stature of the auditing profession:**

- ***Audit Objectives and Subjects of Audit:*** The Law should be a single source summarizing audit objectives and identifying statutory audit requirements. The Law should require legal entity and/or consolidated financial statements to be audited only when there is a public interest for such an audit, irrespective of the entity's legal form. However, the requirements for audit in the Law should be phased in to ensure that number of statutory audits required does not crowd out Azerbaijan's audit capacity.
- ***The Chamber of Auditors' Mandate and Responsibilities:*** The CoAA's mandate should be focused on the task of regulating the audit profession. This includes:
 - Protecting the public interest;

- Requiring statutory auditors and audit firms to carry out statutory audits in accordance with auditing standards. Due to the limited resources available, the ROSC team recommends that Azerbaijan adopt the “ISA Plus” model, whereby ISA would be adopted in full. Additional standards and audit procedures should only be imposed if they follow from specific requirements relating to the scope of the statutory audit;
- Certifying auditors and audit firms. In doing so, the CoAA should ensure the certification requirements meet the education, examination, practical experience and CPD requirements contained in IFAC’s International Education Standards;
- Maintaining a registrar of certified auditors and audit firms;
- Monitoring the compliance of independent auditors and audit firms with the adopted audit standards through a quality assurance system. In particular, the system should:
 - ✓ Ensure the competency of those persons responsible for carrying out the reviews.
 - ✓ Ensure the system is organized in a manner that is independent from the reviewed statutory auditors and subject to public oversight.
 - ✓ Ensure quality assurance reviews take place on a regular basis (e.g., every three to six years), and that the overall results of the quality assurance exercise are published annually.
- Disciplining certified auditors in breach of the audit standards or the Code of Ethics by implementing an effective and transparent system of investigations and sanctions.
- ***The Chamber of Auditors’ structure and accountability:*** The Structure of the CoAA (Board and Committees), the composition of the Board members, and the procedure of election or appointment (including limitation on terms of office, multiple appointments, dealing with vacancies, etc.) should be set forth in the legislation to ensure transparency of the process. The accountability of the CoAA and the annual audit of its financial statements and operations should also be clearly set forth.
- ***Accreditation and registration of auditors and audit firms:*** The following should be set forth:
 - The type of legal entity, which can be registered as an audit firm, the type and value of professional insurance to be obtained, and the number of certified auditors to be employed in an audit firm;
 - The professional license certification requirements;
 - It is recommended that the current citizenship requirements for registration as an auditor be removed as they are an impediment to the development of an efficient market for audit services.
- ***Rights of auditors:*** The Law should clearly set out that the auditors have the following rights:
 - access documents and conduct inspections required in the conduct of the audit;
 - obtain written representations from management on areas deemed appropriate; and
 - resign from or decline an audit engagement.
- ***Responsibilities of auditors:*** In addition to the general obligation of auditors to comply with the adopted auditing standards and the Code of Ethics, the legislation should enshrine the auditor’s responsibility to:
 - protect the public interest;
 - preserve the confidentiality of customer information;

- decline audit assignments, which involve a conflict of interest or lack of independence;
- not profit from information gained in the course of an audit assignment; and
- report to management (or the authorities if management is involved or refuse to take action) fraud or illegal acts, which may have been discovered during the course of an audit.

In addition, the supporting normative basis should be amended to incorporate the following requirements:

- ***Procedures ruling auditor appointment, selection, dismissal and resignation process should be clearly defined.*** Legal provisions defining dismissal and resignation of statutory auditors should provide adequate safeguards for their independence. For example, the Law could introduce the principle that the statutory auditor or audit firm can only be dismissed if there are proper grounds (not a divergence of opinions).
- ***The statutory audit fees and other services for non-audit services provided by the auditor should be disclosed.*** This would allow users to assess whether the fees for statutory audits are adequate to allow proper audit quality and are not influenced or determined by the provision of additional services to the audited entity.

61. **The new Law on Accounting (2004) set a sound basis for the accounting reform, outlining major concepts and a high-level road-map.** Some important areas continue to be addressed:

- ***The Legal Status and Charter ruling operations of the Advisory Council for Accounting have recently been finalized.*** The Law called for the establishment of the Council designed to advise the Ministry of Finance on matters related to accounting and financial reporting, namely (at this stage) on the development and approval of the accounting standards. The members of the Council are required to have essential knowledge of IFRS and International Public Sector Accounting Standards (IPSAS). The Charter, chairperson and members of the Council are approved by the Cabinet of Ministers. The Council, together with the Ministry of Finance, should continue to have sufficient legal rights and independence, as well as the budget and staff required to effectively perform its duties. As the standards' development progresses, the Council could assume responsibilities for guiding and overseeing the accounting reform implementation process.
- ***Normative acts defining enforcement measures for non-compliance with the Law on Accounting have recently been developed and adopted.*** The Law introduced legal responsibility for the infringement of requirements to prepare and submit the legal entity and consolidated financial statements and maintain the accounting books. A specific set of enforcement measures has been developed and incorporated into appropriate legislative acts. Monitoring and enforcement responsibilities should be clearly defined and assigned. With the participation of all stakeholders, the penalty and fine application procedures must be developed and enforced.

62. **Financial reporting of the insurance industry currently regulated by the Law on Insurance (1999) and Regulation “On Chart of Accounts and accounting methods for insurance companies operating in Azerbaijan” (1997) is an area requiring detailed analysis and update of the legislative and methodological basis.** It is a worldwide practice to subject the insurance industry to a special set of monitoring, reporting, and disclosure requirements. Almost none of these are implemented in Azerbaijan. The SISD within the Ministry of Finance should work together with the Accounting Methodology Department to review the existing normative

basis regulating financial reporting and auditing requirements in order to align it with the positions of the Law on Accounting, and to introduce standards and methodology based on the international industry-specific practices. Special attention should be paid to the qualification of the auditor or audit firm performing insurance company audits.

63. **Finally, the fragmented approach based on the remaining multiplicity of normative acts regulating accounting, financial reporting, and auditing needs to give way to a coordinated effort predicated on the positions of the Law on Accounting and other reform acts. This would establish a single robust general-purpose system that would eventually come to treat disclosure and transparency as public goods available to all market participants.** This effort requires analysis, amendment, and harmonization of legislative acts regulating accounting, financial reporting, and auditing issued by various authorities. Special attention should be paid to harmonization of the positions of the new Law on Accounting with already existing requirements. Contradictions between the old and new regulations should be detected and eliminated to the maximum possible extent. Distinctions pertaining to the remaining requirements should be clearly explained to the accounting practitioners. For example, the Ministry of Taxation has been traditionally viewed by the enterprises as the main regulator/user of periodically prepared financial information. To explain the differences between objectives and requirements of the Tax Code and the new Law on Accounting, it could be useful to issue a joint memorandum between the Ministry of Finance and the Ministry of Tax, explaining positions and purposes of both organizations and presenting to practitioners a mutually approved reconciliation mechanism that bridges tax and financial accounting.

64. **In addition to the continuous improvement of the statutory framework, implementation of already-introduced legislative acts should be secured by a set of clear and coordinated measures.** The Law on Accounting created a legal basis for rolling-out large-scale, comprehensive accounting reform. The task at hand is immense; the timeframe for the transition is quite tight. To successfully follow it will require full mobilization of available resources and funds. The following steps, involving both institutional and capacity building measures, have primary importance for this process:

- ***Establishment of a permanent group within the Ministry of Finance responsible for the IFRS translation and NAS development.*** This group should consist of a qualified staff supported by a sufficient budget. In the future, this group might assume responsibility for the development of implementation guidelines and for the technical and methodological support to the practitioners during the transition period. While this report can not concisely state the number of staff necessary for this task, it is estimated locally that in the region of 20 staff may be required to effectively supervise the following sectors: i) implementation of NASBOs based on IPSAS (3 staff); ii) implementation of NASCOs based on IFRS (3 staff); iii) implementation of IFRS (3 staff); iv) interpretation of NASCOs and NASBOs (3 staff); v) implementation of other accounting guidance (4 staff); management of the department may require two further deputy managers and a competent advisor. This group should work in close coordination with the Accounting Advisory Council.
- ***Development of accounting standards and disclosure preparation guidelines.*** Preparation of adequate disclosures is an integral part of high-quality, transparent financial statements. Until now, disclosures have not been required by existing accounting rules. Thus, special emphasis should be placed on explaining the significance of various disclosures required to be prepared by IFRS, such as related party transactions, accounting policies, subsequent events, contingent liabilities, etc.

- ***Design and roll-out of a large-scale pre-transition training program.*** As discussed in Section III, current accounting rules and practices adopted in Azerbaijan are still mostly derived from the old Soviet system. Successful implementation of a new approach should be supported by a thorough and comprehensive training program, and must involve a profound change in the “professional mindset.” Not only questions about how to implement the new accounting rules should be answered, but moreover, why it is necessary. Special attention should be paid to the training of SOEs’ personnel. Development of specific, economic sector-tailored training programs would be beneficial. Further recommendations on enhancing the education and training of accountants and auditors over the longer term are included below.
- ***Facilitate transition process for the SOEs, operating in the most strategic areas of Azerbaijani economy.*** This may include the following:
 - Promptly conduct gap analysis and prepare detailed accounting reform implementation plans for the major SOEs. The plan should include information on the training and assistance needs, terms of the management-information system installation/upgrade, additional budget requirements, etc. SOEs’ management and the Government should further act upon these plans, using internal and/or external resources whenever necessary.
 - Develop detailed instructions for the application of accounting standards and preparation of specific disclosures²⁴ to be included in the financial statements of the state-owned companies. Such disclosures should be comprehensive and transparent, providing sufficient information on the relationships between the companies and the Government, including amount of the subsidies paid and received, profit remittance information, reconciliation of payables, and receivables, etc.

65. **Significant enhancements regarding the CoAA’s structure, oversight and due process are needed to improve its success and legitimacy.** The CoAA should only retain its right to regulate the statutory audit profession if it successfully addresses these issues.²⁵ To effectively enforce requirements of the audit legislation and foster the professionals able to meet the new needs of economy, the CoAA should address the following major issues:

- ***Focus on its mandate of regulating the audit profession and part with its non-core activities.*** The CoAA should abandon its involvement with internal audit activities, and let a separate, independent body take on the advancement and regulation of the internal auditors in Azerbaijan. The CoAA should not be involved in reviewing or auditing of the financial statements. It should set education and examination standards for certified auditors, but it should not be the exclusive provider of the courses preparing for certification examinations and of the CPD.
- ***Develop, implement, and follow a comprehensive quality assurance system able to effectively monitor auditors’ compliance with applicable auditing and ethical standards, and independence requirements.*** The system should be compliant with international good practices, including the principles set forth in IFAC’s Statements of Membership Obligations (SMOs).²⁶ To facilitate development of the quality assurance

²⁴ Disclosures should be prepared according to either IFRS or NAS, depending on whether the SOE falls into the PIE category or not.

²⁵ This report does not delve into the details of these reforms, since these will be covered by a grant from the World Bank Institutional Development Fund (IDF).

²⁶ IFAC SMOs are designed to provide clear benchmarks to current and potential IFAC member organizations to assist them in ensuring high quality performance by accountants worldwide. SMOs

system, the CoAA could put together guidelines describing the quality assurance process and design a public practice manual including forms and checklists, which could then be used as a benchmark in the conduct of quality reviews. The CoAA should have at its disposal a sufficient set of measures to permit them to penalize those breaching regulatory requirements.

- **Ensure that Azerbaijani official translations of ISA and the IFAC Code of Ethics are readily available to all professionals.** Whilst the official translations must be in Azerbaijani in accordance with legislation, the CoAA may consider making the Russian translations of ISA available for practical but not official purposes..
- **Ensure that it has adequate resources to perform its many responsibilities.** This could entail a capacity-building program and internships in leading international professional associations and regulators, as well as the recruitment of staff with international accounting and auditing qualifications and experience.

66. **The State Committee for Securities, as one of the main regulators of reporting requirements applied by the issuers of securities, should play an important role in promoting and enforcing positions of the new Law on Accounting and its own supplementary regulations.** The following improvements should be prioritized:

- **Definition of enforcement.** The completeness, accuracy and truthfulness of the financial information are the responsibility of the issuer's board of directors. Statutory auditors should act as a first external line of defense against misstatements by expressing their opinion on the financial statements based on their audit. The SCS should monitor compliance of the financial information presented by companies – issuers of securities with the reporting requirements, and take appropriate enforcing measures in case of infringements discovered.
- **Necessary powers.** The necessary powers of the SCS should at least include power to monitor financial information, require supplementary information from issuers and statutory auditors, and take measures consistent with the purposes of enforcement. The SCS should be responsible for the setting up of an appropriate due process of enforcement and the implementation of that due process. The SCS should therefore be provided with resources sufficient to establish and carry out an effective monitoring system. This includes having professionally skilled staff that should be experienced with IFRS and the legal implications of enforcement.
- **Issuers and documents.** Financial information should include annual and interim financial statements and reports, prepared on an individual and consolidated basis, as well as prospectuses and equivalent documents. SCS should clearly define its requirements of the interim financial information. Currently this is missing.
- **Actions.** Where a material misstatement in the financial information is detected, the SCS should take appropriate actions to achieve an appropriate disclosure, and, where relevant, public correction of the misstatement (in line with the requirements of IFRS). Non-material departures from the reporting framework will not normally trigger public correction, even though they normally deserve an action as well. Actions should be effective, timely, and proportional to the impact of the detected infringement.
- **Reporting.** The SCS should periodically report to the public on its activities providing at least information on the enforcement policies adopted and decisions taken in individual cases including accounting and disclosure matters.

cover quality assurance, education standards, auditing standards, ethics, investigation and discipline, etc. For additional information, refer to <http://www.ifac.org/Compliance/index.php>.

67. **In parallel to improving the statutory and institutional framework, there is a strong need to improve the capacity of the accounting and audit professions.** The genuine understanding and adoption of these new accounting and auditing requirements requires relevant education and training for financial statement preparers, auditors, and regulators. Although there will continue to be the need for training in the requirements of Azerbaijani tax reporting, there must also be a greater focus towards the needs of general-purpose financial reporting. In this regard, it is essential to enhance the capacity of existing accountants as well as ensure the capacity of future accountants.

- **“Retool” existing accountants.** Encourage “chief accountants” and other preparers of financial statements at Azerbaijani companies to improve their understanding of IFRS, accrual accounting, and their application to their work within the financial reporting framework in Azerbaijan.

On the demand side, policymakers could incentivize company management to invest in such “retooling” through a combination of positive (e.g., education tax credits) and deterrent incentives (e.g., liability for the probity of financial statements). In the context of SOEs, the State, acting as a shareholder, could take the lead and ensure that accountants in SOEs enroll in ‘retooling’ programs. Companies should also be encouraged to support employees’ training and study towards accountancy qualifications.

On the supply side, private sector accountancy education centers could also be incentivized to open in Azerbaijan through specific measures. Their offering should however be tailored to the needs of Azerbaijani companies. In most companies, much of the finer detail of IFRS will be irrelevant. The core concepts, such as the accrual basis, the separation of tax and financial reporting, and the interaction of financial statements, management accounting and cash flow accounting, should be central to the education of the profession.

- **Vocational and academic education.** Accounting syllabus and training programs should be updated and redesigned. In order for the accounting reform process to be sustainable in the longer term, it is essential that university courses are designed to ensure that future accountants become thoroughly proficient in the matters of accounting, financial reporting, and auditing, based on the best international practices. The curriculum for accountancy and business courses at universities in Azerbaijan should be fundamentally overhauled. The CoAA and the Ministry of Finance should work with the Ministry of Education and the leading Universities to design courses, which are based on IFRS/ISA, but which also seek to:
 - Develop within students the intellectual and imaginative skills required to critically understand fundamental concepts;
 - Provide practice-oriented teaching with stronger focus on business administration and case studies to best prepare accountants (rather than bookkeepers or tax compliance officers);
 - Include the ethical dimensions of business management, finance, accounting and auditing;
 - Gain significant exemptions in the professional certification programs for auditors and accountants offered by established accounting bodies as agreed by the Ministry of Finance; and
 - Promote high quality research both for its own sake and as a feed into teaching.

There may be a need to “retool” some of the faculty members to achieve these changes.

- ***The professional qualification requirements for all individuals, who wish to obtain the right to conduct statutory audits in Azerbaijan, needs to be strengthened.*** The professional qualification should comprise an examination of professional competence and a requirement for suitable and adequate relevant professional experience. It should draw upon IFAC IESs, in particular IES 6, *Assessment of Professional Capabilities and Competence* and IES 5, *Practical Experience Requirements*.
- ***Similarly, the CoAA should articulate CPD requirements, which are consistent with IFAC.*** The CoAA should not be the exclusive provider of training courses to its members, but should ensure that members maintain sufficient theoretical knowledge, professional skills and values in order to retain their certification.