THE APPLICATION OF IAS/IFRS IN AZERBAIJAN, A COMPARATIVE APPROACH

A THESIS SUBMITTED TO
THE GRADUATE SCHOOL OF SOCIAL SCIENCES
OF
MIDDLE EAST TECHNICAL UNIVERSITY

BY

EMIL MUSTAFAYEV

IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
FOR
THE DEGREE OF
MASTER OF BUSINESS ADMINISTRATION

SEPTEMBER 2009

Approval of the Graduate School of Social Sciences

Prof. Dr. Sencer Ayata
Director

I certify that this thesis satisfies all the requirements as a thesis for the degree of Master of Business Administration.

Prof. Dr. Cengiz Erol
Head of Department

This is to certify that we have read this thesis and that in our opinion it is fully adequate, in scope and quality, as a thesis for the degree of Master of Business Administration.

Prof. Dr. F.N. Can Mugan
Supervisor

Examining Committee Members

Asst. Prof. Dr. Adil ORAN	(METU,BA)	
Prof. Dr. F. N. Can Mugan	(METU,BA)	
Dr. Nazlı Akman	(BILKENT, BA)	

I hereby declare that all information in this document has been obtained and presented in accordance with academic rules and ethical conduct. I also declare that, as required by these rules and conduct, I have fully cited and referenced all material and results that are not original to this work.

Name, Last name : EMIL MUSTAFAYEV

Signature :

ABSTRACT

THE APPLICATION OF IAS/IFRS IN AZERBAIJAN, A COMPARATIVE APPROACH

Mustafayev, Emil
MBA, Department of Business Administration
Supervisor: Prof. Dr. F.N. Can Mugan

September 2009, 82 pages

The purpose of the study is to illustrate to the management of entities and professionals who are against the application of IAS/IFRS in Azerbaijan why it is essential to adopt IAS/IFRS. The thesis aims to provide differences of current accounting policies and procedures applied by those entities from IAS/IFRS and justify the application of IAS/IFRS. The thesis provides benefits associated with the adoption of IFRS/IAS, and illustrates the problems that may be faced by the management of entities.

Keywords: International Accounting Standards, International Financial Reporting Standards, Azerbaijan

ÖZ

UMS/UFRS'İN AZERBAYCAN'DA UYGULANMASI, BİR KARŞILAŞTIRMA

Mustafayev, Emil
Master, İşletme Bölümü
Tez Yöneticisi : Prof. Dr. F.N. Can Mugan

Eylül 2009, 82 sayfa

Bu tezin amacı Uluslararası Muhasebe Standartlarını uygulamaya karşı olan işletmelere ve uzmanlara bu standartların uygulanmasının neden önemli olduğunu göstermektir. Tez uluslararası muhasebe uygulamaları ile Azerbaycan muhasebe uygulamalarını karşılaştırarak bu soruyu yanıtlamaya çalışıyor. Tezde uygulamanın faydaları ve uygulama zamanı karşılanabilecek sorunlar da araştırılıyor.

Anahtar kelimeler: Uluslararası Muhasebe Standartları, Uluslarası Finansal Raporlama Standartları, Azerbaycan

TO MY FATHER

ACKNOWLEDGMENTS

The author wishes to express his deepest gratitude to his supervisor Prof. Dr. F.N. Can Mugan for her guidance, advice, criticism, encouragements and insight throughout the research.

The author would also like to thank Asst. Prof. Dr. Adil Oran and Dr. Nazli Akman for their suggestions and comments.

TABLE OF CONTENTS

CHAPTER 1

INTRODUCTION

The main objective of accounting in Azerbaijan during the Soviet Union governance was to comply with the requirements of statistical and tax authorities. The situation was the same after independence for some time. The transition into market economy required adopting new accounting concepts and principles in accordance with market economy requirements. To be more specific, the accounting system strictly adopted the concepts of historical cost convention to report fixed assets, and did not estimate provisions for doubtful receivables or obsolete inventories (ADB 2002). There was no need to be responsible to banks or investors for the performance. Uniform Chart of Accounts was established in order to control the accounting system centrally. The primary function of accounting was to record the factual data necessary to assess plan accomplishments (ADB 2002).

In order to harmonize the accounting system with international reporting standards and requirements of market economy, the Uniform Chart of Accounts was renewed, new concepts were introduced and the Accounting Law was passed in 1995. But still, the accounting system is regulated by the government who specifies what information should be produced, how it should be produced, and whom it should be provided for. The government regulation of accounting has also been established by the Accounting Law passed in 2004.

In order to meet the requirements of market economy and adopt International Financial Reporting Standards (IFRS), the Accounting Reform Plan was prepared by the Ministry of Finance and according to this plan new Accounting Law was passed in 2004.

According to the Accounting Law of Azerbaijan Republic passed in 2004, the main objective of government regulation of accounting is to prepare and implement National Accounting Standards (NAS) for profit and nonprofit organizations based on IFRS and International Accounting Standards (IAS) (Accounting Law 2004, article 4). According to the 1995 Accounting Law, the main objective of government regulation of accounting is to establish the accounting system that is consistent with the international accounting principles and standards (Accounting Law 1995, chapter 38). 2004 Accounting Law seems to specifically address the government objective of accounting regulation. This law sets deadlines on the application of NAS and IFRS for different entities.

All public interest entities, subjects of small entrepreneurships, and profit organizations are required to adopt IFRS and NAS for Commercial Organizations respectively. Subjects of small entrepreneurships are small and medium entities operating in different sectors. Non-government organizations, which are voluntary, self-governed non-governmental organizations that do not aim to earn profit as the major objective, are required to adopt NAS for Non-government Organizations by 2004 Accounting Law (Accounting Law 2004, article 8-9).

Although there is a program and adoption deadlines for IAS and IFRS, there is some resistance to this change from some accountants, professionals and entities. According to "Accounting and Financial System Reform in a Transition Economy: A Case Study of Russia" book by Robert W. McGee and Galina G. Preobragenskaya as the experience of other countries shows, there is resistance to the adoption of the international standards (McGee and Galina 2005). One of the reasons for the resistance is that accountants and managers, who are comfortable with the system they have used for a long time, do not want to change. According to the same book, no one knows the new rules and most universities do not have qualified professors and most accounting firms do not have anyone who has been trained in the new rules. Nobody knows how to implement the new rules, but governments often pass laws with deadlines; the result, the adoption cannot be implemented according to the government's schedule (Robert McGee and Galina 2005, 8).

The purpose of the study is to illustrate to the management of entities and professionals who are against the application of IAS/IFRS why it is essential to adopt IAS/IFRS. The thesis aims to provide differences of current accounting policies and procedures adopted by those entities from IAS/IFRS, and justify the adoption of IAS/IFRS.

This study may be used by the management of entities who consider the adoption of IAS/IFRS, and may help them to adopt these standards. The study may also help the government in the implementation of IAS/IFRS adoption.

The first chapter provides information about the accounting system and accounting policies in Azerbaijan Republic. The information about the accounting system and accounting policies is provided by the illustration of differences of those policies from IAS/IFRS. The aim in this comparison is to illustrate to the managers in what ways Azerbaijan accounting system and policies differ from the international practice, and to illustrate how they can improve the accounting system and reporting by adopting IAS/IFRS.

The second chapter provides information about the preparation and presentation of financial statements according to Azerbaijan accounting policies and procedures, and the elements of the financial statements. This information is also provided by the illustration of the differences from IAS/IFRS. The aim in this comparison is to illustrate to the decision makers the differences between Azerbaijan accounting policies and IFRS, and to illustrate to the entity manager how he/she can improve financial statement preparation and presentation.

The third chapter provides information about the importance of IAS/IFRS adoption and the problems that might arise during the adoption of IAS/IFRS. This chapter also provides suggestions as how to overcome those problems.

CHAPTER 2

THE ACCOUNTING SYSTEM AND ACCOUNTING POLICIES IN AZERBAIJAN REPUBLIC

2.1 Soviet Accounting System.

2.1.1 Characteristics of the Soviet accounting.

This section gives general characteristics of the Soviet Accounting System. Brief information about accounting policies and procedures applied in the preparation of financial statements is also presented. This information is provided in order to provide background to the development of accounting policies and procedures in Azerbaijan.

Azerbaijan was a part of the Soviet Union and was required to apply economic policies in consistency with the Soviet regulations. Accounting system was also organized in accordance with the Soviet regulations in Azerbaijan.

Economy was controlled centrally in the Soviet Union. Central government founded enterprises, organized production, established plans and targets, and established wage levels (Liberman and Eidinov 1995, 777-807). The factors of production, such as monetary capital and capital goods were also allocated to the economy and entities by the central government (Liberman and Eidinov 1995, 777-807). The costs and prices were determined centrally. Thus, the accounting system did not have an economic content.

The central government was the major economic entity in the Soviet economy. The major responsibility of the management of a Soviet entity was to comply with the regulations and fulfill the plans issued by the central government. Those plans comprised the level of production, the use of resources allocated by the government, the level of wages and employment, and the level of prices. The accounting system that provided information about the level of fulfillment of targets and the use of resources was crucial for the central government (Robert and Abbott 1996).

The main objective of accounting in the Soviet Union was to provide information that was necessary to control and plan the Soviet economy. Thus, control was the major function of accounting in the Soviet Union. The performance of an enterprise was evaluated on the basis of fulfillment of the plans issued by the central government (Pecker 1932).

Accounting system had to provide information about the fulfillments of the plans assigned by the central government (Liberman and Eidinov 1995, 777-807). However, actual achievements might have been deviated from the plans. Detailed information provided by the accounting system assisted in the determination of the sources of these deviations.

Since the major user of the accounting data was the government, accounting policies and procedures were tailored to the needs of the government. Those policies and procedures were highly standardized and uniform, and there was no scope for accounting innovation (Liberman and Eidinov 1995, 777-807). Detailed instructions on the reporting of transactions, recognizing items were provided, and departures from those instructions were not allowed. This standardization and uniformity was necessary in order to control the Soviet economy (Liberman and Eidinov 1995, 777-807). Financial statements prepared and presented to the central government were also predetermined and prescribed by the central government. The forms and the items of the balance sheet and other statements were standard.

In summary, Soviet Accounting System was organized in the manner that provided necessary information to control and plan the Soviet economy. Accounting was not a tool of decision making for the management of a Soviet entity, but was a tool of control of the entity by the central government.

2.1.2 The content of financial statements prepared in the Soviet Union.

Financial statements were prepared and presented to the central government. However, these statements were not considered a decision-making tool, instead were considered control and planning tool. Information provided by the Profit and Loss

Statement was not used in the evaluation of the enterprise performance (Liberman and Eidinov 1995, 777-807).

A Soviet balance sheet had some characteristics different from international practices. Soviet balance sheet did not present information about land. Land was not allowed to be traded in the Soviet system (Liberman and Eidinov 1995, 777-807).

Information about intangible assets also was not presented. The assets of the balance sheet were valued at the historical costs. Market values were not considered in the valuation of assets. Depreciation charges were determined centrally and did not decrease the value of the fixed assets. Instead, depreciation was charged against depreciation reserve, which was reported in as a liability. Investments also were not reported in the balance sheet since there were no investment transactions among entities. The only party investing in the Soviet economy was the government. Equity of an entity was established by the investments of the central government. The investments were made either directly or indirectly through the state bank. An example for the direct investment was fixed assets received from the government as a free good. Indirect investments were made by the state bank. The need for the resources by the entity and the objectives of national economic plan were considered in making decisions relative to the investments.

Balance sheet presented only real and valuable assets, i.e. doubtful and useless accounts were written off (Pecker 1932). The following were some of the assets recognized on the Soviet balance sheet:

- Finished goods account

- Accounts receivable

- Statebank profit insurance account. This account reported amount of revenue retained by Statebank. All entities had to perform their monetary and sales transactions through their accounts at Statebank. Statebank used to retain a part of the revenue of an entity in order to guarantee the fulfillment of the production plans by an entity. After the monthly results on the fulfillment of plans presented to

Statebank, the amount of the insurance account was transferred to the current accounts.

- Deferred items. An example for the deferred items was “New Labor-training Expense” account, which reported the cost of training new workers for the plants that were under construction. These training expenses were capitalized when the plant construction was completed. Another example for deferred items was “Demolition and Site Exploration Expense” account.

The term “Equity” was not defined in the Soviet Accounting System. There were capital accounts, but separate “Shareholders’ Equity” concept was not defined. The second part of the Soviet balance sheet reported liabilities which also consisted of owners’ capital accounts (Walton et al. 2003, 335).

The following were some of the liabilities recognized on the Soviet balance sheet:

- Statue capital account. This account reported the amount of capital issued by the government to the entity.

- Modification of statue capital account. This account recognized the changes in the statue capital account. Decreases and increases in the statue capital initially were reported in this account, and at the end of the year the balance of this account was written off to the statue capital account.

- Depreciation capital account. This account accumulated depreciation charges. This is similar to the accumulated depreciation account. Different from the accumulated depreciation account, the amount accumulated in the depreciation capital did not decrease the value of the fixed asset. Instead, the amount recognized in the depreciation capital was written off when the fixed asset was disposed of.

- Extension capital account. This capital was raised in order to increase the capacity of an entity.

- Special reserves

- Accounts payable.

There were other accounts that were not presented in the balance sheet, but were presented together with the balance sheet. These accounts were memoranda accounts. Examples for these "Out-of-Balance Sheet" accounts were leaseholds, materials received for treatment, materials in custody under trust receipt, owners of leased property, owners of materials received for treatment and owners of materials under trust receipt. Liabilities to owners were reported by owners of leased property, owners of materials received for treatment, and owners of materials under trust receipt accounts. These accounts were not recognized in the balance sheet because they were not the property of an entity. For example, leased property was not reported in the balance sheet since an entity was not the owner of the leased asset. The same principle also applies to the materials received for treatment and other "Out-of-Balance Sheet" accounts.

Obtaining high profits was not a primary objective for a Soviet enterprise (Liberman and Eidinov 1995, 777-807). Prices and costs were also controlled by the central government in the Soviet Union. The cost of the factors of production and the sale prices of products, and thus, the profit were determined by the government (Liberman and Eidinov 1995, 777-807). Cost accounting of the enterprise provided information about the cost of an output to the central government. The price of the output was established by the central government based on the information provided by cost accounting.

One of the characteristics of the cost accounting was the establishment of settlement prices. The settlement price was determined centrally and was applied when actual costs were not available. At the end of the year, the difference between the settlement price and the actual cost was reported to period profit or loss. The input and output prices might have been changed in order to efficiently allocate resources throughout the economy. Interest payments to banks and tax payments were not recognized as costs. These items were considered as parts of profit distribution. The following were some of the profit and loss items recognized on the Soviet profit and loss statement (Liberman and Eidinov 1995, 777-807):

- Gross profit on sales
- Bad debts paid in
- Bad debts written off
- Difference between plan prices and actual costs of finished goods
- Unused balance of doubtful-debts written off to Profit and Loss account. This account reported the unused balance of reserve for doubtful debts written off to profit and loss at the end of the year. After the written off the unused balance, the new reserve for doubtful debts was established.

In summary, the determination of profit and loss had some characteristics specific to the Soviet Accounting System.

2.2 Post Soviet Accounting System

This section presents information about the development of Azerbaijan accounting system after the collapse of the Soviet Accounting System.

After the collapse of the Soviet Union, Azerbaijan government began transiting to the market economy. The establishment of private property and certain market economy mechanisms was the main objective. In order to carry out these objectives, state property has been privatized and certain market economy mechanisms have been established. Foreign investment is necessary in the process of transition. Many entities have been privatized by foreign investors. Joint stock companies were established in the oil and gas sector.

One of the major objectives was to organize accounting system that would answer to the requirements of the market economy. The collapse of the Soviet Union and transition to the market economy required new accounting system to be established. The establishment of the accounting system complying with the requirements of the market economy was also required by the foreign investors. Since the accounting policies and procedures were regulated by the Soviet central government, the newly independent country, Azerbaijan, was not ready to take the responsibility to establish a new accounting system (Derek 1995, 595-623). In the early years of independence, old Soviet accounting policies and procedures were still in application.

In the process of establishment a new accounting system, the experience of post-Soviet Russia was adopted. Accounting reform in Azerbaijan almost took the same path as the accounting reform in Russia. The Accounting Law of Azerbaijan Republic was passed in 1995, and a new chart of accounts was issued. The objective of the Accounting Law was to organize and control the accounting system, to establish new accounting policies and procedures (Accounting Law 1995, chapter 1). The law and a new chart of accounts introduced accounting policies and procedures that were characteristic to the market economy. Examples for these accounts were intangible assets, financial assets and liabilities, shareholders' equity, leasing. Some accounting policies and procedures that were characteristic to the Soviet Accounting System were also retained. The objective was to gradually transit the accounting system, since the economy and interested parties were not ready to fully adopt market-economy accounting system (Derek 1995, 595-623).

The accounting system is still regulated by the government. The central government issues accounting norms and policies, and requires entities to adopt those policies. The government is the major interested party in the financial statements of entities because of tax and other considerations. The Tax Code also determines some accounting policies and procedures. For example, period profits are determined according to the Tax Code. Entities determine accounting profits according to the Tax Code and no deferred taxes are established. According to many accountants, accounting is regarded as a control system by the management of most entities. The management of many entities is not accustomed to and expertised in the evaluation of and making decisions based on the financial statements. The statements are only considered as reports to be issued to the tax and other authorities.

Azerbaijan economy is still in the transition to the market economy. Accounting system is also in transition. The government is highly interested in the transmitting the accounting system and adopting IFRS and IAS. The establishment of the accounting system in consistency with the IFRS/IAS is the primary objective of the government. But the majority of entities operating in the transition economy are not ready to adopt this accounting system. These entities still apply accounting policies and procedures established by the old accounting law passed in 1995.

In summary, the Soviet Accounting System that was in application for many decades is in the process of transition. Post Soviet Accounting System established policies and procedures in order to harmonize accounting with the international standards. Despite changes in the post Soviet Accounting System, the fundamental structure of the old accounting system was maintained. This is evident from the financial statements prepared and presented according to the Accounting Law passed in 1995. It is deducible that the accounting system carrying both the characteristics of the Soviet and market accounting is going to be relevant until accounting system based on the IFRS and IAS is fully applied.

2.3 NAS based on IAS/IFRS

In order to meet the requirements of market economy and adopt IFRS, the Accounting Reform Plan was prepared by the Ministry of Finance and according to this plan new Accounting Law was passed in 2004.

According to the Accounting Law of Azerbaijan Republic passed in 2004, the main objective of government regulation of accounting is to prepare and to implement NAS for commercial and non commercial organizations based on IFRS and IAS (Accounting Law 2004, article 4).

Accounting Reform is regulated by the Finance Ministry. The regulatory body is responsible for translation of IFRS and IAS into Azerbaijani language. The regulatory body is also responsible for the obtaining certification from the IAS Board (IASB) confirming Azerbaijani language translations as the official translations (Accounting Law 2004, article 4). The Ministry also monitors and reflects the changes made to IAS to NAS in a timely manner (up-to-date changes). All these responsibilities are given to the Finance Ministry by the Accounting Law (Accounting Law 2004, article 4).

In order to provide assistance to the Finance Ministry and consult the ministry in accounting and financial reporting issues, the Advisory Council for Accounting was founded in 2005. The ministry of Finance has to consult with the Council about application of international standards and preparation of National Accounting Standards (Accounting Law 2004, article 5).

The following requirements were set by the Accounting Law regarding the preparation of financial statements for different organizations:

- All Public Interest Entities are required to prepare their financial statements in accordance with IFRS starting from January 1, 2008 (Accounting Law 2004, article 8).

- Subjects of small entrepreneurship are required to prepare their financial statements in accordance with either "Simplified Accounting Rules for Subjects of Small Entrepreneurship" or "NAS for Commercial Organizations" starting from January 1, 2006 (Accounting Law 2004, article 9).

- Commercial organizations other than public interest entities and subjects of small entrepreneurship are required to prepare their financial statements in accordance with either "NAS for Commercial Organizations" or IFRS starting from January 1, 2008 (Accounting Law 2004, article 10).

- Non-commercial companies such as, municipalities, budgetary organizations and non-budgetary funds must prepare their financial statements according to the NAS for Budget Organizations starting from January 1, 2009 (Accounting Law 2004, article 13.1).

- Non-government organizations are required to prepare their financial statements according to the NAS for Non-government Organizations starting from January 1, 2009 (Accounting Law 2004, article 13.2).

The following are the ratified NAS for commercial organizations based on IAS/IFRS:

Table 1. **National Accounting Standards**

	NASCO №	**Standard name**
1	NASCO 1	Presentation of financial statements
2	NASCO 2	Statement of changes in equity
3	NASCO 3	Current Tax
4	NASCO 4	Deferred Tax
5	NASCO 5	Cash flow statement
6	NASCO 6	Income
7	NASCO 7	Property, plant and equipment
8	NASCO 8	Inventories
9	NASCO 9	Events after the balance sheet date
10	NASCO 10	Provisions, contingent liabilities, and contingent assets
11	NASCO 11	Accounting Policies, changes in Accounting Estimates, and errors
12	NASCO 12	Intangible assets
13	NASCO 13	Borrowing costs
14	NASCO 14	Leases
15	NASCO 15	Financial instruments - disclosure
16	NASCO 16	Construction contracts
17	NASCO 17	Accounting for Government Grants and Disclosure of Government Assistance
18	NASCO 18	Combination of Business organizations
19	NASCO 19	Consolidated Financial Statements
20	NASCO 20	Accounting for Associates
21	NASCO 21	Interests in Joint Ventures
22	NASCO 22	The effects of changes in foreign currency rates
23	NASCO 23	Non-current Assets Held for sale and Discontinued Operations
24	NASCO 24	Impairments of Assets
25	NASCO 25	Related party Disclosure
26	NASCO 26	Fair Value Measurement
27	NASCO 27	Investment Property

2.4 Accounting policies

This section analyses accounting policies established by the Accounting Law passed in 1995 and the Tax Code. These accounting policies are applied by the management of most entities. The reason for this analysis is to illustrate to the managers in what ways Azerbaijan accounting policies differ from the international practice, and to illustrate how they can improve reporting by adopting IAS/IFRS or NAS based on IAS/IFRS.

Information based on accounting policies related to the accounting of assets, liabilities, expenses and profits is provided. Accounting policies for current assets, noncurrent assets, current liabilities, noncurrent liabilities, expenses and profits are provided successively.

2.4.1 Accounting policies for accounts receivable.

Accounts receivable are recognized in the financial statement at their historical amount. There are two alternative policies for the recognition of uncollectible receivables. There are not any criteria for the selection of the methods. One method is to estimate doubtful receivables according to the aging schedule at the end of the reporting period and to create a separate reserve on doubtful receivables (Accounting Law 1995, chapter 22). In this case, accounts receivable are recognized in the financial statements at full amount, and decreased when uncollected. The uncollected receivables are charged to the reserve on doubtful receivables (Accounting Law 1995, chapter 22). If doubtful receivables are collected and the amount of the reserve is not used, the reserve for doubtful receivables is transferred to the profit and loss at the end of the period. The second method is the direct write-off of the uncollected receivables. In this case, a reserve for doubtful receivables is not established and accounts receivable are decreased when there are uncollectible receivables.

2.4.2 Accounting policies for inventory.

Accounting for inventory according to Azerbaijan accounting policies has some similarities with and differences from IAS. These similarities are in the determination of inventory costs, valuations methods applied; differences are in the subsequent valuation, and the application of LIFO method. These accounting policies that are used by the majority of the entities were set at the beginning of the transition to the market economy. The lack of some market mechanisms such as, the unavailability of the determination of fair values and net realizable values did not allow to adopt certain international accounting policies. These policies also have some characteristics of the Soviet Accounting System. This is evident especially in the allocation of costs to the value of finished goods and work-in process inventory. Detailed information about accounting policies for inventories according to Azerbaijan Generally Accepted Accounting Principles (GAAP) is provided in the following paragraphs.

Azerbaijan GAAP defines inventory as assets that are held for production of goods, for rendering of services or performing works with the purpose of sale (Sebzeliyev 2005, 137). In the process of production of goods or rendering of services, inventory is expected to transfer its physical substance or value into finished goods or services at once, in contrast to fixed assets, which are expected to transfer their value into finished goods or services gradually (Sebzeliyev 2005, 138). Thus, assets that are used once and transfer their substance fully in the production process are classified as inventory. These assets consist of raw materials, work in process materials, fuel; that is used in the production process, spare parts, and other inventory.

Azerbaijan accounting policies require recognizing inventory according to contractual agreements where all conditions regarding the legal title of inventory, ownership and shipment rules are established (Sebzeliyev 2005, 140). These contractual agreements are main source of information that is taken into consideration when recognizing inventory.

Azerbaijan accounting policies determine the cost of inventory according to the same principles as the principles of IAS. The cost of inventory is determined considering purchase price, import duties and taxes, transportation and insurance costs, and any costs that are necessary in order to put inventory into usable condition (Sebzeliyev 2005, 140). These costs are costs related to the purchase of inventory.

There are also conversion costs related to the production of finished goods. These conversion costs are included in the costs of finished goods, which are recognized separately in the financial statements (Sebzeliyev 2005, 141). Indirect costs, such as overhead costs are attributed to the finished and work-in process goods on the bases of labor costs, actual worked hours and other factors. Allocation of indirect costs based on the normal capacity is also applied (Sebzeliyev 2005, 142).

When costs are allocated based on the labor costs, these costs are allocated to the cost of produced goods considering the proportion of labor costs incurred in the production process. The allocation of indirect costs based on the actual worked hours considers the proportion of actual labor-time spent on the production process (Sadigov 2002, 2: 36). Both of these allocation methods initially consider the proportion of labor costs and worked hours in the total labor costs and worked hours respectively, and then allocate the same proportion of overall overhead costs to the produced good. For example, if the total working hours spent on the production of a good takes one week, which is the one fourth of a month, the one fourth of overhead costs such as, monthly management salary, is included in the cost of the produced good.

If it is impractical to determine the actual inventory costs, they are approximated using standard costs (Sebzeliyev 2005, 142). The similar application is also applied by IAS 2. Azerbaijan GAAP also applies the retail method, contract costing methods. In the case of contract costing method, the cost of inventory is determined based on the contract, invoice prices and then adjusted as the amounts of actual costs are available (Sebzeliyev 2005, 142).

Azerbaijan accounting policies suggest using specific identification, weighted average, LIFO, and FIFO valuation methods. As seen, Azerbaijan GAAP does not prohibit the application of LIFO method, in contrast to IAS 2.

Azerbaijan GAAP requires that inventory is reported in the Balance Sheet in actual costs (Sebzeliyev 2005, 147). This is regulated by the Accounting Law of Azerbaijan Republic. According to the 19^{th} chapter of the Law inventory, i.e. raw materials, spare parts, work-in process inventory, fuel is to be initially reported at the historical costs (Accounting Law 1995, chapter 19). Finished goods are reported in the actual or standard costs if it is impractical to determine the actual cost (Accounting Law 1995, chapter 19.2). Resale merchandise is reported in the retail or purchase prices

(Accounting Law 1995, chapter 19.2). Paragraph 4 of the 19th chapter of the Accounting Law states that if there is indication of the fall in selling price, obsolescence and quality deterioration the inventory, finished goods and resale goods are subsequently reported in the realizable value (Accounting Law 1995, chapter 19.2). Realizable value is based on the possible selling prices. If realizable value is lower than the current value of the inventory then loss is recognized. As seen, this principle is close to IFRS, but different from IFRS, Azerbaijan accounting principles do not determine net realizable value. Realizable value based on the possible selling prices without the consideration of selling costs is determined according to Azerbaijan GAAP.

The difference between Azerbaijan accounting policies and IAS 2 can be summarized in the following table:

Table 2. **Accounting policies for Inventory.**

Current Assets	
IAS 2	**Azerbaijan GAAP**
Recognition	
When legal title passes to the buyer, it must recognize the inventory on the financial statements.	Azerbaijan accounting policies require recognize inventory according to contractual agreements where all conditions regarding the legal title of inventory, ownership and shipment rules are established.
Inventory costs	
All costs that are incurred in order to put the inventory to its present location and present condition must be considered the cost of inventory.	The cost of inventory is determined considering purchase price, import duties and taxes, transportation and insurance costs, and any costs that are necessary in order to put inventory into usable condition.
Valuation of Inventories	
IAS 2 considers specific identification, weighted average cost and FIFO methods.	Specific identification, weighted average cost, FIFO and LIFO method are applied.
Subsequent measurement	
Inventories are subsequently measured at lower of cost or market.	Inventories are subsequently measured at realizable value, which is based on the possible selling prices.

Table 2 (cont'd)

Disclosure requirements	
Information about the accounting policies adopted in measuring inventories, the carrying amount of inventories, the amount of inventories recognized as an expense, the carrying amount of inventories pledged as security for liabilities is disclosed in the financial statements.	There is not disclosure requirement.

2.4.3 Accounting policies for property, plant and equipment.

Accounting policies for property, plant and equipment also carry the characteristics of the Soviet and international accounting systems. Those policies are more similar to the Soviet Accounting System rather than to the IAS. Accounting policies for depreciation, subsequent valuation, and subsequent costs incurred are adopted from the Soviet Accounting System.

According to Azerbaijan GAAP, property, plant and equipment are classified as Fixed Assets in the Balance Sheet and defined as tangible assets that are held for use in the production or supply of goods or services, for administrative purposes for a use of more than 12 months, or for use in the normal course of operating cycle of more than 12 months (Sebzeliyev 2005, 179). One of the major differences between the two regulations is the cost limit that is established by the Azerbaijan accounting regulations. According to this limit an item of a tangible asset that costs above 100 manats (1 manat=$ 0.8), and that transfers its value gradually to the finished goods can be recognized as Fixed Assets in the financial statements (Sebzeliyev 2005, 179).

Azerbaijan accounting policies require fixed assets to be measured initially at cost, which consists of cash, and cash equivalents paid and necessary costs that have to be incurred in order to bring the assets to the present location and condition (Sebzeliyev 2005, 183). These necessary costs include inspection of assets at the point of acquisition, transportation costs, and costs related to the installation of assets (Sebzeliyev 2005, 184).

There are costs incurred subsequent to initial measurement. IAS 16 clearly sets criteria for the recognition of these costs. These costs must meet the recognition criteria in order to be capitalized (Epstein and Jermakowicz 2008, 253). Azerbaijan GAAP sets some standards for the recognition of such costs. Chapter 115 of the Tax Code establishes thresholds for the repair and maintenance costs incurred subsequent to the initial recognition of fixed assets. The Tax Code requires expense repair and maintenance costs if they are 2%, 5% and 3% of the book value of property, plant; equipment, machinery; and other fixed assets respectively (Tax Code 2008, chapter 115). If repair and maintenance costs exceed these thresholds then they are capitalized and increase the current values of fixed assets (Tax Code 2008, chapter 115).

According to the Accounting Law, fixed assets are to be subsequently recognized in the balance sheet at historical cost (Accounting Law 1995, chapter 18). Chapter 18 of the Accounting Law states that the historical cost of the fixed asset can be changed when they are revalued (Accounting Law 1995, chapter 18). Revaluation method is not considered as an alternative method of valuation, but rather is required to be applied if there are some economic indications. Examples for these economic indications can be inflation, deflation, and technological developments. Revaluation can also be applied from time to time as a requirement of government. For example, revaluation was carried in 1993, 1994 and 1996 by the Cabinet of Ministers of Azerbaijan Republic (Sadigov 2002, 191). This revaluation was mainly due to the privatization. The increase and decrease in the carrying values are subtracted from or added to the additional paid-in capital.

The historical costs are also subject to accumulated depreciation and book value of Fixed Assets is determined as historical cost less accumulated depreciation. Impairment loss is not considered in subsequent measurements.

Different from IAS 16, Azerbaijan accounting policies determine depreciation of fixed assets by the application of annual depreciation percentages to the book values of fixed assets (Tax Code 2008, 114.3). The depreciation percentages differ relative to the class of fixed assets. The percentages are 7%, 25%, 25% and 20% for buildings and property, machinery and equipment, vehicles and other fixed assets respectively (Tax Code 2008, 114.3). These percentages are applied to the carrying values of fixed assets. The above percentages are only upper limits; an entity can apply the depreciation rate that is lower than the relative percentage determined for the class of an asset.

Azerbaijan Tax Code requires writing off the Fixed Assets whose book value is less than 100 manats or 5% of the initial cost. If this occurs the enterprise will deduct the book value of the fixed asset from the income of the period (Tax Code 2008, 114.8). Azerbaijan accounting policies do not consider the separate classification of assets that are intended for sale by the management. These assets are treated as regular fixed assets and in case of sale these assets will be accounted for as normal sale of assets or a group of assets.

The difference between Azerbaijan accounting policies and IFRS relating to the accounting for plant, property and equipment can be summarized in the following table:

Table 3. **Accounting policies for plant, property and equipment**

Noncurrent assets	
IAS 16	**Azerbaijan GAAP**
Definition	
Property, plant and equipment are tangible assets that are held for use in the production or supply of goods or services, for rental purposes, or for administrative considerations and these assets are expected to be used during more than one period. Investment property is not included here.	Tangible assets that are held for use in the production or supply of goods or services, for administrative purposes for a use of more than 12 months, or for use in the normal course of operating cycle of more than 12 months. Investment property is included, i.e. it is not classified separately

Table 3 (cont'd)

Recognition	
If there is a probability that future economic benefits associated with the asset will flow to the entity and if the cost of this item can be measured reliably, the asset will be recognized.	A unit of a tangible asset that costs above 100 manats (1 manat=$ 0.8), and held to be utilized more than one period.
Initial Measurement	
Property, plant and equipment should be initially measured at cost, which comprises purchase price, directly attributable costs, and initial estimate of the costs of dismantling and removing the item or restoring the site on which it is located.	Azerbaijan accounting policies require fixed assets to be measured initially at cost, which consists of cash, and cash equivalents paid and necessary costs that have to be incurred in order to bring the assets to the present location and condition.
Subsequent measurement.	
Property, plant and equipment is measured by applying either the cost or revaluation model	According to the Accounting Law, fixed assets are to be recognized in the balance sheet at historical cost. Revaluation method is not considered as an alternative method of valuation, but rather is required to be applied if there are some economic indications.
Depreciation.	
According to IAS 16 the value of property, plant and equipment is allocated on a systematic way over the useful life of the asset. An entity considers residual value while determining annual depreciation expense.	According to Azerbaijan Accounting rules and Tax Code, depreciation of fixed assets is determined by the application of annual depreciation percentages to the book values of fixed assets. Residual value and useful life is determined by the government.
Impairment.	
International Financial Reporting requires entities to recognize impairment losses while reporting property, plant and equipment	Impairment is not permitted
Non-current assets held for sale and discontinued operations.	
IFRS 5 states that where management has decided to sell an asset, or group of assets, these should be classified in the statement of financial position as "held-for-sale" and should be measured at the lower of carrying value or fair value less costs to sell.	Azerbaijan accounting policies do not consider the separate classification of assets that are intended for sale by the management.

Table 3 (cont'd)

Disclosure requirements	
Information about the depreciation methods used, the useful lives, impairment losses recognized, and acquisitions is to be presented in the notes.	Not provided

2.4.4 Accounting policies for intangible assets.

Accounting policies for intangible assets were mainly adopted from the international accounting practices. "Intangible assets" is a new term in Azerbaijan accounting practices. This term was included in the Azerbaijan GAAP while transition to the Market Economy. The similar definition and recognition principles for accounting of intangible assets were adopted from international accounting systems. But, Azerbaijan GAAP does not give the proper identification and control criteria established by IAS 38. There are no specific regulations and mechanisms relating to the recognition of internally generated intangible assets. The costs incurred while generating intangible assets internally are fully expensed, which differs from international financial standards. Goodwill is also recognized as a part of intangible assets. Accounting policies for subsequent valuation, treatment of subsequently incurred costs, and amortization for indefinite useful life intangibles differ from IAS. The following paragraphs give detailed information relating to the accounting policies for intangible assets.

According to the Accounting Law (Chapter 18, paragraph 11) and the Tax Code (chapter 118.1), intangible assets are initially measured at cost when acquired. The cost consists of purchase price and any directly attributable costs (Sebzeliyev 2005, 224). If intangible assets are acquired as a result of business combinations, they are valued at fair value. Intangible assets acquired by exchange are measured at the book value of the asset received. The book value of the intangible asset acquired through exchange is determined based on the accompanying documents.

Different from IAS 38, Azerbaijan GAAP requires expensing research and development costs (Tax Code 2008, chapter 113). According to 113th chapter of the

Tax Code research and development costs have to be expensed (Tax Code 2008, chapter 113). There is no limitation on the development costs that lead to the generation of the internal intangible assets. Azerbaijan GAAP; on the other hand, capitalize the costs related to organizational activities. The capitalized costs related to organizational activities are costs that are incurred prior to the registration of the entity (Sebzeliyev 2005, 223). These costs are registration fees, advisory fees, professional and advertising fees incurred during the registration. Organizational costs are capitalized and treated as usual intangible assets. They are amortized in the same way as other intangible assets. Any organizational costs subsequent to the registration are expensed (Sebzeliyev 2005, 223).

According to Azerbaijan GAAP, intangible assets are measured at historical cost, which is subject to amortization. Similar to tangible assets, impairment losses are not considered in measurement of intangibles (Sebzeliyev 2005, 227). Due to the difficulties of fair value determination, revaluation model is not required to be employed (the absence of the active market). But the Accounting Law allows to employ the fair value measurement where it is possible for it to be determined.

Azerbaijan GAAP applies straight-line amortization method for intangible assets that have finite economic useful life (Tax Code 2008, chapter 114). For intangible assets with indefinite useful lives, the annual amortization amount equals to the 10% of its initial cost. In this case, the useful economic life of an indefinite intangible asset is assumed to be 10 years (Tax Code 2008, chapter 114.3.6).

The difference between Azerbaijan accounting policies and IAS 38 relating to the accounting for plant, property and equipment can be summarized in the following table:

Table 4. **Accounting for Intangible assets.**

Noncurrent assets	
IAS 38	**Azerbaijan GAAP**
Definition	
Identifiability, control over a resource and existence of future economic benefits.	Non-tangible assets held for more than one year.
Recognition	
IAS 38 states that an intangible asset is recognized if it is probable that the asset will generate future economic benefits flowing to the entity and the cost of the asset can be measured reliably.	Intangible assets are recognized when there is right to use those assets.
Initial Measurement	
Intangible assets are initially measured at cost. The cost will consist of purchase price and directly attributable costs that are required to be incurred in order to prepare the asset to its intended use.	Intangible assets are initially measured at cost when acquired. If intangible assets are acquired as a result of business combinations they are valued at fair value.
Subsequent Measurement	
Subsequent to initial recognition intangible assets can be measured by applying cost or revaluation model.	According to Azerbaijan GAAP, intangible assets are measured at historical cost, which is subject to amortization. Similar to tangible assets, impairment losses are not considered in measurement of intangibles.
Amortization	
Intangible assets with the finite useful life are to be amortized on a systematic basis over the useful life	Azerbaijan GAAP applies straight-line amortization method for intangible assets that have finite economic useful life. For intangible assets with indefinite useful lives the annual amortization amount equals to the 10% of its initial cost.
Disclosure requirements	
Information about the useful lives of intangible assets, the amortization methods used, increases and decreases during the period, impairment losses is provided in the notes.	Not provided

2.4.5 Accounting policies for Leases

The accounting policies for leases were primarily adopted from international accounting practices, since there were no similar leasing policies in the Soviet Accounting System. Operating leases were reported in the out-of-balance sheet accounts in the Soviet Accounting Systems under "leaseholds" name. But there were not financial leasing relationships since the central government was the only organization that distributed resources among entities. The similar accounting treatment was adopted by the post-Soviet Accounting System in Azerbaijan for operating leases. Operating leases are reported in the out-of-balance sheet account. This account is named "Leased Fixed Assets" and reports operating leases. Some criteria are set for the classification of financial leases by Azerbaijan accounting policies.

The criteria for classifying a lease as a financial lease are set by the Tax Code. The following are criteria for a lease to be classified as a financial lease (Tax Code 2008, chapter 140):

1. The lease transfers ownership to the lessee by the end of the lease term,
2. By the end of the lease term the lessee has the right to buy the asset at the predetermined prices,
3. The lease term is for the more than 75% part of the economic life of the leased asset,
4. By the end of the lease term the residual value of the asset is less than 20 % of the market value of the asset at the beginning of the lease term,
5. The lease payments are equal to at least 90 % of the market value of the asset at the beginning of the lease term,
6. The leased assets are of a specialized nature such that only the lessee can use them without major modifications being made.

According to Azerbaijan GAAP, assets and liabilities associated with the financial leasing are to be recognized in the Balance Sheet (Tax Code 2008, chapter 140.1). The amount of the financial lease is based on the agreement between lessor and lessee (Tax Code 2008, chapter 140.2). The Tax Code states that if the interest rate on the lease payments is not stated in the lease agreement, it is based on the interest rate established on the interbank credit auction, or based on the 125 % of the average interest rate of interbank credits (Tax Code 2008, chapter 140.4).

According to both Azerbaijan and IAS regulations, financial lease is to be depreciated in consistency with the depreciation policy adopted for the owned fixed assets.

All expenses and income related with the operating leasing are recognized in the profit and loss statements of related parties.

The difference between Azerbaijan accounting policies and IAS 17 relating to the accounting for leases can be summarized in the following table:

Table 5. **Accounting policies for Leases.**

Noncurrent assets-Financial lease **Current assets-Operating lease**	
IAS 17	**Azerbaijan GAAP**
Definition	
Financial Lease is determined as a lease agreement whereby substantially all the risks and rewards related to the ownership are passed to the lessee. Operating Lease is determined as a lease agreement whereby substantially all the risks and reward related to the ownership are not passed to the lessee.	Financial and operating leases are defined according to the criteria set by the legislature.

Table 5 (cont'd)

Measurement	
Financial leases are to be recognized in the financial statements of the lessee. The amount of the finance lease equals to the lower of the fair value or the present value the minimum lease payments of the leased asset.	According to Azerbaijan GAAP, assets and liabilities associated with the financial leasing are to be recognized in the Balance Sheet. The amount of the financial lease is based on the agreement between lessor and lessee.
Disclosure requirements	
Information about the net carrying amount at the end of the period, the total of future minimum lease payments, description of the leasing arrangements is disclosed in the notes.	Not provided.

2.4.6 Accounting policies for available for sale and held to maturity financial assets.

Accounting policies for available for sale and held to maturity financial assets were adopted from the international accounting practices since there were no similar securities in the Soviet Accounting System. The transition to the market economy and the establishment of Baku Stock Exchange in 2000 year required establishment of accounting policies for financial instruments.

Baku Stock Exchange was founded as a joint-stock corporation and has 18 shareholders (Baku Stock Exchange 2009). Istanbul Stock Exchange, Yapi Kredi Invest, Caspian Financial are among those shareholders (Baku Stock Exchange 2009). However, the financial market is not developed. Currently, the government bonds, stocks and bonds of many banks and insurance companies are traded in the stock exchange. The stocks of the majority of non-finance corporations are not traded in the market. Further development of market economy will also develop the financial market, and accounting policies established according to the international accounting standards will be required to be applied.

According to the Accounting Law, financial instruments are initially measured at the amount of actually incurred costs (Accounting Law 1995, chapter 28). These costs comprise all the considerations given to acquire financial instruments. Transaction costs incurred are also considered in the initial values of the financial instruments.

The Accounting Law of the Azerbaijan Republic states that bonds and other financial assets that are held to maturity are subsequently measured at amortized cost (Accounting Law 1995, chapter 28). The difference between actual and par values is amortized evenly in every month. This difference is included in the profit and loss for the period (Accounting Law 1995, chapter 28).

Stocks are subsequently measured at market values if they are traded at the stock exchange or other non-stock exchange markets. The differences between carrying and market values are recognized in the profit and loss for the period (Accounting Law 1995, chapter 28).

2.4.7 Accounting policies for Revenue.

According to Azerbaijan GAAP, revenue is defined as gross inflow from sales, rendering of services and performance of works, and gross inflow from non-sales activities (Sebzeliyev 2005, 461).

Revenue from sales comprises revenue from the sale of goods bought for resale purposes, revenue from the sale of finished goods, as well as revenue from the sale of fixed and intangible assets (Sebzeliyev 2005, 464).

Revenue from non-sale activities comprises the revenue earned from the following sources (Sebzeliyev 2005, 464):

- Revenues from the financial instruments, dividends on shares, interests on bonds.
- Revenue from leased and rented assets.
- Revenue from royalties.
- Revenue from penalties paid by debtors

- Revenue from the result of recognition of revenue from previous periods. Revenue from previous periods might not be recognized as a result of their uncollectibility. If those revenues are collected in later periods they are recognized in those later periods.

Consistent with IAS revenue collected on behalf of third parties are not recognized as revenue.

Revenue recognition according to International Accounting Regulations is based on accrual accounting principles. Azerbaijan accounting policies in consistency with the Tax Code allow to recognize revenue based on either accrual or cash accounting methods (Tax Code 2008, chapter 132). There are not any criteria to use cash or accrual basis. An entity can apply either method, but the same basis is required to be applied through the reporting period. In later reporting periods, an entity is permitted to change the accounting basis for revenue recognition.

Entities that apply cash accounting recognize revenue when they receive payments for goods sold, services rendered, works performed, and payments received from non-sales activities. The time to recognize revenue is the time when the entity receives payments through cash or transfers to accounts (Tax Code 2008, chapter 132.1).

Entities that apply accrual method recognize revenue when they receive the right to receive the revenue. The time to recognize revenue is the time when the entity met all the requirements of agreements and has the right to receive payments (Tax Code 2008, chapter 135.1). The following recognition principles are applied:

- Revenue from the sales of goods is recognized when an entity has the right to receive payments.

- Revenue from rendering of services and performing of works is recognized when the rendering of services and performing of works is completed.

- Revenue from non-sales activities is recognized when the right to receive payments is established.

According to Azerbaijan GAAP, revenue is measured at the fair value of the consideration received. Trade discounts are deducted during the measurement of revenue (Sadigov 2002, 128). The fair value of the goods or services received is considered in the measurement of revenue in the exchange of dissimilar goods and services. No revenue is recognized for the exchange of similar goods and services (Sadigov 2002, 128).

The difference between Azerbaijan accounting policies and IAS 18 relating to the accounting for revenue can be summarized in the following table:

Table 6. **Accounting policies for revenue.**

Income statement account	
IAS 18	**Azerbaijan GAAP**
Definition	
According to IAS 18, revenue is defined as gross inflow of economic benefits resulting from an entity's ordinary activities. The inflow of these economic benefits occurs in the form of inflows of assets, decreases of liabilities, and increases in equity.	According to Azerbaijan GAAP, revenue is defined as gross inflow from sales, rendering of services and performance of works, and gross inflow from non-sales activities.
Revenue Recognition.	
IAS 18 requires revenue to be recognized when its inflow is probable and the amount of this revenue can be estimated reliably.	Azerbaijan accounting policies in consistency with the Tax Code allow to recognize revenue based on either accrual or cash accounting methods.
Measurement of Revenue.	
According IAS 18, revenue is measured at the fair value of the consideration received.	According to Azerbaijan GAAP, revenue is measured at the fair value of the consideration received.

2.4.8 Accounting policies for Income Taxes.

The main difference between Azerbaijan accounting policies and IAS 12 is that Azerbaijan accounting profit is determined by the Tax Code. There are no differences between accounting and taxable profits since they are the same. Temporary or permanent differences are not recognized. Deferred taxes do not arise since accounting and tax profits are the same. Tax expense is directly calculated by the application of annual tax rate to the accounting profit for the period. The expenses that are deducted from revenue are regulated by the Tax Code. The following expenses are some of the expenses required to be deducted in the determination of taxable profit (Tax Code 2008, chapter 119):

- Uncollectible receivables. If an entity recognizes revenue on accrual basis and reports receivables as period revenue, it can deduct those receivables that are uncollectible from the taxable profit of following periods.

- Research and development expenses.

- Depreciation expenses. The rate of annual depreciation expenses are regulated by the Tax Code

- Amortization expenses

- Repair expenses. Only the expenses within the annual limits determined by the tax code are allowed to be deducted.

Period losses are allowed to be carried forward for up to five years. The amount of the loss to be deducted from the future period income is not limited. The current period loss can be wholly deducted from the income of the next period or it can be proportionally deducted from the incomes of the next five years (Tax Code 2008, chapter 121.1).

The taxes are to be paid quarterly. An entity is to estimate the quarterly amount of tax expense employing following methods (Tax Code 2008, chapter 151.1):

- The one fourth of the annual tax paid last year is to be calculated and paid every quarter of the next year

- The ratio of paid tax to the revenue earned in the last year is to be determined and this ratio is to be applied to the quarterly revenue of the current period.

At the end of the year, annual income is calculated and income tax expense is determined. There might be differences between quarterly tax payments during a year and annual income tax expense. If annual income tax expense is higher than quarterly payments, the difference is paid to the government budget (Tax Code 2008, chapter 151.3). On the other hand, if annual income tax expense is lower than quarterly payments, the difference either is returned to the entity or is used to settle other tax liabilities, e.g. if there is a value-added-tax liability, the difference is used to settle that liability. The difference between Azerbaijan accounting policies and IAS 12 relating to the accounting for income taxes can be summarized in the following table:

Table 7. **Accounting policies for Income Taxes**

Income statement account	
IAS 12	**Azerbaijan GAAP**
Definition and recognition	
According to IAS 12, accounting profit is defined as “net profit or loss for a period before deducting tax expense. Taxable profit is determined according to the rules established by taxation authorities. The expenses that are to be deducted from the revenue are determined according to Tax regulations.	Since Azerbaijan Accounting System is the Code based system, accounting profit is determined in accordance with the requirements of the Tax Code.
Temporary and permanent differences	
Temporary and permanent differences arise as a result of differences between tax and accounting bases.	No temporary or permanent differences arise.

2.4.9 Accounting policies for the effects of changes in foreign exchange rates.

According to Azerbaijan accounting policies, all assets, liabilities and equity are presented in the financial statements at national currency (manat) (Accounting Law

1995, chapter 25). All foreign currency transactions are translated to the national currency by applying exchange rates at the date of the transactions (Accounting Law 1995, chapter 25).

According to the Accounting Law of the Azerbaijan Republic, foreign currency transactions are subsequently to be remeasured and the exchange rates that are prevailing during the remeasurements are to be applied (Accounting Law 1995, chapter 25). Differences arising between initial and subsequent foreign currency items are to be recognized in the period profit or loss (Accounting Law 1995, chapter 25).

2.4.10 Accounting policies for construction contracts.

According to Azerbaijan GAAP, a construction contract is a contract that is negotiated for the construction of an asset (Sadigov 2002, 240). Construction contracts might include a contract for the construction of a specific asset and a contract for the construction of some interrelated assets, such as a plant complex (Sadigov 2002, 241). If the revenue and expenses related with the construction can be separately recognized, the contract is regarded as a specific asset construction contract.

Contract revenue is determined to be the fair value of the consideration received. Construction costs comprise directly attributable, indirect and other costs associated with the construction. These costs are classified as follows (Sadigov 2002, 239):

- Inventory cots
- Labor costs
- Social security and insurance payments
- Depreciation of equipment used in the construction process
- Other costs.

General revenue recognition principles also apply for the recognition of contract revenue. Azerbaijan GAAP allows to apply accrual or cash basis of revenue recognition. If accrual method is applied, contract revenue and contract expense are recognized by the reference to the stage of completion of the contract (Tax Code 2008, chapter 138.1).

If cash method is applied, contract revenue and contract expense are recognized by when revenue was received and expenses incurred (Tax Code 2008, chapter 138.1).

In summary, Azerbaijan accounting policies have the characteristics of both international accounting policies and Soviet accounting policies. These policies do not fully reflect the market economy principles. As market economy develops, the management of entities applying these accounting policies will have to improve their accounting system. The accounting policies applied have to be in consistency with the market economy principles. As the accounting grows to be the main tool of the decision making, not just the tool of the reporting to the government, and as the entities begin to attract foreign capital the accounting policies being applied will also improve. NAS based on the IFRS/IAS will provide an improved accounting system for the management of those entities.

CHAPTER 3.

PREPARATION AND PRESENTATION OF FINANCIAL STATEMENTS ACCORDING TO AZERBAIJAN ACCOUNTING POLICIES AND PROCEDURES

3.1 Financial Statements required to be prepared according to Azerbaijan accounting policies.

This chapter provides information about the preparation and presentation of financial statements according to Azerbaijan accounting policies and procedures, and the elements of the financial statements. This information is provided by the illustration of the differences from IAS/IFRS and NAS based on IAS/IFRS. The aim in this comparison is to illustrate to the managers in what ways Azerbaijan accounting system and policies differ from the international practice, and to illustrate how they can improve the accounting system and reporting by adopting IAS/IFRS and NAS.

According to Azerbaijan GAAP, financial statements are to represent financial position of an entity and the financial results of its operations for the period. Financial statements have to be prepared in accordance with the generally accepted accounting principles and 1995 Accounting Law (Sadigov 2002, 2: 193). Accounting Law of 2004 requires preparation and presentation of financial statements according to IFRS or NAS based on IFRS. Since the majority of entities operating in Azerbaijan, do not apply IFRS or NAS, this chapter will illustrate the preparation and presentation of financial statements according to Azerbaijan GAAP and Accounting Law of 1995. These statements have to objectively represent the financial position of an entity as of a specific date, the financial performance of an entity for the specific period; and provide necessary information to decision makers in order to analyze the financial position of an entity and to assist them in decision making (Sadigov 2002, 2: 193). The reporting period is the calendar year, which comprises the period between 1 January and 31 December.

According to Accounting Law of Azerbaijan Republic, financial statements are to be presented to the following parties (Accounting Law 1995, chapter 34.1):

- shareholders
- tax department
- state statistics committee
- other state bodies determined by the legislature, such as Ministry of Economic Development, Ministry of Finance, and Central Bank

Financial information is required to be presented in the uniform form. The Finance Ministry issues special financial statement forms and entities fill in those forms, and present financial information. According to the Accounting Law of Azerbaijan Republic, these forms comprise the following statements (Accounting Law 1995, chapter 31):

- Balance sheet (Form № 1)
- Income Statement and Profit Distribution (Form № 2)
- Supplement to the Balance Sheet (Form № 5)

The Accounting Law states that in addition to the above financial statements, the following statements can be presented. The preparation and presentation of these statements are not mandatory. The Accounting Law does not require those statements to be presented, but an entity can prepare and present these statements. These statements are (Accounting Law 1995, chapter 31.1):

- The explanatory notes. These explanatory notes give information about the complete and thorough analysis of production and financial performance of an entity, and the changes in the accounting policy of an entity for the next reporting period. Entities are not required to issue these notes.

- The statement of uses of government grants, which is presented by the entities using government grants

Different from IFRS, financial statements prepared according to Azerbaijan regulations are uniform in form, and highly standardized. This uniformity and standardization of financial statements were also characteristic to the Soviet Accounting System. An accountant has to fill in those forms and present financial information that is required by the government bodies. Many entities consider these statements as reports to the central government rather than a means of decision making. This look to the role of financial statements will change as the management understands the importance of these statements in the decision making process.

Entities also are not required to present audit reports. The financial statements are audited by the government bodies, and if there are material misstatements companies are penalized. The penalties are generally monetary. The amount of the penalty depends on the nature of the misstatement.

3.2 Presentation of financial statements according to Azerbaijan GAAP.

The Accounting Law and accounting policies establish some requirements on the presentation of financial statements. According to Azerbaijan GAAP, financial statements must fully reflect the results of all transactions. Assets, liabilities and equity must fully be enclosed (Sadigov 2002, 2: 193). Financial statements must be understandable and they must present the financial position and performance of an entity fairly (Sadigov 2002, 2: 201).

It is also required that financial statements must be comparable. Comparability is achieved through the presentation of comparative financial information between two years (Sadigov 2002, 2: 201).

According to the Accounting Law, offsetting of assets and liabilities is not allowed (Accounting Law 1995, chapter 31.1).

Financial statements are required to be presented timely (Sadigov 2002, 2: 201). The Accounting Law sets dates for the financial statement presentation (Accounting Law

1995, chapter 34). According to the Accounting Law, financial statements are to be presented in 90 days after the end of the reporting period. Reporting period generally comprises the period between 1 January and 31 December (Accounting Law 1995, chapter 32).

According to Azerbaijan GAAP, financial statements have to present information about assets, liabilities, equity, income and expenses. Assets, liabilities, and equity are the elements of balance sheet; income and expenses are the elements of the income statement and profit distribution (Sebzeliyev 2005, 18).

3.3 Balance Sheet.

According to Azerbaijan GAAP, Balance Sheet is the statement prepared to reflect financial position of an entity (Abbasov 1998, 50). Balance Sheet is prepared according to the Accounting Law and accounting principles and regulations. This statement reflects assets of an entity on one side and the sources of these assets on the other side. The sources of the assets reflect liabilities incurred in order to obtain those assets and equity capital established as a result of proceeds from shareholders (Abbasov 1998, 50). The asset side is called "active", and equity and liability side is called "passive".

According to Azerbaijan GAAP, an asset is a property of an entity comprising fixed assets, current assets, intangible assets, and financial assets and investments (Kerimov 2007, 12).

Current assets consist of finished goods, resale goods, work-in-process goods, value added tax paid on the purchase, and other current assets.

Financial assets and investments consist of cash and cash equivalents, advance payments to suppliers, short term investments, and given loans. Cash and cash equivalents comprises petty cash, cash held in bank accounts, cheques, and deposits. According to Azerbaijan GAAP, an asset is recognized in the balance sheet when an entity has the ownership right over the asset. As seen, the recognition of an asset according to Azerbaijan GAAP is not consistent with the recognition criteria of IFRS.

According to Azerbaijan GAAP, a liability is an obligation incurred to obtain an asset or settle another liability (Kerimov 2007, 12). Obligations can arise from economic operations of an entity. Examples for liabilities are long and short term bank credits, long and short term loans, obligations to the government budget, obligations to the suppliers, and other liabilities.

According to Azerbaijan GAAP, equity is defined as the investments made by the owners of the entity during its establishment (Accounting Law 1995, chapter 21.1). This definition is different from the IASB's definition. The amount of equity capital can be changed according to the decision of shareholders.

Reserves and retained earnings are also reported in the equity. According to the Accounting Law of Azerbaijan Republic, an entity can establish spare fund, consumption and social reserves by distributing period profit (Accounting Law 1995, chapter 21.3). An entity can also establish a reserve for doubtful receivables. According to the Accounting Law, doubtful receivables are receivables that were not received within the time period determined by the contractual agreement (Accounting Law 1995, chapter 21.3). At the end of the reporting period, an entity examines its receivables and determines whether there are overdue receivables (Accounting Law 1995, chapter 21.3). The amount of the reserve is determined according to the solvency of the debtor entity and the probability of collecting doubtful receivables (Accounting Law 1995, chapter 21.4). In the international practice, this method is identified as "accounts receivable aging schedule".

According to Azerbaijan GAAP, assets, liabilities and equity are recognized as follows (Tax Code 2008, chapter 131):

- An asset is recognized in the balance sheet when an entity has an ownership right over this asset. If an entity owns an item and has the right to benefit from the item, it recognizes it as an asset.

- A liability is recognized when an obligation arises that needs to be settled. The amount of the liability is certain.

Information about assets is generated under following parts:

- Fixed assets and investments
- Stocks (raw, work-in-process, merchandise inventories) and costs
- Cash, receivables and other current assets.

3.3.1 Fixed assets and investments.

This part of the Balance Sheet comprises noncurrent assets. Fixed assets and Investments comprise following accounts:

- Tangible Fixed Assets. These account reports plant, property, equipment, machinery, and vehicles.

- Leased tangible fixed assets. This account reports tangible fixed assets that were financially leased. Operating leases are reported in the out-of-balance sheet accounts. Tangible and financially leased fixed assets are reported net of accumulated depreciation in the balance sheet.

- Intangible assets. This account reports intangible assets that are intended for the long term use. Intangible assets include patents, licenses, "Know-how," organizational expenses, trademarks. Intangible assets are reported net of amortization.

- New machinery. This account reports uninstalled machinery that was newly acquired. An entity firstly reports newly acquired machinery that needs to be installed in this account as follows:

  New machinery xxxx

  Accounts payable xxxx

- New Investments. This account reports investments in tangible fixed assets, intangible assets, construction. Expenses for the newly acquired tangible and intangible fixed assets are generated in this account, and then after the determination of the cost of the assets they are recognized in the related accounts. For example, accounting entry for the purchase of a tangible fixed asset is as follows:

New Investments xxxx

Accounts payable xxxx

Tangible fixed assets xxxx

New Investments xxxx

Acquired new machinery that needs installation is also reported in this account when given to installation. All installation expenses are generated in the New Investments account and then recognized in the Tangible Fixed Assets account. Accounting entries for this transaction are as follows:

New Investments xxxx

New Machinery xxxx

To record the installation of new machinery.

Tangible fixed assets xxxx

New Investments xxxx

To record the installed fixed assets.

- Long-term financial investments. This account reports the financial investments in the shares, bonds and other securities. This account also includes loans given to other entities.

- Shareholders' account. This account reports transactions with owners of the entity. These transactions include investments in the shareholders' equity, dividend payments. The account can have a debit or credit balances depending on the nature of a transaction. For example, to report investments to be made by shareholders' the following accounting entry is made:

Shareholders' account xxxx

Shareholders' equity xxxx

In this case, Shareholders' account reports investments to the equity and is an asset account. When an entity is obliged to pay dividends, the account becomes a liability account. Accounting entry for the reporting of dividends payable is as follows:

Retained earnings xxxx

Shareholders' account xxxx

The actual payment of dividends is reported as follows:

Shareholders' account xxxx

Cash xxxx

3.3.2 Stocks and costs.

Stocks and costs present information about inventory, and some costs. The elements of this part are as follows:

- Production materials. This account reports production materials that are acquired to be used in the production of finished goods. Production materials include raw materials, semi-finished goods, intermediate products, spare parts. Semi-finished and intermediate products are products that are purchased from external sources.

- Work-in process inventory. This account reports costs of inventory which is in the production process. Basic Production account reports all direct expenses incurred in the production process. This is a temporary account and is closed at the end of the reporting period. The debit balance of this account shows that the cost of work-in process inventory and is closed as follows:

Work-in process inventory xxxx

Basic production xxxx

- Prepaid expenses. This account is similar to Prepaid Expenses account applied by international accounting practices. Prepaid expenses include prepaid rent expense, prepaid insurance, site exploration expenses.

- Finished goods. This account reports finished goods. Finished goods are initially reported at plan (standard) costs, and later adjusted to actual costs. When the production of the certain good is finished and it is ready for sale, related expenses incurred (plan or actual costs) are written off to the finished goods account. The accounting entry to recognize finished goods produced in the current period is as follows:

Finished goods xxxx

Basic Production xxxx

The expenses related to the processing of work-in-process inventory recognized in the previous period are also recognized in the "Basic Production" account in the current period. When production process is finished, the value of finished goods is recognized as the aggregate of work-in-process recognized in the previous period and basic production expenses. The accounting entry is follows:

Finished goods xxxx

Work-in-process inventory xxxx

Basic production xxxx

- Resale goods. This account reports merchandise inventory in trading companies. Manufacturing companies use this account to record goods bought for resale purposes, i.e. these goods are not used in the production process, nor are produced by the entity.
- Value added tax (VAT) paid on purchase. This account reports value added tax paid on the purchase of inventory, tangible fixed and intangible assets and other goods and services. The amount in the account is written off to the "value added tax payable to the government budget" account. As noted, there are two accounts reporting VAT. Value added tax paid on purchase and value added tax payable to the government budget. VAT payable to the government budget is the amount of VAT received on the sale of goods and services. The accounting entry to record VAT on the purchase of goods and services is as follows:

VAT on purchase xxxx

Accounts payable xxxx

VAT payable to the government budget arises from sales revenue. The accounting entry to record the VAT payable to the government budget on the sale of finished goods is as follows:

Finished goods xxxx

VAT payable to the government budget xxxx

At the end of a month the balance of the VAT on paid on purchase is deducted from the VAT payable to the government budget, and the difference is to be paid to the government budget. On the other hand, if the balance of the VAT paid on purchase is greater than the VAT payable to the budget, the difference is carried forward.

3.3.3 Cash, receivables and other current assets.

This part of the active side reports current assets such as, cash and cash equivalents, receivables, debtor loans. The elements of this part are as follows:

- Debtor loans. This account reports debtor loans receivable from customers, government budget, employees and other debtor loans. Debtor loans account is the same as accounts receivable account. For example, accounting entry to record the sale of finished goods is as follows:

Debtor loans (customers) xxxx

Sale of finished goods xxxx

- Advances given to suppliers. This account reports the amount of advances given to suppliers. Accounting entry for the given advances is as follows:

Advances given to suppliers xxxx

Cash xxxx

- Short-term financial investments. This account reports short-term financial investments in short-term bonds, deposits and given loans.

- Cash and cash equivalents comprise petty cash, bank account, foreign currency account, and other accounts in banks. Foreign currencies held in banks are reported in the foreign currency account. Other accounts in banks reports money deposited for special purposes.

The amounts of any current and previous period losses are reported at the end of the active side of Balance Sheet. This accounting regulation is different from IFRS. IFRS reports period losses in the equity side of the balance sheet. Specifically, if there is a period loss the capital or retained earnings accounts are decreased by the amount of the period loss.

3.4 Liabilities and equity.

3.4.1 Equity

Passive side of the balance sheet presents information about equity and liabilities. Equity is presented firstly and followed by liability accounts. Short term liabilities are preceded by long term liability accounts. Equity reports the amount of shareholders' equity, reserves and other capital. The elements of equity are as follows:

- Equity Capital

- Additional paid-in capital. This account reports revaluation surpluses, premiums received above the par value of shares, and donated assets. When an entity revalues its tangible fixed assets, the increase in value is recognized in the credit of this account. The difference between market and par values of shares is also recognized in this account. The value of donated assets received from external parties is recorded in this account. The accounting entry to record the donated assets received is as follows:

  Tangible fixed assets xxxx

  Additional paid-in capital xxxx

- Spare fund. The amount of spare and other fund is determined by incorporation articles. Spare fund is established out of current income, and the objective is to compensate for future expenses and losses. If an entity incurred loss in the current period and is not able to pay dividends, the amount of spare fund can be used to pay dividends. An accounting entry to record this transaction is as follows:

Spare fund xxxx

Shareholders' account xxxx

- Consumption fund. Consumption fund is also established out of current income, and the objective is to pay for construction and development expenses, employee motivation expenses, employee benefit expenses and employee credits.

- Retained earnings. Retained earnings is determined as the difference between period profit and distributions made through this profit. In order to report period profit and retained earnings the following accounting entries are made:

Profit or loss xxxx

Profit distribution xxxx

To record the distributions made through period profit

Profit or loss xxxx

Retained earnings xxxx

To record period retained earnings

3.4.2 Liabilities.

This part of the balance sheet records obligations of an entity. The elements of this part are as follows:

- Bank credits. Bank credits include long-term and short-term bank credits, as well as bank credits for employees.

- Taken loans. These loans comprise long-term and short-term loans from financial institutions and other entities.

- Creditor debts. This account reports creditor debts to suppliers, employees, government budget and other creditor debts. This account summarizes amounts of accounts payable, salary payable, tax payable and other liabilities.

- Advances received from customers.

- Revenues of future periods. This account is similar to unearned revenue account. Revenues of future periods reports rent, insurance, subscription revenues.

When we examine the balance sheet prepared in accordance with the accounting regulations of Azerbaijan Republic, we can observe that the statement is prepared in accordance with liquidity principles. The more liquid assets are preceded by the less liquid assets. Assets are classified as fixed assets and other non-current assets, inventories and other current assets, and cash, receivables and other assets.

The second part of the balance sheet comprises equity capital and liabilities. This part reflects the amount of investment into operations of the entity and the source and the nature of these investments. The classification of equity capital and liabilities is based on the timeliness of the obligations to the owners and to the third parties. Obligation to owners is reported before the obligation to the third parties which has to be settled firstly. Liabilities are also classified according to their time of settlement. The most recent settlements are to be classified the last. Current liabilities, such as short-term loans are expected to be settled in the normal course of business within the enterprise's operating cycle or are due to be settled within twelve months of the date of the statement of financial position whichever is shorter.

Balance Sheet prepared according to Azerbaijan accounting regulations contains active (asset), passive (liability and equity) and active-passive accounts. Active-passive accounts might have debit or credit balances depending on the transaction. If an active-passive account has a debit balance, it is reported as an active account and if an active-passive account has a credit balance, it is reported as a passive account. One of these active-passive accounts is Shareholders' Account, which is depicted in the previous paragraphs. When shareholders are obliged to pay for the shares they acquired, this account is reported as an asset. However, obligations of the entity to shareholders are recognized as a liability. For example, when an entity is required to pay dividends then shareholders' account is recognized as a liability account. The accounting entries to record the transactions with shareholders are as follows:

Shareholders' account (active account) xxxx

Capital xxxx

To record the obligation of shareholders. The amount of capital that shareholders must pay.

Cash xxxx

Shareholders' account xxxx

To record the payment of the obligation.

Retained earnings xxxx

Shareholders' account (passive account) xxxx

To record the obligation of an entity to pay dividends.

Dividend payments are charged to retained earnings.

Shareholders' account xxxx

Cash xxxx

To record the payment of dividends.

The other characteristic of the Azerbaijan accounting system is the report of some transactions in the out-of-balance sheet accounts. These economic events are not reported in the balance sheet, but recognized in the out-of-balance sheet accounts. This information is not required to be presented to external financial statement users, but rather maintained for the internal reporting purposes. An example for these accounts is Rented Tangible Fixed Assets account. This account reports operating leases. Operating leases are not reported in the balance sheet because they are considered as items that are not owned by the entity. These items are not the property of an entity and are not consistent with the recognition criteria for assets. Other examples for these accounts are inventory of the third parties accepted for protection, fixed assets of the third parties accepted for installation. The following is the Balance Sheet prepared according to Azerbaijan GAAP:

Table 8. **Example of a Balance Sheet**

BALANCE SHEET
As of 01 January, 2007
"Dashbulagh" Company

ACTIVE	Code	Beginning Balance	Ending Balance
1	**2**	**3**	**4**
I. Fixed assets and other non-current assets			
Fixed assets: initial value depreciation current value	 010 011 012	 75000.00 - 75000.00	 99200.00 17100.00 82100.00
Intangible assets: initial value amortization current value	 020 021 022	 15000.00 - 15000.00	 15000.00 1500.00 13500.00
New Machinery (uninstalled machinery and equipment)	030	-	-
New Investments	040	-	-
Long-term financial investments	050	-	-
Shareholders' Account	060	38000.00	-
Other non-current assets	070	-	-
Total of the part 1.	**080**	**128000.00**	**95600.00**
II. Stocks and costs			
Raw materials	100	-	25600.85
Work-in-process inventory	130	-	5505.00
Prepaid expenses	140	-	
Finished goods	150	-	9480.00
Resale goods	160	-	-
Value added tax paid on the purchase	175	-	7161.19
Other stocks and costs			
Total of the part 2.	**180**	**-**	**47747.04**
III. Cash, receivables and other current assets			
Debtor loans	200	-	34727.26
Advances paid to suppliers	260	-	3500.00

Table 8 (cont'd)

Short-term investments: short-term bonds deposits given loans	270	-	4000.00
Cash and cash equivalents	280	60000.00	87835.00
Other current assets	310	-	-
Total of the part 3.	**360**	**60000.00**	**130062.26**
Total assets		**188000.00**	**273409.30**
PASSIVE	**Code**	**Beginning Balance**	**Ending Balance**
I. Shareholders' Equity			
Equity Capital	400	200000.00	200000.00
Additional Paid-in Capital	401	-	-
Spare fund	402	-	-
Consumption fund	410	-	30899.67
Profit:			
for the period	470	x	55998.30
used and distributed	471	x	55998.30
retained earnings	472	x	-
Total of the part 1.	**480**	**188000.00**	**230899.67**
II. Liabilities		**-**	**-**
Long-term bank credits	500	-	-
Long-term taken loans	510	-	-
Short-term bank credits	600	-	1500.00
Short-term taken loans	620	-	-
Creditor debts:			
Accounts payable	630	-	30190.00
Notes payable	640	-	-
Salary payable	650	-	2000.00
Tax payable	700	-	3419.63
Advances received from consumers	640	-	5400.00
Revenues of future periods	730	-	-
Other liabilities	760	-	-
Total of the part 2.	**770**	**-**	**42509.63**
Total of equity and liabilities	**780**	**188000.00**	**273409.30**

Source: **Kerimov 2007, 340.**

3.5 Income statement and profit distribution.

Azerbaijan GAAP requires entities to prepare the "Profit and Loss Statement" as an equivalent to the statement of comprehensive income. This statement is reported only for one year and consists of three parts (Kerimov 2007, 342):

1. Income Statement
2. Profit distribution
3. Payments to the government budget

Any taxable profit (loss) is recognized in the income statement. Taxable profit or loss is classified as taxable profit (loss) from sales and taxable profit (loss) from non-sales activities (Sadigov 2002, 2: 226).

Sales taxes (VAT) and cost of sales are deducted from sales revenue to determine the amount of gross profit from sales (Sadigov 2002, 2: 226).

Revenue from sales comprises income from the sale of finished goods or from resale, and income from rendering of services (Sadigov 2002, 2: 227).

Sales taxes comprise value added tax, duties and other taxes associated with the sale of goods (Sadigov 2002, 2: 227).

Expenses associated with the production and sale of the goods comprise cost of the goods; salary, depreciation, advertisement, overhead and other expenses (Sadigov 2002, 2: 228).

Cost of the goods include costs associated with the purchase of the raw materials obtained in order to produce finished goods, costs associated with the purchase of finished goods obtained in order to resale. These costs consist of purchase price of inventory, transportation and insurance costs, i.e. costs that are incurred in order to bring inventory to the usable condition (Sadigov 2002, 2: 229).

Gross profit (loss) from non-sales activities comprises profit from the interest or dividend payments, payments of penalties, effects of changes in foreign currency exchange rates, and financial results from other non-sales activities (Sadigov 2002, 2: 229).

As noted, this part of The Profit and Loss Statement determines the amount of the taxable profit or loss. Cost of the goods sold is not separately classified in the statement, but is included in the “expenses associated with the production and sale of the goods” item of the statement. The following table is the example for this part of the statement:

Table 9. **Example of Income Statement**

Items	**Code**	**Profit**	**Loss**
1	**2**	**3**	**4**
Revenue from sale (rendering of service)	010	252400.00	-
Value added tax	015	-	38501.70
Expenses associated with the production and sale of goods	040	-	158300.00
Profit from sale (rendering of services)	**050**	**55598.30**	**-**
Revenue and expenses from non-sales activities, arising from:	**070**	**400.00**	**-**
Interest in other entities	071		
Exchange rate difference between currencies	072	400.00	-
Total	**080**	**308398.3**	**196801.7**
Total taxable profit or loss	**090**	**111596.6**	**-**
Number of entities	091	1	1

Source: **Kerimov 2007, 342.**

The second part of the statement reports the uses and distributions of profit. Profit can be distributed as following (Kerimov 2007, 343):

- Payments to the government budget
- Payments to reserves and funds
- Payments made in charity considerations and other payments

Period income tax comprises income tax payable to the budget for the reporting period.

Payments to capital reserves comprise the payments to established reserves. These payments are made from current period profit. Examples for payments to reserves are payments to consumption reserve, payments to reserve for doubtful receivables, additional reserves, spare fund, consumption fund, social fund.

Payments made in charity considerations comprise payments to charity organizations. An entity may also establish special reserves for charity purposes.

The following table is the example for the second part of the statement:

Table 10. **Example of Profit distribution statement**

Items	**Code**	**As of the end of the period**
1	**2**	**3**
Period Income Tax	200	12319.63
Payments to reserves:	210	
Consumption reserve	220	
Additional reserve	230	26699.67
Charity payments	240	
Other payments	250	16979.00

Source: **Kerimov 2007, 343.**

The third part of the statement reports the payments to the budget. These payments comprise tax payments; such as payment of property tax, income tax, value added tax; the payments for the use of resources and for the environment pollutions, penalties and other payments to the government budget (Kerimov 2007, 343).

Penalties paid to the government budget comprise penalties that are payable to the budget. These penalties originate from overdue taxes, intentionally decreased tax bases, from overdue of other penalties. The following table is the example for the third part of the statement:

Table 4. **Example of Payments to the government budget statement**

Items	Code	Required amount	Actually paid amount
1	**2**	**3**	**4**
Property tax	300	465.00	600.00
Income tax	310	12319.63	9500.00
The payments for the use of resources and for the environment pollutions	340	-	-
	351		
Value added tax	355	18328.74	19500.00
Export duties	360		
Import duties	365	4149.00	4149.00
Other taxes	386	600.00	-
Penalties	390	3000.00	3000.00

Source: **Kerimov 2007, 343.**

3.6 The Supplement to the Balance Sheet required by Azerbaijan GAAP.

Different from IFRS Azerbaijan GAAP requires preparation of the supplement to the balance sheet statement. The supplement to the balance sheet presents additional information to the users about the changes in the elements of the balance sheet during period. The statement is prepared based on the cash or accrual basis of accounting. This statement consists of following parts (Kerimov 2007, 344):

- Changes in Equity Capital and Reserves
- Changes in Taken Loans
- Changes in Debtor and Creditor Loans
- Changes in Intangible Assets
- Changes in Fixed Assets
- Changes in Investments

In the changes in equity capital and reserves part of the supplement to the balance sheet, changes in the reserves, such as consumption reserve, additional funds and changes in equity are reported (Sadigov 2002, 2: 234). The reserves are established through using retained earnings, and payments of owners and other parties. The donated assets are also recognized in the reserves (Sadigov 2002, 2: 234). The amount of these assets is recognized in the paid-in capital. The following table is the example for this part of the supplement to the balance sheet statement:

Table 11. **Example of Changes in Equity Capital and Reserves part of the Supplement to the Balance Sheet.**

Items	**Code**	**Beginning Balance**	**Increases during the period**	**Decreases during the period**	**Ending Balance**
1	**2**	**3**	**4**	**5**	**6**
Share Capital	010	200000.00	-	-	200000.00
Paid-in Capital	020	-	-	-	-
Additional Reserve	040	-	-	-	-
Consumption Reserve	060	-	30899.67	-	30899.67
Reserve on Doubtful Receivables	070	-	-	-	-
Total	**130**	**200000.00**	**30899.67**	**-**	**230899.67**

Source: **Kerimov 2007, 344.**

The statement of changes in taken loans reflects the amount and changes in the loans obtained from banks and from other parties (Sadigov 2002, 2: 235). This statement also reflects the amount of debts that are overdue.

The following table is the example for this part of the supplement to the balance sheet statement:

Table 12. **Example of Changes in Taken Loans part of the supplement to the balance sheet.**

Items	Code	Beginning Balance	Increases during the period (taken)	Decreases during the period (paid)	Ending Balance
1	**2**	**3**	**4**	**5**	**6**
Long-term bank credits, also:	210	-	-	-	-
overdue	211	-	-	-	-
Long-term loans from other parties, also:	220	-	-	-	-
overdue	221	-	-	-	-
Short-term bank credits, also:	230	-	14000.00	12500.00	1500.00
overdue	231	-	-	-	-
Short-term loans from other parties, also:	240	-	-	-	-
overdue	241	-	-	-	-
Total	**250**	**-**	**14000.00**	**12500.00**	**1500.00**

Source: **Kerimov 2007, 344.**

Statement of debtor and creditor loans reflects the amounts and movements of these loans which are classified as short-term and long-term debts. Debtor loans comprise receivables from customers and other parties. Creditor loans comprise payables to suppliers and other parties (Sadigov 2002, 2: 235). The following table is the example for this part of the supplement to the balance sheet statement:

Table 13. **Example of Changes in Debtor and Creditor Loans part of the supplement.**

Items	Code	Beginning Balance	Increases during the period (taken)	Decreases during the period (paid)	Ending Balance
1	2	3	4	5	6

Table 13 (cont'd)

Debtor Loans					
Short-term, also:	310	-	246500.00	216000.00	30500.00
overdue	311	-	-	-	-
Lon-term, also:	320	-	-	-	-
overdue	321	-	-	-	-
Creditor Loans					
Short-term, also:	330	-	150600.00	114600.00	36000.00
overdue	331				
Lon-term, also:	340				
overdue	341				
Total	**360**	**-**	**397100.00**	**330600.00**	**66500.00**

Source: **Kerimov 2007, 345.**

The statement of changes in intangible assets reflects the content and values of intangible assets and the changes during the period in the content of those assets (Sadigov 2002, 2: 236). The statement consists of the changes in the values of patents, inventions, organizational costs. Organizational costs consist of costs that are incurred in registration of the entity, broker costs and other costs necessary in the establishment of the entity (Sadigov 2002, 2: 236). These costs are amortized in 10 years time period (Tax Code 2008, chapter 114.3.6).

The following table is the example for this part of the supplement to the balance sheet statement:

Table 14. **Example of Changes in Intangible Assets part of the supplement.**

Intangible Assets	**Code**	**Beginning Balance**	**Ending Balance**
1	**2**	**3**	**4**
Patents	410	10000.00	10000.00
Rights	420	-	-
Organizational costs	430	-	-
Other	440	5000.00	5000.00

Source: **Kerimov 2007, 345.**

The statement of changes in fixed assets reflects the changes in the fixed assets classified according to their types. The statement reflects the values of leased assets, bought fixed assets and fixed assets that are not used in the production, i.e. fixed assets that are in stock. The value of sold, leased, destroyed and other fixed assets is also reported (Sadigov 2002, 2: 237).

The following table is the example for this part of the supplement to the balance sheet statement:

Table 15. **Example of Changes in Fixed assets part of the supplement.**

Items	**Code**	**Beginning Balance**	**Increase**	**Decrease**	**Ending Balance**
1	**2**	**3**	**4**	**5**	**6**
Property	500	50000.00	-	-	50000.00
Vehicles	503	25000.00	-	-	25000.00
Equipment	504	-	24200.00	-	24200.00
Other fixed assets					
Total	**510**	**75000.00**	**24200.00**	**-**	**99200.00**

Source: **Kerimov 2007, 345.**

The statements of changes in investments and financial capital reflect the changes in the amounts of short and long term given loans, the amount of investments in shares and bonds and other securities (Sadigov 2002, 2: 236). These investments are reported at historical cost (Sadigov 2002, 2: 237).

The following table is the example for this part of the supplement to the balance sheet statement:

Table 16. **Example of Changes in Investments part of the supplement.**

Items	**Code**	**Long-term**		**Short-term**	
		Beginning Balance	**Ending Balance**	**Beginning Balance**	**Ending Balance**

Table 16 (cont'd)

1	2	3	4	5	6
Investments in Equity Instruments	610	-	-	-	-
Bonds	620	-	-	-	-
Given Loans	630	-	-	-	-
Other	640	-	-	-	-
Total	**660**	**-**	**-**	**-**	**-**

Source: **Kerimov 2007, 345.**

Azerbaijan GAAP does not require the preparation of the separate statement presenting the changes in cash, but instead following sections of the "Supplement to the Balance Sheet" can be used to receive information about cash flows during a reporting period:

- Changes in Equity Capital and Reserves
- Changes in Taken Loans
- Changes in Debtor and Creditor Loans
- Changes in Intangible Assets
- Changes in Fixed Assets
- Changes in Investments

If the above statements are prepared on the cash basis they can provide information about cash inflows and outflows during the period. For example; from the changes in equity capital and reserves section it is possible to obtain information about cash inflows and outflow to the capital equity and different reserves, from the changes in taken loans section it is possible to obtain information about the amount of cash inflows from loans and cash outflows to pay for those loans, from the changes in debtor and creditor loans section it is possible to obtain information about cash inflows and outflows from those loans. The tables giving information about these sections are presented above. Specifically, from the Table 10 we see that there was an increase of 24200 manats in equipment, which means that cash outflow of 24200 manats was incurred; from the Table 8 we see that 36000 manats of short-term creditor loans were paid, this implies that 36000 manats of cash outflow was incurred during the period.

In summary, preparation and presentation of financial statements according to Azerbaijan accounting policies and procedures mainly carry the characteristics of the Soviet Accounting System. The standardized financial statements required by Azerbaijan government is the same as the financial statements required by the Soviet Accounting System. Nevertheless, with the transition to the market economy financial statements prepared according to Azerbaijan GAAP recognize and provide information about some market economy transactions and events. Examples for these economic events are the recognition of intangible assets, financial leasing, financial instruments.

An entity prepares and presents financial information in order to report to the government authorities on the financial position and financial performance of the entity. External users other than government bodies also use these statements for decision making purposes. But, these statements are not consistent with IFRS and do not provide international decision makers with required information. One of the main differences between the two regulations is the presentation of disclosure notes. The presentation of disclosure notes is required by the IFRS, but it is not required by the Azerbaijan accounting practices. Majority of entities do not prepare disclosure notes. The main reason for the absence of disclosure notes lies in the unavailability of alternative accounting policies. Since accounting policies to be applied by the management is strictly regulated and standardized, there might not be need for extra disclosure notes. Nevertheless, disclosed information about accounting regulations and policies will be of great assistance to the external decision makers.

Financial Statements can be prepared based on either accrual or cash accounting. Since the statement of cash flows is not required by Azerbaijan accounting principles, decision makers can acquire information about cash flows based on the information of financial statements prepared based on the cash accounting. For example, income statement and supplement to the balance sheet statement prepared based on the cash accounting might provide information about cash flows. However, presentation of the separate statement of cash flows is important for the understandability and fairness of financial information.

CHAPTER 4

THE IMPORTANCE OF AND THE PROBLEMS ARISING DURING THE APPLICATION OF IAS/IFRS

4.1 The benefits of the application of IAS/IFRS.

This chapter analyses the importance and problems of application of IAS/IFRS or NAS based on IFRS for entities. This analysis is mainly based on the information obtained from three auditors working for International Auditing Firms in Azerbaijan. The experience of other transition countries was also studied. The auditors were submitted a questionnaire. The questionnaire asked for the benefits, costs and the importance of IFRS application in Azerbaijan. The questionnaire and the responses of auditors are provided in the Appendix A.

As noted in the previous chapters, Azerbaijan is in transition to International Financial Reporting Standards, but the majority of entities are reluctant to adopt IFRS. Adopting IAS/IFRS or NAS based on IAS/IFRS gives some benefits to entities. These benefits can be generalized as follows:

- Increase in transparency. The application of IFRS/IAS promotes transparency in financial reporting. Accounting policies applied, and financial statements prepared and presented according to IFRS/IAS is advantageous over accounting policies applied, and financial statements prepared and presented according to national accounting regulation and practices. As noted in the previous chapters, Azerbaijan accounting system is mainly based on the Soviet Accounting System. This system does not provide transparent financial statements. The main reason for the lack in transparency lies in the shortage or absence of disclosure notes. Disclosure notes are one of the main sources of information to decision makers. The absence of those notes promotes less transparency in the financial position and financial performance of entities.

- Increase in quality of financial reports. Application of IFRS/IAS provides decision makers with more qualitative financial information. Since IFRS/IAS has been engineered for the needs of an entity operating in the market economy, the adoption of these standards is mandatory in order to achieve a high quality financial reporting. Accounting policies and procedures according to Azerbaijan GAAP do not provide high quality financial reporting for an entity operating in the market economy. Thus, the application of more qualitative financial reporting standards is of great importance.

- Facility in decision making. Financial statements prepared according to IFRS provide decision makers with more and fair financial information. Especially, foreign investors rely more on the financial statements prepared based on IFRS. There are some advantages of IFRS for decision makers. These advantages are as follows (Accounting and Business Research 2006, 5-27):

  - Financial statements prepared based on IFRS promise more accurate, comprehensive and timely financial information.

  - Financial statements prepared based on IFRS reduces international differences in accounting standards and increases the comparability of financial statements.

  - Financial statements prepared based on IFRS reduces the work of an investor. An investor willing to invest in the entity has to evaluate an entity for decision making purposes. Thus he/she has to understand the accounting policies and procedures that are used in the preparation of financial statements. This procedure increases costs for the investor. On the other hand, preparation of financial statements based on IFRS eliminates extra effort and costs associated with the decision making process.

  - Financial statements prepared based on IFRS reduces investor risks, and information risks.

Thus, an entity intending to attract foreign investment has to consider application of IFRS/IAS.

- Facilitate the quotation of entity shares on foreign stock exchanges. The presentation of financial statements prepared based on IFRS will provide more understandable, transparent financial statements and facilitate the quotation of shares on foreign stock exchanges.

- Introduction of fair and relevant financial statements. Entity which prepares its financial statements based on IFRS presents more fair and relevant financial information. One of the characteristics of a relevant financial statement is the consideration of present economic environment in the financial information. IFRS achieves this through the application of fair value accounting. It is important for the decision makers to evaluate an entity based on the financial statements that reflect the changes in the economic environment. The revaluation of tangible fixed assets, fair value measurement, lower of cost or market principle, recognition of impairment losses are all important to accomplish fair and relevant financial statement presentation.

- Benchmark with international competitors. Application of IFRS increases the comparability of financial statements. The management of an entity operating in Azerbaijan might benchmark its financial position and performance with an overseas entity. The application of IFRS facilitates this comparison.

- Availability of internal comparison. In addition to the benefits of international comparison, an entity operating in different countries (owning subsidiaries, joint-ventures) might use IFRS/IAS for internal comparison. For example, by adopting IFRS/IAS the management of an entity operating in Azerbaijan might compare the financial position and performance of its subsidiaries operating in Turkey or other countries.

In summary, the preparation and presentation of financial statements according to IFRS/IAS and establishing accounting system in consistency with the international accounting principles and procedures provide some benefits to an entity. Those benefits are increase in transparency, quality and understandability of financial statements, facility in decision making for foreign investors, increase in foreign direct investment, participation in foreign financial markets, introduction of fair and relevant financial statements, and improvement in comparison.

4.2 Problems arising in the application of IFRS/IAS.

The conversion of accounting system is not a straightforward process. During the transition, entities might face some problems. These problems are more evident in the accounting systems that are more different from the accounting system to be adopted. As previous chapters noted, Azerbaijan accounting policies and procedures are different from IFRS/IAS, and in some cases the comparison of both regulations is not applicable due to the absence of similar applications. Thus, an entity in the conversion process is to face the problems associated with the application of IFRS/IAS or NAS regulations. These problems can be grouped as follows:

- Transition to IFRS is a costly process. The costs associated with the transition to IFRS are training of personnel, software, consulting and other costs. Training of personnel is important in the transition process. First time adoption of IFRS/IAS or NAS requires substantial training of accounting and finance staff. This training also has to be continuous since the standards are changing and improving continuously. The establishment of a suitable IT system is also important for an entity in transition. This computer system is necessary in order to decrease the costs to collect financial information and to prepare financial statements.

- The application of IFRS might result in the change of financial position and performance. The introduction of fair value financial reporting approach will result in the volatility in the balance sheet and income statement. For example, recognition of impairment losses and revaluation increases or decreases might decrease or increase the equity of an entity. Financial position of an entity might change as a result of changes in the measurement and valuation bases for assets, liabilities and equity items. This volatility might present extra difficulties in the making relevant decisions for the management and shareholders who are not skilled at IFRS.

- Complex nature of international financial reporting standards. The complex nature of some IFRS/IAS might present problems in proper application of them. Standards related to the hedge accounting, impairment test, and accounting regulations for financial instruments are some of those complex regulations. An entity might lack necessary expertise in the application of these regulations. Another complexity in the application of IFRS relates to the way accounting is conducted at the entity. Accounting has been considered as a legislative system for a long time. Judgment was not required from accountants, but the application of IAS/IFRS requires some judgment. This requirement also changes the look to the accounting system. Accounting will not be considered merely a legislative system, but a decision making system.

- Demand for change in the accounting thinking of personnel. For many decades, accounting has been considered as bookkeeping and reporting to the central government. However, IFRS provides some alternatives in the financial reporting and an accountant has to employ his judgment and thinking in the accounting process. Consideration of accounting as a means of providing essential information for the decision making purpose must be established at the entity.

- Running parallel accounting systems. Since accounting transition does not mean transition in the tax accounting, this might raise problems in the implementation of parallel accounting systems. IFRS/IAS and tax legislation apply different policies and an entity has to maintain two accounting systems in order to prepare financial statements and report to the tax authorities.

Entities are not used to this parallel reporting system. This might result in the further increase in reporting costs.

In summary, an entity may face some problems in the IAS/IFRS adoption. Those problems are high costs of transition, the change in the financial reporting practices, change in the financial position and performance, complexity of IFRS.

4.3 Suggestions.

The adoption of IFRS/IAS or NAS based on IFRS/IAS is important for entities operating in Azerbaijan. There are benefits and problems of implementing IFRS, but benefits outweigh the problems associated with the application. The result of the questionnaire and the experience of other countries adopting IFRS reveal that it is important to adopt IFRS and the benefits of IFRS outweigh the costs.

In order to implement the transition process, the entity can benefit from the assistance of international auditing firms. As noted above, one of the issues relating to the application of IFRS is the training of personnel and establishment of relevant information system. The expertise of international auditing firms experienced in the transition to IFRS can be used in the training of personnel and establishment of relevant information system. Many entities in foreign countries apply this approach in the transition process (McGee and Galina 2005). Nevertheless, it must be noted that the expertise of the auditing firms must be employed in the proper manner. The managers of many entities employ these auditing firms mainly in order to prepare their financial statements, but not to convert their accounting systems. The experience of foreign entities and the experience of Azerbaijan companies applying IFRS show that entities that are required to present their financial statements according to IFRS by government employ international auditing firms to prepare their financial statements. In sense, international auditing firms audit the reports that are prepared by themselves. This must not be considered a transition process since the accounting system of the entity still operates according to the old regulations. The transition of accounting system means systematic and strategic change in the financial reporting.

The complex nature of IFRS can be avoided by the issuance of proper accounting guidance. There might raise a question regarding the issuance of the guidance. Detailed guidance might be unavailable. But an entity might overcome this problem by referencing to the experience of local and foreign companies applying IFRS. Government which is the initiator of the transition to IFRS has to assist entities in this respect. The Finance Ministry can play an important role by issuing detailed guidance on the implementation of complex accounting procedures.

Another major issue is the change in the relation to the accounting. Accounting has to be considered as a major provider of financial information and a major tool in decision making. This change in the relation to the accounting system will bring the implementation process to minimal cost. The management must understand the importance of accounting; accounting must not be considered as a reporting to the government, but as a reporting to the management and decision making process. The acceptance of this ideology will enhance transition process in entity. The accounting system based on IFRS can also be used for internal management purposes. The statements and reports must be considered not only for external reporting purposes but also for internal management purposes.

4.4 Discussion and results.

As noted, there are some benefits and costs associated with the transition to IFRS. An entity should weigh the benefits and costs of the transition process. It is beneficial to adopt IFRS for an entity intending to grow, to attract foreign investment, and to be more transparent. Thus, it is essential to adopt IFRS/IAS in Azerbaijan since the application of IFRS/IAS will increase the quality of financial reporting and foreign direct investment. The questioning of some auditors working for the auditing companies in Azerbaijan revealed that it is essential to adopt IFRS if an entity wants to attract foreign investment, be more transparent, and increase the quality of decision making. Foreign investors mainly require financial statements to be prepared according to IFRS in order to make decisions regarding a certain company. If a foreign investor wants to invest into an entity operating in Azerbaijan, he/she firstly orders an international auditing firm to audit the entity and present IFRS based financial statements. This is a usual practice in Azerbaijan and is the most important source of auditing firm revenue.

As the questionnaire revealed, the majority of local entities do not prepare financial statements based on IFRS or NAS based on IFRS, but ask auditing firms (International ones mainly) to prepare. Many local entities are not interested in the application of IFRS, but they have to ask auditing firms to prepare financial statements based on IFRS for them when they want to obtain credit from foreign financial institutions.

As seen, it is important to adopt IFRS for an entity and for the economy as a whole. Developing Azerbaijan economy is in the need for the more qualitative and transparent financial information that is used by investors for decision making purposes.

The adoption of IFRS in different Post-Soviet Republics (Russia, Ukraine, and Kazakhstan) was also studied. All Post-Soviet countries seem to have similar benefits and problems of IFRS adoption. It is difficult to deduce whether these countries have benefited from the IFRS application, since the implementation of IFRS still in progress. However, the economy and entities are expected to benefit from the IFRS adoption. The analysis of the amount of Foreign Direct Investments (FDI) in Russia, Ukraine and Kazakhstan revealed that FDI mainly increased since the beginning of the application of IFRS.

Russia, Ukraine and Kazakhstan entities have presented financial statements according to IFRS since 2004, 1999 and 2003 respectively. The statistical data show that FDI increased from $ 13072 million to $ 27797 million between 2005 and 2007 in Russia. FDI to Ukraine has also increased steadily from 1999 to 2008. There was high increase in FDI from $ 1715 million to $ 7808 million between 2004 and 2005. FDI to Kazakhstan has been volatile; it decreased from 2001 to 2003 and increased from 2005 to 2006. However, it is difficult to conclude that the changes in the FDI are due to the presentation of more qualitative financial information. Other factors also influence the amount of FDI, and the influence of financial information to the investment inflow must be examined.

CHAPTER 5

CONCLUSION

The main aim of this thesis was to illustrate to the management of entities and professionals who are against the adoption of IAS/IFRS in Azerbaijan why it is essential to adopt IAS/IFRS. The thesis provided major differences between IAS/IFRS and Azerbaijan GAAP, and analyzed the reasons that stand behind those differences.

The first chapter introduced information about development of accounting system in Azerbaijan and compared accounting policies established according to Azerbaijan GAAP and IFRS. The aim in this comparison was to illustrate to the managers in what ways Azerbaijan accounting system and policies differed from the international practice, and to illustrate how they could improve the accounting system and reporting by adopting IAS/IFRS.

The second chapter illustrated the preparation and presentation of financial statements according to Azerbaijan GAAP. The chapter also commented on the differences between the two regulations over the purpose and requirements of financial statements.

The third chapter illustrated some benefits and problems, as well as suggestions on the problems of implementing IAS/IFRS.

There are fundamental differences between accounting policies and procedures based on Azerbaijan GAAP and IFRS. The main reason for this difference lies in the accounting systems. Azerbaijan accounting system is mainly the reformed form of the Soviet Accounting System, whose major purpose in the preparation and presentation of financial statements was reporting to the central government. This purpose over the financial statements is still relevant, and major entities organize their accounting policies in the way that facilitates the reporting to the central government. This look to the financial reporting must be rejected in the transition to market economy. Accounting system is to be organized in the manner that provides transparent, relevant, fair and credible financial information.

Management should consider accounting as the major tool of the decision making process. The adoption of IFRS is necessary in order to accomplish efficient and effective accounting system that is in consistency with the market economy. Together with the privatization and legal reforms, thorough accounting reforms also have to be performed in the transition to the market economy. In the way to transition, Azerbaijan government has begun the adoption of IFRS. But there is some resistance for the acceptance of IFRS/IAS and NAS based on IFRS/IAS. This resistance mainly derives from the denial of the necessity of IFRS adoption. Many think that it is not necessary to adopt IFRS for the developing economy like Azerbaijan. However, the adoption of IFRS will provide many benefits to entities. The adoption of IFRS adds more credibility and attracts more direct foreign investments, which is essential for the developing economy.

REFERENCES

Abbasov, Gezenfer. 1998. *Muhasibat Uçotu Nezeriyyesi***.** Baku-Azerbaijan.

Accounting Law of Azerbaijan Republic. Augusts 10, 1995. “Azerbaijan” newspaper. Baku.

Accounting Law of Azerbaijan Republic. September 2, 2004. “Azerbaijan” newspaper. Baku

ADB.2002. *Accounting and Auditing Practices in Selected Developing Member Countries:A diagnostic Study of Azerbaijan,Fiji Islands,Marshall Islands,Philippines and Sri Lanka.Manila.*

*Azerbaijan Republic Tax Code***.** 2008. Baku-Azerbaijan.

Baku Stock Exchange. www.bfb.az (accessed August, 2009).

Barry J. Epstein, Eva K. Jermakowicz. 2008. *Interpretation and application of international accounting and financial reporting standards***.** Wiley IFRS.

Derek, Bailey. 1995. *Accounting in transition in the transitional economy.* The European Accounting Review. 4:4. 595-623

Kerimov, Aydin. 2007. *Muhasibat Uçotu, Vergiler.* Baku.

Pecker, Boris. 1932. *The Soviet Accounting and Credit Systems.* Harvard Business Review.

Robert H. Mills and Abbott L. Brown. 1966. *Soviet economic developments and accounting.* The Journal of Accountancy.

Robert W.McGee,Galina G.Preobragenskaya. 2005. *Problems of Implementing International Accounting Standards in a Transition Economy;A Case Study of Russia.*

Liberman, L.V, Eidinov, A.M. 1995. *The development of accounting in tsarist Russia and the USSR***.** The European Accounting Review.

Sadigov, Ali. 2002. *Mühasibat (Maliyye) Uçotu.* Baku-Azerbaijan.

Sebzeliyev, Sifariz. 2005. *Mühasibat (Maliyye) Uçotu.* Baku-Azerbaijan.

Walton, Peter et al. 2003. *International Accounting*. Thomson Learning.

APPENDICES

APPENDIX A

QUESTIONNAIRES

QUESTIONNAIRE 1.

1. **The relevance of IFRS to Azerbaijan. Is it relevant to apply IFRS, does Azerbaijan economy need IFRS, or traditional accounting rules and practices (Azerbaijan GAAP) suffice? What are advantages and disadvantages of IFRS application to Azerbaijan Economy?**

It's quite relevant to apply IFRS in Azerbaijan. Traditional accounting rules are not relevant for money holders which are out of Azerbaijan (foreign investments).

Advantage is:

- *Investors abroad will be able to acquaint with economic situation, financial performance of companies*
- *Azeri companies will be amalgamated with the world's largest capital market*

Disadvantage:

- adoption of IFRS for our local companies is a costly process. Some accounting issues and standards might not be easily adopted due to the cultural differences between foreign economies.

2. **Advantages and benefits of IFRS for the Azerbaijan entity. What are advantages of applying IFRS for the entity?**

Advantages:

- *Comparability – Azeri economy (here it means local companies in comparison with the similar business) will easily be compared with other economies (economic growth, GDP, inflation, production, demand.) ;*
- *Adoption of IFRS will dramatically improve quality of financial performance of the major local companies;*
- *Public awareness, intellectual property of the nation will increase.*

3. Disadvantages of IFRS for the Azerbaijan entity. What are disadvantages of applying IFRS for the entity?

- *Cost consuming*
- *Time consuming;*
- *Extensive process;*
- *Transition arrangements;*
- *Some accounting issues and standards might be difficult for understanding due to culture and mentality*

4. What are the costs of IFRS application for the Azerbaijan entity?

In my opinion adoption costs for local entities are :

Training and Implementation;

Finding and outsourcing specialists or tutors abroad

Translation of materials by appropriate specialist

Accounting system of a company should be changed

Evaluation of the company's assets and liabilities according to IFRS by independent valuer or specialist etc

5. **Is it beneficial to apply IFRS? If "Yes", why is it beneficial for an entity to apply IFRS for the Azerbaijan entity? Do benefits outweigh disadvantages and costs of IFRS application?**

Benefits of applying IFRS for an entity:

- *The entity should, in its opening IFRS balance sheet, apply measuring estimates on an international accounting base which is according to IFRS. Hence assets and liabilities of the entity might be more valuable and measurable according to IFRS, rather than local accounting rules.*
- *Company will involve more investors after applying IFRS and gain more profit*
- *Company will cooperate with more suppliers and expand the business*

6. **Do Azerbaijan entities prepare financial statements according to IFRS? I mean, does the accounting or finance departments of those entities prepare financial statements according to IFRS, or they use the services of auditing firms in order to prepare financial statements according to IFRS? If they use the services of auditing firms, why they do not prepare financial statements according to IFRS themselves? Are they motivated or is it beneficial for those entities to prepare financial statements according to IFRS themselves? Please, answer this question based on your experience. It would be of great importance if you provide an approximate percentage of companies that prepare and present their financial statements according to IFRS.**

Majority of local companies do not prepare financial statements on their own. Very rare companies (those having foreign investors, interesting parties etc.) prepare statements independently and submit to independent auditors for opinion.

Those not independently preparing statements use the services of auditing firms. It is beneficial for them due to time and cost.

Within three years of audit I had around 25-30 (approx.) local and foreign companies. Among foreign companies faced only 5-6 (approx.) of them preparing financial statements independently which means 10%. They are branches of foreign parent companies.

Respondent: Audit manager

QUESTIONNAIRE 2.

1. **The relevance of IFRS to Azerbaijan. Is it relevant to apply IFRS, does Azerbaijan economy need IFRS, or traditional accounting rules and practices (Azerbaijan GAAP) suffice? What are advantages and disadvantages of IFRS application to Azerbaijan Economy?**

Relevance – globalization. There are a number of multi-national organization that play a significant role in Azerbaijan Economy. These entities have to record their transactions in accordance with IFRS, simply because these records are to be consolidated with the records of the same entity that are kept outside the territory of the Republic of Azerbaijan.

Application - Commercial banks and other financial institutions are highly depending on the financial resources from abroad. For example, EBRD (European Bank for Reconstruction and Development), IFC (International Finance Cooperation), IBRD (International Bank for Reconstruction and Development) and similar financial institutions play an important role in Azerbaijan Financial Market, particularly in building of an infrastructure of micro-financing activities and development of energy sector. Therefore, the banks, state-owned monopoly entities and other financial institutions are required by statutory law, to prepare and submit IFRS financial statements to related state authorities, under direct supervision of which they operate.

2. **Advantages and benefits of IFRS for the Azerbaijan entity. What are advantages of applying IFRS for the entity?**

After IFRS being adopted in Azerbaijan properly, we will speak the same language as most of the countries in the World do. This will probably result in an increase in foreign investment in Azerbaijan economy.

3. **Disadvantages of IFRS for the Azerbaijan entity. What are disadvantages of applying IFRS for the entity?**

It will take a long period of time to adopt IFRS fully in Azerbaijan, because of the fact that accountants in Azerbaijan used to use tax accounting and the principles in Azeri Tax accounting differ from the statement of principles of IFRS. For example, entities have right to use the cash basis of accounting in calculation of profit tax obligation, and therefore, most accountants in Azerbaijan are not even familiar with the accrual basis of accounting and matching principles of income and expense, which are the main concepts under IFRS accounting.

It will take a long period of time to train these accountants.

4. **What are the costs of IFRS application for the Azerbaijan entity?**

Cost will be high since the transition projects are carried out by the professional accounting firms, like PricewaterhouseCoopers, Ernst and Young and etc. and the professional service fee in these companies are relatively higher.

5. **Is it beneficial to apply IFRS? If "Yes", why is it beneficial for an entity to apply IFRS for the Azerbaijan entity? Does benefits outweigh disadvantages and costs of IFRS application?**

Refer to an answer to the question number 2.

6. **Do Azerbaijan entities prepare financial statements according to IFRS? I mean, do the accounting or finance departments of those entities prepare financial statements according to IFRS, or they use the services of auditing firms in order to prepare financial statements according to IFRS? If they use the services of auditing firms, why they do not prepare financial statements according to IFRS themselves? Are they motivated or is it beneficial for those entities to prepare financial statements according to IFRS themselves? Please, answer this question based on your experience. It would be of great importance if you provide an approximate percentage of companies that prepare and present their financial statements according to IFRS.**

Refer to an answer to the question number 1

Respondent: Audit manager

QUESTIONNAIRE 3.

1. **The relevance of IFRS to Azerbaijan. Is it relevant to apply IFRS, does Azerbaijan economy need IFRS, or traditional accounting rules and practices (Azerbaijan GAAP) suffice? What are advantages and disadvantages of IFRS application to Azerbaijan Economy?**

Azerbaijan switched to IFRS. Generally, most organizations have to apply IFRS or has an option to use IFRS of Local GAAP. At the same time local GAAP has been developed based on IFRS and has minor differences.

IFRS has a lot of advantages, creates unique approach and philosophy for all companies. IFRS introduces new view from investor and owner point of view, not from the regulator view. At the same time it makes investment environment in the country simple for foreign investors, since the approach is same.

Disadvantage – IFRS is very flexible and sometimes can be treated agressively.

The new law is effective from the following dates depending on categories and applicable standards.

2. **Advantages and benefits of IFRS for the Azerbaijan entity. What are advantages of applying IFRS for the entity?**

   See above, I combined them.

3. **Disadvantages of IFRS for the Azerbaijan entity. What are disadvantages of applying IFRS for the entity?**

   See above, I combined them

4. **What are the costs of IFRS application for the Azerbaijan entity?**

   There are a lot of costs, since there are small number of IFRS specialists on the market, consulting companies have high fee for IFRS transition.

   All such costs can be grouped as following:

   - Staff – IFRS specialists, training of current accounting staff;

   - User – training of users of the financial statements, how to read the financial statements etc;

   - System – Accounting system and/or software need to be adapted to IFRS;

   - Internal procedures – for all departments and responsible people need to be adapted to IFRS principles.

5. **Is it beneficial to apply IFRS? If "Yes", why is it beneficial for an entity to apply IFRS for the Azerbaijan entity? Do benefits outweigh disadvantages and costs of IFRS application?**

If a company has plan for growth, attracting new investments, become transparent, improve corporate governance and demonstrate best practice IFRS is very beneficial.

Sometimes, the local business do not see IFRS benefits, since they are very small or know their business very well without any paper work, this is in the case when owner of the business is very close to day-to-day activity or individual entrepreneurs. Not cost effective for them.

7. **Do Azerbaijan entities prepare financial statements according to IFRS? I mean, do the accounting or finance departments of those entities prepare financial statements according to IFRS, or they use the services of auditing firms in order to prepare financial statements according to IFRS? If they use the services of auditing firms, why they do not prepare financial statements according to IFRS themselves? Are they motivated or is it beneficial for those entities to prepare financial statements according to IFRS themselves? Please, answer this question based on your experience. It would be of great importance if you provide an approximate percentage of companies that prepare and present their financial statements according to IFRS.**

Not available

Respondent: Audit manager