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Azerbaijan Corporate Governance report 2016

Executive summary

The Azerbaijani government has started to implement policies and far-reaching economic reforms aimed at the creation of a sustainable macroeconomic environment in the country, and corporate governance standards are thought to be a significant factor affecting the business climate in the country.

On 12 April 2016, during a meeting with a delegation from the American Chamber of Commerce, Azerbaijani President Ilham Aliyev drew his attention to the importance of having high corporate governance standards in Azerbaijani companies[1].

For decades, Deloitte has been at the cutting edge of corporate governance research, releasing dozens of reports on different aspects of governance, such as the role of the board, executive compensation, strategic oversight and many others.

Moreover, Deloitte Global set up the Center for Board Effectiveness, which helps directors deliver value to the organisations they serve through a portfolio of high quality, innovative experiences throughout their tenure as board members. Whether an individual aspires to board participation or is a board veteran, the Center's programs enable them to contribute effectively and provide focus in governance and audit, strategy, risk, innovation, compensation and succession.

Over the 13 years, Deloitte Azerbaijan has realized a number of corporate governance projects and assisted Azerbaijani companies in implementing best international practices.

In Azerbaijan, the corporate governance requirements under the Azerbaijani Civil Code are based on the principles of the continental model[2]. The continental model is used in the majority of European states and institutions. This model envisages the creation of two main governing bodies that are independent of each other (the executive board and the supervisory board or board of directors). The executive board should consist of managers who receive a salary from the company, while the supervisory board should be composed of independent members who do not depend on the enterprise.

Striving to make an impact in this important area of development, Deloitte Azerbaijan drew on Deloitte Global experience to conduct its first survey among a broad range of organisations across different industries in Azerbaijan and analyse the maturity of corporate governance in the country. This survey provides a unique perspective on the concerns that supervisory boards face in Azerbaijan. Our analysis is based on a survey and interviews with 40+ private, local and foreign companies that operate in the country. The results highlight changes in key governance, risk, internal audit, regulatory, and compliance concerns that Azerbaijani companies face in today's business environment.

"I agree that corporate governance should be the same as in private companies. I have already instructed the heads of such enterprises, and some of them have already embarked on a process of transformation. There are positive changes in SOCAR and the Caspian Shipping Company, and I look forward to other companies also working in this direction. The only difference between them and private companies will be the fact that they are owned by the state"

Ilham Aliyev, President of the Republic of Azerbaijan

1 Source: "Ilham Aliyev received delegation of American Chamber of Commerce in Azerbaijan". President's speech published on the official website of the President of the Republic of Azerbaijan, 12 April 2016. http://en.president.az/articles/19272

2 Source: Management in a Limited Liability Company. Article 91 of the Civil Code of the Republic of Azerbaijan http://www.azpromo.az/uploads/legislation/Civil_code_eng_51b1e34e863c1.pdf)

Findings

As a part of this study, we revealed a number of interesting trends that open new topics in the debate on prevailing governance practices in Azerbaijan. The key findings of this survey include the following:

- Existing standards and international best practices provide a solid framework for corporate governance standards. In accordance with such practices, the supervisory board should be empowered to nominate and propose the candidacy of the CEO and to dismiss the CEO to the general meeting of shareholders for approval. Half of our respondents indicated that their companies' supervisory boards do not have this authority. This means that in these companies the role of the supervisory board is diminished, which contravenes global best practices. Furthermore, among the respective supervisory boards of these surveyed companies, only 25 percent have responsibilities such as succession planning for senior executives.

- However, on a positive note, we found that 43 percent of respondents report that the supervisory board takes strategic decisions, oversees corporate governance standards, implements best practices in governance and is authorised to manage the strategy of the firm.

- Generally, regulators and the market play an equal role in boosting corporate governance standards. The responses for one of the key survey questions show that neither third parties, nor the market pushes companies to improve their corporate governance practices. On the contrary, seventy percent of the respondents think that maintaining a positive image and reputation is the only key motivational factor behind making improvements to corporate governance.

- Respondents indicated a lack of proactive approach of the regulator among the main limitations for advancing corporate governance in local organisations.

- Our findings also raise concerns that 42 percent of local companies have no policy regulating remuneration and compensation issues.

In summary, it would appear that although there are differing views on corporate governance and the weaknesses in putting it into practice, there is broad agreement that corporate governance should be improved and board members may contribute to this more effectively by being committed to success in business through the maintenance of the highest standards of responsibility and ethics.

Methodology

We based our methodology on Deloitte Global best practices. While we conducted our survey in line with the priorities of the best practices, we also wanted to provide an overview that would show challenges and improvements.

Our questionnaire was in Azerbaijani and English and comprised seven sections:

A. General information on the respondent and his or her employer – seven questions

B. Internal control/risk management policies – two questions

C. Supervisory board structure and responsibilities – six questions

D. Audit committee role – seven questions

E. Senior executives' role – three questions

F. Compensation policy and ethics training – four questions

G. Corporate governance principles and future perspectives – four questions

Our survey was conducted among various industries and businesses and gathered responses from C-level management. The survey took place from August to September 2016.

We followed two approaches towards assessing the corporate governance of a given organisation.

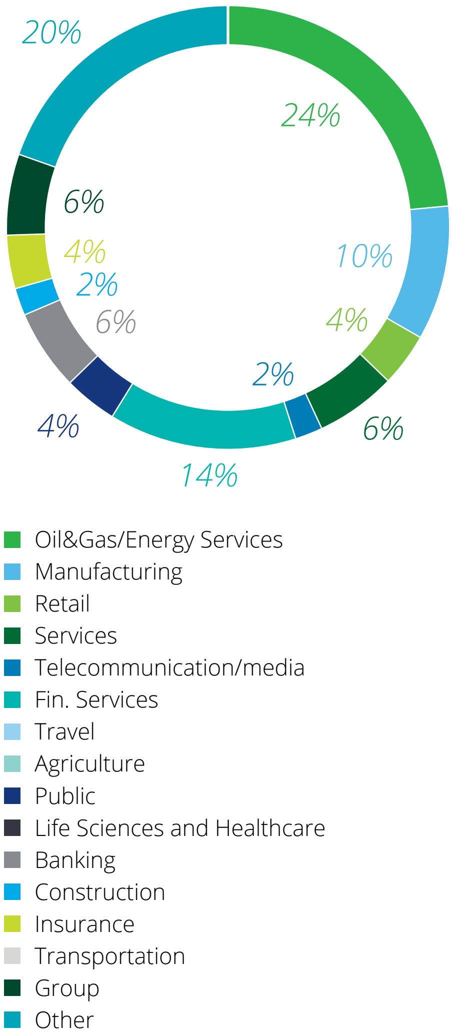
We gathered data through an online survey and through face-to-face interviews. Initially, an online survey questionnaire was created and was accessible from 10 August until 15 September 2016 through the Deloitte Azerbaijan website. In the invitation email with a link to the survey, the goals and methods of the survey were clearly stated. We sent emails to all members of the C-level management of local companies that were in our database. Participants were asked to provide a valid email address and their professional affiliation. Forty respondents completed the online survey, representing a response rate of 20 percent. The electronic questionnaire remained live for more than one month and was deactivated on 20 September 2016.

Secondly, face-to-face interviews were conducted at eight respondents' offices.

In our survey, we examined businesses of various sizes across 12 industries, from oil and gas, banking and telecoms, to construction, manufacturing and many others.

Representatives from more than ten industrial companies that operate in Azerbaijan participated in the first Corporate Governance survey. Small companies with fewer than 500 employees accounted for approximately one third of all responses, while relatively large companies employing more than 2000 people accounted for about a quarter of the sample.

Chart 1. Surveyed industries



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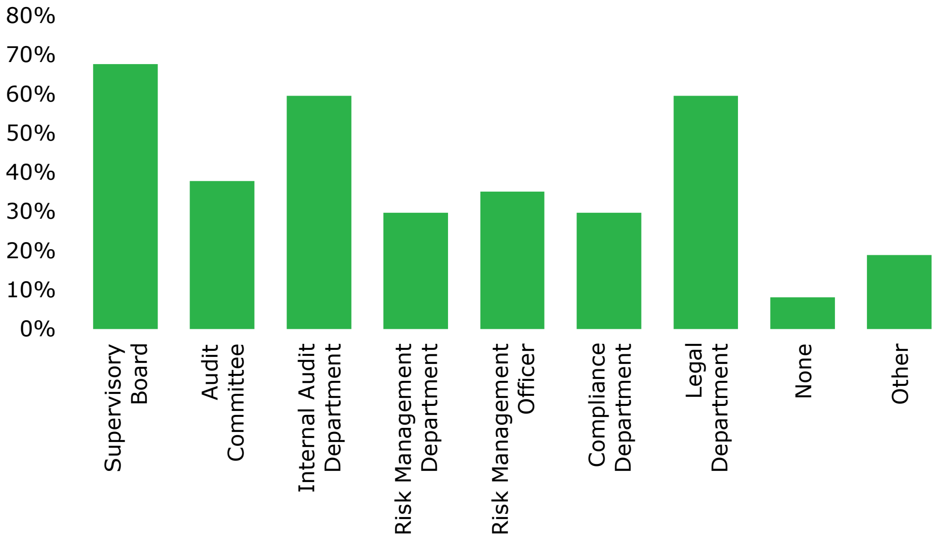
Part 1. The evolving governance landscape

Today small and medium-sized companies in Azerbaijan are shifting from traditional models to some extent and are choosing to become companies with supervisory boards. At the same time, the demands and responsibilities of the supervisory board vary from company to company, and many companies do not have one at all.

Our study showed that around 60 percent of the companies have an internal audit department. However, only 38 percent of respondents stated that they have an audit committee, and 22 percent of Azerbaijani companies have not formed an audit committee.

Sixty-seven percent of respondents to the question, "Which of the following bodies does your organisation have in place?" indicated that they have a supervisory board in place. The survey data suggests that 8 percent of the companies have not formed a supervisory board or audit committee, nor internal audit, risk management, compliance or legal departments, do not have a dedicated risk management officer.

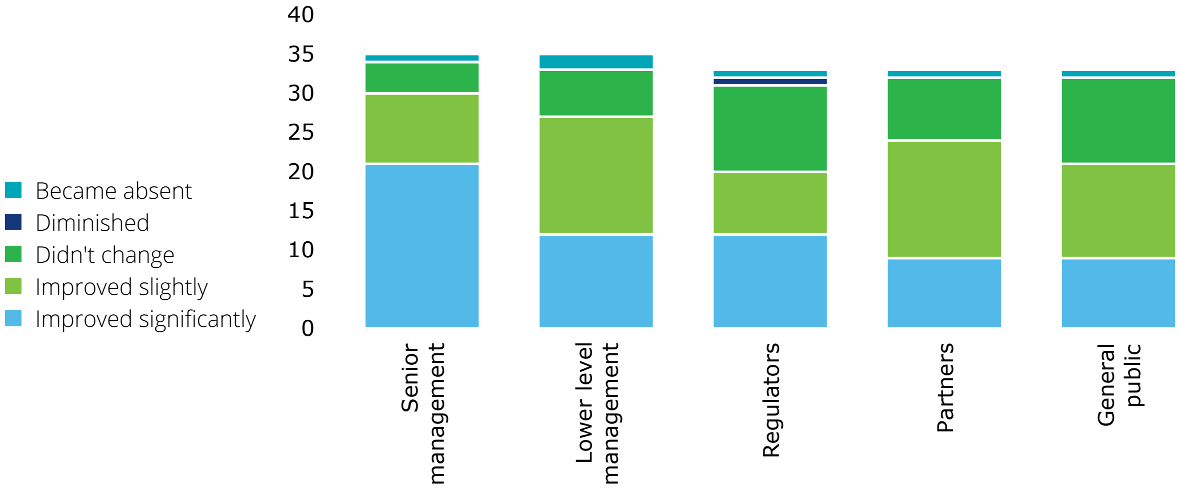
Chart 2. Percentage of surveyed organisations that have certain bodies



Why do boards and management teams need a governance structure to operate? The governance structure helps define the role of the board and management, defines duties and helps prevent replicated efforts while enhancing the smooth management of critical issues.

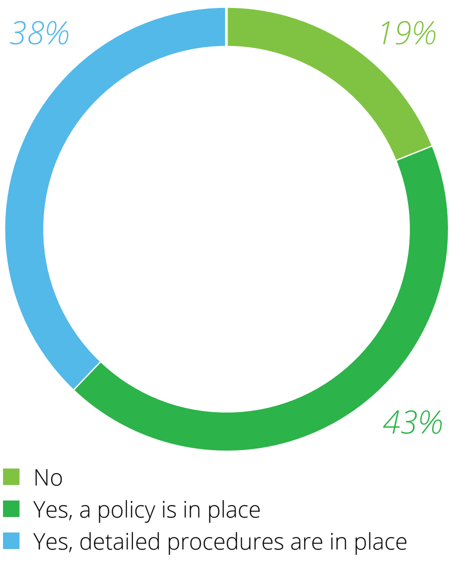
One of the positive findings of our survey is that 50 percent of the respondents believe that senior management's focus on corporate governance has improved significantly over the last five years. Some of our respondents believe that the focus of the regulators has diminished compared to five years ago.

Chart 3. Focus on Corporate Governance compared to five years ago



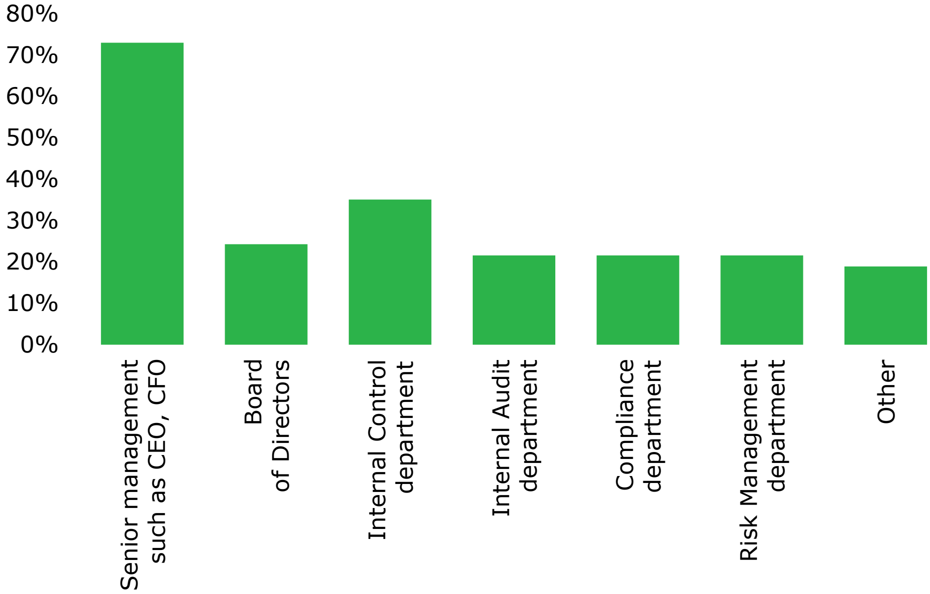
Internal controls should be a central part of any company and can help ensure the success of an organisation's goals in operational effectiveness and efficiency. Half of the survey respondents feel that the internal audit department and supervisory board are responsible for the implementation of internal controls, which is not consistent with best practices in corporate governance. On the other hand, the survey found that 73 percent of C-level management believes that senior management such as the CEO and CFO should be responsible for the implementation of adequate internal controls, which is more in line with best practices in corporate governance.

Chart 4. Respondents' assessment of risk management and/or internal control policies



While 22 percent of the C-level surveyed have an internal audit department in place, only 18 percent of them said that internal auditors monitor compliance with internal control/risk management policies. These responses regarding compliance with internal controls generally appear to contradict those regarding the responsibility for implementing adequate internal controls (please see charts 6 and 7).

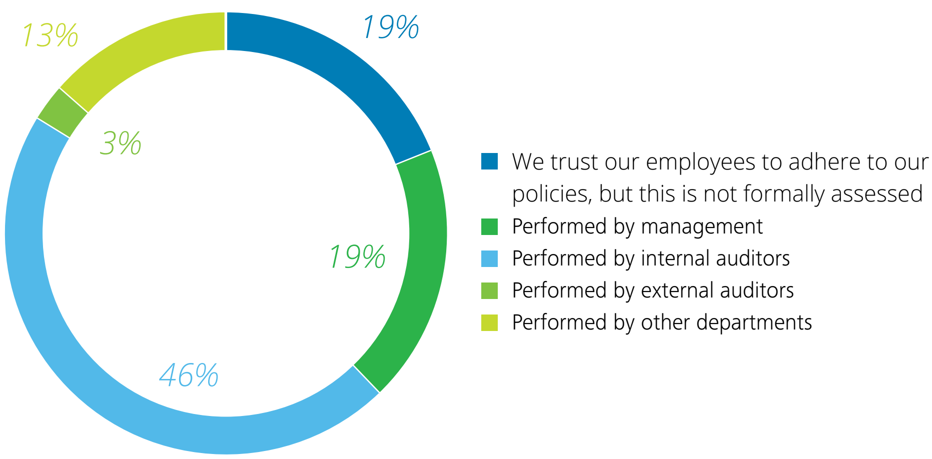
Chart 5. Implementation of adequate internal controls



This contradiction may indicate that most of the surveyed companies are not prepared for implementation of internal to ensure compliance with internal controls. Our survey found that Azerbaijani practices diverge from best practices. Although certain percentage of local companies have internal audit departments, the accountability for compliance with internal control/risk management policies rests with other departments.

The implementation of corporate governance principles is considered an internal issue within each organisation. Our survey found that around 40 percent of respondents are not involved in any business with third parties and because of that, imposing corporate governance principles is not applicable for them or no specific governance over third parties is established.

Chart 6. Compliance with internal control/ risk management policies



Part 2. Focusing on risk and compliance

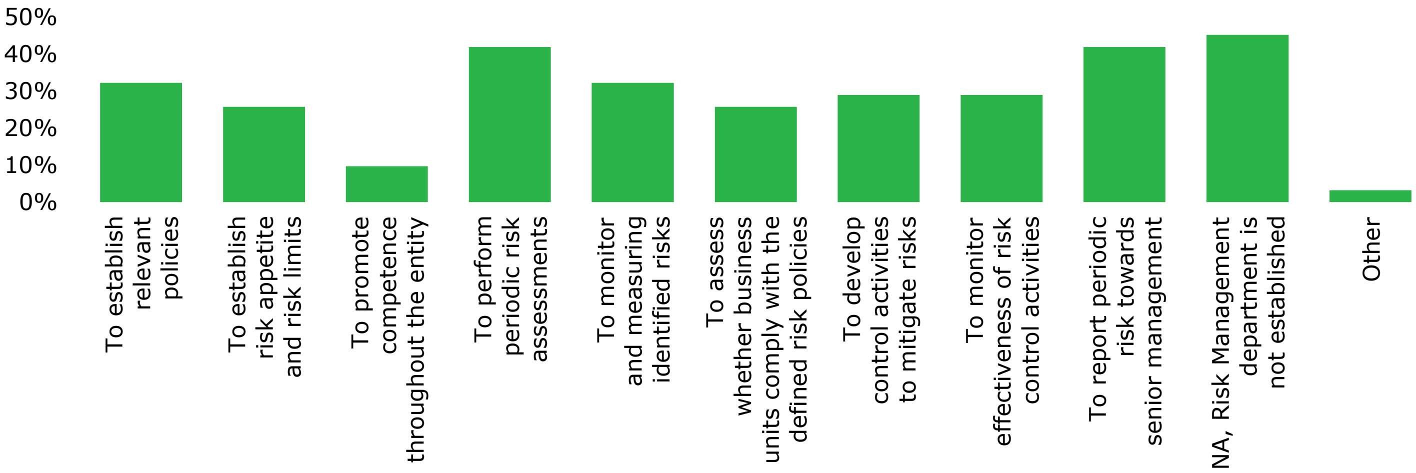
According to the standards adopted by the Ministry of Economics of Azerbaijan, every organisation is required to have policies on risk management[3]. These standards help companies to identify, analyse and monitor risk, and drive the company to achieve its goals in an effective way.

More than 60 percent of respondents stated that their companies do have detailed policies and procedures for risk management and/or internal control. Based on our understanding and observations, this reflects little of the reality of the corporate governance landscape. Furthermore, less than half of the companies (40 percent) reported that the risk management and/or internal control framework has already been defined. This statement also requires profound analysis. Another finding showed that a number of companies (around 19 percent) have not implemented their risk management and/or internal control policies. The lack of an internal control policy makes a company less prepared for a variety of risks from external and internal sources.

All organisations are required to form a special organisational department or unit in charge of risk management. This department ideally is responsible for risk identification, measurement and assessment, and its objective is to minimise the negative effects risks can have on the financial results and capital of a company.

Our study found that 45 percent of the surveyed companies do not have a risk management department. Ten percent said that the risk department is in charge of promoting competence throughout the entity. While in most of the companies, the responsibilities of the risk department are relatively weak, in 42 percent of the companies, the risk management department does report risk to senior management periodically.

Chart 7. Responsibilities of the risk management department in surveyed companies



3 Source: Corporate Governance standards in Azerbaijan adopted by Ministry of Economics, 2011 http://www.economy.gov.az/index.php?option=com_content&view=article&id=98&Itemid=142&lang=az

In any company that applies best practices in corporate governance, responsibility for all transactions identified as related party transactions lies with the audit committee. This committee should give its approval before companies make any deals with a related party. The survey found that 32 percent of surveyed companies still do not have a procedure in place that regulates related party transactions.

Part 3. Board composition and structure

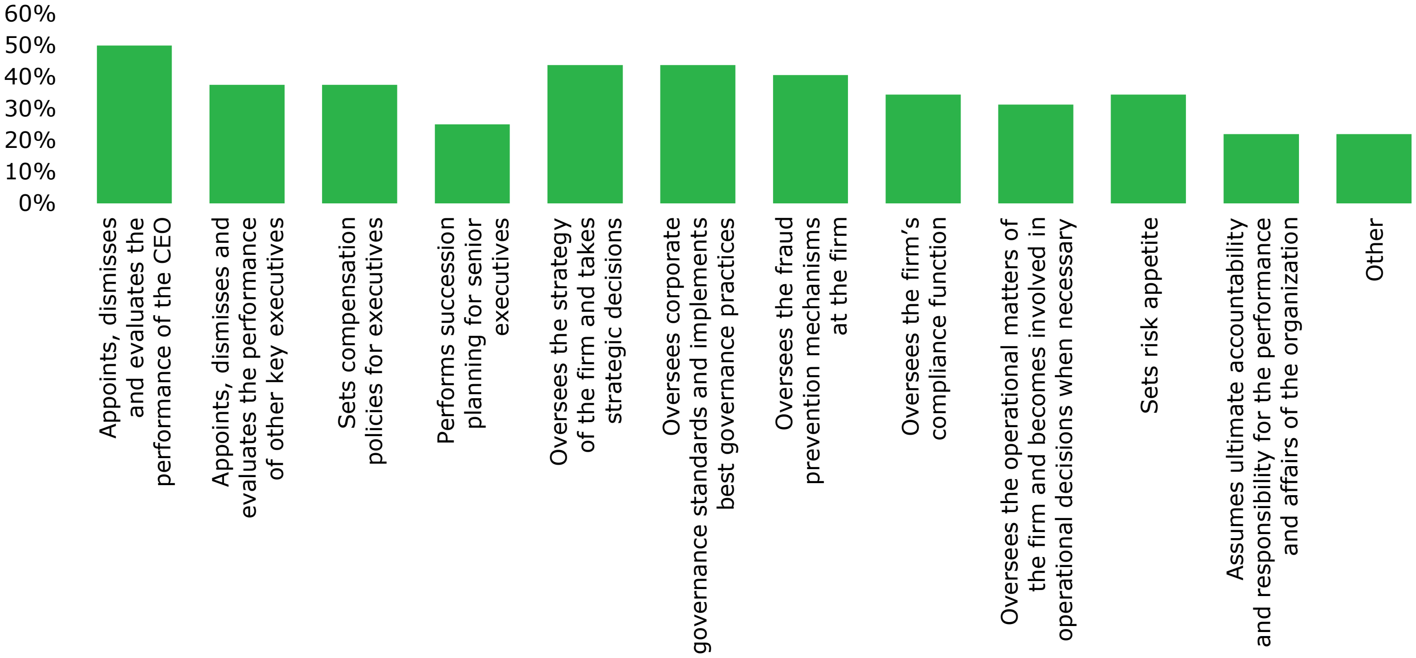
In accordance with best practice, the size of a supervisory board depends on the type of organisation, the industry in which it operates, the number of strategic priorities and the number of shareholders. Conceptually, the number of members of the supervisory board should be no less than three and no more than five.

Our survey showed that three out of the five surveyed banks currently have five members on their supervisory board. Based on international practices in corporate governance, it is worth noting that boards with less than three members are also unproductive for companies. The size of the boards in the non-banking industry companies also reaches a maximum of five, with 35 percent of the surveyed non-banking companies reporting a five-member board. Surprisingly, we found that 14 percent of the surveyed non-banking companies do not have a supervisory board at present.

Ideally, the supervisory board works closely with the chief executive officer (CEO) of the company to give not only support and direction to him or her, but also to challenge the CEO to make sure that he or she leads the company in accordance with the company's strategies. The mandate of the CEO, guided by an active supervisory board, is to drive the value of the company.

Existing standards and international best practices provide a solid framework for corporate governance standards. In accordance with such practices, the supervisory board should be empowered to nominate and propose the candidacy of the CEO and to dismiss the CEO to the general meeting of shareholders for approval. Half of our respondents indicated that their companies' supervisory boards do not have this authority. This means that in these companies the role of the supervisory board is diminished, which contravenes global best practices. Furthermore, among the respective supervisory boards of these surveyed companies, only 25 percent have responsibilities such as succession planning for senior executives.

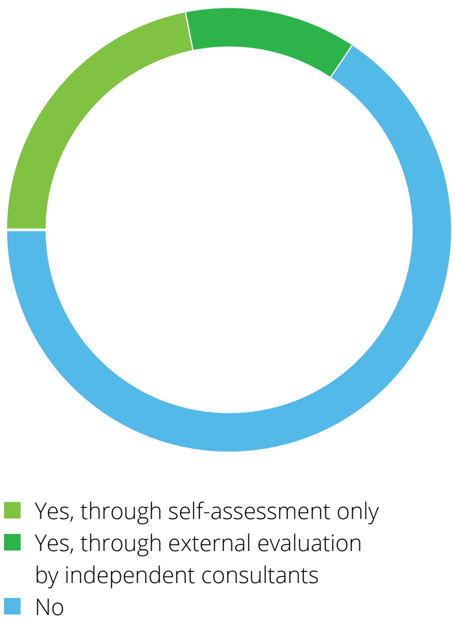
Chart 8. Responsibilities of the supervisory board in the surveyed companies



When asked about performance evaluation for the supervisory board, 66 percent of those surveyed said that over the last three years, the board has not evaluated its own performance in a formalised procedure. On the other hand, 22 percent of those surveyed indicated that the board evaluates its performance through self-assessment only, and only 13 percent of respondents claimed that in their companies the supervisory board evaluates its performance through external evaluation by independent consultants.

Face-to-face meetings have benefits and can help board members build trust and make decisions, and can present a chance for lateral communication. The survey showed that six companies out of 43 hold four to five in-person supervisory board meetings every year, whereas half of those surveyed appeared not to hold face-to-face supervisory board meetings even once a year. However, four companies out of 43 hold one or two direct meetings a year.

Chart 9. Supervisory board's evaluation of its own performance in a formalised procedure over the last three years



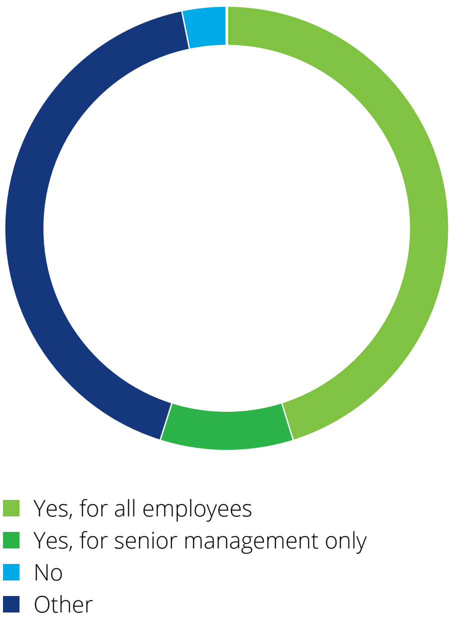
Independent directors form an important boundary between management and the shareholders. When many independent opinions are expressed in the boardroom, the risk of groupthink is reduced.

Of the respondents, 37 percent stated that there is no member of the supervisory board of their organisation that could be considered an independent director. Thirteen respondents (26 percent) skipped this question. More surprisingly, two companies indicated that they have seven independent directors, whereas five companies said that they have only one or two independent directors. Three companies have from three to five independent directors on their board.

Remuneration and compensation

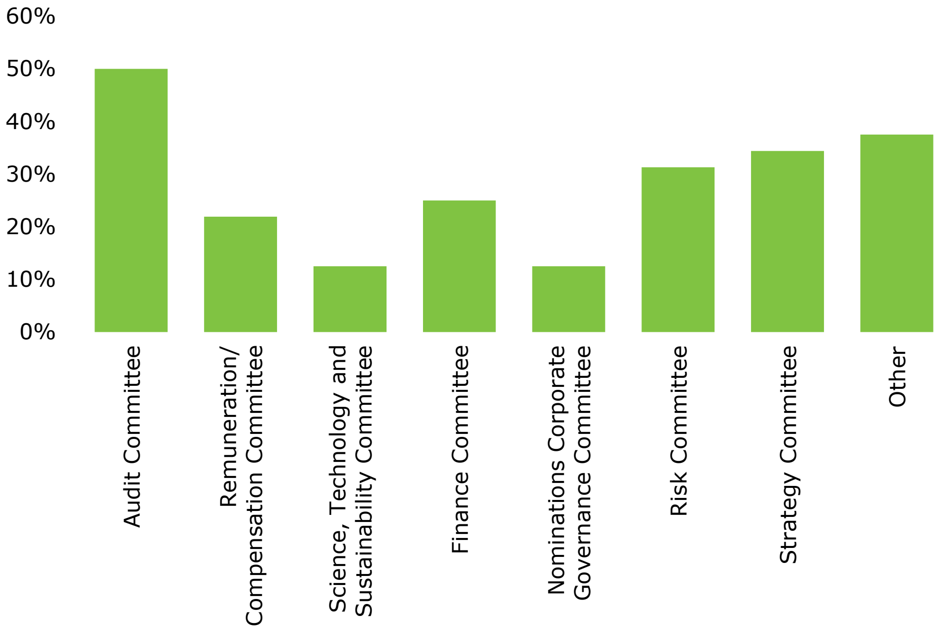
Remuneration and compensation play an essential role in the effective delivery of any organisation's strategic goals. In theory, this committee should have at least two or three members who are all independent non-executive directors.

Chart 10. Companies that have a remuneration/compensation policy



This study examined the remuneration and compensation policy of some Azerbaijani banks. As per the requirements of the Central Bank of Azerbaijan, all local banks should have a remuneration and compensation committee[4]. However, the survey found that the supervisory board of around 40 percent of the local companies that operate in industries other than banking do not have a remuneration and compensation committee. Seven percent of banks, as well as a tiny percentage of other companies have a remuneration and compensation committee within their supervisory board. A few respondents said that they have a nominations and corporate governance committee instead of a remuneration and compensation committee.

Chart 11. Percentage of supervisory boards with certain committees



Audit committee/audit department

Item 3.4, Article 91 of the Civil Code of the Republic of Azerbaijan clearly indicates the role of audit committee[5]. It states that the auditing committee of the entity shall have the right to audit the financial and economic activity of the company and, for this purpose, to receive all documents relating to the activity of the Company.

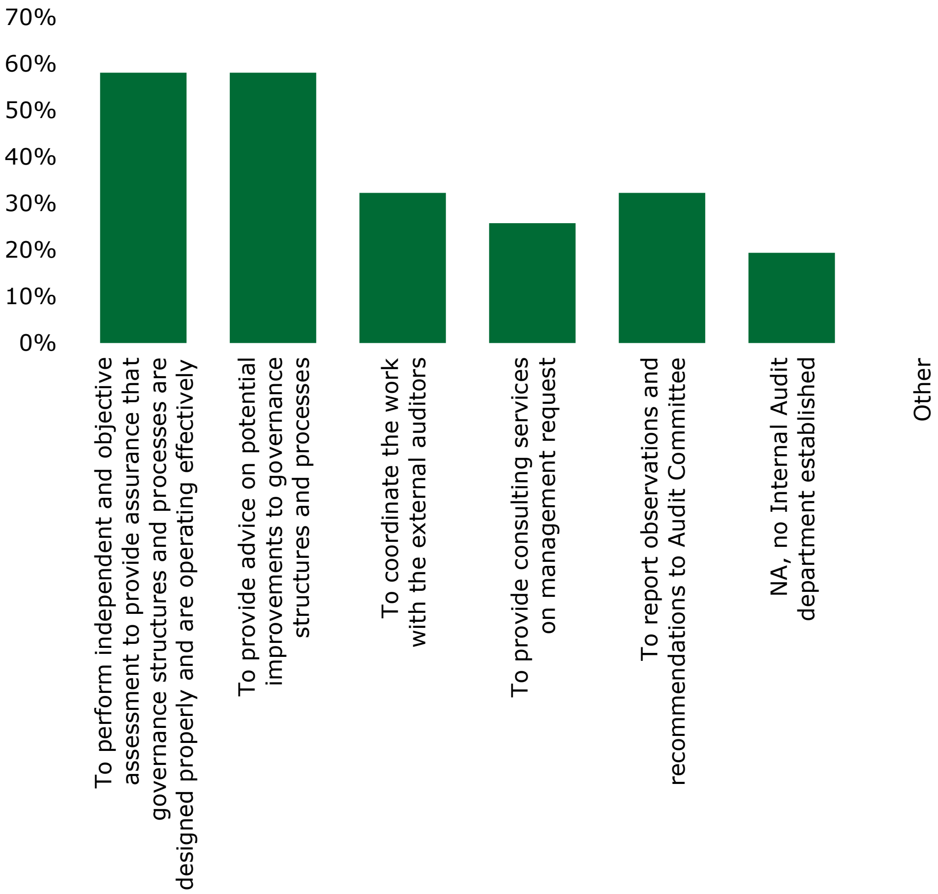
The role of the internal audit department differs from that of the audit committee/ audit department. As regards local legislation, Article 4 of the Law on Internal Audit of the Republic of Azerbaijan of 22 May 2007[6] indicates the roles of the internal audit department. Broadly speaking, the internal audit department is an independent and objective evaluation division within a company. On the internal audit department's responsibilities, our survey found that 40 percent of the companies do not undertake independent and objective assessments to provide assurance that governance structures and processes are designed properly and operating effectively. However, on a positive note, we can see that 58 percent of respondents indicate that advising on potential improvements to governance structures and processes is one of the roles of the internal audit department.

4 Source: Item 12-1.1, Article 12 of the Decision On approval of Corporate Governance Standards of the Central Bank of the Republic of Azerbaijan http://en.cbar.az/assets/196/Corporate_Governance_Standards_in_Banks.pdf

5 Source: Item 3.4, Article 91 of the Civil Code of the Republic of Azerbaijan http://e-qanun.az/framework/13241

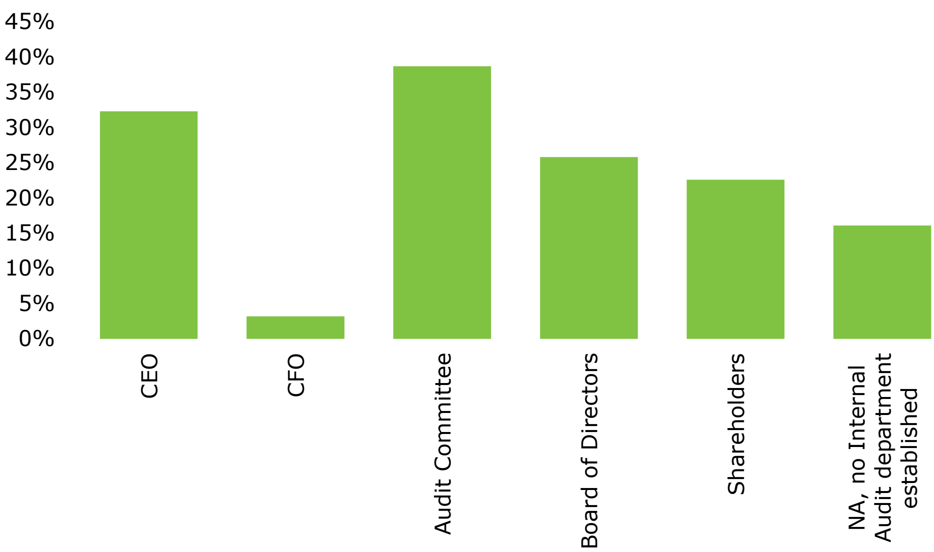
6 Source: Law of the Republic of Azerbaijan No. 332-IIIQ "On Internal Audit" of 22 May 2007. Retrieved from: http://e-qanun.az/framework/13241

Chart 12. Responsibilities of the internal audit department in surveyed companies



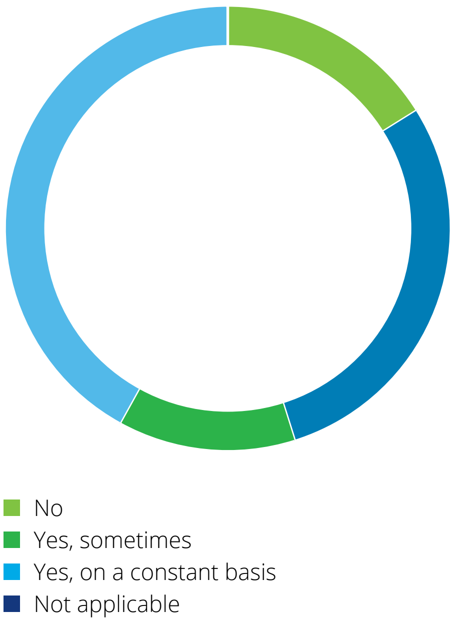
Our survey found that the majority of companies in Azerbaijan split the reporting duties of the internal audit department between the audit committee, the CEO and the supervisory board. An example of a negative practice is our finding that the internal audit departments of 32 percent of those surveyed report to the CEO. As per the requirements of international financial institutions and best practices for audit committees, internal auditors should not report to the CFO or CEO because it can put internal auditors' objectivity at risk. Moreover, the survey implies that 22 percent of internal auditors report to the shareholders, which also contravenes best practice.

Chart 13. To whom internal audit departments report



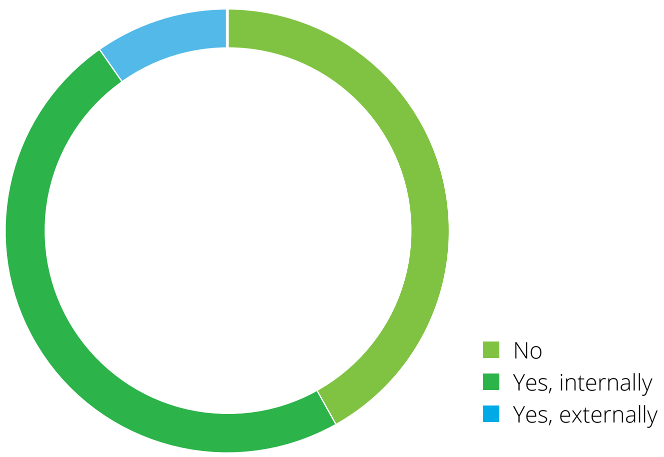
The responses to the question 'If your company does not have an internal audit department, do you involve external consultants to perform internal audit projects?' showed that 16 percent of local companies do not involve outside consultants to perform internal audit projects. Of the respondents, 42 percent answered that working with outside consultants is not applicable for them, whereas 13 percent of companies that took part in our survey said that they cooperate with outside consultants on a regular basis.

Chart 14. Involvement of outside consultants in performing internal audit projects



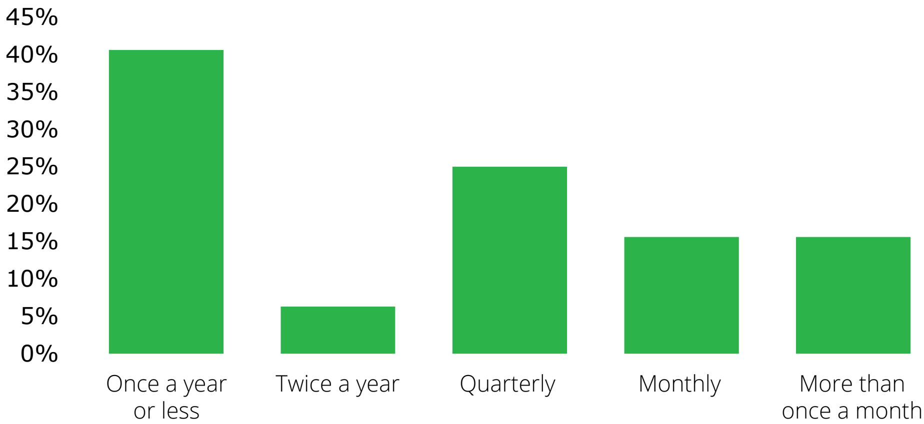
Companies periodically perform an assessment to verify whether the internal audit department is operating in line with the company's expectations and best practices. While 49 percent of respondents said that their companies periodically perform an internal assessment for their internal audit departments, the survey identified a negative tendency whereby C-level management of almost 42 percent of respondents does not assess the performance of the internal audit department at all.

Chart 15. Respondents' assessment of internal audit department performance checks



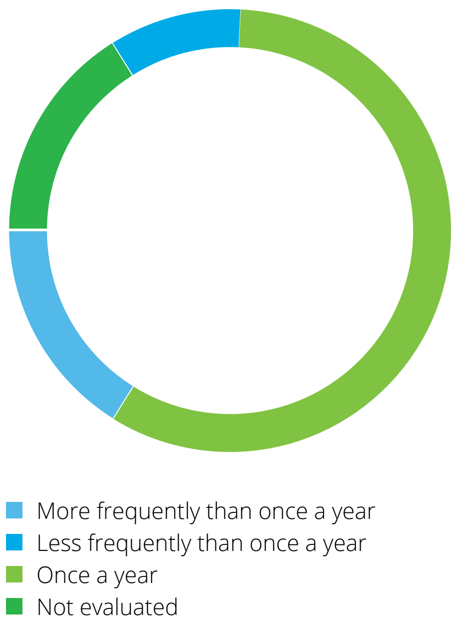
In accordance with global best practices, audit committees around the world have gained more control while interacting with both external and internal auditors in recent years. This is due to frequent live meetings between audit committee members. Our survey reveals that in about 41 percent of the companies, the audit committee meets once a year or less on a face-to-face basis.

Chart 16. Annual face-to-face meetings by the supervisory board in the surveyed companies



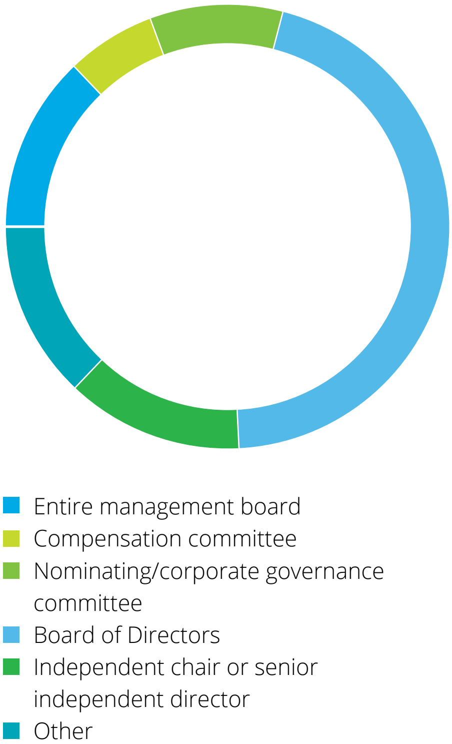
Ideally, the performance evaluation of the senior executives should be aligned with the general organisational values of the company. Though as per best practices the performance of senior executives should be evaluated at least once a year, the survey shows that each organisation takes its own attitude towards the evaluation process. Forty-two percent of companies' processes are not aligned with best practices, assessing the performance of senior executives more or less frequently than once a year, or not evaluating it at all. Our finding that sixteen percent of companies evaluate senior management more frequently than once a year also gives rise to concern and can open further discussions.

Chart 17. Evaluation of the performance of senior executives



Given that, the management board is not allowed to evaluate the CEO's performance, who has the main responsibility over the CEO performance evaluation process? Our survey reveals that in 13 percent of the companies, the entire management board evaluates the CEO's performance. This is a rather problematic result, as it does not comply with best practices. Still, 62 percent of the companies are in full alignment with best practices.

Chart 18. Key responsible bodies in performance evaluation for CEOs



For any company, social media is an important tool for learning about emerging trends. However, it has significant drawbacks when clear policies and procedures have not been established. Half of those surveyed (52 percent) stated that their organisation's social media guidelines (guidelines which inform employees of the company's expectations as regards their behaviour on social media, i.e. Facebook, LinkedIn, etc.) include protection of confidential and proprietary information. Less than 50 percent of respondents said that the use of sensitive information is the most important issue for their company.

Chart 19. Social media guidelines (guidelines that inform employees of the company's expectations as regards their behavior on social media, i.e. Facebook, LinkedIn, etc.)

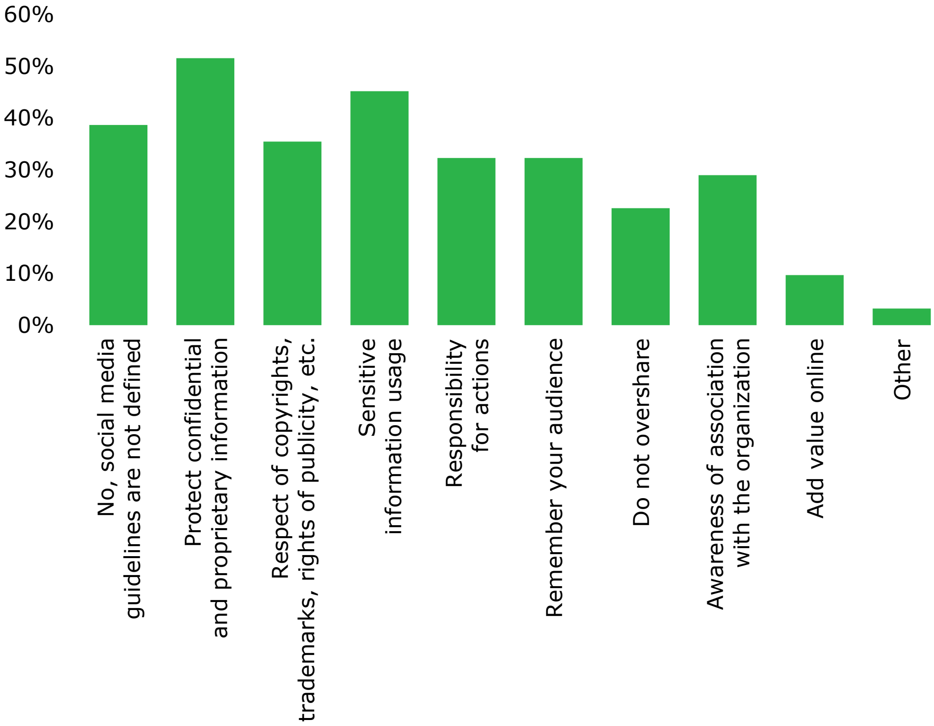
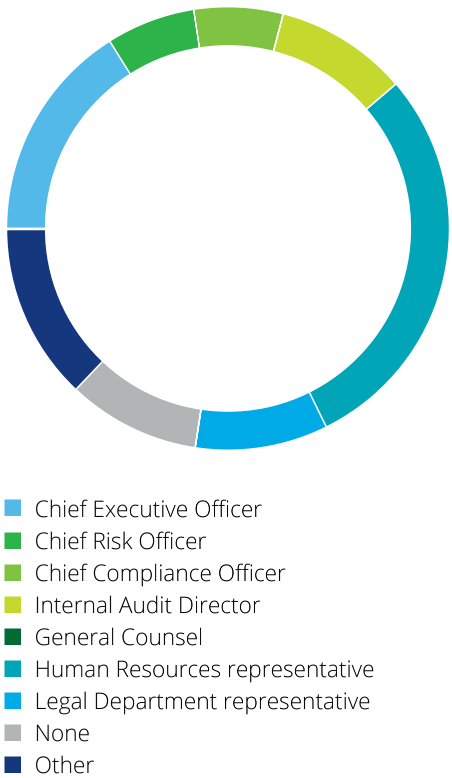


Chart 20. Bodies responsible for reporting ethics and compliance matters to the board



In 29 percent of the companies, the human resources department is responsible for reporting ethics and compliance matters to the supervisory board, which is not in line with best practice. Another deficiency in compliance with best practice is our finding that the responsibility of the chief compliance officer in the majority of the companies is diminished, with only 6.6 percent of them being responsible for reporting ethics and compliance matters to the supervisory board.

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1. "Ilham Aliyev received delegation of American Chamber of Commerce in Azerbaijan". President's speech published on the official website of the President of the Republic of Azerbaijan, 12 April 2016. http://en.president.az/articles/19272

2. The Civil Code of the Azerbaijan Republic, (approved by Law of the Republic of Azerbaijan No. 779-IG of December 28 1999) (brought into effect on 26 May 2000 in accordance with Law of the Republic of Azerbaijan No. 886-IG of 1 September 2000). Retrieved from: http://www.azpromo.az/uploads/legislation/Civil_code_eng_51b1e34e863c1.pdf

3. Corporate Governance standards in Azerbaijan adopted by Ministry of Economics, 2011: http://www.economy.gov.az/index.php?option=com_content&view=article&id=98&Itemid=142&lang=az

4. Item 12-1.1, Article 12 of the Decision On approval of Corporate Governance Standards of the Central Bank of the Republic of Azerbaijan: http://en.cbar.az/assets/196/Corporate_Governance_Standards_in_Banks.pdf

5. Item 3.4, Article 91 of the Civil Code of the Republic of Azerbaijan: http://e-qanun.az/framework/13241

6. Law of the Republic of Azerbaijan No. 332-IIIQ "On Internal Audit" of 22 May 2007. Retrieved from: http://e-qanun.az/framework/13241

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Acknowledgements

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