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ASSESSMENT OF INVESTMENT SECTOR ECONOMIC GOVERNANCE IN GEORGIA

RECOMMENDATIONS FOR EPI SUPPORT

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Name of Component: *Business Enabling Environment*

Author(s)*: Sheri Pitigala*

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ABSTRACT

Attracting investment is one of Georgia's key priorities to promote sustainable economic development. Despite carrying out reforms to reduce burdens on business, as reflected in Georgia's extraordinarily high ranking in the World Bank's Doing Business Index for 2011, its scoring in the World Economic Forum's (WEF) Global Competitiveness Index reflects an environment of pessimism and uncertainty among investors as they express concern about a variety of topics, such as protection of property rights, investor rights, accounting and audit standards, and corporate governance. The elimination of remaining policy barriers to implement a world-class investment environment in Georgia—one that ensures a level playing field and improves investor protections—would enhance Georgia's competitive positioning to attract value-added investment and promote sustainable job creation. Investor confidence would be enhanced by strengthening dispute resolution and enforcement mechanisms related to investor rights, including tax-related concerns. There is also need to enhance legislation that sets corporate governance, and accounting and auditing standards to strengthen business practices in Georgia, improve the ability of companies to access finance, and attract foreign partners.

ABBREVIATIONS

ACCA	Association of Chartered Certified Accountants
ADR	Alternative Dispute Resolution
CFRA	Council of Financial Reporting and Audit
DC-FTA	Deep and Comprehensive Free Trade Area
EPI	Economic Prosperity Initiative
EU	European Union
FDI	Foreign Direct Investment
GAAP	Generally Accepted Accounting Principles
GEL	Georgian Lari
GEPLAC	Georgian-European Policy and Legal Advice Center
GFPAA	Georgian Federation of Professional Accountants and Auditors
GNCG	Georgian National Communications Commission
GNEWSRC	Georgian National Energy and Water Supply Regulatory Commission
GNIA	Georgian National Investment Agency
GoG	Government of Georgia
IAASB	International Auditing and Assurance Standards Board
IASB	International Accounting Standards Board
ICC	International Chamber of Commerce
ICSID	International Center for Settlement of Investment Disputes

IFAC	International Federation of Accountants
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
ISAs	International Standards on Auditing
ISQC	International Standards on Quality Control
LCIA	London Court of International Arbitration
MFN	Most Favored Nation
NBG	National Bank of Georgia
NSC	National Securities Commission
OECD	Organization for Economic Cooperation and Development
OSCE	Organization for Security and Cooperation in Europe
PCA	Permanent Court of Arbitration
ROSC	Report on the Observance of Standards and Codes
SCC	Stockholm Chamber of Commerce
SIDA	Swedish International Development Authority
SME	Small and Medium Enterprise
UK	United Kingdom
UNCITRAL	United Nations Commission on International Trade Law
USAID	United States Agency for International Development
WEF	World Economic Forum

WTO	World Trade Organization

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INTRODUCTION

Attracting investment is one of Georgia's key priorities to promote sustainable economic development. The objective of this study is to identify investment sector economic governance issues and opportunities where the USAID Economic Prosperity Initiative (EPI) can apply technical assistance and capacity building to significantly improve Georgia's ability to attract domestic and international investment. The study assesses the current framework for investment sector economic governance in Georgia against international best practices, including the treatment of foreign investors and investor rights and guarantees, corporate governance, accounting and audit standards, and alternative dispute resolution.

FINDINGS AND RECOMMENDATIONS

The Government of Georgia (GoG) has carried out significant reforms to improve the investment environment, as reflected in Georgia's extraordinarily high ranking, 12th out of 183 countries, in the World Bank's Doing Business Index for 2011 (World Bank and International Finance Corporation, 2010). The elimination of remaining policy barriers to implement a world-class investment environment in Georgia—one that ensures a level playing field and improves investor protections—would enhance Georgia's competitive positioning to attract value-added investment and promote sustainable job creation.

The table below provides an overview of the key strengths and weaknesses in Georgia's investment policy environment compared to international best practices.

Benchmarking Georgia's Investment Sector Economic Governance

International Best Practices	Georgian Practices
Open investment regime that provides full breadth of protections and guarantees for investors	Existing legislation provides for a relatively open regime with many of the protections and guarantees necessary to promote an investor-friendly environment. Critical weaknesses include lack of commitment to international dispute resolution and lack of adequate protections against expropriation.
Strong corporate governance, with adequate protection of minority shareholder rights	Basic shareholder rights and disclosure requirements are in place, however minority shareholder rights are severely curtailed by a squeeze-out clause and financial reporting is not adequately enforced. There is also a lack of adequate provisions related to the roles and responsibilities of the Board of Directors.
Accounting and auditing standards aligned with international standards (IFRS and ISAs)	Georgia has adopted both IFRS and ISAs, but requires compliance by non public interest entities, which imposes a substantial burden on SMEs. Also, professional standards are

	inadequately regulated. As expected, compliance is relatively low and the quality of financial reporting is low.
Access to alternative dispute resolution with court enforcement	Arbitration law aligned with international best practices, but evidence of poor implementation and awareness by the private sector.

Based on these strengths and weaknesses, the study has identified potential areas of future reform for the GoG:

- **FDI and Investor Rights and Guarantees.** A working group at a Parliamentary Committee has recently been established to streamline and update Georgia's investment legislation, including the Law on Promotion of Investment Activities and Guarantees, as well as two related laws, the Law on Georgian National Investment Agency (GNIA) and the Law on State Support of Investments. While existing protections and guarantees are largely aligned with international practices, future reforms should consider: (1) strengthening provisions related to dispute settlement to guarantee State commitment to international arbitration, irrespective of individual investment contracts and treaties; (2) providing clear criteria for expropriation and compensation; and (3) create a more level playing field by extending an explicit guarantee of fair and equitable treatment to foreign investors, as well as Most-Favored Nation (MFN) treatment.

- **Corporate Governance.** The legal framework for corporate governance in Georgia is governed by the Law on Securities Markets (1998, as amended) for listed companies and the Law on Entrepreneurs (1994, as amended) for all legal entities. Both pieces of legislation have been amended over time to strengthen various aspects of the corporate governance framework, though a number of key aspects of the legal framework for corporate governance remain weak in Georgia, particularly those related to the protection of minority shareholder rights and weak enforcement. The GoG should consider the removal of the squeeze-out clause in the Law on Entrepreneurs that was introduced in 1997 in order to strengthen minority shareholder rights and to strengthen monitoring and enforcement mechanisms for corporate governance provisions under the law. Also, while the National Bank of Georgia (NBG) has established powers to sanction listed companies in violation of legally-established corporate governance principles in the Securities Market Law, there is a need to build capacity within the NBG for it to better monitor and enforce provisions under the law.

- **Accounting and Auditing Standards.** Georgia's accounting and auditing standards are governed by the Law on the Regulation of Accounting and Financial Reporting (1999, as amended) and the Law on Auditing (1999, as amended). While the current legislation has adopted both the IFRS and ISAs for mandatory financial reporting and auditing in Georgia, a number of weaknesses in the legal framework remain, including outdated standards, the application of inappropriate standards for small and medium enterprises, weak professional standards, and inadequate enforcement of and compliance with accounting and auditing standards. Beyond the legal provisions, there is also evidence of gaps in the capacity of the private sector to adopt these standards and of the public sector to effectively monitor and enforce the use of these standards.

These weaknesses negatively impact the investment environment in Georgia. Low compliance by listed companies also hampers the growth of the capital market, while reduced transparency further weakens corporate governance and the rights of shareholders. The lack of compliance also affects local enterprises' ability to gain access to finance and to attract potential foreign investors interested in joint ventures or other sensitive transactions. Given the low level of confidence in quality of financial statements, banks base lending decisions on other criteria—such as amount of collateral, business forecasts and other information—which likely increases systemic risk, raises interest rates and reduces access to finance by SMEs.

There is an urgent need to address the weaknesses in the current legislation and to improve the compliance gap through proper regulation and training. The accounting sector, with the support of the GFPAA and the Asian Development Bank, have conducted a comprehensive review of the relevant legislation and have drafted new legislation to address many of these weaknesses. The adoption of such provisions in revised legislation is critical to promote good accounting and auditing practices that promotes the confidence of the investment sector.

- **Alternative Dispute Resolution.** Georgia's legal framework governing private ADR proceedings has been largely aligned with international practices, with the exception of international arbitration between an investor and the State. The Law on Arbitration (2009) brought the Georgian framework, by and large, in alignment with the UNCITRAL Model Law on International Commercial Arbitration, correcting many of the gaps in previous legislation. While Georgia's legal framework is aligned with international practices, it is evident from discussions with the private sector and legal professionals that there remains a gap in the understanding of ADR rights and obligations under the Arbitration Law. A targeted public awareness campaign, coupled, perhaps, with support to the private sector to establish a framework code of ethics or the like for professional arbitrators would substantially improve the performance of ADR in Georgia.

PROPOSED EPI WORK PLAN INTERVENTIONS

In order to assist the GoG to address the weaknesses in investment sector economic governance, it is proposed that EPI undertake a number of interventions. The table below provides a summary of these actions.

Proposed EPI Work Plan Interventions

Action Name	Action Type(s)*	Resources Required
Develop revised set of investment laws	STTA	Expat commercial lawyer, expat economist, local commercial lawyer
Develop Corporate Governance Code of Ethics for non-banking sectors	STTA	Expat expert in corporate governance
Conduct corporate governance workshops with EPI supported sectors	STTA, Event (T)	Expat expert in corporate governance, local expert in corporate governance
Strengthen NBG's capacity to monitor and enforce	STTA	Expat expert in corporate

financial reporting		governance, local expert in corporate governance
Finalize draft Accounting and Auditing Law	STTA	Expat or local expert in accounting and auditing
Conduct PPD on Accounting and Auditing Standards	STTA, Event (T)	Local expert in accounting and auditing
Conduct workshop on accounting and auditing for EPI supported sectors	STTA, Event (T)	Local expert in accounting and auditing
Conduct ADR workshops for private sector	STTA, Event (T)	Local expert in ADR

* Action types include:

STTA = Short-term Technical Assistance

Event (T) = Training event

Event (NT) = Non-training event (e.g. discussions, teambuilding, etc)

Proc (C) = procurement of commodities (e.g. computers)

Proc (S) = Procurement of services (e.g. a subcontract to a printer for printing services)

1. INTRODUCTION

1.1 BACKGROUND

Attracting investment is one of Georgia's key priorities to promote sustainable economic development. The Government of Georgia (GoG) has carried out significant reforms to improve the investment environment, as reflected in Georgia's extraordinarily high ranking, 12th out of 183 countries, in the World Bank's Doing Business Index for 2011 (World Bank and International Finance Corporation, 2010). Despite carrying out reforms to reduce burdens on business, Georgia remains a poor investment environment performer. Its scoring in the World Economic Forum's (WEF) Global Competitiveness Index reflects an environment of pessimism and uncertainty among investors as they express concern about a variety of topics, such as investor rights and guarantees, accounting and audit standards, and corporate governance (World Economic Forum, 2010). The elimination of remaining policy barriers to implement a world-class investment environment in Georgia—one that ensures a level playing field and improves investor protections—would enhance Georgia's competitive positioning to attract value-added investment and promote sustainable job creation.

A number of policy areas within the investment sector are in need of reform. Investor confidence would be enhanced by strengthening dispute resolution and enforcement mechanisms related to investor rights, including tax-related concerns. There is also a need to enhance legislation that sets corporate governance and accounting and auditing standards to strengthen business practices in Georgia, improve the ability of companies to access finance, and attract foreign partners.

Some recent reforms have sought to further improve the investment environment, including a revised Law on Arbitration in 2009. A working group at a Parliamentary Committee has recently been established to streamline and update Georgia's investment legislation, including the Law on Promotion of Investment Activities and Guarantees (1996, as amended), the Law on State Support of Investments (2006, as amended) and the Law on Georgian National Investment Agency (2002, as amended). The Committee recognizes that the revision of these laws needs careful examination and has sought feedback from stakeholders. In addition, various other initiatives, with the support of the donor community and stakeholder inputs, have been undertaken to draft new or amended legislation with respect corporate governance, and accounting and auditing standards. Further efforts are required to finalize this draft legislation and to initiate the parliamentary process.

1.2 OBJECTIVES

The objective of this study is to identify investment sector economic governance issues and opportunities where the USAID Economic Prosperity Initiative (EPI) can apply technical assistance and capacity building to significantly improve Georgia's ability to attract domestic and international investment. The study assesses of the current framework for investment sector economic governance in Georgia against international best practices, including the treatment of foreign investors and investor rights and guarantees, corporate governance, accounting and audit standards, and alternative dispute resolution. This assessment, while not meant to be a comprehensive treatment of each of the policy areas under review, provides an indication of key policies that need to be further reviewed in order to enhance governance in the investment sector.

This assessment looks at current and draft legislation and institutional capacity in each of these areas and draws from the well-developed literature on international best practices and principles in investment sector governance. This includes the Organization for Economic Cooperation and Development's (OECD) seminal *Policy Framework for Investment* (OECD, 2006), the World Bank Group's Investment Climate Advisory Services' *Investment Law Reform, a Handbook for Development Practitioners* (Investment Climate Advisory Services, 2010), and the Organization for Security and Cooperation in Europe (OSCE) *Best Practice Guide for a Positive Business and Investment Climate* (OSCE, 2006).

1.3 REPORT STRUCTURE

The remainder of this report is structured as follows. Chapter 2 assesses the treatment of foreign direct investment (FDI) and investor rights and guarantees. Chapter 3 covers corporate governance issues. Chapter 4 considers accounting and auditing standards. Chapter 5 takes stock of mechanisms for alternative dispute resolution. Finally, Chapter 6 concludes with recommendations for enhancing investment sector economic governance in Georgia and proposed EPI work plan interventions that could support this effort.

2. TREATMENT OF FDI AND INVESTOR RIGHTS AND GUARANTEES

2.1 INTERNATIONAL BEST PRACTICES IN TREATMENT OF FDI AND INVESTOR RIGHTS AND GUARANTEES

Investment policies reflect what governments seek from investment for the purpose of meeting national objectives—whether they are open or closed to certain categories of investment, whether they offer preferences to certain types of investors, as well as the rights and responsibilities they assigned to investors and investment. Investment laws are the legal embodiment of these concepts. Many OECD countries do not have separate investment laws—rather the rights and guarantees are provided in various separate pieces of legislation. In emerging markets, where legal regimes are in a state of evolution, investment laws are critical in that they provide in one place much of the investment policy of a country and its legal underpinning, as well as a signal that the government is welcoming of investment.

The following sections present international practices with respect to legal frameworks for foreign and domestic investors, the entry and treatment of foreign investment, and investor rights and guarantees.

2.1.1 LEGAL FRAMEWORKS FOR FOREIGN AND DOMESTIC INVESTORS

Investment legislation may cover only foreign investors or both foreign and domestic investors. In the past, many countries preferred to only address foreign investment in separate legislation as domestic investors were more familiar with the overall investment and legal environment and also did not have the same concerns as foreign investors, such as repatriation of profits, access to expatriate labor, dispute resolution, and the like. With the growth of globalization, many of these same issues are now of concern to domestic investors, as well. In some countries, the application of separate legislation has also led to the perceived or actual discrimination in favor of foreign investors. More countries are therefore moving toward the use of omnibus legislation that covers both domestic and foreign investors to provide comprehensive and consistent coverage in a single body of legislation.

2.1.2 ENTRY AND TREATMENT OF FOREIGN AND DOMESTIC INVESTMENT

The entry and treatment of investment form the core of any investment policy. As investment policy must ultimately reflect a country's development objectives, legal norms, and even cultural environment, there is no single "best practice" set of specific legal provisions, though the provisions themselves will ultimately determine the degree of openness to investment. The following present the key issues related to the entry and treatment of investment that should be addressed in any investment legislation, irrespective of the degree of openness, as well as the "specifics" that are representative of an open, liberalized investment regime that seeks to bring investment to encourage an efficient allocation of resources in a country to promote sustainable economic growth.

- **Restrictions and Prohibitions on Investment.** Few countries are completely open, allowing investment in all sectors and subsectors, and under identical conditions and procedural requirements for foreign and domestic investment. Many countries restrict entry on national security, health and safety concerns. More restrictive investment regimes prohibit or restrict investment in sectors dominated or monopolized by state-owned enterprises, such as utilities and transportation, or limit the percentage of equity that a foreign investor can own. Whichever sectors are subject to restrictions, countries take two alternative approaches in their legislation—a *negative list* that names only those sectors that are subject to restrictions and prohibitions or a *positive list* that names sectors of the economy that are open to investment (and whether they are open to domestic and/or foreign investment). A positive list is generally less attractive—such a list cannot possibly keep up with the development of new industries and, often, the treatment of the sectors or subsectors that are not on the list is ambiguous. Negative lists are typically more straightforward and, provided that they are narrowly defined and short, more attractive.

- **Authorization and Screening Requirements.** Some developing countries have a screening process that subjects foreign investment projects to host government review and formal authorization. In an open-admission system, the host country admits foreign investment without a formal screening and approval process, though a notification requirement may be in place for statistical or investor aftercare purposes. An open-admission system does not preclude a government from restricting or prohibiting foreign (or domestic) investment, per the above. Such screening is often conducted in order to determine whether a particular investment will be beneficial to the economy. However, governments are generally poorly equipped to make this determination. From the investor's perspective, screening adds to their investment costs in the form of time delays and onerous compliance requirements, and generally signals a less favorable investment environment with a high-degree of government interference in the market.

- **Minimum Investment Requirements.** A minimum investment requirement precludes smaller investments or precludes them from benefiting from the legal guarantees and/or financial incentives provided by the regime. Such restrictions may discourage smaller investments that may be beneficial to the economy in the longer run. It is not certain that an investment of, for example, USD5 million is more beneficial than five projects of USD1million each. Open investment laws should not include any minimum investment requirement in order to encourage investments of any size. The only capital requirement, if any, should be the one already mandated under the country's company act, based on the form of corporate entity to be created and should apply to both domestic and foreign investors.

- **Performance Requirements.** Performance requirements are conditions imposed on investors, requiring them to meet certain specified goals with respect to their operations, such as a certain level of exports, local content requirements, employment targets, and the like. The World Trade Organization (WTO) restricts the application of certain types of requirements, such as those applied to receive incentives for exports or those that tie investment to the purchase of local supplies. In general, performance requirements can discourage investment altogether, defeating the "development objectives" targeted by such requirements.

In short, open investment regimes treat domestic and foreign investors equitably, ensure ease of market entry and exit, enable access to inputs that investors need, and impose few restrictions on sectors in which investors can invest, how they can invest, and how much they can invest.

2.1.3 INVESTOR RIGHTS AND GUARANTEES

Investment laws, in addition to identifying the conditions under which investors may enter the market, also provide clear provisions to protect investor rights and guarantees in terms of the acquisition, management, conduct, operation, and sale or other disposition of the investment. The following provides an overview of the key concepts and best practices with respect to investor rights and guarantees.

- **Standards of Treatment.** The standards of treatment are the fundamental basis for determining the rights and guarantees of investors in their treatment under the law vis-à-vis other investors. There are a number of complementary standards that may be applied, either individually or in concert with each other:

  - *Fair and Equitable Treatment.* Fair and equitable treatment protects investors against discrimination and, where discrimination is claimed, provides due process of law. Fair and equitable treatment ensures that investors are not denied justice in criminal, civil or administrative proceedings, including before the courts—fair treatment extends form the right to bring a claim, the right to fair treatment during the proceedings and the right to an enforceable decision.

  - *National Treatment.* National treatment is closely linked to the restrictions and prohibitions that may be placed on investors—in this case, specifically foreign investors. National treatment extends the same level of treatment to both domestic and foreign investors, i.e. the restrictions identified above apply equally to foreign and domestic investors. National treatment eliminates distortions in competition and enhances the efficient operation of the economy. While no country has granted national treatment without exception, it remains the most effective standard to establish a level playing field between national and foreign investors.

  - *Most-Favored-Nation Treatment.* Related to the above is the application of the most-favored-nation (MFN) standard. Foreign investors seek sufficient assurance that there will be no discrimination that puts them at a competitive disadvantage. MFN treatment requires a host country to treat investors from a given foreign country no less favorably than investors from any other foreign country. Exceptions to MFN treatment are generally embodied in bilateral and multilateral agreements related to tax, investment and/or trade that extend preferences to or different treatment of investors from member countries.

  Open investment environments typically accord all three of the above standards in one form or another to ensure that foreign investors are treated the same as domestic investors and foreign investors from other countries and that they are afforded due process of law.

- **Convertibility and Repatriation.** The ability to repatriate profits and capital is a major concern for a foreign investor. An increasing number of investment laws recognize the principle of “freedom of transfer” applicable to foreign investments, which includes a commitment to foreign investors to guarantee convertibility into a convertible currency and repatriation.

- **Guarantees against Expropriation.** The right to expropriate or nationalize property is a sovereign right of a state, and it is perceived as one of the main political risks by all investors. Expropriation may be direct, whereby the state transfers ownership of property, or indirect, in which case the use of the property is curtailed by regulatory or other government actions, such as when governmental measures force an investor to flee the country, deny him access to his funds or profits, or compel him to sell or transfer at an unfairly low price. To attract investment, governments need to take steps to reduce such risks. This includes clear provisions as to the lawful circumstances for expropriation and/or nationalization and the terms for establishing the level of compensation to investors. Best practice is to guarantee that the government will not expropriate, nationalize or take measures that will have a similar effect, except for a public purpose (the "public good"), on a nondiscriminatory basis, with due process, and subject to the prompt payment of adequate and effective compensation.

- **Armed Conflicts and Civil Disturbances.** Similar to the case of expropriation and nationalization, some investment laws include financial guarantees against losses or non-payment arising from a country's political situation, such as conflicts and civil disturbances. While deemed to be a goodwill gesture, many investors will not feel comforted by such provisions—such conflict or strife may result in a change of regime, making such provisions moot—and obtain third-party guarantees or political risk insurance to manage such risks.

- **Settlement of Disputes.** While measures guaranteeing fair and equitable treatment are meant to ensure the fair treatment of foreign investors in host country courts, court systems in many developing countries suffer from long delays, lack of transparency, and lack of impartiality, particularly when the state is a party to the dispute. The courts of the foreign investor's home country or of third states are typically not an option because they lack territorial jurisdiction. For these reasons, alternative methods have been developed for the settlement of disputes. Alternative dispute resolution (ADR) covers a number of different mechanisms to address commercial disputes:

    - ***Arbitration***, which is the most common choice, is a process through which parties in a dispute agree to allow a neutral third party to hear evidence and make a decision. Arbitration may be *binding* or *non-binding*. When arbitration is binding, the decision is final and can be enforced by a court and can only be appealed on very narrow grounds. When arbitration is non-binding, the arbitrator's award is advisory and can be final (and enforceable) only if accepted by the parties.

    - ***Mediation***, also known as ***conciliation***, is a process by which a neutral third party assists disputants in evaluating the strengths and weaknesses of their respective positions and assists in reaching a negotiated agreement among the parties. Mediation tends to be more interest-based, rather than rights-based, focusing on motivations and interests. The parties retain ultimate control of the decision to settle the terms of resolution. The role of the mediator is to facilitate the process by helping the parties to evaluate their respective positions, explore consequences of not settling and generating settlement options.

Several institutions and systems are available for undertaking international arbitration proceedings, including the Convention on the Settlement of Investment Disputes (ICSID) for disputes between states and nationals of other states, United Nations Commission on International (UNCITRAL) trade law rules, the London Court of International Arbitration (LCIA), Stockholm Chamber of Commerce (SCC), the International Court of Arbitration within the International Chamber of Commerce (ICC), and Permanent Court of Arbitration (PCA).

International investment arbitration is always based on an agreement. Such consent may be given through different channels, including through membership to multilateral compacts (such as ICSID or the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards), an investment contract between the state and investor, an investment treaty between the host and home country governments, and, finally, through an investment law. While individual contracts and treaties may extend benefits to some potential investors, the provision of clear provisions in an investment law provides broader coverage and promotes greater investor confidence.

2.2 ASSESSMENT OF GEORGIAN POLICIES GOVERNING TREATMENT OF FDI AND INVESTOR RIGHTS AND GUARANTEES

The Law on Promotion of Investment Activities and Guarantees governs investor rights and guarantees in Georgia, and applies to both foreign and domestic investors, though some specific provisions only cover foreign investors, such as repatriation of capital and profits.

A working group at a Parliamentary Committee has recently been established to streamline and update Georgia's investment legislation, including the Law on Promotion of Investment Activities and Guarantees, as well as two related laws, the Law on Georgian National Investment Agency (GNIA) and the Law on State Support of Investments. The latter laws provide the framework for promoting investment through GNIA and associated incentives. The EPI program, under a separate scope of work, is currently undertaking an assessment of investment promotion in Georgia and is recommending a strategy for reform, which may also inform the revision of the related legislation.

In terms of investor rights and guarantees, the current Law on Promotion of Investment Activities and Guarantees is aligned with many of the key best practice concepts—most sectors are open, except those related to national security or health and safety, no minimum capital or performance requirements are imposed, and foreign investors are granted national treatment and may repatriate profits and capital (see Table 1).

Table 1: Benchmarking Georgian Policies Governing Treatment of FDI and Investor Rights and Guarantees against International Best Practices

International Best Practices	Georgian Practices
Restrictions and prohibitions on foreign ownership are limited to national, health and safety concerns, and are clearly articulated in a negative list	Most sectors are open to foreign investment, except those related to national security and/or health and safety. A negative list approach is applied, with various degrees of restriction.
No authorization or screening requirements are imposed	None imposed.
No minimum investment requirement is imposed	None required.
No performance requirements are imposed	None required.
Fair and equitable treatment is granted	No provisions.
National treatment is granted	Article 3 provides national treatment to foreign investors
MFN treatment is granted	No provisions.
Convertibility and repatriation freely permitted	Article 3 provides for full convertibility and repatriation, net of taxes due
Guarantees against expropriation provide for clear standard for compensation	Articles 7 and 8 address expropriation in cases directly identified in the Law, by court ruling or in case of an emergency under Georgia's organic law. Required compensation is defined as "appropriate" in Article 7, but appears to be re-defined in Article 8 as "fair market value".
In event of armed conflicts and civil disturbances, clear standard for compensation is provided	Under Article 14, foreign investors are entitled to terms of compensation not worse than the domestic investor.
Settlement of disputes allows for international arbitration	Under Article 16, arbitration is only permitted in cases covered by contract or under Georgia's international agreements. All other cases are subject to the court of Georgia and are not subject to appeal.

The law, however, falls short in a number of important areas, weakening the rights and guarantees of investors and raising the overall risk profile of Georgia as an investment destination. The most critical of these include:

- **Treatment of Foreign Investors.** While the law provides for national treatment, it provides for neither specific provisions for fair and equitable treatment nor MFN treatment. While "national treatment" may be interpreted to implicitly encompass all three guarantees, the investment climate would be further strengthened by separate provisions that explicit address fair and equitable treatment and MFN treatment to reduce any ambiguities in the law and strengthen the protections for investors.

- **Guarantees against Expropriation.** The law addresses expropriation in cases directly identified in the Law, by court ruling or in case of an emergency under Georgia's organic law. Required compensation is defined as "appropriate" in Article 7, but appears to be re-defined in Article 8 as "fair market value". The law also appears to limit the appeals process, particularly when read together with the provisions on dispute settlement with the State of Georgia (see below). These provisions should be more clearly articulated to strengthen protections against expropriation and the due process in case of a dispute.

- **Dispute Settlement.** The law provides for ADR in the event of a dispute between a foreign and domestic investors, but curtails it in the event of a dispute between a foreign investor and the GoG. While Georgia is a member of the ICSID Convention and many of Georgia's 32 existing bilateral investment treaties[1] include provisions for international dispute resolution, the lack of a blanket guarantee for all foreign investors, irrespective of their country of origin, substantially weakens the level of protection for investors and increases the political risk associated with any investment in Georgia. The provision of a blanket guarantee must be backed by efforts to ensure that such provisions are fully respected and that international ADR awards are respected and enforced. This issue is particularly important at this time in Georgia when a number of cases have been brought before international ADR tribunals, primarily stemming from disputes that were initiated under the previous regime. The media attention associated with recent cases can deter future investors. It is also evident from discussions that the GoG lacks the necessary capacity to effectively engage in international ADR proceedings.

Initial discussions with the Parliamentary Committee's team working on the revisions to the investment legislation indicated that they are interested in getting a better understanding of international practices on investment legislation and recommendations from EPI on how best to incorporate them into the Georgian legal framework. Given the sensitivity of some of the above issues—particularly alternative dispute resolution and the future mandate and institutional arrangements for GNIA—it is likely that broader efforts will be required to build consensus on the optimal investment law framework that will meet Georgia's economic development objectives and improve overall governance.

[1] The Government of Georgia has entered into bilateral investment treaties with 32 countries, including Armenia, Austria, Azerbaijan, Belgium, Luxemburg, Bulgaria, China, Czech Republic, Egypt, Estonia, Finland, France, Germany, Greece, Iran, Israel, Italy, Kazakhstan, Kyrgyzstan, Kuwait, Latvia, Lithuania, Moldova, Netherlands, Romania, Sweden, Turkey, Turkmenistan, Ukraine, United Kingdom, United States and Uzbekistan.

3. CORPORATE GOVERNANCE

3.1 INTERNATIONAL BEST PRACTICES IN CORPORATE GOVERNANCE

Corporate governance is a critical factor in promoting a stable and predictable environment for investment and economic development. The degree to which corporations adopt good corporate governance is an important factor for investment decisions, whether in the form of FDI or domestic investment or financing. If countries are to attract long-term "patient" capital, the corporate governance framework must be credible, well understood across borders and adhere to international principles. Good corporate governance practices will also help to improve the confidence of domestic investors, reduce the cost of capital, provide a solid foundation for the functioning of financial markets, and induce more stable sources of financing.

The OECD has developed a core set of corporate governance principles (OECD, 2004), which provides a best practice approach to developing an effective corporate governance framework. The World Bank also uses the OECD Principles as the basis for periodic country corporate governance reviews that have been carried out in more than 48 developing countries, known as Reports on Observance of Standards and Codes (ROSCs).

The following sections summarize the key elements of the six core corporate governance principles identified by the OECD.

3.1.1 BASIS FOR AN EFFECTIVE CORPORATE GOVERNANCE FRAMEWORK

To ensure an effective corporate governance framework, an appropriate and effective legal, regulatory and institutional foundation must be established to provide a basis for private contractual relations. A corporate governance framework typically comprises elements of legislation, regulation, self-regulatory arrangements, voluntary commitments and business practices—the most desirable mix will vary from country to country. It is, however, important to note that while voluntary codes and standards can play an important role in the overall framework, in the absence of effective legal mechanisms to support compliance, voluntary codes may leave shareholders with uncertainty as to their status and implementation.

Corporate governance is typically influenced by an array of legal domains, such as company law, securities regulation, accounting and auditing standards, bankruptcy law, contract law, labor law and tax law. Given the potential for overlaps and/or contradictions, it is critical that the various laws and regulations are clearly defined, in terms of the principles themselves, as well as oversight and enforcement mechanisms.

3.1.2 RIGHTS OF SHAREHOLDERS AND KEY OWNERSHIP FUNCTIONS

The corporate governance framework should protect and facilitate the exercise of shareholders' rights. As a practical matter, a corporation cannot be managed by shareholder referendum as a corporation's management must be able to take business decisions rapidly. The responsibility for corporate strategy and operations is typically placed in the hands of a board of directors and a management team that is selected, motivated and, when necessary, replaced by the board.

Shareholders' rights to influence a corporation typically focus, instead, on fundamental issues, such as the election of board members, amendments to the company's organic documents, issuance of additional shares, approval of extraordinary transactions, and other basic issues as specified in company law and/or internal company statutes. Additional rights such as the approval or election of auditors, direct nomination of board members, the ability to pledge shares, and the approval of distributions of profits are also covered in many jurisdictions.

Shareholder rights should also include basic rights to secure methods of ownership registration, convey or transfer shares, obtain relevant and material information on the corporation on a timely and regular basis, participate and vote in general shareholder meetings, and share in the profits of the corporation. Capital structures and arrangements that enable certain shareholders to obtain a degree of control disproportionate to their equity ownership should be disclosed.

In addition to the above, rules and procedures should be in place to govern the acquisition of corporate control in the capital markets. Extraordinary transactions such as mergers, and sales of substantial portions of corporate assets, should be clearly articulated and disclosed so that investors understand their rights and recourse. Transactions should occur at transparent prices and under fair conditions that protect the rights of all shareholders according to their class.

3.1.3 EQUITABLE TREATMENT OF SHAREHOLDERS

The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain compensation for violation of their rights. Equitable treatment can also be enhanced through clear provisions prohibiting insider trading and abusive self-dealing.

The confidence of minority investors is enhanced when the legal framework provides mechanisms for minority shareholders to bring lawsuits when they have reasonable grounds to believe that their rights have been violated. In countries where enforcement mechanisms are weak—for example, if there are large delays in the court system—stronger minority shareholder rights may need to be legislated, such as requiring a supermajority for certain shareholder decisions.

3.1.4 ROLE OF STAKEHOLDERS IN CORPORATE GOVERNANCE

Contributions of stakeholders—investors, employees, creditors, and suppliers—constitute a valuable resource for building competitive and profitable companies. It is, therefore, in the interest of corporations to foster wealth-creating cooperation among stakeholders. In all OECD countries, the rights of stakeholders are established by law (e.g. labor, business, commercial, and insolvency laws) or by contractual relations. This includes the rights of creditors in the event of bankruptcy and the rights of employees that report unethical or illegal business practices to a corporate board or regulator. In areas where stakeholder interests are not legislated, many firms make additional commitments to stakeholders.

3.1.5 DISCLOSURE AND TRANSPARENCY

A strong disclosure regime that promotes real transparency is critical to shareholders' ability to exercise their ownership rights on an informed basis. The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company. Public disclosure is typically required, at a minimum, on an annual basis for listed companies, though some countries require periodic disclosure on a semi-annual or quarterly basis, or even more frequently in the case of material developments affecting the company.

Disclosure should include, at a minimum, material information on the financial and operating results of the company; company objectives; major share ownership and voting rights; remuneration policy for members of the board and key executives; information about board members, including their qualifications, the selection process, other company directorships; related party transactions; foreseeable risk factors; issues regarding employees and other stakeholders; and governance structures and policies. Information should be prepared and disclosed in accordance with established standards for accounting, auditing and financial and non-financial disclosure.

3.1.6 RESPONSIBILITIES OF THE BOARD

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders. The board should fulfill certain key functions, including:

- Reviewing and guiding corporate strategy, risk policy, annual budgets and business plans, as well as setting and monitoring performance objectives and overseeing major capital expenditures, acquisitions and divestitures;
- Monitoring the effectiveness of the company's governance practices;
- Selecting, compensating, monitoring and replacing key executives and overseeing succession planning;
- Aligning key executive and board remuneration with the longer term interests of the company and its shareholders;
- Ensuring a formal and transparent board nomination and election process;
- Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions;
- Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit; and
- Overseeing the process of disclosure and communications.

3.2 ASSESSMENT OF GEORGIAN POLICIES ON CORPORATE GOVERNANCE

The legal framework for corporate governance in Georgia is governed by the Law on Securities Markets (1998, as amended) for listed companies and the Law on Entrepreneurs (1994, as amended) for all legal entities. Both pieces of legislation have been amended over time to strengthen various aspects of the corporate governance framework, though a number of key aspects of the legal framework for corporate governance remain weak in Georgia.

The most notable weaknesses are the lack of effective protection of minority shareholder rights and weak enforcement:

- **Minority shareholder rights curtailed by squeeze out clause.** An amendment to the Law on Entrepreneurs in 1997 introduced a "squeeze out" clause, whereby a shareholder with 95 percent or more of the shares of a company can forcibly buy out the remaining minority shareholders at a "fair price", to be determined by the courts. While a few other countries—most notably, Germany—provide similar squeeze out clauses and while such provisions are meant to protect majority shareholders against excessive disruptions by minority shareholders and to reduce the costs associated, for example, for calling general meetings of shareholders, the cost to minority shareholder rights is high. This is particularly sensitive in Georgia where privatization led to a large number of minority shareholders with little or no understanding of their rights. Also, given the still nascent state of the Georgian stock market, relative to the German market, there is no effective means to determine the fair value of shares.

- **Lack of effective enforcement mechanisms.** While the National Bank of Georgia (NBG) has established powers to sanction listed companies in violation of legally-established corporate governance principles in the Securities Market Law, there is no effective enforcement for non-listed companies. While the Law on Entrepreneurs sets out many provisions for corporate governance, there are large gaps—for example, no clear powers of the Board of Directors—and also no effective monitoring and enforcement mechanisms. Moreover, surveys by the International Finance Corporation (IFC) indicate that there is a significant compliance gap (International Finance Corporation, 2008).

Table 2: Benchmarking Georgian Policies Governing Corporate Governance

International Best Practices	Georgian Practices
Rights of shareholders clearly articulated including, at a minimum, election of board members, amendments to the company's organic documents, issuance of additional shares, approval of extraordinary transactions, rights to secure methods of ownership registration, convey or transfer shares, obtain relevant and material information on the corporation on a timely and regular basis, participate and vote in general shareholder meetings, and share in the profits of the corporation.	Law on Entrepreneurs covers most shareholder rights, including proper notification of meetings, right to participate and vote in general shareholder meetings, proxy votes, but falls short of listing all the key rights
Minority shareholder rights to equitable treatment	Law on Entrepreneurs includes provisions to protect partners against abuses by major partners. A squeeze out clause allows forced buy-outs by 95% shareholders.
Clear provisions prohibiting insider trading and abusive self-dealing	Securities law has provisions on disclosure of conflicts of interest and insider trading.
Ensure timely and accurate disclosure on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company	Under Law on Entrepreneurs, each partner has the right to obtain the copy of the annual report and all publications of the company. Law on Entrepreneurs sets out requirements for disclosure by joint stock companies as well as registration of shares. Under Securities Market Law, listed companies

	are mandated to submit to the NBG, publish or furnish to registered owners of securities an annual report, a semi-annual report, and a current report (in case of a material event). The NBG also requires notification of significant acquisitions (but not defined).
Clearly defined responsibilities of the Board, including monitoring of management and accountability to shareholders	Joint stock companies are managed under compulsory two tier-system (director/board of directors and supervisory board). The management is appointed by the supervisory board and the supervisory board by the shareholders' meeting. Responsibilities of Boards are not articulated in the law but are part of the company charter.
Legal framework that provides for transparency and enforcement of key legal provisions (e.g. equitable treatment and minority shareholder rights, disclosures and transparency, etc.)	Securities Law grants NBG regulatory authority, including enforcement, and allows NBG to attend shareholder meetings as an observer. The NBG cannot, however, intervene on behalf of a shareholder in a corporate dispute.

In 2007, the IFC launched the Georgia Corporate Governance Project, a three-year initiative, which recently closed in January 2011, aimed at improving the corporate governance practices of Georgian companies and banks. The IFC worked directly on draft amendments to the Law on Entrepreneurs in order to strengthen the corporate governance related provisions. However, the IFC gained little traction in pushing reforms through as they were not deemed to be a high priority by the GoG.

In order to bridge the gaps in corporate governance in Georgia, and the lack of political commitment to date to make the necessary legal changes, the IFC has worked closely with the private sector to promote the voluntary adoption of corporate governance principles. The IFC worked with the Association of Banks in Georgia to develop a voluntary code of ethics which has now been adopted by the majority of member banks. The IFC has also developed corporate governance manuals for use by banks and other companies in Georgia. With the close of the IFC program, there is an opportunity to expand the IFC's pilot initiative to other sectors of the economy, including those that will be supported by EPI through its value chain work. Building momentum within the private sector to adopt and implement best practice corporate governance standards, that go beyond the extent of the current legislation would not only improve the management of private sector companies in Georgia, but would also demonstrate to the GoG the importance of good corporate governance and the need for further legislative reform. Another avenue may be to work with the NBG to better promote corporate governance and to strengthen monitoring and evaluation of the listed companies under its purview, given its established legal powers in this area.

4. ACCOUNTING AND AUDITING STANDARDS

4.1 INTERNATIONAL BEST PRACTICES ON ACCOUNTING AND AUDITING STANDARDS

A corporation can be viewed as a nexus of contracts designed to minimize contracting costs (Coase, 1937). Parties contracting with the firm desire information both about the firm's ability to satisfy the terms of contract and the firm's ultimate compliance with its contractual obligations. Financial accounting information provides an important quantitative representation of individual corporations that supports a wide range of contractual relationships. The quality of financial disclosure can impact firms and their shareholders, as well as influence the cost of capital:

- **Promote efficient allocation of resources.** First, financial accounting information of firms and their competitors aid managers and investors in identifying and evaluating investment opportunities. The absence of reliable and accessible information in an economy impedes the flow of human and financial capital toward sectors that are expected to have high returns and away from sectors with poor prospects. A strong financial accounting regime, characterized by credibility and accountability, is a prerequisite to the development of a vibrant investment market.

- **Enhance governance.** A second channel through which financial accounting information enhances economic performance is its governance role. The identification of investment opportunities is necessary, but not sufficient to ensure efficient allocation of resources. Objective, verifiable accounting information facilitates shareholder monitoring and the effective exercise of shareholder rights; and enables directors to enhance shareholder value by advising, ratifying, and policing managerial decisions and activities.

- **Reduce risk.** A third channel through which financial accounting information enhances economic performance is by reducing risk. The liquidity of a company's assets impacts the firm's cost of capital. Firms' timely disclosure of high quality financial accounting information reduces investors' (or lenders') risk of loss, thereby attracting more funds into capital markets and/or increasing access to finance.

There are, therefore, strong connections between the issues of corporate reporting, auditing, corporate governance and the professionalism of accountants. A regulatory structure which recognizes these connections is more likely to be effective than one which does not. The most important principle is that a well-informed market is the best regulator. The regulation of accounting and auditing cannot be considered in isolation but needs to be seen in the context of the environment in which companies operate and the entire reporting process.

Legislation related to auditing and accounting plays two important roles in shaping the investment environment. First, laws often specify the main criteria for preparing financial reports (e.g., to provide a true and fair view). Second, they designate responsibility for administering the law to a government agency empowered to formulate rules it considers necessary to achieve the legislation's aims.

Depending on the particular regulatory intent, different government agencies may take charge of formulating specific financial reporting requirements: company registrars for corporate governance aims; securities regulators for capital market-related aims; and taxation authorities for tax objectives. In addition, various private sector organizations, including professional accounting bodies and stock exchanges, may also be involved in realizing the regulatory aims.

4.1.1 CONVERGENCE OF ACCOUNTING STANDARDS

The intent of accounting standards harmonization or convergence is to allow investors from any country to be able to interpret and compare financial information produced and disseminated by any business enterprise from any country. As a result of the growing globalization of financial markets and foreign investment into emerging markets, the enforcement of accounting standards can protect both domestic and international investors.

There are a number of accounting standards in use worldwide, some country-specific such as the US Generally Accepted Accounting Principles (GAAP), and others are global, such as the International Financial Reporting Standards (IFRS), set by the International Accounting Standards Board (IASB), which superseded the International Accounting Standards in 2001. The World Bank uses the IFRS as the basis for periodic ROSC reviews of country adoption and compliance with international accounting standards. The IFRS is, increasingly, the standard of choice for the regulation of listed companies. According to the IFRS website, approximately 120 nations and reporting jurisdictions permit or require IFRS for domestic listed companies, and approximately 90 countries have fully conformed with IFRS as promulgated by the IASB while others have converged with national standards largely based on the IFRS. Several other countries are expected to transition to IFRS in the next few years, including Canada, Korea, Mexico and Japan.

The full IFRS is largely designed for usage by “public interest entities”. Public interest entities are defined as entities which are of significant public interest because of their business, their size, their number of employees or because their corporate status is such that they have a wide range of stakeholders. Examples of such entities might include credit institutions, insurance companies, investment firms, pension firms and listed companies. Due to its complexity, its use by small and medium enterprises (SMEs) is generally limited. The IASB has therefore recently issued a separate version of the IFRS designed specifically for the needs of SMEs, which focus more on providing financial statements to enable the assessment of shorter-term cash flows, liquidity and solvency.

4.1.2 CONVERGENCE OF AUDITING STANDARDS

The development of international audit regulation is closely linked to the development of international accounting regulation. Audit regulation is centrally concerned with the issue of ensuring that auditors are *competent* and *independent*. These attributes ensure that auditors are capable of both detecting significant errors and omissions in financial status (*competent*), and faithfully reporting these to investors/stakeholders in the enterprise (*independent*).

The development of international audit regulation is connected to the growing significance of international investors who demand financial reports that are prepared and audited in accordance with globally accepted international standards. Global interest in audit regulation grew in response to the financial reporting scandals one decade ago (Enron, Worldcom and others), which were largely traced back to big audit failures. In July 2002, the passing of the Sarbanes-Oxley Act replaced the self-regulation of the US auditing profession with a system of independent inspection by the Public Company Accounting Oversight Board. Similar initiatives have followed in other countries, and there is a whole new international emphasis on auditor oversight as an essential feature of audit regulation. Convergence of audit regulations has become a high priority as world financial markets have continued to become global.

The International Auditing and Assurance Standards Board (IAASB) sets standards related to the auditing practice, which are embodied in the International Standards on Auditing (ISAs). The World Bank uses the ISAs as the basis for periodic ROSC reviews of country adoption and compliance with international auditing standards. The IAASB also publishes the International Standard on Quality Control (ISQC) that sets the standards for the auditing profession, itself, as well as a Code of Ethics. The ISAs have been adopted in 72 countries, while another 54 countries have largely aligned their national standards with the ISA.

4.1.3 IMPLEMENTATION OF ACCOUNTING AND AUDITING STANDARDS

While there is no single model that can be set forth as “best practice”, there are a number of key principles that any legislation and regulatory bodies should seek to address:

- Types of companies that should be required (and those that are permitted) to implement the IFRS (primarily public interest entities in the case of the full IFRS and the SME version for others of a minimum size), with flexibility to accommodate revised and/or newly issued standards;
- Types of companies that are subject to external audit and the application of the ISAs;
- Designated government body or bodies responsible for regulating implementation of accounting and auditing standards by companies under their jurisdiction, such as securities exchange commissions, banking and insurance supervisory authorities, stock exchanges and capital market authorities;
- Defined role for the private sector, through International Federation of Accountants (IFAC) member bodies,[2] in translating and publishing standards, training and certification;
- Mechanisms for public oversight of the audit function, including the setting of auditing standards and the assurance of audit quality;
- Institutionalized incentives for the rigorous application of international accounting and auditing standards, both positive and deterrent, with the latter achieved through appropriate monitoring and enforcement; and
- Professional licensing and/or certification of professional accountants and auditors, allowing for the regulation of the most common, internationally-accepted certification programs and qualifications.

4.2 ASSESSMENT OF GEORGIAN POLICIES ON ACCOUNTING AND AUDITING STANDARDS

Georgia’s accounting and auditing standards are governed by the Law on the Regulation of Accounting and Financial Reporting (1999, as amended) and the Law on Auditing (1999, as

[2] IFAC sets out education and certification standards for the accounting and auditing profession.

amended). Accounting is regulated by the Accounting Standards Commission and auditing by the Audit Council of the Parliament. The Georgia Federation of Professional Accountants and Auditors (GFPAA) is an IFAC-member organization to promote the adoption of international standards and has been a leader in the translation of standards, as well as training and certification of accounting and auditing professionals.

While the current legislation has adopted both the IFRS and ISAs for mandatory financial reporting and auditing in Georgia, a number of weaknesses in the legal framework remain, as well as gaps in the capacity of the private sector to adopt these standards and of the public sector to effectively monitor and enforce the use of these standards (see Table 3). Many of these weaknesses have been well established by previous evaluations of Georgian policies governing accounting and auditing standards and practices, including recent reports by the World Bank (World Bank, January 2007) and Asian Development Bank (Narasimham, 2010). The most critical of these weaknesses are highlighted below.

- **Full IFRS required for most enterprises.** The IFRS is required for virtually all enterprises in Georgia, including non public interest entities and SMEs. While the Law on Entrepreneurs sets out simplified financial reporting requirements for small enterprises, defined as those employing fewer than 20 employees with an annual turnover not exceeding GEL 500,000, no such accounting standards have been implemented, though, in advance of the publication of the IFRS for SMEs, GFPAA developed a “streamlined” version of the IFRS removing standards that are not relevant to SMEs. Even with the intended exemption of small enterprises, the current legislation would still impose inappropriate standards on medium-size enterprises that are not public interest entities subject to mandatory independent audits.

- **Accounting standards are outdated.** The Accounting Law and related regulations are out-of-date in terms of accounting standards. Current legislation requires use of the 2004 IFRS, despite new updated versions that have since been issued by the IASB and translated by GFPAA. The legislation does not take into account the new IFRS for SMEs.

- **Professional standards are weak.** GFPAA has made substantial efforts to raise awareness of accounting and auditing standards in Georgia and to raise the level of professionalism through training and certification. GFPAA provides training and certification using the United Kingdom’s (UK) Association of Chartered Certified Accountants (ACCA) qualification. The Audit Committee of Parliament provides an alternative track to certification, which appears, on the surface, to be less rigorous. While the GFPAA has raised questions about the quality of professionals certified through the Audit Committee, it is not clear what impact this dual track has had on the level of professional standards. More concerning is the lack of effective regulation of the auditing profession. Licensing requirements were abolished in 2005, effectively leaving the profession unregulated. While the IFAC Code of Ethics has been officially adopted, it is not kept up to date with revisions to the Code (e.g. with respect to independence) and is not backed by any enforcement mechanisms.

- **Enforcement of and compliance with accounting and auditing standards are low.** Enforcement of and compliance with accounting and auditing standards, with exception of banks, is relatively weak. In 2007, for example, the World Bank reported that of the 1,800 joint stock companies registered in Georgia, only 480 submitted audited financial statements to the National Securities Commission

(NSC). Given the complexity of the IFRS and weak professional standards, it is not surprising that there is a substantial compliance gap.

Table 3: Benchmarking Georgian Policies Governing Accounting and Auditing Standards against International Best Practices

International Best Practices	Georgian Practices
Accounting Standards	
Require use of full IFRS by public interest entities. Encourage use by other large enterprises.	Under Accounting Law, IFRS required for public interest entities, as well as non public interest entities. The Banking Law also references required use of international accounting standards.
Encourage use of IFRS for SMEs	Accounting Law implies that small enterprises may adopt simplified "temporary" accounting standards but none have been issued to date.
Legal flexibility to apply most updated standards	Accounting Law specifies applicable version of IFRS, which is currently out-dated. Banking Law is also out-dated.
Defined role for the private sector in translating and publishing standards, training and certification	Private sector (through GFPAA) is designated by the Accounting Law to translate international standards, to elaborate temporary standards for use by small enterprises, and to provide training and certification of accountants.
Effective monitoring and enforcement by regulatory agency or agencies	Lack of adequate monitoring and enforcement by Accounting Standards Commission. Given complexity of IFRS, there is a large compliance gap. Many accountants currently conduct accounting on a cash basis, rather than accrual basis (per IFRS).
Auditing Standards	
Mandatory financial reporting by public interest entities only	Under Law on Entrepreneurs, mandatory financial reporting (annual report and business report) are compulsory for joint stock companies. Under the Banking Law, the NBG only requires balance sheet, profit and loss statement and auditor's report, though all banks are joint stock companies subject to NSC requirements. Small enterprises, may substitute inventory list and profit-and-loss account in compliance with the tax legislation.

Require mandatory independent audits of public interest entities	Under Law on Entrepreneurs, listed companies, financial institutions and enterprises with more than 100 partners are subject to independent audit. Banking Law also requires annual external audits of commercial banks and branches of foreign banks.
Require use of ISA for mandatory audits	ISAs have been legally adopted for mandatory audits. ISAs are automatically approved when they are released by the IAASB. Translation follows and the individual auditor has the duty to inform himself of recent changes in ISAs.
Require licensing of audit firms engaged in statutory audits	No licensing required for firms providing statutory audits.
Defined role for the private sector in translating and publishing standards, training and certification	Legally under the purview of the Audit Council, though GFPAA has translated ISAs.
Effective monitoring and enforcement by regulatory agency or agencies	Audited financial statements must be submitted to NSC. In 2007, of 1,800 joint stock companies registered in Georgia only 480 submitted audited financial statements.
Professional Standards	
Professional training and certification based on internationally accepted programs	Accounting Law provides for self-regulation by the private sector (currently through GFPAA), an IFAC member. GFPAA provides training and certification using the UK's ACCA qualification. The Audit Council within Parliament provides an alternative examination, but no training is required. No continuing education is required by law but GFPAA requires members to offer continuing education. Ethical requirements based on IFAC Code of Ethics are not backed by enforcement.

These weaknesses negatively impact the investment environment in Georgia. With the exception of banks, which are more closely monitored by the National Bank of Georgia (NBG), there is a general perception that the quality of financial statements in Georgia are of a low quality. While demand-side constraints are a factor (i.e. little demand to date by investors for financial information on Georgian companies), efforts to promote investment into Georgia, which may include joint ventures or other transactions with local enterprises, will likely be hampered by the lack of quality financial information. Low compliance by listed companies also hampers the growth of the capital market, while reduced transparency further weakens corporate governance and the rights of shareholders. The lack of compliance also affects local enterprises' ability to gain access to finance. Given the low level of confidence in quality of financial statements, banks base lending decisions on other criteria—such as amount of collateral, business forecasts and other information—which likely increases systemic risk, raises interest rates and reduces access to finance by SMEs.

Given the negative impact on the investment environment in Georgia and, in particular, the SME sector, there is an urgent need to address the weaknesses in the current legislation and to improve the compliance gap through proper regulation and training. The accounting sector, with the support of the GFPAA and the Asian Development Bank, have conducted a comprehensive review of the relevant legislation and have drafted new legislation, the draft Law on Accounting and Audit, to address many of these weaknesses. The drafting process has been ongoing since 2006 and has yet to be taken up by Parliament. In addition to combining the two pieces of existing legislation, the draft law provides for:

- The adoption of IFRS and IFRS for SMEs, including the automatic adoption of any updated standards;
- New criteria for the definition of large, small and medium, and micro enterprises, based on any two of three established criteria according to annual income, asset value, and/or number of employees;
- The minimum standard for a large enterprise is increased to an annual income of GEL 35 million, 150 employees, and/or asset value of GEL 30 million;
- The designation of different accounting standards for each category—IFRS for large enterprises, “local” standards for SMEs and simplified standards for microenterprises, with the latter two to be set out by the nominated IFAC-member professional organization (GFPAA, in practice);
- Translation and publication of all accounting and auditing standards are also delegated to the nominated professional organization;
- Professional certification in compliance with IFAC educational standards is likewise delegated to the nominated professional organization;
- Creation of a new regulatory body, a Council of Financial Reporting and Audit (CFRA), to oversee both accounting and auditing standards, with powers to monitor and enforce;
- Defined timeframes for the financial reporting by financial institutions, listed companies and large enterprises (in effect, public interest entities) subject to mandatory audits;
- Enhanced regulatory measures for the auditing profession, including registration with CFRA through the nominated professional organization, as well as compliance with accounting and auditing standards (again, under CFRA);
- Clear role for the nominated professional organization in the translation and publication of standards, elaboration of local standards (for SMEs and microenterprises), education standards, introduction and monitoring of Code of Ethics, quality control, and the admission of auditors (and suspension from) the profession; and
- Clear provisions for the establishment and operations of the CFRA, to be established under Parliament, with representatives nominated by the Ministry of Finance, National Bank of Georgia, and the nominated professional organization.

The adoption of such provisions in revised legislation is critical to promote good accounting and auditing practices that promotes the confidence of the investment sector.

5. ALTERNATIVE DISPUTE RESOLUTION

5.1 INTERNATIONAL BEST PRACTICES IN ALTERNATIVE DISPUTE RESOLUTION

Credibility in the enforcement of contracts is the foundation upon which all transactions rely. Both foreign and domestic firms need to have the confidence that the contracts they enter will be enforced and that access to redress is timely, fair and accessible. However, many developing and transition economies perform poorly in the area of contract enforcement and the efficiency of their formal justice systems. Lack of timely, predictable and affordable access to the commercial justice system can have a negative impact on the investment climate.

ADR is an important complement to the commercial justice system and, if properly implemented, can benefit the private sector and promote investment. ADR helps the private sector to avoid the often long and expensive process of taking a case through the formal judicial system. This is particularly important in developing countries where the judiciary has a reputation for long delays, corruption, and/or lack of expertise in commercial matters. ADR solutions are generally faster, less expensive, and more likely to allow the parties to return to doing business with one another. ADR can lower direct and indirect costs of enforcing contracts and resolving business disputes, thereby creating a better investment environment.

While international investors are likely to prefer international arbitration in the event of disputes against the host government, as discussed in section 2.1.3, commercial contract disputes can benefit from access to ADR solutions within the host country.

As discussed in Section 2.1.3, ADR covers a number of different mechanisms to address commercial disputes, including binding and non-binding *arbitration*, as well as *mediation* or conciliation. A complementary mechanism is *court-annexed ADR*, which may be made mandatory, a process through which a third party assists disputants in reaching a settlement, thereby reducing the time and cost associated with litigation and reducing court backlog. While some forms of ADR, such as mediation and other non-binding mechanisms, may exist with minimal or even no formal regulation, appropriate legal and regulatory context within a country is essential for a modern ADR system to be sustainable, particularly in the case of arbitration.

Legal provisions supporting **mediation** or **conciliation** are usually found within national civil procedure codes, rules governing court procedures or national mediation or conciliation laws. An appropriate legal framework for these procedures embodies the following key principles: voluntariness of the parties in determining the procedure, selecting the mediators, and final decision-making; confidentiality of the procedure and its outcomes; equality in the mediator's relation towards the parties; neutrality in the mediator's relation towards the subject matter of a dispute and the mediator's recommendations; enforceability of settlement agreements. National legislation on conciliation and mediation is often guided by the UNCITRAL Model Law on International Commercial Conciliation which features these same core principles.

The effective implementation of **arbitration** requires a more robust legal framework, including legal backing to establish the scope and validity of arbitrated settlements, the appointment of arbitrators, any required procedural elements, provisions for appeal, and provisions for court-backed enforcement. Due to the potential participation of foreign investors in domestic arbitration, the functioning of the arbitral system is enhanced if it is based on the UNCITRAL Model Law on International Commercial Arbitration, which is easily recognizable and provides an international standard with solutions acceptable to parties from different countries and legal systems. The Model Law provides useful guidelines for the establishment of a well-functioning arbitration system that would be aligned with the expectations of international investors:

- **Role of the Court System.** Given that an agreement to enter into arbitration is based on the desire to exclude court jurisdiction, the role of the judiciary should be limited to the jurisdiction of the arbitral tribunal, taking evidence, vacating arbitral awards, and enforcing awards, as well as, as appropriate, the appointment and termination of an arbitrator (which can also be under the mandate of a separate body). The Model Law also provides for an explicit provision indicating that no court will intervene in an arbitration proceeding other than in cases that are explicitly identified in the same law—this provides an additional degree of confidence that no other law will supersede the provisions of the arbitration law.

- **Access to Recourse.** Another important area that is well-defined by the Model Law is the right of appeal of arbitration settlements. As the intent of ADR is to reduce the time and costs associated with the court system, it is important that the grounds for appeal, and the avenues and procedures for such recourse are carefully and narrowly defined.

- **Enforcement of Awards.** The Model Law treats awards in a uniform manner irrespective of where they were made in the case of international awards, except on procedural grounds or by reason that the subject-matter is not capable of settlement within the country.

A vital component of a well-functioning ADR system, whether arbitration or mediation, is the institutional framework. The ADR institutional framework consists not only of facilities that provide ADR services, but also of rules that govern institutions dealing with ADR. A strong ADR institutional framework is usually recognized from the following key characteristics: presence of financially self-sustaining ADR centers that do not require donor support; availability of high quality ADR services that are based on global best practice and local demand; and presence of a sufficient number of suitably trained and certified individuals and institutions ready, willing and able to deliver high quality ADR services.

5.2 ASSESSMENT OF GEORGIAN POLICIES ON ALTERNATIVE DISPUTE RESOLUTION

Alternative dispute resolution has been under development in Georgia for a number of years and supported through various donor efforts to both establish the legal framework and to support the establishment of domestic venues for arbitration. The judiciary in Georgia largely lacks competence in specialized commercial matters and has garnered only very low levels of confidence from the private sector. Contract enforcement remains one important category under the Doing Business Ranking where Georgia performs less well (ranked 41). While donor efforts are underway to strengthen the rule of law, including the development of an independent and competent judiciary, ADR is an important vehicle to promote contract enforcement and to settle commercial disputes in Georgia.

Georgia's legal framework governing private ADR proceedings has been largely aligned with international practices—as noted in Chapter 2, there remains a large gap in practices related to international arbitration between an investor and the State. The Law on Arbitration (2009) replaced the 1997 Law on Private Arbitration and brought the Georgian framework, by and large, in alignment with the UNCITRAL Model Law on International Commercial Arbitration, correcting many of the gaps in the previous law.

Table 4: Benchmarking Georgian Policies Governing Alternative Dispute Resolution

International Best Practices	Georgian Practices
Role of the judiciary limited to jurisdiction of arbitral tribunal, taking evidence, vacating arbitral awards, and enforcing awards, as well as, as appropriate, the appointment and termination of an arbitrator	Arbitration Law provides for limited judicial involvement, specific cases in which the court may be engaged in the appointment/termination of arbitrators, taking evidence on request, and vacating or enforcing awards.
Clearly articulated procedures established for arbitral proceedings, including notifications, disclosures and the like	Arbitration Law provides for clearly articulated procedures governing arbitral proceedings, including timeframes and notifications.
Clear articulation of conditions and procedures for appeals	Arbitration Law clearly provides for conditions and procedures for appeals to the court based on procedural grounds. It does, however, also give leeway to vacate awards that are in conflict with public policy.
Uniform enforcement of arbitral awards	An arbitral award, irrespective of the country in which it was made, shall be recognized as binding and enforced. For arbitral awards made in Georgia, the courts of appeal have jurisdiction and in the case of foreign arbitral awards, enforcement is under the Supreme Court.

While Georgia's legal framework is aligned with international practices, it is evident from discussions with the private sector and legal professionals that there remains a gap in the understanding of ADR rights and obligations under the Arbitration Law. While only anecdotal, it is evident that there are a number of cases in which arbitrators have been considered to be less than qualified, where there are accusations that procedures have not been properly followed, and the like. While procedures for handling such issues are articulated in the Arbitration Law, it is clear that there remains an information gap. A quick survey of some of the websites of arbitration centers that have been established in Georgia still show the 1997 law as the basis for ADR. A targeted public awareness campaign, coupled, perhaps, with support to the private sector to establish a framework code of ethics or the like for professional arbitrators would substantially improve the performance of ADR in Georgia.

6. FINDINGS AND RECOMMENDATIONS

6.1 SUMMARY FINDINGS AND RECOMMENDATIONS FOR ENHANCING INVESTMENT SECTOR ECONOMIC GOVERNANCE

The Government of Georgia has made great strides in improving investment sector economic governance in Georgia, as evidenced by Georgia's ranking in the Doing Business Indicators. However, as reflected in the WEF Global Competitiveness Index, there are a number of areas in need of further attention. This assessment, while not meant to be a comprehensive treatment of each of the policy areas under review, provides an indication of key policies that need to be further refined in order to enhance governance in the investment sector. Table 5 provides an overview of the key strengths and weaknesses in Georgia's investment policy environment compared to international best practices.

Table 5: Benchmarking Georgia's Investment Sector Economic Governance

International Best Practices	Georgian Practices
Open investment regime that provides full breadth of protections and guarantees for investors	Existing legislation provides for a relatively open regime with many of the protections and guarantees necessary to promote an investor-friendly environment. Critical weaknesses include lack of commitment to international dispute resolution and lack of adequate protections against expropriation.
Strong corporate governance, with adequate protection of minority shareholder rights	Basic shareholder rights and disclosure requirements are in place, however minority shareholder rights are severely curtailed by a squeeze-out clause and financial reporting is not adequately enforced. There is also a lack of adequate provisions related to the roles and responsibilities of the Board of Directors.
Accounting and auditing standards aligned with international standards (IFRS and ISAs)	Georgia has adopted both IFRS and ISAs, but requires compliance by non public interest entities, which imposes a substantial burden on SMEs. Also, professional standards are inadequately regulated. As expected, compliance is relatively low and the quality of financial reporting is low.
Access to alternative dispute resolution with court enforcement	Arbitration law aligned with international best practices, but evidence of poor implementation and awareness by the private sector.

Based on these strengths and weaknesses, the study has identified potential areas of future reform for the GoG:

- **FDI and Investor Rights and Guarantees.** A working group at a Parliamentary Committee has recently been established to streamline and update Georgia's investment legislation, including the Law on Promotion of Investment Activities and Guarantees, as well as two related laws, the Law on Georgian National Investment Agency (GNIA) and the Law on State Support of Investments. While existing protections and guarantees are largely aligned with international practices, future reforms should consider: (1) strengthening provisions related to dispute settlement to guarantee State commitment to international arbitration, irrespective of individual investment contracts and treaties; (2) providing clear criteria for expropriation and compensation; and (3) create a more level playing field by extending an explicit guarantee of fair and equitable treatment to foreign investors, as well as Most-Favored Nation (MFN) treatment.

- **Corporate Governance.** The legal framework for corporate governance in Georgia is governed by the Law on Securities Markets (1998, as amended) for listed companies and the Law on Entrepreneurs (1994, as amended) for all legal entities. Both pieces of legislation have been amended over time to strengthen various aspects of the corporate governance framework, though a number of key aspects of the legal framework for corporate governance remain weak in Georgia, particularly those related to the protection of minority shareholder rights and weak enforcement. The GoG should consider the removal of the squeeze-out clause in the Law on Entrepreneurs that was introduced in 1997 in order to strengthen minority shareholder rights and to strengthen monitoring and enforcement mechanisms for corporate governance provisions under the law. Also, while the National Bank of Georgia (NBG) has established powers to sanction listed companies in violation of legally-established corporate governance principles in the Securities Market Law, there is a need to build capacity within the NBG for it to better monitor and enforce provisions under the law.

- **Accounting and Auditing Standards.** Georgia's accounting and auditing standards are governed by the Law on the Regulation of Accounting and Financial Reporting (1999, as amended) and the Law on Auditing (1999, as amended). While the current legislation has adopted both the IFRS and ISAs for mandatory financial reporting and auditing in Georgia, a number of weaknesses in the legal framework remain, including outdated standards, the application of inappropriate standards for small and medium enterprises, weak professional standards, and inadequate enforcement of and compliance with accounting and auditing standards. Beyond the legal provisions, there is also evidence of gaps in the capacity of the private sector to adopt these standards and of the public sector to effectively monitor and enforce the use of these standards.

These weaknesses negatively impact the investment environment in Georgia. Low compliance by listed companies also hampers the growth of the capital market, while reduced transparency further weakens corporate governance and the rights of shareholders. The lack of compliance also affects local enterprises' ability to gain access to finance and to attract potential foreign investors interested in joint ventures or other sensitive transactions. Given the low level of confidence in quality of financial statements, banks base lending decisions on other criteria—such as amount of collateral, business forecasts and other information—which likely increases systemic risk, raises interest rates and reduces access to finance by SMEs.

There is an urgent need to address the weaknesses in the current legislation and to improve the compliance gap through proper regulation and training. The accounting sector, with the support of the GFPAA and the Asian Development Bank, have conducted a comprehensive review of the relevant legislation and have drafted new legislation to address many of these weaknesses. The adoption of such provisions in revised legislation is critical to promote good accounting and auditing practices that promotes the confidence of the investment sector.

- **Alternative Dispute Resolution.** Georgia's legal framework governing private ADR proceedings has been largely aligned with international practices, with the exception of international arbitration between an investor and the State. The Law on Arbitration (2009) brought the Georgian framework, by and large, in alignment with the UNCITRAL Model Law on International Commercial Arbitration, correcting many of the gaps in previous legislation. While Georgia's legal framework is aligned with international practices, it is evident from discussions with the private sector and legal professionals that there remains a gap in the understanding of ADR rights and obligations under the Arbitration Law. A targeted public awareness campaign, coupled, perhaps, with support to the private sector to establish a framework code of ethics or the like for professional arbitrators would substantially improve the performance of ADR in Georgia.

While not directly covered in this assessment, the evaluation process highlighted a number of other key issues that have hampered the ability of the GoG to enact and implement investment sector policies. These include, *inter alia*, a lack of legislative stability, lack of transparency in the policy-making process, and lack of effective enforcement by regulators and the judiciary. Investment policy-making is not a one-off event, as the same set of policies may require further refinements in the future to accommodate factors both internal and external to Georgia. The reform process must therefore address not just the individual policy issues, but the institutional framework for policy-making and legislative reform.

6.2 PROPOSED EPI WORK PLAN INTERVENTIONS

In order to assist the GoG to address the weaknesses in investment sector economic governance, it is proposed that EPI undertake a number of interventions. Table 6 provides a summary of these actions.

Table 6: Proposed EPI Work Plan Interventions

Action Name	Action Type(s)*	Resources Required
Develop revised set of investment laws	STTA	Expat commercial lawyer, expat economist, local commercial lawyer
Develop Corporate Governance Code of Ethics for non-banking sectors	STTA	Expat expert in corporate governance
Conduct corporate governance workshops with EPI supported sectors	STTA, Event (T)	Expat expert in corporate governance, local expert in corporate governance
Strengthen NBG's capacity to monitor and enforce financial reporting	STTA	Expat expert in corporate governance, local expert

		in corporate governance
Finalize draft Accounting and Auditing Law	STTA	Expat or local expert in accounting and auditing
Conduct PPD on Accounting and Auditing Standards	STTA, Event (T)	Local expert in accounting and auditing
Conduct workshop on accounting and auditing for EPI supported sectors	STTA, Event (T)	Local expert in accounting and auditing
Conduct ADR workshops for private sector	STTA, Event (T)	Local expert in ADR

* Action types include:

STTA = Short-term Technical Assistance

Event (T) = Training event

Event (NT) = Non-training event (e.g. discussions, teambuilding, etc)

Proc (C) = procurement of commodities (e.g. computers)

Proc (S) = Procurement of services (e.g. a subcontract to a printer for printing services)

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USAID Economic Prosperity Initiative (EPI)
6 Samghebro St.

Tbilisi, Georgia

Phone: +995 32 43 89 24/25/26

Fax: +995 32 43 89 27