

**DRAFT**

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# **Central Asia Business Consultants, Ltd.**



**E-Mail: *adik@cabc-global.com***

**Tel: *(994-12) 497 44 85/86 & (994-50) 210 32 93***

**Fax: *(994-12) 497 44 87***

***40, J. Jabbarly Street  
8<sup>th</sup> Floor, Caspian Business Center  
Baku, AZ1065, Azerbaijan***

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**Att: *Mr. Bahman Askerov/Direktor***  
**CC: *Mr. Babek Shahbazov/Financial Manager***

**Date: *6 April, 2005***  
**Our Ref: *9149/YT***

***Norwegian Microcredit LLC.  
4 J. Jabbarly Street,  
Baku, Azerbaijan***

## **MANAGEMENT REPORT ON THE RESULTS OF THE AUDIT OF THE FINANCIAL STATEMENTS FOR THE YEAR 2005**

Dear Sirs,

According to the agreement between CABC, LTD. and Norwegian Microcredit LLC (Normicro), we have completed an audit of the financial statements of Normicro for the year 2005. Our findings are based on the information and documents provided to us by Normicro's representatives and comply with provisions of the International Accounting Standards. All the documents and information provided for our review is wholly the responsibility of Normicro.

Below are our comments for your consideration:

### **1. Terms of Reference**

Our audit covered the following aspects of financial activities of Normicro:

- Accounting and Internal Control Systems, including internal accounting and controls procedures, documents, packages etc.
- Credit Manual and Portfolio Related policies
- Loan Portfolio and Management Information Systems, Credit transactions, including calculation of credits interests, balances, repayment schedules, credit agreements, collection of fees, principal amounts of credits, file documentations, etc.;

- Loan Loss provisions, including creation of general and special reserves;
- Cash & Bank transactions, including credit and general administration transactions, bank reconciliations etc.
- Debt - recording and classification of loans received, interest paid, etc.
- Grants - classification and use of grants received, recording etc.
- Equity, including share capital and retained earnings;
- Revenues and expenses - correctness of recording, timing, attribution, etc.
- Statutory compliance - taxes, social contributions and other statutory requirements.
- Opening balances - all the opening balances as of January 1, 2005 for the purpose of International Standards on Auditing.

## **2. Accounting and Internal Control Systems**

During the audit we reviewed the accounting and internal control systems operating within the Organization. The systems demonstrated reliability of the information produced by them.

## **3. Credit Manual and Portfolio Related Policies**

During the audit of credit manual and portfolio related policies we have determined that the subject manual and policies meet the requirements of CGAP standards, IAS and government rules with regards to maintenance of credit portfolio.

## **4. Loan Portfolio and Management Information Systems, Credit Transactions**

Accounting of loan portfolio, as well as other transactions was kept using the Management Information Systems (MIS) software. The software is specially designed for credit organizations and allows to account, analyze and report properly and in a timely manner on all transactions and requirements related to customer loans, interest accruals and payments, personal information on customers, loans status, loans securities etc. The audit procedures performed by CABC allows us to conclude that the MIS provides reliable information related to loan transactions.

Our audit of credit transactions was conducted on a sample basis. Representative sample of credits was tested in Baku, Beylaqan and Khachmaz branches. As a result, no material mistakes were revealed in recording of credits issued to customers, credits repayments, interests calculated and received from customers, recording of fees, fines etc., filing of documents etc.

**5. Loan Loss Provisions**

There are no statutory regulations for non-bank credit organizations with regards to provision for possible loan losses. Through the year 2004 provisions were made only for irrecoverable loans which were written off against the provision. General and special provisions for possible loan risks have been accrued only in the year 2005.

Rules of the National bank of the Azerbaijan Republic were applied by Normicro for creation of general and special reserves. Even though the subject rules are not obligatory for non-bank credit organization, we consider the rates provided by them adequate to the level of risk borne by Normicro and would recommend to sustain risk reserves at the percentages recommended by those Rules. Considering that Normicro started provisions for general group of loans only in the year 2005 balances of the loans which were issued to clients prior to this year were not covered by the general provision. Therefore, the general reserve for loan losses as of December 31, 2005 does not constitute 2% of the total loan balances at that date and amounts to USD 11,116. We would like to advise that we regard the above provided reserve sufficient enough for securing the existing loan portfolio. However, from the year 2006 we would recommend to bring the general reserve for possible loan losses to the recommended rate of 2% of the principal loans balances.

**6. Cash and Bank Transactions**

During the audit of cash and bank transactions we have not revealed any material mistakes.

**7. Debt (Credits Received)**

During the audit of debt of the Norwegian Microcredit LLC we did not reveal any material misstatements or mistakes.

**8. Grants**

During the audit of the Grants we did not reveal any material misstatements or mistakes. Usage of grants received by Normicro corresponds with the purposes and classifications stated in grant agreements. Grants received for operational purposes were added to the current period revenues. The grants received for capital and equipment purposes were added to the organization's equity according to the requirements of IAS 20 "Accounting for Government Grants and Disclosure of Government Assistance".

**9. Equity**

During the audit of equity we did not reveal any material misstatements or mistakes.

## 10. Revenues and Expenses

Revenues and Expenses related to credit transactions were recorded and accounted for in US Dollars, which is the primary currency credits issued to customers. All the administrative expenses were incurred in manats and transferred to US Dollars at the rate applicable at the reporting date for the purpose of the including them into the financial statements in accordance with the IAS. Such an approach, even though did not bring to a material misstatement of the accounts does not correspond with the requirements of the IAS 21 "The Effects of Changes in Foreign Exchange Rates". The subject standard requires translation of all transactions made in currency other than the reporting one into the reporting currency at the rates applicable on the dates when those transactions take place. We would recommend to bring the process of currency translations in conformity with the requirements of IAS 21 for the purpose of presentation of financial statements in US Dollars and in accordance with the IAS.

## 11. Statutory Compliance

### VAT

We would like to bring your attention to the fact that currently Normicro is registered with the Tax Department as a VAT payer. VAT paid to suppliers is offset with other taxes due by the Organization. However, according to Article 164.1.2 of the Tax Code of the Azerbaijan Republic, crediting activities are VAT exempt activities. According to Article 175.6 of the Tax Code cannot be claimed from the budget or offset with any other taxes, but should be included in the expenses of the current period and deducted from the revenues for the Profit Tax purposes. The total amount of VAT offset with the Tax Ministry since the moment of VAT registration is AZN 9,592.33 (USD 10,442). There is a possibility that in future the Tax Ministry may require Normicro to return the amount of VAT offset previously and impose penalties for non-compliance with the requirements of the Tax Code. In order to reduce the risk of such penalties we would recommend to apply to the Tax Ministry for clarification of the situation and then treat the VAT paid according to the reply of the Tax Ministry.

### Profit Tax and SPF Balances

Due to uncertainties existing in the legislation concerning non-for-profit credit institutions in the recent years Profit Tax and Social Contributions were reported to the Tax Ministry and Social Protection Fund for the previous years, but not paid. The closing balances as of

December 31, 2005 for Profit Tax and Social protection Fund are AZN 69,717.16 (USD 75,895.01) and AZN 74,256.81 (USD 80,837) accordingly. Considering that the requirements of legislation are determined since the year 2005 and the organization is liable for Profit Tax and 3% social contributions from employees salaries, we would recommend to pay off the balances of Profit Tax and Social contributions, so to avoid imposing of interest by the relevant authorities for late payment.

## 12. Opening Balances

We would like to note that audit of financial statements in accordance with the International Standards on Auditing has not been performed by the Organization prior to the year 2005. In order to confirm correctness of the financial statements as of December 31, 2005 we conducted some audit procedures in order to obtain the reasonable assurance that the opening balances as of January 1, 2005 represent true and a fair view of the financial position of the company at that date. The audit procedures performed by CABC allowed us to confirm the opening balances are free of material misstatements.

## 13. Summary

We would like to summarize the main issues discussed in the current Report as follows:

1. Bringing of general loan loss provision to the rate of 2% of the outstanding non-risky loan balances as recommended by the National Bank of the Azerbaijan Republic.
2. We would recommend to transfer the transactions made in manats into US Dollars at the rates applicable at the dates when those transactions were made for the purpose of presentation of financial statements of the Organization in USD in accordance with IAS.
3. We would recommend to obtain recommendations of the Tax Ministry on the VAT issue. Payment of balances of Profit tax and Social Contributions to the relevant authorities is advisable.

Sincerely Yours,

Adik N. Babayev  
Managing Partner

