

**MICRO FINANCE BANK OF AZERBAIJAN**

**Financial Statements and Auditors' Report**

**31 December 2004**

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**AUDITORS' REPORT**

To the Management Board of Micro Finance Bank of Azerbaijan:

- 1 We have audited the accompanying balance sheet of Micro Finance Bank of Azerbaijan ("the Bank") as at 31 December 2004, and the related statements of operations, of cash flows and of changes in shareholders' equity for the year then ended. These financial statements are the responsibility of the Bank's Management. Our responsibility is to express an opinion on these financial statements based on our audit.
- 2 We conducted our audit in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by Management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.
- 3 In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Bank as at 31 December 2004 and the results of its operations and its cash flows for the year then ended in accordance with International Financial Reporting Standards.


*PricewaterhouseCoopers*

24 March 2005  
Baku, the Republic of Azerbaijan


*Micro Finance Bank of Azerbaijan*  
*Balance Sheet as at 31 December 2004*  
*(in millions of Azerbaijani Manats)*

	Note	2004	2003
<b>Assets</b>			
Cash and cash equivalents	5	3,345	3,807
Mandatory cash balances with the National Bank of the Republic of Azerbaijan		74	4
Loans and advances to customers	6	35,252	17,142
Other assets	7	530	594
Deferred tax asset, net	18	931	962
Premises and equipment	8	3,623	3,889
<b>Total assets</b>		<b>43,755</b>	<b>26,398</b>
<b>Liabilities</b>			
Customer accounts	9	817	42
Other borrowed funds	10	12,356	4,958
Other liabilities	11	251	179
<b>Total liabilities</b>		<b>13,424</b>	<b>5,179</b>
<b>Shareholders' equity</b>			
Share capital	12	33,567	24,500
Accumulated deficit	13	(3,236)	(3,281)
<b>Total shareholders' equity</b>		<b>30,331</b>	<b>21,219</b>
<b>Total liabilities and shareholders' equity</b>		<b>43,755</b>	<b>26,398</b>

Approved for issue by the Board of Directors and signed on its behalf on 24 March 2005.

  
 Thomas Engelhardt  
 Chairman of the Management Board



  
 Elshan Hajiyev  
 Chief Accountant

The notes set out on pages 5 to 22 form an integral part of these financial statements.

**Micro Finance Bank of Azerbaijan**  
**Statement of Operations for the Year Ended 31 December 2004**  
*(in millions of Azerbaijani Manats)*

	Note	2004	2003
Interest income	14	7,108	2,810
Interest expense	14	(514)	(159)
<b>Net interest income</b>		<b>6,594</b>	<b>2,651</b>
Provision for loan impairment	6	(127)	(3,131)
<b>Net interest income/(negative interest margin) after provision for loan impairment</b>		<b>6,467</b>	<b>(480)</b>
Gains less losses arising from trading in foreign currencies		30	20
Foreign exchange translation gains less losses		(73)	123
Fee and commission income	15	77	24
Fee and commission expense	15	(90)	(91)
Other operating income		18	6
<b>Operating profit/(loss)</b>		<b>6,429</b>	<b>(398)</b>
Staff costs	16	(2,161)	(984)
Operating expenses	17	(4,192)	(2,073)
<b>Profit/(loss) before taxation</b>		<b>76</b>	<b>(3,455)</b>
Income tax (expense)/credit	18	(31)	765
<b>Net profit/(loss)</b>		<b>45</b>	<b>(2,690)</b>

**Micro Finance Bank of Azerbaijan**  
**Statement of Cash Flows for the Year Ended 31 December 2004**  
*(in millions of Azerbaijani Manats)*

	Note	2004	2003
<b>Cash flows from operating activities</b>			
Interest received		7,039	2,556
Interest paid		(450)	-
Fees and commissions received		77	44
Fees and commissions paid		(90)	(215)
Other operating income received		48	6
Operating expenses paid		(5,013)	(2,590)
<b>Cash flows provided from/(used in) operating activities before changes in operating assets and liabilities</b>			
		<b>1,611</b>	<b>(199)</b>
<b>Changes in operating assets and liabilities</b>			
Net increase in mandatory cash balances with the NBA		(70)	(4)
Net increase in loans and advances to customers		(18,168)	(19,468)
Net (increase)/decrease in other assets		(152)	5
Net increase in customer accounts		775	-
Net increase in other liabilities		49	1
<b>Net cash used in operating activities</b>			
		<b>(15,955)</b>	<b>(19,665)</b>
<b>Cash flows from investing activities</b>			
Acquisition of premises and equipment	8	(835)	(1,769)
Acquisition of intangible assets		-	(15)
<b>Net cash used in investing activities</b>			
		<b>(835)</b>	<b>(1,784)</b>
<b>Cash flows from financing activities</b>			
Issue of ordinary shares		9,067	-
Proceeds from other borrowed funds	10	7,334	4,923
<b>Net cash provided from financing activities</b>			
		<b>16,401</b>	<b>4,923</b>
<b>Effect of exchange rate changes on cash and cash equivalents</b>			
		<b>(73)</b>	<b>123</b>
<b>Net decrease in cash and cash equivalents</b>			
Cash and cash equivalents as at the beginning of the year	5	3,807	20,210
<b>Cash and cash equivalents as at the end of the year</b>			
	5	<b>3,345</b>	<b>3,807</b>

**Micro Finance Bank of Azerbaijan**  
**Statement of Changes in Shareholders' Equity for the Year Ended 31 December 2004**  
*(in millions of Azerbaijani Manats)*

	Share capital	Accumulated deficit	Total shareholders' equity
<b>Balance as at 1 January 2003</b>	<b>24,500</b>	<b>(591)</b>	<b>23,909</b>
Net loss	-	(2,690)	(2,690)
<b>Balance as at 31 December 2003</b>	<b>24,500</b>	<b>(3,281)</b>	<b>21,219</b>
Net profit		45	45
Share Issue (Note 12)	9,067	-	9,067
<b>Balance as at 31 December 2004</b>	<b>33,567</b>	<b>(3,236)</b>	<b>30,331</b>

## **1 Principal Activities**

Micro Finance Bank of Azerbaijan (“the Bank”) was registered as a closed joint-stock company of the Republic of Azerbaijan on 30 September 2002. The Bank has operated under a banking licence issued by the National Bank of the Republic of Azerbaijan (“NBA”) since 29 October 2002. The Bank’s principal business activity is small and micro lending to individuals and legal entities in the Republic of Azerbaijan. The Bank’s registered office is located at 176 Bashir Safaroghlu St, Baku 1000, the Republic of Azerbaijan.

The Bank has 86 employees and 5 branches in the Republic of Azerbaijan as at 31 December 2004 (2003: 36 employees and 4 branches).

## **2 Operating Environment of the Bank**

The economy of the Republic of Azerbaijan has shown progress in achieving a lower rate of inflation, stable exchange rates and sustainable growth in recent years. The ongoing political stabilisation has been a positive contributing factor for the further development of the political and legal environment.

However, the economy is largely dependent on oil prices and all sectors of the economy, including the banking sector, might be affected by fluctuations in oil prices. The need for further developments in the bankruptcy regulations, formalised procedures for the registration and enforcement of collateral, and other legal and fiscal impediments contribute to the difficulties experienced by banks currently operating in the Republic of Azerbaijan.

The prospects for future economic stability in the Republic of Azerbaijan are largely dependent upon the effectiveness of economic measures undertaken by the government, together with legal, regulatory and political developments, which are beyond the Bank’s control.

In addition, economic conditions continue to limit the volume of activity in the financial markets. Market quotations may not be reflective of the values for financial instruments, which would be determined in an efficient, active market involving willing buyers and willing sellers. Management has therefore used the best available information to adjust market quotations to reflect their best estimate of fair values, where considered necessary.

## **3 Basis of Preparation**

**Basis of preparation.** These financial statements have been prepared in accordance with International Financial Reporting Standards (“IFRS”). The Bank maintains its accounting records in accordance with the Law on Banks of the Republic of Azerbaijan dated 16 January 2004, tax legislation of the Republic of Azerbaijan, and rules and regulations of the National Bank of the Republic of Azerbaijan. These financial statements have been prepared from those accounting records and adjusted as necessary in order to be in accordance with IFRS.

The financial statements have been measured and presented in the national currency of the Republic of Azerbaijan, the Azerbaijani Manat (“AZM”).

The preparation of the financial statements requires the use of estimates and assumptions that effect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities as at the date of the financial statements, and the reported amounts of revenues and expenses during the reported period. Although these estimates are based on Management’s best knowledge of current events and actions, actual results ultimately may differ from those estimates.

Where necessary, corresponding figures have been adjusted to conform with changes in presentation of the current year.

**Going concern.** For the years ended 31 December 2004, 2003 and 2002 the Bank had accumulated deficit amounting to AZM 3,236 million, AZM 3,281 million and AZM 591 million, respectively. Such losses have resulted primarily from operating expenses related to start-up activities of the Bank commenced in October 2002.

As at 31 December 2004, the paid-in capital of the Bank was adequate to meet its financial obligations. Additionally, the Management of the Bank has a written plan to increase the profitability of the loan portfolio and obtain additional borrowings from the shareholders of the Bank.

### **3 Basis of preparation (Continued)**

Accordingly, these financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts and classification of liabilities that might be necessary should the Bank be unable to continue as a going concern.

### **4 Significant Accounting Policies**

**Cash and cash equivalents.** Cash and cash equivalents are items that can be converted into cash within a day. All short-term interbank placements, beyond overnight placements, are included in due from other banks. Amounts, which relate to funds that are of a restricted nature, are excluded from cash and cash equivalents.

**Mandatory cash balances with the NBA.** Mandatory cash balances with the NBA represent mandatory reserve deposits that are not available to finance the Bank's day-to-day operations and hence are not considered as part of cash and cash equivalents for the purposes of the cash flow statement.

**Originated loans and advances and provisions for loan impairment.** Loans originated by the Bank by providing money directly to the borrower or to a sub-participation agent at draw down, other than those that are originated with the intent of being sold immediately or in the short-term, which are recorded as trading assets, are categorised as originated loans.

Originated loans and advances are recorded when cash is advanced to borrowers. Initially, originated loans and advances are recorded at cost, which is the fair value of the consideration given, and subsequently are carried at amortised cost less provision for loan impairment. Amortised cost is based on the fair value of cash consideration given to originate those loans determinable by reference to market prices at origination date. Third party expenses, such as legal fees incurred in securing a loan are treated as part of the cost of the transaction.

Loans originated at interest rates different from market rates are remeasured at origination to their fair value, being future interest payments and principal repayment(s) discounted at market interest rates for similar loans. The difference between the fair value and the nominal value at origination is credited or charged to the statement of operations as gains on origination of assets at rates above market or losses on origination of assets at rates below market. Subsequently, the carrying amount of such loans is adjusted for amortization of the gains/losses on origination and the related income is recorded as interest income within the statement of operations using the effective yield method.

A credit risk provision for loan impairment is established if there is objective evidence that the Bank will not be able to collect the amounts due according to original contractual terms. The amount of the provision is the difference between the carrying amount and estimated recoverable amount, calculated as the present value of expected cash flows, including amounts recoverable from guarantees and collateral, discounted at the instrument's original effective interest rate.

The provision for loan impairment also covers losses where there is objective evidence that probable losses are present in components of the loan portfolio at the balance sheet date. These have been estimated based upon historical patterns of losses in each component, the credit ratings assigned to the borrowers and reflect the current economic environment in which the borrowers operate.

When a loan is uncollectible, it is written off against the related provision for loan impairment. Such loans are written off after all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off are credited to the provision for loan impairment in the statement of operations.

If the amount of the provision for loan impairment subsequently decreases due to an event occurring after the write-down, the release of the provision is credited to the provision for loan impairment in the statement of operations.

The Bank does not enter into transactions for purchases of loans with third parties.

#### **4 Significant Accounting Policies (Continued)**

**Premises and equipment.** Premises and equipment are stated at cost less accumulated depreciation and provision for impairment, where required.

Construction in progress is carried at cost, less provision for impairment, where required. Upon completion, assets are transferred to the premises and equipment at their carrying amount. Construction in progress is not depreciated until the asset is available for use.

At each reporting date the Bank assesses whether there is any indication of impairment of premises and equipment. If any such indication exists, the Bank estimates the recoverable amount, which is determined as the higher of an asset's net selling price and its value in use. Where the carrying amount of an asset is greater than its estimated recoverable amount, it is written down to its recoverable amount and the difference is charged to the statement of operations. An impairment loss recognised for an asset in prior years is reversed if there has been a change in the estimates used to determine the asset's recoverable amount.

Gains and losses on disposal of premises and equipment are determined by reference to the carrying amount and are taken into account in determining profit/(loss). Repairs and maintenance are charged to the statement of operations when the expenditure is incurred.

**Depreciation.** Depreciation is applied on a straight line basis over the estimated useful lives of the assets using the following rates:

Leasehold improvements	20%
Furniture, fixture and other office equipment	20-25%
Computers and communication equipment	25%
Vehicles	25%

**Accrued interest income and accrued interest expense.** Accrued interest income and accrued interest expense, including both accrued coupon and amortised discount, are included in the carrying values of related balance sheet items.

**Operating leases.** Where the Bank is the lessee, the total lease payments, including those on expected termination, are charged by the lessee to the statement of operations on a straight-line basis over the period of the lease.

**Borrowings.** Borrowings are recorded initially at cost, being their issue proceeds (fair value of consideration received) net of transaction costs incurred. Subsequently, borrowings are stated at amortised cost and any difference between net proceeds and the redemption value is recorded in the statement of operations over the period of the borrowings, using the effective yield method.

**Income taxes.** Taxation has been provided for in the financial statements in accordance with the legislation of the Republic of Azerbaijan currently in force. The income tax charge in the statement of operations for the year comprises current tax and changes in deferred tax. Current tax is calculated on the basis of the expected taxable profit for the year, using the tax rates enacted at the balance sheet date. Taxes, other than on income, are recorded within operating expenses.

Deferred income tax is provided, using the liability method, for all temporary differences arising between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. Deferred tax assets are recorded to the extent that it is probable that future taxable profit will be available, against which the temporary differences can be utilised. Deferred tax assets and liabilities are measured at tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates that have been enacted or substantively enacted at the balance sheet date.

#### **4 Significant Accounting Policies (Continued)**

**Income and expense recognition.** Interest income and expense are recorded in the statement of operations for all interest bearing instruments on an accrual basis using the effective interest method. The effective interest method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the interest income or interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Bank estimates cash flows considering all contractual terms of the financial instrument (for example, prepayment option) but does not consider future credit losses. The calculation includes all fees and points paid or received between the parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts. When loans become doubtful of collection, they are written down to their recoverable amounts and interest income is thereafter recorded based on the rate of interest that was used to discount the future cash flows for the purpose of measuring the recoverable amount.

Fees, commissions and other income and expense items are generally recorded on an accrual basis when the service has been provided.

**Foreign currency translation.** Transactions denominated in foreign currency are recorded at the exchange rate ruling on the transaction date. Exchange differences resulting from the settlement of transactions denominated in foreign currency are included in the statement of operations, using the exchange rate ruling on that date.

Monetary assets and liabilities denominated in foreign currency are translated into AZM at the official exchange rate of the NBA at the balance sheet date. Translation differences on debt securities and other monetary financial assets measured at fair value are included in foreign exchange translation gains and losses. Translation differences on non-monetary items such as equities held for trading or available for sale are recorded as part of the fair value gain or loss.

As at 31 December 2004 the principal rate of exchange used for translating foreign currency balances was USD 1 = 4,903 Azerbaijani Manats and EUR 1 = 6,682 Azerbaijani Manats (2003: USD 1 = 4,923 Azerbaijani Manats and EUR 1 = 6,195 Azerbaijani Manats). At present, the Azerbaijani Manat is not a freely convertible currency in most countries outside of the Republic of Azerbaijan.

**Offsetting.** Financial assets and liabilities are offset and the net amount reported in the balance sheet only when there is a legally enforceable right to offset the recognised amounts, and there is an intention to either settle on a net basis, or to realise the asset and settle the liability simultaneously.

**Provisions.** Provisions are recorded when the Bank has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and a reliable estimate of the amount of the obligation can be made.

**Staff costs related contributions.** The Bank's contributions to the social insurance and other funds of the Republic of Azerbaijan in respect of the salary of its employees are expensed as incurred and included into staff costs.

#### **5 Cash and Cash Equivalents**

	<b>2004</b>	<b>2003</b>
Cash on hand	2,460	1,618
Cash balances with the NBA (other than mandatory reserve deposits)	620	3
Correspondent accounts and overnight placements with other banks		
- Republic of Azerbaijan	14	1,826
- Other countries	251	360
<b>Total cash and cash equivalents</b>	<b>3,345</b>	<b>3,807</b>

Geographical, currency and interest rate analyses of cash and cash equivalents are disclosed in Note 19.

**6 Loans and Advances to Customers**

	<b>2004</b>	<b>2003</b>
Current loans	36,136	19,083
Overdue loans	2,385	1,201
Less: Provision for loan impairment	(3,269)	(3,142)
<b>Total loans and advances to customers</b>	<b>35,252</b>	<b>17,142</b>

Movements in the provision for loan impairment are, as follows:

	<b>2004</b>	<b>2003</b>
<b>Provision for loan impairment as at 1 January</b>	<b>3,142</b>	<b>11</b>
Provision for loan impairment during the year	127	3,131
<b>Provision for loan impairment as at 31 December</b>	<b>3,269</b>	<b>3,142</b>

Economic sector risk concentrations within the customer loan portfolio are, as follows:

	<b>2004</b>		<b>2003</b>	
	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>
Trade	28,309	73%	16,013	79%
Production	3,851	10%	2,987	15%
Government institutions	3,811	10%	-	-
Service	2,106	5%	984	4%
Pawn loans	294	1%	153	1%
Transport	150	0%	147	1%
<b>Total loans and advances to customers (aggregate amount)</b>	<b>38,521</b>	<b>100%</b>	<b>20,284</b>	<b>100%</b>

As part of its stated business policy, the Bank mainly issues commercial loans to individuals and legal entities engaged in business activities in the Republic of Azerbaijan. Pawn loans are fully secured by gold collateral and are issued without consideration of the purpose of the loan.

Included in current loans are short term securities issued by the National Bank of the Republic of Azerbaijan amounting to AZM 3,811 million (2003: nil). Those securities bear an average yield of 4.5% p.a. and mature between 21 January and 4 February 2005. The securities have been repaid at maturity dates. No provision has been established against short term securities issued by the National Bank of the Republic of Azerbaijan.

As at 31 December 2004 the estimated fair value of loans and advances to customers was AZM 35,252 million (2003: AZM 17,142 million). Refer to Note 21.

Geographical, currency, maturity and interest rate analyses of loans and advances to customers are disclosed in Note 19.

**7 Other Assets**

	<b>2004</b>	<b>2003</b>
Prepayments	356	462
Computer software	64	86
Items in the course of settlement	91	46
Other	19	-
<b>Total other assets</b>	<b>530</b>	<b>594</b>

Computer software is shown net of accumulated amortisation of AZM 43 million (2003: AZM 22 million).

Geographical, currency and maturity analyses of other assets are disclosed in Note 19.

**8 Premises and Equipment**

	Note	Leasehold improvements	Computers and communication equipment	Furniture, fixtures and others	Motor vehicles	Total
<b>Net book amount as at 31 December 2003</b>		<b>2,339</b>	<b>455</b>	<b>1,062</b>	<b>33</b>	<b>3,889</b>
<b>Book amount at cost</b>						
Opening balance		2,830	541	1,303	43	4,717
Additions		352	166	317	-	835
Disposals		-	-	(2)	-	(2)
<b>Closing balance</b>		<b>3,182</b>	<b>707</b>	<b>1,618</b>	<b>43</b>	<b>5,550</b>
<b>Accumulated depreciation</b>						
Opening balance		(491)	(86)	(241)	(10)	(828)
Depreciation charge	17	(593)	(153)	(342)	(11)	(1,099)
Disposals		-	-	-	-	-
<b>Closing balance</b>		<b>(1,084)</b>	<b>(239)</b>	<b>(583)</b>	<b>(21)</b>	<b>(1,927)</b>
<b>Net book amount as at 31 December 2004</b>		<b>2,098</b>	<b>468</b>	<b>1,035</b>	<b>22</b>	<b>3,623</b>

**9 Customer accounts**

	<b>2004</b>	<b>2003</b>
<b>Legal entities</b>		
- Current/settlement accounts	24	42
<b>Individuals</b>		
- Current/demand accounts	788	-
- Term deposits	5	-
<b>Total customer accounts</b>	<b>817</b>	<b>42</b>

Economic sector concentrations within customer accounts are as follows:

	<b>2004</b>		<b>2003</b>	
	<b>Amount</b>	<b>%</b>	<b>Amount</b>	<b>%</b>
Individuals	793	97%	-	-
Trade	8	1%	42	100%
Insurance	8	1%	-	-
Other	8	1%	-	-
<b>Total customer accounts</b>	<b>817</b>	<b>100%</b>	<b>42</b>	<b>100%</b>

As at 31 December 2004 the Bank had one customer with a balance above AZM 500 million. The total balance on the accounts of this customer was AZM 556 million or 68% of total customer accounts (2003: nil).

Geographical, currency, maturity and interest rate analyses of customer accounts are disclosed in Note 19.

As at 31 December 2004 the estimated fair value of customer accounts was AZM 817 million (2003: AZM 42 million). Refer to Note 21.

**10 Other Borrowed Funds**

	<b>2004</b>	<b>2003</b>
European Bank for Reconstruction and Development	12,257	4,923
Accrued interest expense	99	35
<b>Total other borrowed funds</b>	<b>12,356</b>	<b>4,958</b>

In October 2003 the Bank signed a loan agreement with the European Bank for Reconstruction and Development in the amount of USD 5,000,000 (AZM 24,515 million). As at 31 December 2004 the Bank increased the amount drawn down by USD 1,500,000 (AZM 7,334 million) up to USD 2,500,000 (AZM 12,257 million) of the total loan facility (2003: AZM 4,923 million). The loan carries LIBOR + 3.25% interest per annum and has to be repaid in four equal instalments, starting from May 2008. The Bank pays interest at the rate of 0.5% per annum on the undrawn balance of the total loan facility.

Geographical, currency, maturity and interest rate analyses of other borrowed funds are disclosed in Note 19. The information on related party balances is disclosed in Note 22.

## 10 Other Borrowed Funds (Continued)

As at 31 December 2004 the estimated fair value of other borrowed funds was AZM 12,356 million (2003: AZM 4,958 million). Refer to Note 21.

## 11 Other Liabilities

	<b>2004</b>	<b>2003</b>
Expenses payable	251	179
<b>Total other liabilities</b>	<b>251</b>	<b>179</b>

Geographical, currency and maturity analyses of other liabilities are disclosed in Note 19.

## 12 Share Capital

The Bank's share capital consists of 1,370,000 ordinary shares with par value of USD 5 each, which is fixed in Azerbaijani Manats using official exchange rate of the NBA as at the date of payment of each share capital installment. As at 31 December 2004 paid-in share capital is held, as follows:

	Country of registration	2004			2003		
		Number of ordinary shares	Nominal amount	Share %	Number of ordinary shares	Nominal amount	Share %
Black Sea Trade and Development Bank	Greece	350,000	8,575	25.547	350,000	8,575	35.000
International Finance Corporation	USA	350,000	8,575	25.547	350,000	8,575	35.000
European Bank for Reconstruction and Development	UK	250,000	6,125	18.248	250,000	6,125	25.000
LFS Financial Systems	Germany	78,000	1,911	5.693	50,000	1,225	5.000
Kreditansalt für Wiederaufbau (KfW)	Germany	342,000	8,381	24.964	-	-	-
<b>Total share capital</b>		<b>1,370,000</b>	<b>33,567</b>	<b>100</b>	<b>1,000,000</b>	<b>24,500</b>	<b>100</b>

On 31 August 2004 the Bank issued additional 370,000 ordinary shares with par value of USD 5 each. The total amount of share capital increase in 2004 amounted to AZM 9,067 million. Of these shares 28,000 were acquired by the existing shareholder LFS Financial Systems and 342,000 were acquired by Kreditansalt für Wiederaufbau (KfW) which became a new shareholder of the Bank with effective share of 24.964%.

## 13 Accumulated Deficit

In accordance with the Law on Banks of the Republic of Azerbaijan, the Bank allocates profits as dividends or transfers them to reserves (fund accounts) on the basis of statutory financial statements prepared in accordance with Azerbaijani Accounting Rules. The Bank's statutory accumulated deficit under Azerbaijani Accounting Rules as at 31 December 2004 is AZM 4,167 million (2003: AZM 4,243 million). Statutory profits are normally allocated on an annual basis.

**14 Interest Income and Expense**

	<b>2004</b>	<b>2003</b>
<b>Interest income</b>		
Loans and advances to customers	7,071	2,705
Correspondent accounts with other banks	37	30
Term deposits with other banks	-	75
<b>Total interest income</b>	<b>7,108</b>	<b>2,810</b>
<b>Interest expense</b>		
Other borrowed funds	(514)	(159)
<b>Total interest expense</b>	<b>(514)</b>	<b>(159)</b>
<b>Net interest income</b>	<b>6,594</b>	<b>2,651</b>

**15 Fee and Commission Income and Expense**

	<b>2004</b>	<b>2003</b>
<b>Fee and commission income</b>		
Fees and commissions for fund transfers	30	1
Cash withdrawal fees	20	10
Other	27	13
<b>Total fee and commission income</b>	<b>77</b>	<b>24</b>
<b>Fee and commission expense</b>		
Cash withdrawal fees	(54)	(71)
Commission on fund transfers	(29)	(20)
Other	(7)	
<b>Total fee and commission expense</b>	<b>(90)</b>	<b>(91)</b>
<b>Net fee and commission expense</b>	<b>(13)</b>	<b>(67)</b>

The Bank has a net fee and commission expense for the years 2004 and 2003 as the fee income related to disbursements of loans have been classified as interest income within the statement of operations.

**16 Staff Costs**

In addition to the amount of staff costs shown in the statement of operations, the Bank received management services from its shareholders, including secondment of LFS Financial Systems' employees for the positions of General Manager, Credit Managers/Branch Managers, and various consulting services related to the business of the Bank. These services were provided under the Management Service Agreement between the Bank and LFS Financial Systems dated 14 September 2004, which is a shareholder of the Bank. The cost of such services is not included in the line "Staff costs" within the Bank's statement of operations since the fees charged by LFS Financial Systems for the management services and consulting services are borne by one or several of the other shareholders of the Bank (Note 22).

**17 Operating Expenses**

	Note	2004	2003
Depreciation of premises and equipment	8	1,099	729
Operating lease rentals		767	396
Office supplies and maintenance		652	261
Communication		571	173
Professional services		537	149
Advertisement		175	133
Insurance		13	100
Other		378	132
<b>Total operating expenses</b>		<b>4,192</b>	<b>2,073</b>

**18 Income Taxes**

	2004	2003
Current tax charge	-	-
Deferred taxation movement due to:		
- Origination and reversal of temporary differences	31	(725)
- Reduction in tax rate	-	(40)
<b>Income tax expense/(credit) for the year</b>	<b>31</b>	<b>(765)</b>

**18 Income Taxes (Continued)**

The income tax rate applicable to the Bank is 24% (2003: 25%). Reconciliation between the expected and the actual taxation charge is provided below.

	<b>2004</b>	<b>2003</b>
<b>IFRS profit/(loss) before tax</b>	<b>76</b>	<b>(3,455)</b>
Theoretical tax (charge)/credit at the applicable statutory rate (2004: 24%, 2003: 25%)	(18)	863
Non-deductible expenses	(13)	(58)
Effect of the change in tax rate	-	(40)
<b>Income tax (expense)/credit for the year</b>	<b>(31)</b>	<b>765</b>

Differences between IFRS and the Azerbaijani statutory taxation rules give rise to certain temporary differences between the carrying amount of certain assets and liabilities for financial reporting purposes and for income tax calculation purposes. The tax effect of the movement on these temporary differences is recorded at the rate of 24% both for 2003 and 2004.

As at 31 December 2004 and 2003, the temporary differences giving rise to the deferred tax assets and liabilities were as follows:

	<b>2003</b>	<b>Movement</b>	<b>2004</b>
<b>Tax effect of deductible temporary differences</b>			
Tax loss carried forward	979	(157)	822
Premises and equipment, differences in depreciation rates	-	107	107
Other assets	-	4	4
<b>Gross deferred tax asset</b>	<b>979</b>	<b>(46)</b>	<b>933</b>
<b>Tax effect of taxable temporary differences</b>			
Premises and equipment, differences in depreciation rates	(15)	15	-
Other assets	(2)	-	(2)
<b>Gross deferred tax liability</b>	<b>(17)</b>	<b>15</b>	<b>(2)</b>
<b>Total net deferred tax asset</b>	<b>962</b>	<b>(31)</b>	<b>931</b>

**18 Income Taxes (Continued)**

	<b>2002</b>	<b>Movement</b>	<b>2003</b>
<b>Tax effect of deductible temporary differences</b>			
Tax loss carried forward	284	695	979
Other	39	(39)	-
Accruals	20	(20)	-
<b>Gross deferred tax asset</b>	<b>343</b>	<b>636</b>	<b>979</b>
<b>Tax effect of taxable temporary differences</b>			
Premises and equipment, differences in depreciation rates	(125)	110	(15)
Accruals	(15)	15	-
Other	(6)	4	(2)
<b>Gross deferred tax liability</b>	<b>(146)</b>	<b>129</b>	<b>(17)</b>
<b>Total net deferred tax asset</b>	<b>197</b>	<b>765</b>	<b>962</b>

The net deferred tax asset represents income taxes recoverable through future revenues and is recorded as a net deferred tax asset on the balance sheet. Deferred income tax assets are recognised for tax loss carry forward only to the extent that realisation of the related tax benefit is probable.

As at 31 December 2004 the Bank has incurred statutory tax losses of AZM 3,419 million (2003: AZM 4,079 million) to carry forward against future taxable income. These tax losses will expire in 2007 (AZM 465 million) and 2008 (AZM 2,954 million), if not utilised. Based on the projected five-year annual budgets, the management believes that the Bank will be able to generate sufficient taxable income to utilize the full amount of the tax loss recognised for the purposes of calculation of the net deferred tax asset in these financial statements.

**19 Financial Risk Management**

The risk management function within the Bank is carried out in respect of financial risks (credit, market, geographical, currency, liquidity and interest rate), operational risks and legal risks. The primary objectives of the financial risk management function are to establish risk limits, and then ensure that exposure to risk stays within these limits. The operational and legal risk management functions are intended to ensure proper functioning of internal policies and procedures to minimise operational and legal risks.

**Credit risk.** The Bank takes on exposure to credit risk, which is the risk that counterparty will be unable to pay amounts in full when due. The Bank structures the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower, or groups of borrowers, and to geographical and industry segments. Such risks are monitored on a revolving basis and subject to an annual or more frequent review. Limits on the level of credit risk by product, borrower and industry sector are approved regularly by the Management Board and Credit Committee.

Exposure to any one borrower including banks and brokers is further restricted by sub-limits covering on and off-balance sheet exposures and daily delivery risk limits in relation to trading items. Actual exposures against limits are monitored daily.

Exposure to credit risk is managed through regular analysis of the ability of borrowers and potential borrowers to meet interest and principal repayment obligations and by changing these lending limits where appropriate. Exposure to credit risk is also managed, in part, by obtaining collateral and corporate and personal guarantees.

## 19 Financial Risk Management (Continued)

The Bank's maximum exposure to credit risk is primary reflected in the carrying amounts of financial assets on the balance sheet. The impact of possible netting of assets and liabilities to reduce potential credit exposure is not significant.

**Market risk.** The Bank takes on exposure to market risks. Market risks arise from open positions in interest rate, currency and equity products, all of which are exposed to general and specific market movements. The Management Board sets limits on the value of risk that may be accepted, which is monitored on a daily basis. However, the use of this approach does not prevent losses outside of these limits in the event of more significant market movements.

**Geographical risk.** The geographical concentration of the Bank's assets and liabilities as at 31 December 2004 is set out below:

	<b>Republic of Azerbaijan</b>	<b>OECD*</b>	<b>Total</b>
<b>Assets</b>			
Cash and cash equivalents	3,094	251	3,345
Mandatory cash balances with the NBA	74	-	74
Loans and advances to customers	35,252	-	35,252
Other assets	530	-	530
Deferred tax asset	931	-	931
Premises and equipment	3,623	-	3,623
<b>Total assets</b>	<b>43,504</b>	<b>251</b>	<b>43,755</b>
<b>Liabilities</b>			
Customer accounts	817	-	817
Other borrowed funds	-	12,356	12,356
Other liabilities	251	-	251
<b>Total liabilities</b>	<b>1,068</b>	<b>12,356</b>	<b>13,424</b>
<b>Net balance sheet position</b>	<b>42,436</b>	<b>(12,105)</b>	<b>30,331</b>

\*OECD stands for the Organization for Economic Cooperation and Development

Assets, liabilities and credit related commitments have been based on the country, in which the counterparty is located. Cash on hand, precious metals and premises and equipment have been allocated based on the country in which they are physically held.

The geographical concentration of the Bank's assets and liabilities as at 31 December 2003 is set out below:

	<b>Republic of Azerbaijan</b>	<b>OECD</b>	<b>Total</b>
<b>Net balance sheet position</b>	<b>25,817</b>	<b>(4,598)</b>	<b>21,219</b>

**19 Financial Risk Management (Continued)**

**Currency risk.** The Bank takes on exposure to effects of fluctuations in the prevailing foreign currency exchange rates on its financial position and cash flows. The table below summarises the Bank's exposure to foreign currency exchange rate risk as at 31 December 2004. Included in the table are the Bank's assets and liabilities at their carrying amounts, categorised by currency. As at 31 December 2004, the Bank has the following positions in currencies:

	<b>AZM</b>	<b>USD</b>	<b>EUR</b>	<b>Total</b>
<b>Assets</b>				
Cash and cash equivalents	955	2,267	123	3,345
Mandatory cash balances with the NBA	74	-	-	74
Loans and advances to customers	5,258	29,994	-	35,252
Other assets	439	91	-	530
Deferred tax asset	931	-	-	931
Premises and equipment	3,623	-	-	3,623
<b>Total assets</b>	<b>11,280</b>	<b>32,352</b>	<b>123</b>	<b>43,755</b>
<b>Liabilities</b>				
Customer accounts	18	730	69	817
Other borrowed funds	-	12,356	-	12,356
Other liabilities	251	-	-	251
<b>Total liabilities</b>	<b>269</b>	<b>13,086</b>	<b>69</b>	<b>13,424</b>
<b>Net balance sheet position</b>	<b>11,011</b>	<b>19,266</b>	<b>54</b>	<b>30,331</b>

As at 31 December 2003, the Bank had the following positions in currency

	<b>AZM</b>	<b>USD</b>	<b>EUR</b>	<b>Total</b>
<b>Net balance sheet position</b>	<b>8,466</b>	<b>12,714</b>	<b>39</b>	<b>21,219</b>

The Bank has extended loans and advances denominated in foreign currencies. Depending on the revenue stream of the borrower, the appreciation of the currencies against the Azerbaijani Manat may adversely affect the borrowers' repayment ability and therefore increases the likelihood of future loan losses.

**Liquidity risk.** Liquidity risk is defined as the risk when the maturity of assets and liabilities does not match. The Bank is exposed to daily calls on its available cash resources from current accounts and loan draw downs. The Bank does not maintain cash resources to meet all of these needs as experience shows that a minimum level of reinvestment of maturing funds can be predicted with a high level of certainty.

The table below shows assets and liabilities as at 31 December 2004 by their remaining contractual maturity.

**19 Financial Risk Management (Continued)**

The liquidity position of the Bank as at 31 December 2004 is set out below.

	<b>Demand and up to 1 month</b>	<b>From 1 to 3 months</b>	<b>From 3 to 12 months</b>	<b>More than 1 year</b>	<b>Overdue/ No stated maturity</b>	<b>Total</b>
<b>Assets</b>						
Cash and cash equivalents	3,345	-	-	-	-	3,345
Mandatory cash balances with the NBA	74	-	-	-	-	74
Loans and advances to customers	5,499	9,626	16,555	3,185	387	35,252
Other assets	204	157	105	-	64	530
Deferred tax asset	-	-	-	931	-	931
Premises and equipment	-	-	-	-	3,623	3,623
<b>Total assets</b>	<b>9,122</b>	<b>9,783</b>	<b>16,660</b>	<b>4,116</b>	<b>4,074</b>	<b>43,755</b>
<b>Liabilities</b>						
Customer accounts	812	-	5	-	-	817
Other borrowed funds	-	-	-	12,356	-	12,356
Other liabilities	152	-	99	-	-	251
<b>Total liabilities</b>	<b>964</b>	<b>-</b>	<b>104</b>	<b>12,356</b>	<b>-</b>	<b>13,424</b>
<b>Net liquidity gap</b>	<b>8,158</b>	<b>9,783</b>	<b>16,556</b>	<b>(8,240)</b>	<b>4,074</b>	<b>30,331</b>
<b>Cumulative liquidity gap as at 31 December 2004</b>	<b>8,158</b>	<b>17,941</b>	<b>34,497</b>	<b>26,257</b>	<b>30,331</b>	
<b>Cumulative liquidity gap as at 31 December 2003</b>	<b>6,491</b>	<b>12,043</b>	<b>20,038</b>	<b>16,661</b>	<b>21,219</b>	

Mandatory cash balances with the NBA are included within demand and less than one month as the majority of liabilities, to which this balance relates to, are also included within this category.

The matching and/or controlled mismatching of the maturities and interest rates of assets and liabilities is fundamental to the Management of the Bank. It is unusual for banks ever to be completely matched since business transacted is often of an uncertain term and of different types. An unmatched position potentially enhances profitability, but can also increase the risk of losses. The maturities of assets and liabilities and the ability to replace, at an acceptable cost, interest-bearing liabilities as they mature, are important factors in assessing the liquidity of the Bank and its exposure to changes in interest and exchange rates.

**19 Financial Risk Management (Continued)**

**Interest rate risk.** The Bank takes on exposure to the effects of fluctuations in the prevailing levels of market interest rates on its financial position and cash flows. Interest margins may increase as a result of such changes, but may reduce or create losses in the event that unexpected movements arise.

The Bank is exposed to interest rate risk, principally as a result of lending at fixed interest rates, in amounts and for periods, which differ from those of term borrowings at fixed interest rates. In practice, interest rates are generally fixed on a short-term basis. Also, interest rates that are contractually fixed on both assets and liabilities are usually renegotiated to reflect current market conditions.

The Management Board sets limits on the level of mismatch of interest rate reprising that may be undertaken, which is monitored daily. In the absence of any available hedging instruments, the Bank normally seeks to match its interest rate positions.

The table below summarises the Bank's exposure to interest rate risks. Included in the table are the Bank's assets and liabilities at carrying amounts, categorised by the earlier of contractual reprising or maturity dates.

	<b>Demand and up to 1 month</b>	<b>From 1 to 3 months</b>	<b>From 3 to 12 months</b>	<b>More than 1 year</b>	<b>Overdue/ Non interest bearing</b>	<b>Total</b>
<b>Assets</b>						
Cash and cash equivalents	3,345	-	-	-	-	3,345
Mandatory cash balances with the NBA	-	-	-	-	74	74
Loans and advances to customers	5,499	9,626	16,555	3,185	387	35,252
Other assets	-	-	-	-	530	530
Deferred tax asset	-	-	-	-	931	931
Premises and equipment	-	-	-	-	3,623	3,623
<b>Total assets</b>	<b>8,844</b>	<b>9,626</b>	<b>16,555</b>	<b>3,185</b>	<b>5,545</b>	<b>43,755</b>
<b>Liabilities</b>						
Customer accounts	-	-	5	-	812	817
Other borrowed funds	-	-	-	12,356	-	12,356
Other liabilities	-	-	-	-	251	251
<b>Total liabilities</b>	<b>-</b>	<b>-</b>	<b>5</b>	<b>12,356</b>	<b>1,063</b>	<b>13,424</b>
<b>Net sensitivity gap</b>	<b>8,844</b>	<b>9,626</b>	<b>16,550</b>	<b>(9,171)</b>	<b>4,482</b>	<b>30,331</b>
<b>Cumulative sensitivity gap as at 31 December 2004</b>	<b>8,844</b>	<b>18,470</b>	<b>35,020</b>	<b>25,849</b>	<b>30,331</b>	
<b>Cumulative sensitivity gap as at 31 December 2003</b>	<b>6,072</b>	<b>11,624</b>	<b>19,619</b>	<b>15,280</b>	<b>21,219</b>	

## 19 Financial Risk Management (Continued)

The table below summarizes the effective interest rates by major currencies for major monetary financial instruments. The analysis has been prepared based on period-end effective rates used for amortisation of respective assets/liabilities.

	2004		2003	
	USD	AZM	USD	AZM
<b>Assets</b>				
Cash and cash equivalents	1.5%		0.7%	-
Securities issued by the National Bank of the Republic of Azerbaijan	-	4.5%	-	-
Loans and advances to customers	34.7%	35.4%	34.3%	36.0%
<b>Liabilities</b>				
Customer accounts	8%	-	-	-
Other borrowed funds	5.7%	-	4.3%	-

The sign “-“ in the table above means that the Bank does not have the respective assets or liabilities in corresponding currency.

## 20 Contingencies, Commitments and Derivative Financial Instruments

**Legal proceedings.** From time to time and in the normal course of business, claims against the Bank are received. As at 31 December 2004 and 2003, the Bank was not engaged in any litigation proceedings. On the basis of own estimates and internal and external professional advice the Management is of the opinion that no material losses will be incurred, and, accordingly, no provision has been made in these financial statements.

**Tax legislation.** Tax, currency and customs legislation of the Republic of Azerbaijan is subject to varying interpretations, and changes, which can occur frequently. Management’s interpretation of such legislation as applied to the transactions and activity of the Bank may be challenged by the relevant tax authorities. As a result, significant additional taxes, penalties and interest may be assessed. Starting from the financial year ended 31 December 2001 fiscal periods remain open to review by the authorities in respect of taxes for three calendar years preceding the year of review. This clause of the Tax Code of the Republic of Azerbaijan is applied prospectively, i.e. does not apply to the financial years prior to 2001. Under certain legislative circumstances reviews may cover longer periods.

The tax consequence of transactions for Azerbaijani taxation purposes is frequently determined by the form, in which transactions are documented, and the underlying accounting treatment prescribed by Azerbaijani Accounting Rules. Accordingly, the Bank structures certain transactions so as to take advantage of such form driven determinations to reduce the overall effective tax rate of the Bank. The statement of operations as presented in these financial statements includes reclassifications to reflect the underlying economic substance of those transactions. The effect of these reclassifications was not taken into consideration for the purposes of calculation of the Bank’s profit before taxation or the tax charge recorded in these financial statements.

The Bank’s Management believes that its interpretation of the relevant legislation is appropriate and the Bank’s tax, currency and customs positions will be sustained. Accordingly, as at 31 December 2004 no provision for potential tax liabilities had been recorded (2003: no provision).

**Capital commitments.** As at 31 December 2004 the Bank had no significant capital commitments (2003: no significant capital commitments).

**Operating lease commitments.** The Bank has no non-cancellable operating lease commitments as at 31 December 2004. All lease agreements in force as at 31 December 2004 can be terminated at any time, therefore, the Bank has no contingent liabilities or commitments related to operating leases. (2003: no commitments under operating leases).

**Credit related commitments.** As at 31 December 2004 the Bank had no credit related commitments (2003: no credit related commitments).

## **21 Fair Value of Financial Instruments**

Fair value is the amount, at which a financial instrument could be exchanged in a current transaction between willing parties, other than in a forced sale or liquidation, and is best evidenced by a quoted market price.

The estimated fair values of financial instruments have been determined by the Bank using available market information, where it exists, and appropriate valuation methodologies. However, judgement is necessarily required to interpret market data to determine the estimated fair value. While Management has used available market information in estimating the fair value of financial instruments, the market information may not be fully reflective of the value that could be realised in the current circumstances.

**Financial instruments carried at fair value.** Cash and cash equivalents are carried on the balance sheet at their fair value.

**Loans originated carried at amortised cost less provision for impairment.** The estimated fair value of fixed interest rate instruments is based on estimated future cash flows expected to be received discounted at current interest rates for new instruments with similar credit risk and remaining maturity. Refer to Note 6 for the estimated fair values of loans and advances to customers.

**Liabilities carried at amortised cost.** The estimated fair value of fixed interest rate instruments without a quoted market price is based on expected cash flows discounted at current interest rates for new instruments with similar credit risk and remaining maturity. Refer to Notes 9 and 10, for the estimated fair values of customer accounts and other borrowed funds, respectively.

## **22 Related Party Transactions**

For the purposes of these financial statements, parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial or operational decisions as defined by IAS 24 “Related Party Disclosures”. In considering each possible related party relationship, attention is directed to the substance of the relationship, not merely the legal form.

During the year a number of banking transactions were entered into with related parties in the normal course of business. The major transactions relate to the Management Service Agreement between the Bank and LFS Financial Systems, which is a shareholder of the Bank. Under the Management Service Agreement, LFS Financial Systems provides the Bank with management services, including secondment of LFS Financial Systems’ employees for the positions of General Manager, Credit Managers/Branch Managers and various consulting services related to the business of the Bank. The Bank bears no costs in relation to these services provided by LFS Financial Systems since, in accordance with the Management Services Agreement, fees charged by LFS Financial Systems for the management services and various consulting services are borne by one or several of the other shareholders of the Bank (Note 16).

The outstanding balances at the year end and income and expense items for the year with related parties are as follows:

	<b>2004</b>	<b>2003</b>
<b>Funds borrowed from shareholders</b>		
Funds borrowed as at the year end (contractual interest rate: LIBOR + 3.25%)	12,257	4,923
Accrued interest expense	99	35
Interest expense for the year	514	159

As was reported in the Note 16 the directors’ remunerations are paid by the shareholders under the management service agreement. Therefore, there is no remuneration paid to directors by the Bank.