

MICRO FINANCE BANK OF AZERBAIJAN

Financial Statements and Auditors' Report

31 December 2005

CONTENTS

Auditors' Report

FINANCIAL STATEMENTS

Balance Sheet.....	3
Income Statement.....	4
Statement of Cash Flows.....	5
Statement of Changes in Shareholders' Equity.....	6

Notes to the Financial Statements

1	Introduction.....	7
2	Operating Environment of the Bank.....	7
3	Basis of Preparation and Significant Accounting Policies.....	7
4	Critical Accounting Estimates, and Judgements in Applying Accounting Policies.....	11
5	Adoption of New or Revised Standards and Interpretations.....	11
6	New Accounting Pronouncements.....	12
7	Cash and Cash Equivalents.....	13
8	Loans and Advances to Customers.....	13
9	Other Assets.....	14
10	Premises and Equipment.....	14
11	Customer Accounts.....	15
12	Shareholder Loans.....	16
13	Other Borrowings.....	16
14	Other Liabilities.....	17
15	Share Capital.....	17
16	Accumulated Deficit.....	17
17	Interest Income and Expense.....	18
18	Fee and Commission Income and Expense.....	18
19	Staff Costs.....	18
20	Operating Expenses.....	19
21	Income Taxes.....	19
22	Financial Risk Management.....	20
23	Contingencies, Commitments and Derivative Financial Instruments.....	27
24	Fair Value of Financial Instruments.....	28
25	Related Party Transactions.....	28
26	Subsequent Events.....	28

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 of 31 December 2005, and the related statements of income, cash flows and changes in 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 of 31 December 2005 and the results of its operations and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

PricewaterhouseCoopers Eastern Europe B.V.

Baku, Republic of Azerbaijan
25 April 2006

Micro Finance Bank of Azerbaijan
Balance Sheet as at 31 December 2005

<i>In millions of Azerbaijani Manats</i>	Note	2005	2004
Assets			
Cash and cash equivalents	7	13,869	3,345
Mandatory cash balances with the National Bank of the Republic of Azerbaijan		306	74
Loans and advances to customers	8	79,584	35,252
Other assets	9	1,677	530
Deferred tax asset	21	593	931
Premises and equipment	10	4,299	3,623
Total assets		100,328	43,755
Liabilities			
Customer accounts	11	2,975	817
Shareholder loans	12	46,388	12,356
Other borrowings	13	19,723	-
Other liabilities	14	237	251
Total liabilities		69,323	13,424
Shareholders' equity			
Share capital	15	33,567	33,567
Accumulated deficit	16	(2,562)	(3,236)
Total shareholders' equity		31,005	30,331
Total liabilities and shareholders' equity		100,328	43,755

Approved for issue by the Board of Directors and signed on its behalf on 25 April 2006.


 Thomas Engelhardt
 Chairman of the Management Board




 Eshan Hajiyev
 Chief Accountant

Micro Finance Bank of Azerbaijan
Income Statement for the Year Ended 31 December 2005

<i>In millions of Azerbaijani Manats</i>	Note	2005	2004
Interest income	17	16,333	6,580
Interest expense	17	(3,550)	(514)
Net interest income		12,783	6,066
Provision for loan impairment	8	(271)	(127)
Net interest income after provision for loan impairment		12,512	5,939
Gains less losses arising from trading in foreign currencies		71	30
Foreign exchange translation losses less gains		(1,404)	(73)
Fee and commission income	18	1,750	605
Fee and commission expense	18	(261)	(90)
Other operating income		21	18
Operating profit		12,689	6,429
Staff costs	19	(5,339)	(2,161)
Operating expenses	20	(6,338)	(4,192)
Profit before taxation		1,012	76
Income tax expense	21	(338)	(31)
Net profit		674	45

Micro Finance Bank of Azerbaijan
Statement of Cash Flows for the Year Ended 31 December 2005

<i>In millions of Azerbaijani Manats</i>	Note	2005	2004
Cash flows from operating activities			
Interest received		15,762	6,511
Interest paid		(2,934)	(450)
Fees and commissions received		1,750	605
Fees and commissions paid		(261)	(90)
Other operating income received		92	48
Operating expenses paid		(10,398)	(5,013)
Cash flows provided from/(used in) operating activities before changes in operating assets and liabilities		4,011	1,611
Changes in operating assets and liabilities			
Net increase in mandatory cash balances with the National Bank of the Republic of Azerbaijan		(232)	(70)
Net increase in loans and advances to customers		(44,032)	(18,168)
Net increase in other assets		(930)	(152)
Net increase in customer accounts		2,158	775
Net (decrease)/increase in other liabilities		(36)	49
Net cash used in operating activities		(39,061)	(15,955)
Cash flows from investing activities			
Acquisition of premises and equipment	10	(2,150)	(835)
Net cash used in investing activities		(2,150)	(835)
Cash flows from financing activities			
Issue of ordinary shares		-	9,067
Proceeds from borrowings	12	54,287	7,334
Repayment of borrowings	12	(1,148)	-
Net cash provided from financing activities		53,139	16,401
Effect of exchange rate changes on cash and cash equivalents		(1,404)	(73)
Net increase/(decrease) in cash and cash equivalents		10,524	(462)
Cash and cash equivalents as at the beginning of the year	7	3,345	3,807
Cash and cash equivalents as at the end of the year		13,869	3,345

Micro Finance Bank of Azerbaijan
Statement of Changes in Shareholders' Equity for the Year Ended 31 December 2005

	Share capital	Accumulated deficit	Total shareholders' equity
Balance as at 1 January 2004	24,500	(3,281)	21,219
Net profit	-	45	45
Share Issue (Note 15)	9,067	-	9,067
<hr/>			
Balance as at 31 December 2004	33,567	(3,236)	30,331
Net profit	-	674	674
<hr/>			
Balance as at 31 December 2005	33,567	(2,562)	31,005

1 Introduction

These financial statements have been prepared in accordance with International Financial Reporting Standards for the year ended 31 December 2005 for Micro Finance Bank of Azerbaijan ("the Bank").

The Bank was registered as a closed joint-stock company limited by shares in accordance with Azerbaijani regulations on 30 September 2002.

Principal activity. The Bank's principal business activity is small and micro lending to individuals and legal entities in the Republic of Azerbaijan. The Bank has operated under a full banking licence issued by the National Bank of the Republic of Azerbaijan ("NBA") on 22 October 2002.

The Bank has 7 branches in the Republic of Azerbaijan as at 31 December 2005 (2004: 5 branches).

Registered address and place of business. The Bank's registered office is located at 176 Bashir Safaroglu St, Baku 1000, the Republic of Azerbaijan.

Presentation Currency. According to the Presidential Decree of the Republic of Azerbaijan dated 7 February 2005, the national currency of the Republic of Azerbaijan which is Azerbaijani Manat was denominated in the ratio of 5,000 AZM to 1 New Azerbaijani Manat ("AZN") starting from 1 January 2006. These financial statements are presented in millions of old Azerbaijani Manats ("AZM"). Presentation of the financial statements in AZN is mandatory starting from 1 January 2006. Refer to Note 26.

2 Operating Environment of the Bank

The Republic of Azerbaijan displays certain characteristics of an emerging market, including the existence of a currency that is not freely convertible in most countries outside of the Republic of Azerbaijan, restrictive currency controls, relatively high inflation and economic growth. The banking sector in the Republic of Azerbaijan is sensitive to adverse fluctuations in confidence and economic conditions. The Azeri economy occasionally experiences falls in confidence in the banking sector accompanied by reductions in liquidity. Management is unable to predict economic trends and developments in the banking sector and what effect, if any, deterioration in the liquidity or confidence in the Azeri banking system could have on the financial position of the Bank.

The tax, currency and customs legislation within the Republic of Azerbaijan is subject to varying interpretations, and changes, which can occur frequently. Furthermore, the need for further developments in the bankruptcy laws, the absence of 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 future economic direction of the Republic of Azerbaijan is largely dependent upon the effectiveness of economic, financial and monetary measures undertaken by the Government, together with tax, legal, regulatory, and political developments.

3 Basis of Preparation and Significant Accounting Policies

Basis of preparation. These financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") under the historical cost convention. The principal accounting policies applied in the preparation of these financial statements are set out below. These policies have been consistently applied to all the periods presented, unless otherwise stated (refer to Note 5, Adoption of New or Revised Standards and Interpretations).

Key measurement terms. Depending on their classification financial instruments are carried at cost, fair value, or amortised cost as described below.

Cost is the amount of cash or cash equivalents paid or the fair value of the other consideration given to acquire an asset at the time of its acquisition and includes *transaction costs*. *Transaction costs* are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial instrument. An incremental cost is one that would not have been incurred if the transaction had not taken place. Transaction costs include fees and commissions paid to agents (including employees acting as selling agents), advisors, brokers and dealers, levies by regulatory agencies and securities exchanges, and transfer taxes and duties. Transaction costs do not include debt premiums or discounts, financing costs or internal administrative or holding costs.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. Fair value is the current bid price for financial assets and current asking price for financial liabilities which are quoted in an active market. For assets and liabilities with offsetting market risks, the Bank may use mid-market prices as a basis for establishing fair values for the offsetting risk positions and apply the bid or asking price to the net open position as appropriate. A financial instrument is regarded as quoted in an active

3 Basis of Preparation and Significant Accounting Policies (Continued)

market if quoted prices are readily and regularly available from an exchange or other institution and those prices represent actual and regularly occurring market transactions on an arm's length basis.

In other than active markets, the most recent arms length transactions are the basis of current fair values. Recent transaction prices are appropriately adjusted if they do not reflect current fair values, for example because the transaction was a distress sale. Fair value is not the amount that an entity would receive or pay in a forced transaction, involuntary liquidation or distress sale.

Valuation techniques such as discounted cash flows models and consideration of financial data of the investees are used to fair value certain financial instruments, for which external market pricing information is not available. Valuation techniques may require assumptions not supported by observable market data. Disclosures are made in these financial statements if changing any such assumptions to a reasonably possible alternative would result in significantly different profit, income, total assets or total liabilities.

Amortised cost is the amount at which the financial instrument was recognised at initial recognition less any principal repayments, plus accrued interest, and for financial assets less any write-down for incurred impairment losses. Accrued interest includes amortisation of transaction costs deferred at initial recognition and of any premium or discount to maturity amount using the effective interest method. Accrued interest income and accrued interest expense, including both accrued coupon and amortised discount, are not presented separately and are included in the carrying values of related balance sheet items.

The effective interest method is a method of allocating interest income or interest expense over the relevant period so as to achieve a constant periodic rate of interest (effective interest rate) on the carrying amount. The effective interest rate is the rate that exactly discounts estimated future cash payments or receipts (excluding future credit losses) through the expected life of the financial instrument or a shorter period, if appropriate, to the net carrying amount of the financial instrument. The effective interest rate discounts cash flows of variable interest instruments to the next interest re-pricing date except for the premium or discount which reflects the credit spread over the floating rate specified in the instrument, or other variables that are not reset to market rates. Such premiums or discounts are amortised over the whole expected life of the instrument. The present value calculation includes all fees paid or received between parties to the contract that are an integral part of the effective interest rate (refer to income and expense recognition policy).

Initial recognition of financial instruments. Trading securities, derivatives and other financial instruments at fair value through profit or loss are initially recorded at fair value. All other financial instruments are initially recorded at fair value plus transaction costs. Fair value at initial recognition is best evidenced by the transaction price. A gain or loss on initial recognition is only recorded if there is a difference between fair value and transaction price which can be evidenced by other observable current market transactions in the same instrument or by a valuation technique whose inputs include only data from observable markets.

All purchases and sales of financial instruments that require delivery within the time frame established by regulation or market convention ("regular way" purchases and sales) are recorded at trade date, which is the date that the Bank commits to deliver a financial instrument. All other purchases and sales are recognised on the settlement date with the change in value between the commitment date and settlement date not recognised for assets carried at cost or amortised cost; recognised in profit or loss for trading securities, derivatives and other financial assets at fair value through profit or loss; and recognised in equity for assets classified as available for sale.

Cash and cash equivalents. Cash and cash equivalents are items that can be converted into cash within a day. All short-term inter-bank 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. Cash and cash equivalents are carried at amortised cost.

Mandatory cash balances with the NBA. Mandatory cash balances with the NBA are carried at amortised cost and represent non-interest bearing mandatory reserve deposits which 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.

Loans and advances to customers. Loans and advances to customers are recorded when the Bank advances money to purchase or originate an unquoted non-derivative receivable from a customer due on fixed or determinable dates and has no intention of trading the receivable. Loans and advances to customers are carried at amortised cost.

Impairment of financial assets carried at amortised cost. Impairment losses are recognised in profit or loss when incurred as a result of one or more events ("loss events") that occurred after the initial recognition of the financial asset and which have an impact on the amount or timing of the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. If the Bank determines that no objective evidence exists that impairment was incurred for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment.

3 Basis of Preparation and Significant Accounting Policies (Continued)

For the purposes of a collective evaluation of impairment, financial assets are grouped on the basis of similar credit risk characteristics. Those characteristics are relevant to the estimation of future cash flows for groups of such assets by being indicative of the debtors' ability to pay all amounts due according to the contractual terms of the assets being evaluated.

Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of the contractual cash flows of the assets and the experience of management in respect of the extent to which amounts will become overdue as a result of past loss events and the success of recovery of overdue amounts. Past experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect past periods and to remove the effects of past conditions that do not exist currently.

Impairment losses are recognised through an allowance account to write down the asset's carrying amount to the present value of expected cash flows (which exclude future credit losses that have not been incurred) discounted at the effective interest rate of the asset. The calculation of the present value of the estimated future cash flows of a collateralised financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised (such as an improvement in the debtor's credit rating), the previously recognised impairment loss is reversed by adjusting the allowance account through profit or loss.

Non-collectable assets are written off against the related impairment loss provision after all the necessary procedures to recover the asset have been completed and the amount of the loss has been determined.

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

Costs of minor repairs and maintenance are expensed when incurred. Cost of replacing major parts or components of premises and equipment items are capitalized and the replaced part is retired.

If impaired, premises and equipment are written down to the higher of their value in use and fair value less costs to sell. The decrease in carrying amount is charged to profit or loss. An impairment loss recognized for an asset in prior years is reversed if there has been a change in the estimates used to determine the asset's value in use or fair value less costs to sell.

Gains and losses on disposals determined by comparing proceeds with carrying amount are recognized in profit or loss.

Depreciation. Depreciation on premises and equipment is calculated using the straight-line method to allocate their cost to their residual values over their estimated useful lives at the following annual rates:

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

The residual value of an asset is the estimated amount that the Bank would currently obtain from disposal of the asset less the estimated costs of disposal, if the asset were already of the age and in the condition expected at the end of its useful life. The residual value of an asset is nil if the Bank expects to use the asset until the end of its physical life. The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

Operating leases. Where the Bank is the lessee in a lease, which does not transfer substantially all the risks and rewards incidental to ownership from the lessor to the Bank, the total lease payments, including those on expected termination, are charged to profit or loss on a straight-line basis over the period of the lease.

Customer accounts. Customer accounts are non-derivative liabilities to individuals, state or corporate customers and are carried at amortized cost.

Borrowings. Borrowings are carried at amortized cost.

Income taxes. Income taxes have been provided for in the financial statements in accordance with Azerbaijan legislation enacted or substantively enacted by the balance sheet date. The income tax charge comprises current tax and deferred tax and is recognised in the income statement except if it is recognised directly in equity because it relates to transactions that are also recognised, in the same or a different period, directly in equity.

3 Basis of Preparation and Significant Accounting Policies (Continued)

Current tax is the amount expected to be paid to or recovered from the taxation authorities in respect of taxable profits for the current and prior periods. Taxable profits are based on estimates if financial statements are authorised prior to filing relevant tax returns. Taxes, other than on income, are recorded within operating expenses.

Deferred income tax is provided, using the balance sheet liability method, for all temporary differences arising between the tax bases of assets and liabilities and their carrying amounts for financial reporting purposes. In accordance with the initial recognition exemption, deferred taxes are not recorded for temporary differences on initial recognition of an asset or a liability in a transaction other than a business combination if the transaction, when initially recorded, affects neither accounting nor taxable profit. Deferred tax assets and liabilities are measured at tax rates enacted or substantively enacted at the balance sheet date which are expected to apply to the period when the temporary differences will reverse. Deferred tax assets for deductible temporary differences are recorded only to the extent that it is probable that future taxable profit will be available against which the deductions can be utilized.

Provisions for liabilities and charges. Provisions for liabilities and charges are non-financial liabilities of uncertain timing or amount. They are accrued 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.

Income and expense recognition. Interest income and expense are recorded in the statement of income for all debt instruments on an accrual basis using the effective interest method. This method defers, as part of interest income or expense, all fees 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.

Fees integral to the effective interest rate include origination fees received or paid by the entity relating to the creation or acquisition of a financial asset or issuance of a financial liability, for example fees for evaluating creditworthiness, evaluating and recording guarantees or collateral, negotiating the terms of the instrument and for processing transaction documents. Commitment fees received by the Bank to originate loans at market interest rates are integral to the effective interest rate if it is probable that the Bank will enter into a specific lending arrangement and does not expect to sell the resulting loan shortly after origination. The Bank does not designate loan commitments as financial liabilities at fair value through profit or loss.

When loans and other debt instruments become doubtful of collection, they are written down to present value of expected cash inflows and interest income is thereafter recorded for the unwinding of the present value discount based on the asset's effective interest rate which was used to measure the impairment loss.

All other fees, commissions and other income and expense items are generally recorded on an accrual basis by reference to completion of the specific transaction assessed on the basis of the actual service provided as a proportion of the total services to be provided. Loan syndication fees are recognized as income when the syndication has been completed and the Bank retained no part of the loan package for itself or retained a part at the same effective interest rate for the other participants.

Commissions and fees arising from negotiating, or participating in the negotiation of a transaction for a third party, such as the acquisition of loans, shares or other securities or the purchase or sale of businesses, which are earned on execution of the underlying transaction are recorded on its completion. Portfolio and other management advisory and service fees are recognized based on the applicable service contracts, usually on a time-proportion basis.

Foreign currency translation. Functional currency of the Bank is the currency of the primary economic environment in which it operates. The Bank's functional currency and presentation currency is the national currency of the Republic of Azerbaijan, the Azerbaijani Manat ("AZM").

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. Foreign exchange gains and losses resulting from the settlement of the transactions and from the translation of monetary assets and liabilities into functional currency at year-end official exchange rates of the NBA are recognized in profit or loss. Translation at year-end rates does not apply to non-monetary items, including equity investments. Effects of exchange rate changes on the fair value of equity securities are recorded as part of the fair value gain or loss.

As at 31 December 2005 the principal rate of exchange used for translating foreign currency balances was USD 1 = 4,593 Azerbaijani Manats and EUR 1 = 5,459 Azerbaijani Manats (2004: USD 1 = 4,903 Azerbaijani Manats and EUR 1 = 6,682 Azerbaijani Manats). At present, the Azerbaijani Manat is not a freely convertible currency in most countries outside of the Republic of Azerbaijan. The presentation currency was denominated effective from 1 January 2006. Refer to Note 1.

3 Basis of Preparation and Significant Accounting Policies (Continued)

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 recognized amounts, and there is an intention to either settle on a net basis, or to realize the asset and settle the liability simultaneously.

Staff costs and related contributions. Wages, salaries, contributions to the state pension and social insurance funds of the Republic of Azerbaijan, paid annual leave and sick leave, bonuses, and non-monetary benefits are accrued in the year in which the associated services are rendered by the employees of the Bank.

4 Critical Accounting Estimates, and Judgements in Applying Accounting Policies

The Bank makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgements are continually evaluated and are based on management's experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. Management also makes certain judgements, apart from those involving estimations, in the process of applying the accounting policies. Judgements that have the most significant effect on the amounts recognised in the financial statements and estimates that can cause a significant adjustment to the carrying amount of assets and liabilities within the next financial year include:

Impairment losses on loans and advances. The Bank regularly reviews its loan portfolios to assess impairment. In determining whether an impairment loss should be recorded in the income statement, the Bank makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience. To the extent that the net present value of estimated cash flows differs by +/-5 percent, the provision would be estimated AZM 397 million higher or AZM 397 million lower (2004: AZM 578 million higher or AZM 578 million lower).

Tax legislation. Azerbaijani tax, currency and customs legislation is subject to varying interpretations. Refer to Note 23.

Deferred income tax asset recognition. The net deferred tax asset represents income taxes recoverable through future deductions from taxable profits and is recorded on the balance sheet. Deferred income tax assets are recorded to the extent that realisation of the related tax benefit is probable. In determining future taxable profits and the amount of tax benefits that are probable in the future Management makes judgements and applies estimation based on expectations of future income that are believed to be reasonable under the circumstances.

Related party transactions. In the normal course of business the Bank enters into transactions with its related parties. IAS 39 requires initial recognition of financial instruments at their fair values. Judgement is applied in determining if transactions are priced at market or non-market interest rates, where there is no active market for such transactions. The basis for judgement is pricing for similar types of transactions with unrelated parties and effective interest rate analysis.

Going concern. As at 31 December 2005, 2004 and 2003 the Bank had accumulated deficit amounting to AZM 2,562 million, AZM 3,236 million and AZM 3,281 million, respectively. Such losses have resulted primarily from operating expenses related to start-up activities of the Bank commenced in October 2002. However the Bank has been profitable since 2004.

As at 31 December 2005, the Bank has sufficient amounts to meet its financial obligations. Additionally, the Management of the Bank has a written plan to obtain additional borrowings, increase the loan portfolio and total assets of the Bank.

Accordingly, these financial statements have been prepared on a going concern basis.

5 Adoption of New or Revised Standards and Interpretations

Certain new IFRSs became effective for the Bank from 1 January 2005. Listed below are those new or amended standards or interpretations which are or in the future could be relevant to the Bank's operations and the nature of their impact on the Bank's accounting policies.

5 Adoption of New or Revised Standards and Interpretations (Continued)

IAS 16 (revised 2003) Property, Plant and Equipment. The residual value is now defined as the amount that the Bank estimates it would receive currently for the asset if the asset were already of the age and in the condition expected at the end of its useful life. The Bank's policy is now not to cease depreciating assets during temporary periods when the assets are idle. All changes to accounting policies as a result of the revised IAS 16 were accounted for retrospectively and did not result in a significant effect on the carrying amount of the Bank's assets.

IAS 24 (revised 2003) Related Party Disclosures. The definition of related parties was extended and additional disclosures required by the revised standard were made in these financial statements.

IAS 32 (revised 2003) Financial Instruments: Disclosure and Presentation. Additional disclosures required by the revised Standard were made in these financial statements.

IAS 39 (revised 2003) Financial Instruments: Recognition and Measurement. The definition of 'originated loans and receivables' was amended to become 'loans and receivables'. This category now comprises originated or purchased loans and receivables that are not quoted in an active market. The Bank amended its policies and may designate any financial instrument on initial recognition as one to be measured at fair value, with changes in fair value recognised in profit or loss. Subsequent reclassifications into or out of the 'at fair value through profit or loss' category are prohibited.

The Bank amended its policies for de-recognition of financial assets. Under the original IAS 39, several concepts governed de-recognition. The revised IAS 39 retains the two main concepts of risks and rewards and control, but clarifies that the evaluation of the transfer of risks and rewards precedes the evaluation of the transfer of control. The Bank now applies the guidance added to IAS 39 on how to determine fair values using valuation techniques and how to evaluate impairment in a group of loans, receivables or held-to-maturity investments, which cannot yet be identified with any individual asset in the group. In accordance with the standard's transitional provisions the revised accounting policies are applied retrospectively except for the clarified de-recognition rules, which are applied prospectively from 1 January 2004. Although allowed by the standard, the Bank has not re-designated any financial instrument into 'at fair value through profit or loss' or 'available for sale' categories at the date of initial application of the revised IAS 39.

Effect of Adoption of New or Revised Standards. The effect of adoption of the above new or revised standards and interpretations on the Bank's financial position at 31 December 2005 and 31 December 2004 and on the results of its operations for the years then ended was not significant.

6 New Accounting Pronouncements

Certain new standards and interpretations have been published that are mandatory for the Group's accounting periods beginning on or after 1 January 2006 or later periods and which the Bank has not early adopted:

IFRIC 4, Determining whether an Arrangement contains a Lease. IFRIC 4 requires that determining whether an arrangement is, or contains, a lease be based on the substance of the arrangement. It requires an assessment of whether (a) fulfilment of the arrangement is dependent on the use of a specific asset or assets (the asset); and (b) the arrangement conveys a right to use the asset.

IAS 39 (Amendment) – Financial Guarantee Contracts. Issued financial guarantees, other than those previously asserted by the entity to be insurance contracts, will have to be initially recognised at their fair value, and subsequently measured at the higher of (i) the unamortized balance of the related fees received and deferred and (ii) the expenditure required to settle the commitment at the balance sheet date. Different requirements apply for the subsequent measurement of issued financial guarantees that prevent de-recognition of financial assets or result in continuing involvement accounting.

IFRS 7 Financial Instruments: Disclosures and a complementary Amendment to IAS 1 Presentation of Financial Statements - Capital Disclosures. The IFRS introduces new disclosures to improve the information about financial instruments. It replaces IAS 30, Disclosures in the Financial Statements of Banks and Similar Financial Institutions, and some of the requirements in IAS 32, Financial Instruments: Disclosure and Presentation. The Amendment to IAS 1 introduces disclosures about level of an entity's capital and how it manages capital. The Bank is currently assessing what impact the new IFRS and the amendment to IAS 1 will have on disclosures in its financial statements.

Other new standards or interpretations. The Company has also not early adopted amendments IAS 19 (Actuarial Gains and Losses, Group Plans and Disclosures), IAS 21 (Net Investment in a Foreign Operation), IAS 39 (Cash Flow Hedge Accounting of Forecast Intragroup Transactions; The Fair Value Option), the new IFRIC interpretations 5 to 9 and the new standard IFRS 6 (Exploration and Evaluation of Mineral Resources) including related subsequent corrections to it and to IFRS 1 (First-time Adoption of International Financial Reporting Standards).

Unless otherwise described above, the new standards and interpretations are not expected to significantly affect the Bank's financial statements.

7 Cash and Cash Equivalents

<i>In millions of Azerbaijani Manats</i>	2005	2004
Cash on hand	6,754	2,460
Cash balances with the NBA (other than mandatory reserve deposits)	598	620
Correspondent accounts and overnight placements with other banks		
- Republic of Azerbaijan	3,591	14
- Other countries	2,926	251
Total cash and cash equivalents	13,869	3,345

Geographical, currency and interest rate analyses of cash and cash equivalents are disclosed in Note 22.

8 Loans and Advances to Customers

<i>In millions of Azerbaijani Manats</i>	2005	2004
Current loans	81,127	36,136
Overdue loans	1,997	2,385
Less: Provision for loan impairment	(3,540)	(3,269)
Total loans and advances to customers	79,584	35,252

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

<i>In millions of Azerbaijani Manats</i>	2005	2004
Provision for loan impairment as at 1 January	3,269	3,142
Provision for loan impairment during the year	271	127
Provision for loan impairment as at 31 December	3,540	3,269

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

<i>In millions of Azerbaijani Manats</i>	2005		2004	
	Amount	%	Amount	%
Trade	63,425	76%	28,309	74%
Production	9,518	11%	3,851	10%
Service	7,853	9%	2,106	5%
Transport	1,896	2%	150	0%
Pawn loans	432	2%	294	1%
Government institutions	-	0%	3,811	10%
Total loans and advances to customers (gross of impairment provisions)	83,124	100%	38,521	100%

The loans to government institutions as at 31 December 2004 were represented by short term treasury bills issued by the Ministry of Finance of the Republic of Azerbaijan and matured in 2005. The Bank did not invest into these instruments in 2005 due to their low profitability.

As part of its declared 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.

As at 31 December 2005 the estimated fair value of loans and advances to customers was AZM 79,584 million (2004: AZM 35,252 million). Refer to Note 24.

8 Loans and Advances to Customers (Continued)

Geographical, currency, maturity and interest rate analyses of loans and advances to customers are disclosed in Note 22.

9 Other Assets

<i>In millions of Azerbaijani Manats</i>	2005	2004
Prepaid rent expenses	516	266
Prepayments for leasehold improvement	475	90
Collaterals repossessed	410	-
Computer software and licences	183	64
Items in course of settlement	93	91
Other	-	19
Total other assets	1,677	530

Collaterals repossessed include buildings and apartments foreclosed in satisfaction of the loans to customers fully impaired in prior periods. According to the court rules of the Republic of Azerbaijan the property titles to these assets were transferred to the Bank. The management is planning to sell the assets during 2006.

Computer software and licences are presented net of accumulated amortisation of AZM 81 million (2004: AZM 43 million).

Geographical, currency and maturity analyses of other assets are disclosed in Note 22.

10 Premises and Equipment

<i>In millions of Azerbaijani Manats</i>	Note	Leasehold improvements	Computers and communication equipment	Furniture, fixtures and others	Motor vehicles	Total
Net book amount as at 31 December 2004		2,098	468	1,035	22	3,623
Book amount at cost						
Opening balance		3,182	707	1,618	43	5,550
Additions		505	349	1,001	295	2,150
Closing balance		3,687	1,056	2,619	338	7,700
Accumulated depreciation						
Opening balance		(1,084)	(239)	(583)	(21)	(1,927)
Depreciation charge	20	(686)	(216)	(514)	(58)	(1,474)
Closing balance		(1,770)	(455)	(1,097)	(79)	(3,401)
Net book amount as at 31 December 2005		1,917	601	1,522	259	4,299

10 Premises and Equipment (Continued)

	Note	Leasehold improvements	Computers and communication equipment	Furniture, fixtures and others	Motor vehicles	Total
Net book amount as at 31 December 2003		2,339	455	1,062	33	3,889
Book amount at cost						
Opening balance		2,830	541	1,303	43	4,717
Additions		352	166	317	-	835
Disposals		-	-	(2)	-	(2)
Closing balance		3,182	707	1,618	43	5,550
Accumulated depreciation						
Opening balance		(491)	(86)	(241)	(10)	(828)
Depreciation charge	20	(593)	(153)	(342)	(11)	(1,099)
Disposals		-	-	-	-	-
Closing balance		(1,084)	(239)	(583)	(21)	(1,927)
Net book amount as at 31 December 2004		2,098	468	1,035	22	3,623

11 Customer Accounts

<i>In millions of Azerbaijani Manats</i>	2005	2004
Legal entities		
- Current/settlement accounts	422	24
Individuals		
- Current/demand accounts	1,350	788
- Term deposits	1,203	5
Total customer accounts	2,975	817

Economic sector concentrations within customer accounts are, as follows:

<i>In millions of Azerbaijani Manats</i>	2005		2004	
	Amount	%	Amount	%
Individuals	2,553	86%	793	97%
Insurance	156	5%	8	1%
Trade	128	4%	8	1%
Other	138	5%	8	1%
Total customer accounts	2,975	100%	817	100%

Geographical, currency, maturity and interest rate analyses of customer accounts are disclosed in Note 22.

As at 31 December 2005 the estimated fair value of customer accounts was AZM 2,975 million (2004: AZM 817 million). Refer to Note 24.

12 Shareholder Loans

<i>In millions of Azerbaijani Manats</i>	2005	2004
European Bank for Reconstruction and Development	22,965	12,257
International Finance Corporation	13,779	-
Black Sea Trade and Development Bank	9,186	-
Accrued interest expense	458	99
Total shareholder loans	46,388	12,356

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 22,965 million). As at 31 December 2005 the Bank fully utilised this loan facility (2004: USD 2,500,000 or AZM 12,257 million). The loan carries LIBOR + 3.25% interest per annum and is repayable in four equal instalments, starting from May 2008.

On 6 July 2005 the Bank signed a loan agreement with International Finance Corporation in the amount of USD 3,000,000 (AZM 13,779 million). As at 31 December 2005 the Bank fully utilised the total loan amount. The loan carries LIBOR + 4.25% interest per annum and is repayable in eight equal semi-annual instalments starting from 15 December 2006.

On 19 August 2005 the Bank signed a loan agreement with Black Sea Trade and Development Bank in the amount of USD 3,000,000 (AZM 13,779 million). As at 31 December 2005 the Bank utilised USD 2,000,000 (AZM 9,186 million) out of the total loan amount. The loan carries LIBOR + 4.25% interest per annum and is repayable in six equal semi-annual instalments from 18 February 2006.

As at 31 December 2005 the estimated fair value of shareholder loans was AZM 46,388 million (2004: AZM 12,356). Refer to Note 24. The information on related party balances is disclosed in Note 25.

13 Other Borrowings

<i>In millions of Azerbaijani Manats</i>	2005	2004
Impulse Microfinance Investment	5,741	-
Triodos Doen	4,593	-
Dexia Micro-Credit Fund	4,593	-
Global Microfinance Facility	3,445	-
Vantage Mutual Fund	1,148	-
Accrued interest expense	203	-
Total other borrowings	19,723	-

On 9 June 2005 the Bank signed a loan agreement with Vantage Mutual Fund (registered in the United States of America) in the amount of USD 250,000 (AZM 1,148 million). As at 31 December 2005 the Bank has fully utilised the total amount of the loan. The loan carries 8% fixed interest per annum and is repayable during ten years from initial disbursement date.

On 14 June 2005 the Bank signed a loan agreement with Global Microfinance Facility (registered in Cayman Islands) in the amount of USD 1,000,000 (AZM 4,593 million). As at 31 December 2005 the Bank utilised USD 750,000 (AZM 3,445 million) out of the total loan amount. The loan carries LIBOR + 5.75% interest per annum and is repayable in June 2007.

On 5 August 2005 the Bank signed a loan agreement with Triodos Doen (registered in the Netherlands) in the amount of USD 1,500,000 (AZM 6,889 million). As at 31 December 2005 the Bank utilised USD 1,000,000 (AZM 4,593 million) out of the total loan amount. The loan carries LIBOR + 5% interest per annum and is repayable USD 1,000,000 (AZM 4,593 million) in November 2007 and, if utilized, USD 500,000 (AZM 2,297 million) in May 2008.

On 13 November 2005 the Bank signed a loan agreement with Impulse Microfinance Investment (registered in Belgium) in the amount of USD 1,250,000 (AZM 5,741 million). As at 31 December 2005 the Bank fully utilised the loan amount. The loan carries 9.75% fixed interest per annum and has to be repaid in three years from the disbursement date. Early repayments before 18 months from the initial disbursement date are not allowed.

13 Other Borrowings (Continued)

On 16 December 2005 the Bank signed a loan agreement with Dexia Micro-Credit Fund (registered in Luxembourg) in the amount of USD 1,000,000 (AZM 4,593 million). As at 31 December 2005 the Bank has fully utilised the loan amount. The loan carries LIBOR + 5.25% interest per annum and has to be repaid in two equal instalments in June and December 2007.

As at 31 December 2005 the estimated fair value of other borrowings was AZM 19,723 million (2004: zero). Refer to Note 24.

Geographical, currency, maturity and interest rate analyses of other borrowings are disclosed in Note 22.

14 Other Liabilities

<i>In millions of Azerbaijani Manats</i>	2005	2004
Accrued audit fee	217	162
Other expenses payable	20	89
Total other liabilities	237	251

Geographical, currency and maturity analyses of other liabilities are disclosed in Note 22.

15 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 contribution. As at 31 December 2005 paid-in share capital is held, as follows:

<i>In millions of Azerbaijani Manats</i>	Country of registration	2005			2004		
		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	25.547
International Finance Corporation	USA	350,000	8,575	25.547	350,000	8,575	25.547
European Bank for Reconstruction and Development	UK	250,000	6,125	18.248	250,000	6,125	18.248
LFS Financial Systems	Germany	78,000	1,911	5.693	78,000	1,911	5.693
KfW Entwicklungsbank	Germany	342,000	8,381	24.964	342,000	8,381	24.964
Total share capital		1,370,000	33,567	100	1,370,000	33,567	100

On 31 August 2004 the Bank issued 370,000 ordinary shares with par value of USD 5 each. The total amount of share capital increase in 2004 amounted to USD 1,850,000 or AZM 9,067 million. Of these shares 28,000 were acquired by the existing shareholder LFS Financial Systems and 342,000 were acquired by KfW Entwicklungsbank, which became a new shareholder of the Bank with effective share of 24.964% as at the date of share capital contribution.

16 Accumulated Deficit

In accordance with the Law on Banks of the Republic of Azerbaijan, the Bank distributes 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 2005 is AZM 2,562 million (2004: AZM 4,167 million). The management believes that the Bank will cover its accumulated losses for statutory tax purposes from profits in future periods. Refer to Note 21. Statutory profits are normally allocated on an annual basis.

17 Interest Income and Expense

<i>In millions of Azerbaijani Manats</i>	2005	2004
Interest income		
Loans and advances to customers	16,241	6,543
Correspondent accounts with other banks	92	37
Total interest income	16,333	6,580
Interest expense		
Term deposits of individuals	(46)	-
Borrowings	(3,504)	(514)
Total interest expense	(3,550)	(514)
Net interest income	12,783	6,066

18 Fee and Commission Income and Expense

<i>In millions of Azerbaijani Manats</i>	2005	2004
Fee and commission income		
Cash withdrawal fees	1,454	548
Early repayment fees	139	14
Fees and commissions for fund transfers	98	30
Other	59	13
Total fee and commission income	1,750	605
Fee and commission expense		
Cash withdrawal fees	(209)	(54)
Commission on fund transfers	(49)	(29)
Other	(3)	(7)
Total fee and commission expense	(261)	(90)
Net fee and commission income	1,489	515

19 Staff Costs

In addition to the amount of staff costs shown in the income statement, the Bank obtained 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 to the Bank under the Management Service Agreement between the Bank and LFS Financial Systems dated 14 September 2004. LFS Financial Systems is a shareholder of the Bank. The value of such services was not expensed in the Bank's income statements for the years ended 31 December 2005 and 2004 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 25).

In prior years LFS had commitment to Bank to pay expenses related to newly hired loan officers for the period of probation until they became permanent employees of the Bank. Starting from 2005, this agreement is not valid any more and the Bank currently bears all the costs related to salary of its employees in their probation periods.

19 Staff Costs (Continued)

Included in staff costs are statutory social security contributions of AZM 961 million (2004: AZM 459 million).

20 Operating Expenses

<i>In millions of Azerbaijani Manats</i>	Note	2005	2004
Depreciation of premises and equipment	10	1,474	1,099
Operating lease rentals		1,208	767
Office supplies and maintenance		1,031	652
Communication		916	571
Advertisement		547	175
Professional services		403	537
Transportation		224	74
Insurance		39	13
Other		496	304
Total operating expenses		6,338	4,192

21 Income Taxes

<i>In millions of Azerbaijani Manats</i>	2005	2004
Deferred taxation movement due to:		
- Origination and reversal of temporary differences	282	31
- Reduction in tax rate	56	-
Income tax expense for the year	338	31

The income tax rate applicable to the Bank is 24% (2004: 24%). Reconciliation between the expected and the actual taxation charge is provided below.

<i>In millions of Azerbaijani Manats</i>	2005	2004
IFRS profit before tax	1,012	76
Theoretical tax charge at the applicable statutory rate (2005: 24%, 2004: 24%)	(243)	(18)
Non-deductible expenses	(39)	(13)
Effect of the change in tax rate	(56)	-
Income tax expense for the year	(338)	(31)

The income tax rate was reduced to 22% effective from 1 January 2006.

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 22% for 2005 and 24% for 2004.

21 Income Taxes (Continued)

As at 31 December 2005 and 2004, the temporary differences giving rise to the deferred tax assets and liabilities were as follows:

<i>In millions of Azerbaijani Manats</i>	2004	Movement	2005
Tax effect of deductible temporary differences			
Tax loss carried forward reversal	822	(463)	359
Premises and equipment, differences in depreciation rates	107	121	228
Other assets	4	2	6
Gross deferred tax asset	933	(340)	593
Tax effect of taxable temporary differences			
Other assets	(2)	2	-
Gross deferred tax liability	(2)	2	-
Total net deferred tax asset	931	(338)	593
<i>In millions of Azerbaijani Manats</i>	2003	Movement	2004
Tax effect of deductible temporary differences			
Tax loss carried forward reversal	979	(157)	822
Premises and equipment, differences in depreciation rates	-	107	107
Other assets	-	4	4
Gross deferred tax asset	979	(46)	933
Tax effect of taxable temporary differences			
Premises and equipment, differences in depreciation rates	(15)	15	-
Other assets	(2)	-	(2)
Gross deferred tax liability	(17)	15	(2)
Total net deferred tax asset	962	(31)	931

The net deferred tax asset recognised in the balance sheet represents income taxes recoverable against future taxable income. 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 2005 the Bank has accumulated statutory tax losses of AZM 1,630 million (2004: AZM 3,419 million) to carry forward against future taxable income. These tax losses will expire in 2007 (AZM 465 million) and 2008 (AZM 1,165 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 these tax loss carryforwards and thus recognised respective deferred tax assets in the balance sheet.

22 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.

22 Financial Risk Management (Continued)

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 are subject to an annual or more frequent review. The Management Board and Credit Committee approve limits on the level of credit risk by product, borrower and industry sector regularly.

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.

The Bank's maximum exposure to credit risk is primarily 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 2005 is set out below:

<i>In millions of Azerbaijani Manats</i>	Republic of Azerbaijan	OECD	Non OECD	Total
Assets				
Cash and cash equivalents	10,943	2,719	207	13,869
Mandatory cash balances with the NBA	306	-	-	306
Loans and advances to customers	79,584	-	-	79,584
Other assets	1,588	89	-	1,677
Deferred tax asset	593	-	-	593
Premises and equipment	4,299	-	-	4,299
Total assets	97,313	2,808	207	100,328
Liabilities				
Customer accounts	2,975	-	-	2,975
Shareholder loans	-	46,388	-	46,388
Other borrowings	-	19,723	-	19,723
Other liabilities	237	-	-	237
Total liabilities	3,212	66,111	-	69,323
Net balance sheet position	94,101	(63,303)	207	31,005

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

22 Financial Risk Management (Continued)

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

<i>In millions of Azerbaijani Manats</i>	Republic of Azerbaijan	OECD	Total
Assets			
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
Total assets	43,504	251	43,755
Liabilities			
Customer accounts	817	-	817
Shareholder loans	-	12,356	12,356
Other liabilities	251	-	251
Total liabilities	1,068	12,356	13,424
Net balance sheet position	42,436	(12,105)	30,331

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 2005. Included in the table are the Bank's assets and liabilities at their carrying amounts, categorised by currency. As at 31 December 2005, the Bank has the following positions in currencies:

<i>In millions of Azerbaijani Manats</i>	AZM	USD	EUR	Total
Assets				
Cash and cash equivalents	11,284	1,567	1,018	13,869
Mandatory cash balances with the NBA	306	-	-	306
Loans and advances to customers	7,468	72,116	-	79,584
Other assets	1,588	89	-	1,677
Deferred tax asset	593	-	-	593
Premises and equipment	4,299	-	-	4,299
Total assets	25,538	73,772	1,018	100,328
Liabilities				
Customer accounts	272	2,049	654	2,975
Shareholder loans	-	46,388	-	46,388
Other borrowings	-	19,723	-	19,723
Other liabilities	235	2	-	237
Total liabilities	507	68,162	654	69,323
Net balance sheet position	25,031	5,610	364	31,005

22 Financial Risk Management (Continued)

As at 31 December 2004, the Bank had the following positions in currencies:

<i>In millions of Azerbaijani Manats</i>	AZM	USD	EUR	Total
Assets				
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
Total assets	11,280	32,352	123	43,755
Liabilities				
Customer accounts	18	730	69	817
Shareholder loans	-	12,356	-	12,356
Other liabilities	251	-	-	251
Total liabilities	269	13,086	69	13,424
Net balance sheet position	11,011	19,266	54	30,331

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. As at 31 December 2005 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 liquidity position of the Bank as at 31 December 2005 is set out below.

<i>In millions of Azerbaijani Manats</i>	Demand and up to 1 month	From 1 to 3 months	From 3 to 12 months	More than 1 year	Overdue/ No stated maturity	Total
Assets						
Cash and cash equivalents	13,869	-	-	-	-	13,869
Mandatory cash balances with the NBA	306	-	-	-	-	306
Loans and advances to customers	812	3,463	48,942	26,367	-	79,584
Other assets	654	172	668	-	183	1,677
Deferred tax asset	-	-	-	593	-	593
Premises and equipment	-	-	-	-	4,299	4,299
Total assets	15,641	3,635	49,610	26,960	4,482	100,328
Liabilities						
Customer accounts	2,225	117	143	490	-	2,975
Shareholder loans	458	1,529	3,252	41,149	-	46,388
Other borrowings	203	-	3,446	16,074	-	19,723
Other liabilities	237	-	-	-	-	237
Total liabilities	3,123	1,646	6,841	57,713	-	69,323
Net liquidity gap	12,518	1,989	42,769	(30,753)	4,482	31,005
Cumulative liquidity gap as at 31 December 2005	12,518	14,507	57,276	26,523	31,005	

22 Financial Risk Management (Continued)

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

<i>In millions of Azerbaijani Manats</i>	Demand and up to 1 month	From 1 to 3 months	From 3 to 12 months	More than 1 year	Overdue/ No stated maturity	Total
Assets						
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	16,942	3,185	-	35,252
Other assets	204	157	105	-	64	530
Deferred tax asset	-	-	-	931	-	931
Premises and equipment	-	-	-	-	3,623	3,623
Total assets	9,122	9,783	17,047	4,116	3,687	43,755
Liabilities						
Customer accounts	812	-	5	-	-	817
Shareholder loans	-	-	-	12,356	-	12,356
Other liabilities	152	-	99	-	-	251
Total liabilities	964	-	104	12,356	-	13,424
Net liquidity gap	8,158	9,783	16,943	(8,240)	3,687	30,331
Cumulative liquidity gap as at 31 December 2004	8,158	17,941	34,884	26,644	30,331	

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.

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.

22 Financial Risk Management (Continued)

The following table summarises the Bank's exposure to interest rate risks at 31 December 2005 by showing assets and liabilities in categories based on the earlier of contractual re-pricing or maturity dates:

<i>In millions of Azerbaijani Manats</i>	Demand and up to 1 month	From 1 to 3 months	From 3 to 12 months	More than 1 year	Overdue/ Non interest bearing	Total
Assets						
Cash and cash equivalents	13,869	-	-	-	-	13,869
Mandatory cash balances with the NBA	306	-	-	-	-	306
Loans and advances to customers	812	3,463	48,942	26,367	-	79,584
Other assets	-	-	-	-	1,677	1,677
Deferred tax asset	-	-	-	-	593	593
Premises and equipment	-	-	-	-	4,299	4,299
Total assets	14,987	3,463	48,942	26,367	6,569	100,328
Liabilities						
Customer accounts	2,225	117	143	490	-	2,975
Shareholder loans	13,834	9,360	23,194	-	-	46,388
Other borrowings	3,507	4,593	4,615	7,008	-	19,723
Other liabilities	237	-	-	-	-	237
Total liabilities	19,803	14,070	27,952	7,498	-	69,323
Net sensitivity gap	(4,816)	(10,607)	20,990	18,869	6,569	31,005
Cumulative sensitivity gap as at 31 December 2005	(4,816)	(15,423)	5,567	24,436	31,005	

22 Financial Risk Management (Continued)

The following table summarises the Bank's exposure to interest rate risks at 31 December 2004 by showing assets and liabilities in categories based on the earlier of contractual re-pricing or maturity dates:

<i>In millions of Azerbaijani Manats</i>	Demand and up to 1 month	From 1 to 3 months	From 3 to 12 months	More than 1 year	Overdue/ Non interest bearing	Total
Assets						
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	16,942	3,185	-	35,252
Other assets	-	-	-	-	530	530
Deferred tax asset	-	-	-	-	931	931
Premises and equipment	-	-	-	-	3,623	3,623
Total assets	8,918	9,626	16,942	3,185	5,084	43,755
Liabilities						
Customer accounts	812	-	5	-	-	817
Shareholder loans	-	-	12,356	-	-	12,356
Other liabilities	152	-	99	-	-	251
Total liabilities	964	-	12,460	-	251	13,424
Net sensitivity gap	7,954	9,626	4,482	3,185	5,084	30,331
Cumulative sensitivity gap as at 31 December 2004	7,954	17,580	22,062	25,247	30,331	

The Bank is exposed to cash flow interest rate risk, principally through assets and liabilities for which interest rates are reset as market rates change. Such assets and liabilities are primarily presented in the above table as being repriced in the short-term. The Bank is exposed to fair value interest rate risk as a result of assets and liabilities at fixed interest rates; these are primarily presented in the above table as being repriced in the long-term. In practice, interest rates that are contractually fixed on both assets and liabilities are usually renegotiated to reflect current market conditions.

The Management Board monitors on a daily basis and sets limits on the level of mismatch of interest rate repricing that may be undertaken. In the absence of any available hedging instruments, the Bank normally seeks to match its interest rate positions.

22 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.

	2005			2004	
	USD	EUR	AZM	USD	AZM
Assets					
Cash and cash equivalents	1.0%	-	-	1.5%	-
Securities issued by the National Bank of the Republic of Azerbaijan	-	-	-	-	4.5%
Loans and advances to customers	27.7%	-	35.6%	34.7%	35.4%
Liabilities					
Customer accounts	8.6%	6.2%	6.8%	8%	-
Borrowings	9.7%	-	-	5.7%	-

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

23 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 2005 and 2004, 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 income statement 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, no provision for potential tax liabilities was recorded as at 31 December 2005 and 2004.

Capital expenditure commitments. The Bank had no significant capital expenditure commitments as at 31 December 2005 and 2004.

Operating lease commitments. The Bank had no non-cancellable operating lease commitments as at 31 December 2005 and 2004. All lease agreements in force as at 31 December 2005 and 2004 can be terminated at any time, therefore, the Bank has no contingent liabilities or commitments related to operating leases.

Credit related commitments. The Bank had no credit related commitments as at 31 December 2005 and 2004.

24 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 8 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 11, 12, and 13 for the estimated fair values of customer accounts, shareholder loans, and other borrowings, respectively.

25 Related Party Transactions

Parties are considered to be related if one party has the ability to control the other party, is under common control, or can 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. 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 19).

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

<i>In millions of Azerbaijani Manats</i>	2005	2004
Funds borrowed from shareholders		
Funds borrowed as at the year end	45,930	12,257
Accrued interest expense	458	99
Interest expense for the year	2,754	514

In 2005, the remuneration of members of the Management Board, including amounts paid by shareholders on behalf of the Bank, comprised salaries and other short-term benefits totalling to AZM 1,787 million (2004: AZM 1,561 million).

26 Subsequent Events

According to the Presidential Decree of the Republic of Azerbaijan dated 7 February 2005, the national currency of the Republic of Azerbaijan which is Azerbaijani Manat was denominated in the ratio of 5,000 AZM to 1 New Azerbaijani Manat ("AZN") starting from 1 January 2006. These financial statements are presented in millions of old Azerbaijani Manats ("AZM"). Presentation of the financial statements in AZN is mandatory starting from 1 January 2006.